# AN ASSESSMENT TO DETERMINE THE VIABILITY OF A PEER-TO-PEER LENDING MODEL AIMED AT THE SOUTH AFRICAN MARKET

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**Abstract**

*Borrowing has become an integral part of the lives of many South Africans. Debt is not a topic discussed by many, as it is often associated with negative connotations; however, the fact that so many depend on it has become problematic. With increasingly high interest rates, and nowhere else to turn, borrowers accept their predicament, grossly indebting themselves. Investors, on the other hand, continuously search for investment opportunities. Unfortunately, interest rates at banking intermediaries in South Africa are not always a lucrative proposition; investors often have to search elsewhere. However, since the advent of peer-to-peer lending models,an opportunity for lenders and borrowers to amalgamate could possibly be introduced. The benefit to borrowers would be lower interest rates paid, and to investors, higher interest rates earned. This study focussed on a population of individuals whoreside in the Western Cape, of South Africa, either falling in the category of a prospective investor/lender, or a borrower. The characteristics of investing and borrowing were investigated, in order to establish whether a possible relationship between the two could exist by introducing a peer-to-peer lending environment in which the two parties can interact directly with one another.*

## 1. Introduction

In the South African context, the demand for unsecured loans has been met by the advent of multiple micro-lending organisations. The term 'unsecured loans' refers to loans which are repayable over a period of time, in installments,with no security for the credit provider to rely on by means of which to recover the debt, if repayments are not made (Arde, 2012:1).Naturally, unsecured loans are high risk and are normally associated with a medium to lower LSM group soliciting micro loans. Owing to the high risk factor of the unsecured loan, interest rates associated with these loans can go up to 60% per annum (Reesj, 2012:1). Unfortunately,thanks to the human desire to own products and to use services regardless whether there are sufficient funds, choosing unsecured loans feel like the right decision at the time, for many a person. Without even considering the effect it will have, the high interest rate quickly catches up with the borrower; and shortly afterwards, the borrower falls prisoner to debt.

Contrary to borrowers, investors with a disposable income earn as little as 5, 15% interest per annum on fixed deposits (Anonymous, 2012:1). Although this interest rate is associated with low-risk opportunities, it is evident that there is an enormous gap between 5, 15% interest earned by investors and up to 60% paid in interest by borrowers. This scenario possibly creates an opportunity where the investor/lender and borrower could instead interact directly with each other, subsequently circumventing banking intermediaries.

## 2. Background to problem

The concept of peer-to-peer lending is not new– ithas been in existence for many years. As Anonymous (2012:1) observes, “individuals have loaned money or items to other individuals since the dawn of civilization.” The concept of peer-to-peer lending revolves around lending or borrowing money to or from, a friend or relative. It can, however, be noted that the modern-day concept of peer-to-peer involves the Internet, which has subsequently boosted the concept of peer-to-peer lending (Anonymous, 2012:1).After conducting a substantial amount of research for Byte Orbit, it became evident that the motive for companies such as Prosper and Lending Club was to initiate a peer-to-peer lending model abroad.Banking intermediates abroad, as in South Africa, have an oligopoly in the industry, with discouragingly high interest rates, making borrowing a threatening experience. Although companies such as Prosper and Lending Club are lucrative, it does not mean that copying the same concept in South Africa will have similar outcomes.

## 3. Research Problem

The core problem addressed by this article revolves aroundthe high interest rates paid by borrowers, and low interest rates earned by investors.Unsecured lending is the most expensive debt avenue in South Africa;a borrower can be responsible for interest rate charges up to 60% per annum, which is the maximum threshold allowed by the National Credit Regulator (NCR)(Reesj, 2012:1). Although the interest rate is directly associated with the borrower’s credit profile, it does put tremendous pressure on the borrower when it comes to adhering to high repayments over long periods. Incontrastwith borrowers, individuals with surplus money find it difficult to receive a good return onan investment. As it stands, the average interest on a fixed deposit in South Africa is 5,15% per annum, as per June 2013 (Anonymous, 2012:1). When taking the above-mentioned facts into consideration, a viable problem is posed, pertaining to the enormous interest rate gap between lending and borrowing.

## 4. Aim and objectives of the study

The aim of this study is to gain a better and a more in-depth understanding of the borrowing and lending characteristics within the South African context; and to investigate the possibility of introducing an alternative lending infrastructure which will be more financially viable to both the lender and the borrower.

Within this context, the major objectives were identified as follows:

- To investigate current interest rates on loans and investments in South Africa;
- To ascertain the challenges associated with engaging peer-to-peer lending; and
- To make recommendations on how to promote the knowledge and accessibility of a peer-to-peer lending model.

## 5. Brief Literature review

Rogers(2013:1) defines a loan as an agreement between a lender and a borrower, in which the lender provides upfront funding, and the borrower agrees to repay the money; the repayment is usually accompanied by interest. There would typically be a predestined date on which the repayment needs to occur; usually the lender takes the risk that the loan may not be repaid at the agreed terms. In a worst-case scenario, the borrower will default entirely on the repayment. Credit risk refers to the possibility of a borrower failing to adhere to reparations as per the agreed terms with the lender (Basel, 2000:1). An important aspect for financial institutions is that of managing risk appropriately. Risk may be mitigated by standard means of credit vetting; this allows financial institutions to manage the credit risk exposure within reasonable boundaries (Basel, 2000:1).

There is an array of different loan types available to individuals; however, the following are most commonly used. Open-ended loans are recurring loans which allow continuous borrowing. Credit cards and overdrafts are known types of open-ended loans. Both of these options give the borrower a credit limit which they may purchase against. On every purchase, the credit decreases; once repayments are made, the available limit increases, once more, ultimately, providing the lender with a credit facility, which may be used over and over again (Irby, 2013:1).Closed-ended loans are limited to a specific loan; additional borrowing cannot take place. As the borrower repays the loan, the outstanding balance declines. However, the difference between the original loan amount and repayments that are made, will not be available for more credit. Instead, the borrower will have to apply for another loan. Well-known closed-ended loans include student loans, vehicle finance, and mortgage loans (Irby, 2013:1). Secured loans refer to a loan type dependent on the assets as collateral for that specific loan. Should the borrower default on the loan, the lender may take ownership of the assets in order to cover the outstanding monetary value. The interest rates associated with secured loans are generally lower than those of unsecured loans. It is important to note that in some instances the asset may need valuation prior to the finalisation of the secured loan. An unsecured loan is a loan that is not secured by the borrower's surety or currently owned property. Even though the borrower remains directly liable, and their assets may be sold if they default on payments, they do not need any assets in order to acquire a loan (Arde, 2012:1).Millions of South Africans borrow to survive, and are falling further behind on their debt repayments (Strydom, 2013:1). Alexander (2013:1) notes that 14% of the total debt owed in South Africa are accounts associated with residents of the Western Cape. Western Cape has the second-highest debt per capita, of approximately R2700 per person.

Recently released figures from the National Credit Regulator (NCR) show that, over the past three months, the number of consumers with impaired records increased by 189000 to 9.53million (Strydom, 2013:1).Strydom (2013:1) explains that "an impaired record refers to a consumer and/or account which is three or more payments or months in arrears, or that has been handed over or written off, or against which a judgment/administration order has been granted." The drive behind this is owed to financial maladministration, where "wants" become a priority, and "needs" become secondary. Unsecured loans worth about R30-billion, the regulator revealed were granted during the past year. These loans usually come at higher interest rates, making repayment difficult (Strydom, 2013:1).

Although as per (Anonymous 2013:1) the prime rate is set at 8.5%,an unsecured loan is the most expensive type of loan; it can bear a maximum interest rate of 60% per annum. The amount and the number of loans still grow significantly; this loan facility is dominated by individuals in lower-income brackets (Logan, 2012:7).

Before the introduction of the National Credit Act (NCA) 34 of 2005, approximately a 67 percentile of South African residents relied on micro lenders for credit, however, without the safeguard of legislation (Rossouw, 2008:1). Owing to the high demand and lack of regulation, these micro lenders often furnished borrowers with loans which indebted them even more.

Furthermore, the Usury Act allowed micro lenders to charge higher interest rates to the lower-income earners, while the medium to wealthy income earner was charged realistic interest rates (Usury Act, Act No 73 of 1968). Subsequently, this translated to the fact that the medium and wealthy market had easier access to credit, compared with the lower-income market. Since the advent of the NCA, the Usury Act has been incorporated into the NCA;it now allows a fairer loan platform for the lower-income earners.

Although the NCA strives to promote financial stability, it is evident from a recently published paper by NCA that they are failing to address it effectively. Logan (2012:2) states that "Many South Africans are either highly indebted, or credit impaired, or both. This is surprising, given the stringent provisions of the National Credit Act 34 of 2005 ("NCA") which require that affordability testing be done and which censures reckless lending. Despite these consumer protection provisions, nearly half of all credit-active consumers are credit impaired; and most personal finance indices and living standards reflect that South Africans' personal finances are unhealthy."

Peer-to-peer or person-to-person (P2P) lending, is a method in which lenders and borrowers engage directly with one another on a loan agreement. Generally, this occurs without the involvement of conventional financial intermediates such as banks or micro lenders (Anonymous 2008:1). Henderson (2013:1) argues that "peer-to-peer (P2P) lending represents a new and potentially disruptive force in consumer lending and investment. It doesn't only offer a more proficient platform to investors but also a richer experience for borrowers."
P2P lending platforms vary noticeably, and have different styles and approaches. In some instances, the lender and the borrower interact directly; in others, they interact via third party intermediates. Some of the P2P lending websites allow lenders to select their own interest rates; in some instances the interest rate will be preset, and based on a combination of the borrower's credit history and credit score. Furthermore, many are charity-focused, others strictly for-profit (Galloway, 2010:18). P2P lenders are regarded as investors who invest small amounts in multiple loans. The main attraction, however, is that investors stand to gain higher returns in a more controlled environment Henderson (2013:2). A P2P lending platform is unprejudiced and open to all who have access to the Internet. If the borrower has a good credit rating, the P2P lending market may be able to offer dramatically lower lending rates Henderson (2013:2).

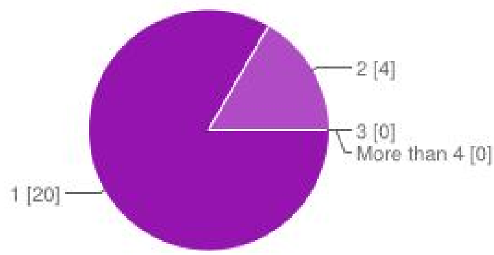
## 6. Research Methodology

This study used a qualitative research methodology in order to obtain primary data from respondents. As pointed out by Hancock(2002:2), qualitative research is concerned with developing explanations of social phenomena. The aim of qualitative research is to assist by providing a better understanding of the world in which we live, and why certain items are perceived the way they are. (Mack, Woodsong, Macqueen, Guest, Namey (2005:1) state that one of the strengths of qualitative research is that it deliversdescriptive explanations of difficult written documentation in such a way that individuals understand the known research issues. It conveys information about the 'human' side of the specific issues, which often revolves around emotions, beliefs, relationships, as well as contradictory behaviour. The qualitative study will explore the possibility of reducing interest rates to borrowers, and increasing the interest rates to lenders,by introducing an alternative lending ecosystem, more commonly known as peer-to-peer lending.Primary data will be acquired by distributing an electronic questionnaire among a very select group of people.

## 7. Research Findings

Findings were divided into a borrower's perspective and that of an investor's perspective. The following findings were from the borrower's perspective.

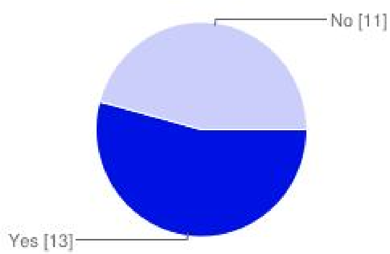
**Figure. 1 The Average Number of Loans per Individual**




| | | |
|---|---|---|
| 1 | 20 | 83% |
| 2 | 4 | 17% |
| 3 | 0 | 0% |
| More than 4 | 0 | 0% |

From the research in figure1 it was found that 83% of the respondents had only one loan; 17% had two loans. None of the respondents had 3 or more loans. From Figure.2 it is evident that 46% of borrowers do not know the percentage of interest they are paying on their loans.Since it was established in Fig. 3 that more than 50% of the respondents are paying in excess of 10% interest on their loans, it could be argued that the minimum number of loans is a reflection of the high interest rates.

**Figure.2 Knowledge of Average Interest Rate by Borrower.**

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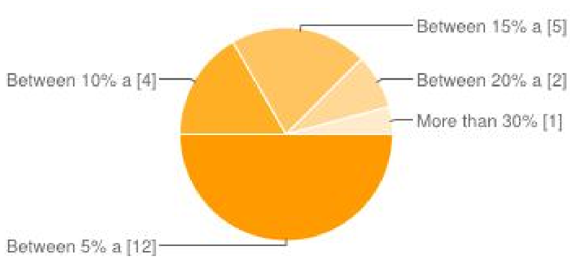
| Yes | 13 | 54% |
| No | 11 | 46% |

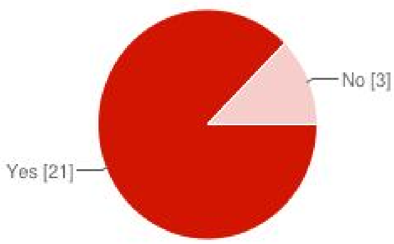
**Figure.3 Average Interest Rate Paid by Borrowers.**




| | | |
|---|---|---|
| Between 5% and 10% | 12 | 50% |
| Between 10% and 15% | 4 | 17% |
| Between 15% and 20% | 5 | 21% |
| Between 20% and 30% | 2 | 8% |
| More than 30% | 1 | 4% |

Although Figure. 3 reflects compulsory questions, it may be argued that the 46%, who were not sure about the interest rate that they are paying, chose the first option, which was chosen by most of the respondents. Although 50% of the respondents pay a 10% interest rate and below, and the rest pay 10% and above, an assumption can be made that more respondents are paying in excess of 10% interest. According to Anonymous(2013:1) the current prime borrowing rate stands at 8.5%, however, interest rates per annum can go up to 60%(Reesj, 2012:1). As Wyatt (2012:1) observes, the most prominent advantage of P2P lending is the possibility of lower interest rates. An individual borrowing money does not have nearly as many expenses as does a bank. Therefore, since 50% of the borrowers are paying more than the prime rate, and 75% of them as per Figure. 5 acquire loans from their banks; a P2P lending platform couldpossibly be beneficial for them.

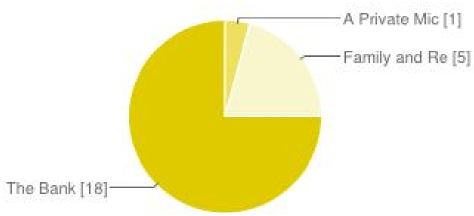
**Figure.4 Ease of Obtaining a Loan.**




| | | |
|---|---|---|
| Yes | 21 | 88% |
| No | 3 | 13% |

Figure.4 revealed an interesting statistic: it acknowledged that 88% of respondents easily managed to obtain a loan, whereas the minority of 13% advised that it had not been easy for them. Unfortunately, this study did not address the method by which the borrowers obtained the loan, for example, via telephone, physical presence, the bank, or online/mobile.

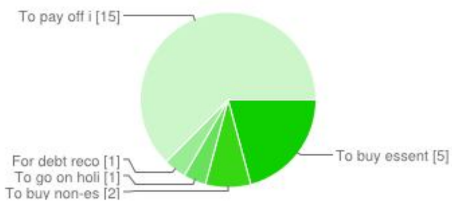
**Figure.5 Intermediary Where Loan was Obtained.**




| | | |
|---|---|---|
| The Bank | 18 | 75% |
| A Private Micro Lending Company | 1 | 4% |
| Family and Relatives | 5 | 21% |

However, when analyzing Fig.5, it is notable that 75% of respondents had obtained a loan from their acquiring bank. The general consensus is that this was conducted by physical presence, although no statistics are available to ascertain where borrowers obtained the loans. Current micro-lending institutions such as Bridge Loans (Taylor, 2013:1) and Wonga (Rudd, 2012:1) have gained tremendous traction with online loans, giving a clear indication that the South African market is operative. Since P2P lending is an online-only-based product it may be able to flourish in the South African market (Henderson 2013:2).

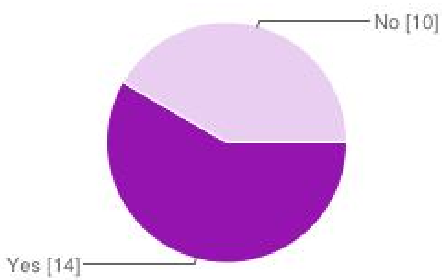
**Figure.6 Reason for Obtaining a Loan**




| | | |
|---|---|---|
| To buy essentials to survive | 5 | 21% |
| To buy non-essentials (Play Station, iPad etc) | 2 | 8% |
| To go on holiday | 1 | 4% |
| For debt reconciliation | 1 | 4% |
| To pay off items (Car, Home, Furniture etc) | 15 | 63% |

Figure. 6 reflect that the majority of respondents (79%) obtained a loan for reasons other than to buy essentials to survive. This supports that 79% of loans were obtained for own consumption (Symington, 2012:16).

**Figure.7 Satisfaction with Current Interest Rate**



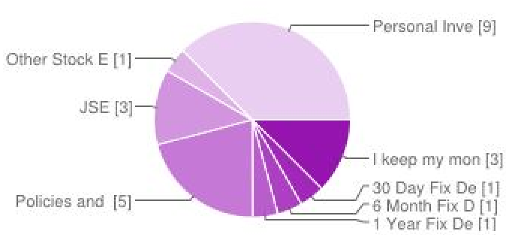

| | | |
|---|---|---|
| Yes | 14 | 58% |
| No | 10 | 42% |

From figure.7 it is evident that 58% of the respondents were satisfied with the interest rate paid on their loans, while 42% are dissatisfied. When taking Figure.2 into consideration, the argument may be made that, since 46% of respondents were not sure of the interest rate that they are paying, their input in this question cannot really provide much substance. However, perhaps it may be said that most of respondents replied on the basis of theexperience they had with their banking intermediary, as opposed to their satisfaction with their current interest rate.

**From an Investor's Perspective:**

The following section is associated with questions answered from an investor perspective.

**Figure. 8 Investment Diversification**

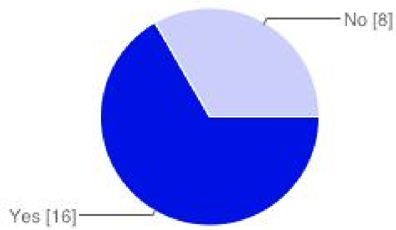



| | | |
|---|---|---|
| I keep my money in the bank | 3 | 13% |
| 30 Day Fix Deposit | 1 | 4% |
| 6 Month Fix Deposit | 1 | 4% |
| 1 Year Fix Deposit | 1 | 4% |
| Policies and Unit Trusts | 5 | 21% |
| JSE | 3 | 13% |
| Other Stock Echanges | 1 | 4% |
| Personal Investments in Ventures | 9 | 38% |

From the statistics illustrated in Figure 8, a mere 25% of the respondents save their money with their acquiring bank. As per the literature, money saved at local banks in South Africa currently only produces a 5,15% return per annum (Anonymous, 2012:1).As pointed out by Anspach

(2013:1),these kinds of investment are low risk; because they are low risk, the interest rate is also substantially lower. Furthermore, it can be noted that 75% of the respondents' investments are medium- to high-risk investments. Medium- to high-risk investments as described by Anspach (2013:1) include term bonds, stock exchanges, and individual stockinvestments.As (Thompson 2008:1) observed, P2P lending is also a form of high risk to investors, therefore, since the majority of respondents are prone to investing in high-risk opportunities, it can be said that a possible opportunity exists for them also to engage in such a platform.

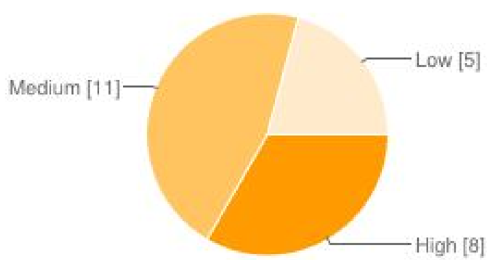
**Figure. 9 Satisfaction with Interest Rate**




| | | |
|---|---|---|
| Yes | 16 | 67% |
| No | 8 | 33% |

Figure. 9 implies that 67% of the respondents are satisfied with the current interest they earned, as opposed to only 33% of the respondents being dissatisfied.

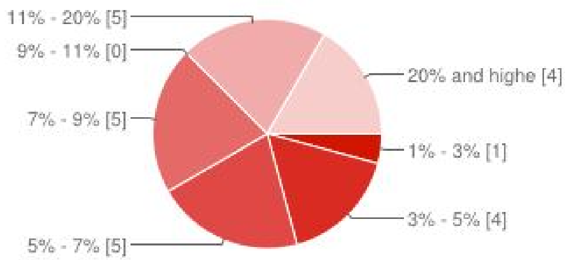
**Figure. 10 Risk Profile**




| | | |
|---|---|---|
| High | 8 | 33% |
| Medium | 11 | 46% |
| Low | 5 | 21% |

Figure.10 displays the different risk portfolio's the investors invest in. Only 21% of the respondents invest in low risk investments compared to 79% of respondents that invest in medium- to high-risk investments. When the results (79% medium and high risk combined) of Figure.10 is compared with that of the results (75% medium and high risk combined) of Figure. 8 the results are concurred with only a 4% difference. The average result (79+75)/2) between these two figures are 77% which confirms the appetite that investors have to invest in loans that are medium and high risk.

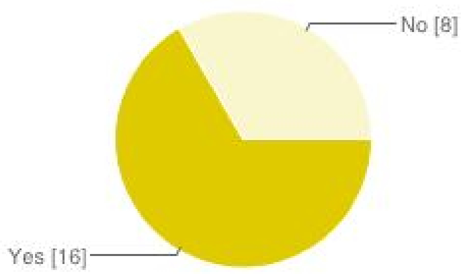
**Figure. 11Average Interest Rates on Investments**




| | | |
|---|---|---|
| 1% - 3% | 1 | 4% |
| 3% - 5% | 4 | 17% |
| 5% - 7% | 5 | 21% |
| 7% - 9% | 5 | 21% |
| 9% - 11% | 0 | 0% |
| 11% - 20% | 5 | 21% |
| 20% and higher | 4 | 17% |

From Fig. 11 it is noted that 21% of the respondents earn the average interest rate of 5,15% (Anonymous, 2012:1),whereas the majority of the respondents (79%) earn interest rates above the average interest rate in South Africa. Statistics from Fig. 10 reiterate the findings that were discovered in Figure 8. Furthermore,they confirmstatistics produced in Figure.10,that 79% of all respondents invest in medium- to high-risk profiles.

**Figure. 12High Risk Investment Opportunity**




| | | |
|---|---|---|
| Yes | 16 | 67% |
| No | 8 | 33% |

In Figure. 12 the question was asked "If you have the opportunity to invest in a high risk opportunity that will give you a return of 10% and above will you consider it? 67% of the respondents answered 'yes' and only 33% answered 'no'. This is the final indication that investor in actual fact is willing to invest in high risk, high return opportunity.

**Findings from the Literature Review**

The following are extracts from the literature review outlining some key findings:

- Owing to the high risk factor of the unsecured loan, interest rates associated with these loans can go up to 60% per annum (Reesj, 2012:1).
- As it stands, the average interest on a fixed deposit in South Africa is 5,15% per annum, as per June 2013 (Anonymous, 2012:1).
- Depending on the circumstances, some credit provided could be classified for consumption or for wealth-creation purposes, for example, in generating income through a business which uses the vehicles and furniture in order to operate; or when the consumer uses the assets in a personal capacity (Symington, 2012:16).
- Peer-to peer lending also has disadvantages, just as any financial model would. On the lending side, the risk is higher, in that there is very little guarantee that lenders will be reimbursed within the borrowing period, or even at all (Thompson 2008:1).

- The most prominent advantage of P2P lending is the possibility of lower interest rates. (Wyatt 2012:1).
- Although P2P lending in itself is a disruptive offering, the fact that it is based online is also a major benefit. An online presence requires minimal infrastructure, and is low cost compared with traditional banks with brick-and-mortar presences, ultimately high in cost (Shah 2009:4).

**Findings from the Primary Research**

**Borrower:**

- 50% of the respondents pay above 10% interest per annum on loans.
- 79% of the respondents purchase goods on credit, although it is not essential to their survival.
- 75% of the respondents obtain their loans form their acquiring bank.
- 83% of the respondentshad only one loan; 17% had two loans. None of the respondents had 3 or more loans.

**Lender:**

- 79% of the respondents earn a return on invest above the average interest rate of 5,15%.
- 77% of the respondents' investments in medium- to high-risk investments.
- 67% of the respondent's advised that they will invest in high-risk opportunities if theywere given the opportunity to earn more than 10% per annum.

## 8. Recommendations

The following recommendations are made on the basis of the primary data andliterature that was gathered.

- **Conduct an In-depth Market Analysis**

This topic requires further in-depth research in order to confirm more specific questions that pertain to Peer-to-Peer lending. This study should expedite via larger target population.

- **Investigate Legal Ramifications**

An investigation should occur to review all the legal ramifications that are associated with building and setting up a Peer-to-Peer lending entity. Since a Peer-to-Peer lending model is an alternative lending mechanism, it relies on financial integration from other third parties such as credit vetting bureau's and automatic debt order companies. Furthermore it might require certification from accredited bodies such as Payments Association South Africa (PASA) and possibly also will have to be an accredited Financial Service Provider (FSP).

- **Business Plan**

Depending on the outcomes of the in-depth market analysis it is advisable to investigate the business opportunity. A business plan will give insight as to whether a Peer-to-Peer lending model is a financially viable opportunity

- **Partnerships**

It is advisable to interview other financial service providers in order to get their input and advice. It could be beneficial to take the stance of partnering with one of the banking intermediaries as they have years of domain knowledge and access to an enormous market. Therefore traditional banking intermediaries may still play a role; however, they could become merely facilitators, merely providing the legal and administrative framework. The financial institutions can also participate as a funder within the system, thereby making additional funds available when required.

## 9. Conclusion

The literature emphasized that borrowers can pay up to 60% interest on unsecured loans per annum. From the primary data it was revealed that 50% of the borrowers paid in excess of 10% interest per annum on their unsecured loan. Therefore it can be said that the average interest rate for borrowers are above 10%. Further literature highlighted that Peer-to-Peer lending models offer lower interest rate charges on loans. Based on this it can be argued that borrowers might be intrigued by the opportunity to pay a lower interest rate.

The literature also found that the average interest rate earned on fixed deposits by investors is 5.15%. However the primary data conveyed that 79% of the investors earned over 5,15% per annum on their investments. This was due to primary data revealing that 77% of the investors invested in medium to high-risk opportunities. Additional literature suggested that one of the challenges associated with Peer-to-Peer lending is the fact that it is high risk to the lenders. Although it can be seen as a challenge from the one spectrum, from the other, it can be seen as an opportunity to investors that are willing to take medium to high risk.

Peer-to-Peer lending is still a relatively new concept to the South African market and therefore it is difficult to determine whether borrowers and lenders will be prone to the idea of engaging directly with one another. One of the challenges identified is that fact that Peer-to-Peer lending is an online based business and in the primary data it revealed that 75% of borrowers still obtain their loans from bricks and mortar, financial intermediaries. However the literature revealed that financial micro lending institutions such as Bridge Loans and Wonga run their business based on the online lending premise. Therefore the conclusion can be drawn that consumers will be prone to engage in lending in the online sphere.

When combining the key findings of the primary data with the literature, it clearly highlights certain opportunities that suggest that a Peer-to-Peerlending model could possibly address the high interest rate paid by borrowers and low interest rate earned by investors.

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