

The Economic Problems of Crowdlending Platforms and the Importance of Control Mechanisms

London 17 December 2019, by Gabriela Arias and Mike Nawas

Peer-to-peer (“P2P”) and peer-to-business (“P2B”) platforms have changed the dynamics in the credit markets. They have become more appealing and useful to the public. In addition, they have become increasingly attractive to investors, who are either looking to invest in P2P and P2B companies themselves, or to utilise borrower- lender matchmaking services offered in these platforms. However, as access to credit becomes progressively effortless thanks to these platforms, market failures surface. Given the significance P2P and P2B platforms have gained in the corporate credit market, we examine whether it possible to mitigate these market failures.

Introduction

Through the past ten years, crowdlending has become one of the Fintech products responsible for turning the financial industry on its head. With their match-making strategy that enables single economic agents to interact directly in a disintermediated and decentralised marketplace, coupled with low interest rates, simplified application processes, and quick lending decisions, they have driven innovation in the credit market and reshaped the behaviours of borrowers and lenders.

Despite their indubitable success, they are still subject to inefficiencies and flaws.

In this edition of Market Insight, we examine the theoretical economics of crowdlending platforms – in particular the corporate

transactions that take place in them – and analyse how the risks that these platforms bring to the financial industry can be mitigated by using third party and contract control mechanisms.

The Scale of Disruption by Crowdlending Platforms

As the public’s trust in the financial system was significantly reduced in the wake of the 2008 financial crisis and the resentment towards banks increased, Fintechs, found an opportunity to offer competitive services that responded to the shift in the public’s mentality.

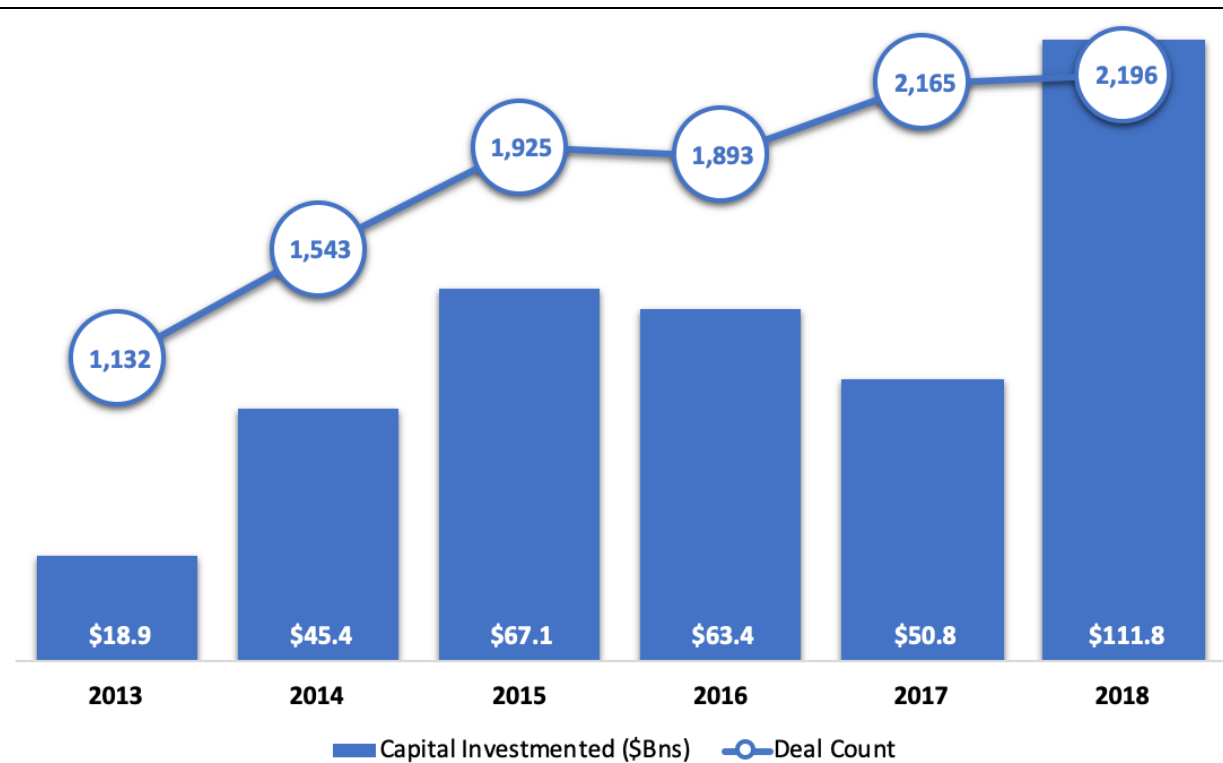
Fast-paced technological changes coupled with the rise of a more digitally savvy population, allowed Fintechs to disrupt and recalibrate the financial industry. They made their inroads by disaggregating the

components of traditional banking, leveraging new technologies and offering targeted solutions for specific needs or issues in the value chain that had been previously missed.

A decade later, Fintechs found themselves amassing 33% of the revenue share in the financial services industryⁱ.

As can be seen in Figure One, this massive achievement was supported by record high global investments of \$111.8 billion across 2,196 dealsⁱⁱ.

Figure One: Total Investment Activity (VC, PE and M&A) in Fintech 2013-2018



Source: **KPMG International**, (13 February 2019), *The Pulse of Fintech 2018, Biannual global analysis of investment in fintech*

Fintechs re-engineered the credit market as they created P2P or P2B crowdlending platforms.

Borrowers, on these platforms, benefit from less paperwork, a fast application procedure and better access to non-bank loan providers.

New and existing lenders are attracted to the cost efficiency of the lending process, with new lenders gaining access to a new type of asset that was previously inaccessible to them: small- and medium-sized company loans.

Given these conditions, it is not surprising that the online lending phenomenon is expected to grow from USD 5.1 billion in 2018 to USD 12.1 billion by 2023, representing a compound annual growth rate of 18.7%ⁱⁱⁱ.

The Economics of Corporate Transactions via Crowdlending Platforms

P2P and P2B platforms allow single economic agents, i.e. borrowers and lenders, to interface directly. Lenders can choose on a case-by-case basis, from the pool of available borrowers, which firms to

finance. This process allows lenders to have a high degree of control over which investments they decide to pursue. Equally, borrowers can choose, through the interface, which lending option aligns best with their needs. Once lenders' and borrowers' attributes/preferences meet up, a match is made. Soon after, a standardised contract is put in place, money is disbursed, and borrowers begin making their interest payments and loan repayments.

The simplified practice just described opens up certain risks of market failure.

In financial economic theory, market failures occur when the pricing mechanisms of freely functioning markets do not deliver an efficient allocation of resources, causing loss in the economic welfare output. Market failure situations can arise, within the corporate transactions of crowdlending platforms, through different inefficiencies. A few examples are:

Firstly, platforms often do not offer high-quality borrower screening mechanisms. Therefore, information is asymmetrically distributed between borrowers and lenders which could lead to a market failure analogous to Akerlof's "Market for Lemons" theory^{iv} - an adverse selection problem. In addition, if borrowers perceive a low degree of lender scrutiny, they have an incentive to over-represent their credit quality - a moral hazard issue.

Secondly, unlike for banks that have a duty of care towards parties that have entrusted them with their funds, platforms typically are not agents of investors with duties of care towards the selection of the investment and performance of the loans. Therefore, the comprehensive principal-agent relationship of traditional bank markets is non-existent.

Thirdly, lenders cannot easily identify whether the borrower is prudently keeping

the lenders' interests in mind - a hidden action issue.

Of course, market imperfections are not exclusive to crowdlending platforms. They also occur, from time to time, in traditional credit markets. Usually, financial institutions try to tackle them by putting control mechanisms in place, afforded by their economies of scale. With this in mind, what can crowdlending platforms learn to overcome the shortfalls previously described?

Regulators, Contracts and Monitoring Agents

Understandably, given their role, financial market watchdogs in several countries have focused on keeping potential systemic risks in the crowdlending sector at bay. In the case of the UK, the government brought P2P platforms into the scope of regulation by creating a bespoke regulated activity under the Financial Services and Markets Act 2000, and, since 2014, P2P platforms have been subject to the Financial Conduct Authority package of rules and guidance – more specifically, under the PS19/14^v.

Despite the protection that regulations provide, they are mostly focused on limiting systemic risks rather than risks to individual lenders. Moreover, rules can be outpaced by the technology they are trying to regulate. To overcome this "pacing problem", a more proactive and flexible tool is needed. The answer to both issues can perhaps be found in contracting and agency work.

The contracts used on crowdlending platforms are generally standard loan contracts. This does not limit the ability of the contracts to have provisions that can help prevent market failures; in such instances the drafting acts to complement regulation. Through contracts, it is possible to set specific information and quality criteria pertaining to the key assets that should be protected, the processes by which

the parties assign a value to the key assets, the standards on transaction structuring, and the risk allocation between the contracting parties. In addition, loan agreements also allow the implementation of mechanisms to prevent, in long-term contracting, possible contract deficiencies or incompleteness - the futurity problem^{vi}. This futurity problem is often addressed by the implementation of governance arrangements in the contracts, and by having provisions that allow the modification of contract terms in an orderly and accountable way.

If contracting is one tool to limit potential market failures, monitoring is another. Here crowdlending platforms can learn from the infrastructure bond market where, we have observed, a “monitoring agent” role, who facilitates orderly and timely communications between the contract parties throughout the life of the loan thus facilitating the management of operational and credit risk. The role can encompass the monitoring of covenants, reviewing and analysing qualitative and quantitative information and data, checking payment calculations, and managing and monitoring remedial actions in the unlikely event that a borrower breaches its loan terms. In the case of crowdlending platforms, the same mechanisms might be contracted.

Conclusion

As Fintechs rattle the financial industry, they enable the flourishing of alternative forms of debt financing, such as P2P and P2B lending platforms. Single economic agents that use these platforms are exposed to risks of market failures intrinsic to the functioning of many of these alternative financing mediums. Therefore, just like in the traditional credit market, control mechanisms are needed to help prevent and manage these risks.

Certainly, financial markets watchdogs provide regulatory responses to help in this regard. However, regulatory frameworks cannot solve these issues on their own as technology outpaces the law^{vii}. Therefore, contracts become essential in complementing regulation, because they are flexible to quickly evolve and adapt to the technology and needs of the marketplace players. On top of that, contracted monitoring agents can exercise a valuable role in overcoming potential market failures, in the same fashion as they do in the infrastructure bond market. As such, monitoring agents have the potential to boost lending platforms’ growth and align the agendas of investors, borrowers, platforms, and regulators, in order to help prevent market failures.

If you agree with our views in this Market Insight, and even if you don’t, we would be delighted to hear from you.

[\(info@bishopsfieldcapital.com\)](mailto:info@bishopsfieldcapital.com)

Disclaimer

This document is for informational purposes only. Although endorsed as market update by Bishopsfield Capital Partners Ltd, it expresses the author’s opinion only. Neither Bishopsfield Capital Partners, nor the author, accept any legal responsibility or liability of whatever nature in relation to the information presented in this document. Statements, opinions, market information and views on market direction are as of the date of this document and can be changed at any time without prior notice. In no way should this document be construed by a reader as a financial promotion to buy, sell, issue or otherwise trade in any financial instrument. This document, whether in whole or in part, may not be copied or distributed by anyone other than Bishopsfield Capital Partners. Any investment decisions should be made with reference to the relevant offering circular for any transaction referenced in this document.

Bishopsfield Capital Partners Ltd is authorised and regulated by the Financial Conduct Authority.

ⁱ [Fintechnews Switzerland, \(22 October 2018\)](#), *Fintech Now Takes Up 33% of Revenue Share in Financial Services*.

ⁱⁱ [KPMG International, \(13 February 2019\)](#), *The Pulse of Fintech 2018, Biannual global analysis of investment in fintech*.

ⁱⁱⁱ [Report Linker, \(November 2018\)](#), *Digital Lending Platform Market by Solution, Service Deployment Mode, Vertical and Region – Global Forecast to 2023*.

^{iv} [George A. Akerlof, “The Market for “Lemons”: Quality Uncertainty and the Market Mechanism”, \(Quarterly Journal of Economics, Vol. 84, No. 3 \(Aug. 1970\), pp. 488-500, The MIT Press\)](#). *The theory examines how the quality of goods traded in a market can degrade in the presence of information asymmetry between buyers and sellers, leaving only “lemons” behind. In American slang, a “lemon” is an item that is found to be defective or imperfect.*

^v [Financial Conduct Authority, Policy Statement PS19/14 \(June 2019\)](#), *Loan-based (‘peer-to-peer’) and investment-based crowdfunding platforms: Feedback to CP18/20 and final rules*.

^{vi} [Daniel Awrey, Law & Economics of Corporate Transactions, Faculty of Law, University of Oxford, \(22 February 2018\)](#), *Seminar six - Problems in Contracting Over Time. The futurity problem refers to the incomplete contracts economic theory (from the field of [contract theory](#)). The incomplete contracting paradigm was pioneered by [Sanford J. Grossman](#), [Oliver D. Hart](#), and [John H. Moore](#). In their seminal contributions, Grossman and Hart (1986), Hart and Moore (1990), and Hart (1995) argue that in practice, contracts cannot specify what is to be done in every possible contingency. At the time of contracting, future contingencies may not even be describable. Futurity problems can derive from pronounced information, agency, and hold-up problems, fundamental uncertainty ([Frank H. Knight, 1921](#)), and high enforcement costs. As a result of these futurity problems, parties are often left to design contracts with an incomplete understanding of the world and future.*

^{vii} [MIT Technology Review, Vivek Wadhwa; Laws and Ethics Can’t Keep Pace with Technology \(15 April 2014\)](#)