New Insights Into An Evolving P2P Lending Industry:

how shifts in roles and risk are shaping the industry

P+SITIVE PLANET
formerly Planet Finance

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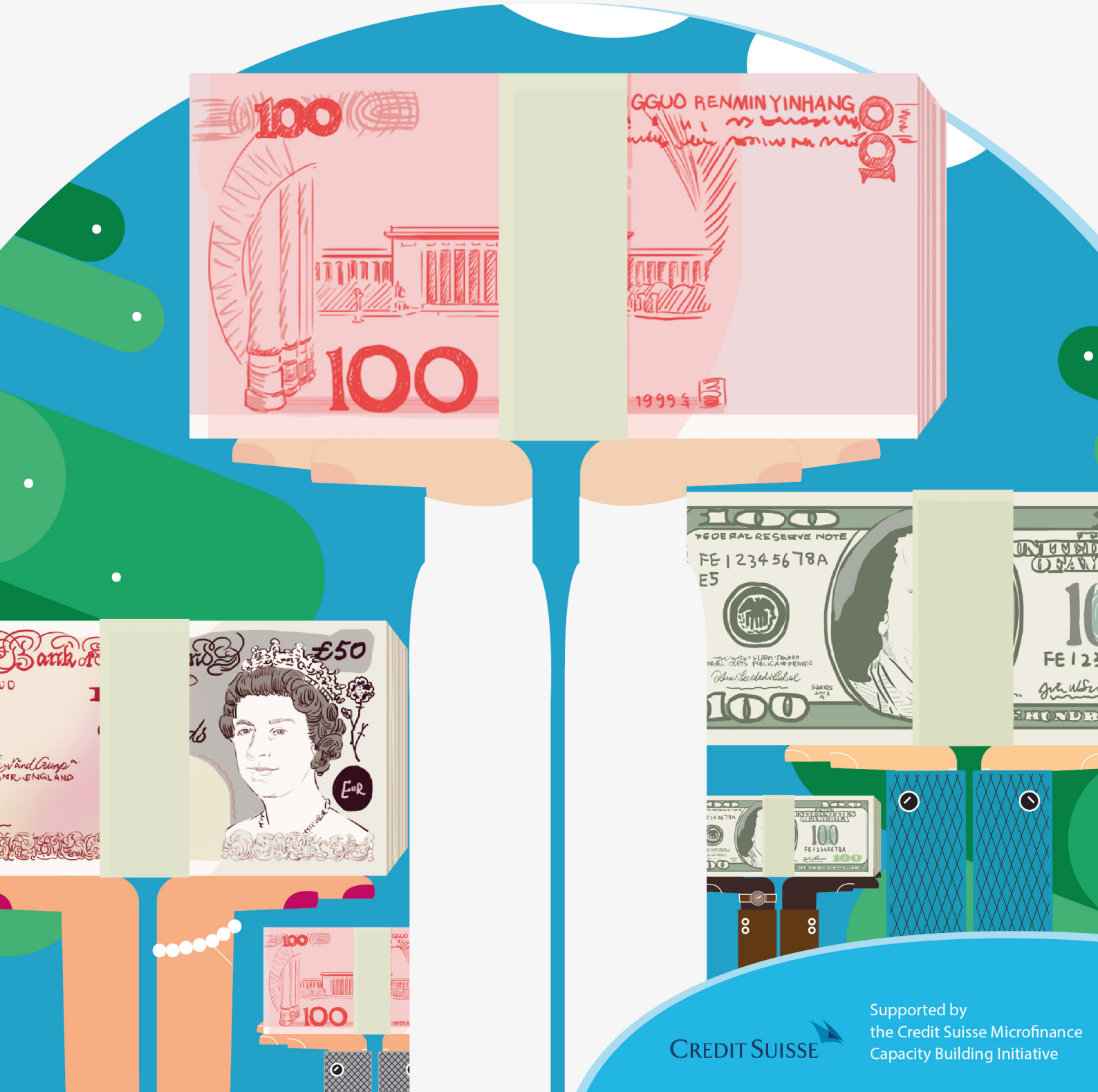
Tyler Aveni



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About the Positive Planet Group

Founded in 1998 by Jacques Attali and Arnaud Ventura, Positive Planet is a global leader in positive and responsible economic actions. For nearly 15 years it has worked to help poor populations gain access to financial services, and so improve their living conditions in a sustainable way by integrating them into the economic system. The Positive Planet Group contributes to the development of the microfinance sector by implementing specific products and services that address the needs of people who suffer due to their exclusion from the mainstream economic system. With an international presence in more than 80 countries, the Positive Planet Group is now recognized as a major force in the fight against poverty.

Positive Planet Group operates MicroWorld, an international P2P lending platform with the social goal of alleviating poverty through providing low-sum loans online to micro-entrepreneurs in more than 10 countries.

www.planetfinancegroup.org

About Positive Planet China

This global research study was spearheaded by the Positive Planet China office. Since 2003, the Positive Planet Group has been active in over 20 provinces in China. As one of the first international microfinance organizations operating on the ground, Positive Planet China counts the leading Chinese financial institutions engaged in microfinance and financial inclusion as its clients and partners. Through its Microfinance Plus programs, Positive Planet China also links microfinance to social development programs (health, education, and environment). In addition, Positive Planet Group operates two microfinance institutions in Sichuan province.

www.planetfinancechina.org

The Microfinance Capacity Building Initiative

The Microfinance Capacity Building Initiative (MCBI) is the Credit Suisse's grant and technical assistance initiative for microfinance institutions (MFIs). Launched in 2008, the MCBI aims to strengthen the microfinance industry, its institutions and their management.

The MCBI works directly with key players in the industry to strengthen institutional and management capacity, innovation and research across regions to enable them to better meet the diverse financial needs at the base of the pyramid. The MCBI is one pillar of the comprehensive and holistic approach to microfinance and impact investing developed by Credit Suisse, ranging from grant-funded technical assistance and expertise-sharing to innovative impact investment products and transactions.

The Microfinance Robustness Program

This paper is part of the ongoing activities of the Microfinance Robustness Program (MRP), a Positive Planet program aimed at upgrading risk management in the microfinance sector to drive long-term sustainability. The Microfinance Robustness program is supported by the Credit Suisse Microfinance Capacity Building Initiative.

List of Abbreviations

P2P = Peer-to-peer (Lending)

FinTech = Financial Technology

MFI = Microfinance Institution

GC = Guarantee Company

CCRC = China's Credit Reference Center

PBOC = People's Bank of China

RMB = Renminbi (China's Currency)

API = Application Program Interface

SME = Small & Medium Enterprise

WDZJ = Wangdaizhijia ("Online House")

LC = Lending Club

SoFi = Social Finance

UP = United Prosperity

CBB = Customer & Business Banking

FCA = Financial Conduct Authority

ECOA = Equal Credit Opportunity Act

ISA = Individual Savings Account

MCBI = Microfinance Capacity Building Initiative

MRP = Microfinance Robustness Program

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Methodology

This paper is a an in-depth analysis that corroborating information from reports, first-hand accounts and interviews with exerts across related disciplines to understanding the dynamics at play in P2P lending. Facts and data presented in the paper come from a wide-range of existing research in the public domain, white paper reports, market analyses, and published documents concerning P2P lending, as well as discussions with P2P company insiders, regulators, researchers, academics, legal authorities and investors familiar with P2P. No P2P borrowers were interviewed. Statistics used in this paper are the work of others and cited as such. Statistics are corroborated from multiple sources when possible and put in context where appropriate.

Our own opinions and predictions are the product of an extensive review of all available resources and consultation with many practitioners. The opinions and representations made do not necessarily reflect the views of Credit Suisse.

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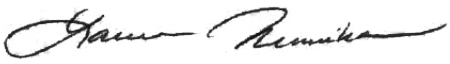
FOREWORD

Laura Hemrika

Marketplace lending, or peer-to-peer (P2P) lending, is buzzing. An increasingly popular topic in the tech industry, but now also mainstream media, it has made its way into the speeches of CEOs of global banks, of tech and social investors. And for good reason. It's exciting and it's moving fast, from China to the UK to the US. P2P is where financial services meet Silicon Valley. It's about technology, innovation and disruption, potentially impacting millions as a new segment in financial services. However, it is this dynamism and enthusiasm that can also make it difficult to distinguish emerging and ever-evolving business models, and the potential risks in the P2P space. Beyond an introduction or update on the space, this report explains the mechanisms and trends that underlie the industry and looks at the nuances of operations, developments and emerging risks, to focus on the big picture learnings that we can extract. It takes a look forward to what will be needed for responsible growth and sound investment. Indeed, for financial services and technology players alike, there is much to learn from the use of big data and the development of perceived new credit evaluation mechanisms, of the exploitation of market gaps and new trends in the social economy. There is also much to consider going forward: regulation, how can banks and P2P connect, and the risk and opportunity for investors.

Many of the better-known P2P players are based in the US and UK, but as a global bank with a strong focus on Asia, we inevitably ask what this means for Asia, with its vast population, economic strength and its exploding online industry. And indeed, at first glance, the numbers for P2P are quite staggering. But, as this paper shows, a closer look at this fast-growing industry reveals differences and dynamics that caution us from painting the industry with one broad stroke, especially when reliable data is often difficult to obtain and existing reports conflict with one another. It shows the relationship between different financial services models, in order to provide more clarity on the future direction of finance more broadly. Our partnership with Positive Planet (Planet Finance) has focused on driving the long-term sustainability of the microfinance and financial inclusion sectors in China, especially through improved risk management. We see that P2P can potentially play an important role in financial inclusion and in financial services – if understood and managed correctly by investors, lenders and consumers alike.

We invite you to take a closer look at this exciting industry and its dynamic nature in this pointed and insightful review of P2P's growth and potential.



Laura Hemrika, Head of the
Microfinance Capacity Building
Initiative, Credit Suisse

MAIN TAKEAWAYS

The global state of peer-to-peer (P2P) lending is hard to summarize in brief. The unique operational structure of P2P lending companies gets a lot of attention, but changes transpiring and their implications do not always get fully covered in media or market reports. In particular, characterizing the trends across P2P can be challenging with so much occurring at once and with so little consistency in lending practices across the world.

To illuminate the complex changes and underpinning details surrounding the topic of P2P, this report attempts to portray P2P lending, at the global level, as a series of contradictions: nascent and mature, simple and complex, innovative and traditional. Throughout, we create a narrative of P2P's development and critically analyze its core features and roles, while extracting broader industry insights into the not-so-nascent industry's impact, commercial value and future growth.

In summary, we have come to these key conclusions about the state of P2P lending worldwide:

• P2P or marketplace lending has become a catchall term for a wide spectrum of online lending providers. Companies range from commercial to social and may facilitate direct lending online or partner with traditional lending institutions. Many models exist, and the accepted use of the "P2P" designation varies widely. Definitions are often disputed.

• P2P lending builds off of market weaknesses by acting on existing needs not being met. In developed countries P2P is helping borrowers refinance, purchase cars more cheaply, and exit high-interest credit card payment cycles. Elsewhere, it both actively and passively promotes financial inclusion by reaching under/unbanked borrowers.

• P2P is most unique for 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.

• P2P companies participate in a larger trend of leveraging new, big data and automating operations to underwrite borrowers. As a result, P2P is inspiring material innovation in emerging economies where P2P and other FinTech actors are leap-frogging the traditional reliance on formal credit bureaus.

• Outside of developing countries, at least part of what P2P companies describe as improved credit evaluation is likely exaggerated and requires further study. Current loan performance suggests leading P2P underwriting practices are meeting high standards, while using innovative models, but a longer track record is still needed.

• P2P companies are growing at impressive speeds but in different directions. As specialization, consolidation and legal classifications of P2P become commonplace, companies providing back-office technology and data servicing are sprouting up.

• On paper, China's P2P market is the biggest in the world by a large margin. In some ways, the remarkable growth makes perfect sense, since China's market is well-primed for such an innovation; however, the new, self-labeled P2P companies companies hardly resemble what is found elsewhere, inciting questions of whether or not it is realistic to compare figures.

• While several banks are testing waters by taking strategic equity stakes in leading P2P institutions, the biggest lending institutions still want more proof of P2P's relevance and sustainability before fully embracing P2P and reinventing themselves.

• Regulation has been playing catch-up. Even with the UK and France now with more robust policies in place, and the US not far behind, P2P's growth continues to outpace risk controls.

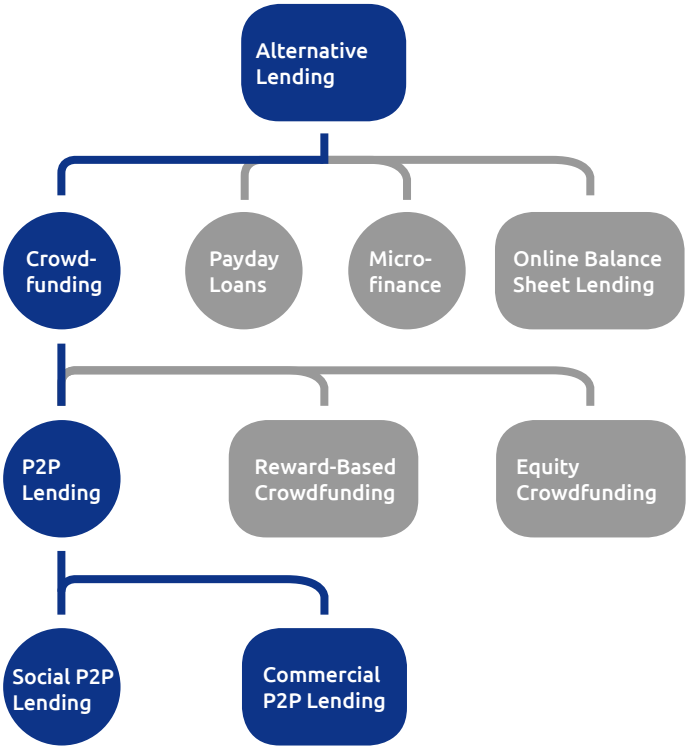
01/ INTRODUCTION

Peer-to-peer lending (hereafter referred to simply as "P2P") goes by many names. Increasingly called "marketplace lending" and sometimes referred to as "social lending," the innovation is part of a large umbrella of non-traditional financing wherein funds for different purposes are solicited from the public online, widely known as "crowdfunding".

In essence, P2P is the segment of crowdfunding specifically concerning loans. Borrowers request loans online, where their loan requests can be viewed as 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 lists the requested sums, much like how consumers buy products and goods online. New financial technology ("FinTech") P2P companies organize the entire process from start to finish, screening loan applications, evaluating the risk of borrowers, providing the online marketplace for buying loans, and eventually overseeing repayments back to lenders.

P2P loans are best thought of as a new approach to lending rather than a specific financial product – financial intermediaries like banks play little to no role. By leveraging the internet's interconnectivity, P2P builds a direct relationship between investor and borrower. This development should excite small and big investors alike since cutting out the middle-men allows more control, faster transactions and better interest rates to all parties involved. Simultaneously, decision-making over who ultimately receives loans shifts into the hands of the people and businesses investing the money.

Figure 1: Alternative Lending Chart



Alternative Lending:

Lending that typically targets businesses and borrowers who may be unable or unwilling 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 a 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.

1.1 THE EVOLVING DEFINITION OF P2P

Receiving loans online from the public is still quite novel for the average bank client, and the recent flurry of news covering P2P make the industry seem new. In reality, P2P loans have existed for nearly a decade. The earliest companies, Zopa in the UK and Prosper in the US, emerged in 2005 and 2006, respectively.

Despite having existed for 10 years, P2P remains an ill-defined innovation. While the online meeting of lenders and borrowers, as just described, reflects the common view of P2P in most cases, a more specific definition can be tricky to detail. Innovations and unique developments across different countries add to the difficulty, with many self-identifying "P2P" business models wandering away from convention. Nevertheless, a basic definition is needed to critically compare new innovations and analyze still growing diversity across P2P companies. We define P2P as the following:

Peer-to-peer lending is the loan-making between borrowers and lenders who are directly matched via online marketplaces. Participating parties are matching as "units" with lenders often investing in pieces of loans to individuals, small businesses, or well defined groups of people and taking on the risk of potential defaults. The P2P companies, which manage and operate the marketplaces, act as loan originators but importantly, "disintermediate" the lending process by bypassing traditional institutional intermediaries, avoiding complex asset engineering such as loan term transformation, securitization, or loan collateralization, and avoiding any balance sheet risk (i.e. not responsible for loan defaults). 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.

This definition comes with several important notes and caveats:

- Some P2P companies do not give investors the discretion to select individual loans, but instead offer "sets" of many pre-selected loan pieces according to risk tolerance and other criteria outlined by the investor.

- Our definition best encompasses the UK and US P2P industries since they are comparatively developed and host the most internationally famous P2P companies. China's P2P industry, however, is both appreciably larger and significantly different, as we discuss in our special report.

- Credit risk is often left with investors, not the platforms, so that if loans go bad, investors assume losses; however, platforms regularly enforce strict lender requirements and provide other services to protect investors.

- Last, large P2P companies, contrary to our definition, are increasingly beginning to securitize and secure loans and are taking on the responsibilities of other more sophisticated financial activity.

Marketplace Lending or P2P?

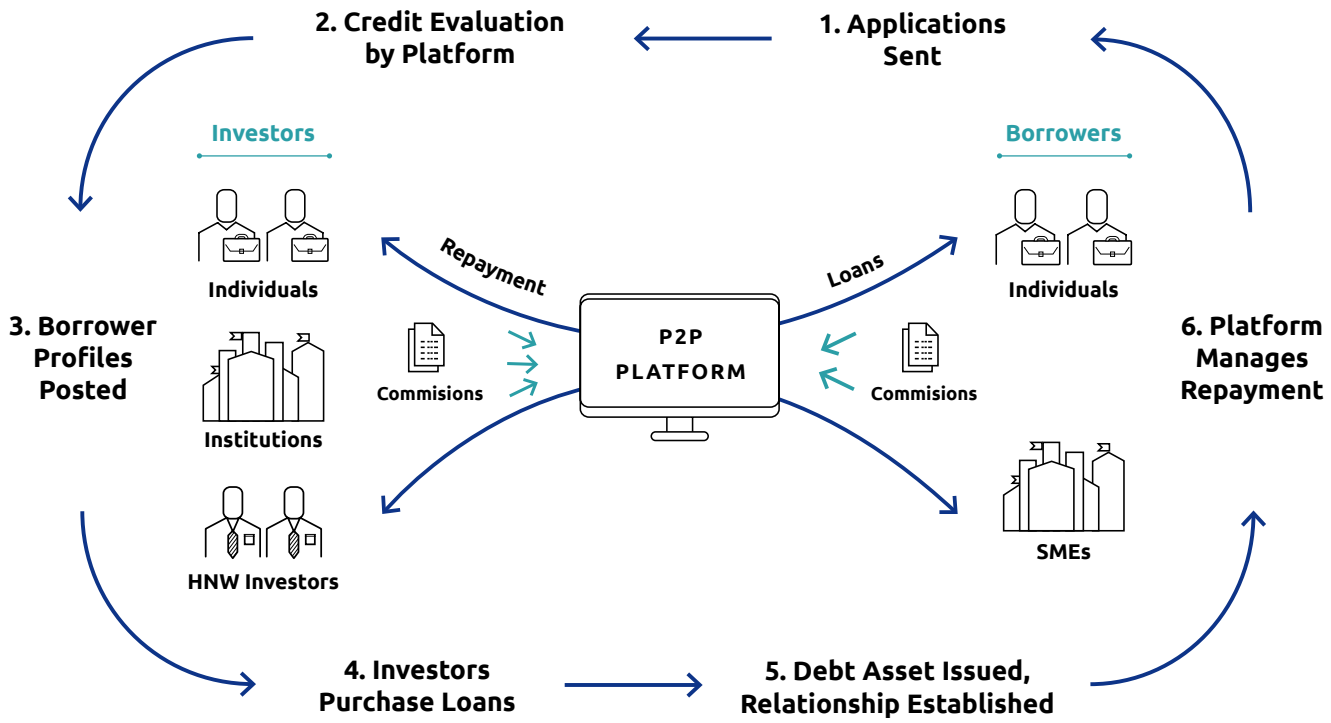
The increasing proportion of institutions participating in the P2P industry – both as investors and borrowers – makes the term "peer-to-peer" lending seem like a misnomer. For this reason, many in the P2P sector instead prefer the term "marketplace lending" which emphasizes the process of matching investors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

1.2 HOW P2P WORKS

In the most common scenario, the P2P platform performs its functions across 3 phases: loan application and credit evaluation; investor funding; and loan repayment. The most complex of these is the first phase (Figure 2, steps 1-3). Potential borrowers apply for loans by sending personal and financial information to the P2P platform through the internet. The P2P company then screens out ineligible candidates and fact-checks, most often by calling employers and verifying information against what can be found online, to identify fraud. Eligible candidates are then evaluated for creditworthiness by viewing traditional credit scores in the context of other compiled data. In cases where preexisting credit information is inadequate or unavailable, big data analysis may try to make up the difference.

Approved loan requests, typically ranging between $5,000 and $35,000 (personal) or $50,000 and $100,000 (small business), are assigned a credit grade. These grades serve as part of a platform-specific rating system with 5 or 6 letter tiers that reflect distinct interest rate ranges and affiliated levels of risk. The interest rate quoted to the borrower combines what the platform deems to be the real market-value interest rate (cost of capital) *plus* fees to the platform. This is because, unlike a bank, P2P platforms charge commissions for their services rather than make money off of a "spread" or the difference in the rates offered to savers/investors and borrowers. (However, the ultimate effect on interest rates is quite similar). In the end, 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.

Figure 2: P2P Loan Origination and Servieing Process



Before any of the above has even begun, platforms have already built up a base of "users" or active investors with registered accounts on the P2P website. Depending on country and platform, investors may include a combination of retail investors, accredited investors, high net wealth (HNW) individuals, and/or institutional investors. During the second phase of the P2P loan origination process (Figure 2, steps 4-5), after borrower and loan information have been uploaded, these investors view and invest in borrower profiles (i.e. loan requests).

Lenders are encouraged to select borrowers carefully and fund tiny pieces of many distinct loans. This way, many investors can chip in to fund one loan; simultaneously, risk is mitigated. Just as with borrowers, the interest rate offered to investors also accounts for the commissions they pay to the platform, often structured as a one-time payment and separate ongoing management fees.

During the third and final phase (Figure 2, step 6), platforms collect and transfer repayments to investors. In exchange for these services, the platform collects ongoing low-interest management fees from the investor until the loan reaches maturity or is charged as a loss.

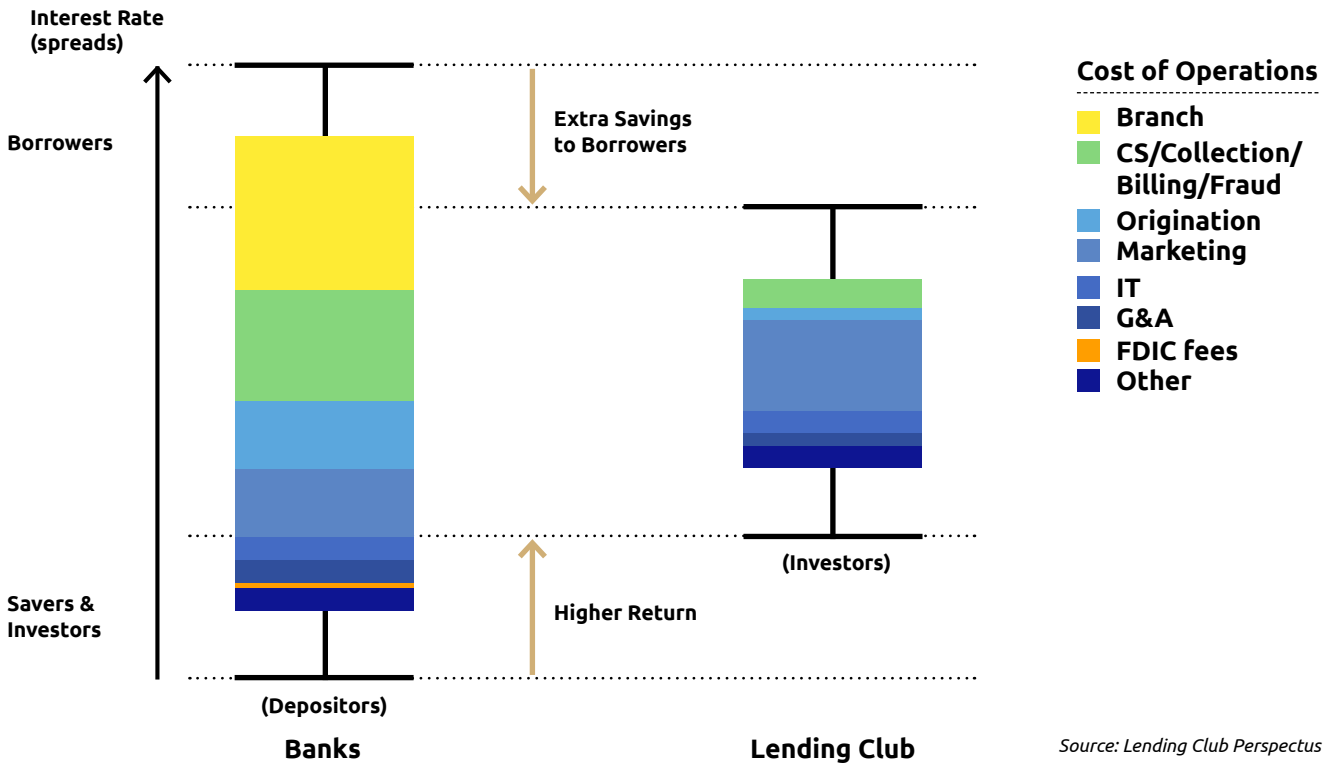
To achieve this while also offering additional post-origination services, P2P platforms rely on a network of partnerships. Banks or other payment service providers help move money. Some investors may use third-party, online analytic tools to track, analyze and manage their portfolio of loan investments. Some platforms allow their loans to be sold on partnering secondary markets. P2P companies' internal collection efforts regularly check-up on borrowers with late repayments to help prevent defaults, but most platforms also partner with third-party debt collection agencies. From start to finish, many different companies can become involved.

1.3 THE POWER OF P2P

P2P is an ambitious industry for what it hopes to accomplish. As an online technology, it brings convenience to users, but its potential far exceeds just that. First, its efficiency and cost savings mean that both savers and investors alike can receive better interest rates. A more nimble online operating model cuts down on costs of money flow management, client services, and financial and administrative back office activities. Also, because P2P companies do not take deposits or make formal guarantees for the loans, they have not yet been constrained by strict regulations so compliance costs are low.

Additionally, most P2P business, such as Lending Club (LC) and Prosper in the US, are feeding new alternative data into the underwriting algorithms, which might boost the accuracy of P2P companies' lending algorithms, in turn, allowing for better interest rates overall. More generally, P2P's online advantages allow it to extend formal

Figure 3: Costs and Interest Spreads for Banks and Lending Club



Source: Lending Club Perspectus

financial services to borrowers who are creditworthy and have internet but have no or limited access to banks.

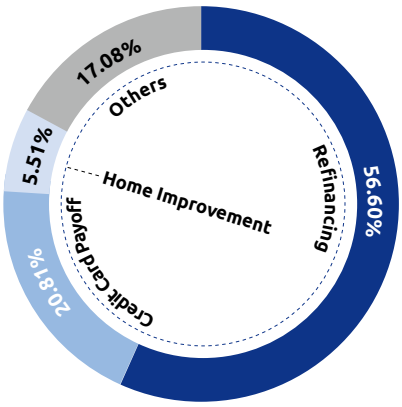
Figure 3 depicts how decreases in operational costs should lead to better rates for P2P borrowers and lenders by comparing the operational expenses and related loan interest rates of a typical bank versus Lending Club (LC), the largest US P2P platform. LC claims to have costs of only 270 basis points versus a typical bank's 695. This means P2P companies can cover their expenses by charging borrowers just 2.7% more than what is given to investors (in the form of commissions). By comparison, banks must charge at least 6.95% more to borrowers than offer to savers in interest *but this covers both operational costs and loan loss.*

Of course, it is important to note that this diagram only represents the theoretical advantage of P2P loans, with banks having to charge much more to cover loan losses and guarantee depositors' money whereas P2P investors risk having their purchased loans go into default above what they or others estimate. Later, we explore specific scenarios that might erode the cost advantages of P2P.

For Lending Club, the benefit to borrowers is much clearer still. Not all borrowers will receive better deals than at banks, but savvy borrowers who check different lending channels often find that the P2P platforms offer lower rates. In many cases, securing any loan is much better than paying down high-interest credit card debt or previous adjustable-interest loans that have since climbed to higher rates. P2P platforms help achieve these positive results as well.

The multi-faceted advantages of online crowdfunding also means that P2P caters to a wide array of investor interests while also serving unique borrower segments. Figure 5 displays three different types of P2P platforms according to the cost and profit structure best suited to achieve platforms' long-term goals. The platforms

Figure 4: Loan Use of LC Borrowers



Source: Lendingclub.com

Figure 5: Types of P2P Platforms

	Non-profit Platforms	Socially Responsible Platforms	Commercial Platforms
Platform Type	Lenders on these platforms actively seek to reach communities that are not fully included in the banking system. The organizations promote formal lending to borrowers who might otherwise turn toward loan sharks or not get loans at all. In theory, the new rates are better for borrowers, but real benefits are often debated. Lending can be less personal than expected, and many of these platforms still rely on volunteer work, donations and/or grants to operate.	These P2P companies are driven by an opportunity to earn profits but are also formed with a clear mission to help support, aid or develop specific communities or geographic regions. Often social enterprises, these businesses try to meet social objectives but minimally also aim to expand operations through profit-making and may also be concerned with producing profits for shareholders.	Commercial platforms offer widespread benefits to a general public and generally do not target specific groups of borrowers for social aims, or these aims are not woven into the business's core mission (as distinguished from a company's values). These companies are not limited by serving particular communities, and typically have more resources at their disposal. P2P's most famous examples are of this type, due to their size, influence, broad appeal and capability.
Examples	KIVA loans that change lives, milaap, united prosperity, zidisha	myC4, Upstart, RAINFIN, 陆金所 Lufax.com, MicroWorld.org PlaNet Finance Group, Rate%Setter, Funding Circle, babyloan.org micro credits, great stories, PROSPER, 宜信 CreditEase, fairplace, STREET SHARES, Prodigy Finance, LendingClub, Zopa	
	Philanthropic Lending		Commercial Lending

span an impressive range of operational models, investor requirements, and social objectives, with the incentive mechanism for the investors and platform being just one axis on which to make comparisons.

1.4 The Dawn and Decade of P2P Lending

Why do P2P loans mark an important departure from what we already have? In particular, they help address some of the long-standing problems of traditional lending channels.

Informal lending – lending between friends, family or local acquaintances who do not formally offer services to the general public – can work well but mainly benefits those with an advantaged background, pedigree or social ties. Moreover, risks get concentrated, and the system is too inefficient to scale.

Banks and other financial intermediaries have traditionally been part of the solution; they match the crediting needs of borrowers with the slack resources of savers while simultaneously evaluating borrowers objectively and often, with stronger information. By doing so, they help extend financial services to many new borrowers while often building long-term customer relationships.

Be as it may, today's clients are often dissatisfied with banks, either for their time-consuming services or interest rates, some combination of the two or simply because they don't meet banks' criteria. P2P businesses feed into this critical view of big lending institutions by often aggressively marketing themselves as a way to beat banks.

More importantly, the innovation's widespread

appeal and recent success stem from how it leverages technology and online interconnectivity. Bridging investors and borrowers directly through online marketplaces has created a new, inclusive and efficient credit option. And by offering convenience, transparency, accessibility and objectivity to clients, P2P combines positive qualities of both informal lending and traditional banking – all within reach of one's fingertips. Whether it is consolidating other high-interest debt, paying for school, or getting working capital for a business, P2P is promising a better, cheaper experience.

P2P's march to success has been steep. Technological advances within finance are hard earned and especially so for P2P companies. First off, P2P is trying to change the entire investor-borrower paradigm. To do so requires an already difficult move to online technology within financial services. (Those with money to invest tend to skew older and are therefore sometimes slower to adopt an online interface). P2P has also had to grow organically and almost entirely outside the scope of banks, which dominate the finance industry. Early on, this meant that fledgling P2P businesses had to navigate the complexities of underwriting borrowers in addition to overseeing every other part of the lending process – not to mention operating as a technology business as well.

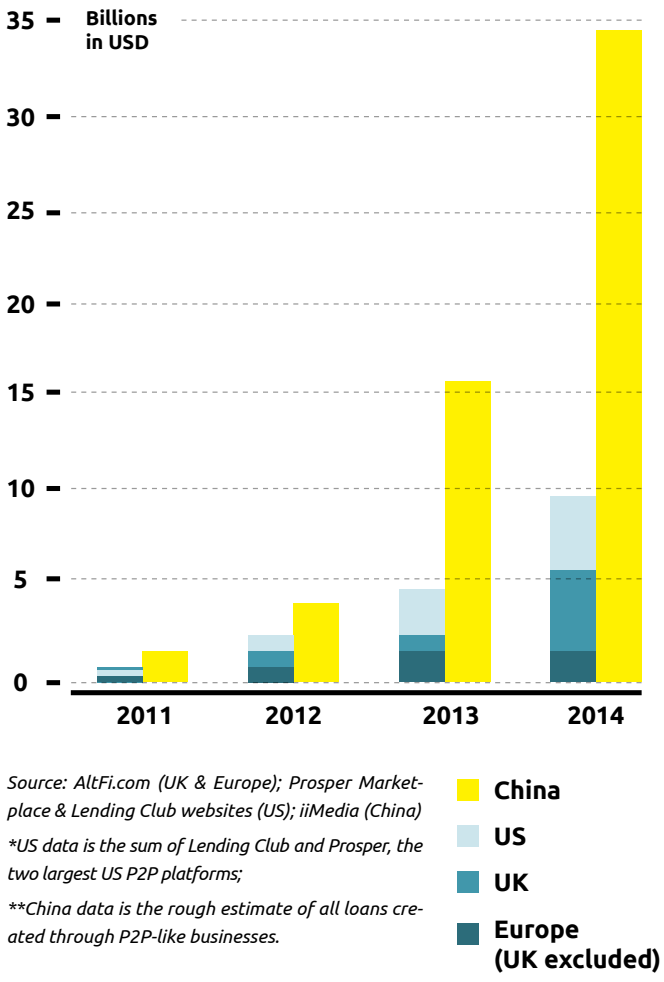
Additionally, P2P is unlike Amazon, Netflix, Uber, and AirBnB, which disrupted their respective industries by moving processes online. To try these services, one might only need to agree to a one-time purchase. However, P2P lending requires the long-term commitment and financial risk that come with multi-month, if not multi-year, loans. Without a robust loan performance history or brand-name credibility, attracting early participants required a leap of faith most were not willing to make.

Interestingly, however, the global financial crisis did not snuff out P2P's early entrants, despite these obstacles. On the contrary, it was the spark needed to ignite the industry's growth. Waves made by the financial crisis forced regulators to roll out strict measures against banks that curbed loan making. The credit-tight environments prevented many borderline loan applicants from receiving loans. Monetary policy depressed interest rates for savers to all-time lows, where they have remained in the US and most European countries. These changes only further pushed borrowers and investors, already fed up with banks over their role in the crisis, toward using new financial channels. High-income consumers stuck with high interest rate credit card debt in the US began discovering they could refinance with cheaper P2P loans. Regulatory grey areas gave the P2P platforms space to innovate and grow. Shortly thereafter, P2P started to emerge in other countries, but notably in China, where a need for financial services at every level fueled explosive growth.

Today, P2P companies have been aggressively investing in marketing, better technology, and technical expertise, such as professionals with credit scoring and technology backgrounds. Feeding into this acceleration in P2P's development are improved credit evaluation techniques and new rounds of equity funding. In the first ever P2P company IPO, Lending Club raised $870 million in its December 2014 IPO that valued it at almost $9 billion. [1]

While big players come into the public eye, new P2P companies continue to crop up. Ongoing specialization and new complementary or back-office service providers are creating niches in the space. In 2014, the industry experienced more than 100% year-on-year growth in the US, the UK and China, the three largest P2P markets. Reports by both *Foundation and Capital* and *Research and Markets* suggest total P2P loan origination will swell to become a $1 trillion industry by 2025. The future of peer-to-peer lending appears strong.

Figure 6: Global Growth in P2P Industry (Total Loan Value Originated)



Source: AltFi.com (UK & Europe); Prosper Marketplace & Lending Club websites (US); iiMedia (China)

**US data is the sum of Lending Club and Prosper, the two largest US P2P platforms;*

***China data is the rough estimate of all loans created through P2P-like businesses.*

[1] Forbes

02/ THREE IMPACTS OF P2P LENDING

2.1 CREATING A UNIQUE ASSET CLASS

P2P loans are an entirely unique asset class for investors to consider. Unlike equity, securities, treasuries, bonds, or mutual funds, P2P loans allow investors to *directly* own many pieces of loans from many distinct borrowers. Since the overall level of risk will vary from platform to platform and from portfolio to portfolio, investors have many options too. They can build comparatively low risk, diversified loan portfolios or apply analytic tools to select high-risk, high-reward loans in hope of outperforming the expected averages. In short, P2P loan assets are flexible and thus complimentary to a wide range of other existing investment products and investor interests.

An Imperfect Alternative to Bank Deposits

On the surface, P2P loans are also a tempting alternative to risk-free bank deposits, but as critics suggest, savers ought to be careful. Despite higher net returns, there are uniformly more risks associated with P2P lending than federally insured bank accounts making the comparison fall flat.

Deposit accounts (savings, money market deposits, certificates of deposit) have all featured depressed interest payouts in recent years. Savings accounts and CD's typically pay less than 1% and 3%, respectively, in most stable economies. In search of higher returns, savers and investors have been drawn to P2P platforms for loans offering 5-7%; for those with a greater tolerance for risk, less safe P2P loans will even offer returns above 10%, at least before adjusting for defaults.

However, according to a report on crowdfunding published by the UK's Financial Conduct Authority (FCA), P2P websites often fail to fairly advertise their services, publicize accurate return information or provide detailed explanation of the risks affiliated with the returns.[2] Savers are therefore of particular concern because their preference for P2P lending may reflect misinformation about P2P assets. Important considerations should include the following:

Credit risk – Because traditional banks assume responsibility to safeguard money for savers, laws that require reserve sums have been established to protect against potential losses. Investors on P2P platforms, on the other hand, often bear credit risks directly since their investments on P2P platforms are not eligible for insurance by governments. Consequently, there are uncertainties about how investors can stay protected; online lending draws concern over fraudulent online loan requests and what would happen should platforms fail.

Collection risk – In the case of default, will borrowers continue to honor the existing contracts with lenders? Who will facilitate collection of delinquent loans? Among P2P platforms that have failed, only a handful continued to service investors; for example, Squirrl.com in the UK facilitated prepayments to investors before winding down completely and MicroPlace by eBay in the US will continue to service investors until all existing investments mature or are redeemed. By comparison, the abrupt closing of Quackle left investors to suffer 100% losses.

Liquidity risk – Deposits in banks are readily accessible for withdrawals. Exits are not as easy for the investments on P2P platforms. Theoretically, once investors enter into contracts with borrowers to lend money, they are supposed to hold the investment until maturity. If investors require an earlier exit, the only solution is to sell the claims to other investors in a secondary market. The secondary market for P2P lending is quickly expanding but currently remains underdeveloped.

Impacts of P2P

- *Creates a new asset class*
  - *a. Provides a unique risk-return tradeoff for investors;*
  - *b. Offers borrowers loans at interest rates lower than the next best alternative;*
  - *c. Simplifies and improves the experience of procuring loans;*
- *Improves underwriting accuracy by utilizing new sources of big, alternative data*
- *Reaches traditionally under-served or "underbanked" borrowers*

[2] FCA Consultation Paper on Crowdfunding

Privacy risk – Although privacy risks are more centered on the borrowers who disclose personal information in order to secure loans, investors are also exposed to privacy risks due to data breaches, unauthorized access, and identity theft. Given the online nature of P2P lending business, many people's information could be stolen in one incident.

Efforts to Minimize Risks

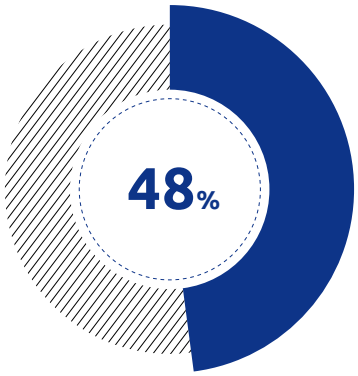
To reassure investors and satisfy regulatory bodies, platforms often go to great lengths to protect investors. Common examples include the following:

Enhancement of risk management practices – Risk management involves credit risk assessment, portfolio monitoring and debt collection intervention. Because some P2P lending targets peoples who are not necessarily seen as credible in traditional contexts, a rigorous underwriting process is crucial. First a stringent borrower vetting procedure is needed. (In 2010, Lending Club was screening out approximately 87% of applicants at this initial review stage[3]). Applications get personal records crosschecked, and platforms contact employers to verify stated income.

Full risk disclosure caps – Some P2P platforms implement measures to allow and encourage investors to make informed decisions based on their own risk versus return preferences. Better P2P platforms clearly establish that they are not responsible for bad loans – this is not always made explicitly clear, intentionally or otherwise. Further, platforms often explain the creditworthiness assessment conducted, including other forms of risk mitigation, and disclose as much historical and forecasted default rates as possible.

Maintaining a well-functioning secondary market – To provide liquidity, some platforms have partnered with secondary market providers or even established a secondary market where investors can trade claims to loans or "notes" for early exits. For example, RateSetter in the UK allows contracts to be sold mid-term to other investors for a fee of 0.25%. Lending Club partners with Folio to do the same. Of the investors funding small businesses on the UK P2P platform Funding Circle, many have already tried a secondary market.

Figure 7: Percentage Of Funding Circle Investors Who Have Used A Secondary P2P Market



Source: Nesta

Establishing a provision fund – Some platforms have created a provision fund, also known as a contingency or reserve fund. First pioneered by Ratesetter, the fund is typically pooled money accumulated by charging a separate one-time fee to borrowers according to their assigned risk grade; this capital in the fund is then held separately from the platform's assets. When a default occurs, the platform will make a claim to the provision fund and use the money to pay back investors; then a third party is deployed to collect repayment which can be used to help reimburse the contingency fund if recovered.

Platforms typically set a target size of the fund such that the ratio of contingency fund to the total loan origination should be greater than historical and/or estimated loan default ratio. A coverage ratio, which is calculated as the amount in the contingency fund divided by the estimated defaulted loan, could be used to gauge how well investors might be covered in case of defaults.

Sorry, No Guarantees

A provision fund is a type of service to investors; it should not be considered a guarantee (the exception being in China, where P2P companies generally must guarantee repayment to stay competitive). Most platforms with provision funds have been able to repay 100% of defaulted loans thus far by growing provision funds at a rate faster than expected defaults. In exchange for the service, investors typically get lower starting interest rates.

In the UK, most platforms set their target size of provision fund as 2% of loan origination; in relation to an industry level default rate of 1.5% , this seems sufficient to cover expected losses. Nevertheless, transparency of these provision funds is of the utmost importance, since new P2P investors may misinterpret the fund as a guarantee and experienced investors will want to evaluate long-term risk.

[3] Source: HBS Lending Club Case Study

Securing Loans – A more direct form of prevention, several P2P companies have begun to offer secured or partially secured loans. Assetz Capital, a UK P2P company that has lent out £50M, only offers P2P loans secured by assets worth more than the loan. Others such as China's Fu'erdai (富二贷), which offers housing and automobile loans, also chooses to offer secure loans.

Loan Choice: Opportunity or Illusion?

In addition to these measures, some platforms may choose to protect investors by requiring diversification of investment. Others brand themselves as putting the investor in control.

The best-known P2P model offers assets to investors and loans to borrowers in a minimalist fashion. Lending Club will encourage a diversified portfolio of smaller loan sizes but will leave actual selection up to the investor, implicitly allowing the lenders to take part in the underwriting process. By doing so, P2P companies neatly avoid the legal and moral arguments surrounding defaults by pointing out that it is the investor who chooses the loans, not the platform.

Of course, platforms still run the risk of irking regulators who worry about ignorant or inexperienced investors swayed by convincing but misleading marketing. Some conservative platforms choose to take on more, albeit still limited, responsibility. Ratesetter is of this "hands-on" variety. Aptly named, the platform has lenders set the return-risk level they would like to lend at, and then Ratesetter offers a pre-selected pool of many P2P loan pieces. An investor will have to select this cross-sectional package of many tiny loans if he or she wants to lend at the specified interest rate.

Generally speaking, institutional investors favor the platforms that offer more independent decision-making. The extra control over loan-selection allows for outside analytics and models to be used. Institutions try to beat the platform's expected performance by picking higher risk loans that the institution thinks are safer and therefore more likely to make repayments than the listing suggests.

Smaller investors often describe this type of marketplace in terms of being disadvantaged. As the thinking goes, if institutions pick the best, strongest-performing loans, then only worse-performing loans go to the little guy. Many of these P2P lenders ultimately look elsewhere.

P2P's more passive retail investors often prefer the direct guidance and security of platforms with built-in investment requirements. These loan products appeal to those who want to diversify their investments away from just mutual funds and see P2P loans as debt markets' investment equivalent.

The diversity in options is ultimately to everyone's advantage.

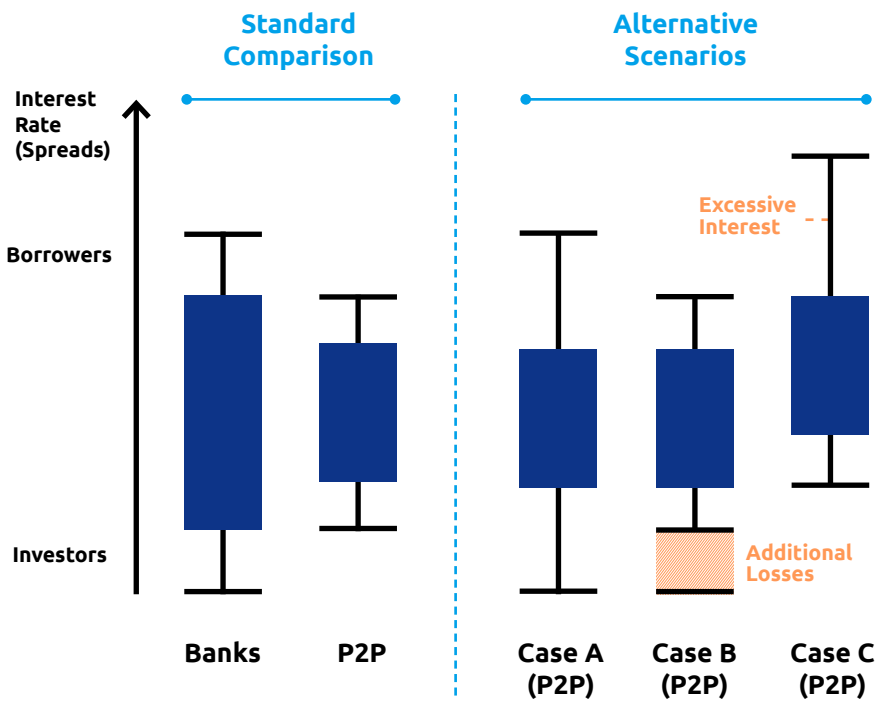
Balancing Returns with Responsibility

Theoretically, since platforms receive commissions rather than directly profit from a spread, the system encourages platforms to pass on benefits to borrowers and/or investors. Online platforms typically already have lower cost of operations, so by incorporating better analytical tools for credit evaluation, they can further improve returns for investors while lowering interest rates. Better rates draw in more clients from whom more commissions can be collected. Platform and client interests are aligned.

Practically speaking though, this differs little from other businesses which also rely on reputation and satisfied clients to grow. And in fact, some people worry just the opposite, that the P2P business model is naturally prone to reckless lending. At present, there is more interest in P2P from investors than borrowers, in terms of capital amount, for all the well-established platforms. For the P2P businesses this means that growth is mainly constrained by the rate at which borrowers can be sourced (and why marketing costs of platforms are so high). For this reason, the business development strategy of large P2P companies focuses much more on acquiring borrowers than lenders.

This dynamic presents a problem. As P2P companies try to reach ambitious growth targets and compete for market-share, more and more risky borrowers may get picked up. In fact, Lending Club and Prosper have

Figure 8: Ways That The P2P Model Can Fail Borrowers & Investors



openly discussed plans to gradually include higher risk borrowers. While new credit evaluation techniques may allow for some new borderline borrowers to receive loans, the present situation does create a potential conflict of interest between platforms and lenders. Figure 8 highlights several of the other ways the system can go awry.

Case A: P2P Platform Increases Profits – P2P companies may increase commissions once they have scaled and established a sufficient client base. In this example, costs to investors and borrowers have been raised so that the benefits of the P2P model go to the company in the form of more profits.

Case B: Lower than Expected Returns to Investors – Lenders receive higher interest on their P2P investments only if defaults occur at or lower than the expected level. In the event that the rate of default increases unexpectedly, realized returns could be much lower than the historic average returns advertised.

Case C: Excessive Interest Rates to Borrowers – Platforms that choose to offer loans to high-risk borrowers in return for exorbitantly high interest payments may be exploiting clients to increase profits. This is especially worrisome in cases where clients do not have access to alternative credit sources or are not provided with enough information or resources to make sound financial decisions.

Ultimately, each P2P company still has a responsibility to proactively protect borrowers. For example, a P2P platform that values statistical outcomes alone might charge as high an interest rate as profitably possible, while ignoring specific borrowers' ability to repay. The larger interest payments might outweigh the higher percentage of defaults, but the practice places profit above the well-being of borrowers, in turn causing greater levels of over-indebtedness. The problem is exacerbated in cases where clients are not adequately equipped with information about their loans or fail to be trained in fundamental money management.

2.2 ADVANCING CREDIT EVALUATION

Ask investors what makes P2P lending so attractive and one answer rings louder than the rest: credit evaluation. A quick review of P2P company websites shows that today's frontrunners tout evaluation or risk management practices better than that of traditional counterparts. It is a main selling point of most platforms and arguably one of their more valuable assets.

Over the course of the industry's development, P2P companies have experimented and evolved by learning underwriting methods from banks and credit scoring companies and then supplementing parts of the model with new data. The trend continues today with a new, competitive bunch of P2P and other alternative finance startups competing to make new breakthroughs in credit evaluation.

If the new algorithms used by these companies are as effective as advertised, then P2P is helping disrupt finance in yet another way. Traditional underwriting businesses may soon need to learn from P2P.

The Hunt for Digital Data

Credit evaluation is an art drawn with numbers. Who deserves a loan? How big should the loan be? At what interest rate? The answers to these questions are teased out through the banking edict of "knowing your client." To do this, banks have primarily relied on credit scores and their own data. Consumer credit history is recorded by public or private credit bureaus, then pulled and re-worked by the major credit scoring companies (FICO, Experian, TranUnion, Equifax) and finally sold to banks, who often further refine their underwriting with their own in-house analytics teams. When a bank reviews a borrower's loan application, they see these scores but also use the private information gathered from accounts and previous transactions with their clients. Because this system still holds the greatest predictive power for repayment likelihood, banks have held their edge as the premier lending institutions.

This is beginning to change, however. Increasingly, "knowing your client" means accessing troves of big, digital data collected through mobile apps, online websites, and client purchase and payment histories. With 90% of the world's data created in the last two years alone[6], new lenders feel at less of a disadvantage to banks and see this alternative data at their way to assess clients without ever having had a prior relationship with them. As a result, various players are scrambling to access alternative data with the aim of underwriting borrowers.

P2P to Data: Specializing in Credit Evaluation

P2P companies represent only a small part of a much greater movement toward big data analysis. Outside of finance, marketing efforts

Alternative Data

Alternative data can be thought of as data collected from sources such as social networks, mobile phone records, utility bills, tax returns, retail and wholesale transactions, and psychometrics – measures of personality traits (often collected through surveys) that are correlated with repayment, like trustworthiness or conscientiousness. Of special importance are people's "online footprints," or tracked history of online activity, because this data is cheaply collected, plentiful, and already in a digital format for analysis.

[6] EFL Global Paper

are pursuing better ways to connect target consumers with their materials; governments are seeking more effective policy decisions; researchers want to measure every kind of change. Data helps achieve these aims.

P2P companies aggressively pursue alternative data as a component of their credit evaluations too. Most platforms are claiming to have their own home-grown, innovative methods of underwriting borrowers. In reality, credit scores still hold much more predictive power than what big data can currently tell us.

Most P2P companies are not trying to supplant credit scores' role in the underwriting process, however. Rather, they rely on credit histories – when they are available – in the same way that banks do. What P2P companies want investors to believe is that their use of big data is matching if not exceeding what banks can do with their private client data.

All this importance surrounding big data has led some businesses to specialize in data for purposes of building powerful, new algorithms that can be sold to P2P or online balance sheet lenders. ZestFinance in the US claims that the credit evaluation algorithms they build are a "40% improvement over the current best-in-class industry score."[7] Another company, INSIKT, creates a cloud-based tool that can be sold to P2P companies and retail brands looking to offer lending solutions like risk model development, loan valuation and stress testing. Another, Lenddo started out in 2011 as an online lending company using big data and social media information to underwrite unbanked borrowers in the Philippines and Colombia. After showing several years of positive loan performance, the business has transitioned to selling its framework and data to P2P platforms and other lenders.

Big Data Solutions & "Emerging Prime Markets"

In the cases where credit bureau information, and therefore, credit scores, are unavailable, P2P companies have the advantage of also being able to leverage big data to reach places banks cannot. As such, P2P companies are trying to beat banks on multiple levels – they not only want to win over traditional bank clients with better rates, but also aim to capture creditworthy borrowers excluded by banks.

These customers that banks do not want (or at least, not cheaply) present an opportunity for online lenders. The largest P2P companies have built reputations on serving safer borrowers are now increasingly looking to capture these borderline client groups, described as "emerging prime markets." Big data helps P2P companies to target this segment of underserved borrowers since short credit histories or borderline credit scores alone can sometimes incorrectly suggest an inability to repay loans.

This stems from an idea that the traditional credit scoring are at best an imprecise tool to measure credibility. Critically, P2P companies claim that many borrowers with lower credit scores are in fact "prime," a designation given to borrowers considered to be low risk (and generally above a 640 FICO score in the US).[8]

Those who deserve credit, but do not have an adequate credit history to receive traditional loans, may now be able to prove creditworthiness through other measures. Platform Upstart serves as a good example. It targets recent graduates who have not built credit histories and evaluates them in the context of their school, major and test scores – factors not always measured or weighed as heavily in traditional credit underwriting.

Questioning P2P's Underwriting Innovation

News outlets often reproduce information provided on P2P company websites about their new credit evaluation techniques. They get depicted as innovators, disruptors, and pioneers. Most seem to take it at face value, letting P2P industry growth speak for itself. P2P companies' ability to accurately underwrite borrowers using big and alternative data still needs to be studied carefully, however.

Analyzing this data is not an easy task. The vast majority of the data is junk or "noise" that has no correlation with creditworthiness. Sorting it out takes time and expertise – which is in short supply. Data management is incredibly complex, and the data scientists needed for the job are currently too few and in high demand.

In light of these difficulties and without clear evidence of effective practices, many still see big data as being simply messy and even risky. Using this kind of analysis to outperform banks in underwriting borrowers is not as easy as P2P companies might like to suggest.

Why? First, P2P lending has grown mainly during a period of relatively stable economic recovery, and P2P companies that did experience the economic downturn saw greater loan losses. For instance, Zopa claims to have one of the best loan performances among all P2P with post-crisis (since 2010) bad debt at only 0.25%; Zopa's default rate in 2008 was 5.72% by comparison.[9] For Prosper, the second biggest P2P platform in the US currently, the 2008-2010 loan loss reached nearly 30% according to Lendstats, a website which tracks past performance of the company[10].

On the other hand, the choice to reflect post-crisis figures, while misleading, is also understandable. Improvements in credit evaluation have since been made; the standards for borrower quality were increased; and the number of loans has dramatically increased to wash out the statistical relevance of early loan-making.

Still, observers are curious how the newer and refined P2P platforms will fare in the face of another decline. It typically takes two

[7] Zest Finance Website
[8] Home Buying Institute
[9] Zopa Website
[10] Lendstats.com

years before a loan's performance can be fully understood. (On a 3-year loan, defaults are most likely in the first two years). So for the majority of firms which choose to measure performance from 2010, complete loan performance data is limited to just a couple of years. The oldest P2P firms rely on this sliver of strong performance to bring in new investors. Newer platforms do not even have this luxury, instead riding the wave of enthusiasm and confidence in P2P and similar online finance companies. In the end, P2P still lacks a historically-proven track record.

Second, if new data inputs are being used, then they may only offer temporal advantages that do not hold over a longer period of time. Standard examples of data might come from cell phone use, web browsing behavior, and the amount of time spent on the P2P platform website. On the other hand, much of the social media and other less predictable data draw doubt from the data-collecting community. For instance, P2P company OnDeck uses data from Yelp![11], an online restaurant reviewing service, as one piece of a complex algorithm to evaluate risk. In theory, posts of a certain length, number, or word character average, may have a meaningful correlation with credibility, but how and why is not so well understood and might easily change if market conditions were to change.

Last, the story behind why traditional institutions have not used big data is not entirely sound. That large banks are slow to adopt online technology makes sense. The brick-and-mortar institution and credit officer approach is hard to change quickly. Banks still compete with one another, and in-person services are still in high demand – even among Lending Club's borrowers.[12]

However, it has always been in banks' interests to pursue cutting edge credit evaluation techniques. P2P has taken full advantage of negative attitudes toward banks and has easily convinced clients that banks are too sluggish to innovate quickly. It is unwise to dismiss banking's strength altogether, though. Efficient or not, banks are quite proactive when it comes to improving their credit evaluation practices, and the credit scoring companies, which focus their business on just that, still approach most big data with skepticism. Perhaps for good reason. Big data analysis is making progress, but more time is needed before its effectiveness will be fully understood.

Privacy & Discrimination

Data is a rapidly growing force in our lives, but with the immense efficiencies and conveniences of it come serious concerns over privacy. Regulators in the US have held a permissive stance toward online lenders with respect to their data use so far. In an effort to allow for innovation in this area, the Consumer Financial Protection Bureau is waiting to see just how the industry develops[13].

One argument supporting big data use is that it helps create objective criteria for fairly and accurately evaluating loan candidates. Data use by P2P companies already has some looking at anti-discrimination fair lending laws though. The concern is that data could easily be used to turn away applicants with health problems or based on characteristics prohibited by the Equal Credit Opportunity Act (ECOA), like sex, race, and religion. Data put into a biased framework would only help lenders to skirt laws under the guise of objectivity. Further, this problem would only be exacerbated in countries with weaker data use and consumer financial protection laws.

2.3 EXTENDING FINANCIAL INCLUSION

In the world today, there are still approximately 2.5 billion adults who either do not use or do not have access to formal financial services[14]. Moreover, public credit bureaus contain entries on less than 10% of the adult population in middle and low-income countries[15]. The credit needs of people unserved go unmet by traditional banks for a host of reasons: tight credit policies create shortages of available capital; some borrowers have incomplete credit histories; in other instances, loan making to unserved populations is not as lucrative as serving more traditional clients or simply unprofitable. P2P lending aims, at least in part, to meet these needs.

P2P in the West has turned to focus on reaching the "emerging prime markets" as just discussed. However, the lightweight structure and lower starting capital costs have allowed P2P to spread to countries where the population of underserved groups is far greater. Consequently, P2P is extending the possibilities for financial inclusion by mobilizing available money to be invested into areas and people that need it.

Unlike the microfinance movement though, P2P's growth lacks a consistent underlying social cause. Rather, most platforms only suggest that they are filling a need left by banks. In other words, who gets served, more often than not, is strictly business. The profitable P2P platforms are doing a good job at targeting large swaths of borrowers and existing

"Digital" Financial Inclusion

Accion's Center for Financial Inclusion defines financial inclusion as "access to a full suite of quality financial services, provided at affordable prices, in a convenient manner, with respect and dignity." Digital financial inclusion therefore helps bring people into the fold of formal financial services through the use of online or digital technologies.

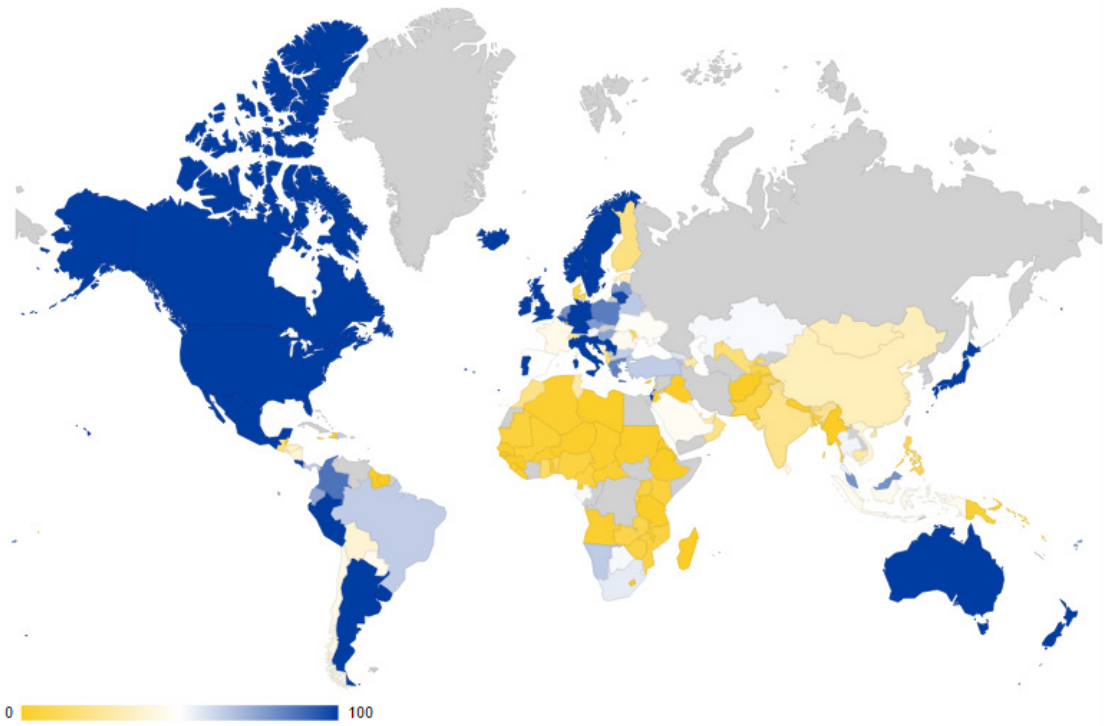
[11] American Banker, "Are Online Lending Platforms Beating Banks at Big Data"
[12] Cognizant, Marketplace Lending: A Maturing Market New Partner Models, Business Opportunities
[13] New York Times, "Loans That Avoid Banks? Maybe Not"
[14] McKinsey & Company, Half the World is Unbanked
[15] World Bank

P2P business models show an impressive range of social initiatives. With so much being offered, platforms may appeal either to more socially minded lenders or to those looking for practical investments.

Creative Partnerships: the MFI-P2P Model

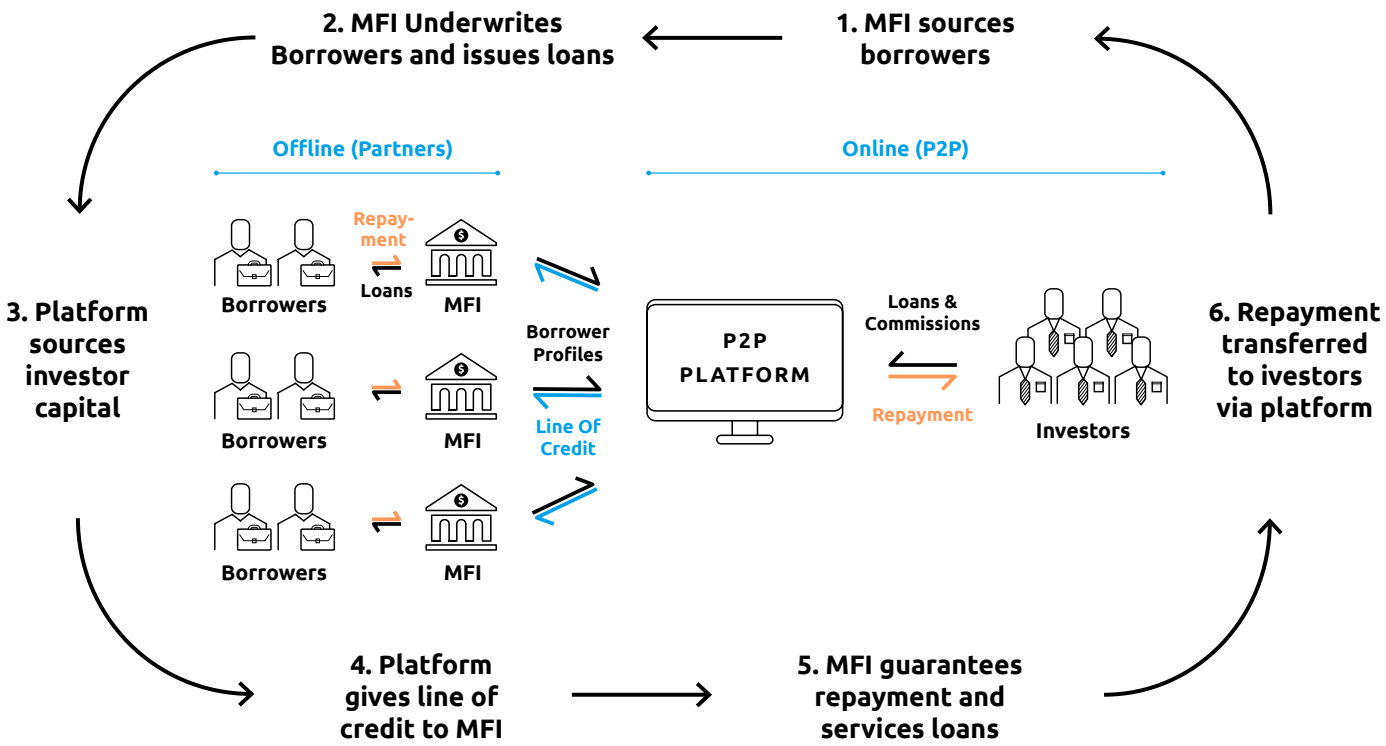
In the most underserved areas, a lack of standard credit ratings and big data has meant that local, on-the-ground expertise is still needed. Here, a complete online model is not yet within grasp. This has not stopped P2P from finding a role in the process, however. Instead of a one-stop shop that services all participants, alternative P2P models facilitate

Figure 9: Percentage Coverage by Credit Bureaus



**In cases where both public and private bureaus exist in a country, the larger percentage of coverage is used.*
Source: World Bank

Figure 10: MFI-P2P Model



What is "True" P2P?

Many within the P2P industry firmly deny that the MFI-P2P matching process is P2P and believe another label should be used. Others, however, still consider P2P to include a wide range of platform and model types. We choose to make the distinction between direct P2P lending (Lending Club, Prosper) and indirect P2P lending (MFI-P2P model) in our report but include both to represent the full range of models that consistently identify as P2P.

indirect P2P lending by only sourcing investor capital through online platforms and leaving borrower acquisition to on-the-ground lending institutions.

The most common arrangement is a partnership between P2P platforms and microfinance institutions (MFIs). Under this model, MFIs operate in their geographic regions of expertise, acquiring borrowers and implementing their own credit evaluation as independent businesses. On the funding side, there are P2P companies. By offering appealing returns to investors, the platforms source and organize investment, then transfer funds to the MFI as a credit line. While P2P funding typically does not exceed 10% of the MFIs total lending capital, one platform may have partnerships with a dozen or more MFIs.

P2P companies screen MFIs and partner only with those with strong practices to limit risk for their online investors. This way the fates of the partnering businesses becomes intertwined. The symbiotic relationship pressures the MFIs to meet higher standards in order to secure the credit line. Of course, even with careful screenings of potential partners and a limited secondary evaluation by P2P lending companies, the primary credit evaluation practices performed by MFIs are ultimately outside of the control of the platforms. To compensate for this, the risk of defaults and loan collection remain with the MFI in most cases. As long as the MFI remains solvent, the P2P investor is usually protected with repayment guarantees.

Philanthropic Lending & Community Building

Reaching the hardest to reach or "last-mile" clients often requires more than just commercial objectives. Fortunately, a number of companies have defined a space for low-interest P2P lending and community-oriented projects. In an effort to expand financial services through P2P platforms, several different models have emerged. Some interesting examples include…

Kiva – The most well-known non-profit P2P platform, Kiva operates in 85 countries with 290 "field partners" or MFIs, operating much like the for-profit MFI-P2P model. The key difference is that lenders lend at 0% interest to specific profiles on the Kiva website; (however, the capital of which is still sent to the MFI, not the actual borrower. The MFI then directly lends at their usual rates). The system aims to alleviate poverty via supporting grassroots microfinance in the hardest to reach places while bringing awareness to lenders. Kiva has mobilized an impressive $685M[16] and is the industry leader for indirect P2P lending to underbanked micro-entrepreneurs.

Zidisha – Another non-profit, Zidisha distinguishes itself as being the first direct community for philanthropic microlending. It removes MFIs from the process to truly disintermediate and bring the full cost savings of low-interest online lending to impoverished borrowers. Zidisha does this by operating the full P2P model, performing basic underwriting and sourcing borrowers through volunteers. Lenders bid to fund pieces of loans at interest rates between 0-15% but in accordance to specific conditions outlined by the borrower. (The interest is designed to offset high rates of loan loss rather than for profit). Online interactions between parties are reportedly common. Roughly $2.5M in loans have gone to almost 10,000 projects in 9 countries at an impressive average interest rate of 5.5% through Zidisha. (Kiva is now piloting a project, called "Kiva Zip," which works similarly).

United Prosperity (UP) – The non-profit platform operates in Sri Lanka. Like Kiva, UP partners with MFIs to offer funding solutions and reach more underbanked clients. The model moves one step further away from full P2P in that the 0% interest capital raised on UP's platform, while associated with online profiles, serve as guarantees at local banks, not actual loans. The banks are then willing to make loans to the MFIs. Ultimately, the new relationship between local bank and MFI encourages capacity building at the local level. Since its 2009 launch to May 2013, UP has facilitated more than $280,000 in loans to 1300 families.

SoFi & Prodigy – While not direct P2P lending, the commercial platforms Prodigy Finance in the UK and SoFi in California operate by matching groups of people in a similar manner. The marketplaces help international and top US MBA candidates, respectively, receive educational loans by appealing to alumni and socially-minded funders. SoFi even provides their MBA borrowers free career advice and placement services upon graduation, as needed.

Milaap – The non-profit P2P company operates in India and uses the MFI-P2P model for reaching last-mile clients. Unlike other examples, Milaap facilitates loans to projects in six core areas in development: water, sanitation, enterprise development, vocational training, energy, and education. The platform has originated $3.41M in loans and improved more than 100,000 lives by their estimates because of the community level impact of these projects.

StreetShares – The US-based P2P company features a Veterans Business Campaign wherein it helps veteran-owned small businesses receive loans via their veteran and veteran group networks. The "affinity based lending" – lending between people of a similar group, experience, or shared community – allows investors to both receive a profit and also feel positive supporting their community. StreetShares benefits by having their targeted communities proactively spread the word of the service, minimizing steep marketing costs.

[16] Kiva website

03 / SCALING UP & REGULATION

The P2P market looks poised for rapid growth. It is estimated that the global P2P lending market will grow to a trillion dollars by 2025[17] [18]. Such expansive growth brings new questions. How will institutional money impact the industry? What will be the relationship of P2P platforms and big banks? As P2P becomes more intertwined with the traditional financial system, what additional risks will it carry?

3.1 INSTITUTIONAL MONEY

Strong returns, diversification of risk, and the ability to invest into a new asset with fixed returns has brought in big institutional money. Since 2012, the proportion of hedge funds and asset managers purchasing P2P loans has grown quickly, as reflected by the dramatic increase in whole loans being purchased. According to one estimate, institutions (asset managers, hedge funds, insurance companies, pension funds, and banks) invest in 66% of all Prosper Marketplace's loan and 60% of Lending Club's loans[19]. Others already put the figure above 80%.[20]

The scale of institutional money is far greater than that of individuals, allowing it to be deployed more quickly and efficiently than that of retail investors. This helps P2P companies reduce the costly and tedious process of originating thousands of loans to different individuals. Also, institutional investors have advanced internal infrastructure, including internal risk evaluation (at the individual loan level, as well as at the portfolio level), analytics, and market research. This gives the institutions an edge for selecting better-performing loans, and doing so faster.

Institutional investor capital is necessary for the growth of the industry, but the flood of capital has long-term P2P retail investors frustrated. On a technical level, retail investors complain that loans posted on larger online marketplaces are now harder to invest in because of excess demand from institutions. More broadly, retail investors worry that institutions' preference for riskier, higher-yield note classes and concentrated influence could push the industry into risky activities or crowd out smaller investors.

Choosing between fundamental P2P ideals and practical growth strategies can be difficult for platforms. Some P2P companies minimize institutional investment, like Zopa, and hold onto the belief that P2P is much more than a product – it is also a channel for individuals to lend to one another. Others like Prosper and Lending Club see the institutional money as a way to scale and reach more borrowers. By Lending Club's estimates, there is about $390 billion in credit card debt that can be refinanced through P2P loans[21]. Finding the capital to fund these new clients will surely require institutional investors' capital.

Maintaining a balance between retail investors, high net wealth investors and institutional investors will still likely prove to be the strongest long-term strategy however. The problem with institutional money is that it is flighty and goes whichever direction offers the most competitive rates. Having other, smaller investors can help keep investment stable.

3.2 LOOKS LIKE A BANK, ACTS LIKE A BANK

Insomuch that P2P lending operates in a space in which banks have not been as successful, it remains unique. To continue with the "disintermediation" model, P2P lenders must avoid the weighty operational structures of traditional banks. Additionally, there are still certain financial functions that P2P platforms cannot engage in; for instance,

Orchard Platform

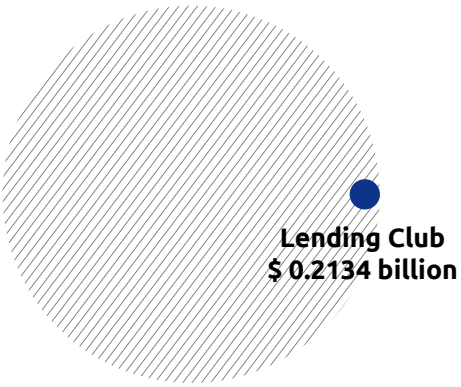
Founded in New York City in 2013, Orchard Platform offers management systems and analytic solutions in the P2P industry by operating in the space between institutional investors and P2P platforms. The institutional clients sign a contract with the P2P platform to buy a set amount of loans each month. They then use Orchard's tools and data as a way to conduct their own analysis and digitally store their own models for loan selection.

As is the case with partnerships, new specialized intermediaries, like Orchard, can help streamline P2P's rapid growth, by breaking up the value chain and providing needed expertise to discrete areas. This also helps build trust in the system which could later suffer if P2P originators are kept in the position of representing the competing interests of borrowers, lenders and the platform.

[17] Foundation & Capital
[18] Research and Markets
[19] Orchard Platform website, Hedge Funds Securitization and Leverage Change P2P Game
[20] New York Times, "Loans That Avoid Banks? Maybe Not"
[21] Lending Club's 2014 4th quarter presentation

Figure 11: Comparison of Revenue

Total Annual Revenue 2014



CBB* of Bank of America
$ 29.9 billion

Source: Bank of America, Lending Club
**CBB - Customer & Business Banking*

P2P Gets a Nod from UK Government

In the UK, coveted ISA (individual savings account) eligibility will be extended to P2P loans. The new ISA status for P2P means UK savers will soon be able to include the riskier P2P investments in the tax-free savings accounts, traditionally available for safer options. The change is expected to lead many new retail clients, especially savers, to lend through platforms. Two more measures, secondary markets and better provision of P2P educational materials for retail investors, are also expected. However, the change will unlikely place P2P loans under the protection of the Financial Services Compensation Scheme (FSCS), the government program for guaranteeing savings in banks.

serving as a deposit-taking institution. This function is at the core of banks' position in the financial system, and P2P businesses would rather not be burdened by the costly and unwieldy operational structures, branch networks, and regulation of traditional banks.

P2P companies are starting to practice an increasing number of bank-like functions though. That these functions are performed in-house means P2P platforms are starting to look like online banks and less like peer-to-peer lending. In late 2013 the marketplace SoFi sold the first-ever, A-rated securitized product of P2P loans, with a $152 million offering.[22] Although other securitized products had been offered before (tied to Lending Club and Prosper loans), the SoFi offering marked the first time that a P2P securitization received an investment-grade rating (DBRS).

The real question is what model will prove to be most successful when the dust settles: full-on expansion into tech-savvy banking, divisions between true disintermediation and new online banks, or the hybrid we are now starting to see. In the UK, bank Santander regularly refers clients to Funding Circle; Barclays Africa purchased a 49% stake in RainFin, a South African P2P company; Lending Club partnered with BankAlliance, a consortium of 20 community banks to co-brand loans through the platform; other small banks purchase P2P loans through the platforms.

3.3 REGULATIONS TO PROTECT INVESTORS

P2P lending is growing in breadth as fast as it is in size, too. Whereas P2P lending in the US was originally used primarily to refinance credit card debt, marketplace lending is now being used to fund investments in more complex debt asset types in small business, real estate, and higher education. Lax regulation has helped the industry to innovate, but as it approaches meaningful size and market impact, it would be wise for regulation to play a bigger role.

P2P Staying Ahead of Regulation

Established P2P platforms worry that new entrants could get into trouble with naïve credit models or risky lending. A few bad companies could quickly cool off the overall positive outlook investors and the public has of P2P lending. In an effort to both squash reputation-damaging practices and avoid innovation-crushing regulation, P2P platforms have actively self-regulated themselves to stay one step ahead of regulation. We explore two examples:

Case of Lending Club – In 2008 the SEC was considering if the *promissory notes* Lending Club was issuing should be classified as securities or not. The classification would lead to a lengthy and expensive registration process with the SEC for each loan, but another option would be to have all P2P investors be designated as debt "issuers," effectively destroying the industry.

In order to preempt the SEC's decision, Lending Club decided to proactively file with the SEC as a securities issuer. In doing so, the company established a precedent: P2P notes would act just like a municipality's issuance of special purpose bonds to support infrastructure projects.[23]

Case of P2PFA – Big UK P2P companies organized their own self-regulating organization, the Peer-to-peer Finance Association (P2PFA). By doing so, member platforms held themselves to higher standards. In response, P2P companies enjoy a tremendous amount of public and governmental goodwill in the UK.

The Start of Regulation

Globally, the existing legal framework and regulations covering P2P lending is patchy at best. New regulations in the UK & France are

[22] Financial Times, "peer-to-peer lender wins landmark rating"
[23] HBS Lending Club case study

still vague but can serve as a guide to other regulators interested in helping P2P platforms operate and grow in a more responsible way. In summary, here are several of the new documents' guiding principles:

Raising managerial standards – In France's 2014 crowdfunding law, it is stipulated that managers must meet requirements on professional competency (e.g. degrees in a relevant field, proper professional training, or minimum work experience) to have strong capabilities and good, moral judgment to prevent calamities and best serve clients.[24]

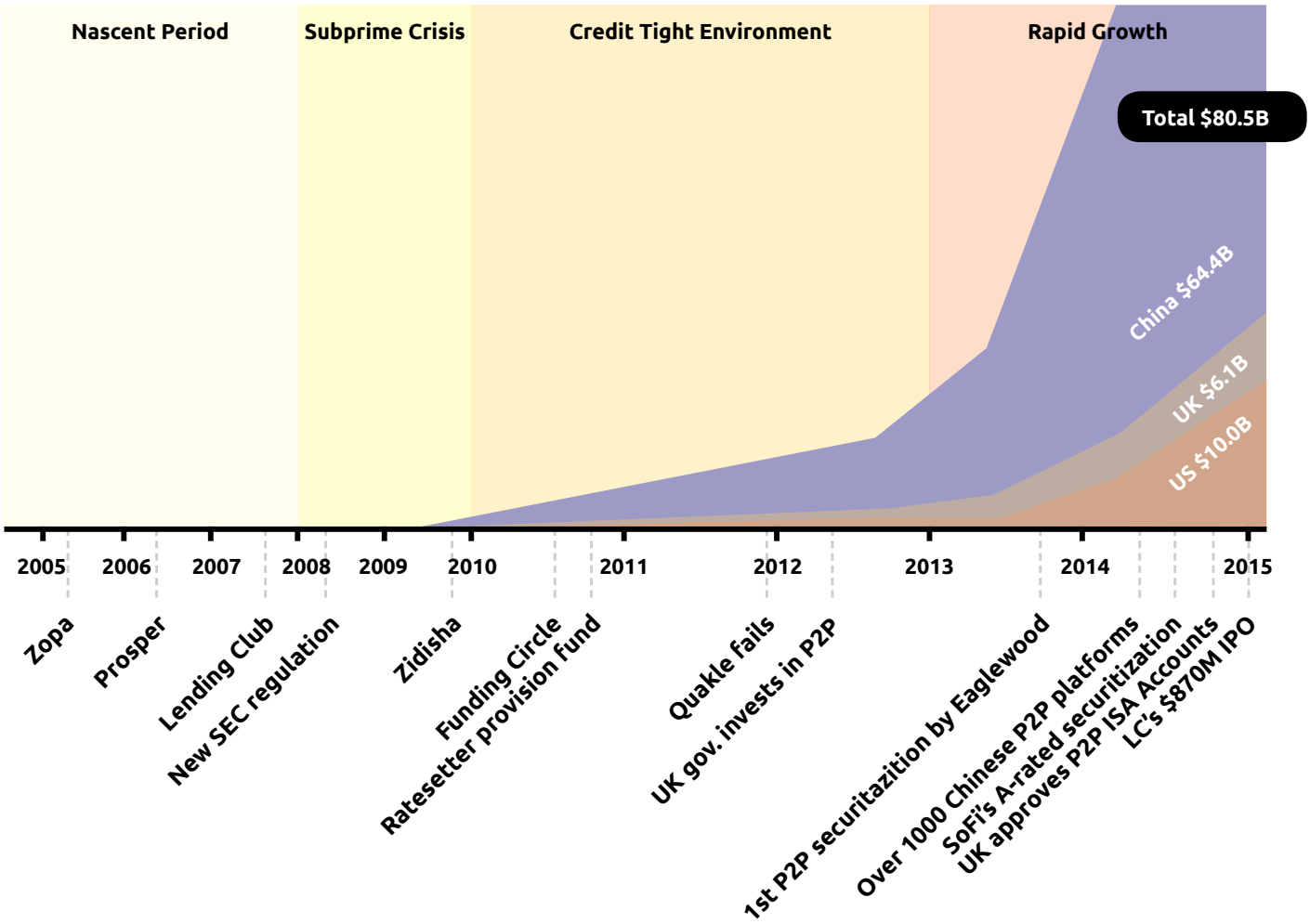
Transparency – Information disclosure is at the core of both the UK and France's crowdfunding laws. Platforms are obligated to disclose all relevant information in light of nature and risks of platforms. Investors should be clearly told what happens in the event of requiring an early exit before debt matures and "how far the platform will go to secure payment."[25] Under the laws, platforms are required to file periodic reports so as to monitor the activity and health of the industry on an on-going basis.

Contingency plan for P2P platforms – Whether and how services would be continued if P2P platforms exit the market remains a great uncertainty for investors. If the platform fails, it is hard for investors to recover investments because platforms no longer pay for debt collection, transfers and custodian services. The regulation tries to ensure outstanding loans can be managed and serviced until maturity should the platform fail. The UK crowdfunding law does this by requiring a contract with another platform or debt service agent.

Investment Caps – Regulators encourage P2P companies to institute maximum investment caps and minimum total disposable asset barriers (which many already have). These caps and barriers help prevent cash-strapped lenders from making risky investments and helps inexperienced investors to diversify their investments; for example, Lending Club only allows investors to invest up to 10% of their net worth, determined exclusive of the value of an investor's homes, home furnishings and automobiles[26]. France's crowdfunding laws restricts investors from lending more than €1,000 in any one loan.[27]

[24] French Monetary and Financial Code
[25] FCA Consultation Paper on Crowdfunding
[26] Lending Club Lender Agreement
[27] French Monetary and Financial Code

Figure 12: Timeline of P2P's Growth



04/

BEHIND THE CURTAINS OF CHINA'S RAPID RISE IN P2P LENDING

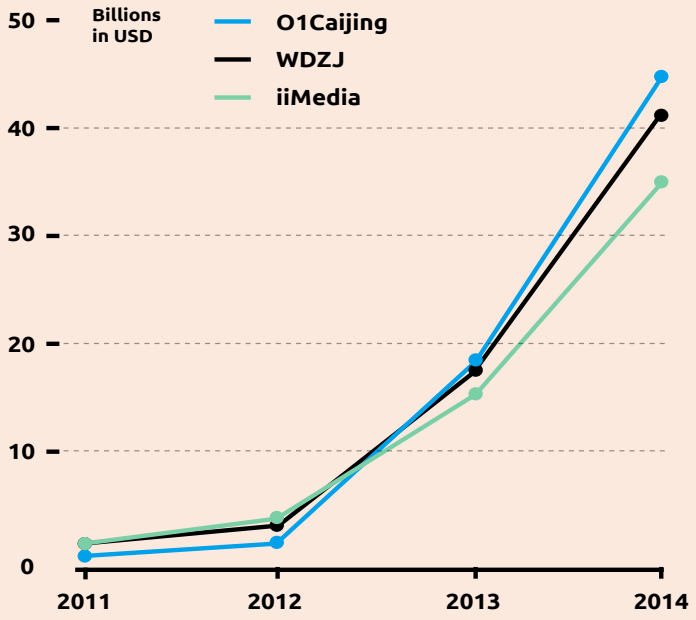
Among this buzz of international P2P companies disrupting finance with new technology and online platforms, China's expansive P2P market can feel distinctively out of place. Unlike in the US or UK, P2P in China is almost uniformly less focused on technology. In fact many of the hundreds of P2P organizations operating in China – sometimes without licenses – focus more on finding creative solutions to bridge investors with borrowers that do not always rely on innovative technology. While some Chinese platforms operate much like their US and UK counterparts, such as Jimu Box and PPdai, the majority leverage on existing distribution networks and use some combination of online tools and low-tech, offline means to facilitate lending.

This mix of both offline and online methods works well for China. Many potential P2P borrowers would not be reached through online portals alone. Further, Chinese investors are often indifferent to whether their returns come from databases built on paper-pushing or from an innovative online platform, so long as the brand is trusted. Such flexibility has allowed China's collective P2P industry to swell to the tens of billions. According to Wangdaizhijia (WDZJ), a website monitoring China's P2P market, peer-to-peer lending exceeded 100 billion RMB in 2013 ($17.2B). The same 2014 estimate rose to 253 billion RMB ($40.7B) with the number of P2P platforms doubling to an astonishing 1,575. Figure 13 shows how other sources estimate similar levels of growth. Taken at face value, the data shows that China's P2P industry is the largest in the world, or roughly seven times the size of P2P in the US.

The first Chinese P2P company, PPDai, was conceived in 2007 to serve China's "underbanked" and initially offered its platform services free of charge for both investors and borrowers. Another, Qifang, focused on bridging university students from rural areas with lenders willing to fund their tuition. While models were innovative, it wasn't until 2011 that the growth of "hulianwang jinrong" or internet finance quickly accelerated. E-commerce and mobile payments became the norm for an enormous and expanding group of young Chinese consumers and businesses. A testament to this shift, roughly half of the Chinese e-commerce giant Alibaba's 300 million registered users using its online and mobile payment service have invested with "Yu'E Bao," a money market fund, since its June 2013 launch[28].

[28] NY Times Dealbook, Alibaba Creates a Consumer Credit Rating Service

Figure 13: Estimates of China's P2P Market (Year-on-Year, Total Amount Lended)



Source: Wangdaizhijia, iiMedia, 01Caijing

It is interesting to note just how quickly and seamlessly China has adopted internet finance. It boils down to several key factors:

- With the growth of China's middle class, has come a substantial increase in the number of formal investors, many of whom who have grown up in the internet age. These new investors are adept with technology and are more willing to explore new investment opportunities.

- Regulations have typically been slow to react to new forms of online finance so that new companies are, in effect, allowed several years of unregulated growth and development before officials begin clamping down. In a way, online finance has been a channel through which regulators have allowed non-bank lending to grow. Other non-deposit taking licenses exist in China, but are highly regulated compared to P2P.

- China has maintained very credit-tight conditions with large, state-owned banks confined by 20% capital reserve requirements and other regulations that dis-incentivize banks from expanding to new client segments. Meanwhile, almost 400 million Chinese adults are unbanked or considerably underbanked, leaving a large untapped customer base without alternate banking options.[29]

- Chinese often have fewer options for investing their money. Overseas investment is difficult or impossible, whereas domestic bank wealth management products often go over-subscribed. Housing and real estate – long-time, standard investments for Chinese families – now seem less stable or profitable. Meanwhile, savings accounts are capped, further pushing investors to seek out alternative investments offering better returns.

4.1 LOOKING AT THE NUMBERS

Estimates of China's P2P industry easily surprise. The huge sum collectively being lent through Chinese P2P companies is undisputedly many magnitudes larger in size than other markets; however, the accuracy and circumstances surrounding the numbers requires explanation. Often times, the figures are blown out of proportion or may simply make for a poor comparison to other P2P models.

Accurate figures for the industry's growth and size are hard to come by, primarily because China's P2P companies lack transparency. WDZJ and the other Chinese P2P trackers calculate their estimates by trawling for data online. Many platforms publish their figures publicly or, at least to registered investors, but these numbers can be difficult to consolidate. "Web crawlers" or scripted programs are used to automatically collect data on webpages in accordance to specific conditions; some platforms even provide WDZJ with their application programming interface (API) to streamline information sharing. In the end, however, the reported figures themselves may still be inaccurate or impossible to validate.

Total Origination Estimates – If Chinese P2P companies publish statistics at all, they are very minimal. At this time, no Chinese P2P company provides clear evidence for their reported numbers. Those familiar with the industry claim that Chinese P2P platforms fail to share details both because specific operations involve semi-illegal or risky practices and because P2P platforms are actually exaggerating loan origination figures as a means to seem more reputable and shore up investor confidence in their services.

Number of Platforms Estimates – Current estimates suggest there are well over a 1000 P2P platforms operating in China. By comparison, only a handful of P2P platforms operate in the US and UK. Further, whereas Lending Club and Prosper in the US comprise roughly 98% of the market share[30] (not including OnDeck and SoFi), the largest 100 platforms in China comprise of only about half to two-thirds the total market. This is because China's market is geographically fragmented. Investors tend to trust local brands of which they are most familiar, and these same local firms, regardless of industry, open P2P businesses by first leveraging their local distribution networks to source borrowers.

4.2 CHINESE P2P MODELS

Even more than transparency issues, the largest reason why P2P figures are so jarringly large in China is, in part, because Chinese P2P company practices include many additional forms of lending that would hardly pass as P2P in other countries. Often, the assets appear equally or more akin to wealth management products. By extension, Chinese P2P platforms ultimately differ in both how investors and borrower are matched and the various models for client acquisitions.

As a result of these differences, the overall operational and cost structure is a clear departure from the tech-innovation found in P2P practices elsewhere. Investors and borrowers are primarily acquired online by P2P companies in the US and Europe, and minimizing costs through staying light-weight (both in physical capital and necessary personnel) is the focus. For China, this is not the case.

Borrowers & Investors in China

In China, hundreds of millions of borrowers still live in less developed cities or are not familiar with online finance. Further, the first credit information database, founded in 2006 and operated by the Credit Reference Center

[29] Microfinance Gateway

[30] The Economist, "P2P Lending: Banking without Banks"

(CCRC) of the People's Bank of China (PBoC) only reflects repayment history of borrowers within the commercial banking system; in 2013 there were 830 million entries, but most of the data is quite limited[31].

The first generation of P2P platforms typically served migrant workers in large cities who did not use bankcards, let alone have a credit history. They mostly used P2P loans to bridge over existing loans used on large-ticket purchases or to start micro businesses. Now approximately two-thirds of P2P loans go to college educated borrowers[32], and P2P has become a major financing channel for consumption loans, and also many small-medium enterprises (SMEs) starved for credit.

The majority of P2P investors in China, on the other hand, are tech-savvy young professionals aged 30-50. Younger investors may have less savings, but P2P investment offers an attractive yield compared to bank deposits while having lower investment thresholds than most bank wealth management products, which are typically set at 50,000 RMB ($8,000). The industry has attracted about 1 million P2P investors[33] – only a tiny fraction of the overall potential.

Operational Structure

Online and offline client acquisition are both practiced by Chinese P2P companies, but market conditions have kept sourcing clients offline more efficient in certain instances. Essentially, many P2P companies in China employ huge teams across the country to market investment products and service loans, no different from traditional financial institutions; Creditease, China's largest P2P company in terms of historic loan origination, employs more than 30,000 employees[34] to do just this. Others remain relatively light-weight by adopting the MFI-P2P model and partnering with microcredit companies to source borrowers. Figure 14 shows the spectrum of models from typical direct, online P2P loans to an offline "bank without branches" model.

Risk to the Industry and Investors

Many P2P platforms function very similarly to online banks, with most debt products not being directly matched with discrete loans. Further, of those platforms that do offer direct P2P loan products, most will also offer wealth management products. Consequently, the reported loan making is actually an amalgamation of direct P2P loans, quasi-P2P products and traditional wealth management products.

Chinese P2P Companies have successfully been mismatching maturities of loans with financial products in this way largely because investor interest has grown steadily. Additionally, tightly regulated areas tied to China's finance industry can use P2P platforms to meet their needs. A careful balance has been struck between investors, platforms, and the partnering organization, that a lack of transparency helps cover up. Dangerous practices put investors at risk, however:

Figure 14: Four Chinese Models

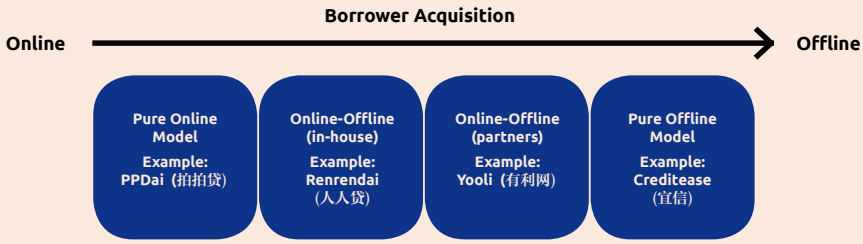
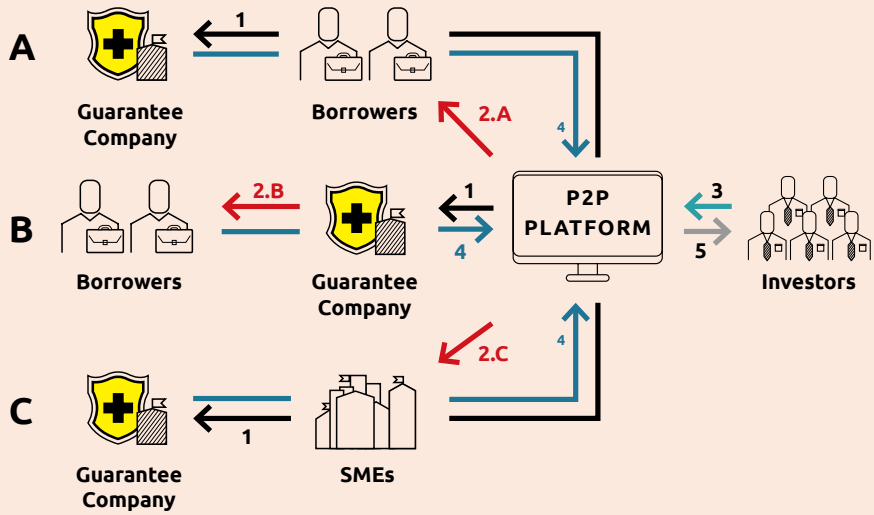


Figure 15: Three Roles of Chinese Guarantee Companies



[31] CCRC of PBoC (Xiaolei Wang, the Associate Director)
[32] 01Caijing Baipishu
[33] P2Peye, orient securities
[34] CCRC

False Guarantees – all Chinese P2P platforms make explicit promises that all of the principle or in some cases, both principle and interest will be repaid. In the Chinese context, to not offer such promises would make the platforms non-competitive. Even those platforms that establish contingency funds have no means to actually guarantee loan repayment if losses continue to increase.

Guarantee companies play an important role in this. A financial entity unique to China, guarantee companies help facilitate loan-making by promising to make good on repayments if borrowers default. Of China's $13 trillion in outstanding debt, about one-fourth is backed by these or similar companies[35], in part, because many businesses and individual borrowers can only legally receive loans if they are guaranteed by such third-party institutions. As a result, they have the undesired effect of channeling funds to industries, such as real estate, that the government has tried to restrict due to dangerous market conditions. Figure 15, shows the different ways that guarantee companies play a role in the P2P origination process.

These guarantee companies typically only charge around 3.5% percent fee for their service but can leverage their assets more than 10 times under current regulations[36]. Undercapitalized and shaky, guarantee companies put the responsibility off of P2P companies on paper, but realistically, most guarantee companies would quickly fail if unexpected defaults would occur. Strong economic growth has so far propped up the system.

Pooling Money – To avoid accusations of money pooling, P2P companies have begun partnering with banks that supervise the flow of money designated for investment (through P2P company accounts). But this falls short of custodian accounts controlled by third parties, and P2P companies likely maintain discretion over when and how to use the capital, which in turn, encourages the pooling of capital. In most cases, this pooling of capital is needed to offer competitive products; short-term products with flexible early exit terms encourages P2P platforms to engineer simple mechanisms to mismatch loan maturities with investor payment plans. Consequently, the system likely relies on a surplus of investor interest in P2P debt (supply) relative to approved loans requests (demand) to smooth over repayments.

To exemplify this, one need only to review the products being offered. Many platforms will sell lower-yield products with near instant liquidity. Other typical products have three or six month commitments. These maturities do not correspond to unique borrower profiles.

Also of concern is the money pooling of un-invested investor capital. Because the demand for online products often exceeds the total amount loaned to borrowers, platforms often hold investor capital with instructions to invest as soon as more borrowers are sourced. This and other money could easily be used to make repayments if defaults run high.

In fact, more and more observers believe that this practice has already begun. As

Should Chinese P2P Platforms Be Considered "P2P"?

The incredible differences between standard P2P models in the West and the operations of Chinese P2P companies begs the question: are Chinese "P2P" platforms even P2P? From the perspective of measuring the achievements of a discrete, new model of online finance, the comparison between UK & US platforms with Chinese P2P is somewhat flawed. Chinese P2P companies are viewed by some as a veiled attempt to bank illegally, circumventing laws by self-identifying as an unregulated legal entity.

Others consider Chinese P2P as a necessary complement to traditional banks in a market with pent up demand. The lack of regulation and a growing focus on internet finance allows these companies to innovate in ways that expand well beyond the scope of what typical Chinese financial institutions practice, which are limited by strict regulation on geography. The innovation, while very fragmented and hodge-podge, is also pushing domestic platforms to move closer in the direction of what is occurring in the US and UK.

[35] Wall Street Journal, "Loan 'Guarantee Chains' in China Prove Flimsy"

[36] Renmingwang Finance

just one example, Creditease has already been accused of the Ponzi-scheme tactic in early 2014. The claims were never confirmed, but doubts spread quickly. More recently, 354 P2P companies, including many the larger, more reputable services were blacklisted by Dagong Global Credit Rating for similar concerns over transparency[37]. Continuing doubts raised by the public and media have left platforms in a state of alert to manage potential crises, for fear of the impact on the reputation of their platforms, and ultimately, their liquidity.

Nuance Needed in Regulations to Come

The sprawling development, non-transparent risks and rapid growth of China's P2P market have brought the issue to the attention of regulators. But P2P still represents only a tiny portion of non-bank finance (relative, for example, to trust companies), and regulators are generally supportive of innovative finance in China.

Further, despite unique challenges facing P2P companies in China, P2P is playing an important role in supporting financing channels to underserved Chinese borrowers. Whereas much of the alternative finance in China works around state-supported, formal finance to meet a gap in supply for middle and higher income Chinese, P2P is doing relatively more to serve smaller borrowers. Much of P2P lending still targets SMEs by offering larger loan sizes, but there are still many standout P2P companies which either work through MFIs or directly try to provide financing to borrowers not served by banks. As a conduit for broad retail funding, it also has the flexibility to adapt to the specific needs of various underbanked regions of China.

Regulators will need to take this into consideration but also address the fact that much of what is now labeled as "P2P" in China does not match an international definition and react accordingly. Whether room will be left for direct, online P2P companies to thrive in the environment created afterward is left to be determined.

New regulation from the CBRC is expected to address the topic near the time of this publication. Formal guarantees will likely be strictly prohibited as to prevent investors from falsely assuming there is no risk. A draft of new P2P guidelines also outlines a plan for formalization of policies and other key regulatory changes: there will be central regulation, but enforced by regulators at the local level; platforms will need to be registered as a unique P2P entity; capital requirements for registration will be required; 3rd party institutions (namely big banks) will be required to hold investors' funds in escrow; there will be a need for credit risk evaluation; and loan size will be capped at 20 million RMB (~$3.2M). These changes, if implemented, will help curb some of the growing risks, but regulators should too consider regulation that rewards strong practices, and particularly those that extend services to regions and clients that most benefit from the access to new forms of credit.

[37] South China Morning Post, "China mulls tighter rules on booming P2P lending business"

05/ THE FUTURE OF P2P

Proponents of P2P like to explain that big banks are too slow to compete. And yet, despite P2P's evident potential, banks' lack of interest in directly competing with P2P reflects a tacit bet against P2P's ability to challenge their core businesses. Many within financial services see P2P credit underwriting as unproven and the model unable to transition to the kind of investment paradigm needed to scale to massive proportions. Others note that P2P may indeed be enjoying a "perfect storm" of events that is fueling its growth.

Whether this is true or not (and P2P companies make a strong argument for themselves), the P2P lending model still contains an intrinsic value-add, irrespective of the current market circumstances. Proponents of P2P lending argue that the core-operating model of P2P platforms is fundamentally lower-cost than that of traditional banks, and P2P should be taken seriously as such, separate of any other potential flaws.

Household-name financial institutions have taken notice, too. So while banks may not appear threatened, their big investments in P2P companies and forays into P2P-like alternative lending suggest that strong currents lurk beneath the surface.

5.1 FORECASTING OF P2P INDUSTRY

To address the large discrepancies in opinion, we weigh in on the future trajectory of the industry by outlining five key predictions:

New, Big Competition

In recent years, many non-traditional lenders have integrated loan-making into their own business models to support existing clients. High-profile examples include China's Alibaba which provides loans to sellers using its e-commerce platforms, and Paypal, a payment services company, that has provided loans based on a cash flow-based account of creditworthiness. In addition to traditional financial institutions and businesses adopting more competitive online cost structures, e-commerce platforms and payment services will follow the lead of Alibaba and Paypal in utilizing customer data to issue loans. The growth of these businesses with captive client bases will increasingly overlap with P2P companies as the pool of borrowers shallows, and the two industries will become competitors. To prevent major retailers from doing the same with their own customers or employees, P2P companies will have to convince businesses to lend through their platforms or risk being marginalized.

Subject to increasingly stringent regulation, the expectation is that traditional brick-and-mortar retail banks will consequently continue to be slowly reduced to "the safe, deposit-taking option" matched with higher value commercial loans. Borrowers will naturally benefit from the competition and new diversity in investing options, but will need to be provided effective tools and literature for understanding the differences between various loans and their providers.

Super-sized P2P Companies

In countries with developed credit histories and financial markets, P2P firms will undergo a process of consolidation so that now large P2P companies will become industry behemoths; this process will occur as competition for new sets of big data and other sources of exclusive information intensifies.

Alternatives to large P2P companies will also thrive, however. Thanks to affinity-based lending, smaller P2P platforms, organized around communities wishing to support one another, will find niches to flourish and navigate waters that big P2P players find more trouble than they're worth, just as P2P lending companies do now with banks.

A few socially minded platforms that appeal to different investor and borrower populations

will maintain operations along similar lines, but those focusing on the human element of P2P lending and making philanthropic loans will remain modest in size comparably.

To Be, or Not to Be (a Bank)

It is unlikely that the financial markets in five years' time will be dominated entirely by alternative finance companies, or at least not as they are understood now; it is more likely that they will come to coexist with banks through intertwining partnerships over the next few years, with some P2P platforms eventually registering as (online) banks, as is already the case in some countries, and others seeking clearer regulatory delineations to prevent getting caught up in over-arching policy changes that restrict safer, more innovative platforms along with larger, bank-like P2P companies.

Retail banks will continue to watch the development of P2P. Ongoing equity investments in both established and new P2P companies will position banks well to maintain their foothold as dominant financial players should P2P fulfill its promise, contrary to detractors' predictions. Strong future performance will encourage some retail banks to consider two-track systems of servicing loans with slightly cheaper rates offered to borrowers who opt out of in-person services. Fair lending laws that prevent discrimination along lines of age may implicitly be challenged as a result.

Investing for Retirement

P2P and other alternative, widely available investment channels mark an important change in how households save. Gone are the days when investing in CD's and savings accounts were practical options for ensuring a safe retirement. In the long-run, rates of deposits will likely never rise much above inflation. As a result, recovering market conditions will not dilute P2P's low-cost value proposition; rather, fully guaranteed deposits will remain at extremely low levels of interest because P2P and new alternative financing channels will increasingly dissect return-reward segments. New tiers of safer, but not fully-guaranteed products will emerge to fill the gap in between traditional savings and riskier equity or debt investments, just as P2P is beginning to do now. These new low-risk products will become increasingly common and available, drawing in traditional savers and reducing the demand for bank deposits.

Potential for Market Trouble

New behemoth P2P companies will IPO and increasingly perform securitizations. As the industry expands, institutional money will pull the industry further into the larger financial market by slowly integrating P2P loans into more complex asset types and requiring more convenient and readily available exit options. Further, to address the pressure of acquiring new borrowers in light of new competition and satisfying equity investors with quarterly goals, P2P will continue to expand to include riskier borrowers. Likewise, P2P companies will continue the trend of offering higher value loans – mortgages, large ticket consumer loans, and loans to medium sized companies. These loan types will give P2P companies new areas to develop into and provide space for new, more specialized players, but the larger loan sizes will also introduce risks originally avoided by the industry. Regulation will eventually etch stronger guidelines to monitor these activities, but the question is whether regulation will be in place before or after risks get out of control. If left unchecked by regulation for too long, it will be difficult to prevent the P2P companies expanding beyond their capacity to comprehensively manage or monitor risks. This is troubling because in five to ten years' time, the P2P industry may very well have grown enough to impact markets significantly in the event of systemic platform failures.

Three levels of specialization

In addition to consolidation of large companies and many new niche players emerging, we expect to see three types of specialization occur. On the largest level, we expect the largest P2P companies, to comply with new regulations, will have to ultimately choose between a model that offers products to institutional investors or to retail investors – or at least clearly separate the fates of these businesses. Second, more and more intermediaries will enter the market, sliding into pockets of opportunity in between P2P companies and investors (e.g. Orchard) and those between platforms and borrowers (e.g. third-party repayment services). Last are geographic specializations. In countries with regionally fragmented populations, such as China, local expertise will keep the industry scattered. In small developing countries where P2P is just taking root, market conditions and unique borrowers will require specific data and considerations preventing encroachment by bigger foreign players. P2P will thus remain a complex topic for years to come.

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Microfinance Capacity Building Initiative

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Previous MRP Reports

Study on Microcredit Companies Accessing the Short- and Medium- Term Bond Market in China

Joint research between the The People's Bank of China Research Institute of Finance and Banking and Positive Planet

Ping Liu (Research Group Leader)

Shaohua Zhang
Zhi Wu
Xiang Xiao
Dawei Zhao
Gabrielle Harris
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Yun Wu

The Role of Microfinance Ratings In The Sustainable Development of China's Financial Inclusion Sector

A joint research publication of Positive Planet and Planet Rating

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Gabrielle Harris (Co-author)

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