

POLICY AREA:  
**Financial Resilience**

## **Enabling the wisdom of the crowd: Transparency in peer-to-peer finance**

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### **Abstract**

The rapid growth exhibited by peer-to-peer finance markets raises hopes that especially young ventures might obtain better access to funding. Yet, consumer protection concerns are looming as borrowers and projects requesting finance from the crowd are inherently opaque. We suggest clear rules to enable peer-to-peer lenders and investors to more effectively screen projects. We plea for strengthening self-responsibility of the investor crowd by clearly assigning, and limiting the responsibilities of regulatory authorities and recognizing the regulatory difference between new peer-to-peer, and traditional financial markets. As a result the peer-to-peer market can develop to more effectively complement traditional sources of finance, instead of turning into a funding source for bad investment projects looking to exploit uninformed lenders and investors.

### **Challenge**

The market for peer-to-peer finance has experienced rapid growth over the past decade. It has grown from roughly €8.6 billion in 2013 to €133.5 billion in 2015, and is estimated to grow at a similar pace in the future. Peer-to-peer finance bears a large promise to complement or even replace bank- and capital market financing at least in part. The most important potential benefit of a functioning peer-to-peer market is an improved access to funding especially of young, innovative, and specialized firms, for which screening is difficult and too costly for traditional financial institutions. At the same time there remain numerous challenges that require attention of international policy makers. Herding behavior and the financing of small-scale, opaque ventures raise concerns regarding the potential to exploit uninformed investors. Whereas this is a salient feature of financial intermediation within each jurisdiction in general, the footloose nature also of small-scale investors and savers across national borders via crowdfunding renders the international coordination of this playing field necessary. We suggest that uniform general standards, clear responsibilities of regulators but also investors and borrowers, paired with internationally coordinated regulation for the peer-to-peer market helps to achieve the goal of complementing more traditional forms of financial intermediation while containing the most pressing risks. By making the “rules of the game” clear for all parties involved in peer-to-peer

finance and by providing adequate tools for investors to form opinions and make appropriate decisions, the peer-to-peer market can evolve into an effective complementary source of funding next to traditional finance. As a result of a better functioning market, more lenders will participate, thereby increasing the pool of financial funds available to borrowers and projects. Concretely, we suggest that G20 countries should assign a dedicated regulator to the market to assign clear responsibilities, maintain light and less detailed rules compared to banking that emphasize self-responsibility of market participants, regulate peer-to-peer funding separately from other financial markets and institutions, and provide peer-to-peer platforms with the authority to channel funds from lenders to borrowers without needing a full banking license to break an enforced nexus between incumbent financial institutions and new contestants. We also suggest to implement clear rules for recouping lenders' loans if borrowers fail, and to encourage borrowers to disclose information on prior loans and performance. Because peer-to-peer finance is conducted via the internet and thus almost borderless, we highlight the importance of coordination of national regulatory authorities at the G20 level in order to avoid regulatory arbitrage, i.e. peer-to-peer platforms moving their servers to countries, where they can most easily exploit investors and lenders from all around the world.

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## Proposal

### Basics of peer-to-peer finance

In general, financial markets fulfill the role of allocating capital from people with excess savings to those with (potentially) profitable investment opportunities. This intermediation of financial funds has traditionally been conducted by financial institutions, such as banks, which provide two key features[1]:

◦**Size transformation:** Financial intermediaries pool small funds from many depositors and transform them into larger loans, which could not be financed by individual depositors. Financial intermediaries thus serve as a coordination mechanism for investors to come together to finance projects larger than those that they could finance individually. Such a pooling function therefore entails the realization of rents due to scale economies;

◦**Risk transformation:** Financial intermediaries, in particular banks and indexed mutual funds, transform risk by diversifying market risk. Complete diversification is often not possible as cost efficiently for agents with smaller portfolios, higher transaction costs, and less expertise.

Traditional financial intermediaries have executed these tasks for a long time very successfully, largely because these transformations require **expertise in screening potential borrowers** to assess as precisely as possible the risk of applicant projects ex ante, competence in **monitoring existing investor relations** to ensure ex post behavior of borrowers or managers in line with the incentives and interests of lenders and investors. Put differently, the **information asymmetry between borrowers and lenders** as well as **equity investors and managers** is resolved successfully by financial intermediaries if these are able to develop expertise to assess risks and generate private information from repeated interaction with their borrowers and clients. The generation of such information advantages require a sufficient size of operations, both in terms of collecting retail deposits as well as originating sufficiently large and diversified loan portfolios in order to achieve an efficient size transformation.

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The advent of the internet and general information technology progress, however, reduced information asymmetries drastically. Consequently, the scope, level of detail, and frequency of information has become ubiquitous. The cost of acquiring it deteriorated, such that it is increasingly difficult for banks to retain their core comparative advantage: knowing more about the risk of idiosyncratic projects compared to individual agents because observing privately a pool of akin ventures.

But the mind-boggling interconnectedness of people in the internet age led to the emergence of alternative systems that curb banks as “the men in the middle”, enabling instead the **transfer of financial funds directly from person to person** (peer-to-peer). Peer-to-peer financial intermediation typically involves online platforms. People with investment projects (but without finance) can advertise their investment and potential investors can choose to contribute then themselves to a part of the project. Hence, the traditional size transformation formerly conducted by banks is now done in a DIY fashion: “do-it-yourself” by (micro-)lenders and investors directly. Likewise, lenders can (and should!) spread their credit engagement across multiple projects offered on these platforms, thereby also conducting DIY risk transformation.

Peer-to-peer finance typically takes two forms: **Peer-to-peer lending and peer-to-peer equity investment**. The former replaces the function of banks in the sense that lenders get a fixed interest rate, no matter how well the project performs. This rate is sometimes voluntarily set to zero in the case of the charitable lending, see for example kiva.org. Peer-to-peer equity investing is similar to purchasing stock. Investors are promised a share of the future profits of the investment project in exchange for a (very small) ownership share. In this proposal, we mainly focus on peer-to-peer lending, because the market is more prominent and regulation of peer-to-peer investment appears to be mainly depend on the ability to enforce the contracts offered.[2]

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### Opportunities of peer-to-peer finance

While peer-to-peer finance is still in its infancy, evidence suggests that it can be a very important addition to existing financial markets, and even replace it to a certain extent. Peer-to-peer finance can fulfill size and risk transformation just as conventional intermediaries can:

- Investment projects are financed by a multitude of lenders/investors directly (size transformation);
- Because individual funds channeled to one project can be very small[3], each investor can diversify his/her own portfolio (risk transformation).

In fact, an obvious benefit of directly connecting borrowers and lenders is the elimination of intermediation cost associated with maintaining the infrastructure of large financial institutions, such as branch networks or large IT-infrastructure. These advantages might already entail lower cost of funding in and of themselves. More importantly though, this intermediation mode might provide some agents with access to external finance that would otherwise be excluded from financial sources altogether. The small lot sizes that potential investors are able to allocate to projects through peer-to-peer platforms paired with the possibility also for more exotic and innovative projects to convince committed crowd-funders without having to comply with compulsory requirements of banks, such as collateral, might lead especially the most innovative ideas to receive funding that would otherwise

never receive support in an increasingly tightly regulated banking industry. And peer-to-peer finance may have further advantages over traditional finance:

- **Crowdsourcing decisions can be beneficial** (Surowiecki, 2004). **Crowdsourcing the screening** of borrowers can be more efficient than screening by traditional lenders.
- The screening of borrowers by lenders may benefit from crowd-expertise. Whereas bankers have high investment cost in screening a specialized project, the crowd may have sufficient experts with knowledge about the project, such that screening is less costly for the crowd.
- Screening may be low-cost for members of the crowd, because they enjoy the process. This may be because of overlapping interest, or the feeling to contribute to a person or cause.[4]
- **The crowd scales easily and quickly.** Whereas banks might require the project to be of a certain size for it to even be worth the time to screen, this is not true for peer-to-peer finance, where projects can be much smaller for screening to be efficient.
- Peer-to-peer **eliminates the premium of the traditional intermediary**, because funds are transferred directly.[5]

All of these aspects imply a potential reduction in the cost of lending as well as potentially access to new lending market segments that have previously been constrained from obtaining finance altogether. This is true especially for small (scale argument), specialized (crowd-expertise argument), and opaque borrowers. Conventionally, these characteristics apply especially to very young, innovate new ventures that are important to push technology frontiers in dynamic economies. Especially in economies with less well-developed financial markets, these type of firms are well-known to face massive challenges to raise external finance.

A further advantage of the development of peer-to-peer finance may be the fact that it is in line with the cultural development of the internet. While online-banking has become fairly standard, loan applications often tend to be a time-intensive and costly process for the borrower. In peer-to-peer lending this is not the case. With a few clicks and a quick application anyone can apply for a peer-to-peer loan online – much more conveniently than dealing with the formalities of a bank-loan.

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## Risks and challenges of peer-to-peer finance

### Theoretical

The central challenge for peer-to-peer finance to be successful is the existence of information asymmetries. They arise, because it is not easy for lenders – especially those without expertise – to ascertain the value of the project applying for debt or equity funding in terms of expected return and risk. This is exacerbated by the fact that **peer-to-peer finance is unsecured**, i.e. contracts usually do not require collateral, covenants, or other forms of insurance against moral hazard. Borrowers, in turn, face difficulties to convince lenders of their ability to repay.[6] Thus, the challenge of peer-to-peer finance is not technological anymore. It is about individual lenders making **appropriate lending decisions** on **credible claims**. If this challenge is not successfully overcome, the peer-to-peer market may just be a platform for exploiting relatively uninformed investors.

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## Empirical Evidence

Ultimately the question of whether peer-to-peer finance currently provides benefits in terms of cost reduction or is exploitative is an empirical one. The empirical evidence on peer-to-peer finance is so far scarce. The few existing studies point to significant problems in the peer-to-peer market, which clearly hint at exploitation of uninformed lenders by borrowers.

First, empirical evidence points to the fact that peer-to-peer lenders make decisions that are not based on loan quality, but on peer-group effects (Lin et al., 2013), group leader bids (Hildebrand et al., 2016) and presentation of the particular project (Herzenstein et al., 2011). The first study directly evaluating the performance of new ventures in Germany that received peer-to-peer equity funding (Blaseg and Koetter, 2017) finds that these firms are more likely to subsequently fail in comparison to young ventures with similar starting conditions that received bank and/or venture capitalist funding. Overall, the evidence points toward the fact that at least currently the cost-saving potential of peer-to-peer markets is not living up to its potential. More often than not, it seems that bad investments are financed with peer-to-peer investment, whereas good investments still receive traditional financing.

## Solving the Problem

In its current form, the peer-to-peer market is not working as efficiently as it could. This deficiency is also related to the fact that policy makers are unaware of it and market participants often have to work around existing regulation that were designed for the traditional financial market. We thus suggest three simple steps to render the peer-to-peer market more efficient and boost it as a complement to existing traditional finance:

### 1. Assign a **designated regulator**

Most G20 countries do not explicitly state, which regulator is in charge of observing and potentially regulating the peer-to-peer market. This makes it difficult to collect data and have regulatory security for all parties involved. Great Britain is leading in this regard, having assigned the Financial Conduct Authority. Other countries should follow.

### 2. Create a convenient and standardized **licensing system for peer-to-peer platforms**

Peer-to-peer platforms are not lenders in the traditional sense; they only create the platforms for borrowers and lenders to find each other. However, the laws in most G20 countries are at times not completely clear if they are considered banks or not. As a result, many peer-to-peer lenders work with banks to allocate financial funds to borrowers. This lack of a consistent and clear distinction from banks might result in peer-to-peer lenders being exploited as cheap refinancing option by banks at worst, and peer-to-peer turning into direct banking[7] at best. Instead, creating a system where no participant in the peer-to-peer market has to apply for a banking license but where platforms can be licensed and regulated would be a way forward to create a more formal framework how banks and peer-to-peer intermediation differ.

### 3. Creating **transparent resolution mechanisms**

Most peer-to-peer lending is currently hampered by the fact that once the project has been financed, lenders lack the traditional enforcement mechanisms of banks in order to recoup the loan if the enterprise fails. Equipping lenders ex post with a mechanism to reclaim some of the value of the loan – potentially via the platform as well – is crucial. Providing them ex ante with access to standardized information, for example on funding applicants' previous attempts to crowd-source, ratings, etc., enables agents to make informed and rational choices that are the prerequisite for self-responsible investment behavior.

In peer-to-peer investment, contracts must be properly enforceable and enforced, by enabling investors to have a claim on the investments profits and losses.

We highlight the importance that regulatory efforts of peer-to-peer markets occur by international coordination efforts, in order to ensure that as many countries as possible have similar regulation to avoid regulatory arbitrage. Regulatory arbitrage occurs, when companies move their businesses and products to specific countries specifically in order to evade certain types of regulation. Evidence of regulatory arbitrage is significant in banking (Houston et al., 2012 and Acharya and Steffen, 2015) and will be a much greater concern for peer-to-peer finance, because it is entirely internet based and thus inherently borderless. As a result, as the peer-to-peer market grows, there is significant risk of cross-border lender and investor exploitation, if no international coordination effort takes place.

The peer-to-peer market is still relatively small compared to traditional financial markets, but it is highly innovative and experiencing rapid growth, despite the absence of regulatory safety. While exact numbers are hard to come by (in part because it is not clear which authority is tasked with collecting data), the peer-to-peer market was estimated to be about €133.5 billion in 2015, up from just €5.5 billion in 2013, an almost 25 fold increase in just two years.[8] In Europe, the market has reached €5.5 bn in 2015, with 3/4th of that volume in the UK alone. This is small compared to the (world) total amount of private credit, which exceeds world GDP, but it is comparable to the size of venture capital markets. For example, in the US – the main country for venture capital investment – in 2016 roughly \$60 billion dollars were invested in new firms.[9] This means that peer-to-peer finance is not an unimportant market, and is only expected to get more important. Setting clear rules on an international stage early, will not only enable the market to grow safely, but will be easier to accomplish now, as the market is still in its growing phase.

All in all, the suggested policy recommendations should make the peer-to-peer market function much more smoothly. The involvement of traditional financial institutions would become transparent. Lenders and investors will be empowered to make informed choices about which project to finance with equity, debt, or even both at which terms. Defining which regulatory authority is responsible for chartering and supervision provides transparency to agents about who is in charge of setting “the rules of engagement”. This will not eliminate the potential for the exploitation of uninformed lenders and investors. But a clearer and more harmonized framework that is explicit in putting self-responsibility of investors at the center stage should incent more conscious savers with adequate appetite for risk to participate in peer-to-peer finance. This pattern should help to raise funds especially for those innovative new projects that might not receive funding from more traditional, less risk-inclined, and more regulation-constrained intermediaries. As a result peer-to-peer finance can develop to be a good complement to traditional financial markets.

[1] Note that financial transformation also occurs across the temporal and spatial dimension. The spatial dimension has seen decreasing importance with the increase in access to Internet technologies (although it is still relevant in some contexts). Banks and peer-to-peer markets can perform very similar functions in this regard. Temporal Transformation usually does not exist in peer-to-peer markets, as the repayment on the borrower side is equal to that on the lender side.

[2] In that the investor can expect a claim on the investments profits and losses as advertised on the platform.

[3] Small typically means as low as a few Euros/Dollars. In theory, as transaction costs shrink, there is however reason to believe that this lower bound will continue to become lower

[4] An indication that this factor may be very important is that one of the largest peer-to-peer lending platforms worldwide is in fact a charity, where lenders do not charge interest (kiva.org).

[5] The peer-to-peer platform usually charges a premium, but its much smaller compared to the traditional financing, because they need to do minimal screening only.

[6] This seminal „lemons“ problem modeled for the first time by Akerloff (1970) entails that information asymmetries can lead to market failure.

[7] That is banks that predominantly use the internet as sales channel and maintain no or only very few branches.

[8] Zhang, B., et al. "Sustaining momentum—The 2nd European alternative finance industry report." Cambridge Centre for Alternative Finance 120 (2016).

[9] PricewaterhouseCoopers, National Venture Capital Association „MoneyTree Report“. 2016.

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