Mitigation of Default Risk through Insurance in Peer-to-Peer Lending Financial Technology

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Abstract. Mitigation of default risk through insurance is a solution to the high default rate. The non-collateral loan system in the Peer-to-Peer Lending (P2PL) is the reason for the high popularity of this service. Nevertheless, some legal problems result from the absence of collaterals from the borrower and P2PL provider in the event of default because no one guarantees the lender's rights. A borrower can run because the P2PL provider does not require the lender and borrower to meet face to face. In addition, a lender also has to spend much money collecting the borrower's debt. This problem weakens the lender's interest in investing, thus hindering credit accessibility in society. This study applied a normative legal research method using a conceptual approach. This study concludes that default risk mitigation has not explicitly been regulated in the positive Indonesian law, thus creating legal problems related to legal certainty and legal protection, especially for lenders investing their funds in P2PL services. The implementation of default risk mitigation through an insurance mechanism in providing P2PL service is the best scheme to provide legal protection for lenders in investing their funds which have implications for increasing public confidence in improving capital needs in Indonesia.

Keywords: Insurance, Default, Risk Mitigation, Peer-to-Peer Lending

1 Introduction

The presence of Financial Technology (Fintech) is the result of technological advancement that offers convenience in the loan system compared to banks. Although Fintech does not have access to finance, it is suitable for the market in Indonesia due to the significant internet penetration rates in Indonesia [1]. Based on the 2019-2020 Indonesian Internet User survey, internet users' penetration rate is 73.7%. When combined with the projected figures of the Central Bureau of Statistics, the number of internet users in Indonesia is approximately 196.7 million users [2]. In Indonesia, Fintech users are dominated by millennial generations accustomed to online shopping through social media and e-commerce platforms whose payment systems use electronic payment instruments [3]. The Fintech product of great interest to borrowers is Peer-to-Peer Lending (P2PL), with a non-collateral loan system. The P2PL loan mechanism is more accessible with various schemes in its principal balances, interest rates, and payment periods [4].

P2PL is a marketplace that brings together lenders and borrowers through an electronic system using the internet network. P2PL is defined as a financial exchange between individuals without involving traditional financial intermediation institutions [5]. Just as a coin has two sides, so does P2PL service. Despite its advantages, P2PL also contains a risk for lenders.

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Nevertheless, lenders often ignore such a risk because P2PL providers set high interest rates, much higher than bank interest rates. The most considerable risk in a non-collateral loan system is the possibility of default and borrower run. Article 43 letter c of Financial Services Authority Regulation (FSAR) Number 77/POJK.01/2016 is the basis for some P2PL providers to have no obligation to return the lenders' funds.

Based on the Financial Services Authority (FSA) data in January 2021, the number of Fintech providers with official licenses is 149 companies. The Non-Performing Loan (NPL) rate above 90 days is at the level of 7.58% as of October 2020 [6]. This figure tends to be higher than the target of NPL on P2PL Fintech, which FSA has set to be below 1%. The risk figure of increasing NPL can weaken the guarantee of legal certainty and protection, especially for borrowers. This urges the FSA to immediately form a special regulation that governs risk mitigation for the implementation of P2PL. The increasing number of NPL on P2PL services, together with the development of P2PL companies, impacts the more complicated situation of online lending. Therefore, a person needs to understand the existing provisions before deciding to become a P2PL service user.

Article 21 of FSA Regulation Number 77/POJK.01/2016 emphasizes that both the Provider and User must mitigate risks from providing funds. Unfortunately, a risk mitigation model has not been expressly regulated by the FSA. Risk mitigation is all risks contained in the P2PL service, i.e., operational risk and credit risk. One of the efforts to mitigate the risk of default is through an insurance mechanism based on Law Number 40 of 2014. Insurance is an agreement in which the guarantor promises to the guaranteed party to receive an amount of premium as compensation for losses that the guaranteed party may suffer due to an unclear event. In terms of risk transfer needs, the insurance company functions as a guarantor for the risk of default to create a balance between P2PL Users and P2PL operators' interests.

Increasing capital in the community must be supported by protection for lenders in investing their funds in P2PL services. A strong collaboration involving the P2PL fintech industry, the credit insurance industry, and the government as policyholders is urgent to create a responsible digital financial ecosystem and support national economic recovery. Insurance is an important issue in the protection of users of P2PL services. The implementation of insurance as a model for mitigating the risk of default on P2PL has become necessary to realize protection for lenders in investing their funds in P2PL services.

Based on the rationale elaborated above, the problem of this study is elaborated into the following questions: (i) How is default risk mitigation regulated in the positive law in Indonesia? and (ii) How is insurance implemented as a model of default risk mitigation in P2PL services?

2 Research Method

This study used the normative legal research method by reviewing the material law containing normative legal rules [7]. The approach was carried out by examining various relevant laws and regulations and documents that can help solve the problem addressed in this study and explore how positive law in Indonesia regulates the problem. The research used a conceptual approach. The data sources were primary, secondary, and tertiary legal materials consisting of laws, regulations, views, and related doctrines.

3 Results and Discussion

3.1 Mitigation of Default Risk at P2PL in the Positive Law in Indonesia

The discourse of globalization has awakened the spirit of old debate where laws were transplanted from one place to another [8]. The legal systems that exist in the world can be classified into three generally recognized legal families that include civil law, common law, and socialist law [9]. Early P2PL services developed in countries that adopted a common law system. Singapore is a country that has chosen to accept the existence of Fintech even though a legal system regulating it is not yet stipulated. Unlike in Singapore, the emergence of Fintech in Indonesia leads to a shift in financial services that can present opportunities for financial inclusion.

In Indonesia's positive legal system, a loan agreement with an interest is based on an agreed provision between a lender and a borrower. This type of agreement is recognized or permitted in the customary and civil law systems. The amount of interest agreed is not stated, but it is said that the law does not prohibit it. An interest rate of 10% is not a crime, but it is called the abuse of circumstances in civil law. The lender applies a high interest to take advantage of the borrower condition who urgently needs money. The borrower is forced to agree to the interest set by the lender [10]. An easy process offered by P2PL includes a fast loan disbursement process. It only takes one day or even a few hours. The repayment time is usually very short and without collateral [11].

The implementation of P2PL activities involves several parties: P2PL provider, lender, and borrower. Article 18 of FSA Regulation Number 77/POJK.01/2016 states there are two agreements: an agreement between the provider and the lender and an agreement between the lender and the borrower. Meanwhile, an agreement between the P2PL provider and the borrower is not included in this rule. An agreement is an important instrument that frames the legal relationship of P2PL providers, lenders, and borrowers, and that secures transactions. The provider has a significant role in assessing the borrower‘s feasibility. In its practice, lenders provide loans to borrowers based on the P2PL provider‘s feasibility assessment results. Consequently, fintech companies must apply the precautionary principle in doing borrower assessments to reduce the risk of default.

The legal relationship of Service Providers, Lenders, and Borrowers will certainly create credit risk. The most considerable risk in P2PL services is generally a default. Therefore, a risk mitigation model is needed to prevent the risk of default in order to protect lenders‘ funds. Risk mitigation in P2PL requires identifying, measuring, monitoring, and controlling credit risks and operational risks that arise to mitigate such risks [12]. From a macro point of view, the big opportunity to enter the P2PL industry at a certain level can create uncontrollable macro risks. Meanwhile, from a micro point of view, most P2PL platform businesses are still in the growing stage [13].

Risk mitigation is an effort to prevent the emergence of various risks in the implementation of P2PL services. The risk studied in this research is the risk of default. FSA efforts in risk mitigation in P2PL services are outlined in the regulation of FSA Number 77/POJK.01/2016 as follows:

a. Providers are required to apply for registration and licensing to FSA so that the FSA can supervise the activities of implementing the P2PL (Article 7);
b. Providers are required to prepare and submit a report to the FSA every three months (Article 9);

c. Providers and Users are obliged to mitigate risks (Article 21);
d. P2PL providers become members of the Financial Information Service System (FISS) of the FSA to support the implementation of supervisory duties and information services in the financial sector (Article 22);
e. Providers cooperate and exchange data with information technology-based support service providers in order to improve the quality of P2PL (Article 23);
f. Providers are required to use an escrow account and virtual account (Article 24). An escrow account is a checking account at a bank in the Provider's name, which is a deposit and is used to receive and disburse funds from and to users of the P2PL service. Meanwhile, a virtual account is a banking service in identifying numbers of service providers (end users) to identify receipts and disbursements of funds from and/or to an account. Providers are required to set up a virtual account for each lender.

Risk mitigation management is also outlined in the regulation of FSA Number 13/POJK.02/2018. The P2PL service is a form of Digital Financial Innovation (DFI) growing rapidly in Indonesia. FSA realizes that the development of DFI causes risks that threaten the community. These risks may include business risks, legal risks, and information technology risks [14]. The escrow account and virtual account management show that, in performing DFI, each provider must pay attention to the aspects of user protection, mainly by applying the principles of risk management and prudence.

P2PL industry players have a Fintech Data Center (FDC) managed by AFPI which contains a track record of borrower transactions on all legal platforms. The function of the FDC has similarities with the Financial Information Service System. The P2PL platform is required to make a feasibility analysis of prospective loan recipients as a form of risk control. Although the role of regulators and the P2PL platform is very large in risk mitigation, lenders must choose a platform with a good reputation including having SNI ISO 27001 certification on information security management systems [15].

The absence of specific regulation governing obligation and risk mitigation model of default has led to some legal issues related to legal certainty and legal protection for users of P2PL services. In the context of default that impacts terrible credit, lenders are the most disadvantaged parties. Therefore, the legal protection of investor-owned funds is a crucial issue in implementing P2PL.

3.2 Implementing Insurance as a Risk Mitigation of Default in P2PL

A legal relationship does not always run perfectly or without any problems or disputes, including the non-collateral loan in P2PL service, which has placed lenders as concurrent creditors. In this system, in the event of default, repayment is not prioritized. This system does not provide proper protection to lenders; besides, it may cause borrowers to run easily because the parties have never met each other [16].

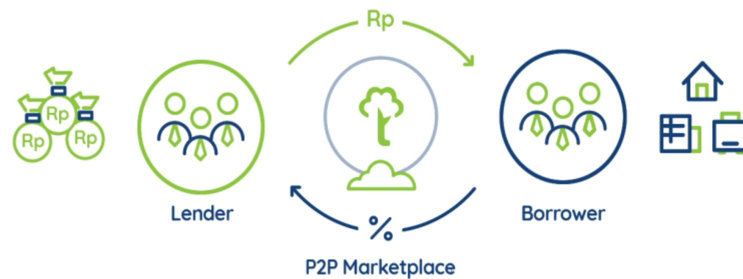

Fig. 1. P2PL Workflow [17].

OJK has recorded a decrease in loan repayments as of August 2020 which reached 91.12%. However, in January 2021, the value of bad debt borrowers decreased even though the number of accounts increased. Non-current individual borrowers reached 188,928 people (Rp. 285.28 billion), while business entity borrowers were 494 entities (Rp. 39.01 billion). AFPI revealed that this new normal era brought P2P lending fintech players even more stringently in approving loan applications [18].

Insurance basically arises because of the human need for uncertain events. Thus, insurance has a function as a risk transfer and sharing. Credit insurance is a solution for borrowers who need loans for their business capital but do not have goods or objects that can be used as collateral. In the insurance agreement, the insurance company acts as the insurer for the risk and the insured party is willing to pay fees in the form of a premium to the insurer. The extent to which the insurance company bears the risk should be clearly stated to make claim submission easier.

To realize the application of credit insurance in P2PL Fintech, FSA as an institution that functions to implement a regulatory and supervisory system for all activities in the financial services sector establishes a regulation that requires P2PL fintech companies to cooperate with insurance companies. Therefore, legal protection for lenders against the risk of default in P2PL services is getting even better [19]. In order to achieve convenience and smoothness in credit accessibility in the community, protection must be provided for lenders in investing their funds in P2PL services. The transfer of default risk from borrowers to insurance companies is an effort to protect lenders from increasing their capital accessibility.

In credit insurance, there are three forms of loan repayment: (i) payment of the remaining loan without arrears and interest; (ii) payment of the remaining loan plus arrears and interest for a maximum of 3 months; and (iii) payment as much as the initial loan. The form of loan repayment depends on the agreement of the parties in the insurance agreement. Non-collateral credit schemes can be trusted by borrowers when supported by an insurance company to guarantee the lenders for secured debt. Although the role of regulators and the P2PL platform providers is huge in risk mitigation, Lenders can choose the most reputable platform. Insurance is one of the risk mitigation efforts in P2P Lending. Dominant legal P2P lending players have collaborated with insurance companies [20].

Table 1. Implementation of default risk mitigation through insurance mechanisms

No.	P2PL providers	Default risk mitigation through insurance
1	Amartha [21]	1. Amartha cooperates with PT JamKrindo. 2. The amount covered in the event of default is 75% of the remaining principal. Default takes place when the borrower's

		installment is not paid for four consecutive installments. With the guarantee of funding insurance coverage, the claim will run on the 5th week or one week after the failure of 4 consecutive installment payments. 3. The funding guarantee program is not mandatory for the user. 4. Funding insurance will pay a claim of 75% of the remaining principal with an estimated time of 6 weeks to 12 weeks after the claim is submitted. 5. The Non-Performing Loan (NPL) rate as of April 2021 is 5.56%.
2	KoinWorks [22]	1. KoinWorks cooperates with PT Mitra Ibisnis Terapan, PT Fuse Nano Tekno, and PT Futura Finansial Prosperindo to provide credit insurance for specific borrowers at KoinWorks. If the borrower experiences default, the claim for credit insurance will be disbursed by the insurer, where the claim provides coverage for the principal amount of the borrower's initial debt. 2. The NPL rate as of March 2021 is 1.36%. 3. The amount covered in the event of default is 20% -100% of the remaining principal.
3	Investree [23]	1. Investree cooperates with PT Asuransi Simas Insurtec; 2. The amount covered in the event of default is 90% of the principal, excluding interest and late fees. 3. The claim period is 91 days (according to the calendar) after the loan due date. 4. Investree pays the premium, so Investree is also a policyholder. 5. The NPL rate as of April 2021 is 2.26%.

Table 1 above describes the amount to be covered in the event of default is 75% of the remaining principal of the loan. The insurance company will pay the lender within six weeks of being declared a default. The amount is adjusted to the risk borne by the lender where the borrower gets a loan in a short time and without including collateral. P2PL funds managed by Fintech are derived from investors, both individuals and companies [24].

In principle, each P2PL provider defines its internal policies to mitigate the risk of default. The use of credit insurance in the P2PL fintech service does not necessarily affect the level of non-performing financing or NPF when a default occurs, but it can protect lenders' funds. The basic principle in protecting P2PL service users is that the provider must carry out such basic principles as transparency, fair treatment, reliability, data confidentiality and security, and fast, simple, and affordable resolution of users' disputes. However, the transfer of risk through insurance is one of the best risk mitigations for the possibility of default of the borrowers due to unexpected events.

4 Conclusion

Positive legal arrangements regarding risk mitigation in the implementation of P2PL still exist in several regulations. These regulations include (i) Financial Services Authority Regulation Number 77/POJK.01/2016 concerning Information Technology-Based Borrowing and Lending Services; (ii) Financial Services Authority Regulation Number 18/POJK.03/2017 concerning Reporting and Requests for Debtor Information through Financial Information Service System; and (iii) Financial Services Authority Regulation Number 13/POJK.02/2018 concerning Digital Financial Innovation in Financial Services Sector. The absence of specific regulations regarding credit risk mitigation can result in weak legal certainty and legal protection for P2PL users.

Indonesia has a great potential to become a market in developing P2PL services due to the high public interest. Therefore, if the risk of default can be reduced, the P2PL service has the potential to continue providing benefits for its users. In principle, each P2PL provider defines its internal policies to mitigate the risk of default. Implementing default risk mitigation through an insurance mechanism in providing P2PL service is a mitigation model that can provide legal protection and certainty for lenders in investing their funds.

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