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Wait for P2P lending to evolve before investing

Lending on a peer-to-peer platform may fetch you higher returns, but be aware of the perils—you alone bear the risk of default and returns are not assured

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With the interest rates of savings bank accounts as well as fixed deposits on a decline, you will come across multiple investment proposals promising returns higher than what bank deposits give. One such area of interest being advertised these days is peer-to-peer or P2P lending.

Before we go any further on the subject, the most important aspect on P2P lending in India as of now is that it does not have specific regulations. At the same time, it is not illegal either. The Reserve Bank of India (RBI) has taken cognisance of the existence of P2P lending and came out with a consultation paper in April 2016. This is expected to be followed by formal guidelines for the sector, which the companies in the segment are expecting soon.

You might still be attracted to the high returns being advertised if you invest in this market. Read on to know the basics first.

What is P2P lending?

Just like an online marketplace brings buyers and sellers on a single platform to transact, P2P lending marketplaces bring borrowers and lenders together. If you want to invest some money, you go to a P2P marketplace and register as a lender. Some marketplaces charge a one-time fee to register, while others charge based on the amount you lend. There are multiple borrowers listed under different risk categories, with varying interest rates.

“The low-risk borrower will get (an interest rate of) 12-13% while the rate for a high-risk borrower can go up to 25-30%,” said Rajat Gandhi, founder and chief executive officer,

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Faircent.com, a P2P marketplace. In other words, this could be the possible range of returns per annum if you are a lender on the platform. However, it is important to note that this is unsecured lending and hence carries high risk. “There is no assured return. Assured returns go contrarian to the model, and claiming so would be misleading the public,” Gandhi said.

Borrowers too have to register on the marketplace and these companies have their own system of determining the creditworthiness of a borrower. “Banks usually give a weightage of around 80% to credit score while determining the credit worthiness of a borrower. In our algorithm, credit score gets a weightage of only 30%. We give a lot of weight to social behaviour by extrapolating financial behaviour from social activity,” said Shankara Vaddadi, founder and director of i-Lend.in, another P2P marketplace. Borrowers are charged registration fee and also a processing fee after they get a loan, which is in addition to the interest payment.

Risks for lenders

Since P2P lending is unsecured lending, it carries higher risk than other investments. The biggest risk is the borrower defaulting on repayments. These platforms claim to minimise this risk by using a strict filtering of borrowers at the time of registration itself. For instance, Faircent rejects close to 90% of applicants. “We take the required relevant information from borrowers, including banking details, credit scores and income tax returns. We also do a physical verification of the borrower. It is not that anyone can come and get a loan,” said Gandhi. Similarly, i-lend approves only around 30% of the borrower requests, according to Vaddadi.

Despite the filtering process, it is possible that a borrower delays or defaults on repayments. Delayed payments attract a penalty. In case of defaults, these platforms attempt a recovery. If that does not work, the lender has an option of taking legal recourse, the costs for which she has to bear.

At best, as an investor or lender, you can minimise your risk by diversifying your lending to various borrowers at different interest rates. “As a lender, you should build a portfolio as diverse as possible, with small ticket size per borrower.

Also, you should invest gradually rather than investing all the funds in a single month. The longevity and frequency are the factors that can determine good returns,” Gandhi said.

Be prudent about where you invest. “How defaults really work in this environment is not clear to users as of now,” said Vishal Dhawan, founder and chief financial planner, Plan Ahead Wealth Advisors. “It is similar to what happened in the early days of micro-finance. When micro-finance started, there weren’t any defaults initially. But when they started, they spiralled to a large number very quickly,” he said.

If you choose to put your money in P2P lending, ensure that it is a small portion of your wealth. “As the deposit rates in banks have gone down, the thinking going around is that if you are getting X amount in a bank deposit, you could get 2X in P2P lending. So there is a tendency to go in there and be aggressive. It is the lenders who have to worry about defaults and do due diligence,” Dhawan said.

Should you borrow?

“Of the 20,000 users registered on i-lend, only around 5,500 are lenders,” said Vaddadi. This means that there are many more borrowers than lenders. Financial planners advise planning properly before taking a loan. “Look at what is your cost of borrowing elsewhere. People need to understand that lending costs have come down across channels. If you benchmark P2P lending cost against credit card debt, it would look very attractive, but that should not be a benchmark,” said Dhawan. “Therefore, if the cost of borrowing in a P2P marketplace is similar to the cost (of borrowing) from other places for you, then as a borrower you are okay,” Dhawan added.

P2P platforms are looking to attract those people who may not get a loan at a bank or a non-banking finance company (NBFC). “The problem is that typically banks are ready to give a personal loan to a person who does not need it,” Gandhi said. If a consumer has a salary account with a bank and works for a reputed organisation, the bank will offer the personal loan at a lower rate of interest. But if you are working for a tier-2 company or start running your own business, you may not get the same loan or at the same rate, he said.

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If a borrower with a good credit score takes a personal loan from a bank, the landing cost of the loan could be 16-17%. The person can get the same loan at around 14% from P2P lending. And at points where NBFCs come in and give loans at 22-23%, the difference could go up to 4 percentage points, said Gandhi.

So if you happen to be creditworthy but are unable to get a loan from a bank, a P2P marketplace could be your solution.

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