Online or Offline?
The Rise of “Peer-to-Peer” Lending in Microfinance

Susan Johnson, University of Bath, UK
Arvind Ashta, Burgundy School of Business (Groupe ESC Dijon-Bourgogne), France
Djamchid Assadi, Burgundy School of Business (Groupe ESC Dijon-Bourgogne), France

ABSTRACT

Over the past five years, “peer-to-peer” lending websites have become a new approach to mobilizing funds for on-lending to impoverished people in developing countries (microfinance) and domestic markets. In this paper, the authors review these developments and use the analytical lens of asymmetric information and transactions costs to explain the characteristics of the different models in operation. The authors find that “peer-to-peer” lending is more of an aspiration than a reality. Although web 2.0 technologies have offered new means of mobilizing funds, the borrowing mechanisms at work follow mainstream conventional approaches to the management of lending.

Keywords: Microcredit, Microfinance, Online Lending, P2P, Peer-to-Peer, Social Lending, Web 2.0

INTRODUCTION

The internet has reduced transactions costs dramatically in a wide range of contexts, either through the ease of searching for information on the web, or communicating via email. From an economic perspective, the key feature of ‘Web 2.0’ tools compared to ‘Web 1.0’ are the reduced costs in terms of time and skills needed in making information available for a much wider range of users. No longer is it necessary to bear the costs of setting up a website to disseminate information in a “one-to many” fashion. These technologies offer much easier access to platforms through which information can be made available about the firm or the individual, and devices for interaction that reduce the costs of finding peer groups with similar interests.

For institutional economists, reducing transactions costs is a key means through which economic development takes place (North, 1990), as this results in improvements in market efficiency and hence also in the allocation of resources in the economy. In economic theory, transactions costs arise in a number of ways. First, they may arise from the simple fact of geography and distance: for example, the time and costs incurred for going to the bank to deposit savings or seek a loan. Second, they
arise from the need to search for information: to find out where a particular product or service is available, or what is the most reliable and appropriate bank account to deposit the savings in. Third, they may relate to the particular product or service involved, in that the bank will charge for example to undertake certain checks e.g. a credit check if you want to take a loan. In this latter case the cost may be included in the interest rate instead of an upfront fee and is effectively the bank charging for its own need to find out about the customer before it lends.

One of the key problems of lending to poor people is the transactions costs incurred in making very small loans. The rise of microfinance in the past two decades is, in part, due to reducing the transactions costs of lending to poor people. The internet offers the possibility that transactions costs can be reduced over greater distances – even across national boundaries – and that lenders in developed countries can lend small amounts directly to poor people in developing countries. Online lending firms have entered the market to seek to achieve this.

The purpose of this paper is to review the nature and characteristics of seven such companies in order to better understand the role of the internet in this approach. This peer-to-peer lending industry is evolving rapidly having about $650 million in outstanding debt in 2007 (Lee-St. John, 2008) to which can be added another $100 million to $150 million for 15 online microfinance platforms, according to a spokesman from Babyloan. A rising number of individuals are now looking towards networks of friends or even strangers on the Internet to finance purchases, pay for one-time events (such as weddings or vacations), consolidate debt, finance their small business or pay off a mortgage. The paper proceeds as follows. In the Background section, we discuss transaction costs web 2.0 and the rise of online lending. We then proceed to examine the operational models of each of these companies in greater depth. Finally, we draw conclusions about the models and their characteristics using the insights offered by transactions costs analysis.

BACKGROUND

This section aims to scrutinize the impacts of Web 2.0 tools on transaction costs. Theories and applications will be discussed.

The Nature of the Problem: Transactions Costs in Microfinance

We outlined in the introduction three types of transactions costs involved in lending: the physical costs of travel and time incurred; the costs of searching out products or services and the costs of checking the quality of the customer or client. It is the latter two of these that we will focus on here as both of these arise from the problem of asymmetric information.

The information asymmetry between the borrower and lender produces two particular problems: adverse selection (Akerlof, 1970) and moral hazard (Stiglitz & Weiss, 1981). The problem of adverse selection is, for example, that the borrower may give the lender information about the potential returns to the project being higher than they actually will be. Moral hazard, on the other hand, is the case where after the loan is given, the lender cannot be sure that the borrower’s interests in the project are aligned with his own and hence that she will act to ensure the project is effectively carried out; rather she may prefer to default.

The means by which lenders seek to overcome these problems are threefold: screening of the borrower and the investment project; ongoing monitoring of the project and loan repayment; and finding means to enforce repayment in the event of default. It is the costs of carrying out these functions that contribute to the costs of borrowing in the form of the interest rate. The interest rate in turn has four key components: (i) the cost of funds i.e., what must be paid to depositors or investors offering the funds for on lending (including inflation rate coverage); (ii) the cost of actually lending in terms of these transactions costs of screening, monitoring and follow up enforcement; (iii) the costs of default when funds are not repaid
Base Erosion and Profit Shifting (BEPS) and the Digital Economy: Challenges and Issues
Marianne Ojo and James A. DiGabriele (2018). Internet Taxation and E-Retailing Law in the Global Context (pp. 45-60).
www.igi-global.com/chapter/base-erosion-and-profit-shifting-beps-and-the-digital-economy/199940?camid=4v1a