Peer-to-Peer Lending

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An introduction for financial advisers

This paper is in response to member's 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 inclusive and should not be relied upon at the exclusion of other sources of information.

Preface

Peer-to-peer lending has become something of a controversial business.

Some providers haven't particularly covered themselves in glory and the public may not fully understand the associated investment risk. A few providers have even closed their doors for business after burning bright and failing fast. What's more, the head of the Financial Services Authority (FSA), Lord Adair Turner, recently predicted that losses in the fast-growing sector 'will make the worst bankers look like absolute lending geniuses'.

Most advisory firms have so far chosen to steer clear of this fast-growing market so it may seem like an odd subject for the Personal Finance Society to provide guidance on. So why are we?

Well, thanks to the attractive interest rates on offer of 3% to 10%, depending on the term and level of security, peer-to-peer lending platforms are proving increasingly popular. It's an area of the market that has grown dramatically in size over the last few years, to a volume of nearly £2.4 billion in 2015, and it's one that advisers are now permitted to advise on, too.

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.

Keith Richards

Chief Executive, the Personal Finance Society

How is peer-to-peer lending regulated?

Also known as online lending or loan-based crowdfunding, peer-to-peer 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

Britain's investors are stuck between a rock and a hard place.

On the one hand, they could suffer with savings accounts...

The Bank of England's recent decision to lower the base rate, to its new historic low of 0.25%, has 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.

Or, on the other hand, they could ride the waves with equities...

They could always settle for the sometimes unsettling experience of equity investing, of course. But if there's one predictable thing about the stock market, it's that returns will be anything but. To put it in perspective, past performance would suggest that investing in the FTSE 100 for three years or fewer carries a nearly 20% chance of loss: quite a risk for investors seeking a stable return.

It's a dilemma with which investors and advisers will be familiar. 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. And one asset class that has caught the public attention like few others is peer-to-peer lending.

A story of growth

Peer-to-peer (P2P) lending refers to the practice 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.

The practice of 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 of this year the IFISA comes into force. At the same time, advisers are automatically permitted to advise on P2P lending.

Moving to the mainstream: 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'.

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. It came into force in April 2016, though few providers have the full authorisation required to be able to offer it.

Investors can choose to split their annual allowance (currently £15,240) between Cash ISAs, Stocks and Shares ISAs and IFISAs in any way they wish – as well as transfer existing ISA holdings into eligible P2P lending products without jeopardising their tax free status.

It's a move that looks set to prove popular with the British public – who, after all, seem particularly fond of their ISAs. Together, they currently hold £500 billion within the wrapper – some £250 billion of it in cash. Some commentators estimate that as many as half a million new investors will experiment with P2P lending for the first time, as a direct result of the IFISA, and the stamp of mainstream approval that it brings.

It was perhaps unsurprising, then, that April 2016 also saw another important milestone for P2P lending. From the new tax year onwards, 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 it a fast growing area of the market; it's also one which the Regulator seems keen for advisers to play an active role in.

An untapped opportunity

Despite the enormous growth of P2P lending over the past few years, many advisers have remained cautious of the opportunity.

It's hardly surprising. Most if not all P2P providers don't have established brands within the intermediary space. Nor have they made it easy for advisers to write the business – let alone earn through it.

It stems from the fact that few P2P platforms have any experience of engaging with financial advisers directly, and so remain unfamiliar with the challenges they face, or the solutions they require. There's something of a disconnect.

But P2P lending is not going to go away. The young market represents a powerful, but untapped, opportunity for financial advisers to add value. Why?

1. **Growing demand**
   As awareness of P2P lending builds, it follows that more and more clients will be proactively approaching their adviser for an informed view of the market, and a recommendation. Advisers need to be up to speed – and if they are, they can capitalise on the growing interest in this space.
2. **Growing complexity**
   The P2P lending market is as diverse as it is high-growth. Advisers can add real value by helping their clients navigate the tricky and unfamiliar territory of new products and providers.
3. **Growing your business**
   And, at the end of the day, P2P lending products also offer the potential to broaden the scope of 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 everyone. But, nonetheless, there are a wide array of potential applications which advisers may wish to consider. For example, the right product could be appropriate for...

1. Clients who are nearing retirement and wish to reduce their exposure to equities, while maximising their returns in the last years that they are earning
2. Retirees looking to supplement an existing annuity with an additional income stream
3. Investors looking for alternatives to maturing structured products
4. Companies looking to boost returns on their excess balance sheet capital, to which they don't require instant access. Most business deposit accounts pay very low levels of interest – and some banks (e.g. NatWest and RBS) have even raised the prospect of charging companies to hold cash on deposit.

Peer-to-peer lending: the key considerations

The P2P lending market is incredibly diverse. To put it in perspective, over 80 individual platforms are currently awaiting their full authorisation from the FCA (the requirement for IFISA eligibility), each with their own models, and methods. It's crucial that advisers understand the vast differences that can exist between each of them.

After all, you wouldn't view all lenders, or all loans, as alike. You wouldn't equate revolving credit card debt with a 20-year secured mortgage, or car finance with unsecured business loans. The same goes for P2P lending – which can span all these types of lending and many more.

Because at the end of the day, the moniker 'peer-to-peer' means little. It refers to the mechanic of matching one group of people with another. It's the lending that's important.

Let's take a look at some of the key differences within the market – and the key questions you should be asking:

Is the lending secured or unsecured?

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 – meaning that if they default, an investor's capital will be lost.

Secured lending, on the other hand, is a different beast entirely. 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 residential property. This may prove attractive to those for whom property represents a tangible, easily understood asset class which displays less volatility than equities.

How is it valued, and by whom? What's the loan to value (LTV) ratio?

If the asset is worth only as much of the loan, there's no 'headroom' against any fall in value. Whereas if a loan is made at a 60% LTV, the asset can fall in value by 40% before any capital would be lost.

Is there an insurance policy – and does the provider have skin in the game?

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 (above and beyond any security. So if the loan was unsecured, then all the money would be lost).

Other products employ a 'provision' or 'safeguard' fund – 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 means that they have 'skin in the game' – a sign of 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.

So which is better? Let's assess the pro's and con's:

Provision funds

- ☒ No material alignment with investors
- ☑ A pooled fund which can be used to fund entire loans

Balance sheet risk

- ☒ Partial coverage on a loan-by-loan basis
- ☑ Aligned with investors: their money where their mouth is

Is the portfolio diversified – and who manages it?

The amount of responsibility given to the investor in building and managing portfolios also varies. 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.

This is particularly true of property-backed P2P lending products – where individual 'deals' are often showcased, with particular reference to the property which is offered as security.

Others automatically spread investments across a portfolio of different loans – sometimes hundreds.

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 deemed preferable, instead, for the product provider to act as a 'discretionary manager' and bring their expertise to bear on the portfolio.

But the same question holds true of them, too: 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)?

Is the product fixed term or easy-access – and how are withdrawals facilitated?

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

While others allow for investments of a fixed duration: be they 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 ask 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 bits of loans in which an individual might be invested to be bought and sold; meaning that, even if the loan hasn't reached the end of your term, they can access the money that's tied up in it.

Or 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.

But it's important to note that no peer-to-peer 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, below are eight questions that we believe advisers should be asking 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, and what sort of systems and controls do they have in place?
   If it exists, be sure to consult any third party due diligence into the provider, to help you better assess how robust they are.

2. **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? For example, in the case of its product, Octopus Choice, Octopus Investments contributes 5% to each and every loan – which would be lost first in the unlikely event that anything was to go wrong. It aligns their interest with investors.

3. **Are the loans secured?**
   In many cases, if the borrower fails to repay, then the investor's money will be lost. But some products only offer 'asset-backed' loans – meaning there's some tangible security that can be used to fund repayment of the debt if the borrower defaults.

4. **Who are the borrowers?**
   Each P2P platform tends to appeal to specific types of borrower, be they individuals or businesses, with widely varying motivations and associated risk profiles. 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?

5. **How good is the underwriting?**
   Once you know who the borrowers are, the next stage is crucial: how are they assessed? What sort of credit profiling is undertaken? 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 was to fall over the course of a loan?
   Back in February, former head of the FCA, Lord Adair Turner, warned that some P2P firms were trying to automate the lending process and that proper credit checks were not being completed.
   With this in mind, 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. **How easy is it to get out?**
   It is always easy to invest but at times it can be hard getting your money out when you need it. Does the product carry a fixed term, or can investors 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 peer-to-peer 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 peer-to-peer 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

Final thoughts

Peer-to-peer lending is a broad church, with a whole host of different providers offering a diverse array 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. And advisers can play a powerful role in helping them do just that.