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Impact of Peer-to-Peer Lending on the Indian Banking Industry

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Abstract-This paper explores the ramifications of Peer-to-Peer (P2P) lending on the Indian banking sector. By analysing regulatory frameworks, market trends, and economic implications, we assess the disruptive influence of P2P lending on traditional banking practices. Our findings highlight both challenges and opportunities arising from this emerging financial model, including increased access to credit, risk management concerns, and potential shifts in consumer behaviour. Ultimately, this study contributes to a deeper understanding of the evolving landscape of financial intermediation in India amidst the rise of P2P lending platforms.

Keywords-P2P Lending, Indian Banking Industry, Alternative finance, Crowdfunding, Marketplace Lending, Online lending, Fintech, Credit Risk, Loan organisation, Underwriting, Credit Scoring, Default rate, Loan servicing, Securitisation, Risk management, Regulation, Micro loans, SME Lending, Consumer lending, Loan diversification, Financial inclusion, Credit worthy, Loan terms, Loan agreement

INTRODUCTION

This paper deals with the relationship between the P2P lending industry and the negative and positive impacts it has on the banking industry and the economy as a whole. P2P lending has its roots in history, when the general public was unable to obtain funding from the traditional banking system, they would look for alternative sources. In India there has been an age-old system of money lenders, they would loan you a certain amount in return for interest on that amount, collateral had to be provided to obtain this amount. Traditionally, the interest rate is relatively higher than the rate charged by banks, but as the customer had no other alternative they were compulsed to pay interest to obtain funds. With the introduction of P2P lending and with its rapid growth, financing needs could be met through borrowing without collateral or evaluating credit- worthiness.

P2P lending has major importance for the borrowers and investors of the modern financing world, it has the potential to increase financial inclusion by providing alternative methods of finance to various sects of the population. P2P lending streamlines the process of borrowing and lending on a single site, and most importantly investors are able to evaluate the borrowers before investing their funds. It also acts as a medium of risk diversification for investors looking to expand the portfolio and spread their risk over various sectors. P2P lending can act as a catalyst to economic growth, providing funding to small businesses and entrepreneurial ventures.

The Indian banking system is multi-faceted and diverse, considering a population of 1.42 billion people, it can only be imagined how massive the system is. The banking system is governed by the RBI (Reserve Bank of India), the system includes Public sector banks, Private sector banks, Foreign banks, Regional rural banks and Cooperative banks. There are various services and products offered by banks, some of them are listed below:

- Savings and Current Accounts
- Fixed Deposits and Recurring Deposits
- Loans
- Credit Cards
- Investment and Wealth management
- Insurance
- Payment services
- Foreign exchange services

REVIEW OF LITERATURE

The banking industry acts as the backbone of the economy, without its effective functioning the economy would remain stagnant. The banking industry helps the economy in several ways such as providing credit to the general public, financial intermediation, payment services, risk management, interest rate management. By performing all these functions, the banking industry serves as a centrepiece of the economy promoting economic growth and efficiency.

The main function of a banking institution is connecting savers to borrowers, providing loans to individuals and businesses allowing them to invest in projects, purchase materials and services and expand operations. Banking institutions acts as a mediator in between the two parties in exchange for charging fees and generating revenue due to the difference in rates of deposits and lending.

- "There is a moral hazard that makes this business need to be monitored. This threat begins with verification of the borrower's data that is not appropriate". (Suryono*, R et a. 2019)*
- "The past decade has witnessed the rapid development and prevalence of online P2P lending platforms, examples of which include Prosper, LendingClub, and Kiva. Meanwhile, extensive research has been done that mainly focuses on the studies of platform mechanisms and transaction data." (*Zhao, H et al. 2017)*
- *"*P2P lending individual investors bear the credit risk, instead of financial institutions, which are experts in dealing with this risk. P2P lenders suffer a severe problem of information asymmetry, because they are at a disadvantage facing the borrower. For this reason, P2P lending sites provide potential lenders with information about borrowers and their loan purpose. They also assign a grade to each loan. (*Serrano-Cinca et al. 2015)*
- *"*The advancement of information technology (IT) has resulted in a rapid growth of electronic markets (Malone et al., 1987). One of the most impressive features of electronic markets is its enabling role of eliminating or reducing the reliance on traditional middlemen" (*Chen D et al. 2012)*
- "We find that higher interest rates charged on the high-risk borrowers are not enough to compensate for higher probability of the loan default." (*Emekter et al. 2014)*
- "The lending website provides a variety of functions that enable borrowers to indicate their creditability. It also provides functions for lenders to search for loan requests" (*Wang H et al. 2015)*
- *"*P2P lending is substituting the banking sector for high-risk consumer loans since banks are unwilling or unable to supply this slice of the market." (*De Roure C et al. 2016)*
- *"*Unlike a commercial bank, the platform does not take risks through its own contractual positions. Whereas banks accumulate risks by taking positions on their balance sheet, platforms decentralise the risks by spreading them to their users." (*Lenz R 2016)*
- *"*We argued that P2P lending is fundamentally complementary not competitive too conventional banking. We therefore expect banks to adapt to the emergence of P2P lending, either by co-operating closely with third party P2P lending platforms or offering their own proprietary platforms."(*Milne A et al. 2016)*
- "They can organize secondary markets to trade loan contracts before maturity and some P2P lending platforms aim at providing a fixed income to lenders. To ensure efficient and sustainable financial intermediation, P2P lending platforms need to ensure that they are not subject to principal-agent problems and that their incentives coincide with those of lenders*." (Havrylchyk O et al. 2108)*
- "P2P lending is an example of how modern technology enables the integration of a range of economic functions, including market operator, financial services provider and credit broker." (*Davis K. (2016)*
- *"*They prefer to avoid high risk investments and apply rational economic considerations, and search for economic information about the borrowers, such as their debt/income levels, home ownership, employment status, etc." *Klein G et al. 2021)*

After reviewing various papers, it has been observed that the relationship between the P2P lending system and the banking sector and the economy has not been explored. There is a growing importance of the P2P industry and how it works as an alternate method of financing and thus feel the need to address it through this paper.

RESEARCH METHODOLOGY

- Research objectives

1. To analyse the growth trend of the P2P lending industry and compare it with the traditional banking industry.
2. To investigate the extent to which P2P lending has disrupted the traditional banking system

- Research hypothesis

"The P2P lending industry has the capability to disrupt the current financial system and replace the role played by the traditional financial institutions"

- Population

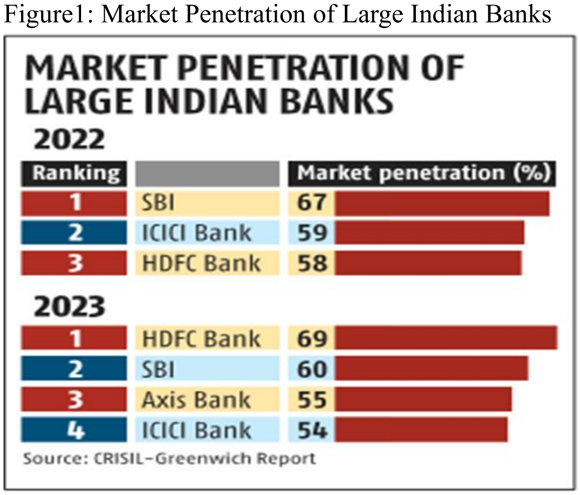
Data is not being collected through primary methods, we have resorted to secondary means and gone through freely available information. Thus, the population is unknown but focuses on the Indian subcontinent.

- DATA ANALYSIS

BANKING INDUSTRY

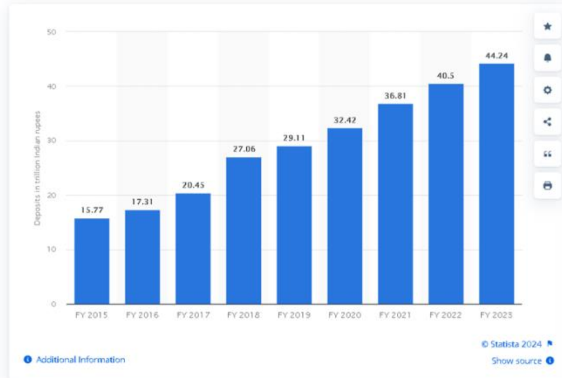
For the sake of this study, we shall take SBI (State Bank of India) and HDFC as they share almost 50% of the market and can be fairly taken to represent the whole market.

Figure1: Market Penetration of Large Indian Banks



Source: Business Standard, 2023

Figure2: Deposits collected by SBI

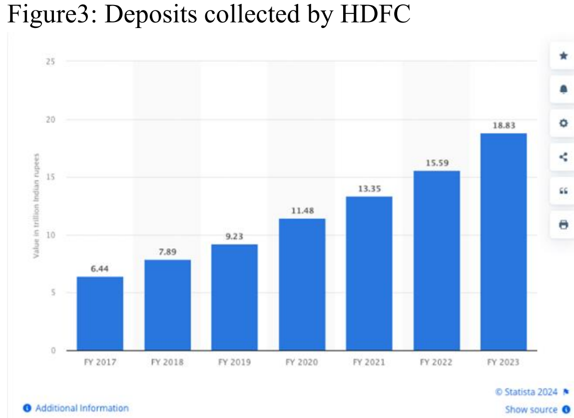


Source: Statista, 2024

We can see that the deposits collected by the SBI continue to grow at a steady rate from 2015-2023, SBI is the most trusted public sector bank and, it has 23% market share when it comes to assets, SBI has reported total deposits over 44 trillion Indian Rupees. The growth of deposits will probably not slow down for the fore coming years, Indians prefer investing in bank deposits as they provide stable returns, safety, security, and liquidity on demand.

"*In FY2023, the whole Bank deposits grew by 9.19% YoY to `44.23 Lakh Crore, of which domestic deposits increased by 8.50% to `42.53 Lakh Crore and foreign offices deposits by 29.60% to `1.70 Lakh Crore. Current account deposits grew by 7.47%, while saving bank deposits grew by 4.51%.*" as per SBI's annual report of 2022

Figure3: Deposits collected by HDFC

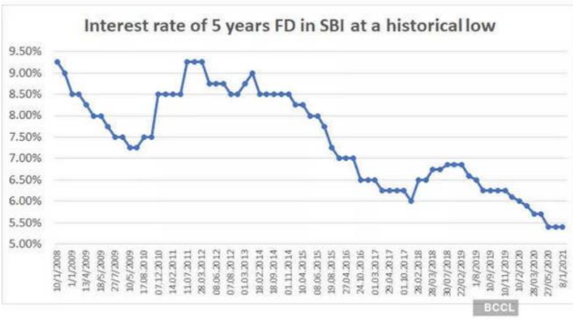


Source: Statista,2024

HDFC's deposits also have been steadily growing from 2017-2023 to 18.83 trillion Indian Rupees, it is India's largest private bank.

With the steady growth of deposits in SBI and HDFC we can say that the Indian public still sees deposits in banks as the primary option of safely parking funds for consistent returns and liquidity on demand.

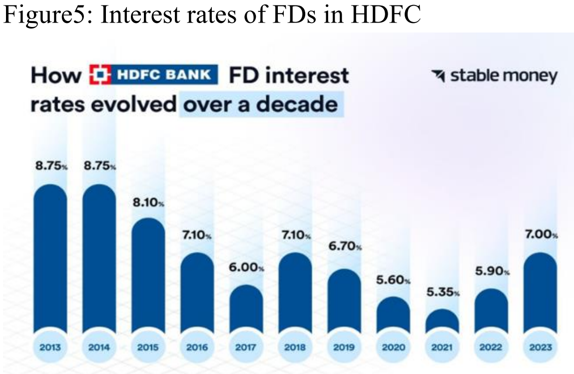
Figure4: Interest rates of FDs in SBI



Source: Economic Times,2022

The fixed deposit rates of SBI have fallen drastically from 9-9.5% to 5-5.5% in a span of 13 years, this probably caused investors to look out for other alternative sources of investment where they are able to fetch better returns. This also has a ripple effect on the mentality of the borrowers as the rates of loans also would have lowered, this would have made it more attractive to borrow during this period.

Figure5: Interest rates of FDs in HDFC



Source: Stable Money, 2023

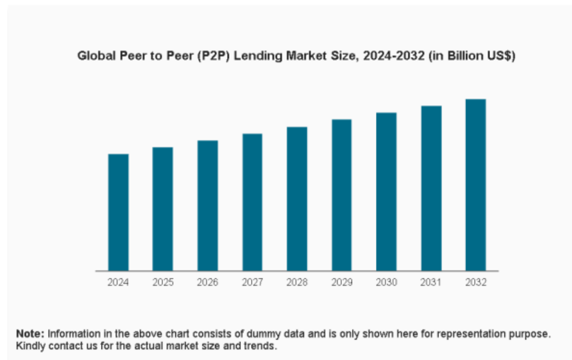
HDFC's fixed deposit rates have had an uneven trend over the previous decade. It currently sits around 7%, but had fallen to its lowest at 5.35% during the COVID-19 pandemic. But overall, the interest rate has fallen as compared to 2013.

"*SBI's domestic advances growth has rebounded and grew 5.67 per cent to over Rs 21.82 lakh crore. The bank's strong domestic loan growth was led by growth in retail personal loans, which grew 16.47 per cent to Rs 8.71 crore during the reported year, driven by home loans.*" (Economic Times, 2021)

From the above graphs it can be observed that borrowing and investing are growing at a steady pace, there is little reason to believe that this trend will slow down for the foreseeable future. With the Indian economy on the rise, flow of credit will play a major role in its upward trend.

PEER-TO-PEER LENDING SYSTEM

Figure6: Growth of the global Peer-To-Peer lending market



Source: IMARC, 2023

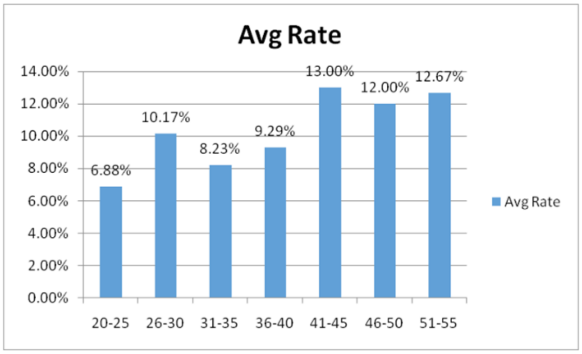
The global P2P lending market has grown to \$188.1 billion as of 2023, at this rate of growth it is expected to reach \$1223.0 billion in 2032. This may be due to rapid digitisation of financial services, ease of use, rise in demand of personalized financing solutions. The Indian P2P lending market is expected to reach a \$10.5 billion by 2026, with a CAGR of 21.6%. This growth may be complimented by the enthusiastic drive of the Indian government to digitize transactions and rise of digital literacy.

Figure7: Operation pattern of the Peer-to-Peer lending market

Source: IndustryARC, 2023

As we can see from the above chart most of the P2P lending operations occur online, this gives the industry a massive advantage as it can be accessed from anywhere with an internet connection.

Figure8: Average rate of interest relative to age



Source: Faircent, 2022

The above graph shows the average interest rate as per age group, overall, it comes out to an average rate of 10.32%, this is conventionally lower than the rate provided by banks. It is doubly advantageous as the rate of interest is the same or lower and there is no obligation to provide collateral.

From the lenders perspective a rate of 12-13% is much higher than FD rates in banks.

Figure9: Digital transactions in India

Financial Year	Volume (in crore)
2017-18	2,071
2018-19	3,134
2019-20	4,572
2020-21	5,554
2021-22	8,839
2022-23	13,462
2023-24 (Till 11th Dec)	11,660

Source: Reserve Bank of India (RBI), National Payments Corporation of India (NPCI) & DIGIDHAN Portal

Source: Press Information Bureau, 2023

The above given numbers relate to the rise in digital transactions in India, for the financial year 2023-24 we can see that ₹11660 crores were transferred digitally. This shows a steady growth, indicating a strong move towards digital transactions rather than physical.

FINDINGS

From the above data presented the following observations have been made:

- Deposits of SBI and HDFC are growing steadily and are at their highest in the previous 5 years.
- Rapid growth is spotted in the P2P lending sector
- Fixed deposit rates are at their lowest in a decade
- Average rate of interest given by P2P sites is higher than that of FD's for investors and lower for borrowers

As deposits show no signs of receding, investors still find FD's a viable and safe option to park their funds, even with the FD rates being at their lowest. The P2P sector has seen massive growth over the years, with the loan volumes increasing. The difference between the rates of interest of the P2P sites and banks are the major cause for debate, it is seen that P2P sites usually give lower rates of interest for borrowers without any collateral, this makes it an attractive source of funding. The main problem is that borrowers take only small to medium sized loans from P2P sites. RBI has come up with new regulations for these sites, stating that an investor cannot invest more than 50,00,000 Indian Rupees. Also, these sites cannot replace the vast variety of functions done by banking institutions such as acting as a medium of payment, locker functions, credit cards functions amongst others. As of the next 10 years it seems impossible for the P2P sector to replace the banking institutions, matter of fact it does not look viable that P2P sites could replace banks. They could take up some of the market share when it comes to giving out loans but to a very negligible amount. As of today, the industry is booming but it has not disrupted the banking system, even if it has, the amount is negligible.

LIMITATIONS OF RESEARCH

1. SBI and HDFC have been taken as examples of banks for this study, it may not fully capture the market sentiment.
2. No primary data has been obtained
3. The data range varies from 2020-2023

CONCLUSION

This paper deals with the impact of Peer-to-Peer lending sites on the Indian banking system. The Peer-to-Peer lending system is new to the market as compared banks, but within the span of a few decades it has created a name for itself in the market as a source of alternative funding. It is believed that Peer-to-Peer lending sites may reduce the need for banking institutions, while this view is optimistic, it is highly improbable for this to occur anywhere soon. Banks provide a wide array of functions that Peer-to-Peer lending sites do not. Peer-to-Peer lending sites do not need any kind of collateral to be provided to obtain the loan which makes it riskier. With the Indian economy heading into a new phase, the flow of capital is required more than ever and Peer-to-Peer lending sites offer an alternative to banks but cannot challenge the legitimacy and the security of these institutions. Peer-to-Peer lending sites make it so that bank acknowledge their presence and try and work on providing more attractive sources of funds, overall, this benefits the borrowers, as they have various options to choose from. It also benefits the economy as the amount of spending will increase.

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