CONSUMER'S STATUS IN CROWD AND PEER TO PEER FINANCE

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Abstract

Taking into account the decrease in nominal yields of traditional savings products, consumers are increasingly attracted to alternative ways of investing, such as those offered by crowdfunding platforms. As control over the traditional financial sector has been strengthened after the crisis, new forms of financial intermediation have emerged, such as crowdfunding or peer-to-peer loans. Simple individuals and regular institutions use these types of platforms to lend money directly to consumers or businesses in order to make a financial return from interest payments and the repayment of capital over time.

Such services are usually provided by new market operators known to intensively digitize their processes, including technology support for credit analysis and payments settlement.

From the perspective of consumer protection, these are risky tools where protection is particularly necessary. It is likely that consumers will not understand the risks involved in the transaction, especially the value of the investment, and an additional problem is the reliability of the trading platforms.

Existing EU legislation does not harmonize consumer protection standards in the crowdfunding field and leaves the full development of Member States. It is also a matter of applying a mix of regulations of public and private law to achieve the desired results. Applying the rules of private law on consumer credit by their consumers is another problem. Consumers are often unaware of the legal complications involved.

The purpose of this study is to show how, in the absence of harmonization of private-law measures for breaches of the national rules transposing the Consumer Credit Directive and due to the insufficient regulation of crowdfunding, the traditional division of public law (especially financial supervision) and private law (in particular contract law and consumer protection) at national level may create obstacles for consumers to rely on consumer protection standards in private actions against financial institutions.

Keywords: *consumer protection, peer-to-peer loan, crowdfunding, digitalization, risk*

1. Introduction

FinTech, technology-enabled innovation in financial services, has developed significantly over recent years and is impacting the way financial services are produced and delivered. FinTech does not only lead to an increasing automation of processes, but also to a fundamental reorganization of financial services with new business models (for example, peer to-peer lending and robo-advising). FinTech is set to have a profound impact on consumers in retail finance. While FinTech comes with opportunities such as increased competition and new services (e.g. peer-to-peer lending, mobile payments and peer-to-peer money transfers, telematics insurances, crowdfunding), it also poses huge challenges regarding privacy, fairness and security

After a financial crisis and credit crunch, caused, among other things, due to irresponsible lending and increased risk appetite, retail investors are lending billion of dollars over the Internet, on an unsecured basis, to total strangers. Technological and financial innovation permit now person-to-person or peer-to-peer lending ("P2PL") to connect lenders and borrowers in ways never before imagined. But, not everything is all right with peer-to-peer loans.... The emergence of peer-to-peer online is especially due to the recent global financial crisis, which has prompted banks to tighten lending rules.

Online peer-to-peer lending (P2PL) is a fast growing financial service industry that presents challenges such as rationality and compliance with consumer protection as it allows unsecured loan transactions between consumers, intermediated by online platforms.

P2PL has been praised enthusiastically as a miracle that could help fill the space left by traditional bank and non-bank lending.[1] Subsisting in the marginal lending economy for ages, in the form of credit unions, payday loans and microcredit[2] and friendly societies, P2PL has reappeared on a widespread scale thanks to the Internet.

Consumers are eager to have access to a simplified, streamlined lending process, and peer to peer companies are capitalizing on this need. Auto loans and mortgages, once the territory of "traditional lenders" are now offers on innovative peer-to-peer lending platforms.

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[1] M. Pagano, 'Peer-to-peer lending boom could make banks obsolete' *The Independent*, Monday 17 December 2012, http://www.independent.co.uk/news/business/news/peertopeer-lending-boom-could-make-banks-obsolete-8421241.html [Accessed May 10, 2014].

[2] A. Brill, "Peer-to-peer lending: innovative access to credit and the consequences of Dodd-Frank" (2010) 25 *Wash Leg Found Leg Backgrounder* 1.

Consumers who did not fit the new tighten conditions required to obtain a bank loan or a credit from non-bank entities, now have an alternative way of doing so. Internet technology has transformed the lending market in different aspects, creating various modalities and facilitated the ease of contact between lenders and borrowers. The P2P platforms allow the conclusion of a lending contract by clicking on an option on a screen. However, the internet has also led to the rise of concerns regarding the need to protect consumers in the online environment from the perils such as pyramid schemes[3]unlicensed and shadowy lending[4] and abusive practices.

In United Kingdom, the Financial Conduct Authority set out new rules for this crowdfunding activity, in March 2014[5]. It is, for example arguable that the FCA's classification of P2P lenders as retail investors[6] shows failure of anticipation that P2PL can involve consumers- lenders and borrowers- on both sides of a loan transaction. P2PL open debates about the definition of a "consumer of financial services" by modifying the features of key participants in a lending transaction.

The issue of online peer-to-peer lending appears to contest fundamental presumptions, settings and purposes of consumer protection law and policy of the EU and everywhere.

In this article the aim is to show the suitability and propriety of a more interventionist consumer protection approach, after assessing the consumer protection justifications for regulating peer-to-peer lending. I stress out that regulation ought identify and admit the consumer-to-consumer transaction possibility in peer-to-peer lending and as a result to consider the need to protect two very different types of consumers: lenders, which, as these platforms become more popular will increasingly involve more inexperienced and unsophisticated investors and borrowers, generally associated with consumers category.

2. Crowdfunding regulation at EU level for peer-to-peer lending

Across European Union, national regulatory frameworks for P2P lending are not yet (definitively) established and are very different from each other and most EU regulatory measures provide a framework for either peer-to-peer business lending or peer-to-peer consumer lending. The current regulatory system in European Union is a weak struggle for the needs of consumers and the platforms that connect them. Peer-to-peer lending platforms are no credit institutions under Article 4(1) (1) of the Regulation (EU) No 575/2013 on prudential requirements for credit institutions and investment firms.

Crowdfunding is considered an emerging alternative funding method at the level of EU institutions, especially in the immediate post-crisis economic context, characterized by the decline in bank lending and difficult access to finance. To this end, the European Commission explores the potential and the risks of this new and growing form of funding, as well as the existing national legislative framework at Member State level.

The recent European Commission Proposal on European Crowdfunding Service Providers for Business (March 2018)[7] establishes an (optional) legal framework for investment- and lending-based crowdfunding platforms that enables platforms to easily provide their services across the EU Single Market and aim to approach crowdfunding risks in a in a balanced way. Investors will be protected by clear rules on information disclosures, risk management, with coherent approach to supervision, not to forget the rules on governance.

Although the legal framework set out in the proposal is considerably innovation-oriented, the question arises whether the European Commission could not go (much) further in its innovation-oriented approach by relying on block chain technology to address some or several risks of peer-to-peer lending, of course without undermining consumer protection. *Consumer lending falls outside the scope of the proposal. These aspects are covered by other EU legislation such as the Consumer Credit Directive (CCD) and the Mortgage Credit Directive (MCD).* EU regulatory measures are preponderantly addressing peer-to-peer lending risks. In this regard, the proposal refers to the (partial) application of existing EU consumer protection legislations. More specifically, (i) when a consumer is receiving a loan for personal consumption and operating outside his professional capacity, P2P lending falls within the remit of the Consumer Credit Directive and (ii) when a consumer is receiving a loan to purchase an immovable property, P2P lending falls within the remit of the Mortgage Credit Directive. Therefore, regarding P2P consumer lending, we discuss the relevant regulatory measures laid down in EU consumer protection legislations with a focus on the CCD. Note that when P2P lending platforms offer both business lending services and consumer lending services, it is very likely that they need to comply with the strictest regulatory measures applicable. Additionally, the proposal is characterized by extensively elaborated measures to prevent conflicts of interest (Article 7) and money laundering (Article 9, 10 and 13). Especially the initial evaluation of

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[3] See, for example, *4finance UAB v Valstybinė vartotojų teisių apsaugos tarnyba and another* (Case C-515/12) [2014] Bus LR 574.

[4] R. Mayer, "When and why usury should be prohibited" (2013) 116 *Journal of Business Ethics* 513 at 524.

[5] Policy statement 14/4, The FCA's regulatory approach to crowdfunding over the internet, and the promotion of no readily realisable securities by other media, March 2014: http://www.fca.org.uk/static/documents/policystatements/ps14-04.pdf

[6] Financial Conduct Authority, (Policy Statement, PS14/4) at 16, 31. Contrast Financial Services Authority, "The Financial Conduct Authority: approach to regulation" (June 2011) at 16.

[7] https://ec.europa.eu/info/publications/180308-proposal-crowdfunding_en

suitability of a potential client and the possibility to simulate their capacity to support losses are worth mentioning (Article 15).

In particular, there is the dual aspects of the status of peer-to-peer lenders (as investor and consumer) and the suitable degree of protection that should be accord to them.

In the EC's proposal for a regulation of the European Parliament and of the council on European Crowdfunding Service Providers (ECSP) for Business, Brussels, 8.3.2018 COM (2018) 113 final 2018/0048 (COD). Article 3(1)(a): '*crowdfunding service'* means the matching of business funding interest of investors and project owners through the use of a crowdfunding platform and which consist of any of the following: the facilitation of granting of loans […]. Article 3(1) (g): '*investor*' means any person that, through a crowdfunding platform, grants loans or acquires transferable securities. The EU consumer law and policy, as paradigm, defines a consumer *as a natural person acting for purposes outside of his or her normal business, trade or profession.*

Though, nothing suggests that users of peer-to-peer platforms are not simply individuals acting outside their *business, trade or profession*. Lenders on peer-to-peer platforms are often described as investors rather than consumers because they lend money directly to borrowers. Categorization as investor rather than consumer is worthy of attention and with important consequences because investor protection is totally different from consumer protection. Investor protection regulation often suppose mastery and a level of competence and are therefore less likely to be interventionist than ordinary consumer protection regulations.

For instance, in United States, Supreme Court in Securities & Exchange Commission v. Howey Co., 328 U.S. 293 (1946), establishes the *test* of whether *there* is an "*investment contract*": An investment contract exists if there is "an investment of money in a common enterprise with profits to come solely from the efforts of others. „This three-part test, thus, requires: (1) investment of money with the expectation of profits, (2) commonality, and (3) the entrepreneurial efforts of others[8]. Consequently, this, appears to defy the business-consumer antithesis and also reignites topical consumer lending issues such as fairness of commercial practices and responsible lending[9]. Typical investor protection rules including the segregation of client and financial intermediary's accounts[10] may be irrelevant in consumer protection[11]. Different types of consumer are provided with different levels of consumer protection and different regulated activities are subject to varying levels of intervention depending on what category a consumer of that service falls into. This differential approach is, however, problematic for peer-to-peer lending which involves two consumers with similar levels of knowledge and experience who may find themselves subject to different levels of protection simply because of their participation as lender and borrower. It is noticeable that experience is a key element in whether consumer protection measures apply to particular individuals.[12]

3. What are the key-points for peer-to-peer lending?

The European Commission's Proposal on European Crowdfunding Service Providers for Business provides a fairly comprehensive framework for peer-to-peer risks. There are provisions regarding the extensive disclosure standards and warnings related to credit risk for investors and the extensive regulatory measures for money laundering and conflict of interest. On the other hand, peer-to-peer consumer lending has a considerably less extensive regulatory framework. The application of the Consumer Credit Directive (CCD) on peer-to-per lending platforms is highly limited and is not certain the application of MiFID II[13] on peer-to-peer lending, which would be relevant for credit risk and conflict of interest. There are not specific regulatory measures which address operational risk in peer to peer consumer lending or norms addressing money laundering.

3.1. Regarding the peer-to-peer lending risks

In order to subsequently evaluate which types of regulatory measures can be eliminated or reduced by block chain technology, when we approach consumer lending Article 85 of the CRD IV could inspire for regulatory measures addressing operational risk in P2P (consumer) lending.288 Article 85 stipulates: "1. Competent authorities shall ensure that institutions implement policies and processes to evaluate and manage the exposure to operational risk, including model risk, and to cover low frequency high-severity events. Institutions shall articulate what constitutes operational risk for the purposes of those policies and procedures. 2. Competent authorities shall ensure that contingency and business continuity plans are in place to ensure an institution's ability to operate on an

[8] https://supreme.justia.com/cases/federal/us/328/293/

[9] S. Brown, "Using the law as a usury law: definitions of usury and recent developments in the regulation of unfair charges in consumer credit transactions" (2011) 1 *Journal of Business Law* 91.

[10] Staikouras, "A novel reasoning of the UK Supreme Court decision in Lehman Brothers: the MiFID segregation rule from the angle of financial intermediation and regulation theory" (2014) 2 *Journal of Business Law* 97.

[11] Financial Services Act 2012 ss.1C(2)(a) and (b); Joint Committee on the draft Financial Services Bill, Session 2010-12 at [108].

[12] *Maple Leaf v Rouvroy* [2009] EWHC 257, [2009] 2 All ER (Comm) 287; *Patel v Patel* [2009] 3264 (QB), [2010] 1 All ER (Comm) 864; *Rahman v HSBC Bank plc* [2012] EWHC 11 (Ch).

[13] Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU

ongoing basis and limit losses in the event of severe business disruption.”

3.2. Creditworthiness assessments of peer-to-peer lending borrowers/consumers.

Creditworthiness is what creditors look at before they grant any new credit. Creditworthiness assessments aim at protecting lenders when making an investment decision and borrower when concluding a peer-to-peer loan agreement.

Article 8 of the Consumer Credit Directive states the obligation on the creditor to assess the creditworthiness of consumers on the basis of sufficient information, where appropriate obtained from the consumer and, where necessary, on the basis of a consultation of the relevant database. This obligation is imposed on the creditor, i.e. the P2P lender, without expanding this obligation to credit intermediaries.

The Proposal on European Crowdfunding Service Providers for Business does not present any disposition regarding creditworthiness assessments of borrowers at all.

Considering the insufficient pre-contractual information standards requirements in peer-to-peer, it is controversial that there are no regulatory measures that impose to this lending platforms to conduct qualitative creditworthiness assessments of borrowers.

3.3. Disclosure standards for peer-to-peer consumer lending

If we consider the important asymmetric information aspects in peer-to-peer lending, disclosure standards regarding the peer-to-peer lending risks creditworthiness of borrowers are crucial to reduce credit risk for platform lenders, Article 16 of the proposal approaches “Key investment information sheet”, requires peer-to-peer lending platforms to provide (potential) investors-lenders with a clear, comprehensible and correct key investment information sheet with the aim of this key investment information sheet to warn intending peer-to-peer lenders that the investing environment they have entered into imply risks covered neither by the deposit compensation scheme nor by investor compensation guarantees. The key investment information sheet contains the following explanatory statement, appearing directly underneath the title of the key investment information sheet: *“This crowdfunding offer has been neither verified nor approved by ESMA or national competent authorities. The appropriateness of your education and knowledge have not been assessed before you were granted access to this investment. By making this investment, you assume full risk of taking this investment, including the risk of partial or entire loss of the money Second, the key investment information sheet contains the following risk warning: “Investment in this crowdfunding offer entails risks, including the risk of partial or entire loss of the money invested. Your investment is not covered by the deposit guarantee and investor compensation schemes established in accordance with Directive 2014/49/EU of the European Parliament and of the Council and Directive 97/9/EC of the European Parliament and of the Council. You may not receive any return on your investment. This is not a saving product and you should not invest more than 10% of your net wealth in crowdfunding projects. You may not be able to sell the investment instruments when you wish.”*

As previously stated, consumer lending falls outside the scope of the Proposal on European Crowdfunding Service Providers for Business. The Consumer Credit Directive applies to credit agreements between a creditor and a consumer. In this regard, in (Article 3(b)), ‘credit agreement’ means “an agreement whereby a creditor grants or promises to grant to a consumer credit in the form of a deferred payment, loan or other similar financial accommodation […]”. The concept of ‘creditor’ is problematic. ‘Creditor’ means a natural or legal person who grants or promises to grant credit in the course of his trade, business or profession. (Article 3(c)). Consequently, consumers cannot be considered as ‘creditor’ in the view of the Consumer Credit Directive, as they do not grant or promise to grant credit *in the course of [their] trade, business or profession*. The definition of ‘creditor’ leads to a few considerations: Consumer Credit Directive is only applicable to business to consumers lending (and it’s not applicable to consumer to consumer lending). Supplementary, peer-to-peer lending platforms are no ‘creditor’ as they do not give nor promise to give credit. Therefore, peer-to-peer lending platforms do not fall within the principal scope of application of the Consumer Credit Directive.

But, Consumer Credit Directive regulates certain duties of credit intermediaries in relation to consumers[14]. It is highly probable that peer-to-peer lending platforms qualify as ‘credit intermediary’ in the meaning of the CCD. The Consumer Credit Directive stipulate “only certain obligations of credit intermediaries in relation to consumers” with the scope to protecting borrowers. Considering peer-to-peer lending platforms as ‘credit intermediary’ this imply the pre contractual information duties. Pre-contractual information relevant for addressing credit risk includes: the type of credit; the total amount of credit and the conditions governing the drawdown; the duration of the credit agreement; the borrowing rate, the conditions governing the application of the borrowing rate; the annual percentage rate of charge and the total amount payable by the consume; the amount, number and frequency of payments to be made by the consumer the interest rate applicable in the case of late payments and

[14] Credit intermediary’ is defined as “a natural or legal person who is not acting as a creditor and who, in the course of his trade, business or profession, for a fee […]: (i) presents or offers credit agreements to consumers; (ii) assists consumers by undertaking preparatory work in respect of credit agreements other than as referred to in (i); or (iii) concludes credit agreements with consumers on behalf of the creditor” (Article 3(f)).CCD

the arrangements for its adjustment, a warning regarding the consequences of missing payments; where applicable, the sureties required; the existence or absence of a right of withdrawal; (p) the right of early repayment, and, where applicable, information concerning the creditor's right to compensation and the way in which that compensation will be determined.

If peer-to-peer lending platforms are considered as ‘credit intermediary’, this means that the lending platforms have a duty to assist the consumer in deciding which credit agreement, within the range of products proposed, is the most appropriate for his needs and financial situation Member states shall ensure that credit intermediaries provide adequate explanations to the consumer, in order to place the consumer in a position enabling him to assess whether the proposed credit agreement is adapted to his needs and to his financial situation, where appropriate by explaining the pre-contractual information to be provided , the essential characteristics of the products proposed and the specific effects they may have on the consumer, including the consequences of default in payment by the consumer[15].

4. Romania’s specificities

In Romania, the lending activity is carried out professionally through credit institutions and financial institutions provided by OUG 99/2006 on credit institutions and capital adequacy as well as by non-banking financial institutions under the conditions established by Law 93/2009 on non-banking financial institutions. The prohibitions in these normative acts concern only the carrying out of the professional activity, without restricting the commercial and civil lending operations that are not circumscribed to this character.

Limits of legal lending in civil relations. In Romania, Law no. 216/2011 on the prohibition of usury activity regulates the issue of “usury”, and the usurer appears as the only natural person (unprofessional) who carries out a professional loan with interest, although not authorized (according to Law 93/2009 or GEO 99/ 2009, only legal persons may be authorized to do so). Therefore, usury implies a “business” of giving money with interest, a violation of the banking monopoly and “non-banking financial” in the matter.

It does not import the amount of the interest (it is however limited to the legal interest rate plus 50%, and in case of exceeding this threshold the interest null and void), but only the use of the loan activity as “business”, i.e. as a constant source of income and repetitive character. In the initial draft law, the interest rate was an essential element, but the determination of the “excessive” nature was not defined by law. This approach was not, however, agreed by the Legislative Council, which suggested a similar form of the offense already contained in the New Criminal Code.

Therefore, the usury appears to be only the individual (non-professional) who carries out a professional loan with interest, although not authorized (according to Law 93/2009 or GEO 99/2009, only legal persons may be authorized to do so) . Therefore, usury implies a “business” of giving money with interest, a violation of the banking and “non-banking financial institutions” monopoly field. The interest rate is not imported (it is however limited to the statutory interest rate plus 50%, and in case of overrun, this interest rate is canceled altogether), but only the use of the borrowing activity in a use of the loan activity in a “business” as a source of income and with a repetitiveness character.

From Law no. 216/2011 prohibiting usury, it should not be understood that any interest-bearing loan will be banned. In order to constitute an offense, it is necessary to prove the practice of interest-bearing loan “as a job”. Loans between unauthorized individuals or between commercial companies and individuals or other legal entities will still remain legal, but within certain limits, subject to the conditions imposed by law. Government Ordinance no. 9/2000 on the legal interest for pecuniary obligations established limits that should have interest in non banking loans to comply with the law. The interest collected or paid by the National Bank of Romania, banks, credit union organizations and the Ministry of Public Finance, as well as the method of their calculation, are established by other specific regulations. The prohibition to set a higher interest rate than the one stipulated in Government Ordinance no. 9/2000 refers only to civil relations.

An additional argument for the validity of the borrowing operation and the charging of interest is represented by the provisions of art. 23 par. 5 of the Fiscal Code which states as the source of the loan and other entities than the credit institutions or the non-banking financial institutions, where the deductible interest rate is limited to the reference interest rate of the NBR for the loans in lei. Therefore, operations are possible, irrespective of the quality of the lender's physical or legal person.

In civil relations interest can not exceed legal interest rate by more than 50% per year. Legal interest in civil matters (i.e. loans not commercially traded) is set at the reference rate of the National Bank of Romania, down 20%.The reference interest rate of the National Bank of Romania is published monthly in the Official Gazette of Romania, Part I, through the care of the National Bank of Romania. In civil relations, the obligation to pay interest higher than the statutory interest plus 50% per annum is null and void. However, the usurers know this, and there are no high interest rates in contracts, but they go from the start to a higher amount than the one borrowed, to which the legal interest is applied.

Finding justification in the new social reality, the new Romanian Criminal Code criminalizes the

[15] https://eur-lex.europa.eu/legal-content/EN/ALL/?uri=CELEX:62013CJ0449

patrimonial exploitation of a vulnerable person in art. 247[16]. Two variants of the offence are brought under regulation: a basic and an aggravated one. The Lawmaker provides the specific conditions for the existence of each of the variants of the offence. If the basic form of the offence requires that the passive subject should be in a visibly vulnerable situation before the offence takes place, in the case of the aggravated variant, the state of vulnerability does not exist before the offence, but is caused by the active subject.

5. Conclusions

FinTech innovations such as the peer-to-peer lending platforms can be game changers for financial services and beyond. We need to create the framework for innovation to flourish, while managing risks and protecting consumers. There is a need for regulation and reform of legislation to better accommodate consumer needs and to protect their rights in peer-to-peer lending.

To preserve peer-to-peer lending, appropriate legal treatment must sustain and discipline this nascent market. Peer-to-peer loans are disintermediated financial transactions on a small scale — but with grand ambitions. The regulation should target at least four key areas of reform: disclosure, oversight and enforcement, prudential regulation, and borrowers. At the same time, in order to operate properly, crowdfunding needs to have an institution / supervisory authority with attributions in the field. If properly designed, this grand experiment may provide a transparent, consumer-benefiting product where opaque, costly products now dominate.

European Union and Member State's regulators should place strong emphasis on consumer protections in financial market, including the FinTech. The Financial Conduct Authority (FCA) in the United Kingdom issued its regulatory approach to crowdfunding over the internet in 2014. Also, it is not surprising to see that the European Commission to take a more active role in oversight and regulation of peer-to-peer lenders as they expand their product offerings and increase customer base.

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[16] Article 247 Patrimonial exploitation of a vulnerable person, New Penal Code
(1) The act creditor who, while putting borrow money or goods, taking advantage of the state particularly vulnerable debtor, due to age, health, infirmity or relationship of dependency in which the debtor is to him, makes him constitute or convey for himself or for another, a real right or claim value manifestly disproportionate to the benefit shall be punished with imprisonment from one to five years. (2) Putting a person in a state of obvious vulnerability by causing poisoning with alcohol or psychoactive substances in order to persuade it to agree to the creation or transmission of a real right or claim or waive a right, if there was a loss shall be punished with imprisonment for 2-7 years.