Good Practice Guide

April 2020

An asset class growing in popularity: What advisers need to know about peer-to-peer lending

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In association with

This April 2020 update replaces the earlier Good Practice Guide of the same name first published in January 2019. This paper is in response to members' requests to provide a summary of good practice within one source document and is based upon the Personal Finance Society's understanding of the regulators rules and current stance. Whilst a summary, it is not intended to be exhaustive and should not be relied upon at the exclusion of other sources of information.

Foreword

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Thanks to the attractive interest rates on offer of 3% to 10%, depending on the term and level of security, peer-to-peer (P2P) lending platforms are proving increasingly popular. It's an area of the market that has grown dramatically in size over the last few years and it's one that advisers have been permitted to advise on since 2016.

As the market continues to grow, we think it's important that advisers and investors alike are equipped with the information to make sense of it, in all its diversity.

For those looking to take their first steps into what might appear an unfamiliar and confusing arena, we hope this guide provides useful guidance.

How is P2P lending regulated?

Also known as online lending or loan-based crowdfunding, P2P lending refers to a particular subset of crowdfunding, whereby money is lent to individuals or businesses on the expectation of regular interest payments (and capital repayments).

It's an activity that has been regulated by the FCA since April 2014. It falls under article 36H of the Regulated Activities Order of the Financial Services and Markets Act (FSMA) 2000, as 'operating an electronic system in relation to lending'.

Introduction: the search for regular returns

The Bank of England's historically low interest rates have made any returns from deposit accounts increasingly hard to realise. So low are typical rates that, after the effects of inflation, money saved today could actually shrink in value over time, not grow.

On the other hand, buying shares could mean more risk than some are comfortable with.

Past performance would suggest that investing in the FTSE 100 for three years or fewer carries a nearly 20% chance of losing money over the period (SOURCE: Lipper, Percentage annual change: FTSE 100 Total Return Index (1984 to present)). That's quite a risk for investors seeking a stable return.

Investors and advisers will be familiar with this dilemma. And, in today's increasingly polarised investment landscape, it's not surprising that many have looked to alternative investment options to try and find a middle ground. One asset class that has caught the public attention like few others is P2P lending.

An asset class growing in popularity

P2P represents another opportunity for financial advisers to add value. Here's why:

1. **Growing demand** Awareness of P2P lending is building. Advisers who are up to speed will be able to make the most of this opportunity.
2. **Growing number of P2P providers** The P2P lending market is very diverse. Advisers can add real value by helping their clients navigate the territory of new products and providers.
3. **Growing your business** P2P lending products offer the potential to bring more assets under management. For suitable clients, it could prove a useful vehicle for excess cash holdings which may currently fall outside of the adviser's view.

For those prepared to investigate the market, P2P lending could hold enormous potential.

P2P lending: planning scenarios

P2P lending is not suitable for every client. But, nonetheless, there are a wide array of potential applications which advisers may wish to consider. For example:

1. Clients who are nearing retirement and wish to reduce their exposure to equities, while still staying ahead of inflation.
2. Retirees looking to supplement an existing annuity with an additional income stream.
3. Investors looking for alternatives to maturing structured products.
4. Clients who hold substantial amounts of cash, and who are comfortable taking on a bit more risk to target a higher return but don't want to add to their equity exposure.
5. Landlords looking for an alternative way to make a yield, or a vehicle they can put money into before making their next real estate investment.
6. Companies looking to boost returns on their excess balance sheet capital, to which they don't require instant access.
7. Self-employed clients with limited companies looking for a way to get excess cash in their business working harder.
8. P2P loans can be made with cash or wrapped within an ISA, SIPP or SSAS tax wrapper.

A quick history of P2P

P2P lending is a way of using technology to connect those who are seeking finance with those who have money to invest. It's sometimes known as 'marketplace lending' or even 'loan-based crowdfunding' – though shouldn't be confused with the fast-growing but very different practice of equity crowdfunding.

The idea is that both sides receive a better deal by cutting out the financial intermediaries – typically banks and building societies – through which this sort of lending has traditionally only been possible. For investors, it means better returns. For borrowers, it means a convenient and competitive source of finance.

P2P lending has been around for over a decade. But it's only during the post-recession environment of the last few years that the market has witnessed dramatic growth.

Fuelled by low interest rates, championed by the backing of successive Governments, and made possible by a regulator that has proved supportive of new and innovative financial solutions, P2P has come of age. Let's take a look at the major milestones...

2005 – Zopa, the world's first P2P lending platform, launches

2009 – Ratesetter opens its doors

2010 – Funding Circle, the third of the 'big three' P2P players, begins trading

2012 – The market has by this stage already grown to become an industry with an expected £1 billion in annual turnover

2014 – The Financial Conduct Authority (FCA) takes over regulation of P2P lending from the Office of Fair Trading

2015 – The Government announces the intention to launch the Innovative Finance ISA (IFISA)

2016 – In April 2016 the IFISA came into force. At the same time, advisers were automatically permitted to advise on P2P lending.

Advisers and the Innovative Finance ISA

In his Emergency Budget of July 2015, George Osborne announced the Government's intention to launch the so-called 'Innovative Finance Individual Savings Account', or 'IFISA'. This came into effect in April 2016.

Another addition to the growing stable of ISA options, the IFISA allows interest earned through eligible P2P lending products to be included within the ISA tax wrapper.

Investors can choose to split their annual allowance (currently £20,000) between Cash ISAs, Stocks and Shares ISAs and IFISAs in any way they wish. They can also transfer existing ISA holdings into IFISAs without jeopardising their tax-free status.

ISAs remain highly popular with the British public. Together, they hold nearly £600 billion within the wrapper, some £270 billion of it in cash. The creation of the IFISA has made P2P another option for investors looking for somewhere to put their ISA funds.

April 2016 also saw another important milestone for P2P lending. Firms that already held permission for the regulated activity of 'advising on investments' automatically had their permissions varied to add the new regulated activity of 'advising on peer to peer (P2P) agreements'.

Not only is P2P a fast-growing area of the market, it's also one which the Regulator seems keen for advisers to play an active role in.

In June 2019, the FCA issued a policy statement PS19/14 on Loan-based (P2P) and investment-based crowdfunding platforms which provided feedback and final rules on their CP18/20 consultation paper. All rules and guidance referenced in the PS19/14 policy statement came into force for all P2P and investment-based crowdfunding platforms on 9 December 2019.

The Senior Managers & Certification Regime (SM&CR) also came into force on 9 December 2019. The SM&CR effectively replaced the previous Approved Persons (APER) regime for directly authorised FSMA firms and for EEA and third-country branches; its introduction is intended to improve conduct and has been driven by criticism of the perceived failure of the Approved Person regime in the light of the banking crisis. The two major stated FCA objectives are:

- to develop a culture whereby financial services employees at all levels take personal responsibility for their own actions, irrespective of their level in the organisational hierarchy; and
- to ensure that firms and their personnel unambiguously understand and can articulate exactly where responsibility resides in a given instance.

P2P lending: the key considerations

P2P is just the technology

P2P is a way of using technology to allow lots of different investors to lend money to lots of different borrowers. There are many different ways to achieve that, and the P2P lending market is incredibly diverse. It's crucial that advisers understand the vast differences that can exist between different P2P platforms.

Is the lending secured or unsecured?

This is arguably the most important of all considerations. Unsecured lending will bring higher returns, but will carry far higher risks. Loans aren't backed up by an asset which can be sold in the event that a borrower fails to repay. That means if they default, an investor's capital will be lost.

Secured lending, on the other hand, tends to target lower returns but adds a measure of protection against risk. Because loans are asset-backed, if a borrower became unable or unwilling to repay, the asset can be acquired and sold to pay back what's owed.

If the loans are secured, then other questions need to be asked.

What's the security?

For example, a growing number of P2P lending products allow investors to invest in loans secured against an asset, such as commercial or residential property, the assets in a business, or even an unpaid invoice. This may prove attractive to those for whom property represents a tangible, easily understood asset class which displays less volatility than equities.

What's the loan to value (LTV) ratio?

This is particularly relevant when assessing loans secured against property. If the asset is worth only as much as the loan, there's no 'headroom' against any fall in value. Whereas if the value of a loan is only 60% of the asset's value (that is, a 60% LTV), the asset can fall in value by 40% before any capital would be lost.

How experienced are the people doing the lending?

Successful lending relies on underwriters who can make good assessments about the risk of lending to a given borrower. In addition, you want people who know the sector they're operating in. For secured lending, they a need to have a sound valuation of the security so that the estimate of LTV is reasonable. So, for example, a team making loans secured against residential property should have a very good understanding of the housing market, the segments of that market they specialise in and the prevailing trends. Ask providers about their track record, including the losses they've made. Make sure they have the right expertise.

Who is building the portfolio?

The amount of responsibility given to the investor in building and managing portfolios varies across different products. Some products allow (or even require) the client to invest on a loan-by-loan basis, picking and choosing individual loans which appeal to them. Others automatically spread investments across a portfolio of different loans.

If the onus is on the individual investor to build their portfolios, the question must be asked: are they sufficiently experienced to do so? It may be better to choose a solution where the product provider acts as a 'discretionary manager', especially where they have the relevant expertise.

Which brings us to the next important question: what underwriting experience does the product provider have? Are they an experienced lender, able to adequately assess the quality of the loans they are including within a portfolio (or indeed in the product as a whole)?

What else does the provider do to mitigate risk?

Different P2P lending products have different provisions in place in the event of default.

With some products, if a borrower defaults, there's no further recourse. So if the loan is unsecured, then there's no way to recoup the money.

If the loan is secured, then in the event of default the provider can sell the asset it's secured against to recoup some or all of the loan.

Other products employ a 'provision' or 'safeguard' fund. This is a pot of money that can be used to reimburse investors if borrowers miss payments. Think of it as a kind of insurance policy in case of default. These are normally funded by the borrowers rather than the product providers themselves.

Instead of creating a product-wide provision fund, other product providers might choose to invest alongside investors in each and every loan, contributing a portion of the loan capital which would be lost first in the event of a default.

These sorts of 'first loss' investments on the part of the product provider offer a layer of protection in each loan, above and beyond any security that may exist. The investor would get their money back before the provider received theirs.

The fact that the money is contributed from the provider's own balance sheet also signals confidence in the underlying assets that they are making available for investment. But, at the same time, it's important to note that there's only so much protection offered in each and every loan.

How easy is it for an investor to take money out again?

Some products have no fixed term. Investors can choose to withdraw at any time without any charge or loss of interest.

Others allow for investments of a fixed duration, for example one month, one year, five years or beyond. The investor won't be able to access their funds within that time, or at least not without incurring a cost or penalty.

Beyond the term of the investment itself, you should explore what mechanisms are in place to facilitate liquidity. For example:

Is it just a matter of when the loan redeems?

This is the 'natural' element of liquidity in P2P lending. At some point, loans will come to the end of the term, at which point the money should be repaid.

Is there a secondary market?

Some products allow for parts of loans in which an individual might be invested to be bought and sold. This means that, even if the loan hasn't reached the end of your term, an investor can access the money that's tied up in it.

Is there a liquidity provider?

Some products are supported by liquidity providers, be they third party institutions or the product provider itself, who are able to buy and sell loan parts to facilitate withdrawals.

It's important to note that no P2P lending product can ever guarantee instant access.

Understanding the risks

Though certain types are far riskier than others, it's important to be aware that all P2P lending products are investment vehicles. It's important that both advisers and their clients understand the risks involved.

P2P lending is not covered by the FSCS

There is no Financial Services Compensation Scheme (FSCS) protection for investors in P2P lending products. Were an investor to lose money as a result of mismanagement of the product by the provider, they would have no recourse to the usual £50,000 of cover that applies to most investment products.

However, it's important to remember that FSCS never covers against losses arising from investment performance.

Investors' capital is at risk

P2P lending products are never replacements for a deposit account. As with any investment, investors may get back less than they put in. No provider can guarantee that their customers will receive all of their interest, or get all of their initial investment back.

Instant access cannot be guaranteed

This is because investors' money is allocated to loans. Access prior to the full repayment of these loans relies on other investors purchasing your part of each loan.

Conclusion: the questions you should be asking

Given the sheer diversity of P2P lenders out there, here are eight questions we believe advisers should ask on behalf of their clients.

1. Who's the provider? Are they a familiar face in the financial services sector? How well capitalised are they? What sort of systems and controls do they have in place? Consult any third party due diligence on the provider, to help you better assess how robust they are.
2. Are the loans secured? A secured loan means there's some tangible security that can be sold if the borrower defaults, with the proceeds used to fund repayment of the loan.
3. Who are the borrowers? Each P2P platform tends to appeal to specific types of borrower. Some lend to individuals, others to businesses. The purposes for which they lend vary, as does the value of a typical loan. Borrowers have widely varying motivations and associated risk profiles from one platform to another. So it's important to understand who the borrowers are and what they're planning to do with the money that's lent to them. Does the lender know?
4. How well do they work with financial advisers? Are advisers a major distribution channel? Does the provider offer dedicated adviser support? Do they have a track record of working with advisers?
5. How thorough is the underwriting? Once you know who the borrowers are, the next stage is crucial. How are they assessed? What sort of credit profiling happens? And if loans are secured, what assets are they secured against? How are they valued, and what level of buffer is there in case that value falls before the loan is repaid? Does the product provider have an experienced underwriting team to analyse every loan application?
6. What's the loss rate? You should always ask the P2P lender for their loss rate and be wary of lenders that don't openly publish it. But remember, past performance is not a reliable indicator of future success.
7. What do they have at stake? Some P2P products include a 'provision fund' – a pot of money that can be used in the event of default as a sort of insurance policy. How big is it? and what level of cover does it provide? But more importantly, what does the product provider suffer if a loan goes bad?
8. How easy is it to withdraw? Does the product carry a fixed term, or can investors ask to withdraw at any time? And are there any costs or penalties for doing so?

Regulatory Guidance

The section of the FCA's website that relates to advising on P2P investment can be found at:
https://www.fca.org.uk/firms/advising-p2p-agreements

The FCA also provides consumer guidance at: **https://www.fca.org.uk/consumers/crowdfunding**

The FCA has also produced a number of documents salient to P2P lending which advisers should familiarise themselves with, including:

- PS 14/4 (March 2014) – "The FCA's regulatory approach to crowdfunding over the internet, and the promotion of non-readily realisable securities by other media"
- FCA Review paper (February 2015) – this includes commentary on the authorisation process and FCA supervision
- PS 16/8 (March 2016) – "FCA Handbook changes regarding the segregation of client money on loan-based crowdfunding platforms, the Innovative Finance ISA, and the regulated activity of advising on P2P agreements"
- FCA (July 2016) "Call for input to the post-implementation review of the FCA's crowdfunding rules" – responses deadline 8 September 2016. Watch out for the FCAs final report following this call for input, which is expected to be published in the coming months
- PS19/14 (June 2019) – The FCA's policy statement on Loan-based (P2P) and investment-based crowdfunding platforms which provided feedback and final rules on their CP18/20 consultation paper. All rules and guidance referenced in the PS19/14 policy statement came into force for all P2P and investment-based crowdfunding platforms on the 9 December 2019
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  1. The Senior Managers Regime – this applies to the most senior people in the company; individuals must be approved by the FCA before undertaking a Senior Manager role. There are three levels to this part of the regime: Core, Limited Scope and Enhanced
  2. The Certification Regime – this applies to those who are not Senior Managers but whose job can cause "significant harm" to the firm or its customers. The FCA will not approve these individuals but firms will now be responsible for checking them and confirming their suitability for their role at least once a year
  3. The Conduct Rules (COCON) these set out certain standards of behaviour – a number of the rules are taken from the Approved Persons Code of Conduct and so will be familiar. However, COCON will apply to virtually all staff (except those in ancillary roles such as post room staff or cleaners) – with additional rules for Senior Managers.
- Notable changes that came into force from PS19/14 on 9 December 2019 are as follows:
  1. Introduction of mandatory Appropriateness Tests and Client Categorisation for all Lenders to ensure they understand the P2P platform and product that they are investing through/in
  2. Ensuring that the P2P Platform's Risk Management Framework (RMF) not only focussed on the underwriting and debt management, but also on the wider RMFs which govern the business. The key focuses were:
     a Firms should ensure they gather sufficient information in order to assess credit risk
     b Firms should categorise borrowers by their credit risk in a systematic and structured way
     c Firms should set the price of the agreement so it is fair and appropriate, and reflects the risk profile of the borrower
     d Firms must have a person approved under a SM&CR senior manager function (SMF) responsible for the management of the RMF
  3. Firms need to have an effective "Living Will"/Standby Servicing arrangements in place
  4. Firms are required to have an effective Wind-Down Plan and Resolution Manual in place
  5. Firms must publish within four months of their financial year-end an Outcomes Statement, which should give sufficientclarity to help Lenders monitor and understand the performance of their investments/loan portfolio as it will show the expected and actual default rate of all loans originated within a financial year by reference to risk categories. It will also show the actual return against any Target Rate offered.

Final thoughts

P2P lending is a very diverse market, just like the market for funds, trusts and other investments. There are lots of different providers offering a wide range of products. Some products are, by definition, riskier than others, and consumers should work out what's right for them.

In a fast-moving market, it's important that investors know what they're getting into, and choose the product that's right for them. Advisers can play a powerful role in helping them do just that.

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