International Journal of Science Technology and Management
Vol. No.5, Issue No. 11, November 2016
www.ijstm.com
ISSN (O) 2394 - 1537
ISSN (P) 2394 - 1529

A STUDY ON PEER TO PEER LENDING AN ALTERNATIVE IN SME FINANCING

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ABSTRACT

India's start up market is booming with more SMEs AND MSMEs entering into Indian market in the previous decade. India occupies its position as the third largest start up market in the world next to USA and UK. The growth of this sector depends on the degree of funding that the sector is able to receive. There is a demand for short term funds among SMEs in India but lack supply from traditional sources mainly because of procedures and documentation. This led to emergence of alternative sources of funding or innovation in financial instruments. Crowd funding invoice financing companies for example are a boon for SMEs, who often face liquidity issue and are in need of cash. Peer-to-peer lending (P2P lending) functions on an online marketplace and provides a link between supply and demand. Such platforms and sites have gained popularity and is doing very well across the world as it provides a viable alternative outside the traditional financial system for SMEs and start-ups to raise money. Investors including institutional investors who always look for new avenues to maximize their returns have gained interest in the peer-to-peer sector. Until now P2P concept was famous in countries like US, UK and China but from past 5 years P2P companies are increasingly becoming popular even in India causing potential threat to banking institutions. In 2015 alone, around 20 new online P2P lending companies were launched in India. At present, there are around 30 start-ups in the P2P lending business in India. RBI has proposed registering P2P lending platforms as non-banking financial companies (NBFCs). This paper studies about the effect of p2p on traditional financial institutions and its effect on policy reforms. Does non-conventional financial institutions pose a threat to traditional institutions in imposing policy reforms?

Keywords: Crowd Funding, SME, MSME, P2P Lending, NBFC

I. INTRODUCTION

P2P platforms are seen as a major interfaces or platforms in bringing together lenders and borrowers. Conventional and traditional financial institutions are facing various challenges in terms of standardisation especially when new financial technologies aim at reducing costs and risks through quality of service they render to customers. Non-conventional institutions do not follow rigid rules and standardization procedures, and therefore necessitates greater regulatory and policy intervention. Lending-based crowd funding operates on the principle of "full financing," i.e., the loan request gets funded only if it receives enough bids to cover the entire amount requested by the borrower within an established pledging period, which may range from a few weeks to several months. However, over time, P2P has become increasingly mediated by online intermediaries. The

growth prospects of these institutions depends on their strategies, responses from public authorities, security associated with transactions etc. It is simply too early to make any reliable judgements on how large P2P lending will become in a few years from now.

There are various factors that have led to continued rapid growth of P2P lending institutions. By exploiting new technology, they have facilitated disintermediation by allowing parties to communicate directly with one another. But the potential for growth is also because of number of competitive advantages that P2P lending platforms offer over the banks. Lenders on P2P platforms in the past five years have achieved substantially better returns than on conventional bank savings deposits. P2P platforms just facilitate interface of lenders and borrowers and do not hold loans themselves. P2P lenders are compensated by higher rates of return as they are exposed to greater risk in absence of any deposit guarantee or insurance.

P2P lending has provided greater access to credit to borrowers and small businesses at competitive rates who are not provided credit by banks and traditional lenders as they do not satisfy the more stringent criteria in terms of credit capacity that banks now place on granting loans. This has led to a new dimension to the banking structure the socially beneficial form of financing.

The final advantage of P2P lending is the technology. P2P have adopted a system of online auction approach in which borrowers indicate the maximum interest rate they are willing to pay and lender indicate the minimum rate they are looking for at classified levels of risk. The technology matches the borrowers and lenders. The platform also conducts reverse auction to match the parties by gradually increasing the interest rate payable on loan until sufficient bids are made. This facilitates fast, effective decision making, matching of loans, monitoring payments, follow up with interest payments etc.

As most of the conventional banking institutions are showing interest in participation in these platforms and structure, we should assess the impact of P2P lending as complementary to rather than competitive with conventional bank offerings, taking off-balance sheet lending that would otherwise consume relatively large amounts of bank capital. As already being introduced in US, Banks can therefore be expected to either set up their own P2P platforms or work with existing platforms, allowing them to market P2P borrowing to their existing customers as well as improving the availability of credit to some customers who do not easily qualify for conventional bank lending.

1.1 Risks of P2P intermediation and transparency

A number of potential risks such as default risks etc need to be given greater attention in the future. Industry standardization may provide the most effective response to these risks. The risk of default is overcome by greater diversification across a large number of borrowers and lenders. The need of the hour is quantification of risks over business cycles, business downturn and to educate investors on these risks. P2P lending agencies should try to bring in some standardization when it comes to loan scheduling and recovery. Example: loan on property – recovery levels depend to a greater extent on the role of lenders in contract enforcement, to obtain maximum recovery in the event of loan default through exercising claims on security or reaching agreement with borrowers on loan rescheduling. Banks have specialized units to carry out such tasks, but it remains unclear how much activity of this kind will be carried out by P2P lenders to minimize post-default loan losses. Investors

also need to be aware of the possibility of falling P2P loan prices resulting from a self-reinforcing withdrawal of funds by institutional investors subject to 'mark-to market' valuation of their P2P investments. One attraction of P2P loans to institutional investors, and a factor behind the substantial increase in institutional lending on P2P platforms, is the possibility of readjusting their exposure by selling loans to other investors. However, this liquidity -- while useful to individual investors -- may not always be reliably available. A decline in the returns anticipated on P2P lending – triggered for example by a rise in default rates -- or simply a desire to readjust investment portfolios and shift them into safer assets because of some economic shock unrelated to P2P lending, could cause investors to seek to liquidate their exposures and lead to a sharp rise of P2P rates and decline of P2P loan valuations. With mark-to-market valuation, especially if some investments are highly levered or subject to binding short-term portfolio performance metrics, this could in turn trigger further sales and price falls. Over time, such instability should decline, as investors become more familiar with this new asset class and less constrained market participants become willing to commit capital to stabilize prices during episodes of price volatility. But until the market matures in this way, investors should expect episodes of relatively large price instability. Finally there are ever-present dangers of fraud, cybercrime and operational problems.

In the case of equity or investment crowd funding, a firm offers a certain proportion of its equity for a set amount of capital it is aiming to raise. As P2P institutions are not guarded by adherence to accounting standards nor are they professional capital providers they may be landed into trouble. Gradually the participation may also be motivated by non- financial aims such as becoming part of an entrepreneurial venture or supporting a particular individual or business.

An important aspect is assessing the value of the equity or firm to decide on the volume and pattern of fund raising. Some platforms operate a market–driven approach to setting valuation, whereby the entrepreneurs set out the amount of equity and number of shares they are offering, and, through a bidding process, investors who are willing to pay the most for the shares get in on the deal. Some platforms also provide to entrepreneurs training on how to value a business, engaging ex–investment bankers, fund managers and venture capitalists.

Crowdfunding platforms also are engaging in offering services such as due diligence, consultation etc. Nevertheless, over time, crowdfunding has become an alternative source of funding across many other sectors and it is increasingly used to support a wide range of for-profit activities and businesses. New product-development is an activity for which crowdfunding can provide specific advantages, as the financial dimension is importantly complemented by direct contact and feedback from current and potential customers.

The crowd-lending, or P2P lending, option can be attractive for small businesses in the form of unsecured loans. Borrowers can receive lower rates than those offered by banks, since overhead costs and regulatory burdens are lower.

Crowdfunding activities require a reliable internet connection, access to the banking sector (in the form of bank accounts for entrepreneurs and investors) and/or online payment systems for the funds to be transferred. In this regard, an efficient banking system can ease the development of crowdfunding platforms, by providing the infrastructure for payments, as well as information about the creditworthiness of the entrepreneurs. In the case of crowd lending, for instance, the platforms may use credit history to decide on whether to accept a project for financing through their site and on the interest rate to charge.

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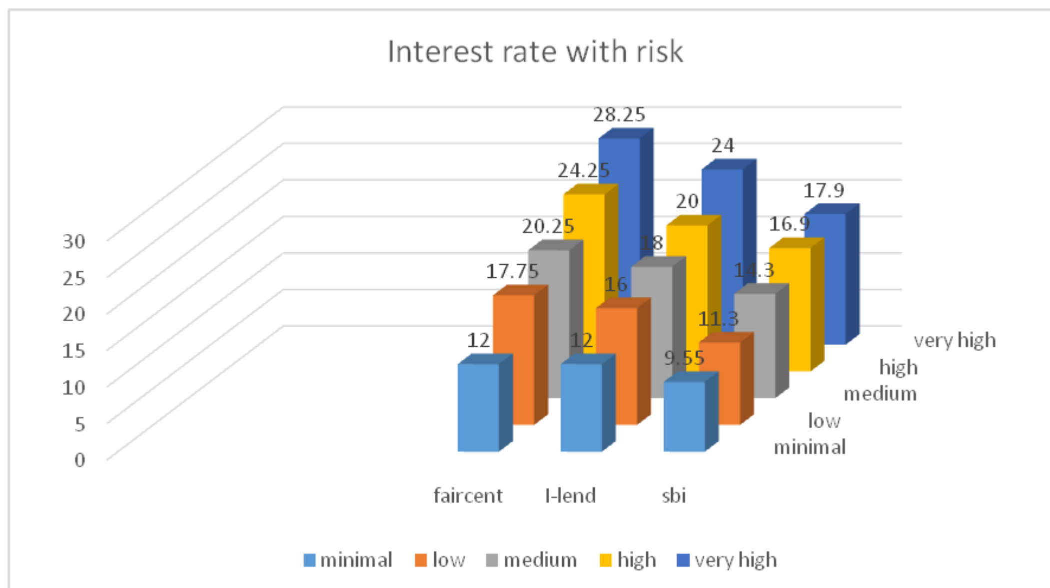
Various P2P lending platforms have emerged during a course of time and are very successful such as i-lend, Fair cent, Lending club etc. these platforms have their interest rates and terms of repayment based on nature of loan, number of borrowers, interest charged by commercial banking institutions etc. the question is whether there is any relationship between the interest rates charged by traditional institutions and these platforms. Is it really beneficial for the borrowers and lenders to participate in this framework?

The data collected from various websites of Faircent P2P lending show that these agencies have highest number of borrowers with an intention of debt consolidation, business funding etc. The rate of interest charged is also high for debt consolidation services than on vehicle loans or educational loan.

With respect to I lend highest loans are lent for personal purposes such as for wedding, two wheeler loans etc and interest rates also follow suit.

A comparison of interest rates of Fair cent, I-Lend and SBI shows that the rate structure followed by P2P is actually high than SBI at varied level of risks.

Interest rate with variations in risk of faircent, i-lend and sbi:



Regression analysis of relationship between interest rates charged by Faircent and I lend as compared to SBI keeping in view Risk profile of borrowers shows a positive coefficient i.e. they have a direct relationship with interest rate of SBI. It indicates that an increase in Interest rate of SBI will lead to an increase in Interest rate of Fair cent (p value of 0.004614 and 0.00996). It indicates that an increase in Interest rate of SBI will lead to an increase in Interest rate of Fair cent and I lend.

	F SIGN	MULTIPLE R	R SQR	ADJ R^2	P VALUE
FAIR CENT	0.004614	0.975403	0.951412	0.935215	0.004614
I LEND	0.008996	0.961557	0.924592	0.899456	0.008996

II. CONCLUSION

The business models and economics of P2P lending suggests that rather than disrupting banking, P2P lending is best viewed as complementary to conventional bank business models, allowing banks to economize on risk capital and concentrate on the provision of liquidity services, which are the fundamental core of their business model. Banks can either expand their operations or include one or two characteristic features of P2P lending or they offer their own proprietary platforms, in order to provide both loan and investment services to their customers and mainly SMEs. In short the extent to which P2P lending platforms are successful in capturing credit activity depends largely on meeting the challenges of amending and adapting existing business processes, including the adoption of industry-wide standards, in order to support this new form of intermediation and only to a much more limited extent on exploiting technological innovation.

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