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**Research Report**

## Surveillance of peer to peer payment systems and peer to peer lending platforms

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Policy Letter No. 18

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## Surveillance of peer to peer payment systems and peer to peer lending platforms

*Ester Faia*

In recent times we are witnessing historical changes in financial regulatory frameworks. On both sides of the Atlantic supervisory authorities are refining and strengthening rules for banks' capital and liquidity requirements, consumers' protection, etc. All this was enacted to reduce systemic risks, as generated by past financial innovation and intermediaries' business models.

However, financial innovation is, as usual, faster than regulation and new forms of speculation and intermediation are rapidly emerging. Largely as a result of the evaporation of trust in financial intermediation, an exponentially increasing role is being played by the so-called peer to peer intermediation. There are two prominent examples:

The first is Bitcoin, a peer to peer payment system and electronic currency, introduced in 2009. The control of money creation for this electronic currency is guaranteed by the use of cryptography rather than by a central bank and participants into the network settle payments charging small transaction fees or exchanging Bitcoins. The currency can be used for both speculation as well as for transactional purposes. The advantage of using this currency is primarily that of small transaction fees. The survival of the currency is dependent on the expectations of participants in the network about the future value assigned to it. Excessive money creation is not a risk, as it is controlled by the cryptographic technology. The price of the currency is highly volatile, however, due to the lack of central bank control which would guarantee higher stability of value and due to the primarily speculative nature of the transactions. Transparency is very limited, as it is difficult for each trader to assess, how trustworthy the trading partners of his own counterpart are. Needless to say, lack of transparency can also foster the use of this currency for criminal activities. All these peculiarities seem to suggest that this type of payment system can be beneficial as long the trading network remains small and its speculation side limited.

The second example is peer to peer lending which takes place, for instance, through the electronic lending platform in the United States. Participants in these networks can get unsecured lending, without providing any collateral and without the need of intermediation. Obviously, also in this case, a great advantage is given by the small transaction fees resulting from the absence of an intermediary. Trust depends on the possibility of trading in small networks.

Although largely outside of the radar of the supervisory authorities so far, it seems clear that peer to peer intermediation systems are highly likely vehicles of financial instability, speculations, and market bubbles.

As financial innovation will continue to progress and as markets for peer to peer intermediation seem to be growing, it is advisable that controls are enacted on several fronts. I foresee at least three necessities: First, there is a need for clearing houses to reduce losses in speculative uses of electronic currency. Second, there is a need of consumer protection for trading in unsecured loan markets. Third, it is necessary to reduce anonymity, in order to avoid that those currencies become vehicles for illegal activities. While these measures might not seem urgent at the moment, they might become so if one expects that shocks in those markets could destabilize also traditional financial markets.