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Challenges for the Peer-to-Peer (P2P) Lending Market



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Challenges for the Peer-to-Peer (P2P) Lending Market

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Abstract

Through this paper, I would like to point out some pain points faced in P2P lending marketing and suggest appropriate ways to tackle these issues. To put things into perspective, I will start by talking about the history of P2P lending and the growth it has already achieved. Then, I will first talk about how fraudulent agents can act as deterrents to prospective market participants. Then, I will discuss how financial regulation is not always uniform across borders and the challenges that can arise out of this. Finally, I will conclude the paper with some recommendations of my own.

Keywords: *Peer-to-Peer Lending, Financial Inclusion, Regulatory Cooperation, Financial Education, Fraud Prevention*

Introduction

For thousands of years, banks have catered to the credit requirements of businesses and individuals. Records suggest that banking activities were being carried out as early as 2000 BCE by temples in Babylon.[1] In comparison, modern peer-to-peer (P2P) lending is at most two decades old. The first P2P lending platforms were launched in the US and UK in 2005-07.[2] Prosper Marketplace, one of the earliest players in the P2P lending platform business, facilitated 29,013 loans from November 2005 to 12th July 2009.[3] From 13th July 2009 to 30th September 2023, Prosper Marketplace facilitated 1,779,240 borrower loans.[4] If we simply look at the average annual number of loans facilitated, we can observe an increase for the later period.

These trends are not unique to only Prosper Marketplace. According to a paper by Olena Havrylchyk, Carlotta Mariotto, Talal Rahim, and Marianne Verdier,^[2] P2P lending in the US grew exponentially starting in 2013 for Prosper Marketplace and from 2012 for Lending Club, another early player in the P2P lending marketplace. The rise in P2P lending holds great promise for improving access to credit, and improvements in lending price discovery in the borrowing market. However, P2P has its share of challenges to overcome. In this paper, I will attempt to throw light on some of these issues preceded by a brief history of P2P lending.

Methodological approach

To gain some perspective and understand the significance of peer-to-peer lending, we will look at the growth unfolding in this market. After this, I will briefly discuss the two main challenges to peer-to-peer lending – fraudulent agents and regulatory concerns.

Fraudulent agents can lead to a loss of trust in the marketplace. To protect investors, peer-to-peer lending marketplaces assign interest rates to borrowers based on the risk involved. Depending on the quality of research into the borrower, this could protect investors, however, it takes away organic price discovery, an important potential benefit of peer-to-peer lending.

On the other hand, the difficulty in regulatory cooperation across borders inhibits the peer-to-peer market from becoming truly global.

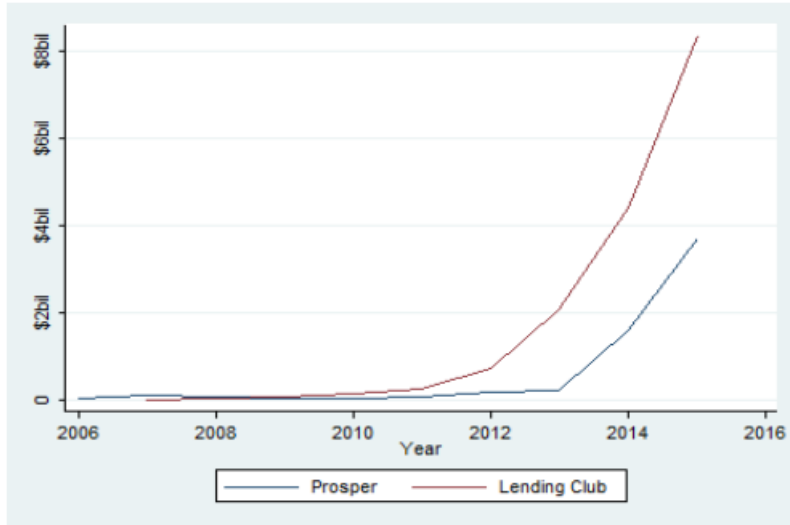
The approach to understanding both challenges is systematic reviewing.

History of peer-to-peer lending

Peer-to-peer lending platforms have been around since the turn of the century. However, a chunk of the growth that led to peer-to-peer lending reaching today's levels started in 2012 in the US. We can observe this through the following table that describes the growth of P2P lending in the US.

Figure 1

P2P lending in the US – Prosper Marketplace and Lending Club



[2]

If we turn our attention to the current market size and prospects, we can see that various experts believe that the P2P lending market will continue its high growth at least until 2032. In 2022, Precedence Research valued the global P2P lending market at \$88 billion. Precedence Research expects the market to grow at a compound annual growth rate (CAGR) of 26.5% until 2032 and reach a market size of \$919.73 billion.[10]

Figure 2

Peer-to-peer (P2P) lending market size, 2022 to 2032 (in \$ billion)[10]



Fraudulent agents

A key problem with P2P lending would be the ‘peers’ lacking information and financial knowledge. It should be noted that not everyone knows all or all the important caveats of financial agreements and how they can be enforced. As a result, there is an increased risk of either party engaging in fraudulent behavior. By concealing or lying about material information, a borrower could get loans they never intend to repay or cannot repay. Similarly, lenders could overcharge interest rates.

To counter these issues, it is essential that loan agreements on P2P lending marketplaces are regulated and the marketplaces themselves should educate their users and bring about awareness regarding existing market conditions.

Prosper Marketplace and Lending Club collect credit scores from their loan applicants. Currently, only Prosper Marketplace is offering individual investors to lend through its platform, so we will be focusing on them for this paper.

On Prosper Marketplace, once a loan is given, Notes against that loan are issued that can be invested in by individuals. The Notes are assigned credit ratings by agencies like Fitch Ratings and Kroll Bond Rating Agency (KBRA). The company also assigns Prosper Scores to these Notes based on machine learning-driven risk models using their historical data as well as a data archive from a consumer credit bureau.

Let us see some key statistics regarding Prosper Scores and Prosper Ratings.

Table 1

Prosper Ratings and their estimated annualized losses [4]

Prosper Rating	Annualized Rate	Loss
AA	0.00% - 1.99%	
A	2.00% - 3.99%	
B	4.00% - 5.99%	
C	6.00% - 8.99%	
D	9.00% - 11.99%	
E	12.00% - 14.99%	
HR	>=15.00%	

Table 2

Prosper Scores and probability of bad[4]

Probability of bad	Prosper Scores
> 13.00%	1
12.00 < x <= 13.00%	2
9.50 < x <= 12.0%	3
8.00 < x <= 9.50%	4
6.90 < x <= 8.00%	5
5.90 < x <= 6.90%	6
5.00 < x <= 5.90%	7
4.20 < x <= 5.00%	8
3.50 < x <= 4.20%	9
2.70 < x <= 3.50%	10
0.00 < x <= 2.70%	11

Interest rates on Prosper Marketplace are not decided by an auction-like process of proposing a low interest and going higher until someone funds the loan. Instead, the interest rates are set by Prosper Marketplace. While this is not relevant to the point being made in this section, it is important to note it as, both, a barrier to free price discovery in the borrowing market and a safeguard against unfair pricing.[9]

Regulatory concerns

Regulatory concerns with P2P lending can be clubbed into two categories, which are coordination between regulators across borders and the sheer number of lenders to be regulated. P2P lending could potentially connect borrowers and lenders across borders. Understanding such cases and their regulatory circumstances is important since they hold the potential to alleviate mismatches of supply and demand in domestic borrowing markets by creating an international borrowing market.

In cross-border P2P lending, the loan terms would be subject to regulation from the countries of the lender and the borrower. However, these regulations are seldom uniform across countries. Monetary policies differ for developing and developed countries. Even among countries of the same category, monetary policies would differ if there were differences in economic conditions.

For instance, a developing economy experiencing high economic growth but high inflation as well would want to increase the cost of borrowing and the reward of lending, i.e. the interest rates, to control inflation. On the other hand, a developing economy experiencing low economic growth and low inflation would want to decrease the interest rates and try to spur economic growth.

An example from real life that should be considered is the US and UK. These are two of the largest economies in the world that are quite interconnected. In 2022, the UK was the fifth-largest purchaser of US goods, and the US was the biggest export market for UK goods and services.[6][7] The Center for Financial Stability notes that the countries' economies are tightly interconnected via massive volumes of capital flows. Yet, the two countries had differences in how they regulated Global Systemically Important Financial Institutions (G-SIFIs) due to differences in domestic politics, differing timelines, and processes for implementation, competing domestic and cross-border regulatory interests, and lack of effective coordination mechanisms to assist jurisdictions overcome these problems.[8]

The other key regulatory issue with P2P lending would be the staggering number of lenders. Fortunately, since lending would occur via online marketplaces, regulatory bodies could give directives to these marketplaces.

Conclusion

In this paper, we took a brief look at the growth of P2P lending in the US and then looked at the prospects for the global P2P lending market. Then, we discussed how fraudulent agents could undermine the growth of P2P lending by violating the trust of other peers. We also noted some measures taken by Prosper Marketplace to help lenders understand the risks involved. Then, we noted that differences in political situations, priorities, and economic conditions could lead to divergences in the financial regulations of even the most intertwined economies. We also talked about how with the rise of P2P lending central banks would have to actively govern P2P marketplaces to maintain their control over interest rates, and the resulting economic growth inflation.

Recommendations

- Greater transparency of credit history and scores can enable investors to discern the inherent risk of lending to a borrower in a P2P lending market. This could be an opportunity that can be exploited by credit bureaus. In fact, their involvement could standardize the risk assessment and interest rate-setting process across various P2P lending marketplaces.
- While regulatory concerns of economies experiencing completely opposite economic cycles may not match, economies with similar economic conditions and political climates could benefit by opening a dialog to build a framework that supports P2P lending.
- At the same time, countries can benefit by preparing a P2P lending framework to be activated when credit is in short supply. Under this framework, countries could open up their lending market to overseas P2P lending marketplaces.

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