

**REGULATING FINTECH BASED PEER-TO-PEER LENDING: A NEW
APPROACH TO SME FINANCING**



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CHTNET001

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DECLARATION

Research dissertation paper presented for the approval of the Senate in fulfilment of Master of Laws degree in approved courses and a minor dissertation. The other part of the requirement for this qualification was the completion of a programme of courses.

I hereby declare that I have read and understood the regulations governing the submission of LLM research papers, including those relating to length and plagiarism, as contained in the rules of this university, and that this research paper conforms to those regulations.

Signature:

Signed by candidate

Date: 30 January 2022

DEDICATION

My dearest BK,

The greatest gift was in the wealth of Knowledge you shared.

A course of life forever altered...

Baie Dankie.

Vir **Alles**

Sincerely yours,

JB

ACKNOWLEDGMENTS

I would like to express my deep and sincere gratitude to my research supervisor, Dr Andrew Hutchison, whose valuable support and guidance carried me throughout all stages of my writing project.



To the little Jellybean who lives on.... Once confused, lost and despondent... Now more determined than ever. Enjoy the warm light cast upon you and trust yourself in the journey that lies ahead.

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CHAPTER 1

INTRODUCTION

1.1. SMEs access to capital

Small and medium enterprises (SMEs) refer to a separate and distinct business entity, together with its branches or subsidiaries, if any, including co-operative enterprises, managed by one owner or more, predominantly carried on in any sector or subsector of the economy mentioned in the Small Businesses Act.¹

South Africa's SMEs are estimated to contribute roughly over 40 per cent of the total national gross domestic product (GDP).² Collectively, SMEs employ over 87% of the labour force.³ As such, they have been identified by the National Development Plan as a key element towards economic growth.⁴ Nevertheless, SMEs are subject to the same regulatory burdens as large corporates and are severely underfunded.⁵

Access to finance is crucial for the survival and prosperity of SMEs. In reality, banks and other traditional financial institutions find it hard to extend funding towards SMEs due to the perception of high costs and a limited financial return.⁶ Nevertheless, the finance sector has the potential to contribute towards greater financial inclusion of SMEs by easing broader access to credit.⁷

In the interim, the South African economy continues to be plagued by slow growth, high rates of unemployment and a crisis of entrepreneurship. This has been further exacerbated by the global recession induced by the ongoing COVID-19 pandemic. Against this backdrop, SMEs serve as a particularly important vehicle towards stimulating the country's economic recovery.

1.2. Peer-to-peer (P2P) lending

Financial technology (Fintech) is used to describe new technology that seeks to improve and

¹ Schedule 1 of the National Small Business Act 102 of 1996.

² FinMark Trust 'FinScope MSME Survey South Africa 2020' (May 2020) Report at 7.

³ Ibid.

⁴ South Africa National Planning Commission *The National Development Plan 2030: Our Future – make it work* (2018) at 135.

⁵ Ibid.

⁶ Ibid.

⁷ Ibid.

automate the delivery and use of financial services.⁸ At its core, fintech is utilized to help companies, business owners and consumers better manage their financial operations, processes, and lives by utilizing specialized software and algorithms that are used on computers and, increasingly, smartphones.⁹ There are currently six developing Fintech business models, namely payment, wealth management, crowdfunding, P2P lending, capital markets, and insurance services.¹⁰

P2P lending is a fast-growing FinTech business model in which multiple investors pool their money together to offer a loan to borrowers through a P2P lending platform.¹¹ This third-party platform is usually technology-based and takes the form of a website, mobile application or service. By harnessing the power of online technologies, these platforms provide quality direct lending marketplaces that would not be possible otherwise. Due to the direct matching up of borrowers and lenders, P2P lending is also referred to as social lending.¹²

The idea behind alternative finance is to disrupt the banking industry and democratize access to capital.¹³ P2P lending is one particularly viable alternative to the traditional bank industry because it allows investors to lend money to those who do not have access to funds from other sources. Moreover, the bar of entry is lower since most P2P loans are unsecured loans of varying amounts- with some of the largest amounts typically being lent to businesses.¹⁴ This presents an opportunity for SMEs who typically do not have the requisite capital and credit history to qualify for traditional bank loans. Instead of borrowing from a bank, SMEs can enjoy easier access to capital through these fintech based lending platforms.

1.3. Research question

In an opening address at the 2020 World FinTech Festival, Rashad Cassim (the Deputy Governor of the South African Reserve Bank), confirmed that the government has recognised

⁸ Popescu Andrei-Dragos 'Empowering Financial Inclusion Through Fintech' (2019) 6 *Social Sciences and Education Research Review* 197.

⁹ Ibid.

¹⁰ Lee & Shin 'Fintech: Ecosystem, Business Models, Investment Decisions and Challenges' (2018) 61 *Business Horizons* at 4.

¹¹ Lenz Rainer 'Peer-to-Peer Lending: Opportunities and Risks.' (2016) 7 *European Journal of Risk Regulation* at 689.

¹² Lee & Shin op cit note 10.

¹³ Ibid at 5.

¹⁴ OECD *New Approaches to SME and Entrepreneurship Financing: Broadening the Range of Instruments* (2015) *Report* at 55.

the importance of using P2P lending to finance economic projects within South Africa.¹⁵ At the moment, there are currently no fintech product and services-specific laws or regulatory bodies. However, since certain fintech products and services may fall within the scope and ambit of general financial services regulatory frameworks, they are unfairly treated as traditional financial service intermediaries and therefore subject to the overarching complex regulatory burdens imposed by the Financial Sector Conduct Authority (FSCA), the Prudential Authority (PA), the National Credit Regulator (NCR), the South African Reserve Bank (SARB) and the Financial Intelligence Centre.¹⁶

Beyond the issue of regulatory burdens, FinTechs themselves are facing the same financing problems as the very SMEs which they intend to serve.¹⁷ This is because FinTechs are often SMEs struggling to find the early-stage capital required to launch their P2P lending platform and assist other SMEs with financing. This state of affairs reflects the cyclically crippling endemic nature of funding scarcity. If the regulatory issues are not addressed to open new funding avenues, South Africa's FinTech industry will fail to launch beyond its current stages of infancy. As a consequence of stifling the FinTech industry, SMEs will continue to be underfunded and the potential of P2P lending will not be realised.

The aim of this thesis is thus to answer the question: **What regulatory framework on P2P lending would improve South Africa's SME's access to capital?**

1.4. Objectives of the research and significance of the study

The goal of this research is to investigate the potential of SMEs in South Africa and the role of P2P lending as a funding solution and a more equitable approach to unsecured lending in an unbalanced credit market. At this point in the current global technological industrial revolution, P2P lending should have been adopted as a solution for SMEs with limited access to traditional finance.

¹⁵ Rashad Cassim 'Challenges Facing FinTechs and Opportunities to Respond' December 2020 at 5, available at <https://www.resbank.co.za/en/home/publications/publication-detail-pages/speeches/speeches-by-governors/2020/An-opening-address-by-Rashad-Cassim-a-Deputy-Governor-of-the-South-African-Reserve-Bank-at-the-World-Fintech-Festival>, accessed on 14 June 2021.

¹⁶ Bowmans 'First-step analysis: FinTech in South Africa' *Lexology* 18 September 2020, available at <https://www.lexology.com/library/detail.aspx?g=59efd1a9-7143-4430-989a-a5173249c546>, accessed on 23 June 2021.

¹⁷ Cassim op cit note 15.

The results of this research will contribute to the growing body of knowledge that highlights the emerging opportunity to leverage P2P lending platforms as an alternative financing solution for SMEs. At present, little research has been conducted specifically on the legal aspects of South Africa's fintech based P2P lending market. As such, this innovative research will be of interest and importance to FinTech entrepreneurs seeking guidance on the legal compliance aspects, as well as SMEs and investors seeking to inform themselves before entering into these digitised credit agreements.

Finally, it is hoped that this research will guide the implementation of a sustainable South African FinTech regulatory framework that would increase SMEs access to capital and manage risks in a way that does not stifle the development of this fast-growing innovative industry.

1.5. Methodology

The methodology used in this dissertation will be based on doctrinal desktop research. There will be a strong relation to primary legislation such as the National Credit Act (NCA)¹⁸ and the South African Banks Act.¹⁹ Further documentary evidence will include consideration of articles and textbooks written by scholars in the field. In cases where primary legislation from a foreign jurisdiction is in a foreign language, translated summaries from reputable academics will be relied on. Lastly, empirical data from FinScope, the Organisation for Economic Co-operation and Development (OECD) and parliamentary committee reports will be incorporated into this study.

A comparative analysis approach will be adopted when examining the different global regulatory frameworks on P2P lending.

The following categories will be used for this assessment:

- i. Partial exemption: this framework is an easing of the banking monopoly.
- ii. Regulatory sandbox: creates a safe space for financial technology services.
- iii. Ban: P2P lending is banned to protect the banking monopoly.²⁰
- iv. Laissez-faire: no regulatory efforts.

¹⁸ National Credit Act 34 of 2005.

¹⁹ South African Banks Act 94 of 1990.

²⁰ The first three categories were developed by Dr Dirk Andreas Zetzsche, professor of financial law at the University of Luxembourg.

To situate the above categories, this comparative analysis will be constructed through a discussion juxta-positioning South Africa against The United Kingdom, Germany, Belgium and China respectively. These countries are representative of the regulatory frameworks developed by Zetzsche.

The United Kingdom is an ideal comparator because it represents more than 80% of the P2P loan volume in Europe and it has developed a set of specific regulations to support the investment in crowdlending. It, therefore, provides a prime example of a regulatory sandbox, and explores SMEs general access to capital. Therefore, it provides us with a seminal case study illustrating the potential benefits of this regulatory approach. The historical influence of English law on South African law solidifies the applicability and value of this regulatory comparison.

Germany has been selected as an additional jurisdictional comparator because its fintech industry is thriving under partial exemption offered by a comprehensive body of supervisory laws. More broadly, Germany shares elements of South Africa's strict and 'protectionist' Banking Laws.

For completeness, Belgium demonstrates a brief cautionary case study, foreshadowing the extent to which a complete ban on P2P lending would negatively impact South African SMEs. In a similarly grim tone, China reveals the systemic economic risk of allowing FinTechs to develop completely unfettered without a dedicated regulatory framework.

1.6. Limitations

The main limitation to this dissertation has been accessing publicly available data on the balance sheets and loan books of P2P platforms across jurisdictions. In the case of South Africa, the concept of fintech driven peer to peer lending is relatively new to both the market and local academia. As such, the ability to consider the relationship between regulation, systemic risk and P2P lending in times of financial distress was limited to the available timeframe.

The economic shock caused by the global coronavirus pandemic magnifies the issue of incomplete data. Shortly after the genesis of this research proposal, the nationwide lockdown measures were introduced. This sudden forced shift to remote e-commerce birthed a host of new local Fintech platforms as well as some novel regulatory efforts initiated by the

government. As things continue to develop rapidly, this research is limited to being an unintended snapshot of the present situation as it stands.

Furthermore, assessing the borrower experience from the SMEs perspective was also limited by the lack of concrete statistical information available. Although much has been written about SMEs, very little is truly known about them. This is because the high number of unregistered SMEs makes it difficult to determine how many there are - to gauge the full extent of their financial restraints. As such, the research findings are rather theoretical.

Lastly, it is well known that research based on a limited number of countries does not allow for strong general conclusions regarding the viability of a regulatory scheme. Beyond the regulatory scope of this dissertation, there are further socio-economic factors that influence the development of the P2P lending industry and its potential to finance SMEs.

1.7. Chapter Outline

Chapter 1 has laid out the scope of the research question with a description of P2P lending platforms and their role in releasing capital for SMEs in need. The importance of SMEs was highlighted with a description of their significant contribution towards job creation and economic growth.

Chapter 2 explores how SMEs traditionally access capital through the banking industry and the related regulatory framework. Since SMEs typically lack the collateral to secure a loan, an initial overview of the unsecured lending market necessarily precedes the discussion. Thereon follows an analysis of the various creditworthiness eligibility criteria employed by banks, as well as the methods by which banks recover defaulting loans. Understanding the banking procedures will be relevant for comparison to the processes employed by P2P lending FinTechs. Finally, the data available on successful loan provisioning will be consulted to assess whether the banks provide adequate funding for SMEs.

Chapter 3 consists of a comprehensive literature review that dissects the mechanisms by which peer to peer lending operates and mitigates risks. In this analysis, 'borrowers' refers to the SMEs seeking additional funds for new investments or deleveraging. The P2P lending system will be analysed through financial intermediation theory to understand the nature of disintermediation and how this financing model can be adequately regulated. Furthermore, the

analysis will reveal the advantages and risks that P2P lending FinTechs present for SMEs, when compared to the traditional banking system.

Chapter 4 explores the South African FinTech lending landscape and the emerging local P2P platforms. The objective of this chapter is to investigate whether the current body of non-service specific financial regulatory framework is being appropriately applied to P2P platforms.

In Chapter 5, the research will track the different regulations in place to regulate P2P lending activities in the United Kingdom, Germany, Belgium and China. The goal is to ascertain whether these governments are promoting or limiting the investments made in P2P lending platforms. Furthermore, an understanding of how these regulatory bodies classify P2P platforms will serve as the foundation for the proceeding discussion in Chapter 6.

Chapter 7 concludes this dissertation. In this chapter, two possible solutions are proposed in favour of a hybrid regulatory model adapting some of the standards used in the United Kingdom and Germany. These solutions will address the issues flagged in Chapter 3 and Chapter 6.

CHAPTER 2

TRADITIONAL LENDING SYSTEM

2.1. Unsecured lending: market regulation

An unsecured credit transaction is not backed by a security deposit or collateral. Examples of unsecured loans include credit facilities such as traditional credit cards, store cards and garage cards.²¹ Before approving the borrower's application, The NCA requires lenders to conduct an affordability assessment in addition to a creditworthiness check conducted through the credit bureau.²² By contrast, an unsecured loan requires the borrower to pledge some form of real or personal security (such as property, land, cession of a valuable asset or a suretyship) as collateral for the loan.²³ Examples of secured loans include mortgages and car financing.

In the past, unsecured credit was unavailable to the bulk of South Africans due to unfavourable provisions in the now repealed Usury Act.²⁴ The Usury Act covered loans of up to R500 000 but capped the interest rate per annum.²⁵ By disincentivising lenders from extending credit to high-risk consumers through this cap, the act had the adverse effect of excluding lower-income consumers from accessing credit.²⁶ However, in 1992, the Usury Act was amended to create an exemption for small, short-term loans. To prevent reckless credit, the Micro Finance Regulatory Council was established to ensure that registration was adopted. As a result of these new regulatory policies, unsecured lending began increasing steadily.²⁷

When the NCA came into force on 1 June 2007, it aimed to promote a fair and non-discriminatory marketplace for access to Consumer credit.²⁸ In addition, the NCA established the National Credit Regulator (NCR) as a government agency tasked with regulating the credit

²¹ James Chen 'Unsecured Loan' *Investopedia* 27 December 2020, available at <https://www.investopedia.com/terms/u/unsecuredloan.asp>, accessed on 9 June 2021.

²² Regulation 23A of the National Credit Act.

²³ Rebecca Lake 'Secured Loan' *Investopedia* 26 October 2020, available at <https://www.investopedia.com/secured-loans-5076025>, accessed on 9 June 2021.

²⁴ Usury Act 73 of 1968.

²⁵ Nanziri Lwanga *Financial literacy, use of finance and welfare in post-apartheid South Africa* (School of Economics PhD Thesis, University of Cape Town, 2016) 24.

²⁶ *Ibid.*

²⁷ *Ibid.*

²⁸ National Credit Act. See the preamble: "to promote and advance the social and economic welfare of South Africans, promote a fair, transparent, competitive, sustainable, responsible, efficient, effective and accessible credit market and industry, and to protect Consumers."

industry in South Africa.²⁹ The NCA applies to any individual (including sole proprietors) and juristic persons whose asset value or annual turnover is under R1 million and a transaction size of less than R250 000.³⁰ As such, qualifying small businesses do benefit from some protection as a consumer in terms of the Act.

The NCA regulated the unsecured lending market intending to stimulate the provision of fair credit at the bottom of the economic pyramid.³¹ It was hoped that the eased controls on unsecured lending would boost financial inclusion in one of the world's most unequal nations. By extending fairly priced credit services to poor and low-income clients, the government effectively opened the credit market to business and enabled competition.³²

After the promulgation of the NCA, the unsecured lending industry exploded and fundamentally altered the composition of the domestic credit market. According to data published by the NCR, unsecured credit is increasing at a higher pace when compared to other credit products.³³ The ongoing COVID-19 global pandemic and the associated national lockdowns have also had a significantly negative effect on South African credit consumers. Many have reported job losses, income reductions and an overall greater financial stress on their households. This has prompted a reignited soaring demand for unsecured credit transactions.³⁴

2.2. Value of developmental credit

At this point, it is necessary to make a distinction between the different uses of credit - as this relates directly to the value generated from granting unsecured loans to SME owners. Credit procured by a borrower is usually allocated to either consumption or developmental purposes.

Consumption loans refer to credit that is used to service day to day needs such as food and transportation costs.³⁵ According to Janssens, consumption loans also include durables such as

²⁹ Section 12 of the NCA.

³⁰ Section 4 of the NCA.

³¹ Shane Stephen Lavagna-Slater *Investigating Peer-to-peer lending as a Solution to Unsecured Lending in an Unbalanced Credit Market* (Faculty of Economic and Management Sciences PhD Thesis, University of Pretoria, 2012) 4.

³² *Ibid* at 12.

³³ National Credit Regulator (2019) *Annual Consumer Credit Market Report* at 36.

³⁴ National Credit Regulator (2021) *Report on Unsecured Credit, Credit Cards, Store Cards, and the Impact of COVID-19 on the Consumer Credit Market in South Africa* at 35.

³⁵ Wendy Janssens *Social Capital and Cooperation: An Impact Evaluation of Women's Empowerment Programme in Rural India* (Faculty of Economics PhD Thesis, University of Amsterdam, 2007) at 183.

household appliances, electronics and furniture.³⁶ Credit procured for consumption-related purchases does not create an opportunity to build wealth in the future. This is because the financial returns on these purchases are either zero or negative, and only allow households to manage daily expenses and upgrade their lifestyles temporarily. The ‘return’ is therefore measured in terms of personal enjoyment and standard of living rather than its direct effect on income.³⁷

Conversely, developmental credit is distinct in that it is a loan used to invest in projects or activities that will create wealth in the future.³⁸ Furthermore, according to the NCA, a developmental credit agreement includes an educational loan, loans for the development of a small business, loans for the acquisition, rehabilitation, building or expansion of low-income housing, or loans used to finance any purpose as prescribed in the Act.³⁹

The continued use of developmental credit contributes to financial stability by generating a financial return greater than the cost of credit.⁴⁰ In light of this awareness, the NCA attempts to encourage developmental loans by creating specific provisions for exceptional treatment of developmental credit agreements such as less stringent disclosure requirements.

Borrowers in South Africa generally use unsecured debt to fund consumption purchases. According to a recent report compiled by the NCR, less than 10% of surveyed borrowers used unsecured loans for developmental purposes.⁴¹ Because unsecured lending is not backed by an asset, it tends to be a far more costly form of private credit that is marked by high levels of consumer defaults. Before the economic contraction due to COVID-19, unsecured credit transactions were a chief contributor to growing over-indebtedness, as they regularly fell lower down on a consumer’s repayment priority list.⁴²

Overall, the predominantly consumption-driven nature of these unsecured credit transactions highlights that South Africa’s unsecured lending market is not sustainable in its current form.

Outside of South Africa, the vast majority of loans are used for developmental purposes such

³⁶ Ibid.

³⁷ Lavagna-Slater op cit note 31 at 13.

³⁸ Ibid at 12.

³⁹ Section 10(1)(b) of the NCA.

⁴⁰ Lavagna-Slater op cit note 31 at 29.

⁴¹ National Credit Regulator (2021) Report op cit note 34 at 22.

⁴² Ibid at 17.

as education, business ventures and housing.⁴³ Most importantly, the credit used to finance SMEs is particularly beneficial due to its developmental use. It has the net effect of creating jobs, building wealth, and stimulating the economy in a country that is ravaged by high levels of unemployment and a crisis of entrepreneurship. This thesis is based on the premise that a shift towards developmental and investment-oriented unsecured credit would encourage economic growth. Unsecured lending at egregious costs, used primarily for consumption purposes only makes the borrower poorer and has no net economic value.⁴⁴

2.3. The role of banks in providing debt finance to SMEs

South Africa's financial industry is dominated by traditional banking institutions. These banks offer an array of services from electronic transactions such as online and mobile banking, in addition to their core business of accepting deposits, the advancing of loans, overdraft facilities and investment options. As a result of their comprehensive offerings, they face little to no competition from smaller niche participants within the financial services sector.⁴⁵

Overall, although over 8600 credit providers are registered with the NCR, banks represent the biggest lenders of unsecured loans.⁴⁶ Other institutional credit providers include life insurance companies and smaller micro lenders. At present, Capitec controls the lion's share of the unsecured lending market.⁴⁷

2.3.1. SME credit scoring and risk mitigation

Credit scoring is a statistical risk assessment performed by lenders and financial institutions to determine the creditworthiness of a borrower.⁴⁸ Due to the inherent risks of unsecured loans, banks have developed rigorous credit scoring techniques to mitigate the incidence of these challenges in SME lending.⁴⁹

SME credit scoring is based on the analysis of large amounts of historical data about the SME's

⁴³ Lavagna-Slater op cit note 31 at 20.

⁴⁴ Differential Capital *Unsecured lending has consumers sliding towards financial ruin- how do we reverse the course?* (2019 August) Report at 13.

⁴⁵ Lavagna-Slater op cit note 31 at 3.

⁴⁶ Differential Capital – Report op cit note 44 at 19.

⁴⁷ Ibid.

⁴⁸ Thomas Brock 'Credit Scoring' *Investopedia* 8 April 2021, available at https://www.investopedia.com/terms/c/credit_scoring.asp, accessed on 9 June 2021.

⁴⁹ OECD Report op cit note 14 at 55.

owner as well as the firm.⁵⁰ The data is entered into an automated loan performance prediction model, which yields a score for the loan.⁵¹ In theory, the approach allows a reduction in costs and time of granting a loan, greater consistency of credit evaluation and focus on difficult cases or large loan requests.⁵² However, a restrictive consequence of such practice is that it gives a strong preference to ‘long-term clients’ over start-ups.⁵³

In addition to requiring a high SME credit score, commercial banks rely strongly on the existence of collateral.⁵⁴ In the absence of collateral, banks will typically demand an alternative form of credit guarantee such as a suretyship binding a third party to compensate the bank in the event of default.⁵⁵

2.3.2. SME Financing Gap

At present, the low level of SME financing appears to be emanating from the supply side. The NCR reports that out of the 84.4% of SMEs which apply for an unsecured bank loan, only 25% are likely to be successful in their application and only 18% will finally get the loan.⁵⁶

The strong preference for collateral in the form of a tangible asset or personal right indicates that banks perceive the risk profile of SMEs to be too high and offer very few avenues for unsecured SME loans.⁵⁷

Absent this collateral, the key issue with the involvement of a commercial bank in providing finance to SMEs is the difficulty of obtaining information on the creditworthiness of potential SME clients.⁵⁸ From the supply perspective, the data gathered in the credit scoring process is available only to large banks. By failing to pool this data with other financial institutions, there is an acute lack of detailed information wherein other lenders cannot assess the SMEs creditworthiness based on past performances. These information problems and barriers further

⁵⁰ Ibid at 14.

⁵¹ Ibid.

⁵² Ibid.

⁵³ Falkena et al *SMEs’ Access to Finance in South Africa – A Supply-Side Regulatory Review (2004) Report* at 86.

⁵⁴ Ibid.

⁵⁵ OECD *Report* op cit note 14 at 55.

⁵⁶ National Credit Regulator *Literature Review on Small and Medium Enterprises’ Access to Credit and Support in South Africa (2011) Report* at 55.

⁵⁷ Falkena et al *op cit* note 86 at 86.

⁵⁸ Ibid at 90.

prevent the few successful SME loan recipients from switching between financial service providers. As such, this heavy reliance on a credit history makes traditional debt particularly challenging for SMEs because of their intrinsic nature of being new ventures.⁵⁹

In the post-crisis environment, it is recognized that bank financing will continue to be crucial for the SME sector. Policy measures are needed to encourage lending for developmental and constructive purposes. In doing this, constructive credit consumption in the true spirit of NCA will be promoted.

In the interim, the introduction of P2P platforms has broadened the range of financing instruments available to SMEs.⁶⁰ Platforms such as Lending Club (one the largest lending websites in the world) have originated approximately \$2 billion worth of unsecured loans.⁶¹ P2P lending, therefore, depicts a new small business venture loan market, where previously underserved early-stage entrepreneurs can access unsecured credit through the relaxation of collateral.

2.4. Conclusion

The unsecured credit market is heavily exposed to consumption spending at the expense of arrested business activities. P2P lending is particularly attractive for small businesses that lack the requisite credit history and collateral required by traditional lenders. In this sense, it fills a gap in the market that banks are not interested in servicing. The proceeding chapter highlights the necessity for an appropriate regulatory framework that can enable the development of P2P lending as an alternative source of financing for SMEs.

⁵⁹ Ibid at 86.

⁶⁰ Naoko Nemoto & Miriam Koreen 'Digital Innovation Can Improve Financial Access for SMEs' *G20 Insights* 8 May 2019, available at https://www.g20-insights.org/policy_briefs/digital-innovation-can-improve-financial-access-for-smes/, accessed on 9 June 2021.

⁶¹ LendingClub 'First Quarter 2021 Results' 28 May 2020, available at <https://ir.lendingclub.com/news/news-details/2021/LendingClub-Reports-First-Quarter-2021-Results/default.aspx>, accessed on 14 January 2021.

CHAPTER 3

PEER TO PEER LENDING

3.1. Historical developments and contemporary context

Fintech based P2P lending is distinguished by its disintermediation.⁶² This means that people, rather than institutions, stand on both sides of the transaction.⁶³ One of the significant advantages of this decentralized form of lending is its accessibility – virtually everyone can borrow from anyone willing to allocate the funds. By excluding the bank as a middleman, this fundamental disintermediation also allows investors to deal directly with borrowers without incurring costly monitoring responsibilities.⁶⁴

Disintermediation is not new. Before today's traditional banking institutions, individuals lent to and borrowed from one another without making use of financial intermediaries.⁶⁵ Up until the 16th century, almost all moneylenders were private individuals- anybody who had any additional capital and wished to lend it out could easily do so.⁶⁶ Evidence of P2P lending schemes in 18th century France demonstrates that these money markets were mostly localized within close communities.⁶⁷ Borrowers and lenders typically knew one another in person and were connected by relationships or geographical proximity.⁶⁸ By leveraging the social networks around them, borrowers were connected to several lenders. This helped to increase the flow of information, facilitate the matching process, and maximise capital allocation. Both money and bartered goods were exchanged in the form of deferred payments and these funds would be used for both consumptive purposes and investment purposes such as living expenses or purchasing livestock.⁶⁹

Centuries later, this time-tested practice of directly lending to and borrowing from one another is being embraced yet again. Fintech based P2P lending is a new twist on the old way of lending

⁶² Lavagna-Slater op cit note 31 at 73.

⁶³ Eric C. Chaffee and Geoffrey C. Rapp 'Regulating Online Peer-to-Peer Lending in the Aftermath of Dodd-Frank: In Search of an Evolving Regulatory Regime for an Evolving Industry' (2012) 69 *Washington and Lee Law Review* 492.

⁶⁴ Lavagna-Slater op cit note 31 at 55.

⁶⁵ Ibid.

⁶⁶ Ibid.

⁶⁷ Dermineur, E.M. 'Peer-to-peer lending in pre-industrial France' (2019) 26 *Financial History Review* 364.

⁶⁸ Lavagna-Slater op cit note 31 at 55.

⁶⁹ Dermineur op cit note 67 at 368.

and borrowing money.⁷⁰ The key difference is that the internet breaks down financial and geographical borders to allow for considerably scaled exchanges.⁷¹

The current development of modern P2P lending has fostered mass collaboration by enabling individuals to work together online in large groups aimed towards achieving mutual goals.⁷² Facebook Marketplace, Gumtree, Craigslist, and eBay are some prime examples of this phenomenon. It is this aspect of social and financial inclusion that forms the very essence of P2P lending.⁷³

3.2. Emerging importance of P2P lending

The first online peer-to-peer lending company originated in the United Kingdom when a lending platform named Zopa was founded in 2005.⁷⁴ Since its establishment, the lending platform has reportedly issued more than £2 billion worth of loans to borrowers in the United Kingdom.⁷⁵

The global financial crisis of 2008 provided a turning point that boosted the development of the P2P lending market niche. Amidst the economic crisis, public confidence and trust in financial institutions collapsed. As investments became both uncertain and unattractive, traditional banks instituted stricter lending controls.⁷⁶ A large number of individuals and businesses suddenly found themselves unable to secure a loan and fervently sought out alternative avenues to satisfy their credit needs.⁷⁷ At the same time, investors were turning away from conventional banking products in favour of alternative solutions that could yield higher returns.⁷⁸

⁷⁰ Lavagna-Slater op cit note 31 at 33.

⁷¹ Ibid.

⁷² Ibid.

⁷³ Ibid.

⁷⁴ Hulme, M. K., & Wright, C. 'Internet Based Social Lending: Past, Present and Future. Social Futures Observatory' *Citeseer* October 2006 at 52, available at <https://www.finextra.com/finextra-downloads/featuredocs/internetbasedsociallending.pdf>, accessed on 5 August 2020.

⁷⁵ Oscar Williams 'Peer-to-peer lender Zopa passes £2 billion loans milestone'. *Business Insider*. 11 April 2021, available at <https://www.businessinsider.com/peer-to-peer-zopa-passes-2-billion-lent-over-platform-2017-1?IR=T>, accessed on 23 November 2021.

⁷⁶ Eric C. Chaffee and Geoffrey C. Rapp 'Regulating Online Peer-to-Peer Lending in the Aftermath of Dodd-Frank: In Search of an Evolving Regulatory Regime for an Evolving Industry' (2012) 69 *Washington and Lee Law Review* 503.

⁷⁷ Chaffee and Rapp opcit note 76 at 504.

⁷⁸ Ibid.

Many of these shunned loan seekers and diversifying investors landed on P2P lending platforms and the parties began to revert to the antiquated practise of directly lending to and borrowing from one another.⁷⁹ Boosted by the global economic crisis, P2P lending emerged as an alternative to the current financial status quo.⁸⁰ This was simply because these platforms promised credit at a time when banks and other traditional financial institutions were experiencing fiscal difficulties.⁸¹

The newfound success of the first platforms triggered a wave of new entries. In 2009, the American non-profit platform known as Zidisha became the first P2P platform to link lenders and borrowers across international borders without using local intermediaries.⁸² Shortly afterwards, the Funding Circle emerged as the first significant peer-to-business lender and offered small businesses loans from investors via the platform.⁸³ Since its inception, the Funding Circle has helped over 188 000 small businesses access more than £13.1 billion in finance and established itself as the leading platform for small business lending.⁸⁴

In July 2012, RainFin was launched and became South Africa's first P2P lending platform.⁸⁵ RainFin's vision is to remove the high costs and barriers of traditional lending through innovative technology.⁸⁶ Today, Rainfin has helped SMEs access over R125 million worth of loans and has successfully positioned itself as South Africa's largest and most successful online lender.⁸⁷ Following their launch, Peerfin, Bright On Capital, Funder, Funding Hub and several other platforms have emerged in South Africa's online lending marketplace.

Across the world, P2P lending has been developing at an extraordinary pace and is now considered a multibillion-dollar industry.⁸⁸ Within this context, fintech driven P2P lending has caused a disruption within the traditional financial services industry. Slow and expensive

⁷⁹ Lavagna-Slater op cit note 31 at 73.

⁸⁰ Ibid.

⁸¹ Ibid.

⁸² Chen, Dongyu, Lai, Fujun & Lin, Zhangxi 'A trust model for online peer-to-peer lending: a lender's perspective.' (2014). 15 *Information Technology and Management* 241.

⁸³ Ibid at 241.

⁸⁴ Funding Circle 'Our Statistics' available at <https://www.fundingcircle.com/uk/statistics/>, accessed on 23 Jan 2022.

⁸⁵ Intergovernmental FinTech Working Group *FinTech scoping in South Africa (2019) Report* at 62.

⁸⁶ Ibid.

⁸⁷ Ibid at 63.

⁸⁸ World Economic Forum *The Future of FinTech: A Paradigm Shift in Small Business Finance (2015) Report* at 12.

legacy banking systems are struggling to keep pace with the speed and convenience that digital P2P lending offers its borrowers.⁸⁹ The COVID-19 pandemic has accelerated the digital transformation of financial services.⁹⁰ To operate within the social distancing and lockdown measures, new borrowers were introduced to P2P lending platforms where no physical appearance at a bank is necessary, and one can apply for a loan on a laptop computer while sitting on the couch.⁹¹

Together, the digital transformation of financial technology alongside the proliferation of new P2P platforms on the local South African market indicate that P2P lending is inevitably becoming an intrinsic part of the financial services sector. As such, it is this study's premise that lawmakers urgently need to work on new regulatory frameworks for this emerging sector.

3.3. Current regulatory framework

On 1 April 2018, the Financial Sector Conduct Authority (FSCA) was established by the Financial Sector Regulation Act (the FSR Act) to become a dedicated market conduct authority replacing the Financial Services Board (FSB).⁹² The FSCA is an autonomous organisation responsible for overseeing the South African non-banking financial facilities industry in the interest of the public. The main mandate of the FSCA is to:

- (a) enhance and support the efficiency and integrity of financial markets; and
- (b) protect financial customers by—
 - (i) promoting fair treatment of financial customers by financial institutions; and
 - (ii) providing financial customers and potential financial customers with financial education programs, and otherwise promoting financial literacy and the ability of financial customers and potential financial customers to make sound financial decisions; and
- (c) assist in maintaining financial stability.⁹³

The FSCA is responsible for the regulation and supervision of financial institutions entities under its authority.⁹⁴ At present, FinTech P2P lending is not fully regulated in South Africa in

⁸⁹ Ibid at 10.

⁹⁰ Erik Feyen *et al* 'Fintech and the digital transformation of financial services: implications for market structure and public policy' (2021) 117 *Bank for International Settlements* at 1.

⁹¹ World Economic Forum *Report* op cit note 88 at 13.

⁹² Section 56(1) Financial Sector Regulation Act 9 of 2017.

⁹³ Section 57(a)-(c) Financial Sector Regulation Act 9 of 2017.

⁹⁴ Section 58(1)(a) Financial Sector Regulation Act 9 of 2017.

the sense that there are no dedicated entity or activity-specific regulations for the industry. As such P2P lending platforms are subject to a myriad of financial sector regulations as administered by the FSCA. These regulations include the following:

a. National Credit Act

At present, the NCA applies to P2P lending platforms and requires them to register as credit providers.⁹⁵ As a registered credit provider, P2P lenders are subject to the NCA's constraints around fees, charges, interest and credit vetting processes as described in the National Credit Act Regulations.

b. Consumer Protection Act

In addition, P2P lending platforms must adhere to the regulations prescribed by the Consumer Protection Act (CPA).⁹⁶ This is because both the borrowers and lenders on the platforms behave as consumers in so far as they consume the platform's products and services. As such, they need the benefit of consumer protection regulation.⁹⁷

c. Financial Advisory and Intermediary Services Act

In terms of the Financial Advisory and Intermediary Services Act (FAIS), a financial services provider includes any person who furnishes advice; furnishes advice and renders any intermediary service; or renders an intermediary service.⁹⁸ Based on this definition, South African P2P lending platforms fall into the broad category of payments and money services and are therefore required to register as financial service providers.

As the potential magnitude of FinTech becomes harder to ignore, the South African government has indicated an interest in clarifying the regulatory stance.⁹⁹ In 2016, the Intergovernmental Fintech Working Group (IFWG) was formed as a response to the pace of change and scale of impact that fintech has on the financial sector. The IFWG is a joint initiative between South Africa's financial sector regulators including the Financial Sector Conduct Authority (FSCA), the National Credit Regulator (NCR), the South African Reserve Bank

⁹⁵ Section 40 of the National Credit Act 34 of 2005.

⁹⁶ Consumer Protection Act 68 of 2008.

⁹⁷ Intergovernmental FinTech Working Group Report op cit note 84 at 27.

⁹⁸ Section 1(1) of the Financial Advisory and Intermediary Services Act 37 of 2002.

⁹⁹ National Treasury of South Africa *An Inclusive Financial Sector for all (2020) Report* at 33.

SARB), the Financial Intelligence Centre (FIC) and the South African Revenue Service (SARS), and the National Treasury (NT).¹⁰⁰

In 2020, the IFWG published its first Fintech Landscaping Report. The purpose of the report was to comprehensively map the FinTech market in South Africa so that regulators and policymakers could understand and manage the risks and set policies to enable more solution-orientated engagement among the industry's stakeholders (e.g. incubators, venture capitalists, new fintech start-ups etc.)¹⁰¹ The publication of the report led to the formation of an Innovation Accelerator and a FinTech Regulatory Sandbox designed to accelerate the testing of new FinTech products and services.¹⁰²

Under the oversight of the SARB and FSCA, any firm proposing to engage in fintech activities or the delivery of fintech products and services, not otherwise specifically regulated under prevailing legislation is eligible to apply for admission into the sandbox.¹⁰³ To date, these authorities have been engaged in several *ad hoc* projects within the private sector using the concept of a sandbox.¹⁰⁴ However, they have not yet created a standardized regulatory sandbox framework with clearly defined rules and entry into the sandbox is currently by discretion. Ultimately, despite the official establishment of a FinTech regulatory sandbox, there are no specific laws, rules or regulations establishing regulatory sandboxes in South Africa.

Although the government can be commended for its attempt towards regulating FinTech, the pace of change has been lethargic at best. In addition, although a FinTech regulatory sandbox has been established in theory, it is not P2P lending specific. This is fundamentally problematic because FinTech is an overly broad umbrella term that encompasses various types of online platforms ranging from debt and equity financing, consumer banking, insurance products, personal credit, international money transfers, cryptocurrency and general payment services.¹⁰⁵ By lumping all FinTech products together, regulators are unable to adequately address the

¹⁰⁰ Intergovernmental FinTech Working Group Report op cit note 84 at 2.

¹⁰¹ Ibid.

¹⁰² Ibid at 30-33.

¹⁰³ Intergovernmental FinTech Working Group 'Regulatory Sandbox FAQs' 2020 at 4, available at https://www.ifwg.co.za/wp-content/uploads/Regulatory_Sandbox_FAQs.pdf, accessed on 13 November 2021.

¹⁰⁴ An overview of the Innovations currently being tested as part of cohort 1 is available at www.ifwg.co.za/regulatory-sandbox, accessed on 14 October 2021.

¹⁰⁵ Anton Didenko 'Regulating FinTech: Lessons from Africa' (2018) 19 *San Diego International Law Journal* 318.

unique needs of each product. Apart from the problematic nomenclature, evidence suggests that P2P lending is not foremost on the regulatory sandbox agenda whose efforts thus far have been heavily focused on cryptocurrency. Accordingly, this paper makes the case for a P2P specific regulatory sandbox as a means for targeted and deliberate support for the industry.

3.4. Loan Issuance Process

An outline of a typical P2P transaction is necessary for the proceeding analysis of the risks and sustainability informing the feasible regulation of this model of alternative SME financing. While not as extensive as a traditional bank loan, the P2P lending process still follows certain protocols and requires particular documentation.

The legal structures that P2P platforms adopt to affect the lender-to-borrower investment vary across P2P platforms.¹⁰⁶ Furthermore, P2P lending platforms across geographies and differing market environments have structured their operations in various ways. These various operating structures come with varying degrees of risk as well as different legal relationships between the borrowers and lenders. The two most common business models of P2P lending are direct P2P lending (also known as the client segregated model)¹⁰⁷ and indirect P2P lending (also known as the notary model).¹⁰⁸ These two models are very similar in the early stages of the loan origination process described below:

First, the online marketplace is created to serve as a platform to facilitate interaction between lenders and borrowers. Borrowers then submit their loan applications on the intermediary's online platform. The platform then vets the prospective borrowers for creditworthiness and assigns them with an internal credit score and risk category that is made visible to lenders.¹⁰⁹ From this point onwards, the lenders then use this information to decide on their desired interest rate. In turn, the platform assesses the lenders to ensure that they are compliant with all applicable legislation (including, but not limited to that described in Chapter 3.3).¹¹⁰ The actual lending process typically takes the form of an auction in which lenders offer their interest rates.

¹⁰⁶ Chaffee and Rapp op cit note 76 at 529.

¹⁰⁷ G. Claesson and M. Tengvall, *Peer-to-peer lending: The Effects of Institutional Involvement In Social Lending* (Working Paper, Jönköping International Business School, 2015) 10-11.

¹⁰⁸ Ibid.

¹⁰⁹ Adrian Fong 'Regulation of peer-to-peer lending in Hong Kong: state of play' (2015) 9 *Law and Financial Markets Review* 252.

¹¹⁰ Ibid.

Through an election process, borrowers are then able to select lenders offering the best rates.¹¹¹

The subsequent process depends on whether the P2P platform itself issues the credit to the borrower (direct P2P lending) or whether a partner bank functions as a lender of record (indirect P2P lending).¹¹²

3.4.1. Direct P2P lending

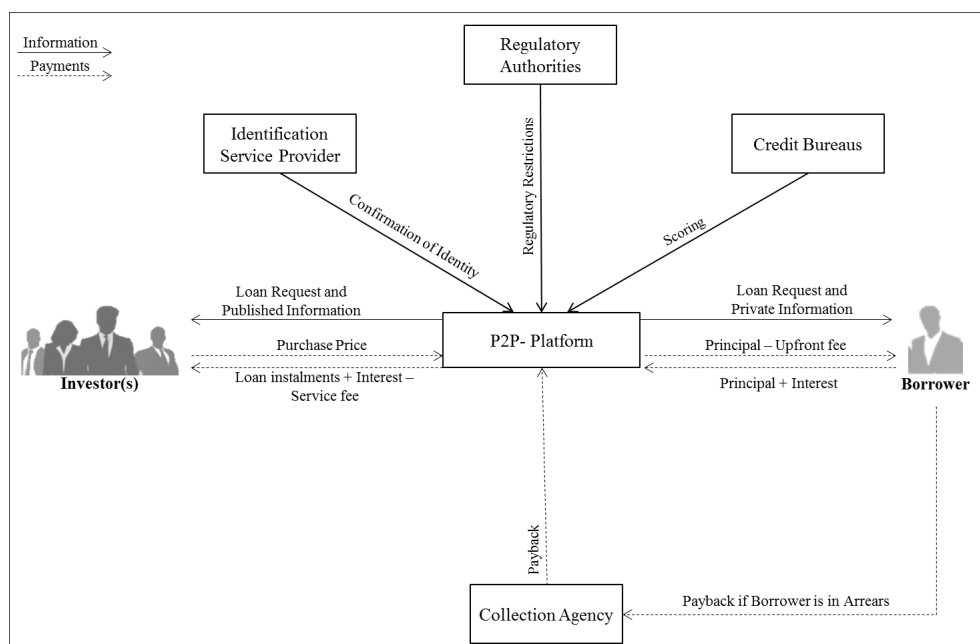


Figure 1¹¹³

Direct P2P lending represents the purest form of P2P lending as there is no involvement of an official financial institution participating as an intermediary.¹¹⁴ In this case, the platform will enter into a loan agreement with the borrower once a loan has been completely funded and into a sale and transfer agreements with the investors corresponding to their commitment to the loan.¹¹⁵ The loan relationship, therefore, exists between the lender and the borrower -with the platform effectively acting as a facilitation agent.

¹¹¹ Ibid.

¹¹² Annalena Dierks *The regulation of peer-to-peer lending platforms in the consumer credit market* (Faculty of Law PhD Thesis, Humboldt University of Berlin, 2018) 27.

¹¹³ Ibid.

¹¹⁴ Chaffee and Rapp op cit note 76 at 492.

¹¹⁵ Dierks op cit note 112.

To execute the loan transfers and collect payments, the platform will likely make use of a transactional or trust account in its name.¹¹⁶ This allows the platform to effectively ring-fence the lender's money in the interim stage where the money leaves the lender but before it arrives at the borrower. In this manner, the true creditor at all times remains the lender.¹¹⁷ The platform pays out the borrower using the funds from the trust account. The borrower then repays their loan by making deposits into the P2P platform's trust account. The platform then proceeds to credit the originating lender's account.¹¹⁸

Once a borrower begins to repay the debt, the borrower is classified as either 'performing' or 'non-performing.' Here, performing loans refer to loans that are paid within their due date. On the other hand, non-performing refers to where payments have been paused for a period longer than 90 days and are at risk of default.¹¹⁹

Lenders in the direct P2P lending model are exposed to the bulk of the risk as they carry the losses in the event of default. In addition, for the short period that lenders' money passes through the P2P platform's transactional account, the lender may be exposed to the credit risk of the platform.¹²⁰ If the platform was to go into liquidation at that point, the lender's money would become part and parcel of the liquidation process.¹²¹

European P2P platforms such as Zopa operate under this direct model. South African platforms such as Peerfin initially operated under this model. However, as will be explained in Chapter 5, hostile legislation was implemented that made this type of business model impractical in South Africa.

¹¹⁶ Fong op cit note 109 at 252.

¹¹⁷ Ibid.

¹¹⁸ Ibid.

¹¹⁹ Lavagna-Slater op cit note 31 at 33.

¹²⁰ Rainer op cit note 11 at 692.

¹²¹ Tamarin Floyd *Investigating the application of banking regulation to online peer-to-peer lending platforms in South Africa to counter systemic risk* (Faculty of Economic and Management Sciences PhD Thesis, University of Pretoria, 2012) 24.

3.4.2. Indirect P2P lending

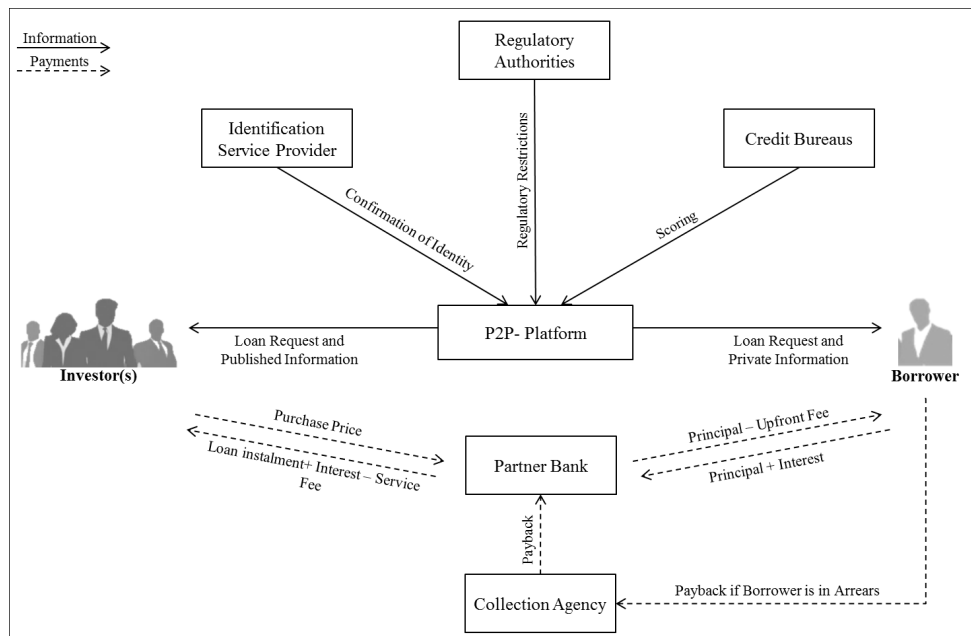


Figure 2¹²²

In contrast to direct P2P lending, indirect P2P lending involves affiliation with a partner bank. Instead of the platform originating the loan itself, the process is managed by a commercial bank.¹²³ The P2P platform merely offers a meeting place for borrowers and investors to connect and acts as an intermediary to the conclusion of the loan contract.¹²⁴

When the investor puts their money into the platform and the amount of money required for the loan is reached, the loan is originated. The partner bank enters into a consumer loan agreement with the borrower.¹²⁵ The P2P lending platform contracts with the bank and is assigned interests in the loan. A note is then issued by the P2P lending platform to the lender representing the value of their contribution.¹²⁶ The note's capital and interest are conditional upon repayment of the connected loan's capital and interest to the platform.¹²⁷ As such, the

¹²² Dierks op cit note 112 at 28.

¹²³ Fong op cit note 109 at 252

¹²⁴ Ibid.

¹²⁵ Dierks op cit note 112 at 28.

¹²⁶ Fong op cit note 109 at 252.

¹²⁷ Ibid.

lender and the borrower do not share a direct legal relationship. In turn, the partner bank earns interest on the loan amount for the holding period and a fee from the platform.

P2P lending platforms resort to the indirect P2P lending business model when the regulatory environment is hostile and allows only banks to originate loans. By partnering with the intermediary bank, the P2P lending platforms do not have to apply for and comply with restrictive banking regulation which is prohibitive and costly.¹²⁸ One prominent example of a notary-model P2P lending platform is the US-based Lending Club, which is affiliated with WebBank (a Federal Deposit Insurance Corporation-insured bank). In this indirect P2P lending transaction, WebBank is the actual entity and ‘true creditor’ that issues the loan.¹²⁹

Although not nearly as costly as banking regulation, indirect P2P lending increases the cost of lending since the partner bank has to be compensated for its participation. Nevertheless, in both models of lending, the last stage of performance is critical as it is where value for the lender and platform is either generated or destroyed.¹³⁰ The collection agency will only step in if the borrower defaults on the repayments.¹³¹ Lenders may elect to withdraw or reinvest their earnings. When more borrowers perform, more lenders invest through the platform.¹³²

3.5. Risk Mitigation

Like all methods of debt financing, there is the risk of the borrower defaulting on the loans taken out from peer-lending websites. In the context of P2P lending, it is important to mitigate risk to ensure that the platform functions smoothly in ensuring the deliverables for both the borrowers and lenders alike.

Since P2P operators do not typically invest any of their capital into loans on their platform, they are not exposed to the credit risk. This means that a thorough credit assessment of borrowers is employed as the primary preventative risk mitigation tool. The platform’s main goal is therefore to furnish investors with sufficient information needed to make an informed decision.

¹²⁸ Ibid.

¹²⁹ Ibid.

¹³⁰ Lavagna-Slater op cit note 31 at 80.

¹³¹ Dierks op cit note 112 at 28.

¹³² Lavagna-Slater op cit note 31 at 80.

Several checks are performed in assessing the borrower's creditworthiness per the National Credit Act regulations.¹³³ Furthermore, the revisions made to the affordability assessment regulations following the decision in *Truworths Limited*, have enabled credit providers to utilise alternative affordability assessment methodologies in instances where the consumer's income cannot be ascertained from a bank statement or payslip.¹³⁴ The widening of the regulations in this regard has the potential to enable South African P2P platforms to pioneer new alternative scoring mechanisms in the credit industry.

One such development has seen P2P platforms around the world utilising Artificial Intelligence to predict the disposable income of a prospective consumer as well as the risk of default.¹³⁵ In practice, the platforms often give priority to lower risk borrowers to generate financial security. Thereon, the bid is opened to riskier borrowers. It is important to note that the absence of a highly favourable credit rating does not necessarily preclude the SME from obtaining funding. On the contrary, the main target of P2P lending FinTechs is high risk and innovative SMEs.¹³⁶ This is likely because higher risk may generate a worthwhile return that is several percentage points above those for a bank deposit. Within this context of 'risky investments,' it can be argued that is a charitable element at play since investors may still invest in a borrower with imperfect credentials- if they nevertheless believe in the project and are still willing to assume the higher risk.

Making use of behavioural underwriting as a mitigation tool has allowed platforms to better determine the financial position and economic activities of a prospective borrower. In this context, behavioural underwriting is where the borrower's endorsements from friends, family and further social networks are utilised to assess the borrower's credibility.¹³⁷ Further alternative data sources such as online transactions and social media activity are increasingly incorporated to form a comprehensive digital borrower credit profile.¹³⁸

In cases where the borrower does not meet the criteria to obtain the initially requested loan

¹³³ Regulation 23 of the National Credit Act discussed in Chapter 2.1.

¹³⁴ *Truworths Limited and Others v Minister of Trade and Industry and Others* 2018 (3) SA 558 (WCC).

¹³⁵ Helga Smith 'Peer-to-Peer lending in the South African context' available at <https://www.mylexisnexis-co-za>, accessed on 16 October 2021.

¹³⁶ OXERA *The Economics of Peer-to-Peer Lending* (2016) Report at 8.

¹³⁷ Namratha Minupuri 'Rushing to Regulate: Rethinking the RBI's Directives on Peer-to-Peer Regulations in India' (2019) 33 *Emory International Law Review* 440.

¹³⁸ *Ibid.*

sum, they may be subject to a series of loan rounds where the funding is increased with each round.¹³⁹ This allows the borrower to build up their creditworthiness by proving that they are indeed a ‘performing’ borrower.¹⁴⁰ In this case, the loan rounds serve as a risk mitigation technique by shielding cautious lenders from a larger default sum.

Lastly, although the lenders’ funds are typically not insured, the growing investment in fintech based P2P lending has allowed some platforms to procure provision funds.¹⁴¹ Provision funds are insurance funds operated by the platform to indemnify investors so that they can expect a return on their investment even if borrowers’ default.¹⁴² In practice, these provision funds are exercised at the discretion of the platform and do not give the lender a right to payment.¹⁴³

As investment in fintech based P2P lending grows, more platforms may begin to offer default insurance. Nevertheless, the best course of action at the present stage is to employ efficient credit scoring techniques to keep borrower defaults as low as possible.

3.6. Comparing P2P lending to banks

P2P lending is traditionally defined in contrast to banking. Fundamentally, P2P lending platforms are two-sided markets that channel funds from investors to borrowers.¹⁴⁴ In doing so, they form part of a wider spectrum of financial institutions channelling funds, including banks, asset managers, and venture capitalists. This is referred to as financial intermediation.¹⁴⁵

As non-bank financial intermediators, P2P lending platforms share similar operational process models with traditional banks, but are distinct in the following ways:

a. Fund origination

To begin with, the major difference between P2P loans and bank loans is the original source of the funds. When the money is sourced from a lender through the P2P platform, this is a P2P loan. When the bank or another financial institution originates the loan, this is a bank loan.

¹³⁹ Lavagna-Slater op cit note 31 at 94.

¹⁴⁰ Ibid at 94.

¹⁴¹ Nemoto, N., D. Storey, and B. Huang ‘Optimal Regulation of P2P Lending for Small and Medium-Sized Enterprises’ (2019) 912 *Asian Development Bank Institute* 5.

¹⁴² Ibid.

¹⁴³ Ibid.

¹⁴⁴ OXERA Report op cit note 136 at 7.

¹⁴⁵ Ibid.

b. Fund Aggregation

A further critical distinction between P2P transactions and traditional banking institutions is that, unlike banks, P2P platforms do not initially pool funds before lending them out.¹⁴⁶ This distinction is critical because the collection of deposits would put P2P platforms within the ambit of the Banks Act. Traditionally, pooled deposits spread the risks associated with loans and default.¹⁴⁷ Instead, P2P platforms allocate loans across various investment types to diversify their portfolio.¹⁴⁸

c. Lender risk exposure

The P2P platform plays its role in the financial transaction as a matchmaking and facilitation agent. Ultimately, the lender bears the credit risk if the underlying borrower defaults. On the other hand, when a commercial bank makes a loan to a borrower that defaults, this does not affect the bank's obligation to refund its depositors.¹⁴⁹ A depositor (investor) at a bank takes on the bank's credit risk and will not get their money back if the bank defaults. Notably, although the Financial Sector Laws Amendment Bill intends to introduce a deposit protection scheme, there is currently no explicit regulations in place to protect depositors in the event of a bank failure.¹⁵⁰

d. Information Asymmetry

Peer to peer lending platforms provide lenders with information regarding the borrower's creditworthiness. These lenders are then able to make informed choices about which loan to invest in and which risk profile is acceptable. In contrast, depositors of money into traditional banking institutions do not know to whom their funds have been lent.¹⁵¹ In this sense, peer to peer intermediaries can be said to mitigate (but not entirely solve) the issue of information asymmetry involved in traditional lending transactions.

¹⁴⁶ Lavagna-Slater op cit note 31 at 90.

¹⁴⁷ Ibid.

¹⁴⁸ OXERA Report op cit note 136 at 6.

¹⁴⁹ Floyd op cit note 121 at 3.

¹⁵⁰ National Treasury, the South African Reserve Bank & The Financial Services Board *Strengthening South Africa's Resolution Framework for Financial Institutions (2015) Report* at 13.

¹⁵¹ Lavagna-Slater op cit note at 90.

e. Credit Creation

P2P intermediaries do not own the money that they facilitate in the same way the banks do. In contrast, banks can create and multiply money because they are deemed to be the legal owners of the depositor's money.¹⁵² To protect the depositor, the regulations relating to banks requires banks to maintain minimum capital and unimpaired reserve funds as prescribed by the Prudential Authority from time to time.¹⁵³ Banks are then able to extend loans as a multiple of their deposit reserves. This process is known as fractional reserve banking.¹⁵⁴ Through the process of lending these deposits, banks create money in the economy. On the other hand, P2P platforms merely facilitate the flow of funds between parties, and no new money is created.¹⁵⁵

3.7. Conclusion

P2P lending is an old form of lending that has been updated through the use of modern financial technologies. It ultimately provides smaller scale lenders with an opportunity to enjoy a better return on investment. From the lender's perspective, the technology underpinning P2P lending makes access to finance quicker and more accessible than traditional bank financing.

The use of algorithms as credit vetting tools has the potential to enable South African P2P platforms to pioneer new alternative scoring mechanisms in the credit industry. Although access to this digital footprint allows P2P to mitigate the information asymmetry issues associated with credit, it does not entirely solve the issue.

In comparison to traditional bank loans, both P2P lending and bank deposits do not have deposit guarantees. However, the lenders in P2P transactions do have the advantage of knowing who they are lending their money to. Overall, P2P lending is generally less risky because the platforms do not create and multiply money through fractional reserve lending in the way that the way banks do.

The lack of a dedicated regulatory framework has incidentally placed P2P lending under the curatorship of the NCA and draconian banking regulation- among other pieces of legislation. This has had the effect of arresting the development of P2Pl due to the impractical requirement

¹⁵² Ibid at 89.

¹⁵³ Regulation 38 of the Banks Act 94 of 1990.

¹⁵⁴ Vincent Bavoso 'The Promise and Perils of Alternative Market-Based Finance: The Case of P2P Lending in The UK' (2020) 21 *Journal of Banking Regulation* 397.

¹⁵⁵ Lavagna-Slater op cit note 31 at 90.

for all lenders to register as credit providers under the NCA. The following chapter provides an overview of the legal challenges that regulators face in allowing P2P lending platforms to operate.

CHAPTER 4

LEGAL CHALLENGES OF P2P LENDING

4.1. Shadow Banking

The legal issues surrounding P2P lending operations stem from the lack of clarity surrounding the nature of a P2P platform as an entity. Shadow banking refers to lending and other financial activities conducted by unregulated institutions or under unregulated conditions.¹⁵⁶ Since P2P lending falls within the broader realm of financial intermediation, it is mistakenly perceived to be a form of ‘shadow banking’ where loans are made through an online platform instead of traditional institutions.

According to the Banks Act, no person shall conduct ‘the business of a bank’ unless such a person is a public company and is registered as a bank in terms of the Banks Act or has been authorised by the Prudential Authority to conduct the business of a bank utilizing a branch of a foreign bank.¹⁵⁷ To avoid banking laws and regulations, the activities of a P2P lending platform must therefore not fall within the ‘business’ of a bank. More specifically, the ‘activity’ must not involve the acceptance, advertising or utilisation of a ‘deposit.’

The Banks Act defines ‘the business of a bank’ as:

1. *the acceptance of deposits from the general public as a regular feature of the business in question;*
2. *the soliciting of or advertising for deposits;*
3. *the utilisation of money, or of the interest or other income earned on money accepted by way of a deposit:*
 - *for the granting by any person, acting as lender in such person’s own name or through the medium of a trust or a nominee, of loans to other persons;*
 - *for investment by any person, acting as investor in such person’s own name or through the medium of a trust or a nominee; or*
 - *for the financing, wholly or to any material extent, by any person of any other business activity conducted by such person in his or own name through the*

¹⁵⁶ South African Reserve Bank Occasional Paper (OP/17/01) *Measuring shadow banking activities and exploring its interconnectedness with banks in South Africa* (2017).

¹⁵⁷ Section 11 read with section 18A of the Banks Act 94 of 1990.

medium of a trust or a nominee;

4. *the obtaining, as a regular feature of the business in question, of money through the sale of an asset, to any person other than a bank, subject to an agreement in terms of which the seller undertakes to purchase from the buyer at a future date the asset so sold or any other asset; or*
5. *any other activity which the Prudential Authority has, after consultation with the governor of the South African Reserve Bank, by notice in the Gazette declared to be the business of a bank.*¹⁵⁸

Critical to this definition is the understanding of the term ‘deposit.’ The Banks Act defines ‘deposit’ to mean an amount of money paid by one person to another person subject to an agreement in terms of which:

1. *an equal amount or any part thereof will be conditionally or unconditionally repaid, either by the person to whom the money has been so paid or by another person, with or without a premium, on demand or at a specified or unspecified dates or in circumstances agreed to by or on behalf of the person making the payment and the person receiving it; and*
2. *no interest will be payable on the amount so paid or interest will be payable thereon at specified intervals or otherwise, notwithstanding that such payment is limited to a fixed amount or that a transferable or non-transferable certificate or other instrument providing for the payment of interest on such amount mutatis mutandis as contemplated in this paragraph 2) is issued in respect of such amount.*¹⁵⁹

This overly broad definition of deposits likens all institutions that effect deposit-taking and on-lending behaviour to banks.¹⁶⁰ Furthermore, it ignores the element of consumer intention and places FinTech companies in South Africa at risk of unintentionally contravening the Banks Act. Based on this definition, indirect P2P loans would only fall within the meaning of a deposit if the platform operator directly received a sum of money, which has to be repaid with or without interest and which is lent to others.¹⁶¹ However, in the context of indirect P2P lending, the banking regulation is entirely avoided because the actual originator of the loan is the bank

¹⁵⁸ Chapter 1 of the Banks Act 94 of 1990.

¹⁵⁹ Chapter 1 of the Banks Act 94 of 1990.

¹⁶⁰ Floyd op cit note 121 at 17.

¹⁶¹ Dierks op cit note 112 at 79.

to the borrower.

From a technical perspective, the platform operator offers the lender the possibility to invest in the borrower. The investor ultimately acts as a lender of record and the platform merely transfers the repayment plus interest to the investor.¹⁶² This does not qualify as deposit-taking (on the platform's part) because the money is only held by the platform for the sole purpose of transferring it to another person. In addition, it has been highlighted that the platform holds this money in a separate trust account and does not involve its own balance sheet in the transaction between the borrower and the lender.¹⁶³ Therefore, in so far as banks are defined as entities that borrow to lend out, P2P lending platforms do not classify as banks because they are not a party to the loan agreement between the borrower and the lender. By operating as a mere facilitation agent, P2P lending platforms avoid the reach of the Banks Act.

4.2. National Credit Act and Zero Threshold Registration

The NCA previously allowed an individual to lend up to R500 000 to another individual without being registered as a credit provider. This allowed P2P lending platforms to operate within these limitations. However, in 2016 the Minister of Trade and Industry amended the new threshold amount for registration as a credit provider under the NCA to be zero Rands.¹⁶⁴ Accordingly, any person who lends any amount will be required to be registered as a credit provider under the NCA.

Consequently, failure to register as a credit provider will result in the credit agreement being declared unlawful by the courts and the unregistered credit provider will have limited legal recourse against the credit consumer.¹⁶⁵ For instance, the unregistered credit provider will no longer be able to rely on the credit agreement and the terms therein to claim repayment of the credit amount from the credit consumer and would instead have to rely on a claim for unjustified enrichment to prevent the credit consumer from retaining the money to which they are no longer entitled.¹⁶⁶

In *Du Bruyn and Others v Karsten*, the SCA confirmed that the obligation to register as a credit

¹⁶² Ibid at 27.

¹⁶³ Floyd op cit note 121 at 80.

¹⁶⁴ Determination of a Threshold for Credit Provider Registration in GG 39981 of 11 May 2016.

¹⁶⁵ *Vesagie NO & others v Erwee NO & another* 2014 (734) 121 (ZASCA).

¹⁶⁶ *National Credit Regulator v Opperman and Others* 2013 (1) SA 1 (CC) para 88.

provider also applied to one-off transactions.¹⁶⁷ The interpretation within the context of P2P lending is that all the lenders on P2P platforms must register as credit providers even if they only provide a single loan. There is no distinction between lending as a course of business versus a once-off loan transaction. This burden to register as a credit provider is entirely impracticable for the direct P2P business model when one considers the grassroots, low quantum and high-volume nature of the SME loans that P2P platforms generate.¹⁶⁸ The requirement to register as a credit provider has inevitably made the direct P2P lending model inoperable in South Africa. As a result, P2P lending platforms in South Africa have resorted to the notary business model to avoid these regulatory hurdles.

By partnering with the intermediary bank, the P2P lending platforms can avoid this NCR requirement (to register as a credit provider) and continue to remain outside of the direct ambit of the Banks Act. Peerfin is an example of a platform that was forced to exit the market after the zero-threshold requirement was introduced.¹⁶⁹ Similarly, to maintain its foothold in the market, Rainfin initially resorted to a partnership with Barclays Africa-owned Absa in 2014. However, this short-lived partnership ended in late 2016 when RainFin bought back its shares from Absa. Following this, RainFin concluded a transaction with LeBashe Investment Group, allowing the latter to acquire a 30% stake in RainFin.¹⁷⁰ Both partnerships reflect RainFin's strained efforts to operate its business in compliance with applicable laws and regulations. The overall result of the zero threshold rule is that the true direct P2P lending model is effectively banned, and the only legally permissible operating structure is the notary model.

By placing P2P lending under the umbrella of the NCR, P2P lending to individual borrowers and small businesses has been rendered impractical. The current regulatory framework is designed to maintain a tightly regulated banking industry alongside consumer rights protection. However, since P2P represents a case of moving away from traditional banking, consumer law and banking regulation cannot simply be supplanted and applied uniformly to P2P lending. There is no doubt that regulators need to formulate dedicated specific regulations to encourage the growth of these platforms to the benefit of SMEs and the economy more broadly.

¹⁶⁷ *Du Bruyn and Others v Karsten* (2019) JOL 45633 (SCA).

¹⁶⁸ Floyd op cit note 121 at 24.

¹⁶⁹ See Peerfin's declaration available on <https://peerfin.co.za>.

¹⁷⁰ Business Tech 'Investment group buys into SA peer-to-peer lending firm RainFin' available at <https://businesstech.co.za/news/banking/158327/investment-group-buys-into-sa-peer-to-peer-lending-firm-rainfin/>, accessed on 13 September 2021.

4.3. Money laundering and terrorist financing

As with any other financial service, P2P lending is exposed to the risks associated with money laundering and terrorism financing. Virtual credit transactions entail greater risks since malicious users may conceal their identity and falsify documents to obtain funds for financial crimes.

Money laundering is regulated by the Financial Intelligence Centre Act (FICA).¹⁷¹ The Act establishes the Financial Intelligence Centre (FIC) and a money laundering and advisory council to combat money laundering activities and the financing of terrorist and related activities. The FIC has the mandate to collect financial information to identify the proceeds of crime, money laundering and terror financing and report this to the relevant domestic and international authorities. In addition, the Act imposes various duties on accountable institutions to identify and verify clients, to keep records and to report suspicious or unusual transactions to the FIC.

Accountable institutions are listed in schedule 1 of FICA and include various financial institutions such as banks, foreign exchange dealers, trusts and money remitters. No explicit reference is made to P2P lending platforms as accountable institutions. It is submitted, however, that P2P lending platforms qualify as accountable institutions as being: “A person who carries on the business of a financial services provider requiring authorisation in terms of the FAIS.”¹⁷²

Since P2P lending platforms have been determined to be Financial Service Providers in terms of the FAIS, they, therefore, qualify as an accountable institution that falls under the governance of the FSCA. Notwithstanding the above, the list of accountable institutions is not a closed list and the duty to report unusual transactions applies to all persons who carry on business in South Africa.¹⁷³ Therefore since FinTech lenders fall into the category of ‘accountable institutions,’ they have a legal obligation to screen transactions for potential money laundering activities.

This submission is supported by IFWG stance on the FIC’s role in ensuring that fintech lending

¹⁷¹ Financial Intelligence Centre Act 1 of 2017.

¹⁷² Schedule 1 of the Financial Intelligence Centre Act 1 of 2017.

¹⁷³ Section 29 of the Financial Intelligence Centre Act 1 of 2017.

platforms comply with the FICA obligations due to their inherent high risk for money laundering and terrorist financing. This designation is based on the substance over form principle which focuses on the substance of the financial product and/or service provided to clients, rather than the medium or infrastructure used for that purpose.¹⁷⁴

As demonstrated in an earlier description of the process and risk mitigation techniques used in P2P lending, the platforms always perform due diligence procedures in their credit vetting process to ascertain the identity of their clients. The FIC obliges platforms to verify the source of funds of customers and verify the supporting documents.¹⁷⁵ In the case of a company, the ownership and financial transactions can be verified through the articles of incorporation and shareholder register alongside the verified business bank and account statements.¹⁷⁶

In addition to FICA, the Prevention of Organised Crime Act (POCA)¹⁷⁷ and the South African Exchange Control Regulations assist in effectively preventing the loss of foreign currency resources through the transfer abroad of real or financial capital assets held in South Africa. As a general rule, persons wishing to remit money cross-border would have to apply for permission. However, since P2P lending is still in its early growth stages in South Africa, the fear of capital flight from South Africa through borderless online lending transactions is not currently major.

The existing financial legislation as it pertains to money laundering and terrorism financing has the potential to adequately accommodate the regulation of fintech P2P lending platforms through its substance over form principle. However, as technology becomes more sophisticated, South African financial regulators may need to consider dedicated regulation to manage this risk accordingly.

4.4. Data Protection and Cyber Security

Similar to the above, the concerns regarding data protection and cyber security stem from the virtual nature of P2P lending transactions. Given the online nature of the P2P lending business, many people's information could be stolen in one incident due to data breaches, unauthorized

¹⁷⁴ D Geral, B Tibane, K Kern 'Fintech in South Africa: Overview' *Bowmans* 1 May 2018 at 6, available at <http://www.bowmans.com/wp-content/uploads/2018/05>, accessed on 2 July 2021.

¹⁷⁵ Section 21 and 21(A) of the Financial Intelligence Centre Act 1 of 2017.

¹⁷⁶ Section 21 and 21(A) of the Financial Intelligence Centre Act 1 of 2017.

¹⁷⁷ Prevention of Organised Crime Act 121 of 1998.

access, and identity theft.

To protect the privacy of the borrower and the lender, P2P lending platforms often issue their users with unique alphanumeric or pseudonymous identification profiles.¹⁷⁸ Nevertheless, it is entirely impractical for borrowers and lenders to expect total privacy when participating in a P2P loan. During the loan subscription process, both the borrower and investors disclose their personal information on the P2P and must accept the platform Privacy Policy Terms and Conditions to participate in the transaction.¹⁷⁹ This data privacy policy must comply with the conditions for the lawful processing of personal information as including accountability, processing limitation, purpose specification, Further processing limitation, information quality, openness, security safeguards and data subject participation.¹⁸⁰

POPIA came into effect on 1 July 2020 as South Africa's first legal framework to protect individual privacy and combat the threats of financial and identity theft. POPIA codifies how organisations can source and use people's personal information, including digital information.¹⁸¹ Such information must be used responsibly, with legitimate purpose and the person must approve how their data is used. Non-compliance with the POPIA may lead to a fine and/or imprisonment of not more than 10 years.¹⁸² It is, therefore, incumbent upon P2P platforms to make sure that they understand and meet the criteria of POPIA by ensuring that their systems are secure and able to adequately safeguard the personal information of third parties.

In addition to POPIA, the new Cybercrimes Act offers enhanced data protection for P2P lending platform users. The Act criminalises the dissemination of harmful data messages and further regulate law enforcement's jurisdiction over cybercrime by granting extensive powers to investigate, search, access and seize articles used in committing an offence (such as computers, databases or networks).¹⁸³ Once the Cybercrimes Act comes into operation, it will repeal the relevant provisions in the Electronic Communications and Transactions Act (ECT

¹⁷⁸ Tanja Jørgensen 'Peer-to-Peer Lending – A New Digital Intermediary, New Legal Challenges' (2018) 1 *Nordic Journal of Commercial Law* 252.

¹⁷⁹ Dierks op cit note 112 at 158.

¹⁸⁰ Section 4(1) of The Protection of Personal Information Act 4 of 2013.

¹⁸¹ Section 2 of The Protection of Personal Information Act 4 of 2013.

¹⁸² Section 107(1) of The Protection of Personal Information Act 4 of 2013.

¹⁸³ See the preamble of the Cybercrimes Act 19 of 2020.

Act) relating to cybercrime offences.¹⁸⁴

With the rise of Fintech and its use of sophisticated and alternative sources of data, data protection and cyber protection become an important element of trust in credit transaction. At the same time, a minimum level of transparency is required to reduce the costs of the transaction. Altogether, the provisions of POPIA and the imminent Cybercrimes Act adequately address the privacy issues stemming from the operation of a digital P2P lending platform.

4.5. Syndicated loans: a parallel

Both P2P lending and syndicated loans are generally characterized by more lenders contributing to the total loan amount of a borrower, and an intermediary that sets up and manages the loan contracts. These similarities must be kept in mind when drafting regulations to pre-empt this legal conflict.

A syndicated loan is an agreement in terms of which a group of lenders advance multiple loans to a single or group of borrowers, on a *pro-rata* basis and for a specified purpose.¹⁸⁵ The loans are arranged by an ‘arranger’ who is typically the agent of a lead lending financial institution or bank.¹⁸⁶ The lead arranger is mandated to form a syndicate and negotiates the terms of the loan with the borrower.¹⁸⁷ The syndicate itself is essentially a group of lenders who contract with each other and act together to lend money to the borrower on identical terms.¹⁸⁸ Although these loans have identical terms and are documented in a single loan agreement, it is a series of individual loans extended by each of a group of lenders on the same terms.¹⁸⁹ Each lender has an individual claim against the borrower and the borrower owes obligations to each lender.¹⁹⁰ To reduce the administrative burden and spread the risk, the lenders in the syndicate agree to share the risk of non-payment, share the reward when the borrower does perform, and act jointly in their interactions with the borrower.¹⁹¹ Once concluded, lenders are represented by a jointly appointed agent.¹⁹²

¹⁸⁴ Electronic Communications and Transactions Act 25 of 2002.

¹⁸⁵ Tracey Gutuza *Legal Aspects of Financing Corporates* (2019) 55-56.

¹⁸⁶ *Ibid.*

¹⁸⁷ *Ibid.*

¹⁸⁸ *Ibid.*

¹⁸⁹ *Ibid.*

¹⁹⁰ *Ibid.*

¹⁹¹ *Ibid.*

¹⁹² *Ibid.*

On the face of it, a P2P lending platform can be viewed as sharing the same function as the lead bank in a syndicated loan.¹⁹³ This is because as the intermediary standing between the borrower and the investor, the platform facilitates the establishment of a loan agreement.¹⁹⁴ In addition, lenders in both a P2P credit transaction and syndicated loans enjoy the advantages of spreading the risk since a multiplicity of lenders can lend a proportion of the total required amount.¹⁹⁵ There are thus some similarities between P2P lending and syndicated loans in so far as intermediation and the spreading of risk is involved.

Nevertheless, although the functions and structures may bear a similar resemblance, P2P lending has a digital set-up and often has another focus than syndicated loans. The critical distinction between syndicated loans and P2P loans is that in the latter case, there is hardly any relationship between the individual investors to a project.¹⁹⁶ In a P2P credit transaction, each investor provides separately the funds to the borrower- even though the loan agreements are contracted on the same terms.¹⁹⁷ An investor of a P2P loan is thus not responsible for another investor's loss brought about by the default of their non-performing borrower- even when they are sponsoring the same borrower on a proportional basis.¹⁹⁸ Investors of P2P loans, therefore, act independently and the principle of joint and several liabilities does not apply as it does in syndicated loans.

4.6. Principal-agent issue

The principal-agent issue refers to a conflict in priorities between a person or group and the representative authorized to act on their behalf. In this instance, an agent may act in a way that is contrary to the best interests of the principal. As a non-bank financial intermediary, the P2P platforms operate as an 'agent' to the investor/lender (i.e., the principal). This is observed in the manner in which P2P operators manage (over several years) the subsequent physical delivery to the purchaser (investor) of the obligations (interest and principal repayments) of the vendor (borrower), thereby creating a principal-agent relationship.¹⁹⁹

¹⁹³ Jørgensen op cit note 178 at 246.

¹⁹⁴ Ibid.

¹⁹⁵ Ibid at 252.

¹⁹⁶ Ibid at 258.

¹⁹⁷ Ibid.

¹⁹⁸ Ibid.

¹⁹⁹ Kevin Davis and Jacob Murphy 'Peer to Peer Lending: Structures, Risks and Regulation' (2016) 3 *JASSA: The Finsia Journal of Applied Finance* 39.

The investor's main goal is to make money by investing in quality loans. On the other hand, the lending platform's main goal is to make money by successfully matching investors with borrowers because the main source of revenue for P2P operators is borrower transaction fees from matching loans on their platforms.²⁰⁰ The conflict of interest arises when the agent's (as being the P2P platform) incentives do not encourage it to act in the best interests of the principal (the investors). This creates a principal-agent problem since P2P operators have a short-run incentive to maximise loan volume.²⁰¹ Moreover, competition between P2P operators for borrower listings could also have similar effects as platforms compete for the lion's share of the marketplace.

The principal-agent conflict of interest has the potential to influence the stringency of the P2P platform's credit assessments. An irresponsible lending platform can increase its loan volume quickly by relaxing its loan approval criteria.²⁰² By doing so, it originates more loans and earns more fees. Although the loan defaults will come later, the costs will be borne ultimately be borne by investors rather than the platform.²⁰³ This is because P2P operators do not typically invest any of their capital into loans on their platform and thus are not exposed to the credit risk despite being responsible for the credit assessment of borrowers. Due to the totality of their risk insulation, P2P platforms are said to lack 'skin in the game.'²⁰⁴

In the case of indirect P2P lending, the principal-agent conflict of interest is mitigated through their mandatory partnerships with the partner banks. The banks are subject to strict regulatory requirements, and they pass some of this burden onto the P2P partner platform by exercising their oversight and ensuring quality control of the loans issued.

4.7. Systemic Risk

There is no widely accepted definition of systemic risk in a financial context. The most natural illustration of the concept is possible in the area of health and epidemic diseases.²⁰⁵ As observed

²⁰⁰ Jørgensen op cit note 178 at 258.

²⁰¹ Davis and Murphy op cit note 199 at 39.

²⁰² Olena Havrylchyk & Marianne Verdier, 'The Financial Intermediation Role of the P2P Lending Platforms' (2018) 60 *Association for Comparative Economic Studies* 11.

²⁰³ Ibid.

²⁰⁴ Ibid.

²⁰⁵ O. de Bandt and P. Hartmann 'Systemic risk: A survey. Financial Crisis, Contagion and the Lender of Last Resort: A Book of Readings.' (2000) 35 *SSRN* 10.

in severe cases (such as the ongoing coronavirus pandemic) uncontrolled widespread contamination may wipe out a significant portion of the population. Similarly, financial systemic risk refers to a breakdown in a financial sector, that causes a rippling cascading failure across the linked financial system and the wider economy.²⁰⁶ The collapse of the Lehman Brothers in 2008 is an example that illustrates the devastating economic impact of a systemic failure within the financial system.²⁰⁷

As developed in the previous sections, P2P lending presents some risks. Moreover, as the FinTech industry continues to morph into its own online independent decentralised finance ecosystem, there are concerns that P2P lending presents systemic risks to the financial system at large. The primary objective of all financial regulation is to ward off systemic risk. Such concerns drive the desire to regulate P2P lending platforms similarly to banks concerning liquidity and capital requirements. This section, therefore, examines the potential of systemic risk posed by P2P lending, and the extent to which the application of banking regulation would be appropriate.

Indirect P2P lending as it is currently practised in South Africa does not pose a systemic risk at all. This is because the mandatory intervention of traditional credit providers their role as a depositary for the platforms' accounts and the users brings indirect P2P lending within the indirect ambit and oversight of the Banks Act. This section, therefore, examines whether the introduction of direct P2P lending in its purest form would pose a systemic risk to the financial system at large. Since P2P lending platforms are relatively new in South Africa, the occasions of financial distress are relatively infrequent. As such, the considerations relating to systemic risk will be limited to existing literature based on foreign jurisdictions.

4.7.1. Lack of 'Skin in the game'

The threat of systemic risk is primarily based on the reality that P2P platforms lack 'skin in the game' since they do not typically invest their capital into the loans that they arrange.²⁰⁸ Instead, it is the lenders who are exposed to the financial risk of losing their funds. However, the success of P2P platforms depends on their ability to attract investors.²⁰⁹

²⁰⁶ Ibid.

²⁰⁷ OECD Report op cit 14 at 50.

²⁰⁸ OXERA Report op cit note 136 at 53.

²⁰⁹ Ibid at 54.

In the case of direct P2P lending, a strong argument can be made that despite lacking skin in the game, P2P platforms have sufficient incentives to manage risk. To begin with, digital lenders have a comparative advantage over banks in so far as they can use algorithms and big data to screen and monitor borrowers at a cheap and expedient rate. In addition, given the small yet voluminous nature of SME loans, there is a relatively rapid feedback loop from increasing default losses due to the transparency of default data.²¹⁰ The risk of losing their reputation in the marketplace, coupled with the external incentive to remain competitive relative to other platforms on the market, both combine to ensure that the platform works to maintain operational profitability.²¹¹

One can therefore argue that the platform's 'skin in the game' is realised in the form of profits from successful credit agreements between the borrowers and lenders. Accordingly, direct P2P lending cannot be said to pose a systemic risk based on its agency-based business model alone. The platform's success ultimately depends on its ability to conduct thorough creditworthiness checks.

4.7.2. Scale of the Industry

Although P2P lending shows strong potential and has witnessed rapid growth to date, the volume of transactions is not yet comparable to those in the wider traditional financial system. The reality is that banks simply have higher systemic importance than P2P lending platforms. Banks sit at the centre of financial risk, whereas P2P lending platforms do not. As such, concerns about systemic risk are unfounded due to the comparatively very limited wider economic impact of a failed platform. However, as P2P lending grows to become a more mainstream investment product (and therefore more interconnected with wholesale channels of finance) the issue of systemic risk may become more pertinent in the future.

4.7.3. Access to Secondary Markets

Linked to the above, P2P lending does not pose a systemic risk because platforms generally do not have access to the secondary market.²¹² The secondary market is where investors can purchase securities or assets from other investors, rather than from the issuing companies

²¹⁰ Ibid at 20.

²¹¹ Ibid at 52.

²¹² Havrylchyk & Verdier op cit note 202 at 7.

themselves.²¹³ It effectively allows the financial market to use debt as leverage to scale up into what is commonly referred to as a ‘bubble.’ The 2008 financial crisis is a prominent example of a financial bubble that was triggered by sales of subprime securities on the secondary market.

On the one hand, there are limited jurisdictions that permit the securitisation of P2P loans. In these two countries, the practice of securitising P2P loans is gaining traction. In the context of P2P loans, securitisation refers to the pooling of underlying loans in a special purpose vehicle (SPV) conducted by P2P investors. The securitisation of P2P loans is problematic given the intrinsic low transparency of the underlying assets and the lack of standardised data which is not consistent across platforms.²¹⁴ Furthermore, the employment of securitisation would further complicate the credit risk assessment of individual underlying loans due to the longer intermediation chain.

4.7.4. Access to the Global Financial Market

Further linked to the above, P2P lending does not pose a wider systemic risk because the South African Exchange Control Regulations in force largely restrict the interaction of the domestic financial system with foreign ones. As previously described, persons wishing to remit money cross-border would have to apply for permission. Moreover, since P2P lending is still in its early growth stages in South Africa, the fear of capital flight from South Africa through borderless online lending transactions is not a salient issue.

Further practical barriers to the global financial market are imposed in the regulations of the National Payment System Act (NPS Act).²¹⁵ The Act empowers the SARB to designate settlement systems, as well as non-bank clearing system participants. However, only the SARB as well as a bank, mutual bank or branch of a foreign institution that complies with the entrance and other applicable requirements laid down in the rules of a payment system management body and has been approved as a member of the Payment System Management Body (PSMB) may participate in the settlement system.²¹⁶ Third-party payment providers such as Fintech driven P2P lending platforms, therefore, have to register with the PSMBs through their banks. Under the oversight of the SARB and FCA, these platforms are practically unable to dispense

²¹³ Will Kenton ‘Secondary Market’ *Investopedia* 27 November 2020, available at <https://www.investopedia.com/terms/u/unsecuredloan.asp>, accessed on 9 June 2021.

²¹⁴ Bavoso op cit note 154 at 406.

²¹⁵ The National Payment System Act 78 of 1998.

²¹⁶ Section 3 and 4 of the National Payment System Act 78 of 1998.

or remit loans outside of the domestic market.

Altogether, the current financial regulations ensure that P2P lending is effectively contained within the South African market and poses no broader risk to the financial ecosystem at large.

4.7.5. Lack of investor protection

Further concerns of systemic risk are based on the fact that P2P lending platforms typically do not provide default insurance and deposit guarantees for lenders.²¹⁷ According to this public policy-driven argument, these same lenders constitute members of the public. When these lenders experience financial shocks within the P2P lending ecosystem, their vulnerability extends to the wider economy.²¹⁸ It is not unusual for a lender in one sphere to be a borrower in another and to have multiple co-existing debts. Since P2P lending platforms involve the circulation and reallocation of money, prejudiced lenders may transmit risk to the wider financial market.²¹⁹

Although this public policy argument finds some merit in the wide variety of interrelating factors that affects the users of P2P lending platforms and their finance, the comparatively small size of the P2P lending market precludes the industry from posing any risk of wider systemic default. Moreover, even lenders within the traditional financial ecosystem have multiple co-existing debts. Consequently, P2P lending does not disproportionately exacerbate the market in times of distress.

4.8. Conclusion

Although P2P lending is a fairly new activity, advancing digital technologies are set to fuel its growth. At present, the existing legislation is not quite sufficient to meet the impact that P2P lending may have on modern society. However, the development of appropriate regulations is currently hampered by the misunderstandings of the P2P lending business model and its unique form of financial intermediation.

The nature of P2P platforms is that of agents or brokers and as such, they do not engage with

²¹⁷ OXERA Report op cit note 136 at 52.

²¹⁸ Ugochi Christine Amajuoyi *Online Peer-to-Peer Lending Regulation: Justification, Classification and Remit in UK Law* (Faculty of Law LLD Thesis, University of Exeter, 2016) 263-264.

²¹⁹ Ibid.

leverage and liquidity risks that are typical of banks.²²⁰ Accordingly, in so far as P2P lending remains a niche lending service operating at the peripheries of the financial ecosystem, there is no systemic risk. However, where the goal is to effectively regulate FinTech P2P lending for its growth in the market, these risks should be kept in mind.

To avoid the current legislative fragmentation brought on by uncoordinated regulatory activities, a dedicated P2P lending specific regulatory framework will be a suitable solution.

²²⁰ Bavoso op cit note 154 at 406.

CHAPTER 5

GLOBAL REGULATORY FRAMEWORKS

5.1. Introduction

FinTech driven P2P lending is changing the nature of financial services at a rapid pace. The fast pace of technological innovation creates pressure on regulators to adapt and foster an environment that is innovation-friendly.

Policy responses seen across jurisdictions to Fintech can be broadly grouped into:

- i. Partial exemption: this framework is an easing of the banking monopoly.
- ii. Regulatory sandbox: creates a safe space for financial technology services.
- iii. Ban: P2P lending is banned to protect the banking monopoly.
- iv. Laissez-faire: no regulatory efforts.

This section explores these regulatory approaches in some detail and highlights the overarching need to achieve the right balance between enabling innovation and safeguarding the financial system.

5.2. Ban: Belgium

In Belgium, the government has taken a different approach to P2P lending, opting to ban the activity entirely. In doing so, Belgium's ban on P2P lending activity symbolizes the regulator's desire to protect the banking industry from competition.²²¹

5.2.1. Regulatory Framework

The Belgian financial sector is regulated by the National Bank of Belgium (NBB) and the Financial Services and Markets Authority (FSMA).²²² Similar to South Africa's FSCA, the FSMA exercises oversight over the financial markets through supervision of financial service providers and intermediaries, the financial products on the market, financial information disseminated by companies, as well as financial compliance related matters.

²²¹ Jørgensen op cit note 178 at 243.

²²² C. Houssa, 'Le peer-to-peer lending: Un Disrupteur Innovant à L'avenir Encore Incertain' *Forum Financier / Droit Bancaire et Financier* 2016 at 12, available at http://www.simontbraun.be/images/Le_peer_to_peer_lending.pdf, accessed on 2 January 2022.

The Belgium Prospectus Act establishes a prospectus regime for the public offering and the admission to trading on a regulated market of securities.²²³ In terms of article 68 bis of the prospectus, only certain persons and a closed list of institutions are authorized to ‘appeal to the public’ to receive and utilise ‘reimbursable funds.’²²⁴

Reimbursable funds refer to funds that are made available to the recipient for their own use and account.²²⁵ In addition, the recipient must be contractually obliged to repay at least a nominal amount of funds received.²²⁶ Put differently, ‘reimbursable funds’ are analogous to ‘bank deposits’ in the South African context. Article 68 bis list all the people and institutions who are authorised to make public offers to receive deposits or other repayable funds including (but not limited to) the National Bank of Belgium, the European Central Bank and approved credit institutions.²²⁷

Article 1 of the Belgian Royal Decree of October 2009 outlines the nature and scope of an ‘appeal to the public’ for reimbursable funds.²²⁸ In terms of these regulations, the solicitation is deemed to be public when the advertisement of an announcement or recommendation for the solicitation of reimbursable funds reaches over 50 people.²²⁹

Most relevant to the context of P2P lending is that this rule applies even when the solicitation is made by an intermediary. An intermediary is defined as “Any natural or legal person who, even as a subsidiary or temporary activity, and in any capacity whatsoever, solicits or receives directly or indirectly, for any remuneration or benefit whatsoever, deposits or other repayable funds on behalf of the beneficiary, except the credit institutions that operated in the context of payment transactions.”²³⁰

When read together, the Belgian Prospectus Act along with the 2009 Belgian Royal Decree effectively prohibit Fintech driven P2P lending. To begin with, the platform’s role as a

²²³ Matthias Godenne & Octave Bigare *The peer-to-peer lending model in Belgium: A disruptive Outsider?* (School of Management MBA thesis, Louvain Catholic University, 2017) 47.

²²⁴ Ibid.

²²⁵ Colaert Veerle ‘On the Absence of Peer-to-Peer Lending in Belgium’ (2016) 5 *Journal of European Consumer and Market Law* 3.

²²⁶ Ibid.

²²⁷ Houssa op cit note 223.

²²⁸ Ibid.

²²⁹ Ibid.

²³⁰ Ibid.

matchmaker is seen as an appeal to the public in order to receive the funds, and the borrowers are contractually bound to repay (at a minimum) the principal amount of funds received. Furthermore, the candidate-borrower on a P2P platform would be considered to make an ‘appeal to the public’ to receive repayable funds and therefore to violate the regulations.²³¹ Lastly, when P2P lending platforms channel funds between the borrower and the lender and are compensated for their services through the levying of transaction fees, they are considered to be acting as intermediaries.²³²

5.2.2. Regulatory Impact on SME Financing

The effect of current regulations has served to benefit the credit institutions (namely banks) that collect the funds of their clients through deposits, and who have the legal obligation to reimburse the deposits.²³³ This outright ban of P2P lending is a reflection of the Belgian regulators’ desire to go the extra mile by guaranteeing banks a monopoly of the credit market.

The hostility towards P2P lending means that Belgian SMEs are unable to utilise this financing option. However, it should be noted that Belgian SMEs have an economic advantage over South African SMEs in so far as Belgium is more economically developed. Although the Belgian regulation protects the lending banks from the entry of new FinTechs performing the same activity, the regulators have been making a considerable effort to support alternative forms of SME financing such as through venture capital with tax reliefs, leasing and factoring.²³⁴

5.2.3 Comment

Belgium provides for a useful preliminary case study because it shares parallels with South Africa’s regulatory ban on P2P lending- albeit on a different basis. Moreover, it highlights South African SMEs’ lack of economic leverage since they do not have access to similar levels of high government and bank support regarding funding.

5.3. Partial Exemption: Germany

Germany presents a prime example of an exemption-based approach to P2P lending where the

²³¹ Veerle op cit note 225 at 3.

²³² Houssa op cit note 222 at 15.

²³³ Ibid at 14.

²³⁴ Naidji, Clara *Regulation of European peer-to-peer lending FinTechs Regulatory framework to improve SME's access to capital* (Working Paper, KU Leuven, 2017) 51.

authorities have rejected the model of adopting special regulations for P2P lending platforms. The effect of this partial exemption is that it creates room for P2P lending platform operators to perform certain activities (such as lending) which are normally confined to regulated banking activity. Under a partial exemption regime, these platforms are only subject to a select portion of the statutory requirements governing lending activities. A preceding overview of the lending requirements outlined in the German banking regulation is therefore necessary to understand the exemptions that allow Germany's P2P lenders to continue operating.

5.3.1. Regulatory Framework

The regulatory framework for Banks and financial service providers is supervised and controlled by the German Federal Financial Services Supervisory Authority (*Bundesanstalt für Finanzdienstleistungsaufsicht* – hereon referred to as 'BaFin').²³⁵ Its primary objective is to ensure the functioning, stability and integrity of the German financial system.²³⁶ In the context of FinTech credit agreements, BaFin is also responsible for regulating the provision of P2P loans. In terms of section 32 of the German Banking Act (known officially as the *Kreditwesengesetz*), anyone wishing to conduct banking business or to provide financial services in Germany requires a written licence from BaFin.²³⁷ Amongst several further categories, section 1(1) of the German Banking Act defines the business of a bank or financial services as including the provision of money loans and the acceptance of deposits from the public.²³⁸

In terms of section 32 of the German Banking Act, the making of loans requires a license from BaFin if the lender acts "commercially" or "on a scale which requires a commercial set-up business operation".²³⁹ In practice, 'scale' can constitute a single transaction, if only the lender has the intention to make further transactions.²⁴⁰ The result is that lenders and borrowers active on direct P2P platforms must apply for a banking license and fulfil the same regulatory requirements as traditional banks.

²³⁵ Dierks op cit note 112 at 13.

²³⁶ Ibid at 51.

²³⁷ Ibid.

²³⁸ Ibid at 58.

²³⁹ Ibid.

²⁴⁰ Renner Moritz 'Peer-to-Peer Lending in Germany' (2016) 5 *Journal of European Consumer and Market Law* 3.

To avoid applying for a banking licence, German platforms adopt the indirect P2P lending business model which involves cooperation with a licensed bank.²⁴¹ Without the involvement of a licensed bank, even small-scale individual lenders making loans through a P2P platform would therefore in all likelihood be required to obtain a banking license.²⁴² By pairing with a licensed bank, the lending platform itself does not make loans on its account and thus does not engage in regulated lending activity.²⁴³

5.3.2. Regulated Taking of Deposits

Similar to the South African Banks Act, the German Banking Act defines deposit-taking broadly as to include any receipt by an individual or institution of external funds from the public, irrespective of the payment of interest.²⁴⁴ In addition, the money must be repayable in the sense that the investors need to have a non-conditional claim against the platform operator for repayment of a specified amount.²⁴⁵ To circumvent this classification of deposit-taking and avoid triggering the requirement of a banking licence, German P2P platforms make it explicit that they do not offer individual accounts to investors. Instead, investors are redirected to open ‘investor accounts’ at the platform’s partner bank. By using a licenced bank as an intermediary, the platform users do not themselves engage in the taking of deposits.²⁴⁶

5.3.3 Regulatory Impact on SME Financing

The effect of a strict regulatory framework for P2P platforms in Germany has significantly hampered the market access of innovative business models.²⁴⁷ Instead of facilitating innovation and development, German authorities prefer to see P2P platform operators collaborate or merge with traditional financial institutions that are already highly regulated with some partial exemptions.²⁴⁸ As a result, platforms seeking to offer direct business loans between lenders and borrowers have had to modify their business model or exit the market.

The aim to avoid supervisory banking regulation has forced German P2P platforms to operate exclusively using the indirect P2P lending business model. At the very least, this has had the

²⁴¹ Ibid at 56.

²⁴² Moritz op cit 240 at 3.

²⁴³ Ibid.

²⁴⁴ Ibid at 4.

²⁴⁵ Ibid.

²⁴⁶ Ibid.

²⁴⁷ Ibid at 7.

²⁴⁸ Ibid at 4.

benefit of avoiding the applicability of consumer law to the platform and its users. The involvement of a licensed bank in the two-fold contracting structure of German P2P lending platforms discharges lenders from their potential obligations under consumer law- which instead have to be fulfilled by the bank.²⁴⁹

It is not recommended for South Africa to adopt Germany's approach to P2P lending. This is because the partial exemption approach is difficult to copy. It depends heavily upon the existing financial jurisdiction framework which may not sufficiently address the nature of P2P lending. In addition, regulators are required to have the necessary technological subject matter expertise to make sound judgements. More often than not, it is highly likely that further specially drafted rules will still be required to facilitate the lending activities.

5.3.4. Comment

Similar to South Africa, the supervisory regulation of P2P lending in Germany is very strict. It tends to treat the P2P lending business in largely the same manner as the traditional lending business by banks. As a result, the market situation in both jurisdictions, Germany and South Africa, is far from the goal of decentralised finance that is envisioned for FinTech P2P lending. The constant reshuffling of rules is susceptible to regulatory arbitrage wherein companies may seek to take advantage of loopholes in the existing regulatory framework for their own benefit.²⁵⁰ Both Germany and South Africa need to develop a proactive and dedicated P2P lending regulatory approach to facilitate innovation and curtail the ongoing market exodus of direct P2P platforms.

5.4. Laissez-faire: China

When FinTech first presented itself on the Chinese market, the government adopted a laissez-faire approach. The purpose of the laissez-faire approach is to allow innovation to develop freely without any regulatory barriers or constraints.²⁵¹ It is believed that the Chinese government deliberately adopted this hands-off approach to encourage fast growth of the lending platforms and thus provide ready access to credit to underserved SMEs.²⁵² The rationale

²⁴⁹ Ibid at 6.

²⁵⁰ Didenko op cit 105 at 331

²⁵¹ Dirk A. Zetzsche et al 'Regulating a Revolution: From Regulatory Sandboxes to Smart Regulation' (2017) 23 *Fordham Journal of Corporate and Financial Law* 31-103.

²⁵² Naysary Babak & Daud Siti 'Peer to Peer Lending Industry in China and Its Implication on Economic Indicators: Testing the Mediating Impact of SMEs Performance' (2021) 12 *International Journal of Financial Research* 106-107.

is that if banking laws or strict rules were applied to FinTech services such as P2P platforms, their market development may be hampered.

As a result of the relaxed lending environment, China's P2P lending industry exploded. In the beginning, P2P platforms took up the opportunity to experiment with a diversity of business models.²⁵³ However, over time, the relaxed regulatory environment created a 'wild west' in China's P2P lending industry. Dubious operators began to take advantage of potential investors by luring them in with false promises of high returns. It was commonplace for the fraudulent platforms to simply disappear from the market after collecting the funds. Unable to track down the operators, investors would then find themselves with an unenforceable claim of unjust enrichment. In due course, these platforms eventually collapsed and filed for bankruptcies since they did not have any cash reserves to compensate for the losses. One prominent example of this type of fraud involved a Chinese P2P platform known as Ezubao.²⁵⁴ After establishment in 2014, the online lender carried out a major Ponzi scheme to fleece investors of more than 58 billion yuan (approximately 134 billion Rands).²⁵⁵ By 2015, the platform was no longer in operation, and it was discovered that over 95% of its borrowers were fictitious.²⁵⁶

5.4.1. Regulatory Framework

In response to the rising level of fraudulent FinTech companies, the government introduced the 'Guiding Opinions on Enhancing Positive Development of Internet Finance' in 2015.²⁵⁷ This broad framework was intended to promote innovation and development of internet finance platforms through 'moderately loose regulatory policies.'²⁵⁸ The Guiding Opinions also clarified the nature and role of P2P lending platforms as being distinct from banking institutions in that they were merely information intermediaries for borrowers and lenders that neither participate in the transaction nor shall they pool or transform financial assets in any other way.²⁵⁹ To ensure that platform operators remained within their permissible scope of business activities, the China Banking Regulatory Commission (CBRC) was then appointed as the P2P

²⁵³ Ibid at 106.

²⁵⁴ Wang, J 'The Party Must Strengthen Its Leadership in Finance!: Digital Technologies and Financial Governance in China's Fintech Development.' (2021) 247 *The China Quarterly* 778.

²⁵⁵ Ibid.

²⁵⁶ Ibid.

²⁵⁷ Tsai, Chang-hsien 'To Regulate or Not to Regulate? A Comparison of Government Responses to Peer-to-Peer Lending among the United States, China, and Taiwan' (2018) 87 *University of Cincinnati Law Review* 1093.

²⁵⁸ Ibid.

²⁵⁹ Ibid.

lending supervisory agency.²⁶⁰

Due to the lack of punitive sanctions in the Guiding Opinions and ongoing market turmoil, the government went on to introduce the ‘Interim Measures for the Administration of the Business Activities of Online Lending Information Intermediary Institutions’ in August 2016.²⁶¹ These interim measures were the first real attempt to regulate P2P lending activities and protect the legal rights and interests of lenders.

According to the Interim Measures, P2P lending platforms were now required to establish a third-party depository system for customer funds with a qualified banking institution, conduct adequate creditworthiness checks, disclose financial information regarding their business operations, introduce borrowing caps and register with the local financial regulatory departments.²⁶² In addition, P2P lending platforms were expressly prohibited from certain business activities including taking deposits from members of the public; creating asset pools; conducting offline promotion of financing projects; selling wealth management products; transferring debts by issuing asset-backed securities.²⁶³ Where the platform operators were found to exceed the scope of their permissible business activities (for example: by pooling funds or underwriting loans), the local regulators were empowered to advise the lending platforms on how to meet the requirements or shut down disqualified platforms.²⁶⁴

The key requirement to engage a qualified financial institution as a third-party banking custodian meant that dubious platform operators were no longer able to construct fund pools to misappropriate the investors' funds. However, genuine platforms would also face increased compliance costs which would squeeze the profit margins. In recent years, the regulatory regime has tightened to the point of restricting P2P lending.²⁶⁵ As a result, a large number of existing platforms have been forced to change their business models or cease operation altogether.²⁶⁶

²⁶⁰ Ibid.

²⁶¹ Ibid at 1094.

²⁶² Ibid at 1095.

²⁶³ Ibid.

²⁶⁴ Ibid at 1096.

²⁶⁵ Reuters ‘China Takes Forceful Steps to Tame Unruly Peer-to-Peer Lending Sector’ available at <http://www.reuters.com/article/us-china-banks-cbrc/chinatakes-forceful-steps-to-tame-unruly-peer-to-peer-lending-sector-idUSKCN10Z17F?il=0>, accessed on 13 September 2021.

²⁶⁶ Ibid.

5.4.2. Regulatory Impact on SMEs

The underlying internet and data technology behind P2P lending helped to modernize the Chinese financial market and brought rigour to the SME sector.²⁶⁷ By encouraging interactions between the bona fide P2P platforms, borrowers and investors, the platforms disrupted the rigid top-down and one-to-many relations between banks and customers.²⁶⁸ For some time, SMEs had generated a lot of demand for loan services and remained under-served by the traditional banking system. The expansion of P2P lending increased the available liquidity by connecting a wider variety of borrowers and creditors through the internet.²⁶⁹ From this perspective, China can be recommended for having identified that technology would be among the foremost productive forces for economic development.

Furthermore, the emergence of digital lending allowed internet companies such as Alibaba and Tencent to enter the market, providing business loans to the millions of SMEs which received inadequate financing from state-owned banks.²⁷⁰ Such companies then went on to claim over 70 per cent of the payment and clearance market (which was previously controlled by the state-owned banks) - creating an entire industry that ran alongside major banks.²⁷¹

On the other hand, the popularization of P2P lending gave rise to a market brimming with scams and high-risk financial models. From this perspective, the government was correct to intervene and managing financial compliance and mitigate the risks associated with P2P lending.

5.4.3 Comment

China's tumultuous experience with the P2P lending industry highlights the importance of introducing timeous comprehensive and supportive regulations to mitigate systemic risks and protect lender investments. A laissez-faire approach would likely have similarly catastrophic effects on the South African financial markets.

²⁶⁷ Wang op cit note 254 at 778.

²⁶⁸ Ibid.

²⁶⁹ Ibid.

²⁷⁰ Ibid at 779.

²⁷¹ Ibid.

Nevertheless, the Chinese government's approach is useful as it provides a guideline for how the South African government can achieve a balance between the support of financial innovation and the overall control of the growing financial economy. China's experience further demonstrates that P2P lending has great potential to reduce the banks share of the credit market. This evidence explains the root of the drive to protect the banking monopoly.²⁷² However, in a country plagued by ailing growth in a bleak post-covid recession, SME credit needs should be at the forefront of radical economic transformation in South Africa.

5.5. Regulatory sandbox

In addition to the options of either banning P2P lending, adopting a laissez-faire approach or adopting a case-by-case partial exemption, regulators also have the option of tailoring a special set of rules known as a regulatory sandbox.²⁷³

A regulatory sandbox is a regulatory approach, typically summarized in writing and published, that creates a time-bound regulatory 'safe space' for innovative financial institutions and activities underpinned by technology.²⁷⁴ At the most basic level, the sandbox creates an environment for businesses to test products under a set of rules, supervision requirements, and appropriate safeguards.²⁷⁵

In comparison to the previously discussed approaches, a regulatory sandbox provides for greater transparency by implementing pre-defined entry and exit criteria.²⁷⁶ Under this framework, sandbox participants are usually allowed to participate for a limited period.²⁷⁷ The more certain the sandbox conditions, the more likely they will suffice as a risk-mitigating device, thereby reducing the importance of the time limit.²⁷⁸ In return, regulators require applicants to incorporate appropriate safeguards to insulate the market from the risks associated with their innovative business. The result is that a regulatory sandbox brings the cost of innovation down, reduces barriers to entry, and allows regulators to collect important key data points and insights before embarking on further regulatory action.²⁷⁹

²⁷² As demonstrated by Belgium's ban on P2P lending.

²⁷³ Zetzsche *et al* op cit 251 at 21.

²⁷⁴ *Ibid* at 26.

²⁷⁵ *Ibid* at 13.

²⁷⁶ *Ibid* at 26.

²⁷⁷ *Ibid* at 35.

²⁷⁸ *Ibid*.

²⁷⁹ *Ibid* at 36.

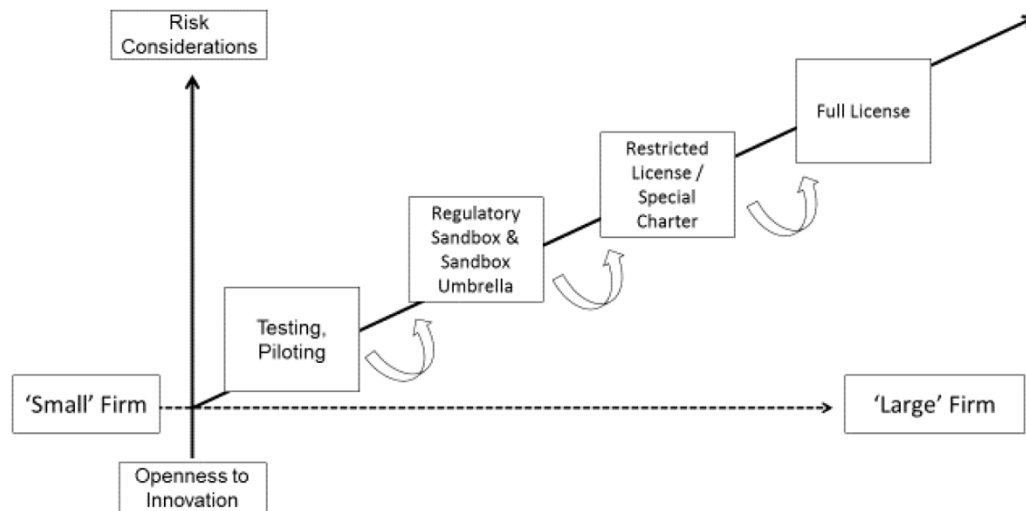


Fig 3 'Lifecycle of regulatory sandbox'²⁸⁰

5.5.1. United Kingdom

In 2015, the United Kingdom became the first country in the world to pioneer a regulatory sandbox. The Financial Conduct Authority (FCA) sets the prudential and specific notification requirements for firms operating in this market.²⁸¹ To allow the market to develop, The FCA has adopted a light touch in their regulation of P2P lending platforms.²⁸² This relaxation of financial regulations is reflected in the P2P lending regulatory rules outlined below:

Firstly, P2P platforms are required to adhere to fixed minimum capital requirements.²⁸³ In comparison, banks require a much larger amount of capital. Furthermore, Platform operators are required to put in place resolutions to ensure that loans can be managed to maturity in the event of the platform's failure.²⁸⁴ This is because, unlike South Africa where bank deposits are not protected or insured by the state, the UK government boasts a Financial Services Compensation Scheme (FSCS) that is designed to protect consumers and businesses from

²⁸⁰ Ibid at 58.

²⁸¹ Nemoto, Storey, and Huang op cit note 141 at 4.

²⁸² Ibid at 5.

²⁸³ This is discussed in Financial Conduct Authority (2014), 'PS 14/4: The FCA's regulatory approach to crowdfunding over the Internet, and the promotion of non-readily realisable securities by other media. Feedback to the CP 13/13 and final rules, March. See 'Client Money Rules' section from para. 3.13, available at <https://www.fca.org.uk/publication/policy/ps14-04.pdf>, accessed on 2 January 2022.

²⁸⁴ OXERA Report op cit note 136 at 59.

losing money if high street banks, credit unions, insurers or institutions go under. However, the FSCS does not cover P2P lending contributions.²⁸⁵ This falls in line with the global trends and the accepted risky nature of P2P lending as outlined. The FCA therefore reasonably expects the P2P firms to have appropriate systems and controls depending on their customer needs and their business model particularities.²⁸⁶

Lastly, the regulatory rules require P2P platforms to ensure investors have enough information to make informed investment decisions and that all communications are fair, clear and not misleading.²⁸⁷ To safeguard this measure, platforms are subject to the FCA's risk control rules regarding credit risk assessment for consumer lending,²⁸⁸ dispute resolution rules. Moreover, to assist with market monitoring, the FCA requires the platform operators to make specific disclosures about their financial position by availing their full loan books to allow proper analysis of the investment options.²⁸⁹

- *Regulatory Impact on SME Financing*

The P2P lending industry in the UK has been relatively successful in serving SMEs, with a high proportion of P2P loans going to businesses and several platforms specializing exclusively in business lending.²⁹⁰ In 2015, the P2P lending market in the UK had a volume of around €4.4 billion, while in Europe the volume was €1 billion.²⁹¹ P2P lending in the UK now represents about 14% of the new lending to SMEs with estimates suggesting that more than half of these credits were unlikely to have been provided by existing banks.²⁹²

The explosive growth of P2P lending in the UK culminated in Zopa's transformation from the world's oldest digital P2P lender into a fully-fledged licensed digital bank.²⁹³ This growth demonstrates the demand and potential of FinTech driven P2P lending as an alternative to traditional banks. In addition, it presents guidance in drawing the line between banks and P2P

²⁸⁵ Ibid at 50.

²⁸⁶ Grant Thornton 'Alternative Lending: A regulatory approach to Peer-to-Peer lending' (2015) at 6, available at <https://www.grantthornton.co.uk/globalassets/1.-member-firms/united-kingdom/pdf/alternative-lending-a-regulatory-approach-to-peer-to-peer-lending.pdf>, accessed on 2 January 2022.

²⁸⁷ OXERA Report op cit note 136 at 50.

²⁸⁸ Ibid at 63.

²⁸⁹ Ibid.

²⁹⁰ Nemoto, Storey, and Huang op cit note 141 at 5.

²⁹¹ Rainer op cit note 11 at 690.

²⁹² Lemma, Valerio *FinTech Regulation: Exploring New Challenges of the Capital Markets Union* (2020) 50.

²⁹³ Nicholas Megaw 'P2P lender Zopa wins UK banking licence' June 2020 available at <https://www.ft.com/content/1146e1f5-85f3-48cb-bb33-7f0d7a5781eb>, accessed on 18 August 2021.

lenders. Zopa's transition into retail banking can guide regulators in designing a regulatory sandbox that sets a threshold at which the volume of the commercial activity of a P2P lender may require the platform to shift into banking regulation to mitigate the potential of systemic risk.

- *Global Adoption of The Regulatory Sandbox Framework*

United Kingdom's positive experience with the regulatory sandbox framework generated great interest from regulators and innovators around the world. This is particularly because the regulatory sandbox is so flexible and easy to copy. Responding to this successful precedent, several other jurisdictions followed the UK's lead, including Australia, Bahrain, Brunei, Canada, Hong Kong, Indonesia, Malaysia and Mauritius.²⁹⁴

5.5.2. Mauritius

P2P lending shows a lot of promise as an innovative solution with the potential to democratise financing in Sub-Saharan Africa.²⁹⁵ The Kenyan story of M-Pesa as Africa's most successful mobile money service is evidence that FinTech has the potential to provide the unbanked with access to financial services and thereby foster financial inclusion.²⁹⁶ Most notably, FinTech based P2P lending goes beyond mobile money as it facilitates the provision of credit which may be used to start small businesses.

In recent years, Mauritius has been working hard to establish itself as Africa's leading Tech Hub and has gained a growing global reputation as the preferred gateway for investment into (and out of) Africa.²⁹⁷ In doing so, the country has taken steps to be proactive in adopting comprehensive a P2P lending specific legal framework that has given investors and market participants clarity and certainty.²⁹⁸

a. Regulatory Framework

The Regulatory Sandbox License (RSL) of Mauritius is spearheaded by Economic

²⁹⁴ Zetzsche et al op cit note 251 at 27.

²⁹⁵ Didenko op cit note 105 at 368.

²⁹⁶ Ibid at 318.

²⁹⁷ Business Wire 'The Mauritius Africa Fintech Hub due to launch in December after appointment of new CEO' available at <https://www.businesswire.com/news/home/20181130005253/en/The-Mauritius-Africa-FinTech-Hub-Due-to-Launch-in-December-after-Appointment-of-New-CEO>, accessed on 13 September 2021.

²⁹⁸ Ibid.

Development Board (EDB). In 2017, the (FSC) issued the P2P lending rules. These P2P Rules aim to, inter-alia, establish a sound and conducive automated environment or platform for the offer and execution of alternative peer to peer lending, other than bank lending, for the benefit of borrowers and stakeholders in the non-banking sector of Mauritius.²⁹⁹ In so doing, the FSC recognises that P2P lending platforms are an important segment of the Fintech space and broader credit market.³⁰⁰

In terms of the most recent 2020 amendment to the rules, the role of a P2P operator is clearly defined as a matchmaker that facilitates access to finance between prospective lenders and borrowers. To this end, the Rules restrict P2P operators from undertaking certain activities (such as deposit-taking, lending and providing or arranging for any credit enhancement or guarantee) in their capacity. As such, Mauritian P2P platforms are required to establish an escrow arrangement with licensed financial institutions in Mauritius to facilitate the transfer of funds between the lenders and the borrowers.³⁰¹

At present, all P2P operators are required to be incorporated in Mauritius and may not have a bank or a foreign bank as a shareholder without prior approval by the FSC.³⁰² Nevertheless, there are no restrictions on the participation of foreign lenders or borrowers on licensed P2P Lending platforms.³⁰³ In addition, the P2P operator may establish a branch outside of Mauritius with the FSC's approval.³⁰⁴ These provisions speak to a desire to contain the P2P lending market within the Mauritian economy.

The Mauritian P2P regulatory sandbox rules go a step beyond the UK by outlining the operational business structure of a P2P platform. According to section 7, The P2P operator shall be managed by a board consisting of a minimum of three directors, one of whom shall be

²⁹⁹ Financial Services Commission *Draft Financial Services Peer to Peer Lending Rules for Consultation* (2017) *Communiqué*, available at <https://www.fscmauritius.org/media/4167/communique-financial-services-peer-to-peer-lending-rules-2017.pdf>, accessed on 16 November 2021.

³⁰⁰ DLA Piper Africa 'The FSC issues peer to Peer (P2P) lending rules' available at <https://www.dlapiper africa.com/en/mauritius/insights/2020/peer-to-peer-lending-rules.html>, accessed on 3 August 24, 2021.

³⁰¹ DLA Piper Africa 'The FSC issues peer to Peer (P2P) lending rules' available at <https://www.dlapiper africa.com/en/mauritius/insights/2020/peer-to-peer-lending-rules.html>, accessed on 3 August 24, 2021.

³⁰² S7(1)(a) Lending Rules made by the Financial Services Commission under section 93 of the Financial Services Act available at <https://www.fscmauritius.org/media/85047/annex-8-the-fs-peer-to-peer-lending-rules-2020.pdf>, accessed on 17 December 2021.

³⁰³ DLA Piper Africa op cit note 301.

³⁰⁴ 7(2) *Lending Rules*.

an independent director and a resident of Mauritius.³⁰⁵ The P2P operator shall at all times establish an office and employ staff proportionate to the size, nature and complexity of its business.³⁰⁶ It also has to put in place all relevant information technology infrastructure for the carrying out of its business activities.³⁰⁷ Furthermore, the P2P operator has to put in place business continuity and disaster recovery plan for its business.³⁰⁸

To protect the lending participants, the P2P rules place limits on the aggregate amount that borrowers may obtain through P2P operators. For instance, a borrower who is a natural person, shall not borrow an amount exceeding Rs1 million, whilst a limit of Rs5 million applies to a borrower who is a legal person.³⁰⁹ To prevent the issues associated with concurrent debt, borrowers are required to provide signed confirmation that they have not sought funds for the same project from other P2P lending platforms. In turn, the rules also impose limitations on the lenders. A lender who is a natural person, shall not lend more than MUR 1.5M in any 12 months, whilst a lender who is a legal person shall not lend over MUR 3M.³¹⁰ As further protection, the reimbursement period of lending through a P2P Lending platform shall not exceed 84 months and the funds may be made available to the borrower only after the required total funding has been pooled or raised for any project.³¹¹

P2P operator is required to carry out due diligence on both lenders and borrowers.³¹² The act obliges P2P to adequately assess the borrower's creditworthiness by taking reasonable steps to identify their identity (including details of incorporation and business registration), ensure their financial standing (based on their financial or credit history, amongst others), and verify the soundness of their projects, per the applicable laws of the jurisdiction where they will be executed.³¹³ These thoroughly outlined minimum standards of credit vetting serve to ensure that platforms act in the best interests of their lender.

In addition to the above, the P2P rules require the P2P platforms to provide both the borrowers

³⁰⁵ 7(3) *Lending Rules*.

³⁰⁶ *Ibid.*

³⁰⁷ *Ibid.*

³⁰⁸ *Ibid.*

³⁰⁹ 6(b)(i)-(ii) *Lending Rules*.

³¹⁰ 6(c)(i)-(ii) *Lending Rules*.

³¹¹ 6(2)-(3) *Lending Rules*.

³¹² Section 12 *Lending Rules*.

³¹³ Section 12(2) and section 13(a)-(d) *Lending Rules*.

and the lenders with a cooling-off period of two business days to ensure that there is informed participation and consumer protection. During this time, either party may cancel their written agreements without incurring any penalty. The P2P operators are further required to disclose the cancellation right before the agreements are signed. This cooling-off provision entails a modern adaptation of consumer legislation by recognising that lenders on P2P platforms are simultaneously consumers.³¹⁴

Similar to the UK, Mauritian P2P loans are not eligible for deposit protection in the way that both Mauritian and UK banks are.³¹⁵ To this end, the rules require P2P operators to make a conspicuous disclaimer on their website to this effect.³¹⁶ To further mitigate risks associated with the platform's lack of skin in the game, the rules require P2P platforms to have a minimum unimpaired stated capital of Rs 2 million or the equivalent in any other currency.³¹⁷ This amount may be subject to revision by the FSC. In addition, the P2P operator is also required to maintain at all times a professional indemnity insurance cover that is commensurate with the nature and scope of its business activities.³¹⁸

b. Further Regulatory Provisions

To protect the participants, P2P platforms are required to comply with certain disclosure requirements on their websites. These disclosures include a description of the borrower's project for which financing is being sought through the P2P lending platform; the latest financial statements of the borrowers and a disclaimer that the P2P operator gives no assurances about the accuracy of those financial statements; a signed confirmation from the borrower that it is not seeking funds concurrently for the same project from other P2P lending platforms; any credit scoring conducted by the P2P operator on the borrower, and the historical default rate by borrowers on the P2P lending platform.³¹⁹ These records must be submitted to the FSC every quarter and maintained for at least 7 years.³²⁰

³¹⁴ This is known as a 'lendsumer.' The concept was originally developed by Ugochi Christine Amajuoyi *Online Peer-to-Peer Lending Regulation: Justification, Classification and Remit in UK Law* (Faculty of Law LLD Thesis, University of Exeter, 2016) 343.

³¹⁵ Section 10(2) *Lending Rules*.

³¹⁶ *Ibid*.

³¹⁷ 7(1)(b) *Lending Rules*.

³¹⁸ 7(6) *Lending Rules*.

³¹⁹ Section 11(a)-(f) *Lending Rules*.

³²⁰ 14(3) *Lending Rules*.

Outside of the sandbox rules, P2P platforms are responsible for putting in place measures to prevent money laundering and terrorist financing in terms of The Financial Intelligence and Anti-Money Laundering Act ³²¹

c. Regulatory Impact on SME Financing

Following the publication of the rules, Fundkiss managed to secure a full-fledged licence to operate a P2P Lending Platform from the FSC. The platform's mission is to simplify and democratise SME financing in Mauritius by offering business loans of up to MUR 5,000,000 (approximately R1.8M).³²²

Due to the novelty of the emerging Mauritian P2P lending landscape and the corresponding lack of data, it is not possible to gauge the extent to which the regulatory sandbox has been instrumental in developing the alternative lending marketplace. However, what is clear is that this FinTech sector has very strong support from its regulators and the P2P lending industry stands to benefit from a first mover advantage on the Sub-Saharan marketplace.

d. Comment

Following on from Mauritius, several African countries such as Nigeria, Kenya, Sierra Leone, Rwanda and have come to recently embraced general FinTech Regulatory sandboxes.³²³ However, the implementation of these sandboxes is too slow. Furthermore, these countries have collectively failed to introduce P2P lending specific legal frameworks.³²⁴

In comparison to the United Kingdom, Mauritius' rules on P2P lending are more robust, comprehensive and specific. The Mauritian regulators have managed to effectively adapt financial legislation and tailor it to the nuances of P2P lending. In addition, the Mauritian regulators have effectively interwoven the relevant applicable provisions about consumer protection, AML/CMT responsibilities, Data protection and Cybersecurity into a single

³²¹ Section 12(1) *Lending Rules*.

³²² Bajaj, N. 'Fundkiss becomes first African company to hold Bespoke P2P lending licence.' *Platform Africa - Economic News for Emerging Market* 12 April 2021, available at <https://www.platformafrica.com/2021/04/12/fundkiss-becomes-first-african-company-to-hold-bespoke-p2p-lending-licence/>, accessed on 17 November 2021.

³²³ Wechsler, Michael & Perlman, Leon & Gurung, Nora 'The State of Regulatory Sandboxes in Developing Countries' available at <https://dfsobservatory.com/sites/default/files/DFSO%20-%20The%20State%20of%20Regulatory%20Sandboxes%20in%20Developing%20Countries%20-%20PUBLIC.pdf>, accessed on 10 November 2021. 34-36.

³²⁴ Didenko op cit note 105 at 353.

consolidated document that is both concise and clear. Mauritius' fintech industry should be regarded as a stepping-stone blueprint for South Africa, as it develops its own P2P lending regulatory sandbox.

5.6. Conclusion

The digital innovation demonstrated by Fintech led P2P lending platforms can improve SMEs' access to alternative financial services and boost long-term economic growth. However, it is difficult to create a single global coherent regulatory regime because P2P platforms' models differ, and they currently operate in markets unique to their jurisdiction.

To this end, the partial exemption method remains too blunt of a regulatory tool with which to approach P2P lending. In addition, the losses suffered by Chinese P2P platform users that dedicated regulation is required in the P2P lending industry to ensure the safety of both the borrowers and lenders.³²⁵ On the other hand, the Belgian case is a clear example of how licensing regulations can prevent new actors from engaging in lending activities. The Regulatory sandbox model is a middle-ground approach that sits on the border between an ecosystem approach and an infrastructural change in regulatory innovation.

By making the substance of a general FinTech regulatory sandbox hard to define, a P2P platform operator may struggle to claim admission to the sandbox.³²⁶ This lack of transparency further compromises the rule of law by placing regulated entities in an uncomfortable position as they do not know the conditions under which their competitors operate.³²⁷

The UK has demonstrated that a P2P specific regulatory sandbox is an effective, responsive and flexible model for the industry's growth. Regulatory action to date suggests that it has helped to build an understanding of the issues and responsiveness to evolving industry dynamics. Authorities in the UK provide consistent feedback to companies on the regulatory implications of their plans and run a regulatory sandbox to allow selected firms to test new models on the market.

The Mauritian adaptation of the P2P lending regulatory sandbox provides South Africa with a

³²⁵ Chaffee and Rapp op cit note 76 at 492.

³²⁶ Zetzsche et al op cit note 251 at 59

³²⁷ Ibid.

blueprint to lay the foundations of its own lending rules. The support of the regulators is critical for a P2P lending sector to emerge and potentially dominate as an international gateway channelling foreign direct investment into the rest of the African market. South Africa's cannot afford to move at a snail pace in this rapidly accelerating mobile gig economy.

The following chapter outlines the dominant policy guidelines required to establish a robust South African P2P regulatory sandbox that can accommodate these technological changes and broaden the range of financing available to support SMEs.

CHAPTER 6

STEPS TOWARDS A DEFINED P2P LENDING REGULATORY SANDBOX

6.1. Introduction

The rise of Fintech based P2P lending shows promise to open new avenues of funding to SMEs and enhance financial inclusion. However, the potential disruption of these new credit products poses new challenges for financial stability and consumer protection. To this end, policymakers have adopted regulatory sandboxes as a tool for spurring innovation in the financial sector while keeping alert to emerging risks.

Although South Africa's IFWG has introduced a FinTech regulatory sandbox in line with global practice, they have failed to structure it in such a way that adequately addresses the unique features of P2P lending. As reflected by the poor representation of P2P operators within the sandbox, the opacity of the rules has made it difficult for P2P operators to ascertain their eligibility for participation in the sandbox. Altogether, the IFWG's regulatory sandbox has not managed to facilitate P2P lending platforms.

However, as things currently stand, the financial regulation is structured in such a way that consumer laws and banking regulations end up applying (directly or indirectly) to P2P lending platforms. In this case, the zero-credit threshold has had the effect of preventing P2P operators from engaging in lending activities by requiring all lenders to register as credit providers regardless of the amount to be lent. As highlighted in the case of Peerfin's P2P platform, the insurmountable compliance traps laid by this regulatory spaghetti has had the effect of forcing P2P platforms to exit the market or restructure their business by partnering with a bank.

6.2. Advantages of a regulatory sandbox

The primary benefit of a P2P specific regulatory sandbox is that it would immediately bring P2P lending to life by extricating it from banking regulations and consumer protection laws and allowing it to thrive within a defined set of permissive rules. This would in turn send a positive innovation-friendly signal to SMEs seeking funding, FinTech entrepreneurs and investors alike.³²⁸ By simply creating a dedicated P2P lending sandbox, the industry could begin to grow.

³²⁸ Zetzsche *et al* op cit note 251 at 38.

In addition, the limited liability within the sandbox would facilitate a dialogue between the regulators and the P2P operators.³²⁹ The pace of innovation and complexity of the technology has left regulators around the world struggling to grapple with the breadth and depth of Financial Technology services.³³⁰ A P2P specific regulatory sandbox would strengthen the capacity of regulators by allowing them to learn from the P2P FinTech start-ups and develop a deep understanding of the industry.³³¹ A better understanding will allow the regulators to act before risks materialise and make informed amendments to the rules as needed.

Furthermore, the transparency and dialogue facilitated within the sandbox would also fast-track innovation by encouraging P2P operators to compete with one another.³³² Healthy market competition is essential to a well-functioning economy and a regulatory sandbox is currently the closest example of free competition in P2P activities. Across the globe, regulatory sandboxes have been seen to fuel the competition as countries compete to become the world's pre-eminent FinTech hub.³³³ On the whole, this competition will have the net effect of increased SME funding options with competitive interest rates.

The competition facilitated by regulatory sandboxes may open space for improvements in financial inclusion through innovations such as biometric IDs and artificial intelligence-driven credit scoring mechanisms.³³⁴ This is important because the success of financial inclusion largely hinges on the capacity of the financial sector to innovate. Innovation can address traditional barriers to financial inclusion such as the geographical limitations and increased costs associated with brick-and-mortar branches as well as the limitation of traditional distribution channels.³³⁵ This has been illustrated by the success of mobile money in Kenya.³³⁶ Lastly, as exemplified in the case of China, this has had the effect of incentivising traditional banks to accelerate their digital transformation to effectively compete with P2P operators.

³²⁹ Ibid.

³³⁰ Alliance for Financial Inclusion 'Creating Enabling Fintech Ecosystems: The Role of Regulators' (2020) at 9, available at https://www.afi-global.org/sites/default/files/publications/2020-01/AFI_FinTech_SR_AW_digital_0.pdf, accessed on 21 December 2021.

³³¹ Ibid.

³³² Zetzsche *et al* op cit note 251 at 38.

³³³ Ibid.

³³⁴ Alliance for Financial Inclusion op cit note 330.

³³⁵ Gomber et al 'On the Fintech Revolution: Interpreting the Forces of Innovation, Disruption, and Transformation in Financial Services' (2018) 35 *Journal of Management Information Systems* 18.

³³⁶ Didenko op cit note 105 at 352.

Although the sandbox concept itself is easy to copy, its true value lies in the substance of the sandbox.³³⁷ This is measured by the extent to which it can promote beneficial innovation based upon an in-depth knowledge exchange between innovator and regulator while addressing the issues surrounding the systemic risks posed by P2P lending.³³⁸ In this regard, the sandbox should be paired with sound minimum standards of investor protection, information disclosure and capital requirements.

6.3. Consumer Protection

For P2P lending platforms to truly become an alternative form of investment for SMEs, the platforms must be attractive for investors and borrowers alike. In the post-crisis financial supervisory climate, consumer protection and awareness are considered to be essential pillars of an efficient financial system. Accordingly, the new P2P regulatory sandbox should be built on the fundamentals of sound credit appraisal procedures coupled with a high degree of informational transparency.

6.3.1. Credit Appraisal

Once established, the P2P sandbox should establish clear rules surrounding the extent to which P2P operators must conduct due diligence of borrowers to assess their creditworthiness. To this end, concrete guidance can be sought from the UK P2P rules on a credit risk assessment which require P2P firms to consider:

- (a) *the types of information to use in the credit risk assessment;*
- (b) *the content and level of detail of the information to use;*
- (c) *whether the information in the [P2P Operator's] possession is sufficient;*
- (d) *whether and to what extent to obtain additional information from the borrower;*
- (e) *whether and to what extent to obtain information from any other sources;*
- (f) *whether and to what extent to verify the accuracy of the information that is used; and*
- (g) *the degree of evaluation and analysis of the information that is used*³³⁹

³³⁷ Zetzsche et al op cit note 251 at 39.

³³⁸ Ibid.

³³⁹ FCA. 'Loan-based ('peer-to-peer') and investment-based crowdfunding platforms: Feedback on our post implementation review and proposed changes to the regulatory framework. Policy Statement PS19/14, June 2019' (2018) at 28, available at <https://www.fca.org.uk/publication/policy/ps19-14.pdf>, accessed on 5 January 2022.

In addition, the UK P2P rules outline the factors to which the P2P platforms must have regard to when deciding which steps are needed to make the credit risk assessment a reasonable one as follows:

- (a) the type of credit;*
- (b) the amount of the credit or, where applicable, the credit limit;*
- (c) the duration (or likely duration) of the credit;*
- (d) the frequency of the repayments;*
- (e) the amount of the repayments;*
- (f) the annual percentage rate of charge; and any other costs, including any charge for non-compliance with the agreement, which will or may be payable by or on behalf of the borrower in connection with the agreement.³⁴⁰*

These comprehensive guidelines are based on the flexible principle of proportionality and reasonableness and can be easily imported into a South African P2P sandbox.

The benefits of importing these credit risk assessment provisions into the prospective P2P cannot be overstated. Detailed rules regarding credit vetting will provide adequate and appropriate consumer protection (for both the investors and the borrowers) without exposing the platforms to the entire body of consumer law. This will allow dealings to proceed with an appropriately adjusted level of risk for the participants.

6.3.2. Information Infrastructure

Lending to SMEs currently remains a risky activity due to the lack of historical financial information behind SMEs. This financial information is extremely important to investors as it provides valuable insight into a company's revenue, expenses and profitability. Investors are then able to use this information to determine the extent of their exposure and the desired interest rate. Absent this information, the P2P platform runs the risk of losing its market share if investors are not timeously and sustainably reimbursed.

The issue of resolving information asymmetry between the investors and the lenders has been handled differently by various jurisdictions. For example, German lending platforms are required to submit a prospectus that must be acknowledged and signed by the potential

³⁴⁰ Ibid.

investor.³⁴¹ A prospectus is a legal document that provides information about an investment, the risks and forecasted return on the investment under different market conditions.³⁴² Because P2P loans are smaller than larger investment funds, only a short form prospectus is required.

The advantage of a prospectus is that it helps investors to properly diversify their portfolios. However, it is a cumbersome process that requires a new prospectus to be issued for each loan. In the case of South Africa, it may not be feasible to impose a prospectus as this may negatively impact the overall cost of lending and deter potential investors.

Instead, South African P2P platforms should adopt the Mauritian approach requiring the platforms to disclose key information on their website explaining the general details on how P2P lending functions; the information on costs and charges applicable; measures adopted to prevent money laundering terrorist financing activities as well as the protection of personal data and privacy; as well as the available dispute resolution process. This information may be standardised and be brought to the lender's attention as part of the platform's terms and conditions.

When a borrower applies for a loan, the platform should provide information about the borrower's project, and the borrower's latest financial statements. Given that investors understand the risks associated with P2P lending and are drawn to the potentially high rewards flowing from such risk, it is acceptable for P2P operators to make a disclaimer absolving them from liability arising from the information.³⁴³ Similar to Mauritius, South African P2P platforms must disclose this prominently on their website. In this manner, investors will be equipped to make informed and autonomous decisions on credit products that they can understand and whose risks they can identify and assess.

Altogether, the data collected through a combination of thorough credit vetting mechanisms and information disclosure will lead to a better understanding of SME credit needs. It is trite that the majority of South African SMEs operate in the informal sector- where there is little supervisory oversight. The digitalisation underpinning P2P lending offers a better overview of SMEs. The collection of this valuable data can be used to map out SMEs accurately according

³⁴¹ Naidji op cit note 234 at 56.

³⁴² Ibid.

³⁴³ In so far as there is no evidence of fraud and misrepresentation.

to their size, geographical location and sector. Over time, the trends revealed can be further used to identify emerging markets that may have the potential to replenish the currently shrinking tax base. This may lead to further initiatives in both the public and private sectors geared toward delivering alternative funds to SMEs.

6.4. Prudential Requirements

As outlined in Chapter 3.6, liquidity and capital requirements imposed on traditional banks are used as tools to mitigate systemic risk. On the one hand, liquidity requirements serve to prevent banks from engaging in the excessive transformation of liquidity.³⁴⁴ On the other hand, capital requirements serve as a key ingredient for banking security.³⁴⁵

Having established that P2P lending does not create money in the way that banks do, the issue of liquidity is therefore not applicable. However, P2P FinTech structures carry the potential for systemic disruption in the future as they grow. As such, the inclusion of capital requirements is a significant concern that should be kept in mind when drafting rules.

In the context of P2P lending, capital requirements can serve to meet unexpected future costs or financial obligations that may occur. From an operational perspective, the capital reserves may also serve to protect the platform from cyclical risk. It is too risky to rely on ‘working capital’ sourced from the transaction fees levied on the lender and borrowers as participants. Although the P2P platform does not have the high overheads associated with traditional brick and mortar credit institutions, it must still finance the development and maintenance of its technological infrastructure. This working capital cannot be sourced from the collected transaction fees as these are effectively ring-fenced. Therefore, the capital requirement for P2P will serve to ensure that they have additional buffers for general conservation of capital and against cyclical and systemic risk.

Altogether, there is a strong case to be made that incorporating capital requirements would serve to mitigate the risks associated with digital P2P lending. This is in line with the successful implementation of capital requirements on P2P lending employed in the aforementioned jurisdictions such as the United Kingdom, China and Mauritius.

³⁴⁴ Acosta-Smith et al ‘Capital and liquidity interaction in banking’ (22 June 2020) at 2, available at <https://deliverypdf.ssrn.com/delivery.php?ID=>, accessed on 13 January 2022.

³⁴⁵ Ibid.

South African regulators are expected to determine how much capital P2P platforms require to be able to sustainably follow their business models. Most importantly, capital requirements must be proportional to the level of risk presented. The higher the risk, the higher the capital requirements. This number can be effectively determined through analysis of the current valuable credit market data collected annually by the NCR underscored with a clear understanding of the distinction between bank loans and P2P loans.

Once established, these minimum capital requirements must be binding and entail legal consequences if they are not adhered to. These consequences ought to depend on how serious the breach is according to determinations made by the FSCA.

Lastly, it is not feasible to expect P2P platforms to incorporate mandatory insurance when banks themselves do not currently operate under any explicit deposit insurance schemes. From a business cost analysis perspective, the cost of P2P lending would increase if South African platforms were required to match the security of a UK bank savings account. The lending platforms would then be forced to cap the interest rate and in doing so, investors would be unable to earn a higher return. Although seemingly counterintuitive, a degree of lack of investor protection is integral to P2P lending as it facilitates the high-interest rate potential that investors are specifically interested in.

6.5 Conclusion

Having highlighted the distinction between P2P loans and traditional bank loans, it is clear that the application of high capital and liquidity requirements is both inappropriate and overly burdensome. The benefit of a tailor-made P2P lending regulatory sandbox is that these amounts could be set in consultation with the FinTech entrepreneurs. The policymakers would then be able to update the amounts from time to time per market developments. Similarly, consumer protection provisions may be imported into the P2P lending rules on a gradual basis. The main benefit of a regulatory sandbox is that it is flexible and responsive to real-time events. Given the fast speed at which Financial Technology is continuously innovating, this approach would ensure that South Africa's P2P platforms do not fall behind global standards. Most importantly, it is an opportunity to allow free markets to prevail outside of the strict regulations within the financial services.

CHAPTER 7

CONCLUSION

Regulators across the globe have come to realise the importance of FinTech in the broader financial system. Fintech driven P2P lending, in particular, has the potential to significantly expand access to financial services available to SMEs by offering better terms at lower costs. By using technology to leapfrog geographical limitations, P2P lending fills a gap that traditional banking is not able to service due to the constraints of legacy banking software infrastructure combined with their expensive business model.

South Africa is a favourable market for P2P lending since it has a high proportion of SMEs which tend to be refused loans by the traditional banking industry. However, the highly regulated nature of the financial industry poses significant barriers to technology entrepreneurs seeking into the financial services market. The zero-threshold rule mandated by the NCR has completed arrested the development of direct P2P lending by forcing platforms to partner with a credit institution. This paper highlights the need for financial regulation that establishes a healthy balance between maintaining market stability, and consumer protection while facilitating the innovation behind P2P lending.

To support the development of an appropriate legal, regulatory and supervisory framework around P2P lending, many jurisdictions have been exploring new regulatory approaches aimed at promoting innovation and experimentation. Some jurisdictions such as China have adopted a 'Laissez-Faire' approach by first observing and monitoring the innovation trends before intervening. Ultimately, this type of deregulation has proven harmful to the participants, who are shielded by neither consumer protection law nor financial stability regulations. On the other extreme, banning P2P lending only serves to stifle innovation and deprive SMEs of potential alternative funding while exacerbating the growing tension between P2P lenders and the traditional banking industry.

Other jurisdictions such as Germany have taken a case-by-case analysis by adopting a partial exemption-based approach towards P2P lending. On the one hand, this approach is an attempt to compromise between the desire to protect the banking monopoly and the desire to foster innovation. In practice, this approach is cumbersome and opaque due to difficulties in

extricating the concurrent regulations to prevent regulatory arbitrage. Furthermore, it demands a high level of industry-specific knowledge on the part of the regulator tasked with drawing the regulatory boundary between regulated banking activity and permissible facilitated P2P loans. In this regard, it is not suitable for regulators without the requisite subject matter expertise.

Compared to the previously discussed approaches, the Regulatory Sandbox has been garnering substantial attention as a more comprehensive effort to develop regulatory systems appropriate to FinTech driven P2P lending. As highlighted, the regulatory sandbox approach is particularly advantageous because it sends an innovation-friendly market signal to technology entrepreneurs and investors alike. In addition, the structured process strengthens dialogue and interaction between the industry and the regulators while simultaneously reducing the risk of litigation for breach of a regulator's supervisory duties. Regulatory sandboxes may also encourage competition and cooperation between incumbents and challengers to the benefit of excluded and underserved customers.

Although South Africa's IFWG has signalled an approach to follow the market in adopting a regulatory sandbox, the implementation is uncoordinated and slow. By making the current regulatory sandbox broadly applicable to all forms of financial technology, it fails to adequately address the unique features of P2P lending. This overly inclusive regulatory sandbox approach has been made worse by a lack of opacity of the eligibility criteria. As highlighted, this makes it difficult for a prospective P2P platform operator to claim admission to the sandbox. Furthermore, this lack of transparency compromises the rule of law by placing regulated entities in an uncomfortable position as they do not know the conditions under which their competitors operate. More broadly, the lack of legal certainty and clarity deters potential investors who are essential for the significant software investments required by P2P platforms. This may lead to major opportunity costs for the South African economy.

The most feasible solution is to adopt a P2P lending specific regulatory sandbox as a targeted and efficient approach towards robust innovations at the edge or even outside of the existing regulatory framework. By drawing on the leading guidelines tested by the Mauritian and UK regulators, a concise set of tailored participation rules could be adopted to deal with both the lenders and the borrowers. Moreover, once the P2P platforms begin their testing, the valuable

data generated can be used to shed a light on SME business needs and their internal activities. Through this incubation model, P2P regulatory sandboxes will create a positive ripple effect that will allow the economy to pivot to support the rapid growth of SMEs fundamental to the economy's recovery.

In the search for tomorrow's Silicon Valley, South Africa shows potential to become Africa's leading FinTech Hub. It is ultimately the regulators' concerns over protecting bank monopolies which have prevented the development of P2P lending for business loans. Making use of a dedicated sandboxing regime will allow the South African government to maintain control over the development of the industry while fostering its development thus allowing it to be a new source of financing for SMEs.

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