PEER-TO-PEER LENDING

THE EFFECTS OF INSTITUTIONAL INVOLVEMENT IN SOCIAL LENDING

Master’s Thesis within Business Administration – Finance

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Abstract

This thesis examines the consequences of an increased institutional involvement in the recently emerging lending business known as peer-to-peer lending (P2PL).

Since the P2PL business itself is a type of originate-to-distribute (OTD) lending model – in which the originator never carries the risk for the loans – this thesis investigates the effects it can have on the quality of the screening of potential borrowers, and if it could create a misalignment of interests between different stakeholders in the P2PL market. It also examines how the information asymmetry in the screening process is affecting moral hazard behavior and adverse selection problems.

From the empirical research – which was gathered from interviews with significant participants in the Swedish P2PL market and the financial market as a whole – the authors find that an increased institutional involvement seems to come hand-in-hand with an increased loan volume, which creates incentives for the P2PL companies to ease their screening of borrowers and thus decreasing the average quality of the loans they originate. Furthermore, it shows evidence of great similarities between the current P2PL market and the sub-prime mortgage market that was the cause of the financial crisis in 2008. By comparing different geographic P2PL markets the thesis is providing the reader with four development phases that the P2PL markets seem to follow.
Glossary

This section provides the reader with basic definitions of the most important concepts and terms used throughout the thesis. Since many concepts can be used in several different ways, this section explains in which way the authors want them to be interpreted when reading this specific paper.

- **Peer-to-peer lending (P2PL)** – The concept of direct borrowing and lending in online platforms, with unsecured loans.
- **P2PL platform** – The online platform connecting the borrowers with the investors, making the loan possible.
  - *Proper* – The first P2PL platform established in the U.S.
  - *Lending Club* – An American P2PL platform, currently the largest in the world.
  - *Bondora* – A pan-European P2PL platform, which also provides a secondary market for individual investors.
  - *Savelend* – A Swedish P2PL company established in 2013, currently in the process of finding banks to possibly collaborate with.
- **P2PL company** – The company providing the P2PL platform.
- **Borrower** – The party receiving the loan, typically an individual or a small business.
- **Investor** – The party providing the funds for the loan by putting capital into the P2PL platform. Can also be seen as a type of lender.
  - *Individual investor* – A private person investing his/her own capital for a desired rate of return.
  - *Institutional investor* – An institution (such as a hedge fund, insurance company, commercial bank etc.) investing capital for a desired rate of return.
- **Ownership investor** – An individual or institutional investor making investments in the P2PL companies.
- **Commercial banking** – The traditional form of banking, in this thesis mainly used as a comparison to P2PL.
- **Institutional involvement** – The development in which financial institutions engage in the P2PL market e.g. by creating alliances with P2PL companies or by acting as institutional investors.
- **Screening** – The process in which potential borrowers – based on an evaluation of their creditworthiness – are allowed or disallowed to look for funding in the P2PL platform.
- **Screening incentives** – The drivers possibly affecting the fairness of the screening process, e.g. the intention to hold or to sell the loan to a third party.
- **The originate-to-distribute (OTD) model** – The approach to lending as a creation of loans with the intention of selling them to a third party, instead of holding the loans to maturity.

- **Secondary market** – A financial market in which previously issued financial instruments – such as bonds and P2P loans – are bought and sold.

- **Asset-backed security (ABS)** – A security whose value derives from a specified pool of underlying assets.

- **Information asymmetry** – A situation in which one party has more or better information than the other, which creates an imbalance of power.
  - **Adverse selection** – The market process in which negative consequences occur when the parties have asymmetric information, and the “bad” customers are more likely to pay for the service than the “good” customers.
  - **Moral hazard** – A risk that occurs when one party takes more risks because another party bears the burden of those risks.
  - **Lemons problem** – The situation in which the “bad” products drives out the “good” from the marketplace, caused by information asymmetry between the buyers and the sellers.

- **Crowdfunding** – The practice of online project funding by raising money from many individuals.

- **Risk management** – The management function of identifying, assessing, and prioritizing the risks the company is exposed to.
# Table of Contents

1 INTRODUCTION ................................................................. 1
1.1 BACKGROUND.............................................................................. 2
1.2 PROBLEM DISCUSSION .............................................................. 4
1.3 PURPOSE .................................................................................... 5
1.4 RESEARCH QUESTIONS ............................................................... 6
1.5 DELIMITATIONS & PERSPECTIVE ............................................... 6
1.6 RESEARCH DESIGN ................................................................. 7
1.7 LITERATURE REVIEW & DATA COLLECTION ......................... 8

2 THE PEER-TO-PEER LENDING MARKET .................................. 9
2.1 CROWDFUNDING .................................................................... 9
2.2 BUSINESS MODELS ................................................................. 9
   2.2.1 Client-Segregated Account Model ..................................... 10
   2.2.2 Notary Model ................................................................. 11
2.3 LOAN AUCTIONS ................................................................... 12
2.4 THE ORIGINATE-TO-DISTRIBUTE MODEL ............................... 13
2.5 SECONDARY MARKET ............................................................... 14

3 FRAME OF REFERENCE .......................................................... 15
3.1 INFORMATION ASYMMETRY .................................................... 15
3.2 SOCIAL EFFECTS IN THE SCREENING PROCESS .................. 16
   3.2.1 Investor Behavior ............................................................ 16
   3.2.2 Borrower Appearance ...................................................... 17
3.3 RISK MANAGEMENT ............................................................. 18
   3.2.1 Financial Risks ................................................................. 19
   3.2.2 Operational Risks ............................................................. 19

4 METHOD ....................................................................................... 21
4.1 QUALITATIVE RESEARCH ...................................................... 21
   4.1.1 Pre-Interview ................................................................. 21
   4.1.2 Interviews ....................................................................... 21
4.2 RISK MANAGEMENT TABLE .................................................. 23
5 EMPIRICAL STUDIES & ANALYSIS ........................................24

5.1 THE ORIGINATON OF THE MARKET ........................................24
  5.1.1 Savelend ........................................................................24
  5.1.2 Swedbank ......................................................................25
  5.1.3 Analysis ..........................................................................27

5.2 MARKET DEVELOPMENT ......................................................28
  5.2.1 Savelend ........................................................................28
  5.2.2 Swedbank ......................................................................29
  5.2.3 Analysis ..........................................................................31

5.3 SECONDARY MARKET
  & THE ORIGINATE-TO-DISTRIBUTE MODEL ................................33
  5.3.1 Savelend ........................................................................33
  5.3.2 Swedbank ......................................................................33
  5.3.3 Analysis ..........................................................................34

5.4 THE SCREENING PROCESS ....................................................36
  5.4.1 Savelend ........................................................................36
  5.4.2 Swedbank ......................................................................39
  5.4.3 Analysis ..........................................................................39

5.5 RISK MANAGEMENT ...............................................................42
  5.5.1 Savelend ........................................................................42
  5.5.2 Analysis ..........................................................................44

6 CONCLUSION .........................................................................47

6.1 THE ORIGINATION OF THE MARKET ........................................47
6.2 MARKET DEVELOPMENT ......................................................47
6.3 SECONDARY MARKET
  & THE ORIGINATE-TO-DISTRIBUTE MODEL ................................48
6.4 THE SCREENING PROCESS ....................................................48
6.5 RISK MANAGEMENT ...............................................................49
6.6 DISCUSSION .........................................................................49

LIST OF REFERENCES

APPENDICES
LIST OF FIGURES

Figure 1: Interest Rates 2005-2015 ................................................................. 1
Figure 2: Interest over Time - Google Trends .................................................. 2
Figure 3: Types of Crowdfunding .................................................................. 9
Figure 4: Client-Segregated Account Model ................................................... 11
Figure 5: Notary Model ................................................................................. 12
Figure 6: Risk Level / Insurance Relationship .............................................. 15
Figure 7: Lending Segments According to Swedbank .................................. 26
Figure 8: Lending Segments – Revised .......................................................... 28
Figure 9: P2PL Development Phases .............................................................. 31
Figure 10: Risk Level / Interest Rate Relationship – Savelend .................... 37
Figure 11: Savelend’s Screening Process ....................................................... 37
Figure 12: Risk / Volume Relationship .......................................................... 40
Figure 13: Risk Level / Interest Rate Relationship ......................................... 41

LIST OF TABLES

Table 1: Similarities between P2PL & the Sub-Prime Loan Crisis in 2008 ........ 36
Table 2: Risk Table According to Savelend .................................................... 43
Table 3: Risk Table – Revised ...................................................................... 45
1 INTRODUCTION

The first chapter introduces the reader to the subject of the thesis by presenting interesting facts about it as well as contextualizing it. To motivate the choice of topic for the thesis, the main problem is described and the purpose of the thesis is presented together with the research questions that the thesis aims to answer.

Peer-to-Peer Lending (P2PL) is a recently emerging lending business in which online platforms connect investors with borrowers without going through traditional financial intermediaries. The high returns earned by the investors, together with beneficial credit terms for the borrowers are contributing factors to the rapid growth of social lending. Since there are few overhead costs associated with originating the loans, the platforms are able to offer relatively low interest rates for the borrowers with respect to their credit ratings. With less intermediation in the market, larger parts of the profits from the loans go to the individuals instead of being absorbed by large institutional intermediaries.

“By offering both borrowers and lenders a better deal, websites that put the two together are challenging retail banks”

(The Economist, 2014)

Another factor affecting the growth of the P2PL market is the low rate of return on standard savings accounts in commercial banks, which has caused individual investors to start depositing their funds in the P2PL platforms instead. When looking at the Scandinavian markets, this has been of extra significance because of the recent interest rate development where for example Sweden has been subject to a negative steering rate (Riksbanken, 2015).

According to The Orchard US Consumer Marketplace Lending Index, which tracks the aggregate amount of loans to consumers originated and funded on eligible U.S.-based online lending platforms, the principal balance outstanding is $4.28 billion when this is written. Based on the AltFi Volume Index the cumulative total loans outstanding is currently £2.87 billion in the UK. According to the AltFi Return Index, the average yearly return for P2P loans between 2006-
Peer-to-Peer Lending

2015 has been 5.04% in the UK market \(^1\). As any other financial investments, the P2P loans are governed by the *risk-return tradeoff* where the average annual default rate has been estimated to 3-4% during 2014 (Renton, 2014).

In December 2014, the world’s largest P2PL company *Lending Club* went public and launched its initial public offering, which can be seen as an indicator of the growth and potential of this industry (NASDAQ, 2014). With an IPO that was the second biggest in the U.S. during 2014, the attention for the alternative lending marketplaces grew intensively (Schubart, 2014; Quittner, 2014). The interest for the P2PL phenomenon among individuals has also increased rapidly during the last years and by looking at *Google Trends*, which shows how often a particular search term is entered in relevance to the total search volumes across various regions, there is evidence that the interest for “Peer-to-Peer Lending” has increased every year since its start in 2006.

![Figure 2: Interest over time - Google Trends](Source: Google Trends: “Peer-to-Peer Lending”)

## 1.1 Background

The industry started out as a crowdfunding platform on which individual borrowers could share their funding requests in order to attract possible investors for their loans. However, during its 10 years of maturity the market has grown and the conditions of the industry has changed. Today an investor has the choice to invest all of his/her funds in one loan to one individual or to split the funds between numerous borrowers. This development has given the lender the opportunity to diversify the investment and minimize the risk. And instead of borrowers seeking for investors as in the beginning, investors and borrowers are now simultaneously entering the market.

The major difference between the P2PL business and the traditional banking institutions is the governmental regulations that give the investor a deposit guarantee for its invested capital, which

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\(^1\) Up-to-date data can be found on the websites of the Orchard and AltFi databases.
does not exist in the P2PL market. This means that the investor in the P2PL market is bearing the full risk and in case of default by the borrower the investor will lose its entire invested capital. Therefore, the individual lending the capital to the borrowers can be categorized more as an investor rather than a lender (Kirby & Worner, 2014).

By a credit check made by the P2PL companies or a credit reference agency, each potential borrower is evaluated and rated. This rating system provides different interest rates, where borrowers assessing a higher risk of default are assigned higher interest rates and vice versa. When the investor is putting capital into the platform, he/she is having the possibility to choose the level of risk that he/she is willing to accept for lending the capital to the individual borrower.

With a high-pace growth of P2PL platform startups, the number of companies extending their domestic money transfer to international markets is increasing. By providing cross-border transactions, the investors can fund individuals in other geographical regions where funding possibilities are limited. Borrowers are benefiting from international funding while yield-chasing investors can look beyond low performing domestic markets (Yoshimura, 2015).

The platform itself is a profit-driven organization with its business objective to connect the peers, originate and distribute the loan. Once the loan is originated, the risk of a borrower defaulting is passed over to the investors, since the platform has distributed the loan to them. This is one form of what today is referred to as the Originate-to-Distribute (OTD) lending model, where the originator issues a loan with no intention of holding the loan until its maturity. In the process of the borrower receiving the investor’s capital, the platform is just an intermediary who originates the loan without carrying the risk for the loan never being paid back. The revenues for the platforms come from administration fees from investors and origination fees from the borrowers.

While the returns on the invested capital have proven to be high for the investors, the interest from large institutions has been growing for the industry. Asset managers, hedge funds, insurance companies and pension funds have all got an increasing interest in the platforms and its loans. The UK market has been subject to a growth rate of 134.14% for the last three months and there have been no signs of a decrease in the near future. The P2PL market in the U.S. has also been growing where the main drivers behind the growth have been the institutional involvement that the market has experienced. During 2013 the institutional investors accounted for 80-90% of all the capital deployed through the largest platforms in the U.S. that have affected the market structure for the P2P loans (Athwal, 2014).

“The investors are mainly institutional – not the average Joe anymore”

(Brendan Sheehy, 2014)
The consequences of the growing interest from large institutions have forced the foundations of the market to change. With the institutional involvement that the platforms have experienced, the P2PL investors are now entering the Asset Backed Security (ABS) market and the loans are repackaged into bundled securitizations. The move towards securitization highlights the shift of the growing P2PL industry (Alloway, 2013). Ray Gatten, the managing director of Bonwick Capital – who executed the first asset-backed security offering in the P2PL industry – explains the securitizations process as: “The asset-backed market is clearly welcoming online marketplace loans as a new and upcoming asset class”. Furthermore he believes that transaction success represents the growing investor interest in this rapidly expanding asset class. Since the financial crisis showed the risks of securitizing riskier loans, investors have avoided anything to experimental in the financial markets, but still Bonwick Capital managed to succeed with securitizing the P2P loans and other financial engineers have followed.

The P2PL market was at the beginning a simple and quick lending market for individuals with low interference from institutions and regulatory authorities. The P2PL market has since then developed towards more intricate processes in which large institutional investors are engaging. Today the loans are treated as any other financial products and the investors are trading the P2P loans in secondary markets with high frequency automated trading programs and desire a fully functioning and liquid secondary market for the loans.

1.2 PROBLEM DISCUSSION
Initially, there were a number of fundamental risks existing for the market participants when the P2PL business started. The lack of a deposit guarantee for investors together with the information asymmetry between the peers are just some examples of risks that shadowed the market. Since the institutions started engaging in the P2PL market, new types and levels of risks have arisen. The growing use of the originate-to-distribute lending model together with the emerging secondary market have enhanced the severity of the initial risks but also been the source of new risks in the market.

By comparing to historic events in the financial industry, one can notice that the originate-to-distribute banking model of asset securitization carried much of the blame for the “Great Recession” in 2008. And it is certainly reasonable to believe that asset originators may have incentives that will not necessarily advance investor protection when they transfer all of the credit risk on the securitized assets (Manbeck & Hun, 2014).

It has been proven that the expansion of sub-prime lending with the originate-to-distribute model was a major contributing cause to the sub-prime crisis in 2008. By 2013, loans that were originated since 1995 had a default rate of one in five according to Palmer (2013), and another
study made by Berndt & Gupta (2009) shows that the borrowers whose loans are sold in the secondary market underperform the peers by about 9% per year on a risk-adjusted basis. This is evidence that the banks have been either originating and selling loans of worse quality or that a secondary market for loans actually leads to diminished screening of the borrowers and moral hazard problems.

Similarly, the use of the OTD model of lending by P2PL companies has caused major concerns in the market. The Yale Journal on Regulation (2013) expresses the severity of the P2PL business models and the absence of a deposit guarantee in the market. Since the originator will be indifferent for the loan repayment once the P2P loan is originated, the standard of the underwriting can be affected. This can be compared to the sub-prime loans where the originator issued the loan, sold it in the secondary market and transferred all risks of the loan ever being paid back to the new owner. Since the platforms that originate the loans want to increase the number of loans originated, there is a risk that the quality of screening of potential borrowers will decrease.

Since the originate-to-distribute approach to lending has had historically prominent effects on the economy, there is a risk of history repetition if the use of the OTD model develops in the same way in the P2PL industry when the market grows, as it did in the U.S. mortgage crisis. When institutional investors are demanding a highly liquid secondary market, the market development with the use of the OTD lending model can be seen as an increasing risk. With an OTD business model, the interest in conducting a correct screening can decrease for the originator if it is not in the best interest of the platform. Therefore, the market is facing a risk of an agency problem of misaligned interest between stakeholders, and a major problem in a growing market will be to handle the OTD lending model and its impact on the quality of screening.

When there is information asymmetry in the P2PL market between the investors and the borrowers, a fair screening of the potential borrowers is crucial for a healthy financial market. This is of extra importance for the secondary market and its securitization where major information asymmetry arises when loans are repackaged by complicated processes (Abrahams & Zhang, 2009).

1.3 PURPOSE

The broad purpose of this thesis is to explore the effects of an increasing institutional involvement in a growing P2PL market. By narrowing this down into two separate purposes, they will help fulfill the broad purpose.
The first purpose is to investigate how the originate-to-distribute model affects the screening incentives in the lending process. The second purpose is to analyze the risks associated with a growing secondary market.

1.4 Research Questions

To be able to fulfill the purpose set for this paper, there are a few questions that need to be discussed and answered.

- Why are financial institutions now interested in this high-risk market segment that they previously ignored?
- How is the Swedish P2PL market growing in comparison to the ones in the U.S. and the UK?
- In what way can the use of the OTD lending model in P2PL create similar problems as it did in the secondary market during the sub-prime loan crisis?
- How are screening incentives affected by the institutional involvement in the P2PL market?
- How does a growing market affect the risk management process in P2PL companies?

1.5 Delimitations & Perspective

The authors will in the thesis always have the focus on the growth of the P2PL market. Since the market is not that significant yet, the effects on the industry are not that significant yet either. Therefore the authors have to look at a future larger market and the consequences it can have within the financial industry when it has increased in scale and significance.

There are of course risks in operating a P2PL company at the moment, which are explored in the Risk Management section in the Frame of Reference chapter. But as the market continues to grow - both in size and complexity - new risks and possible industry effects will arise. However, the authors feel the need to stress that this thesis first and foremost deals with the possible consequences of an increased institutional involvement in P2PL. The risk groups retrieved from the risk management model used in the Frame of Reference and Empirical Studies & Analysis chapters are only used as tools to assess and analyze these consequences. Furthermore, the authors do realize that all consequences of institutional involvement are not necessarily bad. Even if the word “risk” may have negative connotations, all risks can possibly have both positive and negative effects. Hence, “risk” is in this thesis used as an expression for a possible effect that the P2PL companies and its customers will need to deal with.

As previously mentioned, P2PL is actually only one part of the broader term “crowdfunding”. This will be explained in The Peer-to-Peer Lending Market chapter for further understanding of
the background and definition of P2PL. Within this term there are also distinctions between different types and purposes. For the purpose and analysis of this thesis, the focus will be put on the terms consumer loans and business loans – which simply are loans to regular consumers and businesses – because this is the type of lending that easiest can be compared to commercial banking. On this topic, Manbeck & Hu (2014) also noted that this type of P2PL has “attracted the most media attention as these sites generally are thought to have the greatest potential to revolutionize an existing financial market” (p. 1).

But to be able to compare and contrast P2PL to commercial banking – and since a commercial bank is more complex than a P2PL platform – it must be explained what part of the commercial bank that is used. This thesis therefore compares the P2PL platform to the lending business in commercial banks, not any other business in it. In a similar way, this investigation will not try to compare and contrast different types of investors apart from the difference between individual and institutional investors (already mentioned in the Glossary). For example, the terms Consumer Lender (an individual person) and Business Lender (a small company) will be seen as one type of investor – namely the individual investor.

To limit the scope of the data collection research, only the markets in the U.S., the UK, and Sweden will be used, meaning that – perhaps with some exceptions – all other markets will be excluded. The U.S. market is of course of greatest interest because of its size and its maturity making it the most prominent within the P2PL industry. The Swedish market will be interesting to look at partly because it – in contrast to the U.S. market – still is quite young and unexplored, and partly because the geographic proximity of the authors to it means that qualitative information more easily can be retrieved. For the UK market, the belief is that it can serve as a closer point of reference both to the U.S. and to the Swedish market than they can to each other. The P2PL business first started out in the UK with the company Zopa, which adds some historical relevance to examining the UK market.

1.6 Research Design

Working as a foundation to the whole thesis is the originate-to-distribute model that with its historical effects is used as a reference point to which the present developments within the P2PL market is compared. This is apparent in the case of the first purpose, which looks at how the use of the OTD model affects the screening incentives in the lending process. The idea here is to compare the present screening process on the P2PL platforms to the screening processes used by commercial banks. But for the case of the second purpose – which explores the new risks
associated with a growing secondary market for P2P loans – the originate-to-distribute model does not cover the whole issue. Hence, some more intricate perspectives – such as regulatory issues – must also be taken into consideration. In both cases, the analysis is based partly on historic effects found in literature and partly through the qualitative research presented below.

Since both purposes are dealt with by finding relevant research previously conducted, and after that applied to a suitable theory, this whole thesis is based on the deductive theory of doing research (Bryman, 2012). However, the methods used throughout the research must be adapted to the circumstances, which means that it will not be exactly the same in all parts of the research. For example, the quite narrow scope of the P2PL business itself also makes the investigation of this market narrow. But in some parts of the research the P2PL market will not be enough for providing research, so we will have to use research from a broader perspective. Hence, depending on the topic covered, this thesis will use both intensive and extensive investigation to provide the reader with both relevance and generalizations (Jacobsen, 2002).

1.7 Literature Review & Data Collection

Since peer-to-peer lending is a relatively new concept, the amount of literature published on the subject is not as substantial as in older business fields. For the same reason, not all perspectives from which the topic can be looked at are covered. This of course makes the collection of relevant earlier research more difficult, but it also motivates the existence of this thesis. As there are no global databases existing and no reports covering global development of P2PL, the major research challenge will be to manually compile data from each market and each regulatory framework and using this data to compare the markets with one another.

Research that originally was written about another type of financial institution – like commercial banking – can in fact also apply to P2PL. One example can be the limited amount of previous research conducted on the effect of the emerging secondary market in P2PL. By looking at how the economy was affected by the prominent use of mortgage-backed securities in the early 2000s (hence, the 2008 global recession), it can provide an indication of how the OTD model of P2PL can affect the financial industry.

Furthermore, the authors of this thesis have tested to invest capital in one of the P2PL platforms available to the Swedish market, with the intention to get a more hands-on experience of how the business really is working. The platform used was Bondora, which is an Estonian platform that provides investment opportunities in European personal loans. The reasoning behind the choice of that platform was that it is one of the few platforms providing a secondary market for individual investors, as well as one of the few that approves cross-border loans (only within the EU).
2 THE PEER-TO-PEER LENDING MARKET

The second chapter provides the reader with information of the most important concepts of the P2PL business. The purpose of this chapter is to give the reader a comprehensive understanding of the loan originating process in the P2PL market and how it differentiates from and relates to commercial banking.

2.1 CROWDFUNDING

Crowdfunding can be seen as an umbrella term for describing the use of small amount of capital, which is obtained from a large number of organizations or individuals to raise funds for a personal loan or business project through an online platform. Crowdfunding can be divided into four different categories, which are donation crowdfunding, reward crowdfunding, peer-to-peer lending and equity crowdfunding.

<table>
<thead>
<tr>
<th>CROWDFUNDING</th>
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<tr>
<td>COMMUNITY CROWDFUNDING</td>
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<td>Donation Crowdfunding</td>
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<td>Reward Crowdfunding</td>
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<td>FINANCIAL RETURN CROWDFUNDING</td>
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<td>Peer-to-Peer Lending</td>
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<td>Equity Crowdfunding</td>
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**Figure 3: Types of Crowdfunding**
(Source: Claesson & Tengvall)

When looking at donation crowdfunding and reward crowdfunding they can be seen as a way of fundraising for charitable causes through angel investors or pre-paying for a business product for example. Together these two categories can be referred to as community crowdfunding where no financial return on the investment is provided, which is the main difference in comparison with financial return crowdfunding (Kirby & Worner, 2014).

Financial return crowdfunding (or FR crowdfunding) consists of P2PL and equity crowdfunding which both are internet-based funding methods with yield provided for the investor (Corporations & Markets Advisory Committee, 2015). Crowdfunding can often be mistaken for being synonymous with either P2PL or equity crowdfunding but it is important to remember that P2PL is a subcategory of crowdfunding.

2.2 BUSINESS MODELS

While all P2PL transactions for each platform rely on web technologies and virtual lending marketplaces, the business models for all companies differ from each other. However, what all P2PL companies have in common is that the investor does not have a deposit guarantee which exists in the commercial banks, meaning that in case of default by the borrower the investor has no claims over its invested capital. The interest rate for the borrower can either be through a second-bid auction by the potential investors or it can be set by the platform itself. According to
the IOSCO Research, the market can be divided into two different business model groups, which are the *Client-Segregated Account Model* and the *Notary Model*.

The P2PL business started out as “whole loan” investors where one investor funded the entire loan for a borrower. This business strategy has developed into “fractional loan” investors where the invested capital is diversified over numerous loans, making the investor a part owner of many different loans. In the case of a "fractional loan", the P2PL company issues pass-through certificates under indenture recognizing the investor's right to a specific portion of the loan. For "whole loan", the investor obtains ownership of the entire loan (Lustman, 2013).

The P2PL market is regulated under securities laws, where the platforms have to register all loans issued under securities laws in order to proceed with their practice (Chaffee & Rapp, 2011). This means that the notes are considered being securities by jurisdictions, which shifts the risk to the investors away from the originator who initially issued the loan (GAO U.S. Government Accountability Office, 2010).

The P2PL business uses the originate-to-distribute lending model, where under the Client-Segregated Account Model the platform originates the loan and distributes it to the investor. As for the Notary Model, the commercial bank originates the loan and distributes it to the platform, which in turn distributes it to the initial investor. The investor can either hold the loan until its maturity or resell the note in a secondary market to either individual or institutional investors.

### 2.2.1 Client-Segregated Account Model

The *client-segregated account model* is the model with less interference and participation from intermediaries when setting up loans between the borrowers and the investors. After matching investors with borrowers through the platform, the investors’ funds are transferred into a *client-segregated account* before they are wired to the borrowers. All funds from borrowers and investors are separated from the platforms balance sheet and by going through the legally segregated client account the company has no claims in the event of a collapse by the platform. This means that the contractual obligation still applies between the borrowers and investors in case of a failure of the platform, in accordance to the financial conduct authority rules (Assetz Capital, 2014).

Fees are paid both in the form of origination fees by the borrowers and as administration fees for the investors to the platforms. The administration fee can either be a flat rate fee or in percentage terms based upon the funded capital. According to Lending Club – which currently is the world’s

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3 The *International Organization of Securities Commissions* is an association that regulates the world’s securities and futures markets.
largest P2PL company – there are additional fees for the borrowers upon payment failures. Unsuccessful payment fees and late payment fees will be additional requirements for the borrowers in case of default. From the P2PL companies perspective these fees are charged in order to cover the cost of the debt collecting agencies such as Kronofogden in Sweden. These extra fees are equivalent throughout the market, as are the investors’ fees in forms of administration, collection and preliminary assessments on the borrowers’ creditworthiness fees, which usually are all included in the overall service fees charged by the platforms.

**Figure 4: Client-Segregated Account Model**
(For a larger and more detailed version of this figure, please refer to the Appendices.)
(Source: Claesson & Tengvall)

A type of the client-segregated account model is a trust fund based model where the investors purchase shares in a trust structure where the platform acts as a trustee and manages the fund. The loans are granted through the trust with contributions made by the investors. By investing in accordance with instructions from the investors, the trust allows the capital to be diversified to spread the risk. The aim of the trust fund is to build a diversified portfolio that will attract investors who are less familiar with the peer-to-peer lending concept but still are appealed by alternative investments (Caldwell, 2014). Since it is a trust, it is legally distanced from the platform itself, meaning that the investors are protected from losing their invested capital if the platform goes bankrupt, as in the ordinary client-segregated account model (Afluenta, 2014).

### 2.2.2 Notary Model

Similarly to the platforms using the previous model, a platform that uses the Notary Model acts as an intermediary between the investors and borrowers, matching them to each other. Once the borrowers enter the platform and request for a loan, the P2PL company assesses the risk and based upon the creditworthiness assigns the borrower an interest rate in the same way as in the client-segregated account model.
When the investor puts his/her funds into the platform and the amount of money required for the loan is reached, the loan is originated. However, instead of the platform originating the loan itself the process is managed by a commercial bank. The bank originates the loan and a loan promissory note is exchanged between the commercial bank and the borrower, with the P2PL platform intermediating the transaction. The platform immediately purchases the loan from the commercial bank and receives the loan promissory note (platform note) in exchange.

As the investors’ funds are transferred to the platform, the deposit guarantee does not apply for the investors since the funds never deposited into the accounts of the bank (European Commission, 2014). This model is particularly popular in the U.S., where platforms as Lending Club and Prosper are expanding their collaborating with commercial banks. As for the fee structure it is similar to the client-segregated account model.

### 2.3 Loan Auctions

One way of allocating the loans to investors is to auction off the loans on the P2PL platform. For example, by using a Vickrey auction – a type of sealed-bid auction often used by auction companies online – the loan will be funded by the investor who has the lowest bid but the interest rate paid will actually be the rate of the second-lowest bid. Considering this, it is maybe not that surprising that Prosper – America’s first P2PL platform – in its startup years described itself as an “eBay for loans”. The idea was to use “competition amongst lenders to bring down the final interest rate for the borrower” and in that way create a more efficient lending market on the P2PL platform (Chen, Ghosh & Lambert, 2014, p. 368).

However, after Lending Club – which uses a much simpler pre-set rate method of allocating loans – had entered the market in 2006 and overtaken Prosper in only three years, Prosper also decided to move from the auction-based allocation method to a first-come, first-serve method with pre-set interest rates. Chen et al. (2014, p. 385) saw this move as an indication that a system...
“the people understand and is transparent might attract a much larger volume of participants and hence yield better outcomes (for some or all parties) than a complex mechanism such as the Prosper auction”. And this may very well be the reason for why the auction based allocation method is less common today than it was earlier in the P2PL history.

2.4 The Originate-to-Distribute Model

Historically, commercial banks used the deposits they got from their customers to fund loans and kept them in their balance sheet until its maturity. They worked with a traditional originate-to-hold strategy, meaning that they created the loans with the intention of holding it throughout the entire period until its maturity. The aggregate amount of loans outstanding for the banks are regulated by authorities, and with strengthened capital adequacy rules the capital requirements for the banks have tightened. The regulators required the banks to be conservative in their capital planning and implemented requirements where a minimum level of equity capital was required depending on the risk of their loan portfolio (Finansinspektionen, 2014).

In the early 1990s the banks started using a new lending model in which they started selling the loans to investors before the loans had matured. This is what today is referred to as the originate-to-distribute model where a lender originates a loan with the intention of selling it to other institutions or investors in the secondary market (Bord & Santos, 2012). The model is an innovative process that allows the banks to expand their lending business and by using an OTD lending model, the banks can originate loans and sell them in a secondary market without violating the regulators lending limits of its total loans outstanding.

The OTD model contains incentives for the banks to lend and quickly package those loans and transmit the credit risk to third parties (Martin-Oliver & Saurina, 2007). The basic idea of OTD is to originate a credit and sell or securitize a portion of it. The OTD model of lending was a popular method of mortgage lending before the onset of the subprime mortgage crisis. The increase of securitizations during the pre-crisis – together with the great losses on securitized assets during the crisis – have emphasized the importance of securitization in the financial crisis of 2008. The prevalence of the originate to distribute model over the past twenty years has led to a significant growth of the structured financial markets and the level of innovations and complexity of the market structured has increased. This, together with the lack of transparency on complex structured finance products, has posed challenges for valuation and risk assessments for the investors, which have raised financial instability (European Central Bank, 2008).

According to a study made by Purnanadam in 2011, the banks with high involvement in the OTD market during the pre-crisis period in 2008 originated excessively poor-quality mortgages. Liquid securitization markets made it easier for the banks to sell the mortgage loans in the
secondary market once they had originated it and it gave the banks the flexibility to change the volume of mortgages they make quickly without having to make large adjustments to their equity capital or asset portfolio (Goldman Sachs, 2010).

2.5 **SECONDARY MARKET**

A secondary market is where an investor can purchase previous issued financial instruments from other investors rather than from the issuing company or the originator. With primary issuance of securities, the investor purchases the security directly from the issuer such as corporations, federal governments and commercial banks (Ahn & Breton, 2014). With the secondary loan market it becomes easier to generate more loans and thus increase the investment opportunity for investors. In general, trades on the secondary loan market provide liquidity and increasing market activity for the issued loans and does often occur at a large scale where lenders bundle loans into packages.

One form of pooled groups of loans are *Mortgage-Backed Securities* (MBS), which are pooled mortgage loans initially originated by small lenders that later are being bought and pooled into one security and sold on the secondary market by the investors. All these different pooled loans are rated based upon the creditworthiness of the borrowers for each loan. The bundling can allow the lenders to sell off potentially poor performance loan while at the same time generating funds. Once the loan changes owner, the responsibility for servicing the loans changes with it and the loan can be resold by the owner to avoid expenses associated with nonperforming loans. Until the maturity of the loan the ownership of the loan can change several times and whether or not the loans are packaged and resold in the market is out of the control for the borrower (Acharya & Richardson, 2009).

As for the P2PL market, it works similarly to the regular secondary loan markets. The note holder can sell the investment before the individual borrower has repaid the loan. This opens up for another investor who is looking for investment opportunity and gives increased liquidity to the P2PL marketplace (Bondora, 2015). This could in a sense also be seen as a type of originate-to-distribute model from the investor’s point of view, because he/she could fund the loan – hence, finalize the origination of it – with no intention to hold it to maturity, but to instead sell it in the secondary market.
The third chapter presents the relevant theory that is used to answer the research questions of the thesis. It also provides the reader with a summary of the previous research conducted within the relevant fields.

3 FRAME OF REFERENCE

3.1 INFORMATION ASYMMETRY

Information asymmetry is used as a term describing a transaction in which one party has more or better information than the other. This can cause an imbalance of power between the parties involved in the transaction, which in turn can lead to several problems. These problems can take the form of adverse selection and moral hazard (Akerlof, 1970; Stiglitz, 1975). To make a clear distinction between the two different problems, it's important to highlight that adverse selection deals with asymmetry in information prior to a transaction, while moral hazard deals with asymmetry in information after the transaction.

Adverse selection refers to the market process where negative consequences from the transaction occur when the parties have asymmetric information. In previous studies, the issue has several times taken the example of insurance companies. The premium they pay does not compensate for the risk they actually possess, due to withholding information from one party. Research made by Puelz and Snow in 1994 shows empirical evidence of adverse selection in their study about the automobile insurance market. By using data from a private insurer, they claim to have found strong evidence of adverse selection in the insurer’s portfolio, where high-risk individuals have been “wrongly” insured with too low premiums that do not match the risk they carry. This is explained in Figure 6, where it is clear that the high risk insurant (Insurant A) in fact is paying the same premium as the low risk insurant (Insurant B).

Moral hazard deals with the immoral behavior after the transaction that leads to negative consequences due to information asymmetry between the parties. By using the example of the insurance company again, moral hazard occurs when one of the parties (the insurant purchasing...
the insurance) may be more careless because of the existence of the insurance, and thus does not need to pay for the whole damage. In a study by Arnott and Stiglitz (1991) where they examined a situation in which insurance is characterized by moral hazard, they found strong evidence that the more insurance an individual has, the less care will he/she take.

“If I can take risks that you have to bear, then I may as well take them; but if I have to bear the consequences of my own risky actions, I will act more responsibly”

(Kevin Dowd, 2009)

In 2009, Dowd used the example of the sub-prime mortgage crisis to explain moral hazard when brokers sold mortgages while knowing that it was not in the best interest for the buyer. Moral hazard behavior is often connected with the originate-to-distribute lending model. Dowd compares the originate-to-hold lending model – in which the bank would make a loss if the mortgage holder defaulted – to the modern originate-to-distribute model. The old banking model caused the bank to have an incentive to only lend its money to prospective borrowers with high credit. If the originator on the other hand, has the view of selling it or securitizing it, the incentives are seriously weakened, according to Dowd. With the OTD lending model, the originator is comfortable to lend to almost any credit and is only concerned with the payment it gets from the issuance (Tseng, 2009).

In George Akerlof’s study “The Market for Lemons” from 1970, he explains how the quality uncertainty in a transaction can force the low quality to drive out the high quality from the marketplace. Due to information asymmetry, the market mechanism forces the buyer to “guess” the quality of the product, which affects his/her willingness to pay. The mechanism drives the price of the uncertain quality product to an average where the good products are suffering and the bad are benefiting. The consequences are that the good products will not be placed into the market, since the bad quality products will be priced the same due to the information asymmetry.

3.2 Social Effects in the Screening Process

3.2.1 Investor Behavior

A major part of the research previously conducted within the field of peer-to-peer lending has put the focus on the dynamics of the lending process, but maybe not so much on how the whole phenomenon of peer-to-peer lending currently is developing in the financial industry. In fact, almost all of the most frequently cited research tries to investigate how the behavior of investors and borrowers affect the interest rates and the likelihood of funding. Zhang & Liu (2012) looked at the funding dynamics on the American P2PL platform Prosper and found clear evidence of rational herding among its investors. This is a situation in which investors tend to rely more heavily on the choices previously made by other investors than on the actual facts being
presented about the borrowers, or that “they infer the creditworthiness of borrowers by observing peer lending decisions and use publicly observable borrower characteristics to moderate their inferences” (Zhang & Liu, 2012, p. 892).

On the same subject, Herzenstein, Dholakia & Andrews (2011) found evidence of herding behavior in P2P loan auctions in the way that the investors were more likely to bid on loans with more bids than with less bids even if the fundamentals of the loans were the same. They actually found that up to the point at which the whole loan has been funded, “a 1% increase in the number of bids increases the likelihood of an additional bid by 15%” (Herzenstein et al., 2011, p. 27).

3.2.2 Borrower Appearance

“A man I do not trust could not get money from me on all the bonds in Christendom”

(J.P. Morgan, 1912)

How investors behave when selecting loans to invest in is naturally not within the control of the borrowers. However, there is evidence showing that the manner in which the borrowers appear on the P2PL platform can have effects on the likelihood of getting their loans funded and on the interest rate they are charged. One example of this can be found in the social networking type of functions that have been added to some of the P2PL platforms. On some of the P2PL platforms, the borrowers and investors can form “friendships” with each other and also rate how well their “friends” have performed in earlier transactions. For example, one Prosper member can ask to be friends with another member as long as they know something about each other that is not publicly available on the platform. The most common information used is the other member’s email address. If the friendship is accepted, they can invite each other to different “friendship groups” in which all members know the true identity of the other members.

When discussing differences between P2PL and traditional commercial banking, Liu, Brass & Chen (2014, pp. 2-3) states that members using these social networking services can enjoy “benefits such as the ability to broadcast loan requests to friends, and to receive notifications of friends’ borrowing and lending activities” and that “the ability to leverage friendship networks in borrowing/lending activities is a key difference between online P2P lending and traditional lenders such as banks”. Lin, Prabhala & Viswanathan (2013) examined this further by using samples of failed listings on Prosper and found that investors used the friendships of borrowers as signals of good credit quality. More specifically, they found that “friendships increase the probability of successful funding, lower interest rates on funded loans, and are associated with lower ex post default rates ” (Lin et al., 2013, p. 17).

Furthermore, borrowers may influence the behavior of investors by trying to appear as trustworthy as possible. This is of course true in traditional types of loan requests as well, but its
significance has proven to be enhanced in the P2P lending process. This can be explained by the fact that P2PL to some extent is more dependent on trust and appearance – and maybe less on unbiased facts – than the lending process in commercial banking is. One factor that has proven to be of extra significance is the borrowers’ profile pictures on the P2PL platforms. Duarte, Siegel & Young (2012, p. 2455) have found that borrowers who appear trustworthy in the profile pictures are more likely to get financing and that they in fact also “have better credit scores and default less often” than borrowers who appear less trustworthy in profile pictures.

But the logical follow-up question to this is then how a borrower should look to be perceived as trustworthy. Duarte et al. used a focus group of 25 people who got to look at pictures of several borrowers and then rate the trustworthiness, in terms of “ability to make a payment”, of these people. Hence, the ratings were purely subjective. And this is what makes it the most interesting. Since the decision of lending money to someone else is based mostly on trust – and since trustworthiness to at least some extent is a very subjective factor – there is a risk of discrimination in the process of deciding which loans in the P2PL platforms that deserve financing.

This has in fact been proven by Pope & Sydnor (2011), who have studied data from Prosper and found evidence of racial, age, and gender discrimination in the likelihood for borrowers to get their loans funded and in the interest rates they pay. Their research found evidence that “loan listings with blacks in the attached picture are 25 to 35 percent less likely to receive funding than those of whites with similar credit profiles” and that the “their interest rates are 60-80 basis points higher” (pp. 53 & 55).

3.3 RISK MANAGEMENT

“Risk is like fire: If controlled it will help you; if uncontrolled it will rise up and destroy you”

(Theodore Roosevelt)

The concept of risk management has grown in popularity in recent years, and more and more companies now see the benefits of identifying and managing the risks they are exposed to. The American business magnate Warren Buffett has famously said that “risk comes from not knowing what you’re doing”, so by recognizing the company’s key risks at an early stage, the idea is to manage the risks on a daily basis instead of trying to completely avoid taking any. Trying to avoid all risky elements of your business will simply not take you anywhere. Peter Drucker – commonly known as the founder of modern management – has said, “People who don’t take risks generally make about two big mistakes a year. People who do take risks generally make about two big mistakes a year”.

18
One of the main tasks of the European Banking Authority (EBA) – which is the agency handling banking regulations within the EU – is to monitor and adopt guidelines for new types of financial activities. In February, they published the report *Opinion of the European Banking Authority on lending-based crowdfunding*, which among other things assesses the risks for market participants in P2PL markets (EBA, 2015). Based on the risks presented by the EBA, the authors of this paper have divided the P2PL market risks into risk categories often used in risk management systems (Rosenberg & Schuermann, 2006; Power, 2005). The main reason for assessing these risks – as stated in one of the research questions – is to be able to analyze how a growing market affects the risk management in P2PL companies. Simons (1999) argues that one of the three set of “keys” in calculating risks and assessing risks in fact comes from rapid growth.

### 3.2.1 Financial Risks

The term *Financial risks* is commonly used for the risks taken by a company engaging in the financial market, and can be defined as risks of loss due to fluctuations in financial market prices or rates. Since the whole business of P2PL is a part of the financial industry, these are risks that can affect the other market participants as well (Rosenberg & Schuermann, 2006).

- **Credit Risks (Counterparty Risks)** – The risks associated with counterparties not fulfilling their part of an agreement. One example could be the investors’ risk of not getting their money back from borrowers.
- **Liquidity Risks** – The risks of money being tied up in the platform and cannot be reached by the customers. An example could be that the platform has not got enough money available when many investors want to withdraw their funds at the same time.

### 3.2.2 Operational Risks

*Operational risks* concern all risks associated with the day-to-day management of a company. They can be defined as risks of loss due to inadequate or failed internal processes, people and systems, or due to external events (Power, 2005).

- **Business Risks** – The risks associated with fundamental changes in the business the company is engaging in. An increasing institutional involvement in the P2PL market could create such risks.
- **Agency Risks** – The risks of misalignment of interests between the different stakeholders. For example, a lack of transparency from the platform may send mixed signals to borrowers and investors.
- **Moral Hazard** – The risks associated with information asymmetry between borrowers and the ones assessing the risks of borrowers, leading to immoral behavior after the
transaction. For example, there are moral hazard risks from the P2PL companies since their revenues do not depend on whether the loans are paid back or not.

- **Reputational Risks** – The risks for the company of having a bad reputation among customers. One example could be that the investors do not fully trust that the company is screening the potential borrowers correctly.

- **Process Risks** – The risks of inadequate planning and implementation of fundamental processes within the company, in this case the process of screening potential borrowers.

- **Technology Risks** – The risks of failed or not fully functioning technological systems, such as platform shutting down, being hacked, etc.

- **Economic Risks** – The risks associated with a changing economic climate affecting the company and its customers directly or indirectly. Changing rates of interest in the financial market could for example affect borrowers’ and investors’ incentives to borrow and invest on P2PL platforms.

- **Legal Risk** – The risks associated with changes in the regulatory framework the P2PL companies must adhere to. One example could be that they have to make sure that no illegal activities – such as money laundering – are taking place on the platforms.

- **External Market Risks** – The risks of increasing competition, both from similar platforms within the P2PL market and from commercial banks outside the P2PL market.

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4 Sometimes also known as System Risk, but should not be confused with neither Systemic Risk – which is the risk of a collapse in the entire financial system – nor Systematic Risk – which is the undiversifiable part of a stock’s risk.
4 METHOD

The fourth chapter explains the method used to fulfill the purpose of the thesis. It also seeks to motivate the structure of the empirical studies, by relating them to the research questions stated in the first chapter, as well as the theory presented in the third chapter.

With the purpose set for this thesis, the authors have realized that the most suitable way of conducting the empirical studies is through qualitative research. By conducting in-depth interviews with two main participants in the market, the authors will assess an overall market perspective. The main interviews will be with one large financial institution and one P2PL company currently in the process of finding institutional collaborations. This will allow the thesis to highlight the problems and possibilities from different perspectives of the market. Despite that these market participants represent the Swedish financial industry, their expertise of the market as a whole will still provide the empirical studies with insights of the U.S. and the UK markets.

4.1 QUALITATIVE RESEARCH

Qualitative research is the method in which detailed narrative descriptions and explanations of the phenomena investigated are described. The way the qualitative data is collected is through ethnographic practices such as interviewing (Biklen & Bogdan, 1998). Using the form of interviews while collecting qualitative data will make the authors answer questions by analyzing and making sense of unstructured data. This thesis will use semi-structured interviews, which will allow for additional relevant topics to be brought up during the interviews. By using open-ended questions that will be prepared prior to the qualitative research, they will provide the thesis with valuable information to fulfill the purpose.

4.1.1 Pre-Interview

Prior to the interviews, the authors have had a correspondence with Finansinspektionen (Sweden’s Financial Supervisory Authority) to provide further understanding of how the regulatory framework is constructed today. A continuous dialogue gave the authors a fundamental knowledge for the interviews ahead. Additionally, the authors have discussed the regulatory similarities and differences between the secondary markets for “regular” loans and P2P loans.

4.1.2 Interviews

The interviews will target some of the players who – in some way – are affected by or can have effects on the growing P2PL market. The questions used during the interviews are based upon the research questions. Since there are five research questions, there are five different issues that work as a foundation for the interviews. As seen in the Appendices, several different questions
have been discussed in order to reach the five broader research questions. These five different issues are summarized in the *Empirical Studies & Analysis* under corresponding headings.

By providing the reader with testimonies from the following market participants, the idea is that an unbiased picture of the developments within the P2PL market can be presented.

- **Savelend Sweden AB** – one of the Swedish P2PL companies.
- **Swedbank AB** – one of the four large Swedish commercial banks.

The authors will interview the founder and CEO of Savelend – Ludwig Pettersson – as well as three different Swedbank representatives – Fredrik Landin and Mattias Andersson from their *Swedish Lending Products* section and Ted Scheiman who works with their *Digital Strategies* and recently have written an internal report on P2PL. These interviews have also been accompanied by continuous correspondence via e-mail and on the telephone with these actors. All interviews will be recorded and summarized in text. These will – together with the other correspondences – also be translated from Swedish into English by the authors.

The reason this thesis chooses to conduct its empirical studies on Savelend is mainly because of its strategic position in which they are currently looking for institutional collaboration. The interview with Savelend provide insights to how they think the market is functioning today, as well as their views on how it may develop in the near future. The main objective with this interview is to hear what they had to say about the screening incentives in the lending process. Furthermore, the interview will provide the study with information regarding the information asymmetry problems that exist in the market and what they are doing in order to minimize the adverse selection problems. The interview with Savelend will also provide the authors with information regarding structure of their screening process.

The authors will also put focus on the way in which P2PL companies are affected by the emergence of the secondary market and their concerns about the OTD lending model. The interview also deals with the P2PL companies’ incentives to collaborate with commercial banks, and how such collaborations would look like. Another goal with this interview will be to get an idea of what Savelend thinks about the current regulatory framework and if there are any potential regulations in the future they are concerned about.

The main reason why the authors will interview Swedbank is to understand which risks they believe exist in the unsecured loan market. The authors will focus on the consequences the OTD lending model can have and the effects of a growing secondary market. By discussing the lessons learned from the crisis of 2008 – together with the possible downsides of the OTD model, the secondary market, and securitizations of loans – it will hopefully be of great help when analyzing the similar developments currently taking place in the P2PL market. Due to the size of the
commercial banks, they have the possibility to directly change the climate of the P2PL market, depending on their behavior. Therefore, it will be highly interesting to discuss their opinions regarding the P2PL market in terms of competing or collaborating with P2PL companies. Additionally, the interview will cover the regulatory requirements that the banks have been subject to after the sub-prime loan crisis. Their experience of the Swedish lending market also provides understanding of some fundamental differences to other national lending markets, and therefore will they be able to give insights of the markets in the U.S. and the UK.

4.2 Risk Management Table

Since this thesis uses the concept of risk management as a tool to explore the consequences of a growing institutional interest in the P2PL market, the authors have created a risk table in which the different risk categories explained in the previous chapter will be rated and compared. The idea is for Savelend to fill out this table as a part of their interview, and after discussing the development in the P2PL market with the representatives from Savelend, Swedbank, and Finansinspektionen, the authors will present their summarized picture of these risk categories. The task is to – on a scale from 1 to 6, where 1 represents the lowest level and 6 representing the highest – rate the relevance and importance of the risk categories explained in the Frame of Reference chapter. The reasoning behind choosing the scale of 1 to 6 (instead of e.g. 1 to 5) is that an even number of grades makes it impossible to choose a “neutral” answer.

As mentioned in the Delimitations & Perspective chapter, this thesis is primarily not about risks, it rather uses the concept of risk management as a tool for exploring the possible consequences of an increased institutional involvement in P2PL. The risks associated with the current P2PL market are explored in the interview with Savelend and are based on the risk groups presented in the Frame of Reference chapter. But for the new types and levels of risk associated with an increasing institutional involvement in a growing P2PL market, the analysis is made based on the information gathered in both interviews as well as the risks presented by the EBA.
The following is a summary of what was discussed with Ludwig Pettersson – the CEO and founder of Savelend – and Fredrik Landin, Mattias Andersson, and Ted Scheiman – representatives from Swedbank’s Swedish Lending Products section and Digital Strategy Team – in Stockholm, April 2015.

5.1 THE ORIGINATON OF THE MARKET

5.1.1 Savelend

When discussing the reason for entering the P2PL business Pettersson explains that he saw an uncovered part of the market, in which Savelend could establish their business and start growing. Even if Savelend more and more can see the benefits that their platform can offer investors, the reason for starting Savelend was mainly to satisfy the needs of borrowers.

“What we need to remember is that no one likes to take a loan, none the least our customers because they really are in need for it”, Pettersson explained and continued by giving examples of who their customers might be. “When they arrive at our platform, 40-50% of them comes via affiliates ⁵ – from a huge amount of different search words – and the rest comes directly to us. It could be that they need to buy a car to be able to get to work, but the bank will not give them a loan for it. Our customers are then willing to pay a premium to get a loan in our platform, to be able to get to work and earn a living.” But they also have examples of much more short-term needs, such as customers realizing that they need to pay congestion taxes in just a few days but do not have any money at all on their bank accounts. It is thus cheaper for them to get a small loan on Savelend’s platform and pay the taxes now, than to wait and being forced to pay an extra late-payment fee on top of the tax payment.

These are customers that commercial banks – perhaps understandably – do not want to engage in loan agreements with, and therefore a part of the lending market that they primarily do not want to do business in. But according to Pettersson, commercial banks would not be able to enter

⁵ A type of Internet marketing.
this part of the market even if they wanted to. “They are not allowed to, considering capital requirements, the Basel III framework, and such”

“Banks will not be able to offer a similar service as we do, definitely not at the same price”

(Ludwig Pettersson – Savelend, 2015)

Although, Pettersson believes that commercial banks will be starting to look for possible collaborations with P2PL companies in the near future, and says that Savelend is ready to start a discussion when this happens.

5.1.2 Swedbank

Swedbank have met with different P2PL companies several times for open discussions about the positions and in which segments of the market they want to engage in. After analyzing their situation, Andersson has difficulties seeing where the P2P loans would find their share of the market in large volumes, where the commercial banks of Sweden provide the market with generally good access to capital and beneficial credit terms. Additionally, he believes that – from the commercial banks’ perspective – they have only been interested in business loans and not consumer loans of P2PL, which is what Swedish P2PL companies mainly are engaging in at the moment.

They have not seen a direct competition situation between the P2PL platforms and the commercial banks; rather he explains it as a potential partner or complement to their own product offerings. Furthermore, Andersson adds that when talking about P2PL it is more interesting to look at the investors that have capital and where they want to invest and which risks they are willing to take instead of focusing on the ones that do not have capital.

Andersson explains the different market rules that the commercial banks and the P2PL platforms have. He uses the example of business funding, in which the platform can raise capital for start-ups. The commercial banks are not allowed to engage in such “risky” funding since it per definition is considered to be venture capital. “Since the commercial banks in Sweden are subject to strict regulations we have to follow them”, he says. However, for “healthy business” as Andersson calls it, financing from commercial banks are not a problem and he also says that they “have access to relatively cheap capital and have no problems with financing healthy businesses”.

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6 Basel III is the third installment of the Basel Accords and is currently under implementation. It was developed in response to the 2008 financial crisis, and is supposed to strengthen banks’ capital requirements (Bank for International Settlements, 2010).
While discussing the issue with Fredrik Landin from Swedish Lending Products, he instinctively says that they cannot engage in activities where they risk the capital of the bank. Therefore he believes that they are not active in exactly the same lending markets as the platforms. Scheiman – who recently conducted an internal investigation of P2PL and crowdfunding – explains the difference between P2PL platforms and commercial banks as institutions that engage in different segments of the financial market. His way of looking at the market is presented in Figure 7.

He does not see the P2PL platforms as competitors since they are not acting in the same market as the commercial banks in terms of risks as indicated in the figure. “Based upon the risk, we offer much lower interest rates than the platforms can afford to offer”, Scheiman says. He further believes that “the platforms will never be able to enter the market in which the commercial banks are acting, and if they did, they would act as banks and would be required to adhere to the same regulations as the banks”.

FIGURE 7: LENDING SEGMENTS ACCORDING TO SWEDBANK
(Source: Claesson & Tengvall)

“Unique for Sweden is that we have ALMI, which is a public lending institution that covers approximately 50% all denied business who are seeking funding at commercial banks” says Scheiman. Additionally, Landin explains ALMI as “a venture capital firm without ownership aspirations”. Landin also believes that the startups, which are denied funding at ALMI should consider if their business actually is, as good as they think.
When discussing the P2PL market existence, Scheiman sees the short historical experiences within the financial market as a problem and says: “in order to be able to evaluate the risks associated with loans with maturity over 10 years, the industry must have been active for at least 30 years. These experiences involve volume over time, as well as default rates and risks. Currently the market of P2P loans has been active for 3-4 years and evaluating loans with maturity twice its own market existents. Therefore there are many uncertainties and speculations in terms of risk for long-term P2P loans”. When P2PL companies are stating a specific default rate and a level of risk, it does not actually mean anything, is what Scheiman believes. Additionally, he says that there is not an actual risk picture existing, from which the evaluations can start.

5.1.3 Analysis

There is clear evidence that neither the commercial banks nor the platforms see the market for P2P loans as a lost customer base for the commercial banks. Clearly it is a market in which the banks cannot engage in. Shown in Figure 7, Swedbank suggests that there is not a competition situation between the banks and the platforms; rather there is room for collaborations since they are acting on different risk levels. Since P2PL is not seen as a result of lost customers from the banks’ perspective, they are instead looking at it as a solution to higher risk investments.

Since the Swedish lending markets provide great access to capital and there is no problem for healthy businesses to get funding, the P2PL business loans will not target the healthy businesses. Instead, P2PL is engaging on a different risk level, meaning that the commercial banks and the P2PL companies are not competing in the same market segments. And since ALMI currently is taking the lending segment of higher risk businesses, the market in which the P2PL platforms will enter is at an even higher risk level, as seen in Figure 8. And by quoting Fredrik Landin, one can start asking if these businesses really should get funding at all.

“In case you are denied funding at ALMI, you as an entrepreneur should probably start questioning if you are on the right track”

(Fredrik Landin - Swedbank, 2015)

This is the segment in which the P2PL companies want to engage and provide funding to individuals and businesses that have been denied both at commercial banks as well as at ALMI. From the perspective of the society, one can start asking if it really is healthy for the financial market that these risky businesses are getting funding. However, the Empirical Studies show that there in fact exists a market segment for consumer loans with an equivalent risk level as the business loans that ALMI currently is covering. This segment is shown next to ALMI in Figure 8.
5.2 Market Development

5.2.1 Savelend

As mentioned before, the Swedish market for P2P loans is really not that big yet. But according to Savelend, it has the possibility to grow in the same way as the markets in the U.S. and the UK. “We are on the same journey as the American and British markets, but it is a few years too early at this moment”, Pettersson reflects. At this moment, Savelend has not started collaborating with any banks, although some early discussions have been made. Savelend visited one of the big banks a few days earlier, and they did not seem to be interested at all. “In their [the Swedish banks’] same position the British were banks five years ago, and the ones that said ‘yes’ are now bigger than the ones that said ‘no’”, Pettersson claims.

“I said that ‘we can have a discussion in five years, and you will regret that you did not do anything today’”

(Ludwig Pettersson – Savelend, 2015)

One interesting way is to create a partnership in which Savelend and a bank can forward customers to each other, if they feel that that customer would be better off looking for funding at the other institution. So the only upside is not that the bank could forward a high-risk borrower
to the platform, but Savelend could also forward a borrower to the bank if they felt that this borrower should be able to get a cheaper loan at the bank than on the platform. A partnership like this one would probably also come with some type of ownership investment in the P2PL company by the bank.

However, the collaborations that Savelend is interested in at this point is mainly to use the banks as investors on the platform, and not to get any help in the creation of loans, as the case has been for some platforms in the U.S. At this moment, Savelend has no institutional investors at all, as contrasted by e.g. TrustBuddy that has institutional investors both on the platform and in the ownership of the company. A large sum of money from a bank could of course help Savelend to offer more loans to their borrowers, and at lower rates of interest. Pettersson believes that banks – that quite clearly do not want to invest in high-risk consumer loans – would be more open to invest in business loans, because it could work as a way for them to diversify their risks. “Let us say that they have a budget of 100 SEK. Then they could put their money in our platform and quickly invest in 100 different companies, without having to do any screening”, Pettersson explains. And this is also what he thinks will be the greatest source of growth for the P2PL market in the future. “It is more fun to deal with bigger loans, especially business loans”, he admits. “And we will perhaps move away from these small consumer loans”.

Looking at the future, Pettersson thinks that the Swedish market is enough for Savelend at least for one or two years more. But after that, they are planning to move into new markets within the EU. “It is probably easiest to buy an existing company, because it helps us with licensing and similar. Lending between countries are much harder regulated”, Pettersson explains. “It is much easier to enter a country that someone [another company] already has entered. In that way we will hopefully avoid some of the biggest ‘mines’ and traps”.

5.2.2 Swedbank

Before discussing the developments of the different geographical markets, Scheiman believed it to be important to make a clear differentiation between Sweden, the UK and the U.S. According to him, different demands for the P2P loans originate from two different market drivers:

- In the UK, P2P loans rose from the ashes of the financial crisis, after which corporate loans became really hard to get for businesses.
- In the U.S., P2P loans became a solution for paying off previous credit debt for consumers.

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7 For exact numbers and specifications of TrustBuddy’s current ownership structure, please refer to their latest Annual Report.
In Sweden, we have not seen any of the above phenomena and because of that no segment has clearly driven the P2P loans to a greater demand, which drives Scheiman to ask: “Where is the demand in Sweden?” In order to create possibilities for collaborations between Swedbank and P2PL companies, an increased loan volume would be required. Andersson explains that in case the P2PL platforms had larger volumes of corporate loans, a greater demand within the banking industry would arise since investors from “private banking” are looking for higher risk investments. “The financial markets that the P2PL companies are active in are very different from one another”, says Andersson, and further states that he believes the conditions for the platforms to be very different. Right now he has difficulties to see where the P2PL companies should find their part of the market since the Swedish market has good access to capital in comparison with the U.S. and the UK.

“Just because P2PL works in the U.S., it does not mean that it will be the same in Sweden, because there are very different financial markets and regulatory requirements”

(Mattias Andersson – Swedbank, 2015)

For example, securitization of P2P loans has not been seen in Sweden yet but is growing in the U.S. and the UK. In Sweden, Andersson believes that it is really hard to “sub-prime” small consumer loans, and explains that “a solid volume of P2P loans are first required in order to create market practices before the financial engineers can create transactions that no one can understand”. In Sweden, the consumer loans market from a banking perspective is growing really fast and all major banks have a strategy to increase market share. “This could possibly be driven by the new players who are trying to enter the consumer lending market”, Andersson says, referring to P2PL as one of the alternative financiers. When comparing the geographical markets Scheiman sees a similarity between the collaboration that exists between the Swedish commercial banks and ALMI and the American commercial banks that guide denied borrowers to P2PL platforms.

Regarding cross-border transactions for P2P loans, all representatives from Swedbank have difficulties to see it working smoothly. Despite the fact that Sweden is part of the EU, there are still difficulties associated with lending to other countries. Landin explains that the EU is trying to harmonize the financial markets but the major problem is not the legal set-up, rather it is more about the information design since a loan agreement does not look the same throughout all member states of the EU. Regarding the growth of the industry, Andersson says, “It is really interesting to follow their distribution and communication models as well as its accessibility, so we have to follow them but it is to early for the Swedish market to say if this is a thing or not”.

30
5.2.3 Analysis

Before one can start analyzing the developments of P2PL, it is important to realize that there are clear differences in the development between the markets of Sweden, the U.S., and the UK. For example, all representatives from Swedbank wanted to highlight the current market differences in terms of demand, volume and regulatory requirements for the geographical markets. The empirical studies indicate that the market for P2PL in Sweden is in a completely different development phase compared to the ones in the U.S. and the UK. Just because the markets in the U.S. and the UK have developed in one way, does not necessarily mean that the market in Sweden will follow the same pattern. For example, the sheer sizes of the U.S. and the UK markets allow for more specialization than the Swedish market does. However, a simplified step-by-step development process, can explain the development phases that the P2PL markets seem to follow, regardless its geographical origin.

![Figure 9: P2PL Development Phases](Source: Claesson & Tengvall)

- **Stage 1**: Lending/Borrowing
- **Stage 2**: Loan Volume
- **Stage 3**: Institutional Collaboration
- **Stage 4**: Securitization

**Stage 1**: When online platforms connect individual borrowers and investors to mediate loans.

**Stage 2**: Platforms are experiencing growth in terms of loan volume, mainly from business loans.

**Stage 3**: Collaborations between P2PL platforms and financial institutions – such as commercial banks – are starting to form.

**Stage 4**: Financial institutions are starting to pool P2P loans into securitizations.

By looking at the market for the U.S. and the UK, one can understand that the U.S. and the UK markets have been subject to a great institutional involvement where the P2PL loans have been referred to as “the new upcoming asset class” in which large institutions have invested heavily in. The markets have started entering the forth stage where the loans have been pooled into securitization where investors are trading the asset-backed security with the underlying P2P loans in secondary markets. The market is in its early stage but growing as this thesis is written, and there is confidence in the market of a strong future growth of the P2PL industry.
In comparison to the Swedish market, one can conclude that the market is in its start-up phase where it is raising awareness among individual as well as institutional investors. Therefore the Swedish market is in the first stage, where the platforms have started acting as intermediaries between the peers, making the loans possible. From the research conducted there is evidence that the platforms themselves are looking for institutional collaborations, meaning that they want to be in the third stage. However, the market as a whole is still acting in the first stage since the second stage of required loan volume has still not been reached. From the institutions’ point of view, collaborations are highly interesting once the P2PL market increases in volume and when they can form an investment case. In order to increase the volume, the platforms need to issue more loans.

Another way to increase the volume would be to enter the business loan market that seems to have much more potential than the consumer loan market, according to both Savelend and Swedbank. Therefore, there is an indication that the future of P2PL in Sweden lays within the business loan segment, and maybe not in the consumer loan segment.

Interestingly, when the market grows larger and develops further, institutional collaboration will occur. It is just a question of what form these collaborations will take. The development can either continue to the fourth stage or stop at the third stage of Figure 9, where the potential collaboration between the institutions and the platforms can take the following form without securitizing the asset:

- Commercial banks are forwarding high-risk borrowers to platforms
- Financial institutions are investing large sums of capital in P2P loans
- Financial institutions are investing for ownership in P2PL companies
- Platforms are forwarding borrowers to banks for lower interest rates

Regarding the fourth stage of the development phases, it is still too early to say if Swedish P2P loans will be pooled into securities and traded in a secondary market. But since the Swedish market so far has been experiencing similar patterns of development, it is not impossible that it will get to experience a securitization on the Swedish market as well. However, what is more likely is that large Swedish institutions will invest in securitized assets (P2P loans) originated in the U.S. or the UK – as investors did during the sub-prime crisis in 2008 – until the Swedish market has reached the forth stage.
5.3 SECONDARY MARKET & THE ORIGINATE-TO-DISTRIBUTE MODEL

5.3.1 Savelend

The fact that P2PL platforms do not take on any risk themselves implies that they could benefit from easing the screening process to be able to create more loans. For example, if Savelend decided to skip the fourth step in their screening process, they could offer loans to around 50% of the potential borrowers instead of 30%. “We do not take any risk ourselves”, Pettersson agrees.

“Theoretically, we can create more loans. But that would mean that we are ‘shooting ourselves in the foot’ in the long run”

(Ludwig Pettersson – Savelend, 2015)

The emergence of a secondary market for P2P loans – which also Savelend is in the process of offering to its customers – will not affect the way in which Savelend screens potential borrowers, according to Pettersson, mainly because the company itself is not affected by the loans already issued. Since they have already taken their fee when the loan was issued, it does not matter for them if the loan later is resold in the secondary market. Pettersson sees this secondary market more as a tool that helps the investors to manage their portfolios, and for example increase their liquidity by selling off some of their loans. However, the fact that investors might be more willing to fund loans (hence, originate them) if they have the possibility to sell them in the secondary market – which this thesis previously has explained as another type of originate-to-distribute model – implies that an emerging secondary market also could generate greater loan volumes.

Petterson expands on this topic and says, “We could increase our revenues by allowing more loans. That would probably benefit us for about a year. But in the long run, that would negatively affect the investors’ yields. Hence, we would attract fewer investors; we would be forced to spend more capital on bringing capital into the platform”. Petterson further explains this as “a negative spiral in the long run”. “That is why we are so tough [in the screening process]. Sure, we do not make as much money as we could, but it will benefit us in the long run”.

5.3.2 Swedbank

Andersson believes that the P2PL business is far more interesting when the loans are packaged into a portfolio in which one can invest and spread the risk rather than in only one engagement. “If I buy a portfolio of corporate loans where 2 out of 10 are defaulting it feels pretty safe instead of having a high risk with one single exposure”. But in order to make further packaging of the loans the platforms are required to obtain greater volume and structure.
When talking to Scheiman about the emerging secondary market for P2P loans, he believes that there are high risks involved with repackaging and selling loans and says, “We do not want another sub-prime”. “The risk with the securitization as a whole is that financial engineers are making transaction after transaction, and when you as an end-consumer is looking at the security it is really hard to understand what it is and what it consists of”, Andersson explains.

"P2P loans are highly risky instruments that enter the heart of the financial industry"

(Ted Scheiman – Swedbank, 2015)

Scheiman explains the American securitization process by saying, “The problem with the U.S. market is that they bundle P2P loans with traditional products in order to hide the risk”. “The advantage of the sub-prime was that sub-prime was sub-prime,” he adds, when explaining the ambiguity of the securitizing of P2P loans in comparison to the securitization that occurred during the mortgage crisis in 2008. Andersson says, “They are gathering all types of junk and puts it together and the proportion of junk in a traditional transaction is increasing”, when explaining the securitization process of P2PL loans. He sees this phenomenon as “a way of hiding the underlying loan in order to hide the risk”. Scheiman additionally explains that the major problem with the P2P loans in a secondary market is that no one is conducting a quality seal or quality check. The risk is that no one makes this analysis. In comparison with the sub-prime crisis Ted Scheiman explains it as “During the sub-prime crisis the financial engineers knew that they were bundling ‘junk’ while in the scenario of P2P lending, no one is even looking”.

5.3.3 Analysis

Since the originate-to-distribute lending model previously has led to major financial crises, it is appropriate to analyze the risks it actually entails, because it is the foundation of the entire P2PL business. The market will always be affected by it, and the risks associated with it will depend upon which development phase the market is in. Starting by analyzing the markets of the U.S. and the UK, the representatives from Swedbank were raising high concerns about the way the market is developing where the P2P loans are being securitized and traded by financial institutions. From the research conducted one can clearly see that there are high risks involved with securitizations of assets, and that a P2PL market that enters the ABS business potentially can have major economic consequences if the market grows large.

With an emerging secondary market for securitized P2P loans, there is a high risk of ambiguity in the market. The lack of transparency and number of transactions make it very complicated for the end consumer to understand what the security consists of. Abrahams & Lang (2009) explained that a major information asymmetry arises when the loans are repackaged in
complicated processes. This is what the P2PL market currently is experiencing in the U.S. and the UK. By the securitization, the originator can “hide” the risk of the P2P loan by bundling it with other loans. And by doing this, the originator can create more high-risk loans for future securitization purposes. The platforms assessing the risk of the borrowers have a great responsibility in the screening and even more importantly in the rating of the loans. Since the platforms never carry the risk of default, the ratings can be affected in order to get more loans out on the market.

This phenomenon can be compared with the rating agencies and the over optimism during the sub-prime crisis in 2008. The rating agencies’ task was to minimize the information asymmetry by rating the securities based upon the creditworthiness of the underlying, which can be compared to the rating of borrowers that the platforms are doing in the P2PL markets. But due to the agency problems that existed in the mortgage market, the rating agencies rated the asset-backed securities in the way that was profitable for them. And on top of that, the rating agencies never carried any liabilities for an incorrect rating when they were giving AAA ratings to high-risk securities. Similarly, the platforms in the P2PL markets are by jurisdiction not responsible for conducting a correct risk assessment.

Additionally, the information asymmetry in the P2PL market between the lenders and the borrowers opens up for moral hazard behavior form the platforms. It follows the same behavior of the sub-prime crisis as Dowd explained in 2009. Back then, brokers sold mortgages while knowing that it was not in the best interest for the buyer. Now, the platforms are originating loans without having to bear the consequences of the risky action, since the risk is transferred to the investors if the borrower is in default.

Since it can be in the interest of the platforms to increase the volume – as the case was in the sub-prime crisis – there is an imminent risk that it will affect the screening incentives of the platforms. Shown in Table 1, the greatest similarities between the P2PL market and the sub-prime market, are presented, where a misalignment of interests between stakeholders is a result of the OTD lending model. This comparison is based on both the empirical studies in this chapter as well as the previous research presented in the theoretical framework. Since the P2PL and commercial banking businesses are different in both structure and scale, there are of course many differences between P2P loans and the sub-prime loans as well. But for the purpose of this comparison, the similarities in the risk assessments are evidence enough to make this connection.

Since these concerns are applicable to the current market development taking place in the U.S. and the UK – or the forth development stage – this thesis is discussing the possibility for the Swedish market to follow the same pattern of securitization. However, in the first development stage as the Swedish market currently is in, a secondary market has already started growing but
without the engagement from institutions securitizing the assets. Instead it is between individuals and businesses that can sell off their outstanding loans. Even though this behavior occurs in smaller scale, it still raises concern about the ways risky borrowers are funded. As the empirical studies proved, more loans will be funded once a secondary market exists, which means that more risky loans will enter the market. It is always easier to give credit to someone if you know that you later can sell off the loan and get rid of the risk. This is once again evidence of how a secondary market is affecting the quality of loans, which is in line with the study conducted by Berndt & Gupta (2009) about loans sold in a secondary market.

| SIMILARITIES BETWEEN P2PL & THE SUB-PRIME CRISIS |
|-----------------|------------------|------------------|
| **EVENT**       | **P2PL MARKET**  | **SUB-PRIME MARKET** |
| Borrowers       | Poor credit with high risk of defaulting | Poor credit with high risk of defaulting |
| Originators     | Originates loans to high risk borrowers without carrying the risk of borrower defaulting | Originated loans to high risk borrowers without carrying the risk of borrower defaulting |
| Rating Agencies | No liability if their rating of the borrowers proves to be wrong. Threat of not acting as independent authorities | No liability if their rating of the securities proved wrong. Did not act as independent authorities |
| Capital Markets | Combines highly risky P2P loans together with other loans and securitizes the assets for secondary markets | Combined highly risky mortgages together with other loans and securitizes the assets for secondary markets |
| Regulations     | There are no regulatory restraints that give the originators possibility to originate more loans | There were no regulatory restraints that gave the originators possibility to pump out loans |
| Quality of Loans | P2P market is facing a threat of decrease in quality in order to increase the volume | Did not care about the quality of the mortgage, but instead maximized the volume to get a fee from it |
| Profits         | The platform's revenues are based upon the volume of loans originated, and not the repayment of the loans | The mortgage firms were compensated for the volume of loans originated, and not the repayment of the loans |
| Agency Problem  | Threat of misaligned interests between the platforms (originators) and the investors (lenders) | Misaligned interests between the mortgages brokers and the borrowers |

5.4 **The Screening Process**

5.4.1 **Savelend**

As for the screening process of potential borrowers, Savelend is different from many other P2PL platforms in the way that they only offer one single interest rate for all borrowers on the platform, which can be seen in *Figure 10*. “We do not separate one borrower from another, meaning that the investors really do not have anything to say about the risk level nor the interest rate. As an investor, you simply put your money into the platform and let the money work for you”, Pettersson explains. “The rate varies and can depend on how much capital you put in, but even the capital that is not invested in a loan yet still gets 2.2% interest, which of course is considered high in today’s climate”.

36
This also means that Savelend needs to be stricter in their screening process, since all borrowers must be able to meet the same requirements. If you want to get a loan on Savelend’s platform, you first need to go through a few steps that are designed to separate the “good” borrowers from the “bad” ones.

**Figure 10: Risk Level / Interest Rate Relationship – Savelend**
(Source: Claesson & Tengvall)

The first step is to fill out a form about who you are, and then a first control with debt-collection agencies is made to see that the applicant previously have not had any defaulted debt payments from invoices or other obligations. If he/she does, Savelend immediately rejects the applicant. The second step is to do a credit check, which is based mainly on earlier defaulted payments, but also for example on where the applicant is living. “If you have an income of 20,000 SEK, then it is a huge difference [for the ability to pay back a loan] if you live in Stockholm or in Jukkasjärvi. Your costs are simply not the same”, Pettersson added. The third step is to verify the applicant’s Electronic Identity Card\(^8\) – the BankID in Sweden – and in that way receive the bank account number to check that payments are made to and from the right person. This is to be sure that no money laundering is possible.

**Figure 11: Savelend’s Screening Process**
(Source: Claesson & Tengvall)

These first steps are all done automatically. If the applicant has made it through these three steps, Savelend themselves make a manual control by calling Kronofogdemyndigheten to check if the

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\(^8\) The Electronic Identity Card (EIC or eID) is an electronic identification used towards authorities.
applicant currently has any payment orders. If so, the applicant is denied immediately. 20-25% of the applicants are rejected at this final step, and it is also one of Savelend’s most time-consuming tasks. Only around 30% of the applicants make it through the whole process and are allowed to look for funding on the platform. “We are very tough compared to many others”, Pettersson claims, and also adds, “other companies claim that they are at a similar level, but that is simply not true”.

But this straightforward process will be changed when Savelend will start to offer larger consumer loans to their customers in August 2015 and business loans a few months later. Together with these changes, an auction component will also be added to the funding process. “We will still set the rate depending on the creditworthiness of the borrower, but the investors will get to bid to buy the loans at that rate, to avoid the winner’s curse“, according to Pettersson. Hence, the investors will still have to trust that Savelend do their work in the screening process, so that they can be sure that the interest rates really match the creditworthiness of the borrowers. “The investor trusts us making a good credit model. Today we are not that transparent, because the investor has nothing to say about the process”, Pettersson says. “But in the next step [in August], they will be able to see what credit score they [the borrowers] got, where they live, if they have verified their bank statements, and such”.

Pettersson claims that they will only include facts that could affect the borrower’s ability to pay back the loan, and not include things such as personalized texts or pictures, because they want to keep their customers as anonymous as possible. Examples of facts that will be added are the sex of the applicant, age, and education. He also adds that as an investor “you should for example be able to invest only in loans to women in the age of 30-35 if you want to”. Furthermore, all information will be assessed by Savelend and they will notice that they have verified it if they can. For the sake of business loans, investors will of course be able to see which the company is to be able to assess the risk level themselves as well. It is also interesting to notice that the P2PL companies have no obligation to make a “fair” credit check. Pettersson explains, “that we - according to contracts - have the freedom to do whatever credit assessment we think is enough”.

*It is for the investors to trust that we do what is best for their money. And in the long run, that is most often also best for our own money.*

(Ludwig Pettersson – Savelend, 2015)

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9 The Swedish Enforcement Authority (Kronofogden) is a government agency involved in debt collection

10 A documented auction phenomenon in which the winner bids a high price mainly because he/she wants to "win" the auction, and maybe not because he/she actually thinks the asset is worth such a high price.
5.4.2 Swedbank

Regarding the information asymmetry that exists between the peers, Andersson believes that “the one investing its capital has to evaluate whether he/she is willing to enter a quite unfamiliar transaction, in which no intermediary has conducted any due diligence, recommendations and put its seal of quality on it. As an investor, you are evaluating a borrower who is stating his own level of risk”. He further explains, “The investors have to evaluate if they are comfortable with investing their capital based upon such basis”.

In this transaction the platforms want to be totally objective in their risk assessment and just look at the extract from the credit report without taking in other factors. “Because if they do, they have already committed”, Andersson explains the platforms risk assessments and relationship with their borrowers. Scheiman further explains how the screening process for P2P loans in Sweden is done and explains, “The platforms are taking a UC of each potential borrower” 11. According to Scheiman, they are “mass-producing risk assessments with no focus on assets, liabilities and income, which means that it actually says nothing about the repayment capacity of the borrower”.

5.4.3 Analysis

It is easy to say that one of the most important aspects – if not the most important – when dealing with the risks and effects of the P2PL business, is the quality of the companies’ screening of potential borrowers. The borrowers looking for funding in P2PL platforms are generally of higher risk than the ones looking for loans in commercial banks, partly because their credit is usually worse and partly because they often need money fast. This – together with the fact that investors must be able to trust that the company is making a correct risk assessment of the borrowers – is basically the foundation of the P2PL business, and the reason why P2PL companies can generate high interest rates and charge high fees.

After interviewing the CEO of one of the Swedish P2PL companies, it is also apparent that the companies are fully aware of this. One of the questions this thesis seeks to answer is how the companies’ incentives for doing this screening ambitiously are affected by an increasing institutional involvement in the market for P2P loans. When looking at Savelend’s current screening process, there is no actual evidence that this should be the case since the whole process is automated and identical for all borrowers. However, this is not the case on all P2PL platforms and it will – to some extent – change for Savelend when they are starting to offer larger consumer loans later this year. When all borrowers are screened individually and assigned different interest

11 UC is a Swedish company conducting credit reports.
rates depending on their risk grading, the P2PL companies do have an incentive to rate the risks of the borrowers lower than they should be, to be able to more easily get loans funded on the platform.

Since the companies do not bear any risk for the loans, and since their fees generally are independent of whether the loans are paid back or not, they are not at all directly affected by the result of the loans after they have been funded. This phenomenon has in this thesis been compared to the originate-to-distribute model of lending that – in the financial crisis in 2008 for example – meant that banks could originate whatever kinds of loans they wanted and immediately sell them in the secondary market, and thus not bear any real risk for the loans. The OTD lending model in the P2PL market contains incentives to originate a loan, sell it and transmit the risk of it as Martin-Oliver & Saurina explained the “regular” lending model in 2007.

The banks’ revenues basically depended only on the amount of loans they originated, and not on the actual quality of these loans. This is similar to the current situation for P2PL companies, whose easiest way of increasing revenues also is to increase loan volumes, and that the easiest way of doing this is to simply ease their screening demands.

There is a balance between volumes and risk that the platforms have to consider and when never carrying the risk for failure of borrowers this balance is hard to handle for the platforms. This can be explained by a risk/volume diagram, where there is a threat of greater risk for default when the volume of loans originated is increasing.

**Figure 12: Risk / Volume Relationship**
(Source: Claesson & Tengvall)

As long as the companies can continue to attract investors who bring money into the platforms, there is almost no limit to the amount of loans they can originate. This is further enhanced by the possibility of collaborations with banks, which would bring even more money into the platforms. This less strict screening process will ultimately generate a larger loan volume, but it will also lower the average quality of the loans originated. This is also one thing Savelend has thought about, and Ludwig Pettersson meant that an increased loan volume could never occur at the cost of a decreased quality in the screening process, because this would ruin the investors’ trust in the company. So the question for the P2PL companies is to decide if they desire a larger
loan volume that would generate more revenues in the short-term, or a strong reputation that will keep their investors loyal in the long run.

However, it should also be noted that a larger loan volume does not necessarily mean lower quality of the loans originated. As long as the screening process is done ambitiously and the interest rates are assigned fairly considering the risk ratings of the borrowers, a high-risk loan is not the same as a low-quality loan. If investors trust that the company has done the screening correctly, and understand both the opportunities and threats associated with investing in low- or high-risk loans, an increased loan volume does not have to occur at the cost of a lower quality of the P2P loans.

It is necessary to add to the analysis of this thesis that it is not possible to assign a perfect interest rate for all borrowers applying for loans in the P2PL market. This is due to the way borrowers are placed in different risk groups based upon their creditworthiness. Within each risk group there are of course different risk levels since not all borrowers are identical in terms of risk. What this means is that two different borrowers with different levels of risk can be assigned the same interest rate, as Figure 13 is showing.

This can lead to adverse selection where the high-risk borrowers (Borrower A) are assigned interest rates that are lower than they should be. The low-risk borrowers (Borrower B) are assigned interest rates that are higher than it actually should be. In the comparison between commercial banks and the P2PL companies it is true that the risk groups in the P2PL market are larger, which causes the adverse selection to be greater. This can be explained by the amount of resources and time the commercial banks have to allocate for the screening process. It makes the risk groups as small as possible and the interest rate as fair as possible.

For the P2PL markets, a large risk spread within each risk group can create a “Lemons Problem” in the market. While low risk borrowers (Borrower B) are unfairly receiving the same interest rate as the high-risk borrowers (Borrower A), the market mechanism will drive the low risk borrowers out of the market. Consequently, the P2PL market will only be left with the high-risk
borrowers, or the “Lemons” as Akerlof would call them. For the example of Savelend – in which all borrowers are assigned the same interest rate as seen in Figure 10 – the “Lemons Problem” is a severe problem, where only one risk group exist. The large risk spread will make all borrowers beyond the vertical interest rate line (high-risk borrowers) benefiting, which potentially can drive out the low risk borrowers from the market, since they are unfairly rated.

As previously mentioned, on many platforms it is possible for the borrowers to present the investors with some additional information about themselves. In the U.S. and the UK, functions like these have been created in several different ways. On some platforms – similar to how Savelend is planning to create theirs later this year – only some basic facts like gender, age, and such have been allowed. But on a few others platforms, the borrowers have been allowed to write personalized texts about themselves, and also add pictures. As explained in the Frame of Reference chapter, these functions have sometimes generated certain levels of discrimination from both the platforms and the investors. As the study by Duarte et al. explains that trustworthiness is a very subject factor and that pictures enhanced the risks of discrimination, the process of allowing gender and age information can still be discriminating factors for Savelend.

To avoid this, the P2PL companies basically have two options. They can either decide not to include any personalized information at all – like it is on Savelend’s platform today – or only allow facts that actually can affect the borrowers’ ability to pay back their loans. The problem the P2PL companies must deal with is then how to know which facts that actually do this. It is obvious that for example a borrower’s income affects his/her ability to pay back the loan, but is the same really true for the age of the borrower? What effect has the gender of the borrower? These could be difficult questions for the P2PL companies to answer.

5.5 RISK MANAGEMENT

5.5.1 Savelend

In the interview with Pettersson, he also got the chance to fill out a risk table, which is presented in Table 2, and the following is a summary of what he had to say about each risk category. For business risks, Pettersson fully agrees that an increasing institutional involvement could change the foundations of the P2PL business, because it would not actually be loans between peers anymore. “It would be a banking business, in that case. And that is why we have some reservations about it”, Pettersson admits.

“It is difficult to say no to increased revenues. But at the same time, you have to remember where you came from”

(Ludwig Pettersson – Savelend, 2015)
This could also be seen as a part of the agency risks, since the interests of the company do not always align perfectly with the interests of its customers. “Between us and the investors there is definitely a risk, because if we were to increase our earnings, their interest rates would be driven down”, Pettersson admits. “But if you really think about it, it should not be an issue. It is a balance. We have to make some money, and the investors have to make some money”.

Apart from that, Pettersson rates credit risks and reputational risks the highest. As mentioned earlier, the screening process of borrowers is the task that Savelend puts most of their efforts on. This is also closely related to reputational risks since reputation has a lot to do with trust. Especially investors must be able to trust that Savelend is doing their absolute best to fairly assess the risk of the borrowers. “This is something we are evaluating on a weekly basis, so it is absolutely very important to us”, he explains.

In the same way, he believes the liquidity risks to be important because Savelend would never want investors to be worried about them being able to withdraw their money fast. “We are constantly exposed to liquidity risks in the sense that we need to have money available for withdrawals”, Pettersson says. “But in that case, we also have a partner with a lot of capital”. Also associated with reputational risks are technology risks, because Savelend’s customers must be able to trust that their money and information are kept safe. “Since we are dealing with money, nothing is allowed to go wrong. It is simply a matter of trust”, Pettersson explains.

In times like these, when interest rates are low and the stock market is growing rapidly, it is easy to relate to the drivers of economic risks. Pettersson believes that the current climate is beneficial for the P2PL companies, and does therefore not rate these risk that high. He believes that investors seeking higher interest rates than the ones available in commercial banks’ savings accounts transfer their money to P2PL platforms instead, and today’s stock market may have an opposite effect. “Now when people tend to think that the stock market is overvalued, they will move their money away from stocks. And that will benefit us”, Pettersson reflects. Another risk

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**TABLE 2: RISK TABLE ACCORDING TO SAVELEND**
(Source: Claesson & Tengvall)

<table>
<thead>
<tr>
<th>RISK CATEGORY</th>
<th>RELEVANCE &amp; IMPORTANCE ACCORDING TO SAVELEND</th>
</tr>
</thead>
<tbody>
<tr>
<td>Business Risks</td>
<td>5</td>
</tr>
<tr>
<td>Credit Risks</td>
<td>6</td>
</tr>
<tr>
<td>Liquidity Risks</td>
<td>4</td>
</tr>
<tr>
<td>Agency Risks</td>
<td>2</td>
</tr>
<tr>
<td>Moral Hazard Risks</td>
<td>N/A</td>
</tr>
<tr>
<td>Reputational Risks</td>
<td>6</td>
</tr>
<tr>
<td>Process Risks</td>
<td>2</td>
</tr>
<tr>
<td>Technology Risks</td>
<td>5</td>
</tr>
<tr>
<td>Economic Risks</td>
<td>2</td>
</tr>
<tr>
<td>Legal Risks</td>
<td>4</td>
</tr>
<tr>
<td>External Market Risks</td>
<td>1</td>
</tr>
</tbody>
</table>

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category that he actually thinks is beneficial for Savelend is external market risks. At this moment, he mainly sees competitors as new actors that can spread the news about P2PL, and not really as dangerous rivals. “If you do something better than your competitors, it will work. And in our case, it is our customer service that we are extremely good at”, Pettersson explains.

For the sake of process risks, he is really not that worried about it either. As we previously mentioned, it is of course important for Savelend to do their screening correctly, but he is not worried about if they do that or not. “Since the process is done both automatically and manually, there is really no room for mistakes”, he explains. And this also means that the risks of moral hazard do not apply on the case of Savelend, because everything is done automatically. However, when Savelend expands their business later this year, this might become a bigger issue. What also might change in the future are regulations. Even if Savelend is doing everything by the books today, new regulations in the future might force them to change how they do business. “Who knows what will happen in the future? It is a constant worry”, Pettersson admits.

5.5.2 Analysis

Based on previous developments in the U.S. and the UK market – together with what was gathered during interviews with some of participants in the Swedish market – one could start to outline the risks that are the most relevant and important for a growing P2PL market. These objective ratings are presented in Table 3.

What one can notice quite clearly is that many of these risks are not only important because of their direct effects, but the indirect effects they can have on the reputation of one company – or even the whole P2PL business – are just as relevant. Examples of these are process risks and technology risks that both are risks of failing processes within the company, such as fundamental flaws in the screening process or platform shutting down due to technological problems. The direct effects of these events are of course important on their own, but the long-term effects such events can have on the company’s reputation should not be underestimated. Pettersson argued that the reputation is an extremely important factor in the whole financial industry just because these companies are dealing with people’s money and personal information.

When analyzing the business risks – that basically sum up the main focus of this thesis, which is an increased institutional involvement in the market – it is obvious that the P2PL business will lose some of the foundations it was built on. When large financial institutions invest in loans to individuals, it is simply not loans between peers anymore. When individual investors invest in loans to businesses they have no real relationship to, it is not loans between peers either. Hence, that the foundations of the business will change seems inevitable. The real question that the market participants – maybe the P2PL companies especially – need to consider is if it truly matters to them or not.
For the credit risks – that Savelend rated as very important – the representatives from Swedbank argue that this should not really be an issue as long as the screening process is done correctly and the interest rates are assigned fairly. A higher risk comes with a higher rate of interest, so if investors understand and accept the risks they are taking, everyone should be treated fairly. But that is also why the process risks are so important. As mentioned before, investors need to be able to trust that the company is doing the screening of potential borrowers ambitiously. And this is also where the agency risks come in. The risks associated with misaligned interests between the different stakeholders of the company are of course not unique for the P2PL business, but the fact that these interests – for example the interest rates – could be measured easily, makes this an easily noticeable issue in the P2PL companies.

The liquidity risks do not seem to be that big of an issue as long as the companies consider them and take measures to manage them. The liquidity risks seen from the investors’ point of view could of course be an issue for the companies, but the advantage they have compared to for example commercial banks is that they have no capital requirements they must adhere to. So the real risks associated with this once again come down to the how aware the investors are. If they understand that their money is not as safe on a P2PL platform than in a commercial bank, they know what they are getting themselves into.

Similar to the evidence of moral hazard from mortgage brokers using the OTD lending model in the sub-prime crisis – which was shown by both Dowd (2009) and Tseng (2009) – there are moral hazard risks from the P2PL companies, since they could increase loan volumes by easing the screening process without being affected by the decreased average quality on the loans originated. This moral hazard could also apply to the investors funding loans on P2PL platforms just for the purpose of selling them in the secondary market.

When looking slightly into the future, the main worry for the companies seems to be that they cannot know what the regulatory framework will look like. Naturally, they have no other choice than to constantly adapt to the changing regulations. And in this early stage of the business, the
regulations can change very fast. Savelend showed clear concerns about this, which also has made them take in more and more professional help from lawyers. The financial industry is of course one of the most heavily regulated industries, which also is an explanation why a new market like the P2PL market cannot easily be created. The entry barriers in the financial industry are among the highest compared to other industries, and are one of the reasons why there are not that many competitors yet – at least not in the Swedish market.

However, one should also notice that the effects of some of the risks do not have to be negative for the P2PL companies. From a financial point of view, it is widely understood that a higher risk also should come with a higher possible payoff. This is a tendency that seems to be true for some of the risks associated with the P2PL market as well, and is also in line with what Simons (1999) has argued about growth. A rapid growth will generate new and enhanced risks but is still something truly positive. One such risk category is the economic risks, mainly the ones deriving from the changing cycles in the economy. Pettersson did not see these risks as big worries for Savelend, but rather believed them to be potential advantages. One part of his argument was that the P2PL companies should benefit from low interest rates in the market, because then investors are looking for alternative investments with higher rates of return, such as investing in P2P loans.

This is a logical argument that also this thesis has made from the start. But even if this is true, it does not necessarily mean that these risks do not affect the P2PL market. If lower interest rates generate a higher number of investors on the platforms, should not the complete opposite also be true? This would indicate that when interest rates in the market start to increase again, investors would start to wonder if the rates offered on P2PL platforms really are worth the high risks, when they instead could get decent interest rates on e.g. regular savings accounts. Hence, even if a risk's correlation to a certain type of development is inverted, it is still a risk.
6 CONCLUSION

The sixth chapter concludes the entire thesis by answering the research questions stated in the first chapter. By structuring the conclusion in the same way as the previous chapter, the answers provided under each section will together fulfill the purpose of the whole thesis. This is followed by a Discussion section, which provides the thesis with the authors’ own thoughts about the future of P2PL by highlighting the challenges that the market currently is facing.

The purpose of this study was to explore the effects of an increasing institutional interest in a growing P2PL market. By narrowing this down into two separate purposes, they have helped the authors to fulfill the broad purpose.

The first purpose was to investigate how the originate-to-distribute model affects the screening incentives in the lending process. The second purpose was to analyze the risks associated with a growing secondary market.

6.1 THE ORIGINATION OF THE MARKET

Why are financial institutions now interested in this high-risk market segment that they previously ignored?

As proven by the empirical research, neither Savelend nor Swedbank see the P2PL market as lost customers for the commercial banks. The Swedish lending market provides great access to capital, both from commercial banks but also from ALMI. Since the commercial banks are not interested in funding the high-risk borrowers that the P2PL companies are targeting, they do not see the P2PL companies as competitors because they are acting on different risk levels. However, since the P2PL market has proven to function efficiently, financial institutions have detected investment and collaboration opportunities in the P2PL market. These investments could be through P2PL business loans, ownership investments in the companies, or potentially as high-risk investment opportunities in pooled securities when the market has grown larger.

6.2 MARKET DEVELOPMENT

How is the Swedish P2PL market growing in comparison to the ones in the U.S. and the UK?

The Empirical Studies clearly shows that the markets are in different stages of development. Although the developments have been similar this far, it does not necessarily mean that they will develop in the same way in the future. But there are clear stages that the developments seem to follow. The Swedish market is currently in a start-up phase while the U.S. and the UK markets have already experienced great institutional involvement. For the Swedish market to start collaborating with financial institutions and thus continue developing as the U.S. and the UK markets have, an increased loan volume is required. However, the Swedish market is currently
in a *Catch-22* situation, since the P2PL companies need collaborations to be able to increase loan volumes and the financial institutions require larger loan volumes before they can start discussing collaborations.

### 6.3 Secondary Market & the Originate-to-Distribute Model

*In what way can the use of the OTD lending model in P2PL create similar problems as it did in the secondary market during the sub-prime loan crisis?*

Proven by both previous studies and this thesis’ *Empirical Studies*, the OTD lending model enables the originator to issue an almost unlimited amount of loans without carrying any risk of them defaulting. With a secondary market, the originator can transfer the risk and benefit from risky actions that are not in the best interest for all stakeholders. The OTD lending model was the fundamental reason for the sub-prime crisis in 2008 because it provided mortgage firms with an ability to lend in a riskier manner. Today, the P2PL companies are acting very similar to the mortgage firms before the crisis. They have volume-based revenues, no liabilities for their credit ratings, and non-transparent securitization processes, which all are contributing factors for the moral hazard behavior that was prominent during the sub-prime crisis.

Although the P2PL market is not even close to the size of the mortgage market, these are still relevant concerns if the P2PL market continues to grow in significance. In case the P2PL market grows large there is a potential threat of similar consequences as in the sub-prime crisis, because too many with poor credit can get funding without being able to pay back their loans.

### 6.4 The Screening Process

*How are screening incentives affected by the institutional involvement in the P2PL market?*

From the *Empirical Studies*, there is evidence that a greater loan volume is required in order to create collaborations with financial institutions. A sub-optimal way for the P2PL companies to get more loans funded is by accepting a higher number of borrower applications. By easing the screening of borrowers, a greater amount of loans could be accepted, which would increase the loan volume and thus make institutional collaborations possible.

Therefore, the P2PL companies have strong incentives to ease their screening process, which would allow more high-risk borrowers but also create adverse selection problems in the market. When more high-risk borrowers are accepted, the proportion of low quality loans will increase in the market because of the market mechanism referred to as the “Lemons Problem”. A lower quality in the screening will lead to investors either funding sub-prime borrowers, or losing trust in the platforms’ risk assessments. This would oblige the investors to take greater responsibility
when choosing loans to fund, which could open up for possible discriminating situations between investors and borrowers.

6.5 **RISK MANAGEMENT**

*How does a growing market affect the risk management process in P2PL companies?*

Currently, the most significant risks for P2PL companies are project risks – the risk of failed or inefficient screening of borrowers – and reputational risks – the risk of customers losing their trust in the company. A growing market will naturally enhance the significance of each risk category, but also generate new types of risks. Based on the *Empirical Studies*, one can conclude that a growing market and increased institutional involvement seem to come hand in hand. This means that a rapidly growing market will also generate business risks in the P2PL market in the sense that it will not really be a business for loans between *peers* anymore, since e.g. individuals and large financial institutions have very different power and significance in the market.

6.6 **DISCUSSION**

By looking at the origination of the market in Sweden, the authors have concluded that there were no clear market drivers that drove a greater demand of the P2P loans, as in the U.S. and the UK. This forces the Swedish P2PL companies to look for alternative segments in order to reach greater loan volume, which has not been the problem in the U.S. and the UK. Since the Swedish lending market provides great access to capital and since ALMI currently is taking the lending segment of higher risk businesses, the market in which the P2PL platforms partly focusing on is at an even higher risk level. *This is what the authors define as the first challenge for the P2PL market.* One can start asking if these risky businesses really should get funding at all and which consequences it may cause to society when all risky businesses are being financed.

It is also obvious that the Swedish P2PL platforms already are eager to collaborate with financial institutions. In order for the platforms to get the attention from the financial institutions, larger volumes seem to be the only solution. *This is what the authors define as the second challenge for the P2PL market.* Due to the current Catch-22 problem in the Swedish P2PL market, one possible solution would be to ease the screening of borrowers and thus increase the volume. However, one should also consider how the institutions would perceive such behavior when the average quality of the loans would decrease. Another possible solution to the Catch-22 problem could be to focus more on P2P business loans, but this also means entering the high-risk segments that the authors strongly are questioning.

The fact that both Savelend and Swedbank seem to be more interested in business loans than consumer loans raises concerns for the future of the Swedish P2PL market. Since ALMI
Peer-to-Peer Lending

currently is covering one big part of the riskier business loans market, the only ones not getting funding today must be seen as very risky. Is this really the market segment the P2PL companies want to focus on? Or could it possibly be that the Swedish financial market is not as favorable for P2PL companies as the U.S. and the UK market are?

Overall, one important question the P2PL companies must think of is if they desire a larger loan volume that would generate more revenues in the short-term, or a strong reputation that will keep their investors loyal in the long run. This is what the authors define as the third challenge for the P2PL market. The authors believe that there is a tradeoff between quality of the loans and the volume to consider, depending on whose interest the P2PL companies want to satisfy.

The securitization of P2P loans enables the originator to “hide” the risk of the loan when bundling it with other loans. And by “hiding” the risk, the originator can create more high-risk loans for future securitization purposes. This is what the authors define as the fourth challenge for the P2PL market. The authors believe that the P2PL companies have a great responsibility when rating the loans, especially when it will be securitized. Since the P2PL companies never carry the risk of default or are liable for an incorrect rating, the ratings could be prioritized less in order to get more loans out in the market for securitization purposes, which was exactly what happened during the sub-prime crisis.
ARTICLES


Peer-to-Peer Lending


SCHULBARTH, C. (2014). Lending Club hikes IPO target 17%, now hope to raise up to $ 929M. *Silicon Valley Business Journal*.


DATABASES


APPENDICES

QUESTIONAIRES

Pre-Interview – Finansinspektionen

- Under which regulatory framework does the P2PL market adhere?
- How is the market regulated and which are the requirements for the P2PL companies?
- Which licenses are required for operating in the securities market?
- Which liabilities does the P2PL companies have in case of default?
- What liabilities does the P2PL companies have for their credit rating?
- Which regulatory approvals are needed for trading P2P loans in secondary markets?
- If the P2PL market grows larger and a new kind of "bond market" develops, where P2P loans are bought and sold to a greater extent, how would that be regulated?
- How is the current “regular” bond market regulated?
- What are the major risks with the OTD lending model in the P2PL business?
- How is the securitization process regulated?
- Are there any differences in terms of regulations for securitizing P2P loans and mortgage loans?
- Which additional regulatory requirements will most certainly arise in the near future?

Interviews – Swedbank & Savelend

Research Question 1: Why are financial institutions now interested in this high-risk market segment that they previously ignored?

- How would you categorize the P2PL companies? (Swedbank)
- Are they competitors or potential investment opportunities? (Swedbank)
- Why did the market for P2P loans emerge? (Swedbank & Savelend)
- Was it an uncovered part of the market? (Swedbank & Savelend)
- Are the P2PL customers lost customers from the commercial banks? (Swedbank & Savelend)
- What can you offer that the banks cannot? (Savelend)
- Why have not the banks already taken this market segment of high-risk borrowers? (Savelend)
- Can it be seen as a market failure from the commercial banks perspective? (Swedbank & Savelend)
- Would you be open for collaborations? (Swedbank & Savelend)
- How would such collaborations look like? (Swedbank & Savelend)
- Is P2PL a service that you could offer? (Swedbank)
- Why are you not funding short-term loans? (Swedbank)
- How are you affected by the P2PL business? (Swedbank)
- Can the banks offer the same types of P2P loans? (Savelend)
- When did you start to get interested in P2PL? (Swedbank)
- Why are you not offering loans to the customers that the P2PL companies have? (Swedbank)
- Why did you start the P2PL business? (Savelend)
- Can the P2PL market be forced to adhere to similar capital requirements as the commercial banks? (Swedbank & Savelend)
Peer-to-Peer Lending

**Research Question 2:** How is the Swedish P2PL market growing in comparison to the ones in the U.S. and the UK?

- How big is the Swedish P2PL market? (Swedbank & Savelend)
- How much are you “copying” from the U.S. & the UK market? (Savelend)
- Which differences do you see between the geographical P2PL markets? (Swedbank & Savelend)
- Do you have institutional investors on your platform? (Savelend)
- What do you think about the development of the P2PL business in Sweden?
- What do you think about the secondary market in Sweden, since it has been growing in other countries? (Swedbank & Savelend)
- Which similarities and differences do you see in the different P2PL markets? (Swedbank & Savelend)
- What are the risks with the fast pace growing market? (Swedbank & Savelend)
- What are you thoughts about the P2PL market 5 years ago and 5 years from now? (Swedbank & Savelend)
- Which possibilities are there for cross-border transactions from Sweden? (Swedbank & Savelend)
- Is your trading department buying and selling P2P loans? (Swedbank)
- What major difficulties could exist in the Swedish P2PL market? (Swedbank & Savelend)
- Why did the market grow so fast in the U.K. & U.S.? (Swedbank & Savelend)
- Do you have plans to collaborate with banks and let them originate the loans as the case has been in the U.S.? (Savelend)

**Research Question 3:** In what way can the use of the OTD lending model in P2PL create similar problems as it did in the secondary market during the sub-prime loan crisis?

- What are your main concerns regarding the fact the P2PL companies do not carry any risk for the loans? (Swedbank)
- What are your comments to the fact that you never carry any risks? (Savelend)
- What are the economic risks associated with that “wrong” individuals are getting loans? (Swedbank)
- Which actions have been taken since the sub-prime crisis in order to minimize the information asymmetry problems? (Swedbank)
- Have the rating agencies any liabilities for an incorrect rating of the CDO as they did not have during the sub-prime crisis? (Swedbank)
- Have the screening requirements been adjusted since the crisis of 2008? (Swedbank)
- Which are the major “traps” that the P2PL companies can enter that you (the banks) have learned from the crisis of 2008? (Swedbank)
- What are the major risks associated with a secondary market for P2P loans? (Swedbank & Savelend)
- Are you affected by a loan that is not paid back? (Savelend)
- Are you revenues dependent on the risk of the P2P loans? (Savelend)
- How do you handle the problem with the misaligned interest that exist between different stakeholders? (Savelend)
- Which similarities do you see with the development of the secondary markets for P2P loans and the ABS market during the crisis of 2008? (Swedbank & Savelend)
- Are you being affected by a loan that is sold in a secondary market that defaults? (Swedbank & Savelend)
- Since you are using an OTD lending model, what could be the risks with this, considering the consequences of the crisis in 2008? (Savelend)
- What could you benefit from having a secondary market for individual loans on your platform? (Savelend)
How would your screening be affected in case you had a secondary market for individuals on your platform? (Savelend)
Are you having any thoughts about implementing a deposit guarantee? (Savelend)
What are you thoughts about Credit Default Swaps or similar to insure the P2P loans in the future? (Swedbank & Savelend)
How are you being affected by an incorrect risk assessment? (Savelend)

Research Question 4: How are screening incentives affected by the institutional involvement in the P2PL market?
- Can you explain the screening process for the P2PL market? (Swedbank & Savelend)
- How is a P2P loan originated? (Savelend)
- What are your thoughts about the possibilities for moral hazard behavior for the P2PL companies? (Swedbank)
- In what way can you as a borrower appear trustworthy? (Savelend)
- What liabilities do you have in the screening/rating of borrowers? (Savelend)
- What are your thoughts about your responsibility? Does it end once the loan is originated or when it is paid back? (Savelend)
- How is your screening process in comparison with other P2PL companies? (Savelend)
- Is the screening the same for loans you hold and loans you sell? (Swedbank)
- What is the major risk with the fact that the P2PL companies never carry any responsibility for assessing a correct rating of borrower? (Swedbank)
- How have your screening process developed/changed since the start of Savelend? (Savelend)
- How differentiates the screening by the commercial banks and the P2PL companies? (Swedbank)

Research Question 5: How does a growing market affect the risk management process in P2PL companies?
- The authors explained every risk from the Risk Management Table and let Ludwig Petterson fill out the table. By discussing the decisions of Petterson, the authors got a deeper understanding of his decisions.
1) A borrower goes onto the P2PL platform and requests a loan.

2) The P2PL company assesses the risk of the borrower and then assigns an interest rate based on the credit worthiness.

3) The investor puts funds into his/her Client Account on the P2PL platform and chooses a loan to invest in based on the interest rate assigned by the P2PL company.

4) The loan is originated. The loan proceeds and the loan promissory note are exchanged between the investor and the borrower, with little interaction from the P2PL platform.

5) The investor and the borrower pay administration fees to the platform.

6) The borrower makes monthly loan payments into the Client Account, which is in turn transferred to the investor.

7) The P2PL company is also responsible for ongoing servicing.
1) A borrower goes onto the P2PL platform and requests a loan.

2) The P2PL company assesses the risk of each borrower and then assigns an interest rate based on the credit worthiness.

3) Investors put funds into the P2PL platform and choose loans to invest in based on the interest rates assigned by the P2PL company. The loans are divided into "fractional loans", in which the investor can only invest in a portion of the loan, and "whole loans", in which the investor can fund the entire amount of the loan.

4) A commercial bank originates the loan. The loan proceeds and the loan promissory note are exchanged between the commercial bank and the borrower, with the P2PL platform intermediating the transactions.

5) The P2PL company immediately purchases the loan from the commercial bank and receives the loan promissory note in exchange.

6) In the case of a "fractional loan", the P2PL company issues pass-through certificates under indenture recognizing the investor's right to a specific portion of the loan. In the case of a "whole loan", the investor obtains ownership of the entire loan.

7) The borrower makes monthly loan payments to the P2PL company, which in turn transfers the payments to the relevant investor.

8) The P2PL company is also responsible for ongoing servicing.