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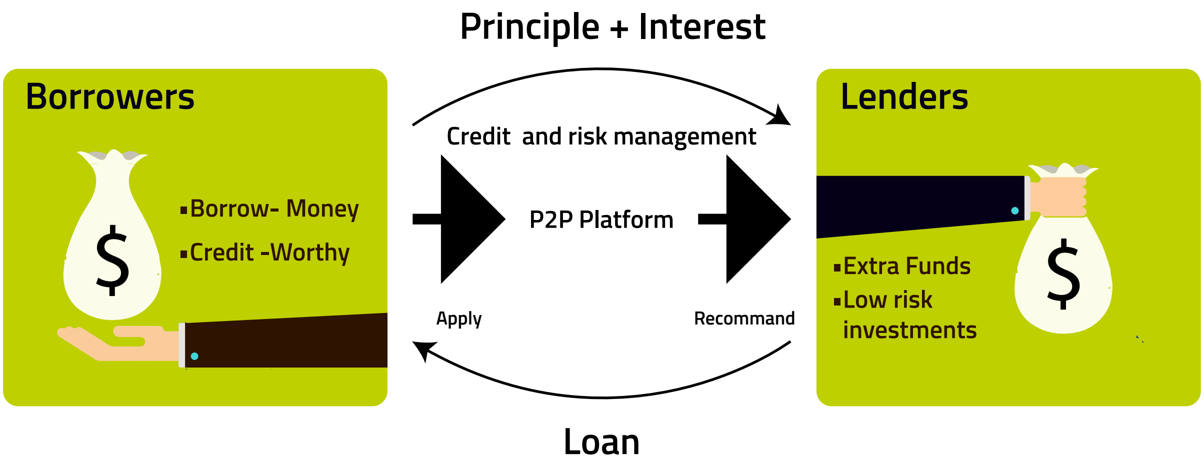
The Peer-to-Peer (P2P) Marketplace

Contents

Abstract

The economic sector is never immune from the advent of online industry and its impending impact. Marketplace advancing, or peer-to-peer (P2P) lending, is bustling not across the country but across the globe. It's exciting and it's moving fast, from China to the UK to the US. P2P is where money makers meet technology makers. It is a new segment in financial services sector which blends technology, innovation, and disruption to provide an improved lending experience, potentially impacting millions of borrowers all over the world. However, the larger dynamism and enthusiasm that surrounds this new segment make it difficult to distinguish emerging and ever-evolving business models, opportunities and the potential risks in the P2P space.

P2P is unique on the aspects of how it sources its capital from investors online and the potential for interaction directly between borrowers and lenders, whereas cost efficiency and innovative underwriting methods are not exclusive to the P2P model.



The official definition for P2P from Wikipedia is "practice of lending money to individuals or businesses through online services that match lenders directly with borrowers." Basically, it acts as a platform where individuals with money (investors) can meet and lend money to people who need money (borrowers). Obviously, this is something that has taken place since the invention of money ages ago and has helped in the evolution of the economy over these years.

Though the concept of marketplace lending is not new, the technology advancement angle of the same has made it the most attractive in the recent time. At a time when banks fail to fulfill the demand of a borrower, retail investors not only fulfill the need but also make easy money by taking risks as per their measurements. Technology has put up the lending process in crystal clear mode by a much efficient streamlined application process, quick funding and 24/7 access to the status, while keeping the base concept untouched.

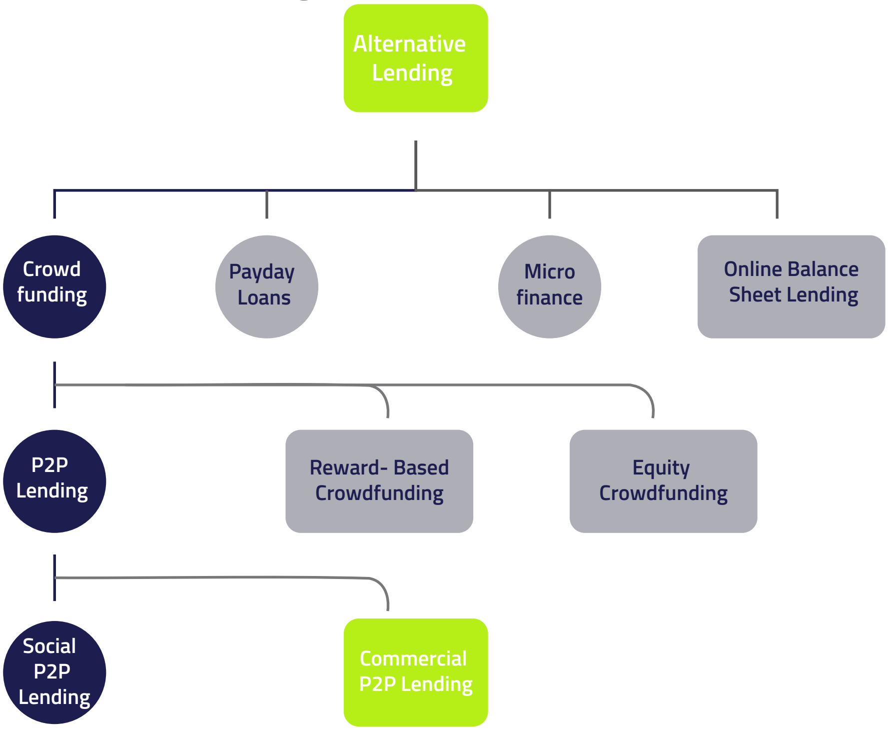
The world's first MPL (Market Place Lending), Zopa, was founded in the UK in the year 2005. The first MPL in the US, Prosper, was founded in 2006, and the first in China, Paipaidai, was launched in 2007. Initially, such platforms enabled retail borrowers and investors to contact each other directly, or 'peer-to-peer' (P2P) without the intervention of a middle man. More recently, institutions have begun investing in bundles of loans, prompting the sector to be named more accurately as 'marketplace lending.'

Introduction

The Peer-to-peer lending (hereafter referred simply as "P2P") goes by many names as per Wikipedia. It is increasingly called as "marketplace lending" and sometimes referred to as "social lending,". It is also known as "crowdfunding wherein funds for different purposes are solicited from the public online, widely known as".
In its whole essence, P2P is the segment of crowdfunding specifically concerning loans. Borrowers request loans online, where their loan requests can be viewed as open loan profiles. Individuals and businesses can then "buy" or invest in pieces of these loans (dubbed "fractional lending") or whole loans through an online marketplace that displays the requested sums, much like how consumers do online purchasing.

New financial technology ("FinTech") P2P companies organize the entire process from start to finish, including the screening of loan applications, risk evaluation of borrowers, providing the online marketplace for buying loans, and eventually overseeing repayments back to lenders.

Alternative Lending



Alternative Lending
Lending that typically targets businesses and borrowers who may be unable or willing to receive a loan through conventional channels. Alternative lending often relies on digital data. These loans are often unsecured or use non-traditional collateral to underwrite borrowers.

Crowdfunding
A term which describes a process of sourcing capital by soliciting to greater pool of individuals or organizations through an online platform. Supporters may contribute many small pieces or entire sums to collectively or independently fund a project, take equity in a new company, or provide business or personal loans.

Some P2P companies do not give investors the discretion to select individual loans, but instead, they offer "sets" of many pre-selected loan pieces according to risk tolerance and other criteria outlined by the investor.
P2P lending is a form or crowd-funding used to take loans which are paid back with interest. It can be defined as the use of an online platform that matches lenders with borrowers for unsecured loans. The borrower can either be an individual, a small group or any entity who is in need of money where the need cannot be fulfilled by banks due to multiple reasons. The interest rate can either be set by the platform or a mutual agreement between the borrower and the lender. The borrowers pay an origination fee (either a flat fee or as a percentage of the loan amount) according to the risk and type of loans and the amount. The lenders have to pay an administration fee and an additional fee for the extra services provided by the platform if they obtain it from the lenders. The platform may provide the services after doing an initial assessment of the borrower and, keeping the documents together, money collection and distribution, etc. The fee is considered as the cost of providing these services or as the business cost. Here the platform makes the money through these services or from the credit scoring but not from the difference of the spread between the borrower and the lenders as the case with other financial institutions.

P2P is further characterized by its lightweight, online operating modules and innovative credit scoring techniques, which are often used to improve or extend access to credit for individuals and businesses.

Marketplace Lending or P2P ?

The increasing proportion of institutions participating in the P2P industry - both as investors and borrowers - makes the term "peer-to-peer" lending seem like a misnomer. For this reason, man prefer the term "marketplace lending" which emphasizes the process of matching investors and borrowers, rather than specific actors.

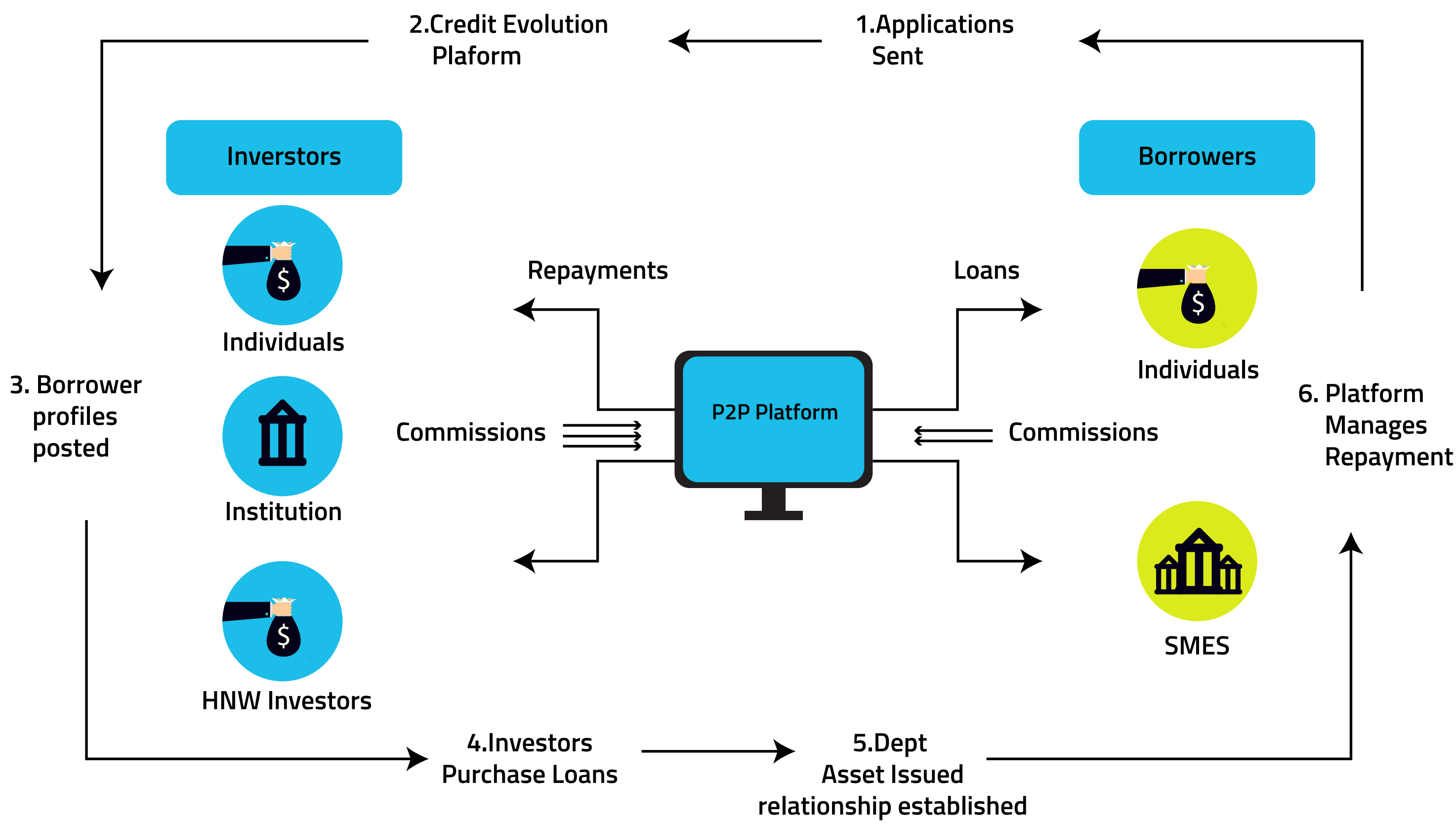
How P2P Works

In a standard scenario, services of the P2P platform can be divided into 3 major key areas:

1. Loan application and credit evaluation
2. Investor funding
3. Loan repayment

Probable borrowers fill up the loan application form, which asks for their personal as well as financial information. This information is sent to the platform through the internet. The P2P company then screens out the loan applications and does check the credit worthiness of the eligible borrower by viewing traditional credit scores in the context of other compiled data. Screening process's main objective is to rule out the ineligible candidates and fact-checks, most often by reaching out to the employers and verifying the information what can be found online, to identify the cons. In cases where existing credit data is not available, big data analytics play an important role to close the gap.

A credit bucket is then assigned to the approved loan requests. These buckets then serve as a core engine of the platform to decide the distinct interest rates and affiliated levels of risk. P2P then quotes these interest rates to the borrower and the lenders but there is always an option of interest rate negotiation between borrower and the lender. The interest rate calculated by the platform combines the cost of capital in the real market and the fee charged by the platform. This is because, unlike a bank, P2P platforms cannot make money through interest rate difference but they make money by charging commissions for their services. (However, in a deeper sense the definitive effect on interest rates is pretty similar). If the borrower agrees to the terms of the loan, then the platform uploads the borrower's details – credit score, assigned interest rate, the borrower's income, specified loan purpose, and other non-sensitive information – onto the online marketplace as a distinct profile. In another scenario borrower's profile can also be directly made available on the portal where the platform has no role to play in interest rates calculation and it's the mutual agreement between borrower and investor.



Before any loan application comes to the platform, platforms have already built up an investor base with registered accounts on the P2P. Depending on the country, platform, type of investments, and business model investors may include retail lenders, high net wealth individuals, and institution investors. During the second phase of the origination process, after loan and borrower information have been made available, these investors view the application and decide to invest in one or more than one loans as full funding or partial funding.

Investors are advised to choose borrowers carefully and are also informed that platform will not be responsible for any kind of money loss. Investors are also advised to invest in multiple loans instead of investing full funding to one loan. This way many investors chip in to mitigate the risk and safeguard their money. Just as the borrowers, interest rated provided to investors also accounts the commission payable to the platform. This can be either a one-time commission or the partial amount of monthly loan repayment.

During the third and final phase, platform collects and transfers the repayment to the investors after deducting the commission, if applicable. To achieve this while also offering additional services, platform relies on the third party applications to manage the money movement as well as the borrower worthiness. A few P2P platforms also use third party tools to provide end to end portfolio structure to investors and also to advise them about the best investment options present on the platform. This is achieved by the use of big data analytics and BI tools. Many platforms also rely on the debt collection agencies in case of late payments or delinquency. This way many companies get involved from the loan application submission till the loan maturing.

Types of P2P platforms

Non-profit platform

Investors on these platforms look for the communities, not mainly included in banking operations. These communities offer loans to individuals who can not get loans from banks In these communities source of the money is from volunteer work, donation or grants to operate. Benefits to the borrower might not be same as expected

Socially responsible platforms

These are the companies operating for profit but are driven by any social cause to support or develop specific communities. These platforms make profit for themselves and for their investors while meeting their social objectives.

Commercial platforms

These platforms have a larger customer base (general public as both investors and borrowers) without aiming any social cause or developing any specific community. These platforms have comparatively more resources to provide loans. Most of the P2P platforms are of this type due to their influences and proficiencies.

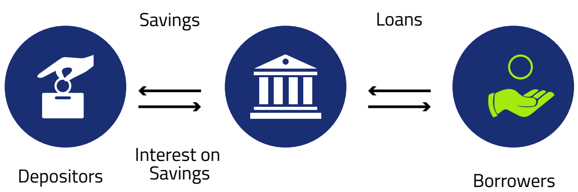
Marketplace Lending Vs Bank's traditional Lending

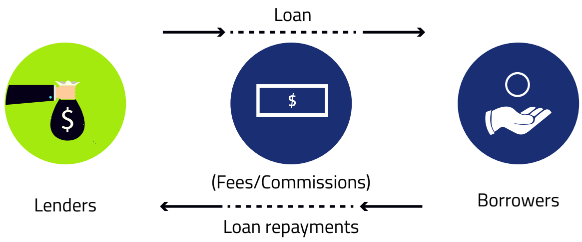
Unlike banks, which take in deposits and lend to consumers and business, MPLs do not take a deposit or lend by themselves. They, therefore, mitigate from their balance sheets. Nor do they have interest income, they generate income from the commission paid by borrowers and the lenders. Investors can select the borrowers based on the return they require on their investments, maturity, or risk profile (based on the credit risk profile presented by the platform) or any combination of all three.

The 'Embedded Securitization' (split the money invested by lenders into smaller 'tranches' and lend it on to several borrowers) aims to minimize the risk of default by spreading lenders investments across a large number of borrowers. In 2014, US$23.7 billion of loans were issued through marketplace lending platforms globally, concentrated primarily in the US (51 percent), China (38 percent) and the UK (10 percent). The total grew at a CAGR of around 120 percent between 2010 and 2014.

Lending Business Models, Banks vs MPLs

Traditional Bank lending model	Marketplace tending (MPL)





Banks act as an intermediary between savers and borrowers. They payinterest on deposits and lend money to consumers and businesses.

They generate income by taking risk onto their balance sheets and managing spreads between the interest banks charge on loans and thatpaid on savings

This risk- taking requires them to hold capital to absorb potential losses

Depositors have limited control or visibility over how their money is used

Banks engage in maturity transformation as the deposits are typically shorter term than the loans, creating a need for liquidity buffer.

Marketplace lenders directly match lenders with borrowers via online platforms.

They do not lend themselves, so they do not earn interest and do not need to hold capital to absorb any losses.

They make money from fees and commissions from borrowers and lenders

MPLs offer transparency and control to lenders, such as through disclosure on recipients of funds lent out

Generally, by design, there is no maturity transformation involved.

Source Deloitte Analysis

Risks Associated

Though Marketplace Lending provides a well-connected end to end processes for lending which is easy to follow and less time consuming, it has few risks associated with it which cannot be simply ignored.

No guarantee of investors' funds

MPL doesn't have access to a minimum deposit since they don't deposit money with. They totally rely on the investors to bring funds which are quite uncertain.

Some MPL has established their own provisional funds to help the investors in case of borrower default. How ever, no MPL platform guarantees complete money recovery to an investor in case of borrower default. There is a risk that investors can misunderstand such funds as a guarantee that their investments are safe and platform will bear the losses.

Liquidity risk

Investors on the platform may not realize that their investments are locked until loan maturity. However, few platforms provide secondary market functionality to sell full or part of their loans to other investors by adding a premium or on some discounts.

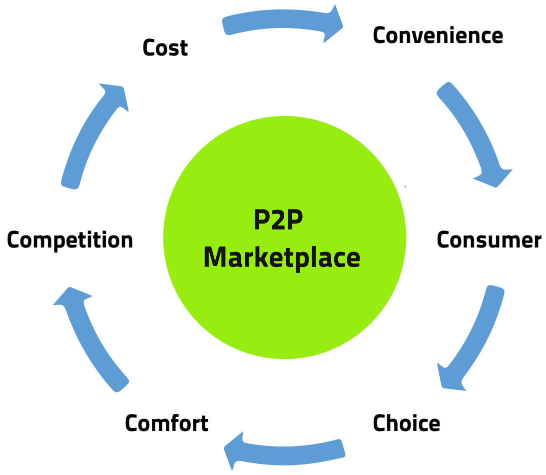
Investor understanding

Though platforms provide a good understanding of the investments made on the platform and the risks associated, still a large set of investors (majorly retail investors) are not well versed with the functioning of these platforms and the regulation etc. It shows that industry has not yet attained the level of customer understanding.

Credit risk and potential for financial loss
Most platforms do provide the credit scoring of the borrower but it's clearly stated that information provided is based on the data present and platforms are not responsible for any kind of financial loss. But instead of considering this scoring as the information, they consider this as to be the decision of the platform and hold them responsible.

The 6 C's of P2P

P2P is an aspiring market for what is expected to attain. Since it's a technology powered by the internet, it brings down the cost and makes lending more convenient to its users. It's not only efficient but also economical which makes it attractive to both investors and borrowers. A more nimble online operating model cuts down on costs of money flow management, client services, and financial and administrative back office activities. Since P2P companies do not take any deposits, or any formal collateral they are not regulated by any financial authority which brings down the compliance cost.
Also, already established P2P companies keep on feeding the new alternative data to the analytics company which is boosting the accuracy in the P2P marketplace. P2P's online benefit extends its reach to the borrower who is credit-worthy but has no fund access from banks. Lower operational costs have enabled P2P players to provide lower inter-est rates to their borrowers. The 6 C's of P2P depicts the advantages of P2P marketplace:



Cost: Due to online presence and lower compliance costs, operational costs of P2P players have gone drastically low. This enables them to attract many borrowers with lower interest rate and make a reasonable amount of profit
Convenience: Since, P2P is not bound by the banking laws, getting a loan on the platform is completely hassle free. Borrowers just need to fill in their information and platform takes care of the background check and the creditworthi-ness. Everything happens online without any manual intervention (most of the time) which makes it more convenient not only to the borrowers but also for the investors.
Consumer: Everybody thinks that it's only beneficial to borrowers since they have easier access to funds where they are not given funds by banks but that's not the only consumer base for P2P. Investors are the other consumer base and platform gives them a place to invest their money to get higher returns by choosing the loans where they want to invest. Also, they can choose the amount to invest. Though there are a few limitations with the processes the investors are made aware of all the risks in most of the instances.
Choice: In a traditional banking scenario, investors don't have a choice to choose the funds for the investment, where-as P2P gives them the flexibility to choose the funds and invest with the amount of their choice. The platform also provides them the information of the borrowers and investors and they can apply their own built-in algorithms for choosing the borrowers
Comfort: Technology has filled our life with a lot of comfort and P2P has taken the benefit of the same . Easy access to borrowers, the choice of amount to invest, user friendly portfolio management etc. are the key highlights that make P2P lending a desirable and comfortable option for both borrowers as well as investors.
Competition: Everybody thinks that banks are the competitors of P2P but that's not the truth. P2P compliments the banks in the real world. When an individual or firm is not able to fulfill their fund demands through a bank, they reach out to P2P platforms for the same. In such a way P2P is making more people creditworthy by showing their capabili-ties to lend and repay.

Conclusion

P2P can be labeled as the 'social media of the banking industry'. P2P is connecting people across geographies based on their financial needs somewhat like the way Facebook, Google+, WhatsApp etc. are socially connecting people across the world, Future of P2P is not completely predictable as of now, but based on the current scenarios it seems to be fast pacing industry giving high returns on a short span of time. Even though high returns are always associated with high risks, the exception here in the P2P lending space is that the investors are willing to take those acceptable/ informed risks.

Apart from traditional investment models with minimum investment and fixed returns, P2P provides another section for money investment. Many players within financial services sector see P2P credit underwriting as unproven and the model unable to transition to the kind of investment paradigm needed to scale to massive proportions. However, many others note that P2P may indeed be enjoying a "perfect storm" of events that is fueling its growth.

About the Author

Sumit Kamra

Sumit is a Business Analysis/Consulting professional with ~7 years of experience in the Banking Domain. His special interests are in the use of latest technology to enhance customer experience and transfiguring pioneering ideas into products. His expertise is in Corporate Banking, P2P Lending Marketplace, Lending Automation. He is currently working on end to end P2P lending solution for one of the lending organizationsin UK. In his spare time, Sumit is passionate about music and exploring new places. He is also a food lover and enjoys experimenting different varieties of food."

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