PEER-TO-PEER LENDING PLATFORMS UNDER PRESSURE FOLLOWING RBI'S GUIDELINES

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Recently, the Reserve Bank of India (the "**RBI**") introduced new comprehensive guidelines for peer-to-peer ("**P2P**") lending platforms (the "**Guidelines**") in the Master Direction - Non-Banking Financial Company – Peer to Peer Lending Platform (Reserve Bank) Directions, 2017 (the "**Master Directions**"). The Guidelines aim to enhance transparency, safeguard lender and borrower interests, and streamline operations for the sector as a whole.

Background

Non-Banking Financial Company P2P lending platforms ("**NBFC-P2P**") serve as a marketplace for individuals to borrow or grant short-term loans and offer an alternative to traditional bank lending. They provide various loan options, including secured and unsecured loans, and are often used by individuals with a poor credit score or businesses that need immediate financing. The Master Directions aimed to regulate the industry, imposing restrictions to protect lenders and borrowers. Prohibited practices included offering credit guarantees and cross-selling non-loan-specific insurance products. Platforms were required to implement a board-approved policy to match lenders with borrowers, enforce strict fund transfer protocols through escrow accounts, and limit fund retention to T+1 days where 'T' is the ninth day on which the funds are received in these escrow accounts. The Master Directions also barred the promotion of P2P lending as an investment product and allowed outsourcing, excluding core management functions. The RBI has now, issued the Guidelines to address and rectify observed violations by NBFC-P2P lending platforms.

Key amendments

- **Credit risks and funds deployment:** NBFC-P2P lending platforms cannot assume any credit risk, and the responsibility of principal or interest loss falls solely on lenders. These platforms are now required to disclose to lenders that the lenders have to bear all credit risks. NBFC-P2P platforms must also ensure the strict deployment of funds as per the Guidelines, including that, one lender's funds should not be used for another's purposes.

- **Ban on sale of insurance products:** Following the ban on default loss guarantee agreements in September 2022, the sale of insurance products that provide credit enhancement or credit guarantees is now prohibited.

- **Pricing policies:** NBFC-P2P platforms are now mandated to adopt a clear and objective approach, and must ensure that fees are disclosed at the time of lending. Importantly, fees must remain fixed and not be affected by the borrower's ability to repay. Additionally, the Guidelines restrict NBFC-P2P platforms from sourcing borrowers and

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lenders through affiliates or closed user groups, thereby emphasizing transparency and fairness.

- **<u>Lender's aggregate exposure cap</u>:** NBFC-P2P platforms are now required to cap the aggregate exposure of a lender to all borrowers across all NBFC-P2P platforms at INR 5 Million (~US$60,000). Moreover, if a lender's exposure exceeds INR 1 Million (~US$11,920) across multiple platforms, the lender must obtain a certificate from a chartered accountant to prove a minimum net worth of INR 5 Million (~US$60,000).

- **<u>Fund transfer through escrow account</u>:** The Guidelines mandate that funds managed through escrow accounts on NBFC-P2P platforms must be transferred within one (1) business day (T+1) of receipt. Previously, the lack of a strict timeline for fund transfers led to potential delays and inefficiencies. This change aims to ensure efficient fund transfers, benefiting lenders with quicker access to their funds and borrowers with faster loan disbursements, which is particularly important in urgent financial situations.

- **<u>Manual borrower selection process</u>:** Lenders are now required to manually select borrowers, shifting away from the previous reliance on algorithms for portfolio diversification. This change from using artificial intelligence (**"AI"**) and machine learning to manually approved matching has disrupted the P2P lending industry, with many NBFC-P2P platforms pausing operations to comply.

- **<u>No guarantees</u>:** NBFC-P2P platforms are now prohibited from providing any guarantees on loan recovery or marketing P2P lending as an investment product with features like assured returns or liquidity options. This aligns with the RBI's actions in 2023 when various NBFC-P2P platforms were asked to halt certain activities after RBI inspections found rule violations and misleading sales practices.

- **<u>Prominent RBI recognition</u>:** NBFC-P2P platforms must prominently display a caveat on their websites and promotional materials, including a disclaimer stating that although the platform is registered with the RBI, the RBI does not guarantee the accuracy of statements or the repayment of loans.

- **<u>Restrictions on cross-selling of products</u>:** The Guidelines restrict NBFC-P2P entities from cross-selling products, except loan-specific insurance products. This change aims to reduce conflicts of interest and prevent platforms from pressuring borrowers into purchasing unnecessary add-ons. Previously, some platforms offered credit enhancement products and loan protection insurance, which could mislead lenders and increase borrowers' financial burden. The RBI's restrictions ensure that P2P platforms focus on their primary function of facilitating loans without burdening borrowers with additional products.

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- **<u>Public disclosures</u>:** Transparency and disclosure are key regulatory requirements. NBFC-P2P platforms must record and maintain detailed borrower information, including personal identity, interest rates, and credit scores. Further, they must publicly disclose portfolio performance, including non-performing assets and losses borne by lenders, on their websites. They must also clearly display their brand name across all customer interfaces and communications to ensure legitimacy.

- **<u>Grievance handling and outsourcing</u>:** Compliance with the Reserve Bank – Integrated Ombudsman Scheme, 2021 (**the "RBIOS, 2021"**) is mandatory, with NBFC-P2P platforms required to facilitate grievance handling by allowing customers to file complaints with the RBI. Regarding outsourcing, NBFC-P2P platforms are prohibited from outsourcing core management functions, such as internal audit, strategic and compliance functions, and the pricing of services. However, internal audit functions may be outsourced within a group or conglomerate, provided the overall integrity of management is maintained.

Conclusion

The introduction of the Guidelines for NBFC-P2P lending platforms marks a significant step towards enhancing the sector's transparency and operational efficiency. By banning the promotion of P2P loans as investment products and implementing stringent operational controls, the RBI aims to protect both lenders and borrowers, streamline fund management, and foster a fair lending environment.

Lenders are now fully responsible for the risk they assume and need to be more diligent in borrower selection, while also adhering to stricter financial requirements. Borrowers may benefit from clearer loan agreements, and they will see fewer bundled financial products. The role of trustees and banks to ensure smooth fund transfers has increased.

However, the shift to manual borrower selection has introduced significant challenges for the NBFC-P2P lending industry. Previously, advanced AI and machine learning technologies allowed NBFC-P2P platforms to efficiently match lenders with borrowers, thereby spreading investments across numerous loans and mitigating risk. The new requirement for manual selection and individual approval for each loan recipient restricts this diversification and potentially increases the exposure and risk for lenders. This move has caused considerable disruption in the industry, forcing many platforms to pause their operations as they adapt to the Guidelines.

The RBI's move towards clear pricing policies and restricting cross-selling practices is to ensure that NBFC-P2P platforms remain true to their core function of facilitating loans without burdening borrowers with unnecessary financial products. These measures, coupled with the emphasis on grievance handling and compliance with the RBIOS, 2021, signal an introduction of a robust framework to protect consumer rights and maintain trust in the NBFC-P2P lending ecosystem.

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