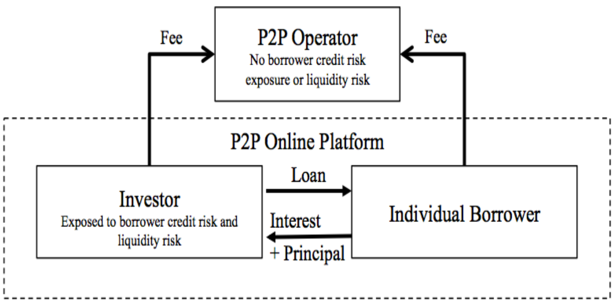
Platforms and Lending: Opportunities, Risks and Regulation

Professor Kevin Davis
Research Director, Australian Centre for Financial Studies

Platform Lending Basics



Often referred to as "Market place lending" –
where institutions rather than individuals are the investors

Platform Mechanics – the basics

- Assess borrower creditworthiness, advertise loan opportunity to investors
- Allocate interested investors to (many) borrowers
  - Determine interest rate which funds loan and satisfies investors and borrower
- Transfer loan funds from investors to borrowers, collect borrower repayments and remit to investors

Investor bears risk of non-repayment by borrower
Investor has funds invested for term of loan
Platform operator bears no credit (default) risk or liquidity risk
The Platform connects borrowers and savers/investors
but
It is not like a bank!

P2P ≠ 

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Economic Benefits of Platform Lending

- Fintech reduces “financial frictions” of information imperfections and real resource costs in financing
- Potential benefits
  - Increased access to debt finance for borrowers – financial inclusion
  - Wider range of investment opportunities for saver/investors
  - More efficient allocation, involving risk based pricing, of finance
  - Increased competition for incumbents – pressure for increased efficiency, lower margins, benefits for consumers of financial services

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Impediments

- Unclear regulation
- Regulatory barriers to entry
- Unreliable telecommunications networks
- Inadequate access to credit information
- Customer identity verification problems
- Scale economies and start-up funding

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Why is P2P Regulation challenging?

New set of activities which don't fit existing regulatory structures

P2P operators perform functions similar to

- Market (exchange) operator
- Provider of individual managed accounts – like stockbrokers
- Credit broker
- Investment banking – loan "IPOs", issuer of securities, "private placements"
- Financial advice
- Credit rating agency
- Securitiser (pooling loans for investors)
- Managed investment scheme

Different types of P2P models (and which regulator?)

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Different types of P2P models

Existing legal/regulatory structures influence how P2P models evolve

Possibilities include

- Credit broker/agent model – money from client accounts used to directly fund loan
- Notary model – platform/bank makes loan and issues notes to investors giving ownership share of loan
- Guaranteed return model – platform makes loans and guarantees investors fixed or minimum return
- Unit trust/collective investment scheme model

P2P Regulatory approaches around world

1. "Exempt/ unregulated" through lack of definition	
2. Specific Regulation based on existing regulatory components	• UK
2. Platforms regulated as an intermediary (market operator, broker)	• Canada,
3. Platforms regulated as a bank	• Germany, France
4. Securities issuance	• USA (SEC) and state level
5. Prohibited	• Japan, Israel)
6. MIS/CIS	• Australia

What are the Risks?

The Borrowers

The Platform Operator

Which of these risks warrant regulatory intervention, and of what type?

The Investors

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What are the Risks?

The Borrowers

“over-borrowing”
Excessive loan charges
Debt collection practices
Privacy breaches

The Platform Operator

Inadequate scale
Operational risk (employees, systems)
Reputational risk (bad credit assessment)
“contagion” risk
Regulatory risk

The Investors

Unsuitable investments
Lack of Understanding
Fraud (Ponzi schemes, embezzlement)
Investment (default) risk
Loan portfolio allocation
Liquidity needs
Platform failure

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A Regulatory Checklist

Definition of P2P activity

Registration/licensing requirements

- Of operator
- Of platform
- Deregistration/delicensing powers

Minimum operational requirements

- Invested/available capital of operator
- Robustness of platform software/hardware/telecoms

Governance

- Fit and proper requirements
- Legal structure of P2P operator
- “Living wills”
- Dispute resolution facilities
- “Arms-length”dealings with counterparties, avoidance of conflicts of interest

Disclosure /reporting requirements (at some specified frequency)

- Website Information about intending and current borrowers
- Contractual arrangements with investors
- Management fee structures
- Past performance
- Investor reporting
- Audit requirements
- Reporting to Regulator

Business Model constraints

- Minimum investor diversification requirements (number of loans and share of any loan)
- Maximum investment size for (or prohibition of) unsophisticated investors
- Custody arrangements
- Segregation of client monies from those of operator
- Specified credit rating scale
- Maximum loan interest rate ceilings (??)
- Loan contract feature limitations
  - Absence of penalties for early loan repayment
  - Allowable penalties for overdue payments
  - Maximum loan size / minimum duration

Borrower relations

- KYC/ALM requirements
- Customer identification protocols
- Responsible lending requirements
- Possibility of third-party guarantors / co-signatories
- Privacy/data use

Investor relations

- "Truth in advertising"
- Sales agent commission structure

Regulatory / Supervisory powers

- Data collection
- Reporting requirements
- On-site / off-site monitoring