RUSHING TO REGULATE: RETHINKING THE RBI'S DIRECTIVES ON PEER-TO-PEER REGULATIONS IN INDIA

ABSTRACT

Almost half of India still does not have a bank account, leaving millions of Indians unable to access traditional sources of credit. For these unbanked Indians, peer-to-peer (P2P) lending platforms have become an important alternative credit source. A recent boom in P2P platforms caused the Reserve Bank of India (RBI) to create a regulatory framework for the P2P sector. This Comment seeks to address some of the issues concerning regulating an unconventional industry that provides a crucial service. First, it is argued that the RBI fundamentally mischaracterizes both the services P2P's provide, and how P2P's provide these services. The Comment then discusses challenges P2P regulation poses for the RBI, arguing that the RBI's framework both over- and underregulates P2P platforms. Finally, this Comment recommends India adopt U.S. P2P regulations, allowing for an exemption-based approach to lending. Given that alternative credit is much needed in India, this comment hopes to better tailor current regulations, in order to avoid a total regulatory overhaul.

INTRODUCTION

Following the 2008 financial crisis, banks scaled back lending, which meant small businesses and individuals were cut off from traditional sources of credit.[1] Peer-to-Peer (P2P) platforms filled this lending vacuum by providing alternate sources of financing.[2] Potential lenders match with borrowers through an online marketplace, allowing them to bypass traditional financial services middlemen.[3] While P2P lending started out as a relatively simple system for facilitating loans between individuals online, it has since grown into a complex system of technologies, institutions, and startups.[4]

In India, the P2P sector is new, with only thirty P2P platforms registered as of 2016.[5] However, India is a credit-strapped country, and, following

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1 Special Report, *From the People, for the People,* THE ECONOMIST (May 9, 2015) https://www.economist.com/news/special-report/21650289-will-financial-democracy-work-downturn-people-people.

2 *Id.*

3 *Id.*

4 *Id.*; *see also* Sven C. Berger & Fabian Gleisner, *Emergence of Financial Intermediaries in Electronic Markets: The Case of Online P2P Lending*, 2 BUS. RES. J. 39, 39 (May 2009).

5 RES. BANK OF INDIA, CONSULTATION PAPER ON PEER TO PEER LENDING 7 (Apr. 2016), https://rbidocs.rbi.org.in/rdocs/content/pdfs/CPERR280416.pdf.

demonetization, it is also cash-strapped.[6] Of the sixty million small businesses in India, only thirty-three percent are able to access institutional credit.[7] Individuals, 80% of whom self-finance, face similar credit barriers, with 32% relying on friends or family, and another 12% raising funds from informal banking networks.[8] Many of these potential borrowers are traditionally unbanked, have limited credit histories, and do not know how to navigate traditional banking institutions.[9] Moreover, 40% of Indians still do not have a bank account.[10] P2P lenders have taken note of these potential borrowers, and thirty lending platforms have collectively disbursed loans totaling $25 million USD.[11]

The Reserve Bank of India (RBI) recognized the potential for Indian P2P growth when it noted that "this industry has the potential to disrupt the financial sector and throw surprise. A sound regulatory framework will prevent such surprises."[12] On October 4, 2017, the RBI issued a Master Direction bringing P2Ps under the RBI's regulatory jurisdiction by classifying P2Ps as Non-Banking Financial Companies (NBFC-P2Ps) under Section 451 of the RBI Act in an effort to stabilize the P2P sector.[13] While many welcomed the structure

6 Manas Chakravarty, *How Demonetisation Crippled Bank Lending,* LIVEMINT (June 6, 2017), http://www.livemint.com/Opinion/j6FWY6uYX5sGxcqW4WR1dN/How-demonetisation-crippled-bank-lending.html ("Indeed, in the second half of FY2017, bank lending to rural Haryana, Punjab, Goa, Maharashtra and Kerala contracted. Lending to rural Maharashtra fell by as much as 9.2%. Putting that in perspective, bank loans in the second half of FY16 to rural Haryana increased by 18% and to rural Punjab by 12.2%, while rural Maharashtra saw an increase in lending of 5.8%. Not a single state had showed a contraction in rural lending in the second half of FY16. In other words, the slowdown in rural lending in the second half of FY17 was very abnormal and may be attributed largely to demonetisation."). Demonetization refers to the Indian government's decision on November 8, 2016 to remove all 500 and 1000 rupee banknotes from circulation. *The High Economic Costs of India's Demonetisation*, Economist (Jan. 7, 2017), https://www.economist.com/finance-and-economics/2017/01/07/the-high-economic-costs-of-indias-demonetisation. By removing eighty-six percent of cash in circulation the government hoped to curb the use of "black money." *Id.* However, the move has been widely criticized for causing massive cash shortages that disproportionally impacted middle to low income Indians. *Id.*

7 Allen Taylor, *Review of India Regulation on P2P Lending Market,* LENDING TIMES (Sept. 18, 2017), https://lending-times.com/2017/09/18/review-of-indian-regulation-on-p2p-market/

8 *Id.*

9 Chethan Kumari, *40 Percent of India is Unbanked & Hurting the Most; Exchange of Currency Permitted Only Once Till RBI Review,* TIMES OF INDIA (Nov. 12, 2016), https://timesofindia.indiatimes.com/business/india-business/40-of-India-is-unbanked-hurting-the-most-Exchange-Of-Currency-Permitted-Only-Once-Till-RBI-Review/articleshow/55392031.cms.

10 *Id.*

11 Tarush Bhalla, *Fintech Startups Join Hands to Form India's First P2P Lending Association,* YOURSTORY (Jan. 10, 2018), https://yourstory.com/2018/01/fintech-startups-join-hands-form-indias-first-p2p-lending-association ("India has around 30 online P2P lending platforms with a loan book of approximately $25 million.").

12 CONSULTATION PAPER ON PEER TO PEER LENDING, *supra* note 5, at 9.

13 *Master Directions - Non-Banking Financial Company – Peer to Peer Lending Platform (Reserve Bank)*

these regulations provided, others are wary of the prudential and governance requirements NBFC-P2Ps now have to meet.[14]

This Comment argues that in trying to structure the P2P sector, the RBI has substantially overregulated the industry by misunderstanding the innovative contributions of P2Ps. By misclassifying P2Ps as NBFCs, the RBI imposed inappropriate prudential and governance regulations. This Comment focuses on the most common form of P2P lending: unsecured consumer loans brokered between strangers through an online platform. Section II explains how P2Ps currently function in India, how P2Ps are uniquely suited to extending credit to Indian consumers, and why the industry must be encouraged. Extending credit to the traditionally unbanked is key for developing Indian financial markets.

Section III documents the problems P2P lending poses for Indian regulators and examines why RBI regulations do not adequately address the problems presented. Part IV concludes by recommending that India should adopt a U.S.-style exemption approach to P2P regulation. The U.S. approach allows the RBI to avoid a total regulatory overhaul and instead focus on tailoring P2P regulations.

Many P2P regulators welcome RBI regulation.[15] This Comment does not argue that the Indian P2P sector should remain unregulated, but rather considers whether the RBI regulations sufficiently address the regulatory challenges P2Ps pose. By building on scholarship analyzing global P2P regulation, this Comment hopes to offer a model of Indian P2P regulation that allows for increased and more equitable financial access.

Directions, Res. Bank of India (Oct. 4, 2017), https://www.rbi.org.in/Scripts/NotificationUser.aspx?Id=11137&Mode=0, [hereinafter *Master Directions*]

14 Shivasnkari Bhuvaneswaran, *What Do Prominent P2P Players Think of the RBI Regulations?*, FINEXTRA: BLOGS (Aug. 5, 2017), https://www.finextra.com/blogposting/14376/what-do-prominent-p2p-players-think-of-the-rbi-regulations; Pratik Bhakta, Rs. *10 Lakh Limit on P2P Lending Will Hurt Industry: P2P Startup Founders,* ETTECH: STARTUPS (Oct. 7, 2017), https://tech.economictimes.indiatimes.com/news/startups/rs-10-lakh-limit-on-p2p-lending-will-hurt-industry-p2p-startup-founders/60980922 ("'The Rs. 10-lakh limit for both borrowers and lenders is a major detriment to the sector as a whole, it is too low and should be revised upwards,' said Sanjay Darbha, founder of Peerlend, a Hyderabad-based P2P startup. 'Such low limits will push people to cash borrowings from expensive money lenders and defeat the entire purpose around P2P lending.' Echoing similar fears, Shankar Vaddadi, founder of another P2P startup iLend, said high net-worth individuals with higher disposable corpus would be discouraged from participating in this sector in the wake of such limitations.").

15 Bhuvaneswaran, *supra* note 14.

I. INDIAN P2PS AND THE DREAM OF FINANCIAL INCLUSION

Of the estimated 260 million Indians (or 26% of the population) who live in poverty, approximately 193 million (or 74%) live in rural areas.[16] The majority of these rural poor Indians have no access to formal credit sources.[17] As a result, they are forced to rely on informal finance, mainly from moneylenders, who are free to charge exorbitant interest rates.[18] There is also the issue of bias—fifty-eight percent of surveyed Indians reported that it is difficult for them to get access to credit because of their gender, ethnicity, or religion.[19] These populations are further disadvantaged when their lack of credit access prevents them from building credit histories for future loans.[20]

Access to credit is similarly out-of-reach for most small Indian businesses. Close to eighty percent of small businesses have no links with formal financial institutions.[21] A study by the Nachiket Mor Committee noted that on the demand side, small businesses have "limited managerial capabilities and financial management skills, lack appropriate documents, and require small ticket size loans."[22] The study further notes that on the supply side "banks lack credit information about the clients, classify small businesses loans as risky, and see financing to small enterprises as a low revenue activity."[23]

P2P platforms address, to varying degrees, all of these credit-access bottlenecks in India. First, P2Ps have no physical location and all transactions

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16 PRIYA BASU, IMPROVING ACCESS TO FINANCE FOR INDIA'S RURAL POOR xxvii (2006).

17 *Id.* at xvi.

18 *Id.*

19 Press Trust of India, *Religious, Gender Bias Greater in India for Jobs, Credit: Study*, BUS. STANDARD, (May 11, 2015), http://www.business-standard.com/article/companies/religious-gender-bias-greater-in-india-for-jobs-credit-study-115051100075_1.html.

20 BASU, *supra* note 16, at xvi.

21 Charan Singh and Kishinchand Poornima Wasdani, *Finance for Micro, Small, and Medium-Sized Enterprises in India: Sources and Challenges* (ADBI, Working Paper 581, 2016), https://www.adb.org/sites/default/files/publication/188868/adbi-wp581.pdf ("According to International Finance Corporation (2012), the supply of finance to the MSME sector is estimated to be 32.5 trillion Indian rupees (Rs). This total comprises contributions from informal finance, formal finance, and self-finance. Informal sources and self-finance contribute Rs25.5 trillion to the sector, of which informal finance accounts for Rs24.4 trillion. In other words, 78% of the finance used by MSMEs is met by informal sources and self-finance. The remaining 22% (Rs6.9 trillion) is provided by banks and NBFCs, of which banks provide the bulk (91.8%).").

22 Anup Singh, Abhapy Pareek, & Raunak Kapoor, *Expanding Access to Finance for Small Businesses in India: A Critique of the Mor Committee's Approach Why Are The Banks Not Financing Small Businesses?*, MICROSAVE CONSULTING: BLOG (May 2014), http://blog.microsave.net/expanding-access-to-finance-for-small-businesses-in-india-a-critique-of-the-mor-committees-approach-part-2-why-are-the-banks-not-financing-small-businesses/.

23 *Id.*

are conducted electronically.[24] By adopting a web-only presence, these lenders are able to cut costs that are incurred in traditional banking.[25] For example, the table below compares the operating costs of a leading U.S. P2P platform, Lending Club. to a traditional bank, Zion Bank and demonstrates that the Lending Club's operating expenses are significantly lower than Zion Bank's.[26]

Operating Expense Comparison – Lending Club vs. Traditional Bank		
(All figures in USD)	**Lending Club**	**Zions Bank**
Net Loan Revenues	$211	$1818
Sales, Marketing and Advertising	$87	$23
Total Op Ex	$243	$1714
Op Ex less Sales & Marketing	$155	$1691
(Op Ex – Sales & Mktg.)/ Net Loan	**74 percent**	**93 percent**

A fully digital platform, alongside rising smartphone ownership, means P2P technology is an increasingly accessible financial option for the traditionally unbanked.[27] P2P platforms are especially useful in rural areas where it is uneconomical for traditional banks to build branches when transactions are

24 Berger & Gleisner, *supra* note 4, at 39.

25 *Id.* at 41 ("Electronic markets can facilitate economic activity even under complex and insecure conditions . . . significantly reduce information and transaction costs, and may in this way displace traditional intermediaries . . . .").

26 Saurabh Sharma, *P2P Lending and Big Data: Banking on the Non-Banks*, CROWDFUNDBEAT, https://crowdfundbeat.com/2015/03/27/p2p-lending-and-big-data-banking-on-the-non-banks/ (last visited Aug. 27, 2018).

27 Smitha Verma, Unbanked Population: How Alternative Financial Services Ecosystem has Become Big Boon for India, Fin. Express (Oct. 22, 2017, 1:26 AM), http://www.financialexpress.com/economy/unbanked-population-how-alternative-financial-services-ecosystem-has-become-big-boon-for-india/901477/ ("For a country with a large unbanked population, the alternative financial services ecosystem has come as a big boon. Customers, who were mostly shown the door by traditional banks, now have an instant, hassle-free and accessible solution at the tap of a key.").

small.[28] Rural Indians no longer have to travel miles to access a credit interface.[29]

Second, by eliminating the banking intermediary, P2Ps can offer low rates for borrowers, high returns for lenders, and increase overall credit access.[30] Platforms use a reverse auction model, in which lenders bid for a borrower's loan proposal, and the borrower has the freedom to either accept or reject the offer.[31] Because loan making is so decentralized, borrowers and lenders can unbundle any unnecessary or unwanted services otherwise required by traditional intermediaries.[32] Tailoring loans this way significantly lowers associated overhead costs.[33] Low lending costs make it profitable to disburse much smaller loans.[34] These smaller loans require less collateral capital and are thus much more suited to the credit needs of small businesses and rural individuals.[35] In 2016, almost thirty-four percent of borrowers were entrepreneurs who used P2Ps to secure enough cash to expand operations.[36]

[28] BASU, *supra* note 16, at 11. ("On average, a rural bank branch in India serves almost three times the number of people served by a non-rural branch . . . . The volume of deposits and credit in rural areas is also much lower than in urban areas. Per capita deposits in rural areas stood at Rs2,150 (US$47) or around 10 percent of national per capita GDP in 2001, compared to Rs33,780 (US$740) or around 160 percent of per capita GDP in the same year for urban areas. Credit per person in rural areas stood at Rs900 (US$20) or around 4 percent of national per capita GDP versus a figure of Rs20,600 (US$450) for urban areas, which is around 100 percent of national per capita GDP. The number of credit accounts in rural areas relative to the total rural population amounts to only 3.4 percent against a ratio nearly three times higher for urban areas.").

[29] *Id.* at 20 ("In general, frequency of visits to formal financial institutions is low, with the main reason for infrequent visits being the high costs related to travel time/transport.").

[30] Rajat Gandhi, *What the Future Holds for the P2P Lending Market in India and the World*, PLUNGE DAILY (June 16, 2017), https://mybigplunge.com/opinion/what-the-future-holds-for-the-p2p-lending-market-in-india-faircent/ ("P2P lending offers the advantage of fixed and higher returns not vulnerable to market turbulence, and that's where it is winning over traditional market-linked investment instruments.").

[31] Bill Snyder, *Exploring Auction Models for Peer-to-Peer Lending*, STAN. BUS. INSIGHTS (Apr. 1, 2011), https://www.gsb.stanford.edu/insights/exploring-auction-models-peer-peer-lending.

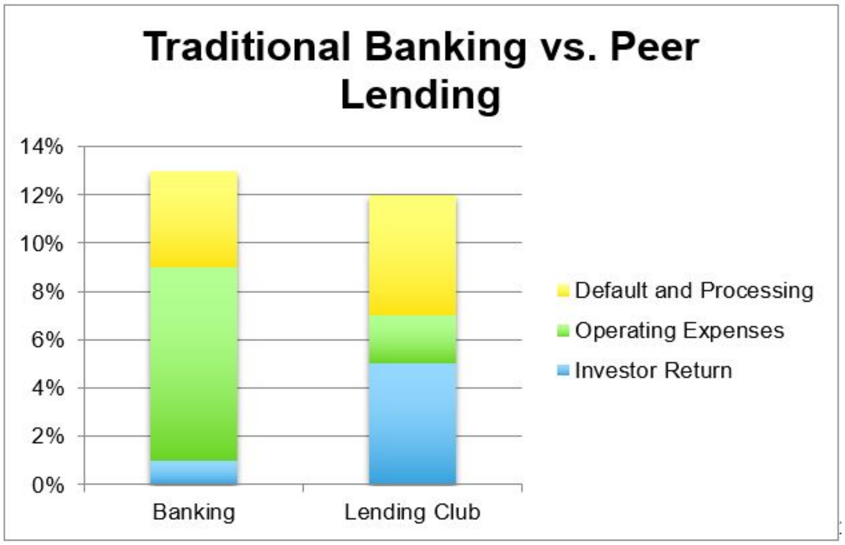
[32] Andrew Verstein, *The Misregulation of Person-to-Person Lending*, 45 U.C. DAVIS L. REV. 445, 460–61 (2011).

[33] ALISTAIR MILNE & PAUL PARBOTEEAH, THE BUSINESS MODELS AND ECONOMICS OF PEER-TO-PEER LENDING 4 (May 2016) ("The focused nature of their activities ensures that the administrative and overhead costs required for setting up a P2P platform are relatively low.").

[34] *Id.* ("Some individuals and small businesses that do not satisfy the more stringent criteria that banks now place on granting loans can, through peer-to-peer lending services, find alternative lenders who are willing to take on the risk of providing such loans or to offer them at lower rates of interest.").

[35] *Id.*; *see also* Aman Malik, *RBI's P2P Lending Norms: A Step Backward or Forward?,* VCCIRCLE (Oct. 23, 2017), https://www.vccircle.com/rbis-new-p2p-lending-norms-a-step-backward-or-forward/ ("P2P lenders, most of whom operate online, typically help borrowers get loans without collateral . . . .").

[36] Bhuvaneswaran, *supra* note 14.



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Third, P2P platforms offer ways for populations who have limited identification documents and credit histories to access loans. When assessing whether to issue a loan to an individual, banks assess the creditworthiness of the borrower.[38] Depending on a risk-assessment of their credit history, a bank will determine if an individual is eligible for a loan and the terms of the loan.[39] The more favorable the credit history of the individual, the better the terms of the loan.[40] However, credit data is hard to find for people who do not participate in traditional banking structures.[41] Underwriting is also a labor intensive and time-consuming process that does not make financial sense for a small business

[37] Anothony Zeoli, *Peer to Peer Lending: Taking the Fear Out of "Shadow Banking"*, CROWDFUND INSIDER (May 27, 2015), https://www.crowdfundinsider.com/2015/05/68355-peer-to-peer-lending-taking-the-fear-out-of-shadow-banking/.

[38] Rajkamal Iyer et al., *Screening in New Credit Markets: Can Individual Lenders Infer Borrower Creditworthiness in Peer-to-Peer Lending?*, AFA 2011 Denver Meetings Paper 1 (Mar. 2010), http://ssrn.com/abstract=1570115 ("Traditionally, banks have played the dominant role in allocating credit partly because they are attributed to have the financial expertise to evaluate borrowers and effectively intermediate capital . . . .").

[39] *Id.*

[40] Bruce D. Smith, *Taking Intermediation Seriously*, 35 J. MONEY, CREDIT & BANKING, 1319, 1321–22 (2003).

[41] Corinne Abrams, *Are You a Credit Risk? Indian Banks Dig Deep in Your Phone to Find Out*, WALL ST. J. (Nov. 23, 2017), https://www.wsj.com/articles/are-you-a-credit-risk-indian-banks-dig-deep-in-your-phone-to-find-out-1511433007.

looking for a small loan.[42] While P2Ps engage in traditional underwriting, they also use big data analytics to determine a borrower's creditworthiness.[43] By analyzing social media activity, mobile phone usage, and whatever demographic material the borrower provides, P2Ps can identify, score, and underwrite credit for low- and middle-income consumers who lack a formal credit history.[44] Nearly three-quarters of borrowers on Faircent, an Indian P2P Platform, have a score of less than 700, below the threshold at which the banks determined lending is too risky or uneconomical.[45] Lending to people with poor credit background can mean higher interest rates.[46] But the only alternate options for those historically unable to access traditional banks are informal money lending arrangements, with no legal protections or supervision.[47] Given limited options, comparatively high-interest P2P loans are the best choice. Some scholarship points toward data analytics, like that done by P2P, being a much more accurate form of risk-management in comparison to traditional credit underwriting.[48] Furthermore, even borrowers with risky credit ratings may be able to find philanthropic lenders through P2P platforms.

Fourth, P2Ps open up investing opportunities to underserved populations by allowing multiple lenders to finance loans. Unlike with traditional lending in which a loan has a single lender—usually a bank—P2Ps allow loans to be fulfilled by multiple lenders.[49] Lenders also can manage risk easily by lending small amounts to many borrowers.[50] P2P loans are also better insulated than

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42 Sharma, *supra* note 26 ("Small businesses, whose capital needs are usually underserved by banks who opt to avoid engaging in the labor-intensive underwriting process when smaller numbers are involved, benefit from the borrowing options offered through these platforms.").

43 *Id.* ("For lenders on P2P platforms, private individuals can enjoy a much higher return than today's savings accounts or other low risk investments offer. Institutional lenders can have direct access to the previously difficult to reach consumer finance asset class.").

44 *Id.*

45 Nishant Sharma, *P2P Lending: In Game of Loans, RBI Arms a New Player*, QUINT (Sept. 20, 2017), https://www.thequint.com/news/business/rbi-with-a-new-p2p-lending-system.

46 *Id.*

47 Vinnie Lauria, *Here's Everything You Should Know About Alternative Lending in Asia*, FORBES (Mar. 13, 2017, 12:52 AM), https://www.forbes.com/sites/vinnielauria/2017/03/13/heres-everything-you-should-know-about-alternative-lending-in-asia/#39558600113e ("P2P interest rates may be higher than those of traditional loans, but in India's mostly cash economy, they are the only option for many. For people who have been historically neglected by traditional banks, the popularity of P2P lending in India continues to rise.").

48 Mikella Hurley & Julius Adebayo, *Credit Scoring the Era of Big Data*, 18 YALE J. L. & TECH. 148, 148 (2016).

49 Vinay Mathews, *P2P Lending: The Real Benefits and Ways to Mitigate Risk*, YOURSTORY (Nov. 21, 2016), https://yourstory.com/2016/11/p2p-lending-risk-mitigatigation/ ("Investing small amounts across a large number of diversified loans will likely keep default rate at a reasonable and consistent level, thereby increasing returns.").

50 *Id.*

stocks from market downturns, leaving lenders better protected in recessions.[51] In the case of one borrower defaulting, lenders are still relatively unaffected. Unlike informal lending networks, there are legal recourses available if a borrower does not repay a loan.[52] This allows rural individuals to invest modest amounts and have steady monthly incomes.

Finally, increased P2P use has the potential to bring more transparency and clarity to the larger credit market. Traditional banks pool, divide, and sell consumer credit loans to investors.[53] This mixing and packaging makes traditional loans complex enough to diffuse accountability in the case of defaults.[54] However, P2P borrowers know the particular lenders to which they are liable, and all P2P lenders know which particular borrowers make their payments. If P2P returns fall, lenders know immediately which loans defaulted and can adjust accordingly, either by modifying their portfolio strategies or leaving the marketplace altogether.

P2P platforms solve some of the most pressing credit access problems in India, without requiring any substantial infrastructure development. However, the P2P model does signal a need for regulation to address some serious concerns about consumer and investor protection.

II. WHAT THE RBI ADDRESSES, WHAT IT MISUNDERSTANDS, AND WHAT IT MISSES

While the P2P sector is still small in comparison to the overall Indian financing sector, legislators, investors, and P2P platforms themselves have called for some type of regulation.[55] Legislators want to set best practices for the sector, investors want regulatory clarity, and platforms want credibility.[56] But the unconventional nature of the P2P model puts them in a regulatory grey space.[57] Unlike banks, P2P platforms do not conduct any direct lending,

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51 *Id.* ("In 2008–09, the stock market had crashed, losing more than 55 percent of its value but globally, P2P loans didn't stop and borrowers continued to pay lenders money.").

52 *Id.* ("The platform should facilitate the signing of a legally-binding agreement as well as collection and holding of borrowers' post-dated cheques which can be used by the lender to initiate criminal proceedings in case of default.").

53 Richard E. Mendales, *Collateralized Explosive Devices: Why Securities Regulation Failed To Prevent the CDO Meltdown, and How To Fix It*, U. ILL. L. REV. 1359, 1361–63 (2009).

54 *Id.*

55 Bhuvaneswaran, *supra* note 14.

56 *Id.*; PTI, '*NBFC Status to P2P Puts Compliance Burden; Lending To Go Up*', MONEYCONTROL (Oct. 9, 2017), http://www.moneycontrol.com/news/business/nbfc-status-to-p2p-puts-compliance-burden-lending-to-go-up-2407535.html.

57 Jitendra Soni & Kanad Bagchi, *RBI Paper on Peer-to-Peer Lending: A Case of Unmindful*

including accepting deposits.[58] Instead, arrangement fees make up the bulk of a P2P platform's income.[59] P2P platforms exist in a middle ground where they simply facilitate lender-borrower connections, but do not engage in directly providing any financial services.[60]

In order to regulate P2Ps, the Reserve Bank of India had to first decide how to classify P2Ps. On October 4, 2017, the RBI issued a Master Directive that brought P2Ps under its jurisdiction by classifying them as NBFC-P2Ps under Section 451 of the RBI Act.[61] This classification subjected P2Ps to a slew of reporting, prudential, and governance requirements.[62] These guidelines provided some much-needed clarity—but they also misunderstood, and so misregulate, a much-needed service. First, it is unclear whether classifying P2Ps as NBFCs is legally justified. Second, the RBI's prudential and governance regulations take an archaic regulatory approach that can inhibit P2P growth. Third, the RBI regulations leave key consumer protection and investing issues unaddressed.

A. Can P2Ps Be NBFCs?

Indian banking laws allow the RBI to regulate both "banks" and "non-banks."[63] To perform lending and borrowing activities, banks have to receive banking licenses from the RBI.[64] Similarly, non-banks engaged in "financial activity'" have to obtain certificates of registration from the RBI.[65] To determine whether a company is engaged in financial activity, the RBI applies the "principal business" or "50-50 Test."[66] The assets and income stream of a company are examined from their most current balance sheet.[67] If a company's income from the financial services it performs is more than fifty percent of its gross income, then the company will be classified as a "NBFC."[68]

Contradictions, WIRE (May 23, 2017), https://thewire.in/37842/rbi-paper-on-peer-to-peer-lending-a-case-of-unmindful-contradictions.

58 *Id.*

59 *Id.*

60 *Id.*

61 *Id.*; *Master Directions*, *supra* note 13.

62 *Master Directions*, *supra* note 13.

63 Soni & Bagchi, *supra* note 57.

64 *Master Directions*, *supra* note 13.

65 *Id.*

66 Press Release, Res. Bank India, Amendment to NBFC Regulations - Certificate of Registration (CoR) Issued Under Section 45-IA of the RBI Act, 1934 – Continuation of Business of NBFI - Submission of Statutory Auditors Certificate - Clarification (Oct. 19, 2006), https://rbidocs.rbi.org.in/rdocs/Notification/PDFs/73378.pdf; *see also* Varun Sriram, *RBI Directive on Treating P2P Lenders as NBFCs Needs Clarity*, VCCIRCLE (Oct. 4 2017), https://www.vccircle.com/rbi-directive-on-treating-p2p-lenders-as-nbfcs-needs-clarity.

67 Sriram, *supra* note 68.

68 *Id.*

In traditional lending—where an institution accepts deposits on their balance sheet and in turn loans out capital—the 50-50 Test easily applies. Simply put, under the 50-50 Test, a traditional lender is classified as an NBFC if the interest collected from their loans is fifty percent of their gross income.[69] But P2P platforms do not lend out any of their own funds or accept deposits from lenders or borrowers.[70] Their primary source of income is from commissions or arrangement fees that are basically service charges that lenders and borrowers pay for using their platforms.[71] Given that P2Ps do not issue loans—they simply facilitate them, and so cannot collect interest on those loans—it is unclear how to apply the 50-50 Test to P2Ps.

While it is too early for any legal challenges to have taken place, Indian courts could conclude that the 50-50 Test does not apply to P2Ps. Given the lack of clarity as to whether P2Ps can be classified as NBFCs, it can be argued that the RBI is overstepping and trying to regulate a tech company—which simply happens to be in the financial sector—as an NBFC. Such a ruling would place P2Ps outside the regulatory jurisdiction of the RBI, as the RBI can only regulate companies that predominantly engage in banking or financial activity.[72] P2P leaders are already pushing to be classified as separate, primarily technological entities, rather than as NBFCs.[73]

However, the RBI can circumvent the 50-50 Test if it consults with the government and invoke special powers to classify an entity as an NBFC.[74] It seems the RBI might have waived the 50-50 Test for P2Ps. The RBI did this in the past with mortgage guarantee companies and account aggregators.[75] In both these cases, however, the companies were exempted from the NBFC prudential and governance requirements to which P2Ps are subject.[76]

If the goal of the RBI is to provide structure and clarity to the P2P sector, it must either explain how the 50-50 Test applies to P2Ps or provide justification

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69 *Id.*

70 Soni & Bagchi, *supra* note 57.

71 *Id.*

72 Sriram, *supra* note 68.

73 PTI, *supra* note 56 ("'Putting P2P lending companies under the broad umbrella of NBFC regulations, however, is going to lead to several major problems,' said LoanAdda Co-Founder & CEO, Anshuman Mishra. He said the sector will much rather be recognized for the technology they use to underwrite and will prefer to be governed as a separate entity rather than being broadly classified as NBFCs.").

74 Res. Bank India, *Non-Banking Finance Companies in India's Financial Landscape*, RBI BULL. 91, 94–97 (Oct. 10, 2017), https://rbidocs.rbi.org.in/rdocs/Bulletin/PDFs/01AR101017F2969F6115EB4B5992BD73976F9A905D.pdf.

75 *Id.*

76 PTI, *supra* note 58; *Master Directions*, *supra* note 13.

for why NBFC requirements apply to entities outside the RBI's traditional regulatory sphere.

B. Archaic Prudential and Governance Requirements

Under the RBI directive, P2Ps as NBFCs are subject to pre-existing prudential and governance regulations, the same regulations that apply to traditional lenders.[77] There are three primary prudential norms:

1. All P2PS must have net-owned funds of more than Rs. 2 crore (approx. $31,000 USD).[78]
2. P2Ps must maintain a leverage ratio of two (i.e., outside liabilities of a platform must not exceed two times its owned funds).[79]
3. The maximum that a single lender can lend and the maximum that a single borrower can borrow across all P2P platforms is Rs. 10 lakhs, (approx. $10,500 USD). The maximum that a single lender can lend to a single borrower across all P2P platforms is Rs. 50,000 (approx. $770 USD).[80]

These capital requirements, leverage ratios, and caps are absolutely necessary in traditional banking. Banks lend long-term loans against short-term deposits. Thus, unexpected deposit withdrawals or surges in loan defaults can bring banks to the edge of insolvency.[81] Regulations imposing stringent capital and leverage ratio requirements insulate banks from liquidity concerns and balance sheet mismatches.[82] Simply, traditional banking and lending is a capital-heavy operation; therefore, regulators must ensure that there is always enough capital on hand to absorb losses.[83]

However, P2P lending is not a capital-heavy lending model. Operating costs are currently minimal. For most P2Ps, technology (e.g., online platform set-up and upkeep) and human capital (e.g., salaries and other remunerations) are the only major expenditures.[84] There are neither property rental nor maintenance

77 *Master Directions*, *supra* note 13.
78 *Id.*
79 *Id.*
80 *Id.*
81 Douglas W. Diamond et al., *Bank Runs, Deposit Insurance, and Liquidity*, 24 FED. RES. BANK MINN. Q. REV. 14, 20 (2000).
82 *Id.*
83 *Id.*
84 MILNE & PARBOTEEAH, *supra* note 37.

costs for physical locations. Moreover, scaling-up does not require new branches, and administrative costs are minimal.[85] The question is: why require P2Ps to have and maintain a minimum Rs. 2 crore of net-owned funds? The RBI justifies the requirement by arguing that mandating a minimal capital requirement ensures that only serious companies can participate.[86] However, currently, there are only thirty registered P2Ps in India, and P2P lending takes up a tiny fraction of the larger consumer credit sector.[87] An oversaturation of the P2P market by small-time companies should not be a primary concern. Rather, the focus should be on developing regulations that promote growth. The Rs. 2 crore requirement has already proven prohibitive to some P2P platforms. Sunil Kumar, the founder of the P2P LoanMeet, said the amount was too large and would hurt most P2P lending marketplaces. He noted, "[w]e need some time, at least a year, to raise that kind of money."[88] However, existing P2P companies only have a three-month window to meet all of the new RBI requirements.[89] Given that P2P platforms are capitalized at tens of lakhs with modest debt-equity ratios, a proportional capital base dependent on the size of a P2P portfolio is more prudent.[90] Having a Rs. 2 crore minimum might force cash-strapped, but otherwise well performing, P2P platforms out of business.

Mandating a leverage ratio is also similarly inappropriate for the P2P lending model and slows P2P growth. In traditional lending, leverage ratios are a way to ensure that a company will be able to honor its financial obligations. Companies can only lend, or carry debts in their books, in proportion to the amount of capital on hand.[91] But once again, P2Ps do not carry any debt and they do not directly lend. As VSSB Shankar, the founder of i-lend, noted: "The question of leverage ratio doesn't arise when you're not lending on your balance sheet."[92] The RBI argues that a prescribed leverage ratio ensures that "platforms do not expand

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85 *Id.*

86 Ira Dugal, *RBI's P2P Proposals: Crossing the River by Feeling the Stones,* LIVEMINT (Apr. 30, 2016, 1:20 AM), http://www.livemint.com/Money/rnZimjeG5rDxNj9N0cCqKO/RBIs-P2P-proposals-crossing-the-river-by-feeling-the-stone.html.

87 Gandhi, *supra* note 30.

88 Priya Prasad, *Read What P2P Lenders Have to Say About RBI's Proposed Norms*, TECHCIRCLE (May 26, 2016), http://techcircle.vccircle.com/2016/05/26/read-what-p2p-lenders-have-to-say-about-rbis-proposed-norms/.

89 *Master Directions*, *supra* note 13.

90 Meghna Rao, *P2P Lending Is Broken in India. What Can We Do To Fix It Before It's Too Late?*, TECH IN ASIA (June 22, 2016), https://www.techinasia.com/p2p-lenders-india-to-regulate-or-not.

91 *Master Directions*, *supra* note 13.

92 Shaswathi Shankar, *Peer-to-peer lending startups seek clarity on guidelines issued by RBI,* The Economic Times, May 2, 2016, https://tech.economictimes.indiatimes.com/news/startups/peer-to-peer-lending-startups-seek-clarity-on-guidelines-issued-by-rbi/52069933

with indiscriminate leverage."[93] But in the P2P model, lending on the platform is not tied into how much debt the P2P company has. The platform is not the lender; the lender is an independent third party that is not bound by the leverage ratio. Mandating a leverage ratio offers no protection or value to the P2P model.

Capping amounts borrowers and lenders can transact again misses the mark and substantially burdens P2Ps. While P2P platforms facilitate, on average, smaller loans than traditional lenders, setting such a low cap for borrowers and lenders cuts off the possibility of P2P platforms drawing in high net-worth individuals.[94] For three out of the four leading Indian P2P platforms, this cap would affect their minimum loan amounts.[95]

Company	**Location/ Year**	**Min. Loan**	**Max Loan**	**Average Rates**	**Borrower Evaluation Criteria**
Lendbox	Delhi, 2015	Rs. 10,000	Rs. 5,00,000	As high as 36%	More than 120 variable sing Big Dat Intelligence
Faircent	Gurgaon, 2014	Rs 30,000	Rs. 5,00,000	22–23%	CIBIL score, salary, bank account data
Lenden Club	Mumbai, 2015	Rs. 25,000	Rs. 3,00,000	15–20%	Third part credit score, salary and other parameters
i-lend	Hyderabad, 2013	Rs. 25,000	Rs. 3,00,000	16–21%	Social behaviour through social network data

Sanjay Darbha, founder of Peerlend, noted, "Such low limits will push people to cash borrowings from expensive money lenders and defeat the entire purpose around P2P lending."[96] The cap significantly restricts P2P growth, as now P2Ps can only grow by bringing many more borrowers and lenders into the platform.

93 *Id.*
94 Bhakta, *supra* note 14.
95 Gandhi, *supra* note 30.
96 Bhakta, *supra* note 14.

RBI regulations also prohibit P2Ps from participating in lending activities or in financial transactions apart from being simple intermediaries.[97] Given their now limited revenue streams, P2Ps might not be able to bear the additional costs of complying with RBI requirements. There will also be significant restructuring costs for many P2Ps. For example, considering the fact that NBFCs are to be regarded as companies, P2P firms that are currently registered as LLPs or partnerships will be required to restructure.[98] The RBI regulations have considerably increased entry barriers while restricting P2P platforms' abilities to explore options for mitigating increased costs.

C. What P2P Platforms and Consumers are Still Waiting for

By trying to control P2Ps through traditional—and often inapplicable—capital regulations, the RBI has overlooked two key P2P areas that require much clarification. The RBI has failed to address P2P remittance transactions and data security for P2P users.

D. P2Ps and Remittances

India is the largest remittance recipient in the world.[99] The majority of Indian remittances are small in amount, with transactions under Rs. 20,000 (approx. $300 USD) making up forty-three percent of remittances in 2010.[100] A large proportion of remittances are sent by migrant laborers to families in rural areas.[101] Given the low incomes of remitters, and the small amounts involved, remittance transfers can be quite costly.[102] The smaller the remittance size, the higher the transaction cost percentage for formal banking to be the cheapest option the remittance must be around Rs. 94,000 (approx. $1500 USD).[103] Most

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97 *Master Directions*, *supra* note 13.

98 *Id.*

99 Vivina Vishwanathan, *New Technology for Faster and Cheaper Remittance*, LIVEMINT (Mar. 31, 2017), http://www.livemint.com/Money/2qdTsh0891LQNaKN7ZgHnI/New-technology-for-faster-and-cheaper-remittance.html ("For about a decade, India has been the largest remittance recipient in the world, according to annual remittance data by The World Bank. In 2015, India received $69 billion in inward remittance, followed by China at $64 billion. For the year 2016, India is estimated to get about $65 billion from remittances.").

100 Res. Bank India, *Remittances from Overseas Indians: Modes of Transfer, Transaction Cost and Time Taken*, RBI BULL. 114 (Dec. 2013).

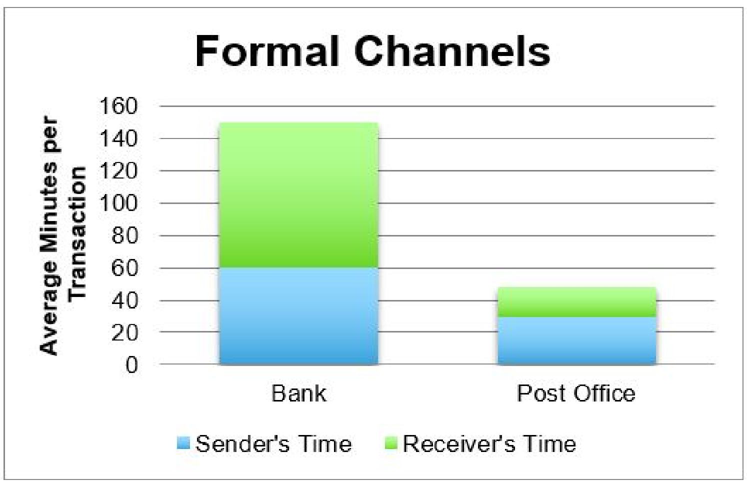
101 *Id.* ("Workers' remittances have remained an important source of external finance for India since last three decades. These flows have not only been a dominant component of India's invisibles, their trend has also been stable over the years as in the case of many other developing countries.").

102 Vishwanathan, *supra* note 99. ("[R]emittances are expensive for small companies. Banks charge on an average over 10%. Some of the third-party companies might charge more, which is often hidden in a bad exchange rate.").

103 Justin Oliver & Dan Radcliffe, *How Do Migrant Workers Move Money in India?*, CGAP (Feb. 18,

rural remittances are not large enough to make formal banking an affordable option.

Even if someone in a rural area wants to make a small remittance through formal channels, villages rarely have banks or agents.[104] A study from the Centre for Micro Finance in India shows that making a transfer through a bank requires an average of fifteen minutes of travel and forty-five minutes of wait time for senders, then another forty minutes of travel and fifty minutes of wait time for recipients.[105] An average transfer would take two and a half hours.[106] In comparison, transferring remittances through informal channels takes on average twenty-eight minutes total.[107] Cost and access barriers force an estimated seventy percent of total domestic remittances to go through informal channels.[108]



2011), http://www.cgap.org/blog/how-do-migrant-workers-move-money-india.

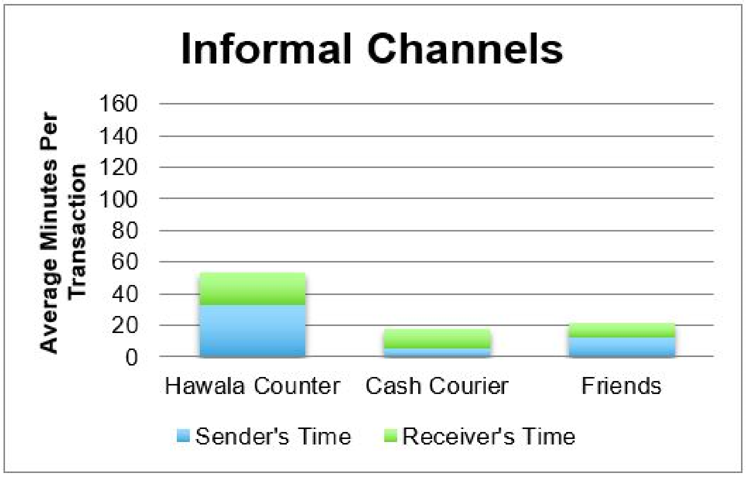
[104] Nikhil Joseph & Benjamin D. Mazzotta, *Frugal Finance: How Eko Helps India's Migrants Move and Manage Money* (Inst. Bus. Glob. Context, Working Paper No. 14-01, 2016).

[105] Oliver & Radcliffe, *supra* note 103.

[106] *Id.*

[107] *Id.*

[108] TNN, '*Payments Banks to Reduce Rural Remittance Costs*', TIMES OF INDIA (Oct. 24, 2015), https://timesofindia.indiatimes.com/business/india-business/Payments-banks-to-reduce-rural-remittance-costs/articleshow/49512996.cms.



However, while informal channels are easier to access and cheaper for many Indians, they also exist outside formal regulations.[109] P2P platforms significantly cut transaction costs for small remittances, while offering regulatory protections.[110] P2Ps cut remittance costs by matching outgoing and incoming remittances. For example, if an individual in any other country wants to transfer money to another individual in India, the individual would then give the money to a P2P office in the transferor's country. The P2P platform then scouts for a person in India transferring the same amount of money to the transferor's country. Next, the P2P platform matches these two transactions to transfer money within the borders of the respective countries. By ensuring that no money actually leaves a country, P2Ps eliminate extra costs.

However, the Indian rupee is not freely convertible.[111] To buy, sell, or covert the rupee, an individual needs explicit legal authorization.[112] These regulations set the price of the rupee by limiting the yearly volume that can be converted and the entities that can transact rupees.[113] The new RBI regulations unambiguously state that the Foreign Exchange Management Act (FEMA), and its rupee conversion restrictions, apply to all P2P platforms.[114] As a result, P2P

[109] Joseph & Mazzotta, *supra* note 104.
[110] Vishwanathan, *supra* note 99.
[111] Arjun Sinha & Aymen Mohammed, *Regulatory Challenges to Fintech in India*, YOURSTORY (Feb. 17, 2016), https://yourstory.com/2016/02/fintech-india-regulatory-challenges.
[112] *Id.*
[113] *Id.*
[114] *Id.*

platforms under FEMA Sections 3(a) and (b) explicitly prohibit any payment "to or for the credit of any person resident outside India in any manner."[115]

More so, any transaction in which the sender and receiver are not both Indian residents qualifies as a cross-border transaction; this triggers even more restrictions under Indian law.[116] The RBI regulations explicitly prohibit P2Ps from engaging in any cross-border activities.[117] The only way for a P2P to work around these restrictions is to submit an application to the Indian Banks Association asking to conduct inbound international transactions.[118] Outbound international transactions require separate applications.[119] Then, the Indian Banks Association can make a recommendation to the RBI, and the RBI has the final say regarding whether an organization can conduct a cross-border transaction.[120] As Dilip Ratha—the manager of migration and remittances at the World Bank—notes, "[t]he technology to provide remittance service for cheap is already there. Because of regulations, new players with efficient technology are not able to get into the market."[121]

Companies that want to capitalize on the informal remittance market look to work around RBI restrictions by adopting a Unified Payment Interface (UPI) approach.[122] The UPI method assigns each user a "unique virtual address" on a smartphone.[123] Users can then transfer money from one address to another. The catch is that each user must have an existing bank account.[124] Unlike P2P transfers that use virtual wallets and do not require a bank account, the UPI method is essentially a cross-bank transfer. Because many rural Indians face considerable barriers to bank access, forcing P2P platforms to adopt a UPI method results in the exclusion of rural Indians from formal banking and its protections. The RBI's guidelines overregulate a key potential use of P2P platforms for rural Indians.

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115 *Id.*

116 *Id.*

117 Nishant Maddineni, *Remitting Money from India: Procedures and Regulations*, INDIA BRIEFING (Dec. 7, 2016), http://www.india-briefing.com/news/remitting-money-india-9934.html/.

118 Foreign Exchange Management Act, 1999, No. 42, Acts of Parliament, 1999 (India).

119 *Id.*

120 *Id.*

121 Madhura Karnik, *Remittances to India Could Be Bigger than Its IT Exports—and the Modi Government Wants to Cash In*, QUARTZ INDIA (Dec. 10, 2015), https://qz.com/566835/remittances-to-india-could-be-bigger-than-its-it-exports-and-the-modi-government-wants-to-cash-in/.

122 Shweta Modgil, *WhatsApp To Roll Out P2P Payments Service in India Within Next 6 Months*, INC42 (Apr. 4, 2017), https://inc42.com/flash-feed/rbi-open-unified-payment-interface-digital-wallets/.

123 *Id.*

124 *Id.*

E. P2P Data Security Concerns

While the RBI's approach to P2Ps over-regulate, and also severely under-regulate, setting data and cyber security standards for P2P platforms. The RBI regulations require all P2Ps to follow stringent Know Your Customer (KYC) guidelines.[125] KYC norms require that all P2Ps store and verify documents to establish the names and addresses of all customers.[126] Indian banks have always been subject to KYC norms; however, banks only have to comply with KYC norms when a transaction exceeds a certain amount.[127] However, in an effort to battle money laundering, the RBI now requires P2P to fully comply with all KYC norms in transactions as low as Rs. 10,000 (approx. $157 USD).[128] Previously, digital transfers were subject to only minimum KYC norms and required only a phone number verification.[129] However, now the RBI requires full KYC norms, which can be "tedious, complicated[,] and expensive" for many users.[130]

While financial transactions must be secure, the RBI fails to understand that the ease of P2P use drew previously unbanked individuals closer towards formal financial institutions. Current regulations require P2Ps to ensure that lenders knows details about the borrowers' personal identities.[131] However, before the new regulations, both borrowers and lenders could rely on the P2P platform to use data from social media accounts or past informal credit history to create a reliable picture of all parties involved in a transaction.[132] Now, the RBI's KYC norms place the burden on clients to prove their identities and addresses through a cumbersome point-based list of Officially Valid Documents (OVD).[133] There is no option to substitute social medial posts, or anything not enumerated in the guidelines, for an OVD.[134] Given that a large swath of new P2P users were

[125] Priyanka Pani, *RBI Guidelines on Full-KYC 'Can Kill Wallets'*, HINDU BUS. LINE (Oct. 12, 2017), http://www.thehindubusinessline.com/money-and-banking/rbi-guidelines-on-fullkyc-can-kill-wallets/article9901830.ece.

[126] *Id.*

[127] *Id.*

[128] *Id.* ("'They (RBI) are asking full KYC for transactions as low as ₹10,000. This will kill the industry and maybe take us back to the traditional mode of money transfers i.e. through banks,' said a source, who is a part of an industry body for wallets.").

[129] *Id.*

[130] *Id.*

[131] *Id.*

[132] Saurabh Sharma, *P2P Lending and Big Data : Banking on the Non-Banks*, CROWDFUNDBEAT (2015), https://crowdfundbeat.com/2015/03/27/p2p-lending-and-big-data-banking-on-the-non-banks/.

[133] *See* KYC Documents-Individuals *Consultation Paper on Peer to Peer Lending,* 2017 S.B.I. (St. Bank of India) https://www.sbi.co.in/webfiles/uploads/files/1357908182658_SBI_OXIGEN_KYC.pdf.

[134] *Id.*

traditionally unbanked, it is likely that the P2P users will not have easy access to OVDs. The more complex the KYC system, the greater the risk that someone will choose to circumvent a formal credit system for an unregulated alternative.

Even if clients do manage to produce OVDs, the "KYC process [remains] tedious, complicated and expensive" for P2P platforms.[135] For example, if a client manages to produce a passport, the P2P platform must verify that the passport belongs to the client, is valid, and does not register on any blacklists. To cut down on KYC costs, P2P platforms require clients to come to their offices, go to a partner officer for verification, or use a courier service to complete the KYC process.[136] Traveling to an office may provide prohibitive for rural Indians; it may also defeat the purpose of having a digital banking service whenever and wherever you need it. Jitendra Gupta, the managing director of a P2P platform, notes that the KYC norms "destroy the idea of a wallet as an intermediate option for customers; they might as well open a bank account now."[137] Requiring a client to use a partner or courier service for verification might also prove prohibitive for P2P platforms. The cost of verification for each client ranges between fifteen and thirty USD. [138] Although most P2P transactions are small, the verification costs still can make previously viable transactions unprofitable. Established banks may be able to absorb these costs; however, smaller P2P platforms may be unable to do so.[139] Sriram Jagannathan, the vice president of payments at Amazon India, issued a statement on behalf of many P2P platforms, urging the RBI "to re-examine this in line with international guidelines, and adopt a framework of proportional KYC."[140]

Of more concern is full compliance with KYC guidelines that entail massive collection of personal data. The RBI's regulations are silent on how this data should be stored and protected.[141] The Kaspersky Cybersecurity Index contends that "India is one of the most vulnerable countries to attacks by banking

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[135] *See* Pani, *supra* note 125.

[136] *The Inconspicuous Great Pain of Fintechs and Their Clients: How to Solve It?,* FINTECH RANKING (Sept. 22, 2017), http://fintechranking.com/2017/09/22/solving-the-most-painful-fintech-problem/ [hereinafter FINTECH RANKING].

[137] Bhakta, *supra* note 14.

[138] FINTECH RANKING*, supra* note 136.

[139] Pratik Bhatra, *RBI's Strict KYC Norms to Keep E-Wallets Safe*, ECON. TIMES (Oct. 13, 2017, 12:41 AM IST), https://economictimes.indiatimes.com/small-biz/money/rbi-brings-in-fresh-guidelines-for-wallet-players/articleshow/61041242.cms ("While the dominant players are adequately capitalised and can meet regulatory requirements, industry watchers fear the new norms will sound the death knell for small PPI (prepaid payment instrument) licence holders, typically those which offer services such as domestic remittance or niche payments.").

[140] *Id.*

[141] CONSULTATION PAPER ON PEER TO PEER LENDING, *supra* note 5.

malware."[142] The Indian Secretary at the Ministry of Electronics and Information Technology noted, "'Mobile is a dangerous device with the kind of data it is leaking.'"[143] And recently, a data security breach in India potentially exposed the entire population's personal data.[144] Subsequently, in November 2017, more than 200 government websites inadvertently published the banking details of thousands of citizens.[145] The Indian government understands the precarious state of Indian cyber security—two working groups from the RBI and the Department of Telecom will establish guidelines on cyber security standards for mobile applications and devices.[146]

However, there is no set date for when these guidelines will be released—the working groups hope to release the guidelines soon.[147] While data security timelines are vague, the RBI has set very clear deadlines by which P2Ps must comply with all KYC norms.[148] All existing P2P platforms were given until December 31, 2017 to fully comply with KYC norms.[149] Unable to meet this deadline, many platforms have asked for extensions. The RBI is currently considering these applications.[150] If the RBI, without addressing data security concerns, continues to rush forward with KYC compliance, it threatens the future of a crucial industry.

All Indian P2P stakeholders recognize the need for regulation. However, the RBI regulations, even if only an initial step in a larger regulatory regime, stand to hinder P2P access and growth. The current scheme overregulates areas critical to P2P growth while simultaneously leaving other crucial areas completely unregulated. Moving forward, the RBI needs to significantly restructure their approach to P2P lending if it is to be kept attractive and accessible. The U.S.

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[142] ANI, *Improved Cybersecurity Must as Cashless Economy Rises Post-Demonetisation: Kaspersky Lab*, ECON. TIMES (June 29, 2017, 5:51 PM IST), https://cio.economictimes.indiatimes.com/news/digital-security/improved-cybersecurity-must-as-cashless-economy-rises-post-demonetisation-kaspersky-lab/59371170.

[143] *Government Working on Cyber Security Standards; Draft on Ransomware Likely Soon*, MONEYCONTROL, http://www.moneycontrol.com/news/india/government-working-on-cyber-security-standards-draft-on-ransomware-likely-soon-2393713.html (last updated Sept. 21, 2017, 2:00 PM IST) [hereinafter MONEYCONTROL].

[144] Michael Safi, *Personal Data of a Billion Indians Sold Online for £6, Report Claims*, GUARDIAN (Jan. 4, 2018, 6:20 AM EST), https://www.theguardian.com/world/2018/jan/04/india-national-id-database-data-leak-bought-online-aadhaar.

[145] *Id.*

[146] MONEYCONTROL, *supra* note 143.

[147] *Id.*

[148] Pani, *supra* note 125.

[149] *Id.*

[150] Bhatra, *supra* note 139.

P2P platform exemption regime offers an alternative framework for P2P regulation in India.

III. What is Next for Indian P2Ps? Lessons from the U.S. P2P Model

The current Indian P2P industry closely resembles its early U.S. counterpart. Much like in India, early U.S. P2P platforms were largely self-regulated.[151] These P2Ps initially comprised a small fraction of U.S. financial markets.[152] However, as in India, the rapid growth of these unregulated platforms caught the eye of government regulators.[153] In 2008, the Securities and Exchange Commission (SEC) intervened and required that platforms register their loans as securities under the Securities Act of 1933.[154] These registration requirements were met with the same critiques seen in India. The costs and logistics of registration force platforms to exit the market and deter new players from entering.[155] The founder of a leading U.S. P2P platform, Prosper, commented, "there should be ten companies up here today. Unfortunately, we're the only two companies [Prosper and Lending Club] that had the capital and the resources to survive the securities' regulatory process."[156]

In response to the impact of SEC registration requirements on the P2P industry, the U.S. Government Accountability Office (GAO) issued a report discussing options for regulating P2P platforms going forward.[157] The 2011 report noted that the SEC system of regulation "lacked flexibility and imposed inefficient burdens on firms."[158] The GAO report offered an alternative approach wherein the Consumer Financial Protection Bureau (CFPB) would regulate P2P platforms.[159] Under the CFPB, P2Ps would be exempt from federal securities

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[151] Eric C. Chaffee & Geoffrey C. Rapp, *Regulating Online Peer-to-Peer Lending in the Aftermath of Dodd-Frank: In Search of an Evolving Regulatory Regime for an Evolving Industry,* 69 Wash. & Lee L. Rev. 485, 503–05 (2012).

[152] *Id.*

[153] *Peer Pressure: How Peer-to-Peer Lending Platforms are Transforming the Consumer Lending Industry*, Consumer Finance Report (PriceWaterhouseCoopers LLP, London, UK), Feb. 2015, at 2, http://www.pwc.com/us/en/consumer-finance/publications/assets/peer-to-peer-lending.pdf.

[154] Chaffee & Rapp, *supra* note 151.

[155] Paul Slattery*, Square Pegs in a Round Hole: SEC Regulation of Online Peer-to-Peer Lending and the CFPB Alternative,* Yale J. Reg. 234, 275 (2013), http://digitalcommons.law.yale.edu/cgi/viewcontent.cgi?article=1369&context=yjreg ("It imposes chronic regulatory costs on an industry focused on simplicity, and it erected insurmountable barriers to market entry.")

[156] Person-to-Person Lending: Hearings Before the Cal. S. Comm. On Banking, Finance & Insurance, 2009-2010 Sess. 13 (2010) (statement of Chris Larsen, Prosper CEO & Founder).

[157] U.S. Gov't Accountability Off., GAO-11-613*,* Person-To-Person Lending: New Regulatory Challenges Could Emerge as the Industry Grows 10–11 (2011).

[158] *Id.*

[159] *Id.*

laws and the associated prohibitive registration costs.[160] Proponents of this approach argue that CFPB can create tailored registration procedures that are better suited for P2P management and growth.[161] However, critics of the CFPB approach argue that moving away from SEC regulation is a drastic step that excludes financial experts from regulating a volatile industry.[162]

U.S. regulators needed to find a way to encourage growth in a burgeoning industry, while managing the unique risks P2P growth poses. Rather than continuing with rigid SEC regulations—or opting for a radical new CFPB framework—U.S. regulators carved out a new classification for P2Ps within the SEC's purview. In 2012, Title III of the Jumpstart Our Business Startups Act (JOBS Act) contained provisions for a new class of P2P platforms called "emerging growth companies."[163] As long as their annual revenue is below $1 billion USD, and they fall under certain lending thresholds, P2P platforms are exempt from SEC registration requirements.[164] Even if they must comply with SEC registration, the JOBS Act exemption gives P2P platforms the option of submitting an initial registration statement to the SEC to address any initial comments before a public filing.[165] The exemption also allows for tailored limits on capital requirements, individual investment limits, and eligibility guidelines.[166] The emerging growth companies category relaxes some of the prohibitive costs and logistics associated with SEC registration, while allowing for government regulation of a still largely unpredictable industry.

The relatively conservative exemption approach of the U.S. is what the Indian P2P industry needs. Just as the SEC regulates the U.S. P2P industry, the RBI oversees the Indian P2P industry.[167] To completely eliminate RBI P2P regulations, even with their imperfections, would be a radical shock to an

160 Benjamin Lo, *It Ain't Broke: The Case for Continued SEC Regulation of P2P Lending*, 6 HARV. BUS. L. REV. ONLINE 87 (2016).

161 *Id.* ("This new agency could craft tailored disclosures that balanced borrower privacy against misleading advertising and disclosures for lenders. The CFPB's prudential regulatory scheme could further negate some of the unwanted side effects of a purely disclosure-based regime.").

162 Chaffee & Rapp, *supra* note 151, at 529 ("[P]lacing P2P lending under the purview of a single regulatory entity, such as the CFPB, would also be a radical step because it limits the regulatory supervision of the industry, excludes various regulators from using their specific expertise, increases concerns about regulatory capture, and creates concerns about inhibiting the evolution of a growing and changing industry.").

163 Benjamin Lo, *supra* note 160.

164 Brad Walker, *P2P Regulation Maturing Across the Globe,* NASDAQ (Mar. 21, 2016, 2:54 PM EDT), http://www.nasdaq.com/article/p2p-regulation-maturing-across-the-globe-cm595969.

165 *Id.*

166 *Practice Pointers on P2P Lending: How It Works, Current Regulations and Considerations*, Client Alert (Morrison & Foerster LLP, San Francisco, C.A.) 2016, https://media2.mofo.com/documents/150129p2plendingbasics.pdf.

167 *Master Directions*, *supra* note 13.

industry that has already scrambled to meet one set of regulations.[168] However, in a further parallel to early U.S. P2P platforms, Indian P2Ps are struggling under rigid and sometimes misinformed regulations.[169] Carving out a P2P specific category in existing NBFC regulations allows the RBI to tailor regulations to meet the needs of Indian P2Ps without resorting to a drastic regulatory overhaul. Rather than fully revising primary prudential norms, such as minimum capital requirements and leverage ratios, the RBI can create an opt-out regime for P2Ps that would be overly burdened. Such an approach leaves the larger NBFC arena undisturbed while nurturing a fledgling industry. More so, following the U.S. approach allows the RBI to focus on filling in regulatory gaps. Rather than pursuing a fundamental regulatory restructuring, the RBI can look towards promulgating data security and cross border transaction rules. Finally, nothing in this regulatory approach precludes a later revision of the Indian P2P landscape. Adopting an exemption approach gives both the RBI and the Indian P2P industry time to understand what the P2P landscape needs to grow.

CONCLUSION

Encouraging P2P growth is crucial to meeting the banking needs of many Indians. However, earlier unchecked P2P growth has shown that without regulation, the P2P industry falters. Regulation is necessary to mitigate risks and instill confidence in an unfamiliar business model.

Unfortunately, the RBI framework overregulates an industry it needs to nurture. RBI prudential and governance norms have increased entry costs and overly burdened existing P2Ps. The capital requirements, leverage ratios, and lending caps mandated by the RBI pose a significant threat to the P2P industry. Similarly, the areas the RBI leaves unregulated—remittances and data security—also jeopardize current P2P operations and future lending. In an attempt to legitimize P2P lending, the RBI has fundamentally misunderstood how P2P lending actually works.

P2P platforms are a unique combination of new financial technology and traditional banking services. Rather than pigeonholing P2Ps into existing, but insufficient, legal categories, the RBI needs to reassess how it regulates P2Ps. However, the RBI should not focus its energy on a total regulatory overhaul. The Indian P2P industry is still scrambling to adjust to current RBI regulations, the effects of which are still not completely understood. The U.S. exemption

[168] Bhuvaneswaran, *supra* note 14.
[169] Soni & Bagchi, *supra* note 57.

approach would allow the RBI to tailor regulations while still benefiting from the resources and stability of an existing regulatory framework. This approach would meet current P2P needs and operate with enough flexibility to allow for future P2P growth. The RBI needs to reform regulations to ensure that it does not stifle an industry that stands to solve India's pressing credit access problems.

NAMRATHA MINUPURI*

* Notes & Comment Editor, *Emory International Law Review*; Deputy Director, Emory Law School Supreme Court Advocacy Project; J.D. Candidate, Emory University School of Law (2019); B.A., magna cum laude, Bryn Mawr College (2013). The author would like to thank Professor George B. Shepherd and the Emory International Law Review Executive Board for their help through the publication process. The author would also like to thank her parents and family, her very patient partner, and the city of Chennai for ensuring there was a comment to submit. Finally, the author would like to thank her grandmother, Vijaya, for being an astounding source of inspiration.