AiR
ALTERNATIVE INVESTMENT REPORT

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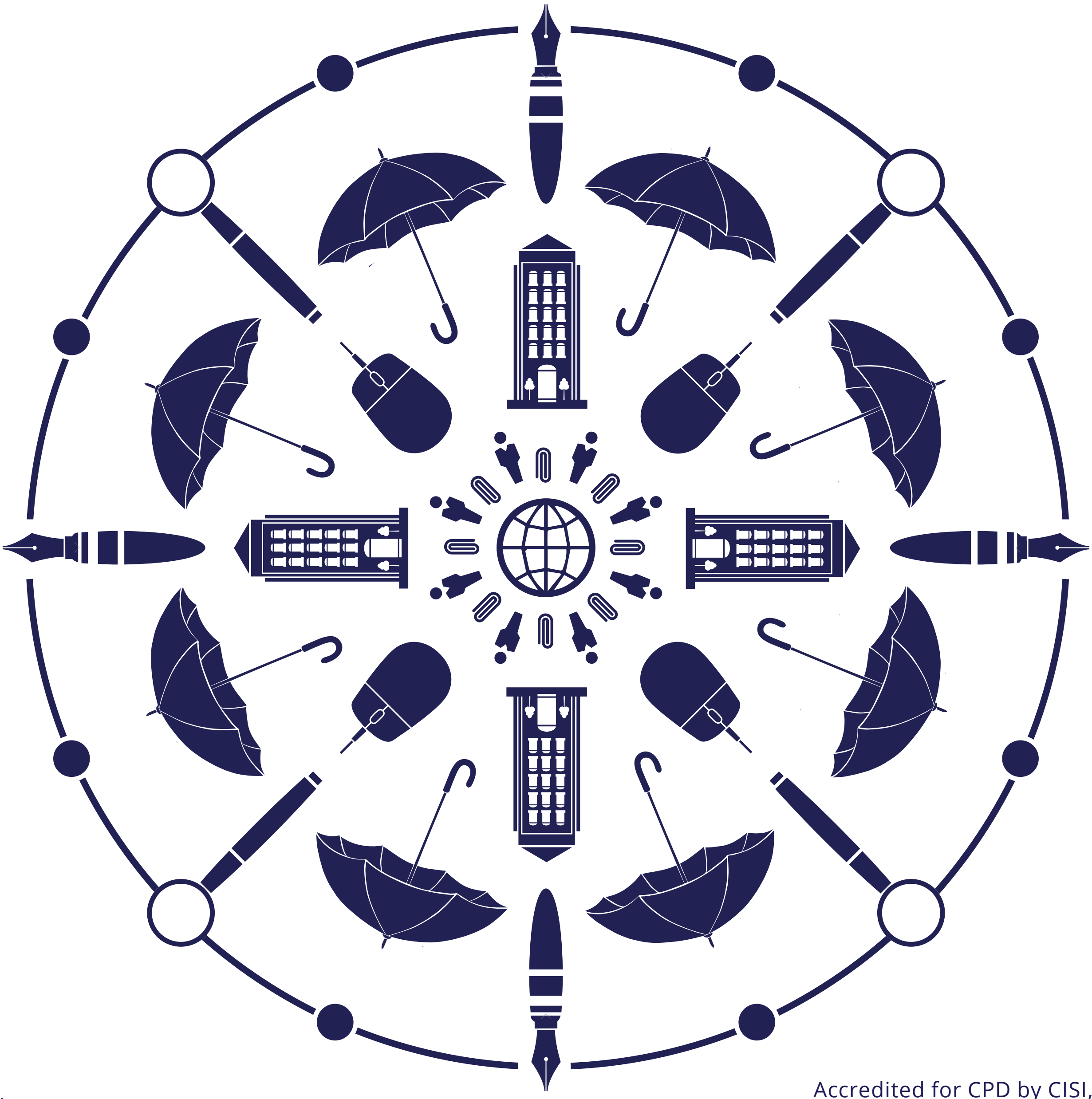
PEER TO PEER LENDING
REPORT



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Welcome to this in-depth report on Peer to Peer Lending. ("P2P").

TISA has long been interested in the potential of Peer to Peer Lending (P2P) and lobbied successfully for P2P to be included within ISAs.

Peer to peer lending enables lenders to be matched directly with borrowers, whether individuals or businesses through online services. Peer to peer lending companies operate entirely online, so they can operate with lower overheads and provide the service more cheaply than traditional financial institutions like banks.

As a result, lenders can often earn higher returns than from banks, while borrowers can borrow money at lower interest rates, even after the P2P lending company has taken a fee for providing the service and carrying out appropriate credit checks on borrowers.

Many peer to peer loans are simply unsecured personal loans, though increasingly, businesses, such as property companies, are using peer to peer as a convenient way to borrow. Interest rates can be set by lenders who compete for the lowest rate or fixed by the intermediary company on the basis of an analysis of the borrower's credit.

On some services, lenders manage the risks of bad debts by choosing which borrowers to lend to, and manage total risk by diversifying their investments among different borrowers. Other models involve the P2P lending company maintaining a separate, ringfenced fund, which pays lenders back in the event the borrower defaults. Peer to peer lending companies that become insolvent can also place lenders' money at risk. And, P2P investors are not covered by the Financial Services Compensation Scheme (FSCS).

So, why do we like P2P?

The primary reason is that P2P introduces choice and competition, for savers (lenders) and borrowers.

Individuals can earn competitive interest from peer to peer lending, albeit with risk, and borrowers can be matched directly with willing lenders, either directly or through a pool of lenders. This can be more flexible than borrowing through traditional banks, both in speed of offer and lower fees, and interest rate. Borrowers do not have to pay for the traditional infrastructure of banks, including lots of High Street premises.

Competition ecourages traditional banks to improve their offerings to savers (lenders) and borrowers. In the meantime, savers can get better rates, and the opportunity to get involved in backing businesses, though many savers choose not to. Borrowers get access to cheaper and more flexible finance.

Peer to peer lending, then, is a new and interesting type of asset class, in the same way that corporate bonds were in the in the 1990s. Then, corporate bonds were new for retail investors. Now, in corporate bond funds, they are an important and essential part of any investor's portfolio, offering diversification of risk, low volatility (compared to stocks and shares) and better yield than available from bank deposits.

Currently, most P2P lending is direct from the individual to the P2P platform. But as the market develops, we expect that many advisers will see P2P as an important asset class to be considered for inclusion in client portfolios. We believe that this will give more savers access to P2P, as advisers will increase the professionalization of the market.

Therefore this guide has been produced as part of a series of educational papers that will be published to improve the understanding of this important and growing market.

JEFFREY MUSHENS

Technical Policy Director
Tax Incentivised Savings Association (TISA)

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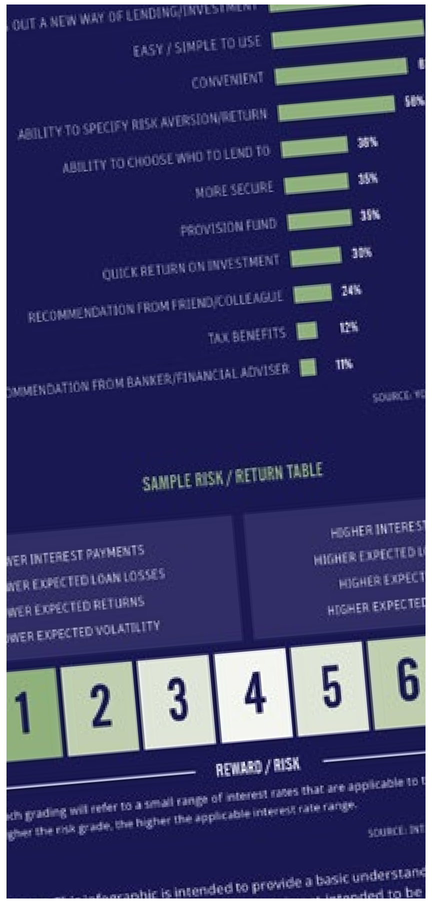

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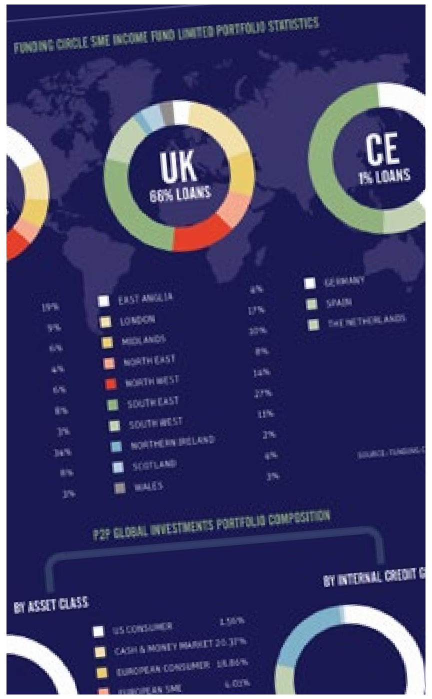

FINAL CONCLUSIONS

* Please note: unless otherwise stated, all charts and graphs have been provided by Intelligent Partnership

Published February 2017

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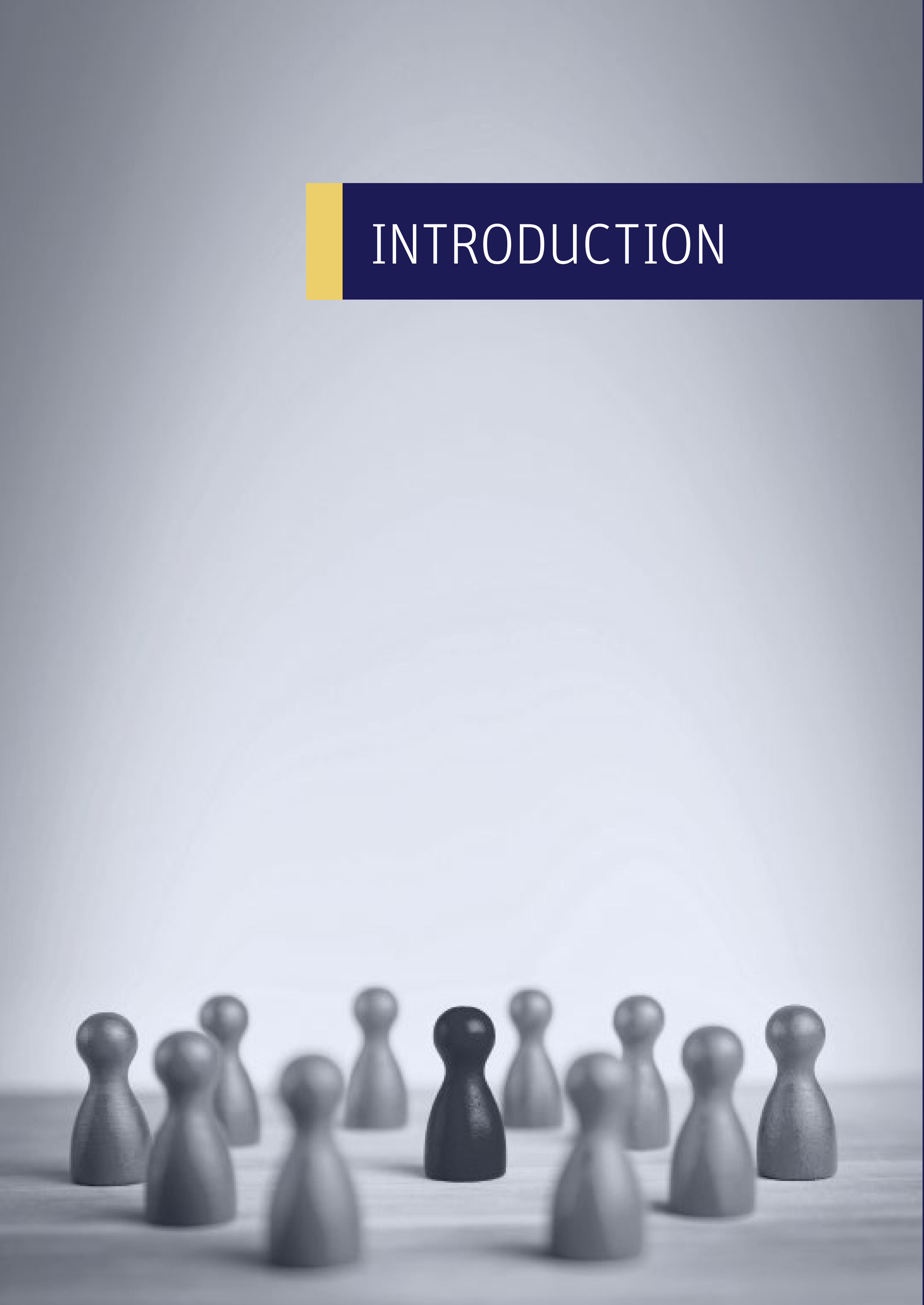
AMPS

FSC is a non-profit international organisation established to promote the responsible management of the world's forests. Products carrying the FSC label are independently certified to ensure consumers that they come from forests that are managed to meet the social, economic and ecological needs of present and future generations, and other controlled sources.



INTRODUCTION

A GROWING NEW ASSET CLASS

Peer to Peer (P2P) lending has grown rapidly since the foundation of Zopa, the world's first online lender, in 2005. The global market has been calculated to have an estimated worth of over $180 billion, and the UK market transacted just over £3 billion in 2016.

Growth in the sector is far from over, with analysts predicting the UK market alone will continue to expand at a CAGR of over 40%, with total lending set to reach £30.3bn by 2022.

Of course, there are lots of reasons behind this extraordinary growth, but the biggest driver is the returns on offer. P2P lenders can earn annualised net returns ranging between 5% and 7% and often higher. These returns are comparable with the highest yielding equities and bonds, and easily beat the returns on high street deposits estimated at an average of 0.62% by the Bank of England[1] November Inflation Report.

However, P2P is still a new asset class and many advisers are understandably wary of recommending that their clients invest in something that doesn't have a long track record and that they themselves do not fully understand. This lack of understanding and reluctance can also be extended to the para-planners, compliance departments, PI brokers and back office teams that support advisers.

This report will address that problem directly, giving readers a thorough overview of the market, helping them to understand the diversity of business models within the P2P sector, outlining the risks and benefits, highlighting the different ways to invest in P2P and pointing to resources that can help advisers who want to learn more. The intention is to provide the information advisers need to understand the asset class and make an informed decision about the merits (or otherwise) of adding P2P to their investment proposition.

ACKNOWLEDGEMENTS & THANKS

We couldn't do this without the help and support of a number of third parties who have contributed to writing this report. Their contributions range from inputting into the scope, sharing data, giving us their insights into the market, providing copy and peer reviewing drafts.

So a big thanks to: Cormac Leech of Victory Park Capital Advisers, Orca Money and Liberum. Their input is invaluable, but needless to say any errors or omissions are down to us.

We also carried out our own extensive research, examining brochures, investment prospectuses, and trawling through websites to verify data and identify the latest trends.

The report is made possible by our sponsors, LendingWell, who have supported us by helping to meet production and printing costs.

DEFINITION OF TERMS

P2P lending has already developed its own specialist language, jargon and acronyms. They will be explained throughout the report, but for the sake of clarity a few key terms are discussed here.

This report is about Peer to Peer lending (P2P lending). This is sometimes referred to as Market Place Lending (MPL) or online lending. Some people who are new to the sector confuse P2P lending with crowdfunding. Crowdfunding is a similar activity inasmuch as it raises capital online from numerous investors who can invest very small amounts, but crowdfunding platforms issue equity, not debt. Investors are purchasing a small share in a company in the hope that it will be worth more at some point in the future. This is likely to be when/if the firm becomes publicly traded or a third party deems it suitable for acquisition, making the risk associated with this form of crowdfunding much higher. Crowdfunding investors are not purchasing an income stream with a defined term, stated interest rate and repayment of principle at the end of that term (bullet loan), or periodic repayments of principal and interest (amortising loan) as they are with a P2P loan.

REGULATORY DEFINITIONS

Confusingly and perhaps unhelpfully, the FCA has decided to use "Crowdfunding" as an umbrella term that encompasses both issuing equity and P2P lending. They subdivide the sector into "Equity Based Crowdfunding" and "Loan Based Crowdfunding", but these terms are rarely used within the industry. Therefore, in line with the rest of the sector, we'll use the terms P2P lending, marketplace lending or online lending.

LEARNING OBJECTIVES

By the end of the report readers will be able to:

- Get up to date on the size and growth rates of the market and what drives them
- Discover how government support, regulatory reform, institutional investment and growing track record are bringing P2P into the financial mainstream
- Evaluate the risks and mitigants of investing in P2P loans in varying market conditions
- Review the routes to investment and due diligence considerations
- Get an understanding of the current fees and charges that may apply in the P2P universe

WHAT IS PEER TO PEER LENDING?

BRIEF OUTLINE

P2P lending is the practice of matching borrowers and lenders through online platforms. The platforms are not banks or traditional financial services institutions, instead they utilise new technology to secure numerous investors who are prepared to lend their funds at a range of interest rates. The loans issued are often comprised of scores or even hundreds of different investors, from individuals to institutional investors. The minimum investment threshold is £10 for many platforms, while the average amount invested per lender runs into several thousand.

Borrowers range from private individuals (P2P Consumer Lending), small businesses (P2P Business Lending), to property developers or individuals raising mortgages (P2P Real Estate Lending). Some platforms specialise in one of these borrower segments and some cover multiple segments.

The platforms have different operating models to mitigate against the risk of loss of capital. Some only do asset backed lending, some operate contingency funds and some provide insurance coverage. Some platforms operate as pure marketplaces, matching borrowers and lenders for a fee, and some invest off their own balance sheets.

So, there is a lot of diversity within the P2P sector. These models and the pros and cons of each are discussed in more detail throughout the report.

WHAT P2P IS NOT

P2P is explicitly not an alternative to a savings account. There is more risk involved because lenders are exposed to any potential borrower defaults, they do not have the liquidity that comes with a savings account and the funds are not covered by the Financial Services Compensation Scheme (FSCS), also referred to as the deposit guarantee scheme that protects money in savings accounts at banks from losses up to a limit of £85,000 per banking group.

P2P AND THE FUNDING GAP

Another driver behind the growth of P2P has been the banks' retrenchment from lending post the financial crisis of 2008. The British Business Bank has found that nearly 100,000 SMEs and approximately £4bn worth of applications for debt are estimated to be rejected each year. P2P lending is an important alternative source of finance for these SMEs and is playing an increasingly important role in this section of the economy.

SUMMARY

P2P lending is an asset class that is here to stay. The returns are attractive, lending volumes are increasing and awareness is growing. The sector is regulated, loans can now be held within an ISA and institutional investors are enforcing higher standards of professionalism. Advisers can't afford to ignore this development, and it's hoped that this report will help educate them about the sector.

INDUSTRY MILESTONES

INDUSTRY MILESTONES

DEVELOPMENT

The P2P lending industry has been around for longer than many people realise, and has achieved some key milestones that indicate that it is maturing and becoming more and more accepted into the mainstream.

LOAN VOLUMES

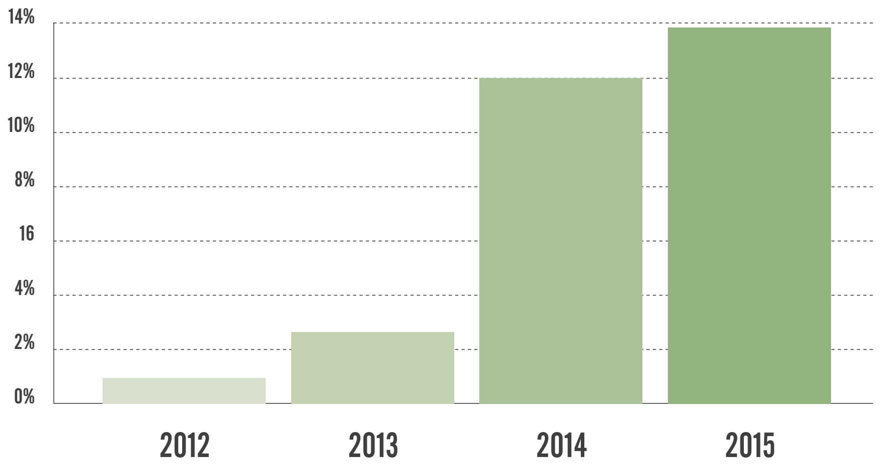
2015 saw very significant increases in the volume of loans made by the peer to peer sector, with the total amount lent at around £2.4 billion. This amount was split between P2P business lending and P2P consumer lending, with P2P business lending continuing its reign as the largest model by volume of the UK online alternative finance market: It generated £1,490 million of lending in 2015. Of this total, £609 million was attributed to property-based debt transactions, largely to property developers.

P2P business lending volume in 2015 represented a near doubling of the 2014 figure and most of the beneficiaries of these loans were SME firms with a trading history. In the real estate sector, this largely took the form of capital for mostly small to mid-sized property development companies, financing both residential and commercial developments.

Nesta and the University of Cambridge Centre for Alternative Finance estimates that P2P business lending (excluding real estate lending) supplied the equivalent of 13.9% of new bank loans (£881 million), to small businesses in the UK in 2015 (based on BBA's 2014 baseline figure of £6.34 billion). The average size of a P2P business loan at £76,280, is a good indicator of the smaller size of the entities accessing these funds.

There are signs of the industry maturing with the Peer to Peer Finance Association (P2PFA) reporting that UK P2PFA lenders lent £658 million in Q2 2016, down 8% from £715 million in Q1 2016 - the first time there has not been an increase in new loan

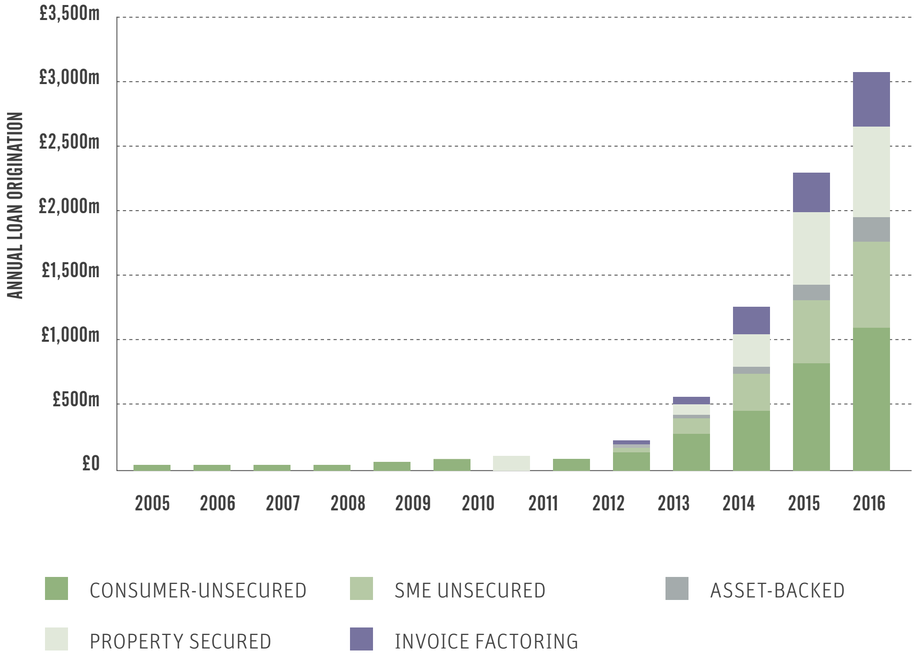
PEER TO PEER BUSINESS LENDING AS A PERCENTAGE OF NEW LOANS TO SMALL BUSINESSES IN THE UK



SOURCE: PUSHING BOUNDARIES, THE 2015 UK ALTERNATIVE FINANCE REPORT, NESTA, FEBRUARY 2016

The remainder of 2015 peer to peer loans, £909 million, were made to individual consumers, a notable 66% year on year increase from the 2014 figure of £547 million[2]. Again, average loan size of £6,583, reflects the audience of borrowers, perhaps looking to buy a car or consolidate credit card loans. In fact, overall volume growth in the last five years has been very impressive.

THE DEVELOPMENT OF ONLINE PEER TO PEER LENDING MODELS



SOURCE: P2PFA

*"The advantage of peer to peer loans for lenders is that they can generate higher interest rates that exceed the interest that could be earned from banks and other financial institutions." – **HMRC***

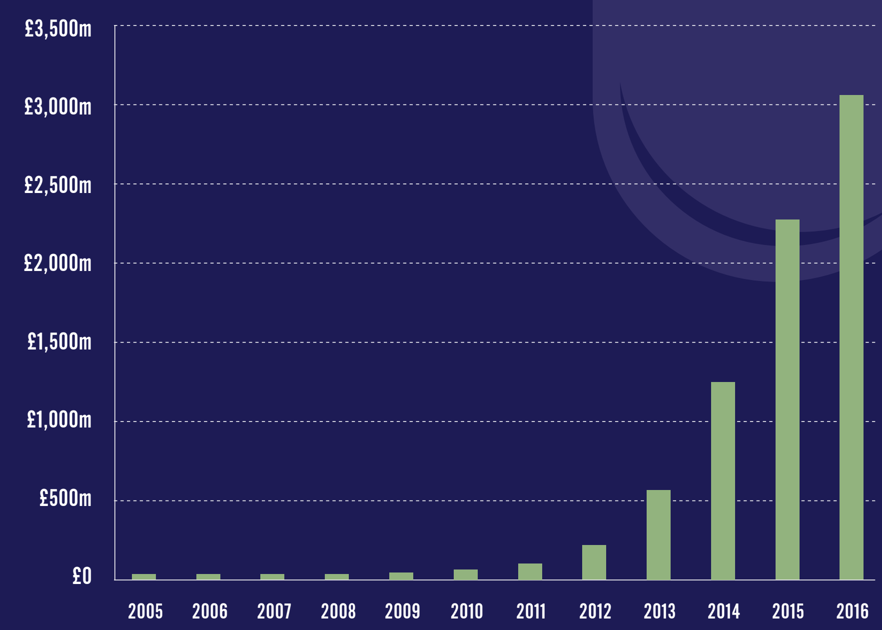
volume in consecutive quarters since the association began reporting the statistic in 2014. Nevertheless, the Q2 figure is only marginally less than that of the fourth quarter of the record year of 2015, the Q3 figure of £701 million showed a bounce back, and industry reports forecast that UK P2P lending will grow at a 45% five-year compound annual growth rate, reaching £16 billion by 2020[3], whilst Liberum predicts a potential market volume of £30 billion by 2025.

NUMBER OF BORROWERS AND LENDERS

According to the P2PFA, the total number of active borrowers using its members' UK platforms almost doubled in 2015 alone, rising year-on-year from approximately 140,000 to approximately 275,000, as of Q4 2015[4]. And despite the dip in the value of new loans in 2016, the number of borrowers with a loan has continued its upward trajectory - rising by around 30,000 per quarter, to reach more than 392,000 by Q4 2016.

This makes it clear that uptake of P2P lending services is spreading amongst the population, which is increasing the number of loans originated.

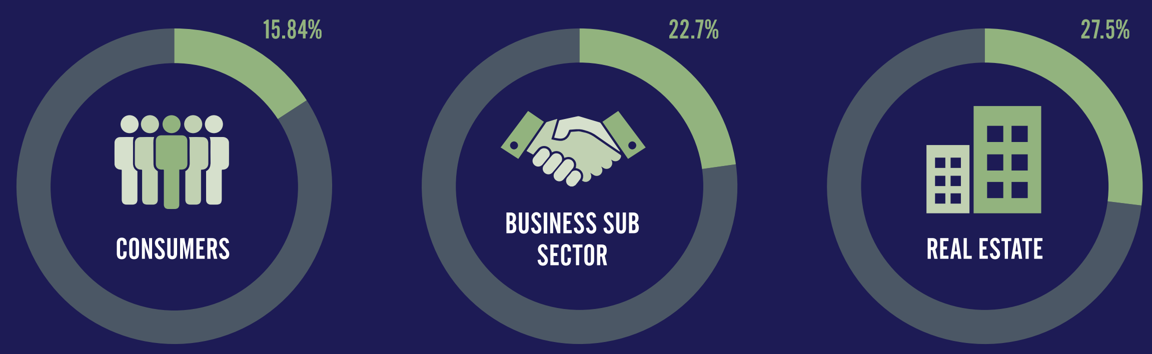
ANNUAL P2P LOAN ORIGINATION (£M)



SOURCE: P2PFA

By far the largest number of peer to peer lending platform users are currently individual consumers - over 213,000 of whom became borrowers through a platform in 2015. Nevertheless, the total number who actually applied is over 1.3 million as those who were actually accepted total only 15.84% of those who applied. This suggests much more stringent credit scoring and underwriting than some might expect. It also indicates that it is not just a case of platforms charging high interest rates to high risk borrowers and offering high returns to investors, with minimal probability of being paid out.

% OF LOAN APPLICATIONS ACCEPTED BY SUB SECTOR (2015)



SOURCE: PUSHING BOUNDARIES, THE 2015 UK ALTERNATIVE FINANCE REPORT, NESTA, FEBRUARY 2016

Around 10,000 UK small and medium sized enterprises (SMEs) raised funding via P2P business lenders in 2015. However, between 2013 and 2015, on average, only 22.7% of loan applications were approved in this sub sector. This may surprise those with the perception that every young or small company can get money thrown at it by reckless online lenders. And each loan required an average of 347 lenders prepared to fund it; given the average loan value, this gives a possible mean contribution as low as just £220 per investor.

"Data suggests that marketplace lendings' annual risk-adjusted returns are competitive with equities. Specifically, while direct lending has underperformed the S&P 500 index over the past 20 years, it has not had any negative return years and has been much less volatile." – **Deloitte**

P2P real estate lending had a slightly higher acceptance rate of an average of 27.5% of loan applications in 2015, perhaps reflecting a higher level of acceptable asset backing with loan to value ratios often falling between 65% and 70% - a decent security buffer for investors. These funds financed in excess of 600 UK commercial and residential developments in 2015, mostly by small to medium sized property developers. (This is a crucial sector given the ongoing UK housing crisis, and it's forecast to continue[5].)

The average number of lenders required to cover loans for this model in 2015 was 490, based on an average loan amount of £522,333, giving a mean 'per investor' amount of £1,066. Since this loan amount is almost seven times that generally loaned out in peer to peer business loans (without real estate), it's not surprising that more lenders providing more funds are needed to back it. Yet, taking into consideration the financial reach of institutional investors, even £1,066 is a very low commitment and demonstrates the potential for extremely diversified, large portfolios[6].

The interest and participation in marketplace lending has continued to flourish in 2016; the number of investors who had lent more than £1 at the end of the second quarter of 2016 grew to 150,000, a 6% increase from Q1 2016 and nearly 30% year-on-year growth[7]. And by the end of Q4 2016, the number had risen to almost 170,000.

NUMBER OF PLATFORMS

According to the FCA, at July 2016 there were over 100 crowdfunding platforms in the market (including those providing equity based and donation based offerings) or seeking authorisation.

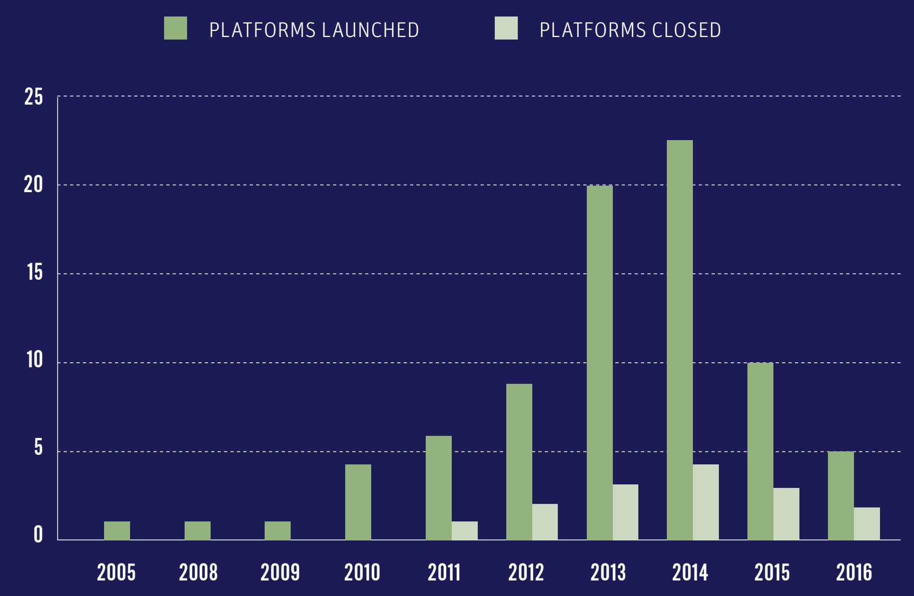
In October 2016, Christopher Woolard, FCA Director of Policy, Risk and Research, reported at the Lendit Europe conference that 12 firms had received full FCA permissions to operate a P2P platform and a further 39 were still operating under interim permissions. A number of new firms had also applied for authorisation[8]. At the time of publishing in December 2016, at least one additional platform was granted full authorisation by the FCA.

This points to more than fifty P2P platforms currently open.

We can see that the number of new platform launches peaked in 2014, with a drop of over 50% in the number that took place in 2015. The figures show a 50% drop in new platforms between 2015 and 2016, although there are perhaps ten more that are planned in 2016 and beyond[9].

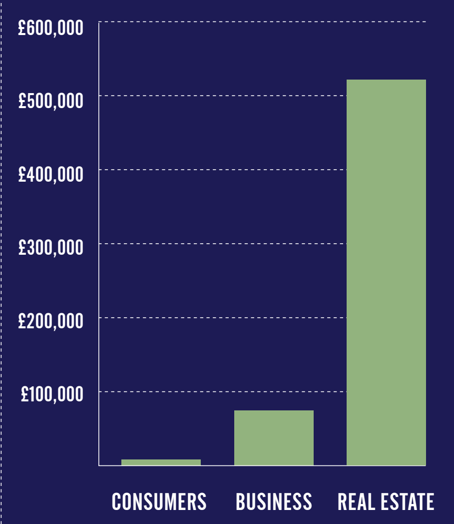
The lower levels of new entrants in the last two years may well reflect a maturing sector, as well as increasing barriers to entry for those without the funding, expertise and ability to navigate the changing regulatory landscape. That said, 2014, the year with the highest number of new platforms was the year in which the FCA took over regulation of consumer credit, including P2P firms, and the imposition of more stringent rules began. But it was also the year with the most platform closures.

LAUNCHES AND CLOSURES OF UK P2P PLATFORMS



SOURCE: P2PMONEY.CO.UK (NOT INCLUDING GRADURATES WHICH WAS TAKEN OVER IN 2014)

AVERAGE PEER TO PEER LOAN AMOUNT (2015)



SOURCE: PUSHING BOUNDARIES, THE 2015 UK ALTERNATIVE FINANCE REPORT, NESTA, FEBRUARY 2016

INSTITUTIONAL MONEY

INCREASING INTEREST

AMOUNT

There is plenty of evidence of the rising involvement of traditional financial institutions such as funds, family offices, banks, governmental and non-governmental organisations in peer to peer lending:

- 26% of all P2P business loans in 2015 were funded by institutions
- 32% of all P2P consumer loans in 2015 were funded by institutions
- 45% of all platforms surveyed for the 2015 Nesta UK Alternative Finance Industry Report stated that their platform had had some institutional involvement (28% in 2014, 11% in 2013[10])
- In peer to peer real estate lending, the level of institutional funding participation can be as high as 75% on some platforms[11].

Institutional investment in 2015 is telling, showing a progression across the year and suggesting a trend that will continue.

This is not surprising given the higher-risk adjusted, lower volatility, predictable absolute returns than available elsewhere, the potential for substantial diversification and the transparency of the P2P market. The modest default rates are also attractive, even if most platform's performance history is too short to reliably inform future performance[12]. That said, Zopa's performance through a full credit cycle, including the global economic crisis of 2007-09, retaining positive returns for lenders is well-documented.

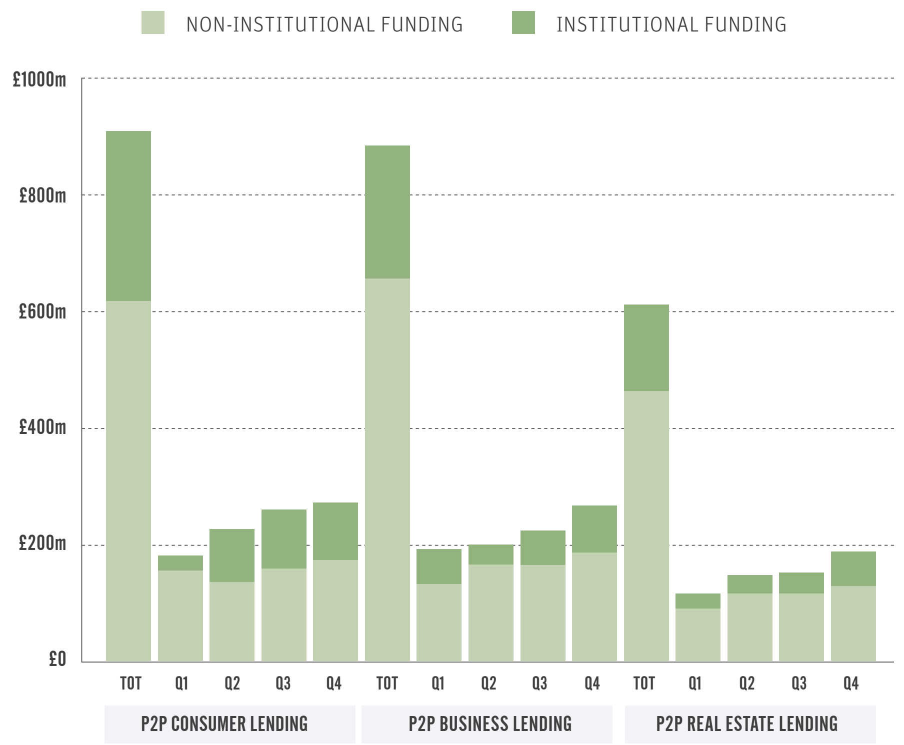
PROS OF INSTITUTIONAL INVOLVEMENT

The British Business Bank (BBB), which has invested close to £200 million through P2P lending[13], is now taking part in this alternative finance route which is becoming less and less alternative. The BBB is deploying funds through marketplace lending as a means to open up new routes for SMEs to access funding, whilst some traditional banks are also using arrangements with peer to peer lending platforms as an entree to business which was previously not financially viable. This is discussed in more detail later in the Industry Milestones section of this report.

In February 2016, Stian Westlake from Nesta said, "Banks can learn about both cost-effective loan origination and data-driven due diligence from the P2P platforms. I think most of the banks are sniffing around for acquisitions." And KPMG's Warren Mead said 2016 would be the year when "alternative financial options finally join the ranks of the mainstream."[14] Moreover, the involvement of more entities such as pension funds and professional financial players is likely to bring significant positives for the platforms which can successfully leverage their participation, with Deloitte suggesting that, "partnerships with banks will help marketplace lenders to increase awareness (and possibly trust) among borrowers and investors, gain scale and possibly lower their customer acquisition costs."[15]

Deeper liquidity and more robust stability could also result from the upsurge in institutional investment in the peer to peer loans universe, as some predict that the majority of growth will come from credit funds investing in securitised assets or secondary loans, rather than from investors lending directly to specific individuals; the creation of this secondary market for loans would certainly improve liquidity, whilst the longer investment horizons of institutional investors such as pension funds means they are in a position to provide enduring and steady funding to the sector[16].

% OF ACTUAL INSTITUTIONAL FUNDING ACROSS PEER TO PEER MODELS (2015)



SOURCE: PUSHING BOUNDARIES, THE 2015 UK ALTERNATIVE FINANCE REPORT, NESTA, FEBRUARY 2016

"The British Business Bank, have invested nearly £200 million in P2P platforms, often by topping up the remaining unfunded portion of near-fully funded loans. Such funding is not only financially but also symbolically important. Arguably, it has boosted public confidence to participate in the market." – **The Bank of England**

CONS OF INSTITUTIONAL INVOLVEMENT

Having said that, institutions do have a reputation for moving their money quite frequently, sometimes being rather flighty and moving their investments on a whim. This is not a beneficial feature in an asset class that may not always be highly liquid.

Another potential negative for other potential investors is the resources and skill that institutions possess which may allow them to identify and monopolise the best deals. This could make it important that individual investors/advisers know what advantages or disadvantages they face when considering a peer to peer lending deal, so that they can make an informed decision.

Nevertheless, platforms are aware of this issue and a recent report which looked at platform members of the P2PFA, found that some P2P platforms have put in place controls to achieve fair treatment of different types of investor (e.g retail and institutional). This involves random allocation of loans across different groups of investor types when auto allocation is used[17].

INCREASING INSTITUTIONAL INVESTMENT

✓ PROS	x CONS
GREATER MAINSTREAM AWARENESS	INSTITUTIONS CHERRY PICKING DEALS
DEEPER LIQUIDITY	
MORE PROFESSIONALISM/EXPERIENCE	'FLIGHTY' MONEY
ACCESS TO MORE CLIENTS/LOAN ORIGINATIONS	

SOURCE: INTELLIGENT PARTNERSHIP

REGULATION

Regulation has been described as a driver that, "will allow the sector to attract even more institutional capital, particularly in this low growth and low interest rate environment. Attracting these types of investors is crucial to the scalability of platforms and is the only way through which the industry will be able to service the huge [SME] lending gap."[18]

Marketplace lenders and the Peer-to-Peer Finance Association also recognise the positive impact of regulation in giving institutions, funds, advisers and investors, confidence in the strong independent governance applied to the sector. And the reality is that this is a critical step on the road to mainstream acceptance.

Until 2014, the regulation of the peer to peer lending space was under the control of the Office of Fair Trading's Consumer Credit legislation. However, from April 1 of that year, the FCA took over regulation of consumer credit and with it, oversight of the crowdfunding universe - both equity and loan based. Since that time, several FCA consultations, new regulations and reviews have taken place and the regulatory landscape has tightened up considerably.

That said, the FCA is keen not to smother the innovation of the sector, meaning that it continues to benefit from a lighter touch and consequently, much lower regulatory overheads than traditional banks[19].

In April 2014, the Financial Conduct Authority (FCA) introduced regulation of P2P lending and equity based crowdfunding, by which the platforms were required to adhere to new rules, the most important of which were:

- All P2P lending platforms must be regulated and authorised by the FCA[20].
- All P2P lending platforms must present information about P2P lending to investors clearly and be honest about the risks associated with the investment.
- All P2P lending platforms must ensure customers' investments and loan repayments are held completely separate from the company's own assets and have a third party to take over loan administration to protect customers' money in the event the platform suffers financial problems.
- Investors in loans sourced by P2P lending platforms were given access to the Financial Ombudsman Service (FOS) in cases where the platform does not resolve a complaint to the investor's satisfaction.
- All P2P lending platforms became subject to the FCA's dispute resolution rules[21].
- In order to assist with market monitoring, all P2P lending platforms are required to submit regular reports on their financial position, the client money held, complaints and the loans arranged each quarter.
- All P2P lending platforms are required to hold capital reserves of at least £20,000, rising to £50,000 by April 2017, to help guard against financial instability.

"Peer to peer lending platforms have a proud record of embracing regulation." – **Christine Farnish, CBE, Peer to Peer Finance Association**

DEVELOPMENT OF P2P LENDING REGULATIONS

OCTOBER 2013
FCA PUBLISHED CONSULTATION PAPER 13/3 WHICH OUTLINED THE FCA'S PROPOSALS TO REGULATE LOAN-BASED AND EQUITY-BASED CROWDFUNDING.

1 APRIL 2014
FCA TOOK OVER REGULATION OF CONSUMER CREDIT FROM THE OFT AND IMPLEMENTED NEW RULES FOR CROWDFUNDING BASED ON POLICY STATEMENT 14/4.

1 OCTOBER 2014
FCA STARTED CONSIDERING APPLICATIONS FOR FULL AUTHORISATION FROM FIRMS WITH INTERIM PERMISSIONS.

FEBRUARY 2015
FCA PUBLISHED A REVIEW OF THE REGULATORY REGIME FOR CROWDFUNDING AND THE PROMOTION OF NON-READILY REALISABLE SECURITIES. IT DECIDED NO FURTHER RULES CHANGES REQUIRED BUT IT WOULD CONTINUE TO MONITOR THE GROWING MARKET.

MARCH 2016
POLICY STATEMENT PS16/8 PUBLISHED SETTING FINAL RULES RE THE SEGREGATION OF CLIENT MONEY ON LOAN-BASED CROWDFUNDING PLATFORMS, THE INNOVATIVE FINANCE ISA, AND THE REGULATED ACTIVITY OF ADVISING ON PEER-TO-PEER AGREEMENTS.

1 APRIL 2016
FULL FCA CONSUMER CREDIT REGIME CAME INTO EFFECT, REPLACING THE INTERIM PERMISSION REGIME.

8 JULY 2016
FCA CALLED FOR INPUT TO THE SCHEDULED POST-IMPLEMENTATION REVIEW OF THE FCA'S CROWDFUNDING RULES BY 8 SEPTEMBER 2016.

DECEMBER 2016
FCA PUBLISHED INTERIM STATEMENT RE FEEDBACK TO THE CALL FOR INPUT, HIGHLIGHTING CONCERNS AND STATING THAT IN Q1 2017 THERE WOULD BE A CONSULTATION ON NEW RULES TO ADDRESS THEM.

1 APRIL 2017
MINIMUM CAPITAL ADEQUACY REQUIREMENT FOR FIRMS RUNNING LOAN-BASED CROWDFUNDING PLATFORMS INCREASES FROM £20,000 TO £50,000.

2019
FCA TO COMPLETE A REVIEW OF RETAINED CCA CONDUCT REQUIREMENTS AND DEVELOP RULE-BASED ALTERNATIVES.

"Consumers need to be clear on what they are getting into and what the risks of Crowdfunding are. Our rules provide this clarity and extra protection for consumers, balanced by a desire to ensure firms and individuals continue to have access to this innovative source of funding."[22]
– **Christopher Woolard, FCA Director of Policy, Risk and Research**

"Before we began regulating the sector, it took an average of 28 months for new platforms to reach their first £25m in sales. In 2014, it took an average of 17 months for new platforms to achieve the same figure." – ***FCA***

At the time these new regulations were introduced, a full FCA review was scheduled for 2016, although it continued to monitor the industry - publishing a review of the regulatory regime for crowdfunding and the promotion of non-readily realisable securities in February 2015. At that time, the FCA decided that no further rules changes were required but in March 2016, Policy Statement PS16/8 was published setting the final rules regarding the segregation of client money on loan-based crowdfunding platforms, the Innovative Finance ISA, and the regulated activity of advising on peer to peer agreements.

In July 2016, the FCA undertook the review promised in 2014, with the intention of scrutinising, "the burgeoning sector to find out if consumers who lend and invest money on peer to peer and similar crowdfunding platforms understood the risks they were taking" — especially as the industry attracts more "retail investors who are less experienced or knowledgeable"[23].

Rhydian Lewis, CEO and co-founder at RateSetter, said, "This review is a fantastic opportunity for our industry to put beyond doubt the case for opening up direct access to investment returns from the asset class of loans. Peer to peer investing is becoming very popular and it makes sense for the FCA to ensure it is appropriately regulated." Christine Farnish, CBE, of the P2PFA commented that, 'Peer to peer lending platforms have a proud record of embracing regulation."[24]

Not only does regulation in general give the perception that markets are fair and orderly[25], but also, stricter regulation raises the barrier for entry into the market, so that platforms must be more serious to participate, dissuading less scrupulous entrants looking for a quick buck. And the tightening controls have been a good thing, which has engendered consumer confidence, something that the FCA points out: "According to data supplied by AltFi, before we began regulating the sector, it took an average of 28 months for new platforms to reach their first £25m in sales. In 2014, it took an average of 17 months for new platforms to achieve the same figure."[26]

P2P PLATFORMS VOLUME BASED CAPITAL REQUIREMENTS (APPLICABLE FROM 2017)

£0 TO £50 MILLION	**0.20%**
£50 MILLION TO £250 MILLION	**0.15%**
£250 TO £500 MILLION	**0.10%**
OVER £500 MILLION	**0.05%**

SOURCE: ALTERNATIVE LENDING: A REGULATORY APPROACH TO PEER-TO-PEER LENDING, GRANT THORNTON

→ FINDING: The Intelligent Partnership 2015/16 Alternative Finance Report, found that 93% of advisers were not aware that alternative finance platforms are regulated. But in April 2016, the FCA added the regulated activity of advising on P2P agreements to the permissions of all those adviser firms which already had permission to advise on investments. This could have a positive effect in raising awareness amongst those firms on the involvement of the regulator in the sector.

The FCA's 2016 review considers how UK marketplace lending has evolved recently and its Call for Input document noted a number of emerging features and concerns that it may take action to mitigate with new legislation.

By December 2016 the FCA had collated responses to the Call for Input and issued an Interim Statement on the feedback, including plans to consult on new rules in early 2017 to address some immediate concerns. These are discussed in the Regulation section of the Risks & Controls section of this report. The points raised in the Call for Input were:

BROADER POOLING OF CREDIT RISK

With investments spread across both loans and platforms as a whole and shared provision funds, with all investors/borrowers dependent on the same provision fund, which is reduced when defaults occur, each investor on the platform may have some indirect exposure to the risk of other loans on the platform in which they may not themselves be invested. (NB, platforms typically take a portion of borrowers' fees to grow their provision fund).

REGULATORY ARBITRAGE

This pooling may result in collective investment schemes, but P2P platforms are not regarded as operating collective investment schemes. If this is the case, the model is similar to asset management and creates a risk of regulatory arbitrage under which firms may conduct business that looks similar to asset management but under a regulatory regime that was not designed for asset management business models.

THE DEVELOPMENT OF MATURITY MISMATCH PRODUCTS ON PLATFORMS

Where borrowers borrow for loan periods of, say, five years, but investors invest in products which aim to allow investors to take out their money after a 30-day notice period. The FCA is concerned with the promises of liquidity that platforms make to investors, and whether an expectation gap exists between the two.

"Peer to peer lending platforms recognise the importance of ensuring that incentives are not skewed merely in favour of writing loans, irrespective of their long-term performance: an increasingly significant amount of income comes to the platforms during the later period of the life of the loans."
– ***Peer to Peer Finance Association***

THE GROWTH OF INSTITUTIONAL INVESTMENT

There are many institutional investors now involved in the sector and also a number of investment trusts with mandates to invest in P2P securitisations. It is important that P2P platforms manage effectively any conflicts of interest arising from the treatment of institutional investors, so that retail investors do not end up carrying a higher degree of risk.

CHANGE IN THE INVESTOR BASE TOWARDS LESS EXPERIENCED

There is anecdotal evidence that suggests P2P investors in the past were relatively wealthy or knowledgeable. The availability of P2P investment through ISAs and pensions, or at retirement using money released from pensions, may create a change in the investor base toward retail investors who are less experienced or knowledgeable, who trust the ISA 'brand', and who may not fully appreciate the risks involved.

ASSESSING THE QUALITY OF CREDITWORTHINESS RATINGS OF BORROWERS

The FCA intends to work with firms to evaluate the quality of their creditworthiness assessments including the approach adopted in peer to peer business lending and whether there is a need to impose new rules. (The FCA visited firms as part of its supervision of the P2P lending market and in 2015 stated, "Overall, we were encouraged by what we found during our visits, including a good understanding of credit risk and robust anti-money laundering (AML) and Know Your Customer (KYC) checks. The firms visited all placed an emphasis on ensuring that consumers interested in lending to individuals or businesses had access to clear information, which would allow them to assess the risk and understand who will ultimately borrow the money.")[27]

DISCLOSURE STANDARDS

The FCA intends to increase its supervisory focus on standards of promotion and disclosure by platforms. If necessary, the FCA will consider whether to mandate in detail the disclosures it expects and the time that those disclosures must be provided.

SUITABILITY CHECKS

The regulator is considering whether platforms should carry out suitability checks for investors. Investment-based equity crowdfunding platforms are required to gauge the suitability of investors prior to allowing them to invest. The FCA's review suggests that it may consider the implementation of a similar set of rules for peer to peer lenders. (This may be directed at non-advised retail investors.)

P2P FINANCIAL PROMOTIONS

There is a concern over P2P financial promotions which are not compliant with the financial promotion rules across all types of media (for example, unbalanced presentation of risks and misleading comparisons with savings accounts and banking). The FCA is encouraging feedback to help gauge whether the current financial promotion rules for P2P promotions are sufficient, and whether firms have a good enough understanding of the rules.

RECOURSE TO FSCS

At present, investors do not have recourse to the FSCS for the failure of borrowers to meet loan payments. Investors also do not have any recourse to the FSCS in the event that a P2P platform fails (they do currently have recourse to the FSCS in the event of unsuitable regulated advice if the advice was given after 6 April 2016 and they entered into a 'P2P Agreement'. Also, if either the platform or the bank in which the money is held (prior to investment) failed before the money was invested, the client money rules provide for the return of client money to clients in the event of a firm's insolvency, or where a bank fails as bank deposits are already subject to FSCS jurisdiction under the Prudential Regulation Authority's (PRA) rules. And, where a client has a claim for a deposit, it may be protected by the FSCS under PRA rules.

→ Interestingly, two items raised in July 2016 in a hearing of the House of Commons' Treasury Select Committee during the oral evidence of the new Chief Executive of the FCA, Andrew Bailey, don't figure prominently in the FCA's 2016 review; Mr Bailey was questioned by MP Chris Philip who contended that, "there is a misalignment of incentives where those operating peer to peer lending platforms receive fees upfront based on the volume of loans originated. In his response, Mr Bailey suggested that structuring lending through taking fees upfront creates uncertainties. The P2PFA countered by letter that, "A significant part of the fees charged for peer to peer lending are earned over the course of the life of the loan, and are not paid at the outset. Peer to peer lending platforms recognise the importance of ensuring that incentives are not skewed merely in favour of writing loans, irrespective of their long-term performance: an increasingly significant amount of income comes to the platforms during the later period of the life of the loans." [28]

"Recent research found that peer to peer consumer lending platforms expect the IFISA to add over 26% to their annual volume."

Mr Philip also advocated co-investment of a proportion of a peer to peer lending platforms' loans to concentrate attention on making good credit decisions. Again, the P2PFA rebuffed this swipe, writing, "the peer to peer lending sector has embraced a level of transparency which is unrivalled in financial services, and it is possible to make judgements about the calibre of credit decisions made by each individual [P2PFA member] platform in respect of their entire loan book through material which is already published. I would argue that ensuring that investors are empowered to[29] appraise a peer to peer lending platform's credit decisions and performance obviates any requirement to mandate co-investment. I would observe that it is not a requirement for asset managers to co-invest, despite incurring greater levels of risk within their investment portfolios."

The Regulator acknowledges that higher consumer protection comes at a price. In 2015, it's cost-benefit analyses indicated that the new rules will result in certain companies leaving the peer to peer industry and that compliance costs will be permanently higher for those that survive. Nonetheless, the expected market consolidation and greater consumer confidence that this could bring are likely to be good for the market as a whole[30].

INNOVATIVE FINANCE ISA

In the 2014 Budget, former Chancellor George Osborne announced that peer to peer debt investments would become eligible to hold within a tax-advantaged Individual Savings Account (ISA) from 6 April 2016. In addition, draft changes were announced by the Treasury in August 2016 which allow investors to place bonds and other 'debt securities' in the Innovative Finance ISA (IFISA[31]) wrapper from 1 November 2016. The ISA represents a mass market financial brand, with a diverse client base among the young and old, rich and poor, sophisticated and unsophisticated, totalling a £500 billion market[32]. No wonder then, that participants in the P2P lending market have high hopes for the positive effects of the IFISA.

In fact, recent research found that peer to peer consumer lending platforms expect the IFISA to add over 26% to their annual volume and peer to peer business lenders expect a 27% increase. Moreover, peer to peer business lending for real estate platforms are expecting a very substantial 52% growth in transaction volume as investors seek to utilise the tax advantages available to them[33]. This has prompted some of the P2P real estate lending platforms to lower their minimum investment thresholds in anticipation of the influx of retail investors[34]. According to analysis by Yorkshire Building Society, that influx could be of around 405,000 people who choose to open an Innovative Finance ISA[35].

One note of caution though - many ISA customers are risk averse and the IFISA will simply not be suitable for them. There is also some concern that the ISA label will attract retail investors who equate it with the security of a cash ISA, rather than the risk of an investment. This is an area where advisers could not only ensure clarity to their clients, but, with only 13% of the general population having a grasp of what the IFISA[36] is, also add value by introducing it as an option to suitable clients.

P2P loans will not be included in stocks and shares ISAs as eligible investments in their own right - they can only be held in IFISAs in their own right. However, subject to certain conditions, these loans can be held within investments that are currently eligible for a stocks and shares ISA, such as investment trusts.

The government has also decided that requiring the transfer of peer to peer loans between ISA managers would impose significant burdens on peer to peer businesses and potentially negative impacts on the consumer. As a result, loans held within ISAs do not have to be transferable, although where secondary markets exist, ISA investors should have the opportunity to sell their loan, where they wish to withdraw or transfer cash from their ISA (which must be transferable within 30 days). Nevertheless, due to the illiquid nature of P2P investments, the government has indicated that the transfer deadline of 30 days will only apply if and when investments in the IFISA have been liquidated to cash. The government stopped short of requiring all peer to peer platforms to have an active secondary market because of the risk of placing disproportionate costs on platforms - particularly new platforms – and because it is unlikely to be effective in ensuring consumers can liquidate without facing potentially significant losses. Consequently, there is also no requirement for guarantees that loans can be sold at market value as a condition of ISA eligibility. Peer to peer platforms will therefore not be required to provide a means by which the investment can be liquidated (and therefore transferred).

This simply mirrors the existing situation in which some P2P platforms operate secondary markets and some investors are able to access liquidity through them, but liquidity is not guaranteed.

In terms of diversification, those who want to hold multiple P2P investments in an IFISA will not be able to do so with loans across several platforms unless they originally invested through an aggregator wrap platform. This is because only one IFISA account will be eligible for the IFISA tax benefits per year. Consequently, unless the individual uses an aggregator platform, they will not be able to create a platform diversified P2P portfolio within an IFISA wrapper.

"Simon Kirby who was installed as the new Economic Secretary to the Treasury after the Brexit vote has a history of supporting P2P."

Whilst some may be excited at the prospect of the IFISA, the FCA has caused delays to the full operation of the P2P lending market in this sphere because of problems with issuing the fully authorised permissions that platforms are required to hold in order to offer the new IFISA. At July 2016, only 9 firms were fully authorised to offer loan-based crowdfunding platforms and the FCA were in the process of considering a further 88 applications from firms. By September, the FCA had only processed an additional 3 authorisations. These include firms operating in the market with interim permission, having previously been licenced by the Office of Fair Trading under the regime pre-April 2014[37]. This suggests that it may take some time before all of those keen to offer the IFISA in P2P lending are in a position to do so.

GOVERNMENT SUPPORT

The government has supported P2P lending since inception and in particular the distribution of funds through it to SMEs. It supports the sector via the British Business Bank and the mandatory referral scheme for high street banks, as well as by aligning taxation so that the interest received from peer to peer loans is taxable in the same way as any other interest received.

COMMENTS BY POLITICIANS

At the LendIt Summit in October 2015, Harriett Baldwin Economic Secretary to the Treasury said, "We believe that peer to peer lending is a brilliantly innovative new form of finance – which we want to see continue to grow and evolve. P2P platforms and fintech provide competition, ideas, and technology – making people's lives better and the markets more effective".[38]

Simon Kirby who was installed as the new Economic Secretary to the Treasury after the Brexit vote has a history of supporting P2P. In 2012 he welcomed the government's move to start lending directly to small businesses and traders through peer to peer lenders. Mr Kirby said, "Small businesses are the lifeblood of our economy and it is essential that they have access to the finances they need to develop and grow."

The FCA has also taken its lead from the government, stating in July 2016 that, "Achieving more diverse and accessible financing for individuals and small and medium sized enterprises (SMEs), as well as more rigorous competition in retail banking services, were reaffirmed as Government priorities in the 2016 Budget"[39]. And the importance of these funding methods was acknowledged by the Parliamentary Commission on Banking Standards which stated that: "Peer to peer and Crowdfunding platforms have the potential to improve the UK retail banking market as both a source of competition to mainstream banks as well as an alternative to them (...) The emergence of such firms could increase competition and choice for lenders, borrowers, consumers and investors."[40]

ALIGNMENT OF TAXATION

On 6 April 2016, the way loan interest from P2P lending is taxed and tax is reclaimed was regularised to match taxation of any other interest received. Until this time, UK tax law did not allow bad debts (i.e. borrower defaults) incurred in P2P lending investments, to be offset against income.

As a result, if a peer to peer loan isn't repaid, the lender can set the loss they suffer on the loan against the interest they receive on other peer to peer loans, before the income is taxed. Tax relief is available to peer to peer lenders who:

- are liable to UK Income Tax on their peer to peer income
- make loans through peer to peer lending platforms that are authorised by the FCA
- are the legal lender at the time when it's agreed that the loan has gone bad

However, it is not possible to offset peer-to-peer lending losses against gains from other types of savings and investments, although the loss relief can be carried forward for up to 4 years.

From 6 April 2016, lenders who do not normally need to submit a tax return will only need to declare any peer to peer interest that they receive through the same platform after bad debts to HMRC. This can be done by contacting their local tax office. If the investor pays tax under Pay as You Earn (PAYE), their tax code will then normally be adjusted to collect the tax due on the interest earned. If tax has already been deducted on the full amount of peer to peer interest received, without a deduction for bad debts, the lender can make a claim for repayment.

Any claims to set relief for peer to peer bad debts from one platform against peer to peer interest received through another platform, or to carry relief forward against peer to peer interest received in future years, must be made through a tax return[41].

In addition, interest earned on peer to peer lending loans is included in the Personal Savings Allowance (PSA) which was also introduced in April

"Partnerships with banks will help marketplace lenders to increase awareness (and possibly trust) among borrowers and investors, gain scale and possibly lower their customer acquisition costs." – **Deloitte**

2016. Consequently, basic and higher rate UK tax-paying investors can treat income from peer to peer companies in the same way as bank or building society income[42]. So, basic-rate taxpayers will be able to earn £1,000 in interest on savings without having to pay a penny to HMRC (ie: a maximum saving of £200 each year). Their higher-rate taxpaying counterparts will enjoy a corresponding threshold of £500, which in turn also equates to a maximum annual saving of £200. But, additional rate taxpayers are not eligible for any relief.

Furthermore, ISA earnings will not count towards the Personal Savings Allowance, which covers income from current accounts, regular savers, fixed rate bonds and more. This means that in the 2016/17 tax year, ISA earnings on up to £15,240 of ISA cash or investments are tax free, along with up to £1,000 of other personal savings allowance earnings. In 2017/18, up to £20,000 of ISA cash or investments, plus another £1,000 of other personal savings allowance earnings will be tax free.

The establishment of an ISA which allows P2P loans to be held within it also signals a coordination of P2P lending returns taxation with other mainstream income generators. Like other ISAs, all interest and gains made in IFISAs are completely tax free.

BRITISH BUSINESS BANK

The 100% government-owned, British Business Bank distributes finance to smaller businesses by deploying its funds through partner intermediaries. Currently it supports over £3.1 billion of finance to UK SMEs[43] and aims to help improve diversity of supply of finance for smaller businesses by expanding support for challenger banks, non-bank debt funds, online platforms, invoice and asset finance providers[44].

According to the Bank of England, "The UK Government Department for Business, Innovation and Skill and, latterly, its subsidiary, the British Business Bank, have invested nearly £200 million in P2P platforms, often by topping up the remaining unfunded portion of near-fully funded loans. Such funding is not only financially but also symbolically important. Arguably, it has boosted public confidence to participate in the market."[45]

The Bank made £20 million available to SMEs through Funding Circle in December 2012 through the Business Finance Partnership (BFP) and in March 2014 the Business Bank Investment Programme committed a further £40 million to Funding Circle. In December 2015 the Bank announced an initiative with Ratesetter to deliver finance to small businesses after previous cooperation between the two parties led to loans to almost 1,000 creditworthy sole traders across the UK.

Another initiative has been the Local Business Lending Partnership scheme, established to stimulate local economic growth and employment through improved access to business finance, which has provided a multi-million pound funding route for SMEs via the British Business Bank. Numerous councils across the country have partnered with Funding Circle to invest in SMEs in their area for a return. They include Lancashire, Nottinghamshire, Gloucestershire, Leicestershire, Camden, Kirklees, Sefton, Newcastle, Rushcliffe and Tandridge councils[46].

This kind of involvement is likely to continue, with a 2.0% return on capital deployed, exceeding the target set by government and the success of the bank's programmes to date[47]. In its Small Business Finance Markets report, 2015/16, the British Business Bank certainly didn't rule it out: "There is still limited diversity in the supply of smaller business finance so new providers and new products need nurturing."[48]

In the aftermath of the referendum by which the UK public voted to leave the European Union, the Bank's Chairman Ron Emerson suggested that the British Business Bank would have a continuing input into UK alternative finance when he wrote, "On 23 June the United Kingdom voted to leave the European Union. This generates some uncertainty for the Bank, as some of our programmes rely on EU funding or guarantees, but also creates opportunity for us to respond to the changing environment, building on the platform we have established. We are in close contact with our stakeholders and are monitoring market conditions to ensure that we respond as appropriate."

EUROPEAN INVESTMENT BANK

The UK is one of the main shareholders in the European Investment Bank (EIB), with a 16.11% shareholding, and it remains one of the four main shareholders of the EIB.

In June 2016, it was announced that the EIB is to offer £100 million of loans to UK SMEs through the online lender Funding Circle. Funding Circle cites its record of receiving investment from a diverse range of investors including national and local government backing in the UK and support from international organisations such as KfW, the German development bank.

"Currently, the British Business Bank supports over £3.1 billion of finance to UK SMEs and aims to help improve diversity of supply of finance for smaller businesses by expanding support for challenger banks, nonbank debt funds, online platforms, invoice and asset finance providers."

"Banks can learn about both cost-effective loan origination and data-driven due diligence from the P2P platforms." – **Stian Westlake, Nesta**

However, this is the first time the EIB has lent money via a peer to peer online service. The EIB said that this new engagement is recognition of the role of marketplace lending as an efficient way for small business to access finance, and an important new channel to stimulate the real economy.[49]

Following the Brexit vote, a spokeswoman for Funding Circle said that the EIB has given assurances about its initial £100m commitment, but any further work on the partnership is now in doubt, although an EIB press release on June 24 2016 states that "At present the UK shareholding in the EIB remains and the EIB's engagement in the UK is unchanged. At present, the EIB's shareholders have not requested the bank to change its approach to operations in the UK. It is premature to speculate on the impact of the referendum result on the EIB, including the bank's future relationship with the UK government and its future engagement to support long-term investment in the UK without clarity on the timing, circumstances and conditions of a withdrawal settlement."

Nevertheless, the support of such a large, international financial institution for UK P2P lending still sends a clear signal of the kind of attention that it is worthy of.

BANK REFERRAL SCHEME

The Small and Medium Sized Business (Finance Platforms) Regulations 2015, set the stage for the bank referral scheme through which 9 designated, major banks are obliged to refer small business borrowers to other sources of funds if they are not prepared to lend. So the government is now legislating to guide borrowers to P2P lending, providing lender origination opportunities to P2P platforms designated by the Treasury (currently Bizfitech, Funding Options and Funding Xchange)[50].

Although delayed for a year, the scheme launched in November 2016. Its success remains to be seen, but there is reason to be optimistic, as Funding Options CEO Conrad Ford stated, "Regulators have made it clear that they will be watching closely, and as no Chief Executive of a major bank is going to enjoy being hauled in front of senior ministers, it will be a very foolhardy business banking executive that doesn't very quickly fix things if the bank is not contributing their fair share of referrals."[51]

BANK TIE UPS

Marketplace lenders are increasingly utilising private and public sector partnerships to source both high-quality borrowers for loan originations, investors and institutional funding. These partnerships help to raise public awareness of the sector and could have considerable implications for deal origination; attracting high quality borrowers, with potential to gather additional borrower data to enhance credit scoring and risk management[52].

The following looks at just two examples of bank and peer to peer platform tie-ups:

SANTANDER AND RBS

In June 2014, Santander became the first high-street bank to refer its customers to an online peer to peer lender for small business lending in a sign that alternative finance providers are achieving mainstream acceptance[53]. That was followed in early 2015 by the Royal Bank of Scotland's P2P lending initiative by which customers, who the bank is unable to financially help at the moment, were to be signposted to both Funding Circle and Assetz Capital as options of alternative sources of finance[54].

METRO BANK

Then, in May 2015, Metro Bank became the first British bank to lend through a peer to peer platform by lending customer deposits through Zopa, allowing consumers to take advantage of the lower online digital fees[55].

Other tie-ups include JP Morgan's deal with On Deck Capital in December 2015 to help make loans to some of the bank's roughly four million small-business customers[56] and another Santander partnership with Kabbage. This is aimed at speeding up the underwriting process so businesses can potentially access working capital of up to £100,000 online on the same day[57].

The benefits for platforms are clear - partnerships with banks will help them to increase awareness (and possibly trust) among borrowers and investors and gain scale[58]. Banks recognise the worth of new, young and dynamic brands providing fast and efficient service and a route to business they would not otherwise have access to.

OPENING UP BANKING

There is political momentum behind the push for a more open and competitive UK traditional banking sector and August 2016 saw the publication of the Competitions and Markets Authority (CMA) retail banking market investigation. This found that older and larger banks do not have to compete hard enough for customers' business, and smaller and newer banks find it difficult to grow. Consequently, many people are paying more than they should and are not benefiting from new services. Amongst the measures being implemented to remedy this and open up banking, is the requirement for banks to publish their prices for smaller, non-complex lending products and the largest banks will also be required to develop online tools which allow small businesses to input some information about themselves and receive tailored

*"Peer to peer and Crowdfunding platforms have the potential to improve the UK retail banking market as both are a source of competition to mainstream banks as well as an alternative to them (...) The emergence of such firms could increase competition and choice for lenders, borrowers, consumers and investors." – **Parliamentary Commission on Banking Standards***

indications of eligibility and price for lending products. The CMA will insist that banks share customers' financial details with other "approved firms" in an attempt to create banking apps which give customers access to all of their financial details from multiple accounts. This could open up access to potential clients for loan originators such as P2P platforms.

A number of the remedies proposed by the CMA aim to empower small businesses so that they are less dependent on their existing bank[59].

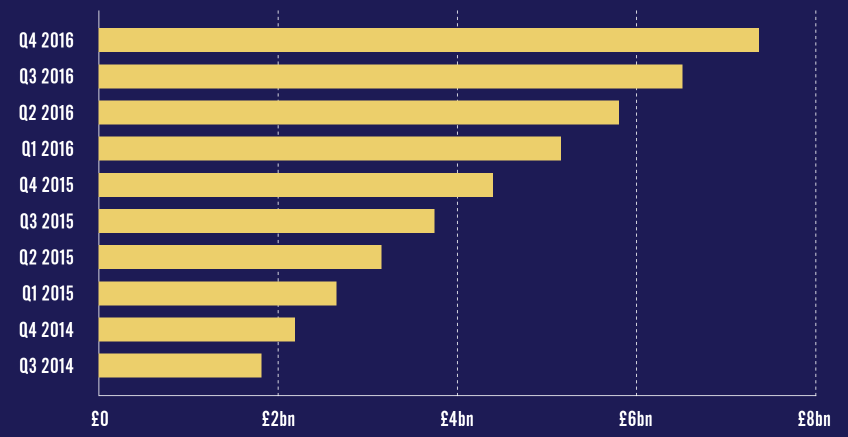
Another potential driver towards a more even playing field in banking-related services, by allowing more access to current account data to regulated entities, with the permission of a customer, is the Europe-wide Second Payment Services Directive (PSD2). Due to come into force in 2018, this could mean that a P2P lender is able to instantly review the current account data that a bank currently views as a matter of course for its account holders. The result would be to cut the huge information advantage that banks currently enjoy and to facilitate more automation of the P2P underwriting procedure by reducing manual processing of documentation such as copies of bank statements[60].

MARKET DATA

The peer to peer lending market started with the establishment of Zopa in the UK, the first P2P marketplace lender in the world. After several slow years of building awareness and business, the sector has experienced very high growth volumes over the last five years - both in the UK and elsewhere.

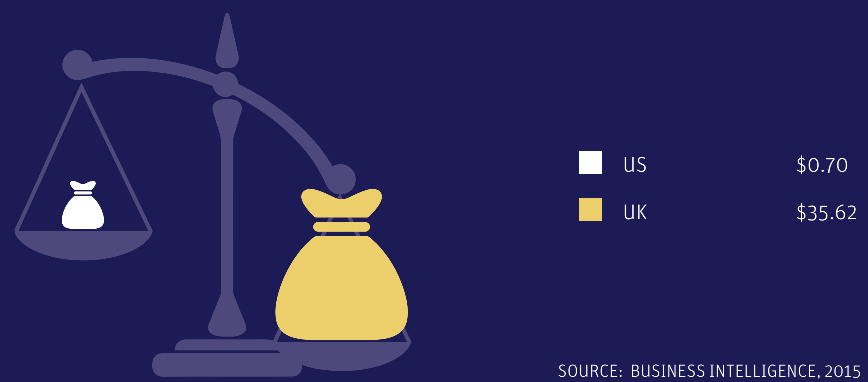
However, in 2016, commentators on the US market stated that they would not be surprised to see massive internet consumer companies like Google, Facebook or Amazon entering

TOTAL CUMMULATIVE LENDING



SOURCE: P2PFA

US VS. UK P2P MARKET PER CAPITA (2014)



SOURCE: BUSINESS INTELLIGENCE, 2015

The US market is more developed than that of the UK in terms of overall loan volume, but the UK market is much larger on a per capita basis. In 2015, it was reported that the UK P2P lending sector was 72% bigger on this basis, with low consumer confidence in banks (even before the financial crisis), a high degree of comfort with online platforms, and a positive regulatory environment all helping to nurture the UK's P2P lending market[61].

UK P2P FINANCE ASSOCIATION MEMBER LENDING

	Q1 2016	Q2 2016	Q3 2016	Q4 2016
NEW LENDING	£715,000,000	£658,000,000	£700,616,000	£843,917,664
O/W LENDING TO INDIVIDUALS	£270,070,000	£252,000,000	£271,138,000	£299,939,490
O/W LENDING TO BUSINESSES	£445,350,000	£406,000,000	£429,478,000	£543,978,474

*"New risks have to be weighed against the desperate need for credit in Europe." – **The Financial Times***

this space and either partnering with, or acquiring existing lending sites. They would have great synergies with lending sites — and be able to offer these loans to a lot more consumers[62]. This type of involvement points to a serious and maturing international industry.

Nevertheless, some commentators reported a slow-down in the second quarter of 2016 and consequently reduced their year on year UK P2P lending market growth predictions (which still stood at well over three and a half billion of originated finance). The P2PFA figures for its 8 influential members mirrored this finding.

UK P2P is not accustomed to a quarter not outperforming the last and this shallowing of origination volume, from Q1 to Q2, was probably not related to the Brexit vote as there were only a few days for the result to feed through into origination figures. Instead, the reasons for the slowdown are more likely to be connected to a variety of factors:

- There are large permanent capital vehicles (PCV) now present in the sector (A PCV is an unlimited life, open or closed ended fund, that is typically structured as an investment company, although limited partnerships are also used) and these fund vehicles are generally fully deployed. Consequently, fundraising has not taken place for some months and this significant driver to the sector's origination growth has been quiet.
- Wider credit markets have offered better returns in 2016 than they did in 2015, reducing the appeal of marketplace lending to new institutional investors. The events of Brexit and the cut in UK interest rates to 0.25% in August 2016 for the first time in seven years, suggest that credit market returns may not remain as attractive.
- UK platforms have been looking to generate securitisation deals.

Securitisation is a key source of funding for banks and non-banks where loans are packaged together and sold on as bond-like products, allowing capital markets to fuel more lending. In April 2016, Deutsche Bank, said that it expected securitisation "to play an increasingly significant role in providing efficient financing for lenders on marketplace platforms"[63], although, by September 2016, only two deals had been done; one involving Funding Circle and KLS Diversified and another in which MW Eaglewood securitised £138 million of Zopa loan assets. In such a young market, larger financial institutions are very sensitive to new risks such as lack of a performance history through the full economic cycle and the controversy over Lending Club in the US has certainly not been helpful. But the FT's comments on the issue in May 2016 are telling; "new risks have to be weighed against the desperate need for credit in Europe. The industry, like securitisation, will be hoping to receive further support from European policymakers keen to stimulate lending."[64]

- As has already been discussed earlier in this report, another driver for the UK peer to peer lending market is expected to be the Innovative Finance ISA, which has been touted as a means of bringing a new wave of retail money into the sector. But to date, very few platforms have been issued with the full FCA authorisation to be in a position to accommodate this tax efficient wrapper. So, the upswing in incoming funds may be more gradual than perhaps originally anticipated as the regulator wades through the necessary administration.
- The second quarter of 2016 saw legacy lenders experiencing increased demand for unsecured personal loans, according the Bank of England. Credit scoring criteria also loosened, and an increased proportion of loans were approved. This suggests that more consumers were successful in borrowing from high street banks in the second quarter of 2016. This may have led to fewer consumers approaching P2P lenders during the period, leading to a decline in originations. It will be interesting to analyse the behaviour of banks in the wake of the uncertainty created by the Brexit vote to get a measure of how much tightening of lending criteria takes place.

Total business loan volume in P2P decreased by 9% in Q2 2016. But without lenders that specialise in property loans, business lenders' quarter-over-quarter volume was flat. Property lenders saw an aggregate decline in volume of 30%, which dragged business lending down. It appears that uncertainty in the UK property market caused by Brexit drove the decline.

This drag on overall performance by the real estate sector marks a change in fortunes for this sub-sector, in 2015, as it was the most popular sector funded on peer to peer business lending platforms, aided in part by the increase in secured-lending particularly against fixed assets such as property and machinery. Nevertheless, a bounce back in property market confidence was evident in the second half of the year, with Rightmove reporting in September that a third of the drop in average house prices experienced in the wake of the vote had already been recovered. Moreover, in the same time frame, UK real estate investment trust shares had regained half of the average of 23% they lost from the day after the referendum[65].

So, in spite of the recent difficulties and, although property lending could still be at risk in the short term due to the UK's vote to leave the EU, it is predicted that it will recover in the long term, continue to grow faster than other segments and make up the largest share of P2P activity in the UK in

"Longer term statistics show the advantage of P2P lending as an alternative to other fixed income products."

2020, followed by business lending and consumer loans[66].

Even in the short term, loan origination, although facing some limiting factors, is not unattractive; the P2PFA has published figures showing a bounceback in Q3 2016.

In the mid to long term, the upward trajectory of the UK market remains impressively steep: Business Intelligence forecasts that UK P2P lending will grow to a value of £16 billion by 2020[67], whilst Liberum predicts a potential market volume of £30 billion by 2025.

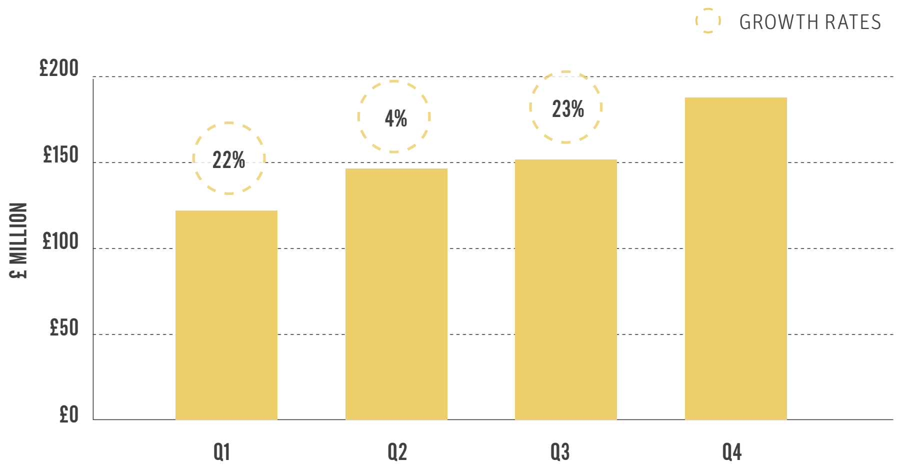
RETURNS

In terms of investor yields, research reveals that P2P lending is a desirable asset class.

Investor net rates of return have remained very stable over the last three years and whilst there has been some divergence, the spread between borrower and lender rates has also been quite steady. The spread between the rates stood at around 4% in the second half of 2016 for business lending and consumer lending, although there has been an increase from 2% for the spread between lenders and borrowers in the consumer lending segment.

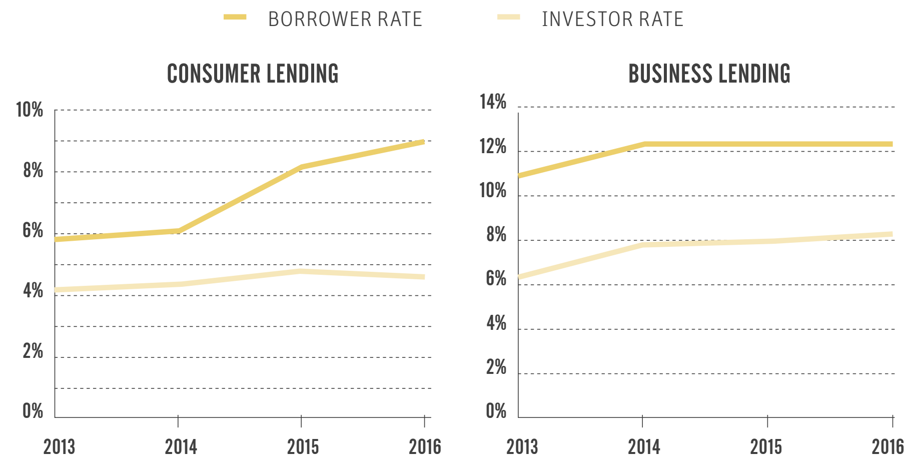
Longer term statistics show the advantage of P2P lending as an alternative to other fixed income products as seen in the graph below.

PEER TO PEER BUSINESS LENDING (REAL ESTATE) MARKET VOLUME BY QUARTER (2015)



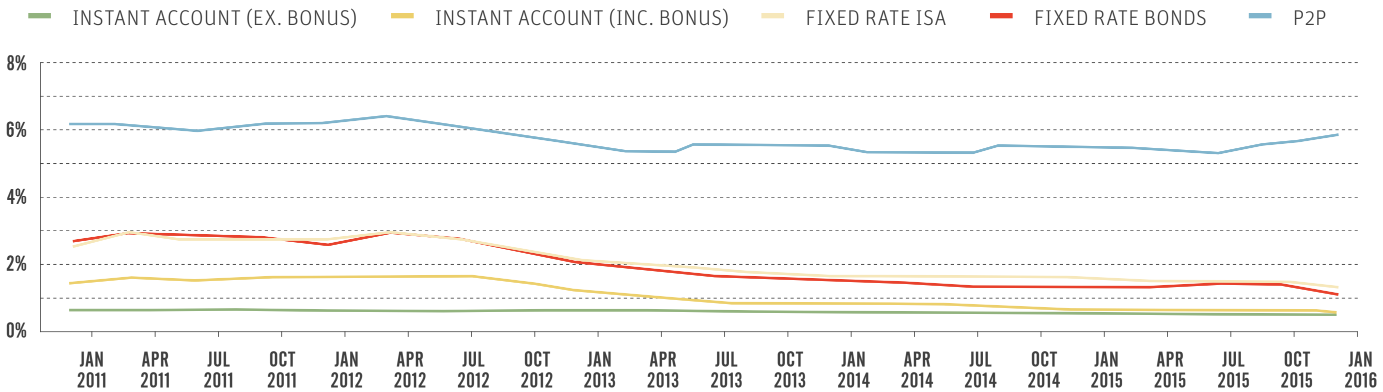
SOURCE: PUSHING BOUNDARIES, THE 2015 UK ALTERNATIVE FINANCE INDUSTRY REPORT, NESTA, FEBRUARY 2016

P2P LENDING ESTIMATED AVERAGE BORROWER RATE OF INTEREST AND INVESTOR RATE OF NET RETURN (2013-2016)



SOURCE: THE ECONOMICS OF PEER TO PEER LENDING, OXERA, SEPTEMBER 2016

P2P LENDERS VS SAVINGS ACCOUNTS RETURNS (2011-15)



SOURCE: MARKETPLACE LENDING A TEMPORARY PHENOMENON? DELOITTE, 2016

"If we look at the largest two individual platforms, we can see that, over the 12 years in which it has been in operation, Zopa's average actual default rate was less than half of that predicted – 2.15% predicted versus 1.06% actual. Funding Circle also undercuts its predicted default rate."

DEFAULT RATES

Expected versus actual default rates is a key metric to look at as it gives an important indication of the accuracy of platforms' projections which are informed by their risk assessments, and the reality of the potential yield.

Default rates vary depending on risk bands which are assigned to borrrowers vetted through platform credit underwriting. In general, we can expect that the platforms which provide secured property loans will have very low bad debt rates, perhaps close to zero, thanks to the collateral available. Consumer loans suffer a slightly higher rate at 2% to 3%, whilst business loans exhibit a higher rate. All the same, the levels of borrowers who discontinue repayments is very limited[68].

Oxera's review of the eight platforms that are members of the P2PFA gives an indication of the range of actual defaults versus the predicted losses, focusing on loans issued in 2013 and 2014. The proximity of the actual and predicted rates gives us a sign as to the effectiveness of each platform's credit risk assessments.

The results of the Loan Losses table to the right, are generally impressive, although, for the longer property loans in particular, defaults will not yet have been fully realised for this period, so actual default rates can be expected to rise.

In fact, the P2PFA's Christine Farnish put industry defaults at around 2% at the end of January 2016[69].

Nevertheless, if we look at the largest two individual platforms, we can see that, over the 12 years in which it has been in operation, Zopa's average actual default rate was less than half of that predicted – 2.15% predicted versus 1.06% actual. Funding Circle also undercuts its predicted default rate over its six year history with an average of 3.92% predicted versus 2.75% actual.

ACTUAL TOTAL LOAN LOSSES SO FAR (AND EXPECTED LOAN LOSSES) AS A PERCENTAGE OF VALUE BY PLATFORM FOR LOANS THAT ORIGINATED IN 2013/14

	MAIN BORROWER TYPE	2013	2014
Funding Circle	BUSINESS LOANS	4.1% (4.6%)	3.0% (4.4%)
ThinCats	BUSINESS LOANS	4.1% (4.1%)	3.7% (4.0%)
RateSetter	CONSUMER LOANS	1.7% (1.5%)	3.0% (2.2%)
LENDING WORKS	CONSUMER LOANS	N/A	4.1% (4.6%)
zopa	CONSUMER LOANS	0.7% (1.3%)	1.5% (2.1%)
marketinvoice	INVOICE FINANCE	0.2% (data unavailable)	0.5% (data unavailable)
LANDBAY	PROPERTY LOANS (buy to let mortgages)	N/A	4.1% (4.6%)
lendinvest	PROPERTY LOANS	0.0% (0.0%)	0.1% (0.1%)

SOURCE: OXERA, THE ECONOMICS OF PEER TO PEER LENDING, SEPTEMBER 2016

"Investors on UK P2P marketplaces should be prudent and diligent, since certain asset classes and originators will be more default-prone than others in a weaker economic environment. As such, there should now be a flight to quality." – **Robert Stafler, Fintex Capital**

FEES AND CHARGES

Low overheads allow platforms to charge lenders little or no fees with all of the costs passed over to the borrowers. Looking at the spread between the lender and borrower rates will give an indication of how much the platform is taking.

Direct fee comparisons with banks can be problematic because of the varying products on offer, but asset management fees, with an initial fee and an ongoing management/servicing fee, mirror the structure of many P2P platforms. This means that broadly equivalent comparisons can be made and based on an analysis of the 8 P2PFA platform members, there is a similar variation and level of fees applicable to the issuing and holding of corporate bonds:

Loan Origination Fees: 0% to 6% of loan value, with the higher amounts generally applied to smaller loans

Ongoing Fees: 0.7% to 1% p.a[70]

These figures show that ongoing fees make up a potentially hefty portion of the overall income of platforms – perhaps a third to half or more, depending on loan origination charges. And since more and more platforms only charge the borrower fees, there is significant incentive for the platform to ensure the borrower repays the loan for the whole loan term.

SECONDARY MARKETS

Two thirds of the 39 platforms on which Intelligent Partnership collected data, had a secondary market. The depth of these markets is uncertain, but their existence is encouraging to those who are interested in longer term loans but have liquidity concerns.

Be that as it may, research has found relatively low usage of secondary markets (largely less than one quarter of the platform loan book) which could indicate that investors understand the long-term nature of P2P lending. This is supported by survey evidence which has found that, currently, investors' general perception of P2P lending is that it carries risk, is suitable for only longer term investments and that liquidity is required to exit early through secondary markets[71].

BREXIT

Currently, there is no pan-European regulation that specifically covers peer to peer lending. This suggests that there will not be any Brexit effect on current legislation, as could be the case with other asset classes where managers very quickly called for simplification and stripping of EU imposed complexities from regulations. This should translate to little disruption in this area.

Christine Farnish, Chair of the Peer to Peer Finance Association, says that the fundamentals of P2P lending will not be affected: "Inevitably the UK now faces a difficult period of economic and political uncertainty. But I would urge observers to remember that none of this short-term turmoil changes the fundamentals of P2P lending. People will still need to borrow, save and invest. And P2P lending's clear consumer and economic benefits are not going to go away."[72]

Robert Stafler, Chief Executive of Fintex Capital, institutional credit investor focused on European marketplace lending said, "investors on UK P2P marketplaces should be prudent and diligent, since certain asset classes and originators will be more default-prone than others in a weaker economic environment. As such, there should now be a flight to quality." Like Christine Farnish, he foresees that there will continue to be a place for P2P platforms but that, in order to ensure they can continue to deliver performance in the weaker economy that is now expected, platforms with riskier assets may want to de-risk some of their originations, even if this is at the expense of some desired growth in the shorter term. Indeed, Stuart Law, CEO of Assetz Capital, admitted that the platform's credit team would have to be "even more careful" going forwards.

In fact, in the immediate aftermath of the leave vote, LendInvest tightened its lending criteria for loans worth more than £3 million, adjusting the cap on loan to values (LTV) for these loans to 65%. The company also temporarily paused lending on new second charge applications[73].

However, the near-certain prolonging of a low-yield period thanks to the post Brexit economic reverberations, with interest rates expected to remain lower-for-longer, could be a real positive for P2P platforms. The spread between the net yields available on leading platforms and base rates, is likely to prevail for longer. Over the past years, yield has been hard to come by in the wider market and those platforms focused on safer loans should be in a position to continue to offer comparatively attractive yields[74]. For those working hard to seek out desirable, stable yields at reasonable risk, the asset class could be very interesting. They certainly haven't been getting that from central governments, with UK gilt yields in particular offering record low yields post referendum.

In fact, Partners Group which has over 850 institutional investors worldwide and $55 billion in assets under management, stated three months after the vote that, "There is risk of further volatility relating to the uncertainties around Brexit, however, this environment is also expected to be a source of investment opportunity for private debt investors with a longer-term view".[75]

Post referendum research by ThinCats has also identified that 30% of those surveyed said they had been put off investing in more traditional asset classes following the Brexit vote.

"The near-certain prolonging of a low-yield period thanks to the post Brexit economic reverberations, with interest rates expected to remain lower-for-longer, could be a real positive for P2P platforms."

Moreover, a significant minority (7%) of investors are more attracted to P2P lending, among other alternative asset classes, as a result of it.

The reaction of banks to the economic turbulence resulting from the Brexit decision will certainly play its part in how the marketplace lenders fair. The prospect of bank interest rates on business loans rising to offset greater perceived risk in difficult times (making banks less competitive) combined with the potential of reduced lending volumes may drive more demand towards P2P loans. At the same time, with even lower base rates, banks are lowering their savings account rates even further, with Santander slashing its 123 account rate from 3% to 1.5% and Natwest warning business customers that it may introduce negative interest rates[76]. In this environment, since P2P platforms are largely independent of monetary policy and Bank of England base rates, (except insofar as they affect bank rates and therefore marketplace lending's comparative competitiveness), they may be in a position to deliver more lending to quality businesses and those with robust loan security, and also provide more interest to lenders.

However, Brexit and any subsequent knocks to business confidence could impact the demand for lending from companies who decide not to proceed with expansion plans during uncertainty/market downturn. Under these circumstances, logic suggests that the larger platforms with greater financial reserves, will be in a better position to weather any drops in loan origination rates. Although, some market participants theorise that well-structured P2P platforms can sustain themselves on a loan book from as little as £7.5 million - £10 million[77].

If the UK does slip into recession, which is by no means certain, there will at least be an opportunity for the P2P platforms to show how they hold up through a part of the economic cycle which is largely missing from their historic performance data.

WHAT'S NEXT FOR PEER TO PEER INNOVATION?

There have been a number of recent launches of products that have the potential to expand the peer to peer lending model and in the next sections, three of them are discussed:

OCTOPUS CHOICE

In April 2016, Octopus Investments launched a new P2P lending platform called Octopus Choice. Octopus states that the new platform was tailor-made for financial advisers, with a strong focus on assisting advisers and aligning with their interests and those of their customers in an attempt to make asset backed lending more retail friendly. The platform gives investors the opportunity to buy Dragonfly loans (Dragonfly is a subsidiary business under the Octopus brand which originates buy to let and bridging finance.) The investor chooses the amount that they wish to invest, and those funds are then spread across a diversified portfolio of secured Dragonfly loans. The target rate of return is between 5% and 6% and Octopus handles all allocation and management responsibilities.

Octopus has selectively adopted the front end of the marketplace lending model, marrying that medium with its existing strengths to create an intriguing new form of investment. The company also finances solar sites and healthcare infrastructure and has suggested that these operations could well come with a peer to peer front-end attached down the line, depending on advisers' appetite[78].

HARGREAVES LANSDOWN

Wealth manager, Hargreaves Lansdown is developing a cash management portal and peer to peer lending service due for launch in early 2017 and intended to lend to both consumer and SME markets.

It will give access to a new pool of assets that it can look to add to its existing one-stop system which already offers a wide range of investments. This integration with other asset class investment offerings on a single platform is a logical, but new next step for the marketplace lending industry.

"Key milestones such as regulation, the launch of the IFISA, the availability of market data and government support all show that this is an industry that is increasingly mainstream."

DOWNING CROWD

Downing

In March 2016 Downing LLP launched its crowdfunding platform, Downing Crowd. The platform does not offer equity, but is a slightly different proposition to the standard P2P loans so far discussed; it offers investors the chance to lend directly to UK businesses via bonds secured on their assets. The product targets advised clients and uses the bond raise to access companies that have exited Enterprise Investment Scheme funding with Downing and are therefore known to Downing and have a successful operating period behind them.

New bond offers will come out regularly, and are likely to stay open for 2-6 weeks only. Downing intends to launch bonds across a range of businesses, including solar farms, hydro plants and pubs, offering a range from 5%-7% p.a. fixed interest over 1-2 year terms. The bonds are transferable, but not listed – so investors should assume they will hold the bond for the full term, although transfers are allowed between members.

Since the funding window is open for several weeks, the speed of investment is not as swift as in the traditional P2P lending model and the very wide diversification benefits of P2P lending across multiple loans/platforms are not available through this bond-based model. Nevertheless, as for some standard P2P loan agreements, the operational assets of the business being funded are provided as security, with Downing Crowd taking a legal charge over them.

For the provider though, there are still legal advantages to P2P loan agreements since they are not caught by the Non Mainstream Pooled Investments marketing restrictions, whereas bonds of this type are. This means that promotions to the retail market will, in general, be restricted to high net worth individuals, self-certified or certified sophisticated investors.

All three of the products discussed are using P2P lending to leverage existing business within their groups. This is a clever usage of the P2P lending concept as it means that the provider firms have ready-made investment options and/or client bases, with which they are already very familiar. This will save time and money in terms of sourcing and give a significant head start in relation to due diligence. And this type of front end adaptation of peer to peer lending demonstrates both the innovation of the sector and the flexibility of marketplace lending as a funding tool.

CONCLUSIONS

The P2P lending industry has been around for longer than many people realise and has come a long way in a short space of time. The growth of the industry to date has been exponential and key milestones such as regulation, the launch of the IFISA, the availability of market data and government support all show that this is an industry that is increasingly mainstream.

INVESTMENT CASE

INVESTMENT CASE

WHY P2P LENDING?

There is a strong investment case for P2P lending as a new method to give retail investors exposure to an asset class that was previously only reserved for banks and institutions.

YIELD

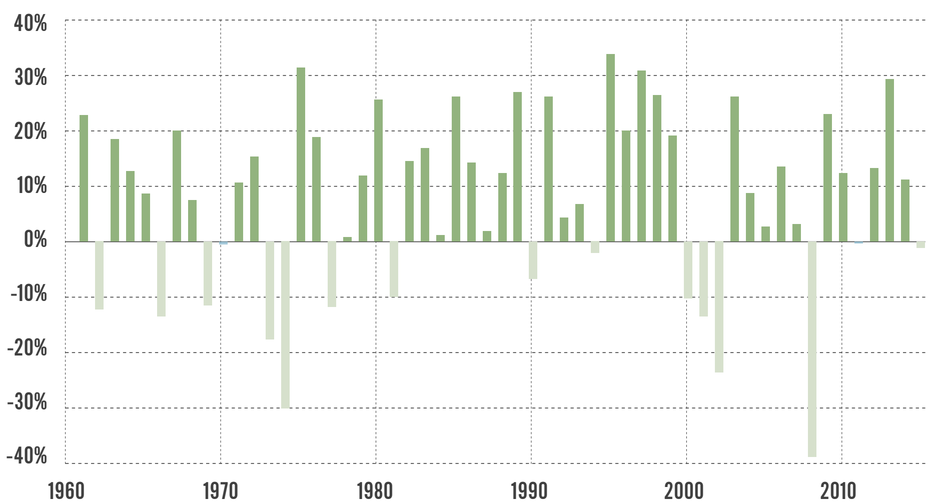
On 6 April 2016, HMRC stated in its guidance for individuals investing in peer to peer loans[79], that, "The advantage of peer to peer loans for lenders is that they can generate higher interest rates that exceed the interest that could be earned from banks and other financial institutions." In 2016 Deloitte research quantified an operating expense advantage of over 200 basis points when comparing the cost economics of illustrative bank and peer to peer loans[80]. And the lower overheads mean better rates for investors in particular: as the banking middle-man is cut out, investors can get far improved headline rates than those charged by traditional banks for instalment loans[81], while borrowers can benefit from lower rates, with the sites themselves profiting via a fee[82].

This disintermediation of banks removes the bank's fee, which can be substantial, from the return calculation equation; and while peer-to-peer lending sites may charge both borrowers and lenders fees for their services, their cut is substantially lower than that which a bank or building society may take[83]. For lending sites, the lower level of regulation is less costly to administrate, and lower capital adequacy ratios require less cash to be held to offset possible losses. In addition, online services mean that P2P lenders don't have to have high street branches in costly properties, with additional staff. Nor do they incur the costs of overcoming issues with legacy IT systems, making their systems more streamlined and efficient, giving quicker service. All of this adds up to P2P platforms often offering competitive rates to both borrowers and lenders[84].

Indeed, according to Deloitte research, marketplace lending can "provide higher yields than many other fixed-income assets (adjusted for duration and risk), data suggests that marketplace lendings' annual risk-adjusted returns are competitive with equities. Specifically, while direct lending has underperformed the S&P 500 index over the past 20 years, it has not had any negative return years and has been much less volatile."[85]

The graphic shows the annual percentage change of the S&P 500 back to 1960 and highlights periods of very strong returns, but also the fairly regular possibility of damaging losses.

S&P 500 PERFORMANCE VOLATILITY



SOURCE:MACROTRENDS, 14 SEPTEMBER 2016

Nevertheless, returns from P2P lending vary widely. Loans to individuals with good credit histories might yield 4% or 5% a year. Loans to property developers might yield 6% to 9%-plus, and loans to small businesses 9% to 15%-plus. Although it is generally safe to assume that if a P2P loan carries a higher interest rate, it is likely also to involve a higher level of risk.

Depending on risk tolerance, investors can find very high yields on offer and certainly, this is one of the reasons that retail consumers lend through peer to peer lending sites. And the P2P offering is even more compelling; at the lower end of the risk range as bond yields have been and declining for a number of years, with 2016 seeing over $13.4 trillion of bonds yielding negative rates[86]; heading up the risk scale, global equity markets at the beginning of 2016 were extremely volatile.

LOWER RISK / HIGHER RISK ADJUSTED RETURNS

As a result of the lower rates available to borrowers, but also because of the speed and efficiency of the automated online services, P2P sites are not just swamped with borrowers who can't get borrowing elsewhere; of those borrowers surveyed by Nesta and the University of Cambridge, more than half reported that they had been offered funding elsewhere. The flexibility of peer to peer lending which can allow borrowers to pay back early without penalty, and the speed at which loans are approved – generally much faster than banks, are obviously attractive features.

Neither does it mean that all of those who apply to the platform are accepted as borrowers who can source loans from the site: The average rejection rate for borrowers across these platforms is almost 80%[87] and the strength of the credit profiles of the loans which are accepted means that some platforms have default rates of less than 1%[88].

Various risk levels of borrowers can be found on P2P sites, from very low to much higher and in order to assist the lender with gauging the risk profiles of the loans on offer (and to allow automatic allocation of loans that fit investor's criteria, including risk tolerances), the platforms obtain a credit report on the applicant. This information is used, along with other data (e.g. loan characteristics), in programmed proprietary models to assign a risk grade to the proposed loan and set an interest rate corresponding to the assigned risk grade. This produces risk rated returns, so that each loan on a platform has a comparative risk rating against other loans on that platform.

As with banks and building societies, different lending sites will have different lending criteria. Potential borrowers need to be a UK resident and at least 18 years of age, hold a current account and have a minimum number of years' credit history. Previous credit defaults, CCJs or a tight budget for repaying the loan will increase the risk rating and the interest payable. Depending on the site, it might mean that the platform will refuse to arrange lending at all[89].

Since the investor has the ability to choose the level of risk they take on and the return they can receive, they have the opportunity to risk adjust their portfolio to minimise volatility by selecting lower risk rated loans which are likely to be very robust. By adding some carefully chosen higher risk ratings to a well-diversified portfolio, it is possible to increase the yield whilst retaining a good measure of stability

LOW DURATION

The typical three to five year duration of a peer to peer loan means that, in comparison to other fixed income assets, such as bonds, it has a relatively

> "In 2016 Deloitte research quantified an operating expense advantage of over 200 basis points when comparing the cost economics of illustrative bank and peer to peer loans."

DRIVERS BEHIND P2P LENDERS (RETAIL CONSUMERS)

SOURCE: YOUGOV PLC 2016

SAMPLE RISK / RETURN TABLE

LOWER INTEREST PAYMENTS	HIGHER INTEREST PAYMENTS
LOWER EXPECTED LOAN LOSSES	HIGHER EXPECTED LOAN LOSSES
LOWER EXPECTED RETURNS	HIGHER EXPECTED RETURNS
LOWER EXPECTED VOLATILITY	HIGHER EXPECTED VOLATILITY

1	2	3	4	5	6	7

← REWARD / RISK →

Each grading will refer to a small range of interest rates that are applicable to that risk grade. The higher the risk grade, the higher the applicable interest rate range.

SOURCE: INTELLIGENT PARTNERSHIP

→ NOTE: This infographic is intended to provide a basic understanding of the type of risk frameworks used by P2P platforms. It is not intended to be representative of the risk spectrum used by any specific platform as each has designed its own risk framework.

*"The return available to P2P loan investors is almost exclusively yield, with minimal capital appreciation element and because there is currently little market speculation about how the price of P2P loans will move, volatility is very limited." – **Oxera***

low duration. Both bonds and P2P loans are debt instruments, but bonds last, on average, around 10 years. A longer term allows for a greater amount of time for inflation or interest rate events to erode the real return available to the investor.

Additionally, short term loans, which don't provide a longer income stream, can generally generate higher returns because lenders need to spend the time and money to source new loans for additional income.

The most secure bonds – gilts – which are issued by governments borrowing money, have certainly been struggling in terms of yields in the last several years and in fact, their rates have recently hit record lows – even negative rates. This has pushed investors looking for stable income streams to look elsewhere and the lower risk, asset backed nature of some P2P loans could well fit the bill.

NEAR CASH

One thing that may interest advisers is the prospect of substituting P2P lending for a proportion of cash. In the low base rate environment, inflation is likely to devalue cash. Even if it's sitting on an adviser wrap platform such as Transact or Novia, it might attract annual management charges or other fees that exceed the yield it is earning.

P2P loans can also be very liquid, depending on the term of the loan and the depth of any secondary market for it. For example, loans can be available with terms from 30 days, so that even if liquidity was required a few days after the deal was made, the cash should be accessible again in around three weeks. If there was a secondary market or the platform would buy back the loan, the cash may be available even sooner, in some cases, on the same day and without a fee.

Longer term loans will rely more heavily on secondary markets for fast access to the original capital and in order to ensure preservation of that capital, loans from lower risk categories can provide useful near cash solutions with low volatility.

It is also worth remembering that an adviser can charge for advising on P2P lending with much more justification than for charging on advice concerning cash holdings. This achieves a win-win scenario, with investors maximising returns on cash and advisers able to charge for these assets under management. Even greater benefits are available when the adviser can ensure tax efficiencies by recommending the building of a P2P portfolio via an aggregator which has FCA permission to provide an Innovative Finance ISA.

DIVERSIFICATION AND LOW CORRELATION WITH OTHER ASSET CLASSES

Within the P2P asset class there are several sectors; consumer, business and property lending, and within these are the multiple sub-sectors in which the borrowers are deploying the funds – for example leisure, hotels, health facilities and many others. Diversification across these can lead investors to avoid difficulties across their entire portfolio if only one or two of the loans they have invested in are subject to particular negative factors effecting individual sub-sectors.

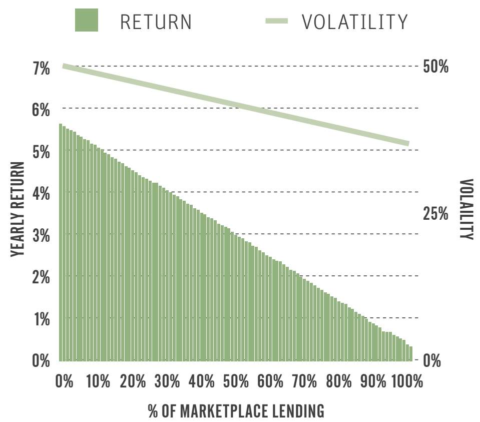
In addition, the majority of investors are unlikely to already be exposed to debt of this sort, particularly retail investors, as this is a relatively new asset class. This means that it can be a diversifier to a balanced portfolio of standard stocks and shares which does not yet include peer to peer lending.

There is a distinct lack of correlation between the two asset classes. Research in the US concluded in 2015 that there was a very low correlation between stocks and P2P lending; A correlation value of 1 would be a perfect correlation while a value of 0 is no correlation at all. So P2P's average correlation of between 0.13 and 0.19 is a minimal overall correlation![90]

In terms of volatility, historically, stocks and shares have exhibited substantial price movement due to the nature of listing which follows the whims of market sentiment. Although there are secondary P2P markets, Oxera's 2016 report finding that there is low use of secondary markets, indicates that investors understand the long term nature of P2P investing. Oxera states that, "This level of transactions is arguably lower than (and at least broadly comparable to) the average rate of transactions in retail equity investment funds[91]. In fact, the return available to P2P loan investors is almost exclusively yield, with minimal capital appreciation element and because there is currently little market speculation about how the price of P2P loans will move, volatility is very limited."

LendingRobot's 2015 report, "How much should you invest in Marketplace Lending?" analysed a classic 60% equity / 40% debentures real portfolio, adding P2P loan investments issued by US platform Lending Club (up to 14% of the portfolio), between 2005 and 2014 when major periods of volatility took place. The analysis found that adding P2P lending makes a striking impact in reducing volatility which decreases faster than the returns.

EFFECT OF P2P LENDING ON INITIAL PORTFOLIO



SOURCE: "HOW MUCH SHOULD YOU INVEST IN MARKETPLACE LENDING?"LENDINGROBOT, 2015

OTHER ASSET CLASSES

COMPARISON WITH P2P LENDING

Relative to other asset classes, peer to peer lending certainly has some favourable features.

PEER TO PEER LENDING COMPARISON WITH OTHER ASSET CLASSES

	LIQUIDITY	VOLATILITY	SECURITY	YIELD
PEER TO PEER LENDING	Dependent on loan term and secondary market depth	Lower risk rated	Tangible security includes real estate (1st and 2nd charge) and non-tangible security includes personal guarantors, insurance coverage and provision of a contingency fund	3% to 10% income. No capital gains
CASH	Completely liquid - although some liquidity has to be sacrificed to earn higher returns	Not volatile although inflation can erode its purchasing power over time	Not subject to loss other than the effects of inflation on purchasing power. Cash is protected by FSCS if deposited within an institution with a banking licence – up to £85,000 per banking group	0% unless deposited with bank. (July 2016 the average easy access savings account rate was was 0.34%)[92]
EQUITY	If listed, liquid, highly liquid for large caps	Subject to market sentiment so very prone to volatility of market movements	None if the business fails. The FSCS applies to financial advice and investment firms, not shares	3%-4% for UK equity income (with the possibility of capital gains)
FIXED INCOME FUNDS	Dependent on the quality of underlying assets - fixed interest securities such as bonds, and debt securities	Bonds traded through agents, brokers or investment banks matching buyers and sellers are less easy to buy and sell than investments that are traded on an exchange and on any particular day there may not be a buyer or a seller for the bonds	Government bonds and those with a higher credit rating are generally more secure. FSCS applies to the fund managers and unsuitable advice	Can be negative or strongly positive depending on interest rate movements
BONDS	Dependent on secondary market depth for that bond type. Corporate bonds may be essentially illiquid	Very sensitive to interest rate movements especially longer dated bonds	Government bonds generally very secure, corporate bonds depend on the financial condition of the bond issuer	Can be negative as many bonds on the secondary market have been in 2016, to double digit returns in higher risk corporate bonds in alternative investments
EXCHANGE TRADED FUNDS	Liquid as they trade like a share on a stock exchange	Passive investment tracking an index. If the index shifts, so will the ETF price. Vulnerable to market volatility	If the index tracked goes down, the investor loses money. But If an authorised investment firm goes into default, investors assets are protected and unsuitable advice from an IFA is covered by the FSCS. But FSCS applies to financial advice and investment firms, not shares and ETFs are considered to be shares in a company[93]	Depends on the market being tracked. Fees (although low) are likely to lead to tracking at just below the index benchmark

SOURCE: INTELLIGENT PARTNERSHIP

"The British Business Bank estimates 500,000 SMEs are deterred or declined for finance every year."

TRANSPARENCY

Many platforms make data on their loans available to the general public as it is published on their websites. This is the case for platforms which are members of the UK's major trade association for P2P lending, the Peer-to-Peer Finance Association. The application process is lengthy to ensure the platform meets the requirements of the P2PFA Operating Principles which include publishing on publicly available pages, their bad debt rates, returns performance and full loanbook disclosure. However, only 8[94] of the current 50+ P2P platforms are members, although the membership does include the four largest UK platforms who make up 73% UK market share. AltFi Data, does also provide several indices that allow for tracking of the P2P universe.

This type of disclosure allows potential investors and their advisers to fully examine items such as defaults, arrears, recovery rates and to get a very good feel for how successful the underlying risk rating is. Since the information is regularly updated, it can be monitored against other platforms so that the relative performances can be measured, allowing investment into the platforms which most closely match the investor's requirements, for example returns stability, and net return over a certain period.

This kind of accountability gives the P2P platform the incentive to list sensible risks at sensible prices as their track record is easily available in great detail and disclosure allows informed choice. Without it there may be a question mark over this because some platforms take the majority of their revenue in the form of an arrangement fee, giving no exposure to the viability of the actual loan. i.e. if a loan defaults, the platform doesn't share directly in the loss. That said, many of the established P2P players take their fees over the life of loans and a significant amount are accrued towards the end of the loan. This aligns platform and investor interests to a greater degree.

Many non P2PFA member platforms provide similar disclosure information, although some provide less detail or none at all. But those who place their money into a bank will never be provided with this type of data, although the first £85,000 of their deposited cash benefits from the protection of the FSCS.

Bank deposits also afford little or no control to the depositor over the use of their money. Almost 70% of those questioned in 2016 for a national survey agreed or strongly agreed that they like to know what their money is being invested in to get a return. This makes the access to credit risk scores and due diligence[95] that marketplace lending allows, a strong driver: Knowledge is, after all, power.

Transparency also extends to the risk ratings used by the platforms: different platforms use different models to score the risk within each of the loans they offer to investors. Zopa, for example, uses credit scores provided by the credit bureau Equifax (and also sometimes additionally information from CallCredit) to allocate borrowers into one of several 'market places' (A*, A, B, C, D or E). On average borrowers in the A* and A categories have incomes well above national average and strong credit ratings. B and C borrowers have incomes closer to the national average and clean credit histories. D and E borrowers have incomes close to the national average and chequered credit histories. Returns increase when moving across the categories.

Funding Circle checks borrowers through Experian and again there is a categorisation into six risk bands (A+, A, B, C, D or E). RateSetter also differs from other P2P lending companies in that it does not categorise borrowers by credit rating, instead it only accepts what it calls "prime" borrowers. Lending rates are then set based on the term of the loan rather than the credit rating of the borrower.

Additionally, aggregators aim to provide collated and consistent independent information on the platforms and products they host, in order to make comparisons easier to undertake.

AUTHENTIC AND POSITIVE

There are very positive factors related to P2P lending connected to ethical standards and the democratisation of finance. These provide a feel-good factor to lenders and have also driven the supply of an alternative to the finance which borrowers may get from traditional financial intermediaries; there is a perception that – by directly linking individual borrowers and lenders – it offers a more socially beneficial form of finance, without the concerns sometimes levelled at banks and other conventional financial intermediaries that, on occasion, they exploit their market power and pursue profit without adequate regard for the interests of their own customers[96].

Marketplace lending has undeniably opened up new asset classes to retail investors. The information age has created access to a previously inaccessible asset class and this has given small investors a choice as to who they allow to use their funds, a very important change as, with banks, retail investors have no choice about who their deposited funds are loaned out to: Since about 70% of those surveyed in the Great British Money Survey of April 2016 agreed or strongly agreed that they would be unhappy if they found out their money was being used to fund unethical activities[97], giving them

"Almost 70% of those questioned in 2016 for a national survey agreed or strongly agreed that they like to know what their money is being invested in to get a return. This makes the access to credit risk scores and due diligence that marketplace lending allows, a strong driver: Knowledge is, after all, power."

the choice in this sphere opens up paths to increased socially favourable investments.

Importantly, there is growing evidence that these investments do work to provide beneficial outcomes to society: a recent report by the Centre of Economics and Business Research (CEBR) states business loans obtained through P2P lending platform Funding Circle have boosted the UK economy by £2.7 billion since 2010. This has created 40,000 new jobs and led to the building of 2,200 new homes by small housebuilders[98].

The FCA recently stated that a number of P2P consumer platforms are now offering substantial volumes of business lending to both sole traders and SMEs[99], in fact, close to £900 million of SME loans were made through marketplace platforms in 2015[100] and P2P business lending increased by 75% in the same year. Whether this is connected to a sentiment of helping the 'little man' by giving greater access to credit, or the potential for higher returns, albeit at potentially higher risk, investors clearly view it as an attractive market. And it has been needed:

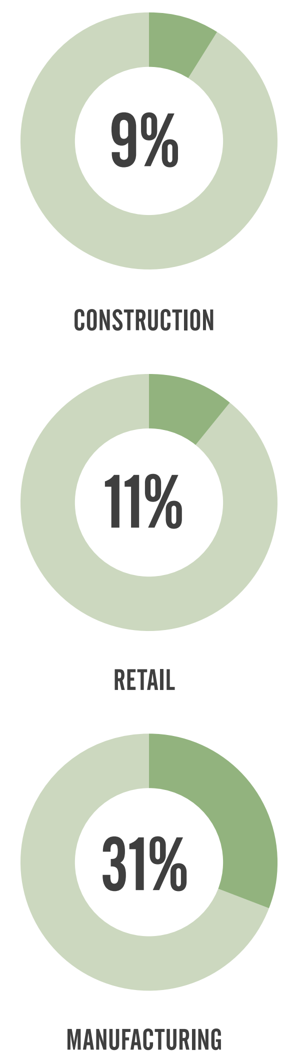
Since the onset of the global financial crisis, banks and traditional lenders have been more reluctant to provide credit to borrowers - the results of mass deleveraging of European banks and higher capital requirements imposed by global regulators. This is also linked to the Basel Accord regulations introduced in 2008, which required banks to hold significant amounts of capital against risky assets, resulting in lending to small ticket loans of £250,000 or less becoming unprofitable for banks. Basel III, due for implementation in 2017, gives even higher capital requirements to banks as security against potential financial shocks and to cushion any failures of higher risk assets[101].

In addition, lending to small firms is harder work as large firms take more money for longer and have more assets to secure loans against[102]. As a result, the British Business Bank estimates 500,000 SMEs are deterred or declined for finance every year.

Nevertheless, some individuals and small businesses who do not satisfy the more stringent criteria that banks now place on granting loans, have been able, through P2P lending services, to find alternative lenders who are willing to take on the risk of providing such loans or to offer them at lower rates of interest[103]. With the lower overheads and better technology and systems boasted by many platforms, this is an easier, more cost and time efficient task for P2P lending platforms. And the speed the technology brings to the transaction should not be under estimated as small businesses can be heavily time-constrained.

Given the huge importance of SMEs to the UK economy, with 85% of new jobs in the UK between 2008 and 2013 created by firms with fewer than 50 employees and 2015 figures showing that the annual turnover of SMEs was £1.8 trillion, 47% of all private sector turnover in the UK, the development of SME access to new sources of funding through peer to peer lending is timely: The 2012 Breedon Report, which examined the financing of UK SMEs, concluded that in the following five years there would be a funding gap of between £84 billion and £191 billion. In late 2015, the World Economic Forum estimated the SME funding gap worldwide to be $2 trillion and named the UK as one of the countries affected[104]. And some of the initiatives put in place by the Government, such as the Funding for Lending scheme, introduced to increase bank lending to SMEs have simply failed. The Policy Exchange said succinctly, "Funding for Lending isn't working"[105]. Among other statistics outlining the shortfalls of SME access to lending, the Albion Growth Report 2015 noted some of the current challenges, with cashflow still an issue and access to finance presenting a barrier to growth for almost one in five SMEs (18%)[106]. The 2016 update of the report found that manufacturing, construction and retail identify access to finance as a major limiting factor[107].

SMEs SUCCESS IN RAISING FINANCE



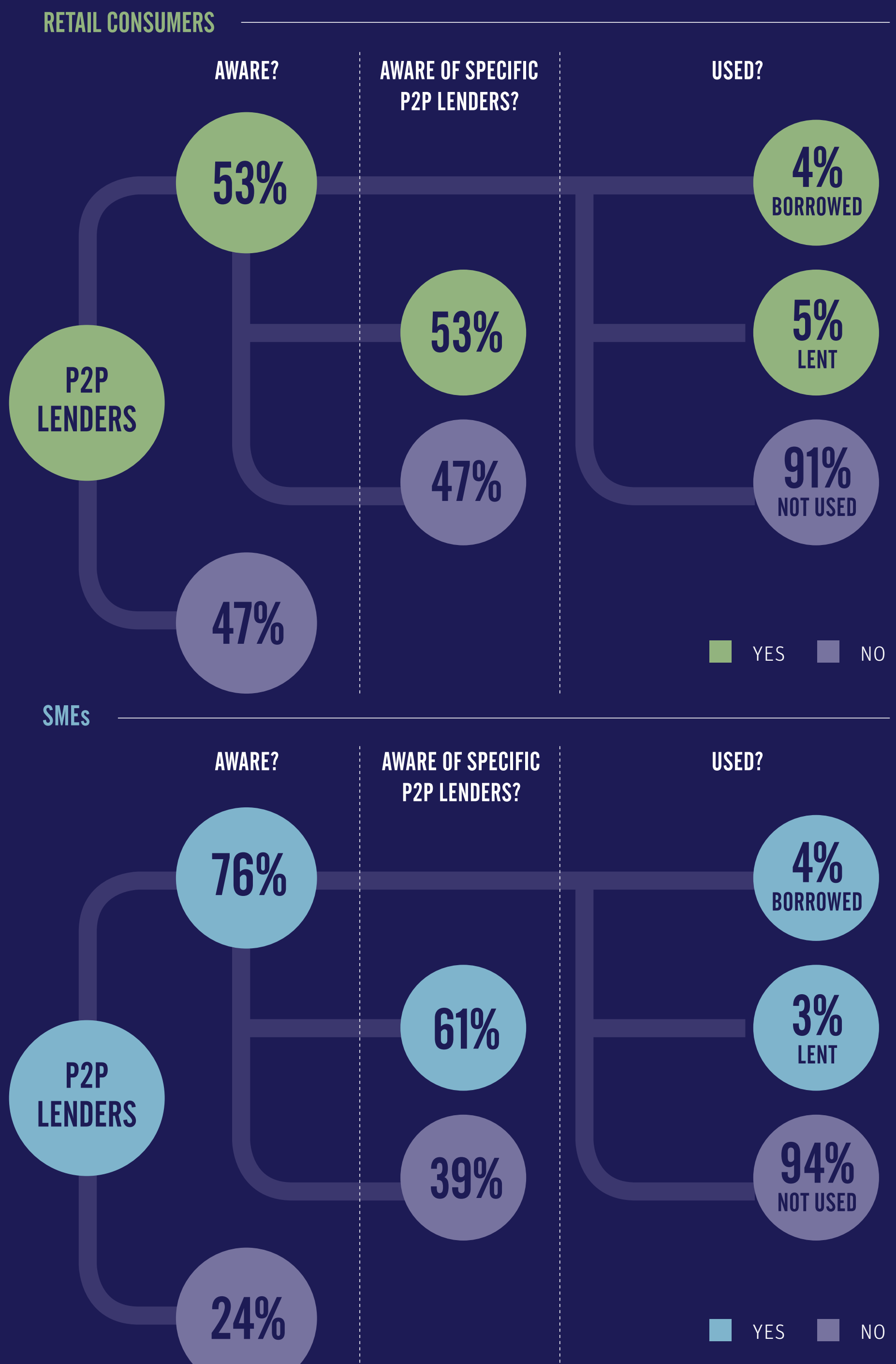
SOURCE: 2016 GROWTH REPORT, ALBION VENTURES

"Consumers purchasing financial products online is increasing – a reflection of both the growing use of the internet in general, as well as confidence in its use for financial services."

Although the Breedon Report did not identify a single solution to this problem, it established that raising awareness about alternative finance methods would be key.

Recent findings are that awareness of marketplace lending is fairly good, and among retail consumers and SMEs in Britain, just over half of consumers (53%) and three-quarters of SMEs are aware of marketplace lenders, but there is more to do to turn that into engagement[108].

AWARENESS AND USAGE OF P2P LENDING



SOURCE: GOV.UK

Over half of UK smaller businesses still go only to their main bank and do not shop around for finance[109]. Taking this into account, the high rejection rates by banks, the economic significance of SMEs and the importance of sentiment to P2P lenders, it would seem that there is definite scope for continued broadening of the P2P lending market in this sector.

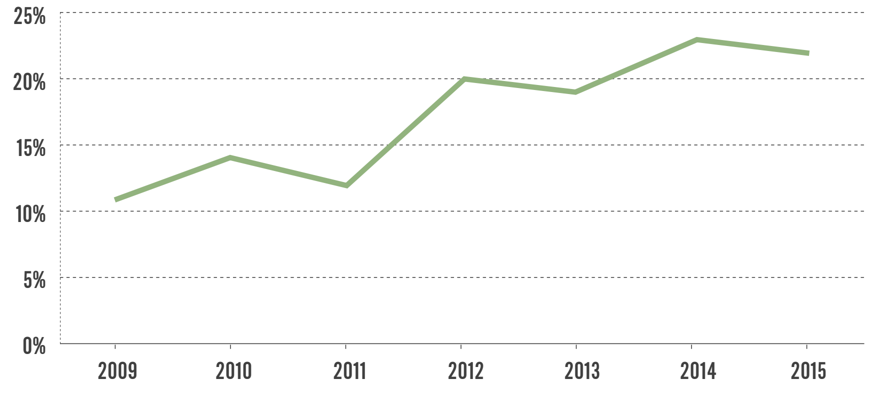
80% combined market share for business loans, excluding P2P lending, was held by the four largest banks - Lloyds, HSBC, Barclays, RBS in 2014 (Competition & Markets Authority, Retail Banking Market Investigation 2015)[110]. Interestingly, in reputation rankings in April 2016, all four of these banks ranked below the 62.4 average rating for UK banks.

The full rankings:

1. NATIONWIDE BUILDING SOCIETY	72.4
2. VIRGIN MONEY	69.8
3. SANTANDER	67.4
4. HALIFAX	67.3
5. METRO BANK	66.6
6. NATWEST	65.1
7. THE CO-OP BANK	62.4
8. HSB	62.1
9. BARCLAYS	59.8
10. TSB BANKING GROUP	59.7
11. LLOYDS BANKING GROUP	57.3
12. RBS[111]	49.3

"The asset class benefits from some disillusionment with the traditional banking sector, but it's advantages are not just sentimental - cutting out the incumbent intermediaries and beating them on costs can have benefits for both borrowers and lenders."

% OF INDIVIDUALS WHO PURCHASED SHARES / INSURANCE / OTHER FINANCIAL SERVICES IN THE UK



SOURCE: EUROSTAT, JULY 2016

In fact, low confidence in traditional mainstream banks has been a feature of the landscape for some time – not surprisingly, a substantial loss in consumer confidence across the banking sector was caused by the 2007/08 crisis. Yet, nearly a decade on, banks are still struggling to regain customer trust and rebuild their reputations as, once lost, customer trust can be hard to regain and often costs a huge amount of time and money. This task has not been aided by the banks' struggles with further scandals including Libor rigging, mis-selling of payment protection insurance and inappropriate interest rate swaps further undermining public confidence: Considering that conduct litigation charges for the UK's five largest banks increased by 40% in 2015 to £15 billion and Moody's expectation is that banks will make even more provisions for litigation and conduct remediation costs in the next two years[112], it is entirely predictable that there are confidence issues. Not to mention the Royal Bank of Scotland (RBS), which is 73% owned by taxpayers, posted a £1 billion loss for the first quarter of 2016. The net loss of £968 million was higher than the £957 million expectation by analysts, and double the £459 million loss in the same period last year[113]. No wonder PWC research has found that fewer than 1 in 3 customers trust their bank.

All of this is whilst consumers purchasing financial products online is increasing – a reflection of both the growing use of the internet in general, as well as confidence in its use for financial services.

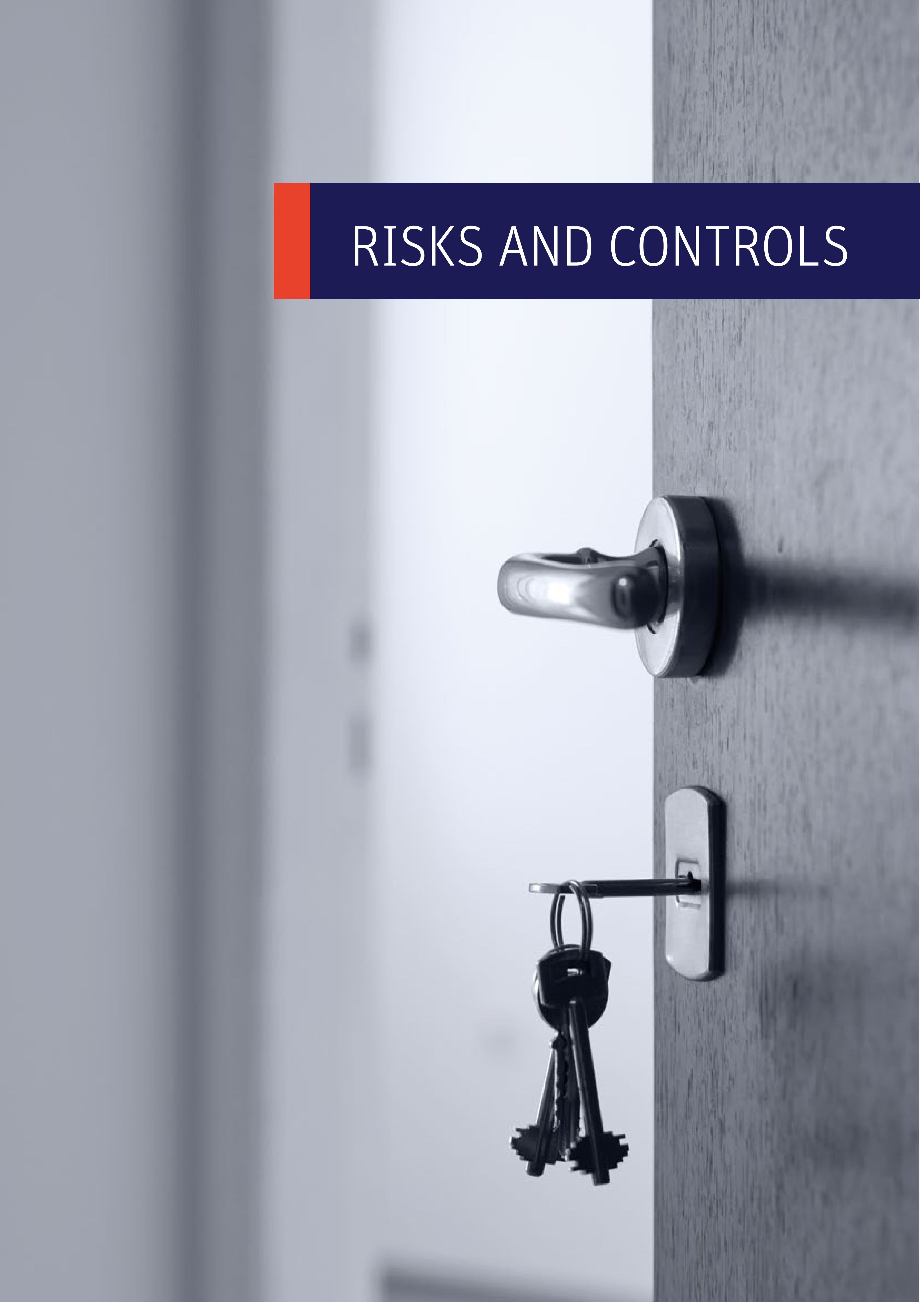
Overall, this suggests a continuing availability of both lenders and borrowers in the P2P lending arena.

CONCLUSIONS

There is a strong investment case for P2P lending, based around achieving better risk adjusted returns than are available elsewhere by accessing an asset class that was previously unavailable to retail investors. These returns can be very predictable, particularly in the lower risk categories and the diversification feature of spreading loans across numerous different borrowers is a powerful default mitigator. Asset backing can also provide robust security and where data is available on default rates, period returns and loanbooks, transparency allows for very detailed platform analysis and due diligence.

The asset class benefits from some disillusionment with the traditional banking sector, but it's advantages are not just sentimental - cutting out the incumbent intermediaries and beating them on costs can have benefits for both borrowers and lenders. Automation allows a measure of efficiency and speed and credit assessments provide an indication of risk for those who are confident in the evaluation methods of their chosen platforms.

"As someone who has personally been using peer to peer sites for a good few years it has always been strong and consistent in terms of returns, but there is no guarantee that will happen. Peer to peer lending is not saving – it's somewhere in between saving and investing.[114]" – ***Martin Lewis, MoneySavingExpert***



RISKS AND CONTROLS

POTENTIAL HAZARDS AND MITIGATORS

While the sector might not be as risky as some advisers may have thought at first glance, of course there are risks and it is vitally important to understand what they are and how various platforms attempt to mitigate them. As P2P lending is still seen as alternative and therefore unconventional, if something goes wrong, it may well attract more attention and more complaints, so making the risks clear to investors is essential.

FRAUD

ONLINE

As online P2P lending platforms are internet-based, there is risk related to cyber-security. This could come in many forms, from overloading the platform's infrastructure to confusing accounts or identity theft: To quote the FCA, "The market has grown and evolved rapidly and there is a risk that firms' infrastructure, systems and controls may not be able to keep pace."[115] Ultimately, Alternative Finance offers a combination of high growth, confidential data and money that appeals to all the wrong people for some very obvious reasons[116]. But platforms don't have their heads stuck in the sand on this issue - the Nesta 2015 UK Alternative Finance Industry Report noted that 51% of surveyed platforms regarded cyber security as a factor that could have a very detrimental effect on the sector[117].

By February 2016, PWC had performed ethical hacking duties for as many as 20 different P2P lending platforms, the findings of which are intended to assist with toughening up security measures. Fergus Lemon of PwC stated in 2015 that he was encouraged by the level of engagement with ethical hacking service providers by the alternative investment industry whose members clearly understand that they are a target. And the platform's creators are taking action to ensure that they have enough technical expertise to prevent such cyber-security issues. Zopa, for example, uses technology to verify borrowers' id online and has reported that this has caught at least one fraudulent borrower trying to withdraw a sizeable amount. And Funding Circle ensures that its website is subjected to an independent and professional security review several times a year. It also says that it "employs some of the strongest forms of encryption commercially available for use on the Web today. During any transaction, our encryption turns your information into a coded sequence with billions of possible variations, making it nearly impossible for unwanted intruders to decipher."

These issues don't just encompass hacking - in May 2015, the FCA, issued a warning against Zopa Loans Review, stating that they are unauthorized to provide loans in the UK, as well as being unaffiliated with the popular P2P lender Zopa Limited. Copying Zopa, the clone site was leveraging the Zopa P2P lending brand[118]. Thankfully both platforms and the regulator are alert to this type of cyber activity. The advent of the regulated activity of running a P2P lending platform means that internet users now need only check the Financial Services Register or the Credit Interim Permissions Register to verify that those running the site are the correctly registered entities.

OFFLINE

The Nesta 2015 UK Alternative Finance Industry Report found that 57% of platforms saw a collapse of one or more of the well-known platforms due to malpractice as a high risk to growth. Such failures - either as a result of breakdowns in corporate governance or outright fraud have in fact occurred in late 2015 and early 2016, although importantly, neither platform was operating in the UK market, where regulation is bespoke and overview more focused:

In October 2015, the Swedish marketplace lender TrustBuddy declared bankruptcy after the platform uncovered alleged misconduct within the organisation, including misuse of lender capital. This was the first significant European example of a platform not playing by the rules and risking tarnishing the reputations of others in the market. Issues were uncovered when new management discovered allocation of new lender capital to existing bad debt and that £3 million loaned to borrowers was not assigned to any lender[119]. Nevertheless, commentators have highlighted that Sweden does not have the same regulation as the UK and continues using existing rules on consumer and business lending which were never designed to ensure the efficient and correct running of peer to peer lending.

There have also been high-profile collapses of well-known internet finance platforms in other much less regulated markets[120]. Most notably, China, where, by November 2015, there were over 3,600 P2P platforms as the industry raised more than 400 billion yuan (over £46 billion), according to the China Banking Regulatory Commission (CBRC). The CBRC also stated that more than 1,000 of those were problematic[121]. Again, Chinese regulation of the P2P marketplace is very loose in comparison to that of the UK. Chinese platforms operated in a regulatory vacuum until 2016 and China's regulatory approach can be best described as hands-off except in the cases of major risk events and outright criminal violations. Industry self-regulation is touted in the latest P2P Lending draft rules document as the ideal approach, and regulators are more interested in controlling

"If firms are abiding by the FCA rules and guidance, what happened at Lending Club shouldn't happen here. Lenders should be made aware of the specific nature and risks of entering into a P2P agreement. Apart from specific rules for P2P lending, the FCA also has overarching conduct of business and client best interest rules." – ***Linklaters Law Firm***

undesired activities rather than setting legal barriers to entry (e.g., a license and permit system)[122].

In comparison, the US market is more regulated, but it has not been immune to concerns: In May 2016, US platform Lending Club, sold a large portfolio of $22 million to a big investor, however, some of the loans did not meet the buyer's criteria but were doctored to look as if they did. Lending Club bought back the loans and launched an investigation, concluding that "the company's internal control over financial reporting was ineffective", firing the boss and two other executives, not to mention triggering a huge loss in the company's share value. The US Treasury Department said that online lenders should support more transparency, but stopped short of calling for new rules.

UK platforms point to the UK's regulatory regime for marketplace lending platforms being the only one in the world which has been designed specifically for the P2P lending business model: The United States and other countries regulate P2P under existing consumer and business lending rules fashioned for banks and other lenders.

Linklaters law firm has stated that, "If firms are abiding by the FCA rules and guidance, what happened at Lending Club shouldn't happen here. Lenders should be made aware of the specific nature and risks of entering into a P2P agreement. Apart from specific rules for P2P lending, the FCA also has overarching conduct of business and client best interest rules."[123]

DEFAULTS

Unlike money deposited in a savings account, money invested in P2P lending is, in the main, unsecured, which means the debt is not guaranteed against property or other assets. In addition, most P2P lending platforms simply match borrowers and lenders and do not take any responsibility for the funds of the lender. This is unlike bank deposit accounts, where banks lend out the funds but they are taken onto the bank's balance sheet. Therefore, if there is a default, they are negatively affected and they have a responsibility to their depositors. In addition, the FSCS guarantees the first £85,000 of funds held for depositors per banking group.

P2P platforms generally have no such 'skin in the game' and only stand to lose their outstanding fees should a borrower stop repayments. Consequently, they are not as incentivised as they could be to ensure the quality of checks on borrowers: In June 2014, Andrew Tyrie, the chairman of parliament's Treasury Committee, wrote to the FCA to warn that "poorly informed investors may be left with a false sense of security about the balance of risks versus returns"[124]. And in February 2016 Lord Adair Turner, former chairman of the UK's financial regulator, the Financial Services Authority, was quoted as saying that insufficient credit checks by P2P sites could lead to big losses over the next decade that would "make even the worst bankers look like absolute geniuses".

The suggestion was that Lord Turner was calling into question the business model of evaluating borrowers based on a series of algorithms. In part, this relates to the rise of automatic-bidding, which can enhance market efficiency, by arranging loans quickly and providing significant diversification according to an investor's set criteria. But, at the same time, auto-bidding challenges P2P business lending platforms to ensure their underwriting and credit risk management capabilities are always rigorous and reasonable, as, in this scenario, the platform is making loan selections on behalf of the lender[125].

However, Lord Turner later clarified that his comments were taken out of context and that he was speaking about individual investors, rather than platforms, making a credit assessment about who they lend to. He said, "But in fact, individual investor credit assessment now plays only a very minor role in the growing direct lending market... only a small percentage of investors now directly select specific portfolios of loans, and even those investors rely crucially on the platform's centralised credit assessment of the relative riskiness of different loans." As long as the P2P industry avoids developing complex and opaque products, Lord Turner felt that direct online lending is "likely to become a stable, significant and useful part of our total credit supply system."[126]

This is because, P2P lenders carry out credit checks on borrowers in the same way as a bank to try to ensure that only borrowers with a good record of repaying credit are considered. This selectiveness is borne out by the number of borrowing applications which are rejected by P2P platforms (around 4 in every 5 in 2015). And, so far, these models have been very largely successful, possibly because P2P lenders have automated their lending decisions and some have leveraged alternative data such as social media to inform lending decisions.

Christine Farnish, chair of the Peer to Peer Finance Association and a former member of the Financial Services Authority, said Lord Turner's original comments were "unfair" and "ill-informed": "The suggestion that platforms serve unbanked customers and small businesses who can't borrow is incorrect. Virtually all can get loans from banks, but prefer keener prices and better customer service from P2P platforms." And, Tim Levene, founder of Augmentum Capital, which invested in the first P2P platform Zopa and is backed by Lord

"New risks have to be weighed against the desperate need for credit in Europe. The industry, like securitisation, will be hoping to receive further support from European policymakers keen to stimulate lending." – ***Financial Times***

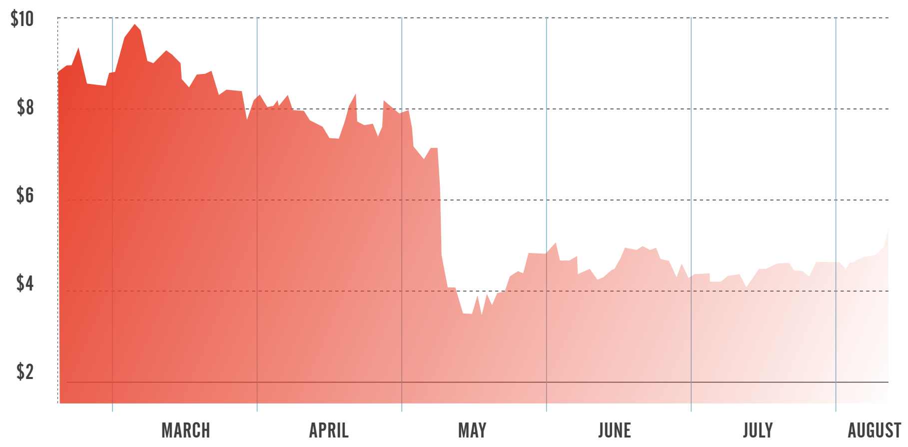
Rothschild, believes Lord Turner's initial remarks "are at odds with the evidence": "Zopa's performance both at the time of the 2008 crisis — where lenders received positive returns — and since, has been superior to most UK banks." During its first full year of operation in 2006, 0.13% of Zopa's loans defaulted, increasing to 4.47% in 2008. Interest payments to investors dipped only slightly during the financial crisis, from about 6% to 4%."[127]

It seems inevitable that commentators would link a notable increase in default rate to the broader issues around platforms' credit scoring, underwriting and due diligence capabilities. And the lack of a standardised methodology amongst platforms, which makes like for like comparison across various platforms difficult, if not impossible, does not help. Certainly, the P2P Finance Association implements standardisation of some operational metrics amongst its members, but credit scoring/risk rating methods are currently not included. That said, the industry is working on delivering more practical tools with which to analyse the lending performance of the sector.

Yet, businesses do fail, particularly if they are early-stage companies; and inevitably some proportion of peer to peer loans will default on platforms. The key issue is whether platforms are doing the utmost to lower the chances of arranging loans to these parties and good underwriting criteria (to provide realistic credit rating) are crucial here.

Whilst platforms are very transparent with making their default rates available to investors, one thing to take account of, is that currently, the data provided by platforms is not independently verified - even if it is published on the P2PFA website. This opens the door to the prospect of issues with unaudited information - whether they be genuine mistakes, fraud or failure of corporate governance.

DROP IN LENDING CLUB SHARE PRICE (2016)



SOURCE: MARKETWATCH, AUGUST 15 2016

Britain's P2P firms have a good record of publishing details of their loans for investors to examine, but the trustworthiness of published details can still be brought into question, as with the Lending Club incident in May 2016, for example; while a big investing institution in the US was able to uncover the mis-selling by Lending Club, it is much harder for small retail customers to examine loans so thoroughly and hold the platform to account if any wrongdoing is suspected[128].

Nevertheless, the damage that can be done by reputational and track record contamination is clear - Lending Club's share value dropped by over 60% in less than a week[129], a sharp reminder to platforms that their disclosure needs to be correct. Ultimately, it may be this type of potential consequence which keeps platforms keen to provide the best commercial outcome for their clients.

ORIGINATION

Some have asked, if you're not a bank, where does your borrower/lender origination come from? Since the income of platforms is very much linked to the origination of lending deals, with much of the revenue generated by fees at the outset, if deal flow were to slow, perhaps because of economic uncertainties, the effects on the operation of the platform could be catastrophic; the temptation to accept more risky borrowers, could become irresistible, leading to higher default rates, leading to even fewer originations, leading to lack of funds to run the platform and eventually, the platform going out of business; if inflows dry up, it could be very difficult for smaller platforms which do not have reserves of cash.

In a market crowded with P2P platform competitors, this could lead to failures and/or the consolidation of smaller players, who are absorbed by those which have managed to scale up or who have specialised in areas such as student lending. Deloitte's view is that the marketplace lenders that 'win' will be those that are right now building either scale or niche expertise through strategic partnerships[130]. This suggests a maturing of the sector, rather than any collapse.

Moreover, the UK market currently benefits from substantial government support which actively promotes peer to peer lending to both individual consumers and companies. The

*"Non-traditional data metrics will increase the ability of marketplace lenders to serve customers with varying credit histories, or none at all, but excellent credit potential." – **Deloitte***

Innovative Finance ISA is expected to drive several hundred thousand additional people to the sector and the involvement of the British Business Bank, targeting credit at SMEs through platforms, looks set to continue whilst the lending gap stubbornly persists.

The advent of the bank referral scheme and the partnerships of P2P platforms with mainstream banks is also likely to be a major factor in raising awareness of and confidence in marketplace lending with a wider range of potential customers. This in turn will create P2P lending deal flow as will the increasing comfort and familiarity of the UK population with online financial services. New advancements in the manipulation of 'big data' will also mean that boutique data providers may help P2P platforms to mine new client categories - "non-traditional data metrics will increase the ability of marketplace lenders to serve customers with varying credit histories, or none at all, but excellent credit potential." [131]

This very much plays into the niche business models that are employed by platforms which develop the skills and technology to service clients and sectors that other traditional credit providers just cannot. This type of innovation has also infiltrated the business processes of platforms, making loan applications and decisions faster, customer service more dynamic and administration more efficient.

MAIN PROTECTION METHODS FOR P2P LENDING INVESTORS

DIVERSIFICATION A well-established way of spreading risk so that individual defaults do not unduly affect the returns lenders can receive from their basket of loans. It is always sensible to spread P2P lending across a number of sites, so that the investor is not depending 100% on the quality of a single site's credit checks.

ASSET SECURITY Security such as property can be very effective in guarding against loss of capital. Security over assets could be a first floating charge over a borrowers' accounts receivables (ArchOver), or first ranking mortgages over tenanted residential properties (Landbay), a first legal charge over commercial property (Proplend) or the right to deduct payment from the borrower's wages (Neyber). In the event of default, such security could be accessed/sold with the proceeds going to the investors. The coverage of losses will depend on the valuation of the secured asset, whether it covers the full amount of the loan at the outset, whether the value of it has increased or decreased whilst the loan period has been running, or whether the borrower still works for the same employer.

CONTINGENCY FUNDS Some platforms run contingency funds, also known as provision funds or safeguard funds. They are set up specifically to provide a safety net in the event of defaults on investors' loans. These are usually built up over a period by taking small amounts from borrowers' fees and whilst they will never be able to guarantee full repayments to all lenders on any platform, they do have a chance of providing useful reassurance whilst default rates remain in the very low single figures. Any contingency fund may also be used if there is platform meltdown as often, the funds are held in trust for all lenders and therefore they may be able to ask for losses to be reimbursed from the fund by the trustees, depending on the terms of the trust and the amount held in the fund. But not all platforms have contingency funds, including some of the larger ones such as Thin Cats and Funding Circle. They feel that proper diversification and asset backing is sufficient.

INSURANCE Some platforms also use insurance. Lending Works, for example, offers insurance which safeguards lenders' money against all the major reasons for borrower defaults such as accidents, illness, death and redundancy.

*"The market has grown and evolved rapidly and there is a risk that firms' infrastructure, systems and controls may not be able to keep pace." – **FCA***

PLATFORM MELTDOWN

A small number of UK P2P sites launched and failed in the earlier development phase of the sector, when new, young, dynamic players entered the industry, some of whom were underprepared for the realities of P2P lending. Quakle, BigCarrots, yes-secure, and Wonga all launched P2P sites which rapidly disappeared and GraduRates was absorbed by Ratesetter in 2014.

FundingKnight provides a more recent example of the potential for platform failure. Founded in 2011, it fell into administration in mid 2016 after its origination volume faltered with only £2.02 million originated in the first six months of 2016, compared to £9.18 million in the same period in 2015[132]. However, the issues were not caused by bad underwriting - but a dispute with GLI Finance, previously one of FundingKnight's main investors, funding 75% of its loans (not a very diversified source!). A change of management in FundingKnight led to personal animosities with GLI who then withdrew their loan funding in February 2016. Since it takes origination and servicing fees, rather than any interest on the loans it originates, FundingKnight's revenues are reliant on a constant stream of new loans and therefore investors willing to buy those loans. No investors means no new loans, which means no revenue[133].

Yet, at the end of June, the firm was rescued by GLI Finance, which also invested a further £1 million in the business. GLI CEO Andy Whelan said: "We believe FundingKnight is a fundamentally good business with strategic value. By acquiring the business at a low entry price, we will help ...provide reassurance to the investors in FundingKnight loans and FundingKnight's SME client base that have existing loans or are seeking to borrow. In the medium term, we will be seeking to maximise the potential of FundingKnight."[134] FundingKnight had previously alluded to a strong pipeline demand on the borrower side, but this still demonstrates the strong interest of institutional money and the potential it sees in P2P platforms. Potential is an important factor and investors can clearly see it - suggesting that, at this stage of the life cycle of the P2P market, consolidation rather than obliteration of smaller P2P lenders may be more likely.

The platforms which have disappeared or changed hands were all very small in comparison to the market size and these types of failures by new entrants are probably less likely moving forward, as the sector is now in a phase where new players could well be backed by very large businesses. The tightening of regulation of P2P lending activities is certainly an indication of the maturing of the market and it also raises the bar to new entries which don't have sufficient capital and expertise to work successfully within the regulatory framework.

Ultimately, that regulatory framework includes provisions to protect against the prospect of platforms going out of business and borrowers and investors being left without their input and therefore unable to make or receive outstanding payments: If the P2P platform is no longer operational, the lender still has its legal rights (through the contract it signed originally with the borrower), against the borrower to continue to receive loan interest and repayments. Any funds held by the platform on behalf of the lender, e.g, funds ready to be loaned or to be paid as interest or loan repayment, at the insolvency of the platform, are subject to the FCA Client Money rules which stipulate that they must be held in a ring-fenced account, separate to the assets of the platform. As a result, they should still be considered as belonging to the lender by any party brought in to distribute the assets to creditors of the platform.

The FCA also requires platforms to ensure loans continue to be administered if a platform fails. To do this, a platform may have an agreement with a third party back-up service provider - the most usual option. This service provider will take over the running of the outstanding loan book and gradually wind it down as each loan is repaid. Alternatively, platforms can arrange for a guarantor for all outstanding loans and hold sufficient collateral in a segregated account to ensure funds are available to cover the costs of winding down the loan book. These types of arrangement should mean that lenders are not affected if a platform fails.

There is limited information of this having already happened though and of the 18[135] platforms which have closed their UK operations since 2011, there were only two cases where investors may have made a loss; one, Quakle, only lent £16,000 in total in the UK, whilst the other, Big Carrots, accounted for less than 1% of the 2012 market[136].

Alternatively, the investors may also have taken advantage of some or all of the Investor Protections discussed on page 42 which may also apply in the event of platform meltdown. But, whatever happens in the event of platform failure, the investors funds are likely to be held for longer than intended at the very least.

LIQUIDITY

Investors on P2P lending platforms may not realise that they are usually 'locked in' to their investments until they mature. As an investment is lent, it can be difficult and expensive for investors who need to access their money sooner than expected to withdraw it before the end of the term. To enable them to do this, there must be another lender to take on the loan. The platform may charge an extra fee for this, although some products

"Any rise in base rates will benefit both our lenders and borrowers as bank spreads will increase as they always do as interest rates rise. Commentators have been talking about the prospective increase in bank profitability as interest rates rise and that will have to be paid for by consumers, making our alternative proposition even more compelling." – ***Giles Andrews, Zopa***

such as Zopa Access, do not. And if there is a shortfall in interest because the new lender is demanding a higher rate of interest or market rates have risen, this money must be made up by the lender transferring the loan.

This issue will also affect the Innovative Finance ISA, as the Government will not extend the maximum 30-day access period to money which has been lent and is yet to be repaid. This means investors may only be able to access within 30 days money and returns which have been repaid. This differs from the withdrawal and transfer rules that are in place for other ISA investments where there is a guarantee that it will be possible to withdraw or transfer the investment in all cases.

P2P platforms though are at a competitive disadvantage relative to banks in providing such liquidity services, not having access to money market funding or to central bank liquidity provision. The bank of England has, however, found that "loan agreements often can be sold before maturity in secondary markets operated by platforms."[137] And whilst the mere existence of a secondary market does not mean that it will be deep enough to guarantee an exit when investors want it at what they judge to be a fair price, a substantial proportion of platforms do have a secondary market.

This indicates that most P2P platforms do offer some liquidity services, for example Funding Circle in the UK allows its business customers to repay loans early, with their automated bidding re-investing funds in new loan applications. Most platforms also allow investors to sell loans they hold, for a fee, for example Zopa Classic. These services are encouraging to those who are interested in longer term loans but have liquidity concerns. The longer investors are willing to tie up their money, the more they will earn, so there is a risk premium at work.

The use of bigger platforms with higher volume suggests greater liquidity capabilities and less investor risk in the event of a run on a platform's loans.

INTEREST RATE RISES

In the event that bank base rates rise, pushing up rates offered by banks on deposit accounts, P2P platform rates could look relatively less attractive, for more risk, triggering a move of investors to the safe haven of traditional savings accounts. This might be more pronounced if inflation rates stayed low, reducing the erosion of cash value that inflation produces.

Of course, such a risk has been pushed further into the future by the Brexit vote and the subsequent economic uncertainty which led the bank of England to drop the base rate in August 2016 to 0.25% with the strong possibility of more downward movement to follow. And currently, P2P lenders continue to benefit from what has been a long term low interest rate environment in which interest on a typical 90 day deposit account has dropped by 82% over the last 10 years[138].

In any event, P2P platforms have a different view of rising rates, with Giles Andrews, Executive Chairman of Zopa, stating that, "Any rise in base rates will benefit both our lenders and borrowers as bank spreads will increase as they always do as interest rates rise. Commentators have been talking about the prospective increase in bank profitability as interest rates rise and that will have to be paid for by consumers, making our alternative proposition even more compelling." He is making a reasonable point that, broadly speaking, a rise in the base rate equates to a greater cost of finance for borrowers, and better returns for savers. And in this situation, the low cost model of P2P lenders is still likely to undercut bank rates and provide more to investors.

Nevertheless, rising borrowing rates might also lead to a spike in borrower defaults, a risk that the P2P platforms will be acutely aware of. But the high degree of diversification across different risk categories that is available within the P2P marketplace is likely to be very useful in limiting these risks.

BANKS RE-ENTER THE MARKET

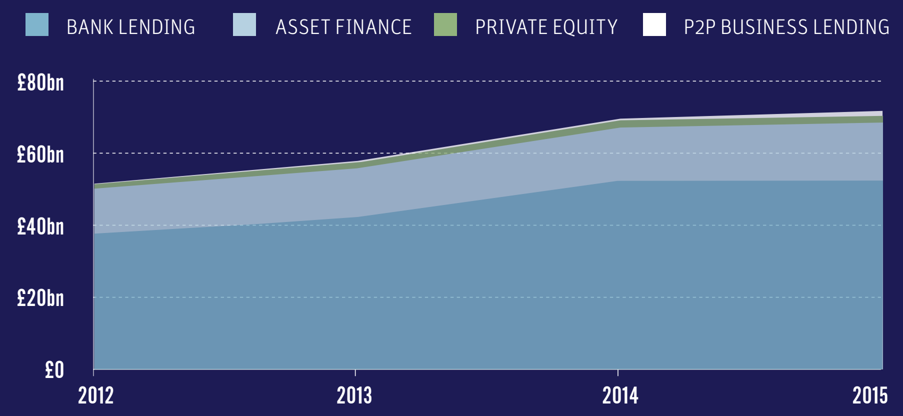
There has been speculation that banks which heavily retreated from the lending market in the aftermath of the 2007/08 crash, are now re-entering the market across many of the sectors in which P2P platforms have had success, to such an extent that the platforms will not be able to compete. The result would then be the slow decline of the platforms until all of their business was re-absorbed by banks and the disappearance of P2P lending as an asset class.

Statistics do reveal that the availability of bank debt to small and medium sized businesses in the UK increased for four consecutive quarters in the year to October 2015 for the first time since 2007-8[139]. What's more, some experts such as Deloitte "do not believe that the banking model will be fully disrupted by marketplace lenders." On the other hand, they also do not believe that P2P platforms are a temporary phenomenon. This is probably the attitude of Keith Morgan, chief executive of the British Business Bank, who stated in February 2016 that, "While there are encouraging signs that volumes are up and alternative finance markets are thriving, there remain areas that still require attention." In the SME sector, he said not enough small businesses were scaling up, a move that would increase UK productivity: only 3% of start-ups become midsized, compared with 6% in the US[140].

More recent developments could mean that the willingness of mainstream banks to re-enter lending

"The Basel III Accord... amounts to higher costs for lending, particularly for higher risk transactions... This may further discourage higher risk assets, such as SME loans, being held by banks."

SOURCES OF UK SME FINANCING



SOURCE:BRITISH BUSINESS BANK

in those areas they shrunk from after 2008/2009 takes a couple of fairly substantial hits:

- The EU Basel regulatory frameworks for banks aim to maintain banks' solvency by strengthening the regulation, supervision and risk management of the sector. This was initially undertaken through Basel 1 in 1992 by introducing capital adequacy requirements that meant a certain amount of the bank's regulatory capital must be allocated (at least notionally) to every loan advanced, or commitment made, by that bank. Therefore, the capital adequacy requirements of any loan carry an implicit cost to the bank advancing it. The original Basel Accord was relatively rudimentary in the way it allocated capital to risk, whereas Basel II adopted a different approach and sought to match the amount of capital required to be held by an institution more closely to the exposures that it faces[141]. The Basel III Accord brings in stricter rules on calculating the capital to be held for each type of asset, adds a requirement for capital buffers to be held and imposes liquidity ratios to ensure that banks have sufficient liquidity to deal with severe market shocks and can continue to run in the medium and long term. This amounts to higher costs for lending, particularly for higher risk transactions. These changes are being phased in up to 2019 and are causing uncertainty among banks about how to recoup the additional lending costs from their existing loans in order to retain their profit margins and therefore available capital. This may further discourage higher risk assets, such as SME loans, being held by banks[142].
- The Brexit vote has created economic and political uncertainty leading to the prospect of slowed growth or possibly even a recession. This may cause some banks to draw back again as deteriorating economic conditions pull more potential borrowers into higher risk categories.

So, P2P lenders perform several valuable functions:

- they may provide supply into areas of the lending market where banks do not have the risk appetite to participate, such as high-risk retail borrowers
- while the likelihood of a significant outflow of deposits from the banking system does not seem strong, marketplace lenders offer a low-cost option for certain investors to gain direct exposure to new asset classes[143]
- they provide a faster, more efficient customer experience than banks.

The traditional banking sector may in fact, be more of an opportunity than a threat to the P2P platforms which engage with it, as the two sectors can provide complimentary services to each other which are mutually beneficial; banks have many existing customers with high levels of brand loyalty, from whom to generate loan originations, and taking deposits gives inexpensive access to funding. Platforms can provide routes to business that banks would otherwise not have been able to access and can shine a light on new and efficient customer service and administration methods.

LACK OF TRACK RECORD

Although there are now over 50 P2P platforms in the UK, Zopa, the first company in the world to offer P2P loans, was only launched in February 2005 and it was not joined by other UK platforms until 2008 when LendInvest was established and 2009 when Funding Circle launched. This means that there is very little data on the performance of the industry that goes back even as far as ten years. It also means that there is no consolidated material collated from a full economic cycle.

Detractors say that, "Thus far, most marketplace lenders have only operated in an environment of historically low interest rates, declining unemployment, and investment friendly capital markets - a perfect storm for these non-bank lenders to thrive as they satisfy borrowers' needs for credit along with investor appetite for high yield"[144].

Whilst default levels are low in the current environment, unfavourable conditions, which restrict cash in the economy could increase defaults, particularly at the higher risk end of the of the scale. However, assessing the underwriting and its overall effectiveness in selecting the best borrowers and allocating the correct level of risk and therefore return is very difficult until the industry has experienced these conditions.

"The peer to peer lending sector has embraced a level of transparency which is unrivalled in financial services, and it is possible to make judgements about the calibre of credit decisions made by each individual [P2PFA member] platform in respect of their entire loan book through material which is already published." – **Christine Farnish, Peer to Peer Finance Association**

However, in February 2015, AltFi Data launched its P2P returns and volume indices as benchmarks for tracking these key indicators on a standardised basis.

Although more time needs to pass for these indices to provide more valuable data over a material period, they are already allowing investors to monitor underwriting standards as meaningful drops in net returns (and possibly thereafter, volume) will reflect increased defaults. This is likely to discourage investors from deploying further capital. In other words, benchmark indices hold platforms credit analysis to account.

Platforms also do much to offset this issue by being very transparent with their data including putting loan books online for analysis, and members of industry trade bodies such as the Peer to Peer Finance Association are obliged to do this in order to give investors their own opportunity to make judgements. Additionally, though not a significant data set, performance information is available for Zopa for 2008, when loans written exhibited a 10x jump in the default rate, giving a general indication of what could happen, although it does not provide specifics on the various risk categories.

This data suggests that Zopa's performance during the 2008/09 financial crisis was impressively stable, largely resisting the volatility that featured in the traditional markets and outperforming the Bank of England base rate by some margin. The predictable income return delivered by the Zopa platform during the decade from 2005 - 2015), averaged at 5.6%[145] whilst the somewhat more alarmingly volatile FTSE 100 averaged just under 6%[146] from 2006 to 2015.

Zopa maintains that the financial crisis marked a turning point in its development. On the credit supply side, new lenders entered the market, attracted by the higher rates (and risk) available from exposure to P2P assets, relative to those offered on conventional banking products. And, on the credit demand side, a wider and more creditworthy pool of potential borrowers appeared as banks deleveraged.

Further information is available as a result of stress testing by some of the platforms which mirrors the Bank of England stress testing on banks. The tests modelled the impact of a recession on the P2P platform loan book of the larger platforms and showed that they exhibit suitable resilience in times of economic downturn. The results indicated that investors who lend over a five-year period, should not lose capital during a crisis[147]. The test assumes a severe scenario: a one in 100-year recession, roughly as extreme as the 2008 credit crisis and 4thWay stated that, "the top P2P lending companies still come out looking very well, provided you spread your money around."[148]

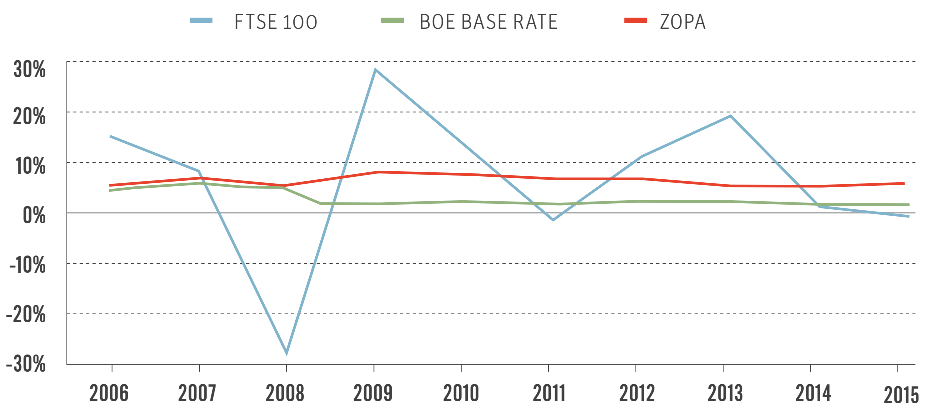
Landbay, Funding Circle and Zopa have also all commissioned their own stress testing. Landbay, a P2P platform for buy-to-let mortgages, commissioned The Wriglesworth Consultancy. The report found that platforms such as Landbay are capable of weathering even the most severe of economic shocks. The results showed expected/projected losses on the current/projected loan book of just 0.03% under current economic conditions – increasing to just 0.30% in the Bank of England's adverse scenario[149].

Funding Circle hired Hymans Robertson who used a scenario in which UK GDP drops by 4%, interest rates increase from 0.5% to 4.2% and inflation increases from 1.8% to 6.6%. The test found that average annualised returns for the Funding Circle loan book would drop from 6.7% to 5.6% in these conditions. Bad debt rates were projected to rise from 2.2% to 3.4% at peak on a yearly basis. To put this into context, the expected increase in loss rates represents a c.50% increase[150].

Gareth Rumsey (Director at Experian) has examined UK business insolvency rates from 1965 to 2014 and found that insolvency rates in recessions also typically peak at around 1.5 times the average. He presented this data at the AltFi Europe Summit 2015 and found that the Funding Circle stress test figures were entirely reasonable. He did point out though, that ongoing monitoring of the risk profile of the platform portfolio is essential because, if it shifts towards higher risk, the potential default rates will also rise[151].

Whilst the Funding Circle results are only averages and will not match specific individual portfolios which may be made up of higher or lower risk, according to credit score, to different geographical spreads etc, the amount of data now available can be useful and it is growing as time passes.

ZOPA PERFORMANCE



SOURCE: BANK OF ENGLAND STATISTICAL INTERACTIVE DATABASE RUSSEL FTSE 100 INDEX (31 MAY 2016)

"P2P lending is likely to prove relatively defensive in a recession based on the performance of the more mature platforms such as ZOPA during the 2008 financial crisis and the performance of similar lending conducted by banks over a longer historical time period." – **Cormac Leech, Victory Park Capital**

P2P LENDING IN A RECESSION

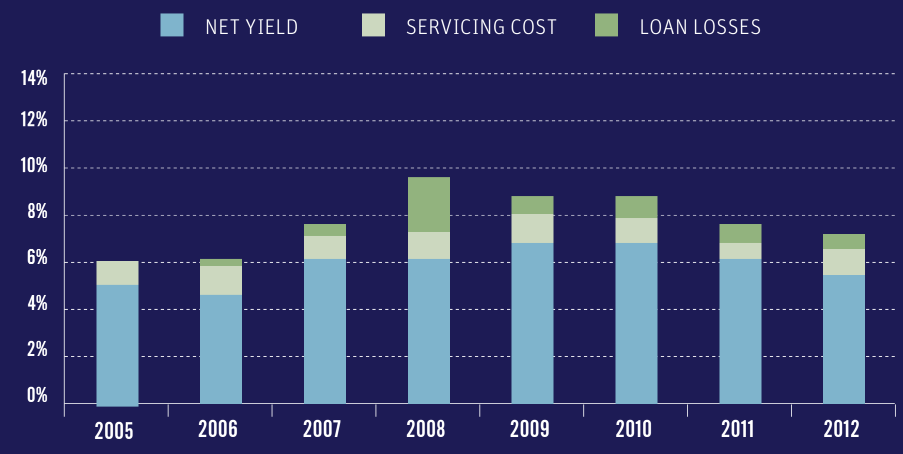
CONTRIBUTION BY CORMAC LEECH, VICTORY PARK

Cormac Leech at Victory Park Capital takes a look at the prospects for P2P lending in a downturn.

P2P lending is likely to prove relatively defensive in a recession based on the performance of the more mature platforms such as ZOPA during the 2008 financial crisis and the performance of similar lending conducted by banks over a longer historical time period.

Looking at Zopa's performance first: loans made during 2008 (the peak of the global financial crisis) had annualized losses of only 2.3% resulting in an IRR for Zopa investors deploying capital in 2008 net of loan losses and servicing fees of 5.9%. ZOPA's gross yields re-priced up by 1.9% upwards in 2008 as lenders demanded better returns to compensate for risk. By contrast bank lending rates were largely static in 2008 vs. 2007 (likely due to negative PR risk for banks increasing consumer loan rates in a recession). At the other end of the spectrum, in 2008, the FTSE100 equity index returned minus 28% and UK property returned minus 22%.

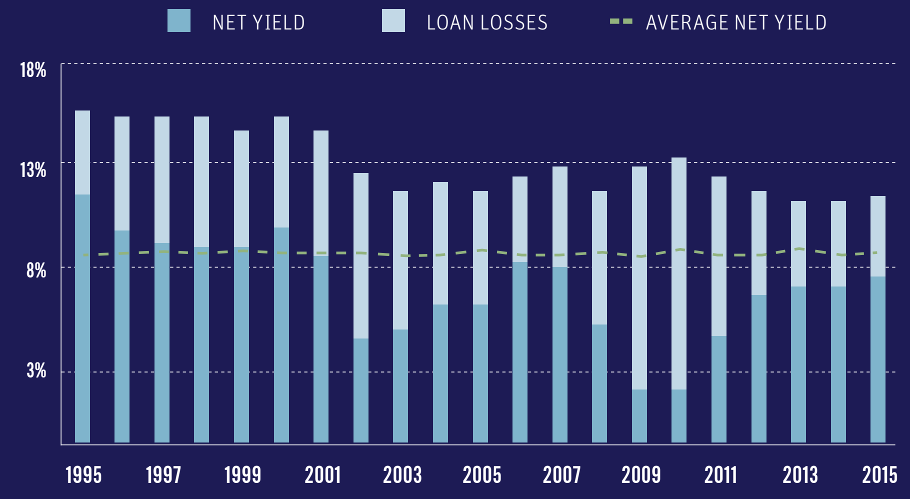
ZOPA LENDER RETURNS (2005-2012)



SOURCE: ZOPA

Similarly we can use central bank data on bank lending to consumers and businesses to get a longer historical perspective. This approach is likely to be on the conservative side since P2P lending to date has outperformed the underwriting and return performance in consumer lending to date. The following chart shows the returns from investing in US credit card receivables from 1995 to 2015. As the data shows, returns remained positive in every year. Peak loan losses were approximately double the average (1.9x).

RETURNS FROM US CREDIT CARD RECEIVABLES (1995-2015)



SOURCE: FEDERAL RESERVE

US credit card receivables, a good proxy for US unsecured consumer loan returns and risk, achieved an average net return of 8.7% over the past 20 years. Peak loan losses were 9.5% and returns were positive for all of the past 20 years. In conclusion: P2P is surprisingly resilient in an economic downturn.

"Investors are broadly aware of the risk and liquidity profile of P2P lending, and their behaviour does not suggest that they are confusing it with deposit accounts provided by banks." – **Oxera**

REGULATION

In its 2016 review of the UK P2P lending industry, the FCA highlighted a number of areas where it sees potential regulatory risk, so that it can decide if new legislation needs to be introduced to mitigate it. These areas are summarised in the Regulation section in the Milestones section of this report. In this section, some of those areas are picked out for a closer look and an outline of items particularly emphasised in December 2016's Interim Statement is provided.

- **Possibility of regulatory arbitrage:** This is a practice whereby firms capitalize on loopholes in regulatory systems in order to circumvent unfavourable regulation. In P2P lending, this may come about by the structuring of products to take advantage of the lighter regulatory touch within the P2P lending market. The FCA is concerned about schemes which are, in reality, collective investment schemes (CIS) which have restrictive regulations relating to promotion to retail investors, taking advantage of P2P lending rules, which exempt P2P platforms from being defined as a CIS. It also has concerns that asset management activity may take place in the guise of P2P lending and therefore operate under a set of rules that were not designed for it. Alternatively, banks might claim that P2P platforms are currently taking advantage of the regulatory arbitrage that occurs because they are carrying out similar functions to banks without being subject to the same capital adequacy requirements. The clear risk here is that consumers invest under rules which perhaps do not protect them in the same way as the rules that really should have been applied.

In the Interim Statement, the FCA noted that, "business models are becoming more complicated and look increasingly similar in substance to other, existing regulated activities, but without being subject to the same regulatory requirements or offering the same consumer protections.

- **Conduct Risk:** This relates to the behaviour of platforms leading to poor outcomes for customers, such as the treatment of borrowers, including affordability, treatment of customers in financial difficulty and clarity of information before, during and after the point of sale. The FCA expects marketplace lenders to manage conduct risk by looking at their business models and strategic plans to ensure that they are identifying, mitigating and monitoring all the risks to consumers arising from them.

The FCA is clear that all firms, including P2P lenders, need to accord equal significance to customer outcomes as to commercial objectives, so that disclosure standards are kept high, financial promotions meet the FCA regulatory requirements and information is fair, clear and not misleading. Again, the FCA is monitoring these three items in particular and has, in the past, expressed concern about a lack of clarity on platform sites regarding the differences between bank deposits and P2P lending and how this affects their risk profiles.

- **Provision Fund Confusion:** Some platforms have established these to help investors recover lost monies in the event of borrower default. However, no P2P platform guarantees that a provision fund will make investors 'whole' (enable them to receive all their money) after borrowers have defaulted. The FCA feels there is a risk that investors will misunderstand such funds as a guarantee that their investment is safe, when their role is simply to mitigate possible losses[152]. The FCA reiterated its misgivings in its Interim Statement.

Platforms are working to ensure that investors are educated on this topic and to ensure that information provided is fair, clear and not misleading.

- **Non-compliance with new regulations:** Some platforms may not be able to keep up with the pace of regulatory change and comply with new legal requirements. In such a fast developing sector, this is not really surprising and the regulator seems keen to work with platforms to iron out issues, suggesting that any issues to date have not been deliberate or malicious. The FCA specifically referred to this issue in it's Interim Statement, but for the future, the FCA appears to be very attuned to the P2P lending market and the Peer to Peer Finance Association has been keen to encourage the industry to embrace regulation. Consequently, most platforms are likely to welcome assistance with resolving any compliance problems.

Should regulatory issues lead to investor detriment, investors currently have access to the Financial Ombudsman Service in cases where the platform does not resolve a complaint to the investor's satisfaction. But investments in P2P lending are not protected under the Financial Services Compensation Scheme (FSCS), which guarantees eligible deposits in building society and bank savings accounts, including cash ISAs, of up to £85,000 per institution. Whilst this is currently under review, with the possibility of introduction by the FCA as a result of the 2016 review of the sector, there are already situations where it does apply such as in the event of unsuitable regulated advice if the advice was given after 6 April 2016 and they entered into a 'P2P Agreement'. Examples of other instances can be found in the Regulation sub-section of the Milestones section of this report.

"Cormac Leech at Victory Park Capital takes a look at the prospects for P2P lending in a downturn."

Interim Statement: Following feedback from platforms, lawyers, compliance consultants, trade bodies and consumers, the FCA intends to undertake further research, possibly leading to strengthening of legislation, on various issues referred to in it's Call for Input. As well as those already mentioned in this report, they include:

- The treatment of retail and institutional investors and how platforms deal with conflicts of interest
- Standards of disclosure and financial promotion of loan-based crowd-funding to investors.
- The adequacy (or not) of wind-down plans and how they work in practice.

The Statement was quite positive in relation to investors' understanding of the P2P market. In relation to the suggestion in the Call to Action that P2P platforms may have to check whether investors meet certain criteria before being able to invest money, in the way that crowd funders must do, it stated, "The research for the review may corroborate feedback from those respondents who said that retail investors have sufficient knowledge of the risks involved in loan-based crowdfunding."

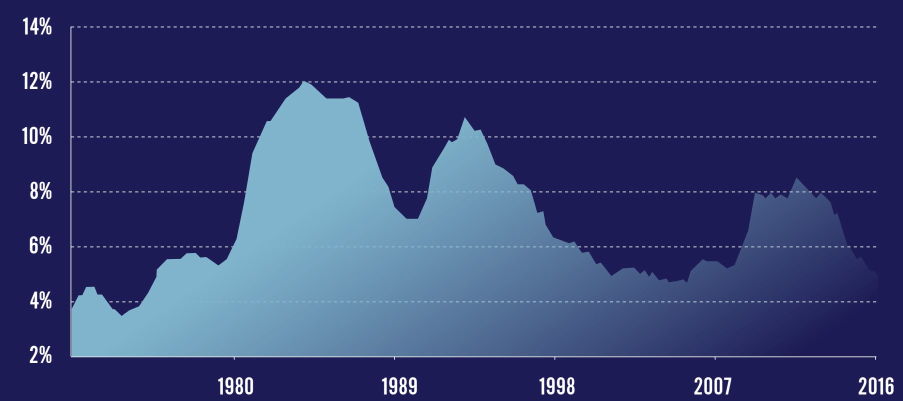
However, evidence from FCA supervisory work with firms has also revealed the risks of:

- Firms' desire to maintain confidence in platforms has occasionally led to firms acting in a nontransparent manner, masking true loan performance and exposing investors to risks.
- Firms that allow investment in loans originated on other platforms (not aggregators) so that the failure of one platform may have a direct impact on the viability of others.

Overall, it is no real surprise that the FCA wants to see more consistent standards around disclosure to investors, management of conflicts of interest, and financial promotions.

The fact that a number of existing platforms such as Folk2Folk, LandlordInvest and UK Bond Network have now received their full authorisation from the FCA is very positive. It demonstrates that their businesses meet the regulator's expectations suggesting that, whilst there is a need for some to raise standards to match current good practice, high standards do already exist within the industry.

UK UNEMPLOYMENT RATE



SOURCE: OFFICE FOR NATIONAL STATISTICS

OTHER MACRO-ECONOMIC RISKS

There are other macro-economic risks that would normally be associated with downturns and which can affect the returns profile of this asset class. These include unemployment, confidence levels of consumers and businesses in the economy, uncertainties in the wider housing market and inflationary pressures. All of these have the potential to erode the ability of borrowers to meet contractual repayment obligations.

If we take unemployment, ONS figures show that it has been falling steadily, reaching an eleven year low of 4.9% in July 2016. And the employment rate was 74.5%, the joint highest since comparable records began in 1971[153]. The Bank of England has forecast that UK unemployment will rise to 5.4% in 2017, 5.6% in 2018 and dropping back to 3.3% in 2019[154]. But this is still relatively low if we consider that the lowest rate on record is 3.4% in 1973/74 and the rate hit 11.9% in 1984 - the highest since ONS records began.

The International Monetary Fund has stated that the UK is likely to experience uncertainty weighing on private firms' investment and hiring in 2017 and 2018 and that consumer confidence is also likely to be negatively affected[155]. Additionally, the Bank of England has projected that CPI inflation will rise to 1.9% in 2017 and 2.4% in 2018 and 2019. Whilst this is a relatively large increase, it is much closer to the 2% targeted by the BoE for a healthy economy, than the negative and just above zero rates of late 2015 and early 2016.

Inflation seems to be a growing threat to real returns and the true value of earnings versus the cost of living, particularly at a time when bank interest rates are so low and generating minimal additional income.

"The industry acknowledges the risks and different platforms have developed different business models to address them."

The Brexit vote and subsequent devaluation of sterling have contributed to a jump in inflation and in August/September 2016 the CPI hit a twenty month high of 0.6%[156]. The Bank of England has revised its projections upwards and now foresees the 2017 annual rate more than doubling the 2016 figure (expected to be 1.3%) at 2.7%[157].

The Bank of England also reported in November 2016, that the housing market has been more resilient than expected, although the commercial property market has been subdued. Confidence in the economy is a strong factor in the housing market, so this is good news for myriad industries and the businesses and individuals who are dependent on it. Nevertheless, annualised growth in the average of the Halifax and Nationwide house price indices slowed to 2.5% in the three months to September 2016 from 4.6% in the three months to June[158].

PEER TO PEER LENDING AND FALLING INTEREST RATES

In August 2016 the Bank of England's (BoE) monetary policy committee (MPC) cut base rates to a record low of 0.25% in an effort to stimulate growth in the wake of the EU referendum. The fundamental reasoning being to encourage banks to lend as their net interest margins increase. However, many platform operators are positive about the opportunities that this could create for the P2P lending industry, without significant concern that banks could attract a chunk of borrowers who would previously have been potential P2P lending customers.

Banks have reduced their rates to savers following the BoE cut, and Stuart Law, CEO of Assetz Capital, thinks that this will lead "savvy savers to continue to turn to the alternative finance market... and get decent returns on their capital". Meanwhile, Ratesetter CEO and co-founder, Rhydian Lewis says it's "not surprising" that P2P lending is gaining in popularity, "as investors look for better returns in exchange for taking on some risk". In fact, RateSetter had one hundred thousand new site visits in July 2016 alone[159].

In terms of the interest rates that investors can now expect from P2P platforms, P2P rates are not directly related to market fluctuations and do not track the base rate in the same way that some bank rates do. Platforms can find their own equilibrium, dependent on the demand within their own lending market. If more investors start to lend, the supply of money increases, and – all other things being equal – the rate that borrowers pay should drop as a result. That means that the platform becomes more attractive for borrowers, whose demand pushes the rates back up[160].

Bearing in mind the low interest savings rates available through banks, with the distinct possibility of further cuts to these, more lenders could well be attracted to P2P lending by the higher returns available. Whilst the BoE base rate cut may have cut banks' overheads, assuming they pass this saving on to borrowers, the 200 basis points operating expense advantage[161] of P2P lending platforms in comparison to banks, will only be eroded by a small proportion of that advantage. And even a drop to 0% bank base rates will leave the platforms with three quarters of their overhead costs advantage intact.

Although this may push platforms to tighten their margins and give borrowers lower rates in order to maintain the spread between banks and P2P lenders, it still leaves the platform lenders with a competitive edge. It also suggests that any drop in P2P returns available to lenders will only be in line with drops in deposit rates passed on to savers by the banks, leaving the platforms' USP of higher than bank returns largely unscathed.

Perhaps the greatest risk lies with smaller platforms, with less developed infrastructure and therefore less advantage in overhead costs and with less capital reserves which allow for a period of fewer originations and therefore less income. Such reserves might be required while borrowers come to terms with how bank lenders react to base rate cuts, and any effects on P2P borrowing rates. Nevertheless, small niche platforms which experience little competition with banks because banks simply are not interested in their specialist market, may not experience any damaging repercussions.

Also, it is worth remembering that falls in base rates do not force banks to lend; Kevin Caley, founder and chairman of ThinCats has welcomed genuine fiscal stimulus, but points out that, "Given the fears about the economy, banks will also become more fearful that companies and individuals will default, which could tip the scales in the other direction." In fact, the reaction of RBS and Natwest to the threat of base rate cuts, in late July 2016, was to write to nearly 1.3 million business and commercial customers, advising them that negative interest rates, (depositors must pay regularly to keep their money with the bank rather than receive a return on it) are a real possibility[162].

CONCLUSIONS

As with any asset class there are risks, and with a short track record in comparison to other assets it remains to be seen just how these risks will play out in a downturn or after a major scandal. Nevertheless, the industry acknowledges the risks and different platforms have developed different business models to address them.

WAYS TO INVEST & ADVISE

WAYS TO INVEST

P2P EXPOSURE AND WHAT TO LOOK OUT FOR

For advisers who buy into the investment case, there are a number of ways to get exposure to the sector, each with their own unique pros and cons and issues to take into account.

FOCUS ON PLATFORMS

When it comes to platforms, the variances in the business models that operate in the current P2P market have already been noted. To give an idea of the models that exist, a sample of 8 of the platforms in the lending market follows.

EXAMPLE PEER TO PEER LENDING PLATFORMS

	assetz	Funding Circle	LANDBAY	LENDING WORKS	lendinvest	Platform Black	RateSetter	Zopa
LAUNCH	2013	2010	2014	2014	2013	2011	2010	2005
FCA STATUS*	INTERIM PERMISSION	INTERIM PERMISSION	INTERIM PERMISSION	FULLY AUTHORISED	INTERIM PERMISSION	INTERIM PERMISSION	INTERIM PERMISSION	INTERIM PERMISSION
LENDING TYPE	P2B	P2B	P2B	P2C	P2B	P2B	P2B & P2C	P2C
SOURCING BORROWERS: SPECIALISM	PROPERTY	SMEs	PROPERTY (MORTGAGE)	CONSUMER	PROPERTY	SMEs	CONSUMER & BUSINESS	CONSUMER
SECONDARY MARKET	✓	✓	✓	✓	X	N/A	✓	✓
NATURE OF PROTECTION (IF ANY)	PROVISION FUND. LOANS SECURED ON ASSETS	PROVISION FUND.	PROVISION FUND. UK BUY TO LET PROPERTY USED AS SECURITY	PROVISION FUND AND INSURANCE	PROVISION FUND. LOANS SECURED ON PROPERTY	INSURANCE	PROVISION FUND (CONSUMER & BUSINESS MAY BE SECURED/ UNSECURED)	PROVISION FUND
MIN / MAX INVESTMENT	£1 /NO LIMIT	£20 /NO LIMIT	£200 /NO LIMIT	£10 /NO LIMIT	£100 /NO LIMIT	£50,000 /NO LIMIT	£10 /NO LIMIT	£10 /NO LIMIT
REPAYMENT METHOD	VARIES ACROSS PRODUCTS	CAPITAL & INTEREST	CAPITAL & INTEREST/ INTEREST ONLY	CAPITAL & INTEREST	CAPITAL & INTEREST/ INTEREST ONLY	CAPITAL & INTEREST	CAPITAL & INTEREST	CAPITAL & INTEREST
INSTITUTIONAL LENDERS	✓	✓	✓	✓	✓	✓	✓	✓

SOURCE: INTELLIGENT PARTNERSHIP

*Firms with interim permission were previously licensed by the Office of Fair Trading, which regulated consumer credit before the FCA, and are able to continue carrying out consumer credit activities until the FCA fully authorises them (or refuses their application for full authorisation). Any delays to full approval are due to the FCA's processing time. The deadline for applications was 31 March 2016 and the FCA has stated that it could take up to 12 months for applications to be processed.

"Most platforms have moved away from the fee model that targeted both lenders and borrowers and five of the top six P2P platforms and a number of others charge no fees to lenders."

The oldest platform on the list, Zopa, was the first P2P lending platform in the world and offers only unsecured consumer lending (including small sole proprietor businesses). The newest platform in the table, Neyber, uses an innovative model of lending to employed consumers and then taking payment through a salary sacrifice system in conjunction with the employer. The largest UK P2P platform, by a small margin, Funding Circle, is not involved in consumer lending at all, supporting instead only lending to small business. LendInvest and Landbay support only lending secured on property, whilst RateSetter is the only platform supporting lending to unsecured consumer, unsecured small business and real estate lending (although it does also deal with secured lending). LendInvest also does bridging finance and is the largest player in this property lending segment. The other platform in the table, Assetz, has a number of options available to borrowers, all connected to property as security which does not have to be real estate - it can be equipment or presales of property developments.

Other models which do not apply to the platforms in the table include lending in bridging loans for property development (SavingsStream) and supporting P2P lines of credit (overdrafts), (Growth Street).

Assetz does not allow investors to pick individual loans or interest rates, instead it provides several different packaged 'accounts' with different access times, investing in different asset classes - such as green energy and at a selection of different target interest rates. These are referred to as products and generally they offer a small range of loan terms and interest rates for investors to choose between. Many platforms offer products, including Landbay, LendingWorks, Ratesetter and Zopa from the comparison table. This type of P2P lending investment will be discussed in more detail in the Active vs Passive Investment Strategy section later in this report.

These are just a few of the differentiators in the P2P lending marketplace. Others to consider are auto bidding availability, the range of loan terms, whether early loan repayment is allowed and if the platform offers fixed rates, variable rates or both.

HOW PLATFORMS CHARGE FEES

How the platforms charge their fees is probably going to be of particular interest and since the fee models tend to be much more transparent than those built by traditional banking institutions, quite revealing. The main P2P platform methods are:

FEES TAKEN FROM BORROWERS

Most platforms have moved away from the fee model that targeted both lenders and borrowers and five of the top six P2P platforms and a number of others charge no fees to lenders. Taking Landbay as an example, it does not charge lenders, but has two borrower fees: firstly, it charges its borrowers an upfront fee ranging from 2% to 2.5% to cover the costs of screening borrower profiles and the establishment of a new loan. Landbay also charges an annual a 0.5% to 1.00% margin on the loan principal outstanding[163].

FEES TAKEN FROM BORROWERS AND INVESTORS

Some platforms do still charge fees from both borrowers and investors. Proplend, for example, charge borrowers a Listing Fee and a Completion fee. Also, loans are secured against property. So, any legal and valuation fee incurred in arranging a loan is also borne by the borrower. Proplend P2P investors also have to pay a fee equal to 10% of interest received. The fee is due when actual interest is received.

Which fees are charged and when depends on the particular platform used so advisers should be looking for the fees chargeable to lenders, if any, as well as checking how returns are quoted on each platform - i.e with or without fees deducted (and projected defaults). However, as the platforms use various return methodologies, it is not currently possible to draw like for like comparisons between different platforms. But market participants such as LendingWell hope to introduce standardisation for investors across products making much more informed judgements about the relative levels of charges possible.

As a result of the limited fees charged to lenders, they can expect typical fees to be very low, if anything. However, advisers should look out for less obvious fees such as service fees built into the interest rate payable by the borrower and taken directly from loan repayments made by borrowers. The reality is that this is coming from money that would otherwise be going into the investor's pocket. These might be called annual investment or management fees or even lending success fees which is the Madiston Lend Loan Invest platform's name for its charge of 0.5% of the amount being lent out per annum. This is deducted from the investors account monthly[164]. Funding Circle has a similar fee of 1%. So, it is essential to look at the overall picture to see how the fees affect the gross yield and how competitive the platform's net yields are when fees are taken into account.

ADVISER PORTALS

Some platforms have already made tentative efforts to engage advisers and this has led to the establishment of adviser portals provided by some of the platforms such as Ratesetter

"The majority of P2P platforms in the UK are marketplace lenders, some of which have been established for some years, with low default rates which suggest that their credit scoring is up to scratch."

which allow advisers to register and transact business online for their clients. This online model provides IFAs with the means to set up and manage client accounts, set their own fees, get notified as client funds mature and benchmark their own clients.

This type of functionality can only be positive for a sector which has historically suffered from low levels of adviser engagement with research published by Intelligent Partnership in its Alternative Finance Report 2015/16 revealing that just 9% of advisers expect the P2P lending sector will form part of their advice process in the next 12 months. Another 2015 survey from Yorkshire Building Society found that less than one in five (18%) financial advisers would invest, or have invested, their own money into P2P lending schemes[165]. But, given that there are so many potential benefits to so many potential clients and that it is only a matter of time before whole of market advisers are obliged to give advice on direct lending strategies, those integrating the needs of advisers into their P2P offerings are taking a sensible route.

PEER TO PEER LENDING PLATFORM BUSINESS MODELS

MARKETPLACE LENDERS (PEER TO PEER PLATFORMS)

Marketplace Lenders are arrangers who generally underwrite, price and service the loans that they originate from consumers and small businesses, but they do not fund them. Instead, they source individuals and institutions to do this as an investment, with the result being that lenders and borrowers are connected. The marketplace lender therefore does not have a stake in the loan insofar as the money that has been loaned does not belong to it and it has no claim on the repayments and any interest due on the capital, aside from the fees it has agreed with the borrower and the lender for its services.

Some commentators do not like this dynamic as they point to the marketplace lenders' position outside of the risk of the deal, receiving some kind of upfront fee and then having no real interest in the loan repayments thereafter. The argument is that this could lead to the credit scoring of the platform being less robust than it should be, with the aim just to make deals from which it receives a fee, whether or not those are good, correctly risk rated deals for the investors. This is a very short term outlook though as, poor borrower selection will lead to defaults and high default levels will lead to investors simply not using the platform.

Indeed, the majority of P2P platforms in the UK are marketplace lenders, some of which have been established for some years, with low default rates which suggest that their credit scoring is up to scratch. But that doesn't mean that thorough due diligence is not called for and where possible, if the interests of the platform can be aligned with the investor, so that the marketplace lender receives a meaningful portion of its fees during the course of the loan repayments, it may be a worthwhile safeguard.

PURE BALANCE SHEET LENDERS

While all online lending sites can be classified as 'marketplaces', some marketplaces are also the lenders themselves. These are balance sheet lenders. Banks are generally pure balance sheet lenders, as they source funds which they take onto their balance sheet and then lend them out to third parties. This means that there have been two lending events – one where the bank has been lent funds from its depositors and one where the bank then lends those funds to a third party. Consequently, the bank is responsible to its lenders for repayment of the funds it has borrowed.

For this reason, the bank has a strong incentive to ensure that whatever it does with the money it has borrowed, will provide secure returns. If this is not the case, the bank is still responsible for repaying the loan to its depositors and it will lose money. In short, the bank takes on some of the risk. The investors risk lies with the bank not repaying them. Therefore, what an investor/depositor should be interested in is the financial stability of the bank and how deep its reserves are. It would also be useful to have access to information regarding its record in picking the parties to which it lends its investors funds, but this kind of data for underlying bank transactions is simply not made available to deposit account clients. But those who save into a bank deposit account do benefit from the FSCS deposit protection scheme.

An example of a pure balance sheet lender is Kabbage, but whether any pure balance sheet lenders who are not banks can be considered as P2P lenders is open to debate. Is it really asset management and regulatory arbitrage?

HYBRID MODEL

There are some P2P lending platforms which invest their own money, from their own balance sheet, alongside their investors i.e, they make up part of the loan from their own capital, such as OnDeck. This means that, not only does the platform originate the loan by sourcing the borrower, and act as an intermediary by matching the borrower with lenders (investors), but it also becomes one of the lenders itself. This gives the platform a very good incentive to price the risk accurately, because it stands to lose if the loan doesn't perform well.

But again, this does not mean that due diligence goes out of the window. Just because a platform has experience

"The fundification of the P2P industry is becoming more evident, firstly in the United States where it is big business and more recently in the UK where it is growing."

of investing it does not mean that no scrutiny is required before other people's money is invested based on the platform's investment decision. This would be like investing in a fund without looking into the fund manager.

All of this platform diversity means retail investors get a wide choice of investment, not just a take it or leave it bank mentality. This obviously means more work for advisers to look at the options and decide the most suitable ones.

METHODS OF ACCESS TO DIRECT LENDING STRATEGIES

GOING DIRECT

Obviously, many investors want to make their own investment decisions. Investors can have varying levels of control and input into their investment beyond choosing their preferred return, risk profile and term. Some platforms allow them to look at each individual loan, whilst others will simply automatically match their inputted preferences against one or more loans without the lender undertaking detailed analysis of each. Of course, those looking for specific sectors to invest their money into, or who have particular knowledge that allows them to make more informed judgements, may be looking for much more control than those who just want a return.

However, from the perspective of portfolio diversification, an investor who goes direct does need to think about the best ways to do this and the time it will take to review all of the possibilities. Some aggregators facilitate this by matching their requirements across a number of lending platforms and then providing the results for the investor to make his own selection. LendingWell, for example, will offer simple, innovative structured products which will allow retail investors to access a curated list of direct lending investment opportunities which have passed LendingWell's stringent risk management criteria and offer ease of diversification across maturity, asset type (consumer, business, property) and target return.

In the process of investing, individuals can retain control over comprehensive investment criteria selection such as maturity, asset type (consumer, business, property), target return and platform.

STRUCTURED PRODUCTS: FUNDS AND BONDS

Some platforms offer innovative structured products. With low yields as the potential "new normal" in the market, the LendingWell bond offers a unitized P2P loan product to enter the market through a single point of access, with a low cost, tax efficient, passive and transparent investment strategy.

The fundification of the P2P industry is becoming more evident, firstly in the United States where it is big business and more recently in the UK where it is growing.

Platforms are understandably positive about this development, and with good reason. For retail IFAs, these funds are retail investments that are easier to understand and therefore to recommend to clients. They could therefore play a big role in taking P2P lending to the mass market. And since the UK is the second-largest wealth management centre in the world, with $1.6 trillion of client assets administered and managed at the end of 2014, according to Deloitte[166], even attracting a small portion of those assets could be huge for P2P lending.

For advisers, their existing tools mean they can buy a fund today and it gives them diversification and global exposure. In fact, some see funds as the new intermediators - providing professional management of more money than amateur "peers" ever could, providing P2P with scale on the deposits side and taking advantage of nimble, technology-driven underwriting by P2P platforms[167].

There are at least four P2P lending focused investment trusts listed on the London Stock Exchange, one of the most recent of which was the Funding Circle SME Income Fund Limited, which raised £150m before its initial close. The fund focuses on loans to small businesses in the UK, US and Europe buying up to 35% of loans originated through the Funding Circle marketplace and allows individual and institutional investors to buy and sell shares in the vehicle, which will manage a selection of loans on their behalf. It targets a dividend yield of about 7% a year and is eligible for SIPPs and ISAs. Two thirds of the loans are UK originated, with 24% from the US.

Other investment trusts include Victory Park Capital Specialty Lending Investments PLC, P2P Global Investments PLC and GLI Alternative Finance PLC. All are suitable for institutional investors and professionally-advised private investors as well as non-advised private investors who are capable of evaluating the risks and merits.

At June 2016, P2P Global Investments (P2P), was the largest in the sector at £868 million, with a yield of 6.9%. It has a large portfolio of loans to consumers and businesses, and can take equity stakes in P2P platforms too. Two thirds of the fund is focussed on European and US consumer loans which account for 18.86% and 46.16% respectively of the portfolio total, with a target net annualised return of 5%-15%.

"There are at least four P2P lending focused investment trusts listed on the London Stock Exchange."

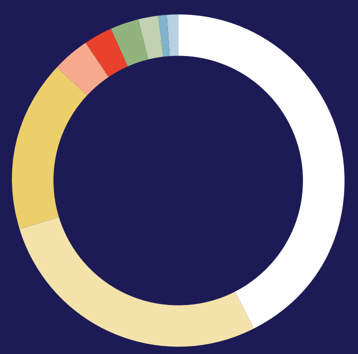
FUNDING CIRCLE SME INCOME FUND LIMITED PORTFOLIO STATISTICS

US		UK		CE	
CALIFORNIA	19%	EAST ANGLIA	4%	GERMANY	41%
FLORIDA	9%	LONDON	17%	SPAIN	11%
GEORGIA	6%	MIDLANDS	10%	THE NETHERLANDS	49%
ILLINOIS	4%	NORTH EAST	8%		
NEW JERSERY	6%	NORTH WEST	14%		
NEW YORK	8%	SOUTH EAST	27%		
OHIO	3%	SOUTH WEST	11%		
OTHER	34%	NORTHERN IRELAND	2%		
TEXAS	8%	SCOTLAND	4%		
WASHINGTON	3%	WALES	3%		

SOURCE: FUNDING CIRCLE SME INCOME FUND NEWSLETTER, JUNE 2016

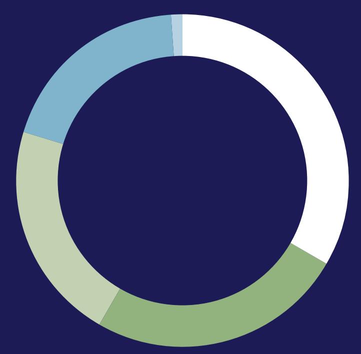
P2P GLOBAL INVESTMENTS PORTFOLIO COMPOSITION

BY ASSET CLASS



US CONSUMER	1.56%
CASH & MONEY MARKET	20.37%
EUROPEAN CONSUMER	18.86%
EUROPEAN SME	4.01%
EQUITY	3.35%
EUROPEAN REAL ESTATE	3.30%
US SME	1.82%
AUSTRALIA CONSUMER	1.56%
BONDS	0.57%

BY INTERNAL CREDIT GRADE



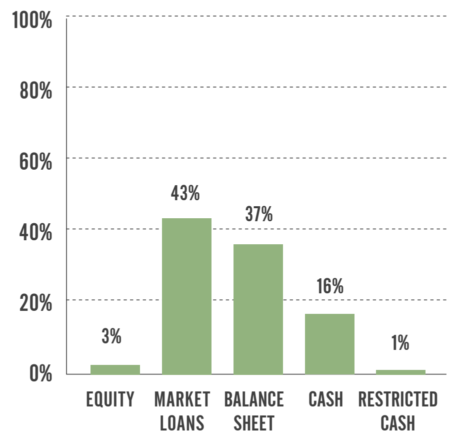
A	33.02%
B	25.07%
C	21.16%
D	19.68%
E	1.07%

SOURCE: P2P GLOBAL INVESTMENTS PORTFOLIO COMPOSITION – JUNE, 2016 P2P GLOBAL INVESTMENTS NEWSLETTER

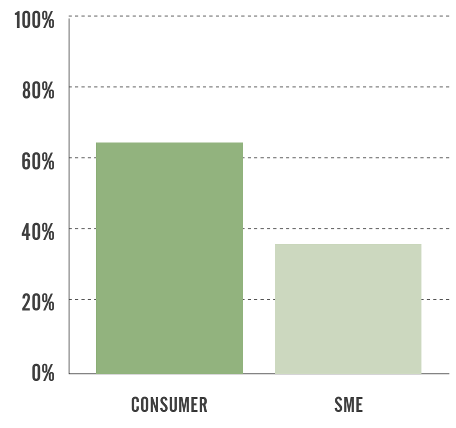
"Some see funds as the new intermediators - providing professional management of more money than amateur "peers" ever could, providing P2P with scale on the deposits side and taking advantage of nimble, technology-driven underwriting by P2P platforms."

VICTORY PARK CAPITAL SPECIALTY LENDING INVESTMENTS STATISTICS

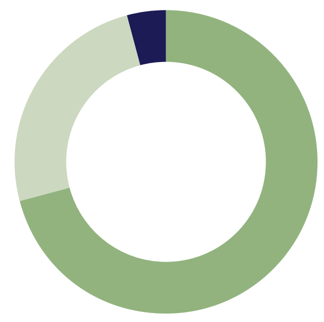
NAV (CUM INCOME) ALLOCATION



INVESTMENT EXPOSURE / BORROWER TYPE



INVESTMENT EXPOSURE / GEOGRAPHY



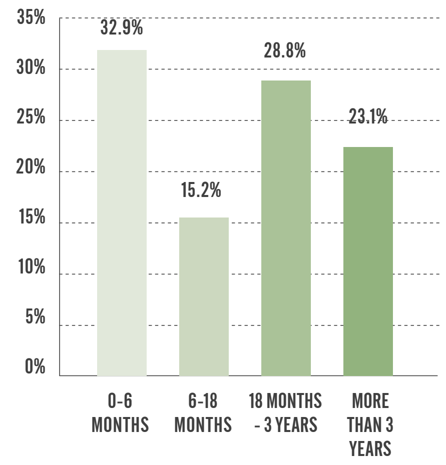
UK	25%	OTHER	4%
US	71%		

SOURCE: VICTORY PARK CAPITAL SPECIALTY LENDING FACTS – MAY, 2016, VPC SPECIALTY LENDING NEWSLETTER

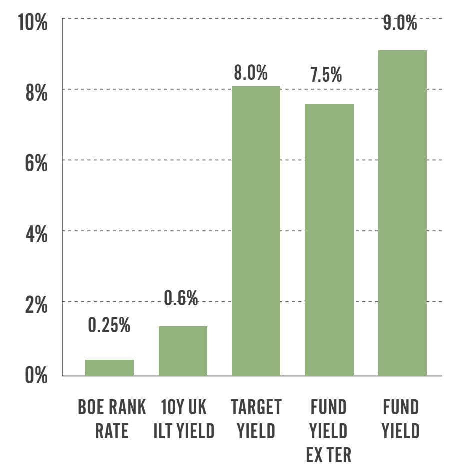
Victory Park Capital Specialty Lending Investments (VSL) takes a similar approach and yields 9.3%[168], while 71% of the portfolio is allocated to US loans and 25% is allocated to the UK. Compared to P2P Global Investments, Victory Park has a much larger allocation to SMEs, making up 37% of their investment exposure.

GLI ALTERNATIVE FINANCE PLC PORTFOLIO ANALYTICS

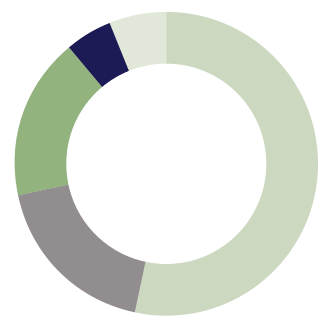
PORTFOLIO BY MATURITY BAND



FUND YIELD VS BENCHMARK INTEREST RATES



PORTFOLIO BY GEOGRAPHY

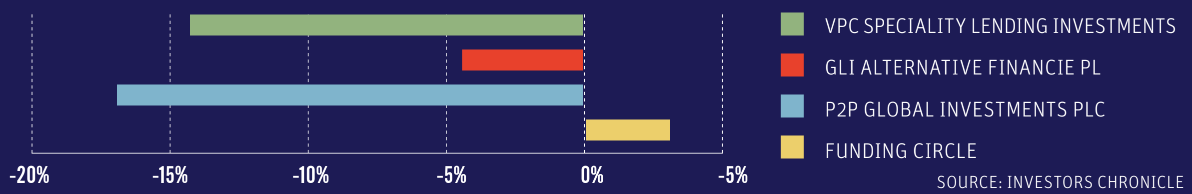


UK	53%	EUROPE	6%
US	17%	ROW	5%
OFFSHORE BRITAIN	17%		

SOURCE: THE SME LOAN FUND MONTHLY FACT SHEET, AUGUST 2016

The SME Loan Fund, previously known as GLI Alternative Finance PLC, invests in loans originated principally through the 19 lending platforms in which parent GLI Ltd is the principal external equity investor. It aims for an 8% yield and closed in September 2015 after an initial raise of almost £53 million. The fund has a focus on SME loan assets, over half of which are UK opportunities, diversified by asset class, geography and duration.

P2P FUNDS YTD PERFORMANCE (9 SEPT 2016)



SOURCE: INVESTORS CHRONICLE

In terms of fees, Funding Circle SME Income Fund Limited charges no management charge or performance fees, only fees associated with Funding Circle's 1% servicing costs. Victory Park Capital Specialty Lending Investments PLC and P2P Global Investments PLC originally charged a management fee of around 1%, which is reasonably normal for a managed fund, although not cheap. However, in June 2016, P2P Global Investments PLC reduced its management fee to 1% of net assets, with leveraged assets charged at 0.5% reflecting that a significant portion of the benefits of the funds' targeted 100% leveraging will accrue to the manager. GLI Alternative Finance PLC fees are up to 0.75% annual management fee, but there is no performance fee.

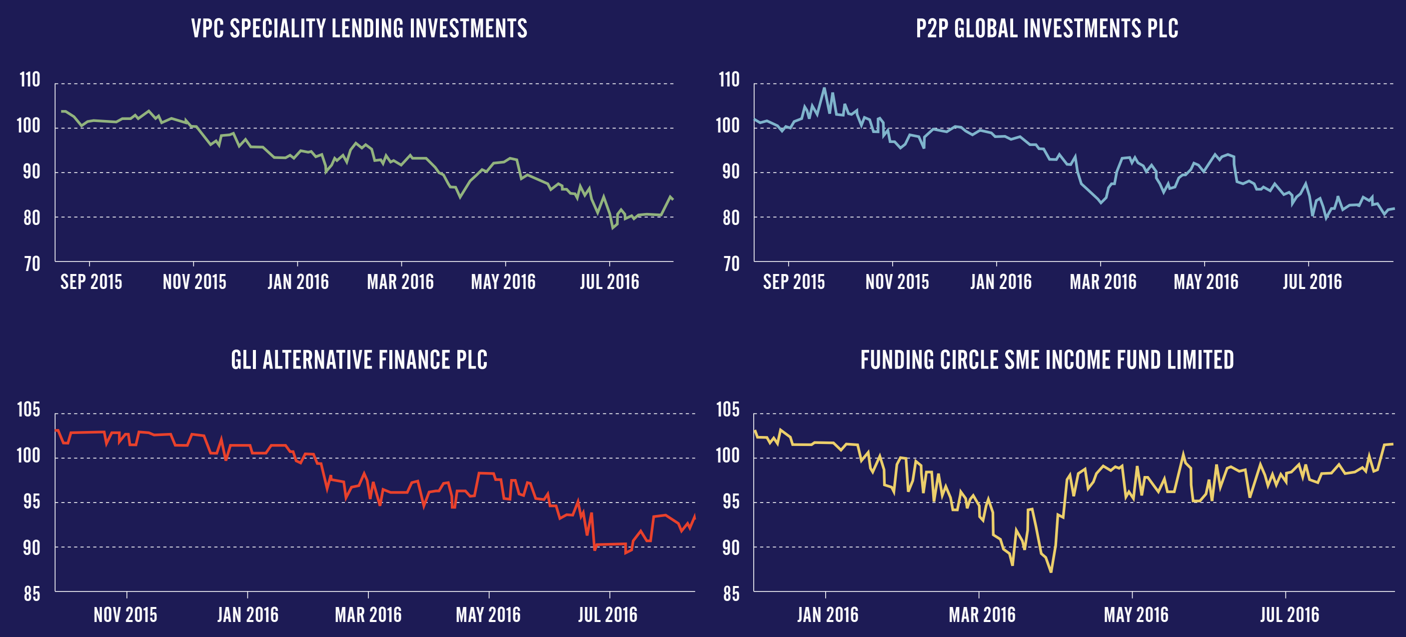
However, some of these funds invest in other funds and these independent funds charge their own management and performance fees on top of the fees charged by the initial P2P fund. It is also worth verifying whether the initial fund is passing on the P2P lending websites' fees for lending through them[169].

In addition, P2P Global Investments and Victory Park Capital Specialty Lending Investments take a 15% annual performance fee for any increase in the share price that is over and above the total (net) value of any P2P loans, cash and other assets in the fund. But there is a high water mark, so that, if the share price falls and then rises again, the performance fee does not apply until the fund gets over its previous high. Nonetheless, the effect of fees of this level on the overall yield could be significant.

Nevertheless, for the most part, it is through these trusts that mainstream asset managers have looked to gain their P2P exposure, rather than buying loans directly from the platforms. And there is some P2P fund investment involvement from some impressive fund entities: Invesco Perpetual, the UK arm of the $790bn US manager, owns a third of VPC Speciality Lending and P2P Global Investments, plus half of Funding Circle SME Income Fund Limited. Meanwhile, Woodford Investment Management, run by renowned fund manager Neil Woodford, is the second-largest holder of both the VPC and P2P trusts[170].

These managers do not seem concerned by the youth of the sector or the difficulty with judging value for money because there is no benchmark to measure the fund performance against. Platforms recognise this issue and the Peer to Peer Finance Association and AltFi Data, which provides quantitative indices on the industry, are working on it: "The next stage of communicating this sector's return to an increasingly wide pool of investors will be the adoption of a returns benchmark by the specialist asset managers in the sector. These asset managers need to advertise to prospective investors the impressive returns that are available. As asset managers adopt an industry standard benchmark it will further improve the visibility of the sector and, in so doing, attract further retail and institutional investors to the space."[171]

1 YEAR PERFORMANCE (12 AUG 2016)



SOURCE: GOOGLE MONEY

"The aggregator can provide an extra layer of due diligence on the platforms that it accommodates."

All of these funds are very new, with P2P Global Investments PLC the oldest, having launched in May 2014. Consequently, they have very little track record.

In addition, listed funds are always at the whim of market sentiment since some of the yield is in the rising share price instead of paid out from loan interest received. Consequently, a change in the share price is an important factor for investors. This has been evident in the uncertain times after the Brexit referendum with all four of the funds mentioned in this report trading at discounts to net asset value in August 2016.

Analysts at Winterflood, have identified the ability of the asset class to withstand more difficult economic environments as a key concern. But, as we have seen, the robustness of the underlying loans is evidenced by the low default rates and by the stress-testing of loan books. And the fear of platforms resorting to poorer quality loans as more deal competition grows, is offset by the relatively rapid loss of reputation and future business caused by rising default rates because of the transparency of loan book data.

It's also worth noting that most of these funds have now deployed their capital, which has been one of the factors in the recent slow-down in net lending in the sector.

Structured products also include packaged deals for loans and other debt instruments which package up debt in slightly different ways, such as within bonds which are issued against P2P loans. Where the bonds are listed, this gives a route to the P2P lending asset class which allows easy access to funds as the bonds are listed and transferable and they are of institutional quality, giving advisers some peace of mind that they have been thoroughly reviewed with robust due diligence analysis.

SHARE PRICE TRADING OF PEER TO PEER LENDING FUNDS AT 11 AUGUST 2016

PEER TO PEER LENDING FUND		01 JAN 2016	30 DEC 2016	
VICTORY PARK CAPITAL	VICTORY PARK CAPITAL SPECIALTY LENDING INVESTMENTS PLC	1012	792.5	-21.69%
GLOBAL INVESTMENTS	P2P GLOBAL INVESTMENTS PLC	94.5	78.75	-16.67%
GLI Finance	GLI ALTERNATIVE FINANCE PLC	101.5	93.69	-7.69%
Funding Circle	FUNDING CIRCLE SME INCOME FUND LTD	101.625	101	-0.62%

SOURCE: CITYWIRE AND INVESTORS CHRONICLE/MORNINGSTAR

AGGREGATORS

In response to the number of platforms, there has been an emergence of aggregator sites. These aggregate information for research and comparisons, but also allow advisers and users to transact. They aim to simplify the selection process, which highlights an awareness of the help investors need to easily compare marketplace finance providers, an important part of bringing non-bank funding into the mainstream[172].

These sites give access to multiple origination platforms as a portal, which allow greater diversification across multiple platforms using a single account log-in. The benefits are substantial:

REDUCED ADMINISTRATION AND PROCESSING: this is exemplified by the treatment of ISAs, where aggregators can have ISAs across multiple platforms unlike platforms themselves which can only wrap investments on their own platform in an ISA.

EASY ACCESS to low cost diversification across multiple platforms: There's no need to fill in multiple investment applications in order to take that extra diversification step that allows for three-way diversification across platforms, sectors and products.

WHOLE OF MARKET IS AVAILABLE in one place: a potentially huge time saver and also providing the user with much greater confidence in finding all of the relevant information and therefore much more control of the overall investment process.

EXTRA DUE DILIGENCE: the aggregator can provide an extra layer of due diligence on the platforms that it accommodates.

INDEPENDENT RESEARCH that the aggregator aims to provide on a like for like basis.

ONGOING MONITORING OF PORTFOLIO facilitated through the production of periodic reports showing the breakdown and performance of advisers' clients' portfolios.

OPPORTUNITIES TO MAXIMISE CASH RETURNS and legitimately charge for that advice on an AUM basis.

"Aggregators can have ISAs across multiple platforms unlike platforms themselves which can only wrap investments on their own platform in an ISA."

AGGREGATORS

There are a number of sites providing a variety of aggregator services, including:

LENDINGWELL

LendingWell will provide a single platform designed specifically to serve retail investors by allowing them to access analyse and invest into the broad P2P lending market. The platform will offer simple and innovative structured products secured by a diversified portfolio of loans suitable for a mass market retail investor base. Such bonds offer a streamlined access point for investors to achieve diversification across sub-asset class verticals, platform loan originators, loan maturities and asset security offered.

WWW.LENDINGWELL.COM — Investor focused

INVESTUP

Allows direct retail investors to buy shares and lend money across multiple P2P platforms from one site with one application.

WWW.INVESTUP.CO.UK — Investor focused

BONDMASON

It allocates investors funds into loans across various P2P lending platforms, working on the basis of building a balanced portfolio of loans for each individual investor

WWW.BONDMASON.COM — Investor focused

GOJI

Has announced an aggregator platform coming soon, which will facilitate diversification of an investor's funds across loans, platforms, loan classes and maturities.

WWW.GOJIP2P.COM — Investor focused

FINPOINT

Offers businesses looking for finance out to their lenders as identified by their criteria on a referral basis. Partners with various finance options including banks and P2P lenders.

WWW.FINPOINT.CO.UK — Borrower focused

INTELLIGENT LENDING ADVISERS

Provides unbiased information and execution for investors in P2P loans. The company has a proprietary model to value and assess risk, and has developed an execution platform to allow investors to obtain access to the same high speed execution that institutional platforms use.

WWW.ILADVISERS.COM — Investor focused

FUNDING OPTIONS

One of the neutral platforms with over 50 lending partners providing finance choices for small businesses. Chosen as a designated platform for the Bank Referral Scheme.

WWW.FUNDINGOPTIONS.COM — Borrower focused

"This kind of efficiency and control may come at a cost, but the benefits suggest that the aggregator model for accessing the investment world of P2P lending does indeed make most sense for advisers."

ACTIVE VS PASSIVE INVESTMENT STRATEGY

Both active and passive investment strategies are available to those seeking investment through P2P lending. A passive investment approach may be a packaged investment product, or simply involve use of an automatic bidding system. It relies on the platform or aggregator to set a sensible mix of risk levels and returns and to diversify effectively across platforms and sectors. This is a convenient option which relies entirely on the expertise of the platform or aggregator.

The automatic bidding system of the platform, matches each tranche of investor money with borrowers as deals matching these criteria become available. The benefit of the auto bidding system is that it quickly allocates the investors funds and reduces the risk of uninvested cash, which is not earning a return, lowering the overall yield (cash drag). This is particularly useful for reinvesting as returns come into the investors platform account, as it allows for compounding of growth. It also means that the investor does not have to spend the time and effort looking at the due diligence and credit information of the borrower - he simply relies on the platform's research in this regard.

The disadvantage of this system is that, unless the investor manually selects his borrowers and conducts his own due diligence, he may never know how the party which is borrowing from him met the criteria and why they need the loan. Such information will depend on the levels of disclosure on underlying loans provided by the relevant platform as this varies across all platforms.

Nevertheless, auto-diversifying makes alleviation of a very significant portion of the risk of borrower default entirely possible because of the sheer volume of loans that funds can be spread across. But it does mean that the choice of platform is critical as, without a good selection of chosen, robust loans in the first place, a high number may fail. Access portals, or aggregators help to mitigate this problem by adding another filter which applies carefully selected eligibility criteria and risk management.

LendingWell offer this option which works like a discretionary fund manager model portfolio, wherein the client and adviser benefit from delegating the day-to-day investment management process, gaining ongoing access to an investment professional and reducing the administrative burden. A model portfolio is one way to access the skills of a full-time manager without paying a small fortune as all monies are managed under the same investment strategy.

Passive investors are likely to be those who trust the platform to find borrowers, assess creditworthiness and then choose suitable loans. This gives them a very straightforward lending experience. It leaves the platform in charge of the investment for the full term and leaves any active investment decisions required to meet the target return, in the hands of the platform. Many investors are happy with this as they consider that the platform has much more expertise than they do.

An active strategy, on the other hand, allows investors to effectively choose their maximum exposure to individual loans and requires the opportunity to review all the available information such as credit rating, location and business sector on each business looking for a loan before actually committing cash. The investor can then select the companies to which he wants to allocate his cash as part of his loans. Also, active investors, may be able to uncover better deals by searching the market themselves, whereas, the product option provides no real prospect of out-performance by superior loan selection as the platform is only looking to meet the product target returns. It is therefore unlikely to look outside of the criteria relevant to those. An active investor, on the other hand, might identify borrowers in a field in which he/she has expertise, and therefore confidence to invest at a higher risk rating and therefore higher return. And an investor's desire for control may not be all about the targeted return. Instead they may be looking to support sectors with which they have an affinity or an ethical connection.

Still, there are issues with this as the most popular loans can fill up with investors very quickly, so timing of the investors due diligence needs to be fast enough to actually take an opportunity if the investors decide they like it. Another negative is that the diversification possible through passive investing can be so high – perhaps across hundreds or thousands of loans, depending on the amount invested, that risk to the overall return from one, several or even dozens of defaults is minimal: even a skilled and experienced investor would find it very difficult to reach these levels of multiplicity.

Of course, there is always the option to play the field by putting some cash into a product and some into loans chosen by the investor as some platforms offer both free choice of all available loans and packaged products to investors.

AGGREGATOR COSTS

By centralizing the mind-boggling array of options on offer – aggregators aim to assist newcomers and those looking for ease of use, with making

"The additional due diligence layer provided by the aggregators is a useful resource as advisers navigate a new asset class and get a handle on the sector."

sense of the options. Nonetheless, their presence re-introduces an intermediary into a disintermediated industry and most will not be doing this for free. Investors and their advisers need to carefully consider the benefits which will be clearer for some aggregators than for others. Those which serve as useful tools for simplifying and centralizing opportunities, saving time and energy, are likely to come out on top.

One factor which is certainly in favour of the aggregators is connected to the Innovative Finance ISA as a result of the HMRC decision that investors will only be able to contribute to one Innovative Finance ISA account per tax year. But, HMRC's announcement in March 2016 that several P2P lending platforms can be chosen by an adviser/investor – using an aggregator platform, is fantastic for investors... and aggregators[173]. Not only does it allow cross platform diversification, but it is a strong justification for using aggregators as it allows all gains from all the platforms invested in through the aggregator to be sheltered from tax in a way that is not possible by investing directly into a number of different platforms. Depending on the amounts invested, this tax saving is likely to offset the aggregator fees and leave the investor better off.

As an example of aggregator fees, LendingWell charges an annual fee of 0.5% of AUM charged once a month.

OTHER COMPARISON SITES

These sites facilitate fast comparison of platforms, much like the already familiar sites for comparing credit cards or insurance, although they are unlikely to provide the real like for like comparisons that are so important. Interestingly, some of the traditional comparison sites are also beginning to cover P2P lending.

We've listed a selection of the P2P comparison websites here, some of which are more lender focused and others which take a greater interest in borrowers:

- 4thway: financial comparison featuring a 'Risk Rating' and also a more in-depth 'Insight Report', for some platforms aimed at explaining all the highlights and key features. It provides links to platform websites, but has no functionality to allow for multiple platform investments in one transaction.
- Alternative Business Funding: a collaboration rather than a straight broking site; all listed funders (over 50) agree to act in the same way and refer rejected SMEs back to the portal. Borrowers can choose which interested lenders they approach.
- Better Business Finance: managed by the British Bankers' Association (BBA) in collaboration with its business and finance partners. Asks SMEs about their finance needs and then directs them to various options such as P2P lending sites. It provides links to platform websites, but has no functionality to allow for multiple platform investments in one transaction.
- BusinessAgent: hosts Crowdfunders and crowdlenders on its website. Asks borrowers about their finance needs and then directs them to various options such as P2P lending sites.
- Informed Funding: a division of Knowledge Peers, Informed Funding offers platforms and other lending partners representation via a microsite managed by each funding platform on the Informed Funding Site.
- Nurture Money - independent crowdfunding comparison and content site[174].

WAYS TO INVEST: CONCLUSIONS

So, it's clear that there are a number of ways to get exposure to P2P lending, all with their own unique advantages and disadvantages. The research carried out finds that most advisers preference will be for aggregator models that provide whole-of-market diversification and simplified administration, while allowing the adviser to retain a hands-on role and oversight on behalf of their clients. And the additional due diligence layer provided by the aggregators is a useful resource as advisers navigate a new asset class and get a handle on the sector.

This kind of efficiency and control may come at a cost, but the benefits suggest that the aggregator model for accessing the investment world of P2P lending does indeed make most sense for advisers.

ADVISING ON P2P LENDING

WHAT YOU NEED TO KNOW

Of course, for advisers their work goes way beyond simply understanding the investment case, risks and benefits of an asset class. They also need to understand where it will fit into their client proposition, which clients it will be suitable for and how it works when they get down to the brass tacks on issues like Professional Indemnity (PI) cover and the investment process.

Advisers would probably be the first to admit that they need to better understand the sector and the opportunities available for them and their clients, so this section aims to give some clarity on the intricacies of advising on P2P lending. (It is not intended to be an exhaustive summary of how regulations govern advising on P2P lending.)

ADVISER PERMISSIONS

From 6 April 2016, the FCA automatically varied the permissions of all firms who held at that time, the permissions of 'advising on investments' to add the new regulated activity of 'advising on P2P agreements'. This means that only authorised persons with appropriate permissions can now provide regulated advice on P2P agreements, although the new permission does not bring any additional regulatory requirements or additional fees[175].

Nevertheless, there may be situations where advisers provide advice that doesn't involve making a 'personal recommendation' or carrying on the regulated activity of advising on P2P agreements; this could be the case if an adviser recommends that a client invest in an IFISA with a particular ISA manager, but does not recommend a specific loan investment. To ensure consumers understand whether they are receiving regulated or unregulated advice, in order to satisfy the fair, clear and not misleading rule, it would be sensible for firms to ensure that financial promotions clarify to potential investors situations where they are not providing regulated advice[176].

SUITABILITY

The FCA has decided to apply its Conduct of Business suitability rules to firms making a personal recommendation involving advice on P2P agreements.

Suitability has been high on the FCA agenda in 2016 with Megan Butler, director of supervision at the FCA, stating in May that "wealth managers should be aware suitability remains one of our main concerns in the sector"[180]. And in the FCA's 2016 regulatory review of crowdfunding, including loan based crowdfunding, one of the items under review is whether platforms should carry out suitability checks for investors: as an indication of what new rules could be introduced, it is interesting to note that investment-based (equity) crowdfunding platforms are already required to gauge the suitability of investors prior to allowing them to invest. Currently, equity based crowdfunding platforms must not sell to retail customers unless they fall within the following other categories:

- certified as high net worth – annual income over £100,000 or net assets of £250,000 (excluding primary residence, pension and insurance benefits)
- self-certified as a sophisticated investor – sufficient knowledge to understand the risk
- certified as a restricted investor – investing less than 10% of net investible assets
- the firm (or another authorised firm) has complied with the 'suitability' requirements in the FCA rules
- the customer is classified as a 'corporate finance contact' or a 'venture capital contact' under FCA rules.

The FCA's review suggests that it may consider the implementation of a similar set of rules for P2P lenders. This would not remove the responsibility from advisers though, as advising on P2P lending is now a regulated activity requiring all of the standard checks specified when advising on investments.

In fact, as a result of advising on P2P lending becoming a regulated activity in April 2016, as noted in the Regulation section of this report, unsuitable advice to invest in P2P lending may now be covered by the FSCS. The FSCS has confirmed this on its website, including the amount of compensation it may be able to provide - up to £50,000, if all of the following criteria are met:

- the advice to buy the investment must have been given on or after 6 April 2016
- the advice firm must have been authorised by the appropriate regulator to do so at that time
- the investor must have lost money as a result of the advice given
- the firm (or its principals) must no longer have sufficient assets to meet claims for compensation
- the P2P loan agreement meets the requirements for the FCA to consider it to be a 'P2P agreement', which will depend on individual circumstances[181].

In addition, a recent report commissioned by the P2PFA found that, "investors are broadly aware of the risk and liquidity profile of P2P lending, and their behaviour does not suggest that they are confusing it with deposit accounts provided by banks"[182].

"Wealth managers should be aware suitability remains one of our main concerns in the sector" – ***Megan Butler, FCA***

FCA P2P AGREEMENT DEFINITION AND INFORMATION

The FCA introduced the following in March 2016:

A 'P2P Agreement' is an agreement between the borrower and the lender by which the lender provides the borrower with credit and (a) either the lender provides the borrower with credit of up to £25,000; or (b) the agreement is not entered into by the borrower wholly or predominantly for the purposes of a business carried on, or intended to be carried on, by the borrower. If neither (a) nor (b) is satisfied, then the agreement is not an article 36H agreement and the article 36H regulated activity will not be applicable[177]. (Article 36H of the Regulated Activities Order refers to Operating an electronic system in relation to lending and in this article the definition of a 'P2P agreement' is described as an 'article 36H agreement'.)

At the same time, the FCA implemented a:

- ban on the payment and receipt of commission by FCA regulated firms in relation to personal recommendations made to retail clients on P2P agreements (see COBS 6.1A; COBS 6.1B; and COBS 6.2A);
- application of the rule on inducements (COBS 2.3.1R) to personal recommendations involving advice on P2P agreements, in the same way that it is applied to other retail investment business;
- application of its training and competence rules to ensure that financial advisers who advise on P2P agreements are appropriately supervised and assessed as competent to carry out that activity (see TC 2.1)[178]

USING DIVERSIFICATION TO INFLUENCE RISK

Diversification is achievable within P2P lending because platforms are able to fractionalise loans into parts which gives the investor the ability to lend to many different borrowers. This is done by the P2P sites creation of multitudes of electronic contracts to ensure that each lender has, in a technical sense, a direct connection to a borrower, despite the fact that the lenders experience of the site has largely been to click a button[183].

Within P2P lending, it is also possible to gain various levels of diversification - across platforms, levels of asset backing security, sectors, risk levels and loan terms: one of the beauties of P2P lending is the very low minimum investment levels of many of the platforms - from as little as £10 on some websites - which allows investments to be split across a variety of loan types and platforms, allowing exposure to a whole raft of options at low levels and limiting the possible default loss from any individual loan.

Investing into a mix of personal loans, business loans, and the various different models of property-connected loans, provides another type of diversification. Moreover, investing in more than one sector can give exposure to different benefits and disadvantages. For example, loans into the technology market are generally affected by different factors in terms of potential default issues, to loans into the renewable energy sector. In other words, different asset classes behave differently in different macro-economic conditions.

The same can be said of platforms which may have varying strengths and weaknesses in different conditions. No platform will lend in exactly the same way and each will have its own lending criteria and risk assessment procedures to set reasonable interest rates to indicate creditworthiness. Security features will also vary – from a provision fund to insurance.

Given these features, the sector exhibits a significant degree of suitability for retail investment, in the right amounts and at the right risk and diversification level, particularly whilst yields are so low in traditional asset classes. Recent research on the P2PFA members has also suggested that the underlying risk characteristics of P2P lending are comparable to those of other retail investments such as bonds and equities, without more inherent risk, complexity or lack of liquidity[184].

Nevertheless, it is worth noting that the larger platforms seem to be the best bets in terms of risk of platform meltdown. Individually picking platforms and products could see better results but the time consuming nature of this is likely to make it an unrealistic option for most advisers. This is why funds, which do that hard work for them after an initial due diligence exercise, might be preferable. Another viable alternative would be to use an aggregator, some of which have pre-selected portfolios which have been carefully constructed by an experienced management team.

PROFESSIONAL INDEMNITY COVER

In March 2016, the FCA published its PS16/8 Policy Statement, entitled 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 Peer to Peer Agreements Including Feedback to CP16/4 and CP16/5, and Final Rules. This policy statement confirmed that the FCA was implementing its proposal in the CP16/5 Consultation Paper of February 2016 regarding professional

"Of course, due diligence will not guarantee the successful repayment of a loan, but it will give an important indication of the chances of success."

indemnity cover for firms that recommend P2P Agreements; this means that the same regulations will apply as those applicable to firms that recommend investments to clients. These firms are generally required to meet minimum capital resources requirements and, in some cases, to hold a minimum level of professional indemnity insurance.

Advisers can choose the excess level of their policy, but there are additional capital adequacy requirements if the firm has an excess of over £5,000. This also applies if the firm has any exclusions in its policy for activities that the firm is or has been involved in[185].

DUE DILIGENCE

Of course, due diligence will not guarantee the successful repayment of a loan, but it will give an important indication of the chances of success.

When it comes to due diligence, the FCA has provided some guidance: "We would expect an adviser to understand the distinctions in risks between different product types, especially those that may appear similar. For example, advisers should consider the risks of P2P agreements when compared to bank or building society deposit accounts... Our existing rules also set out situations where firms can place reliance on other persons [see, for example COBS 2.4.6R]. It is generally reasonable for a firm to rely on information provided to it in writing by an unconnected authorised person or a professional firm, unless it is aware, or ought reasonably to be aware, of any fact that would give reasonable grounds to question the accuracy of that information... Advisers must form their own opinion of the risk of any investment and advise their clients based on this opini
unable to form an opinion based on the information available, then the correct response is not to advise the client to invest in that product..."[186]

Selecting a P2P platform is the first step in checking that investments in P2P lending are sound: there are many variations in the operations of P2P lending sites and being aware of these will inform how due diligence progresses; questions to think about are:

- Who can invest? Retail, institutional, high net worth investors?
- How is the credit assessment carried out? Completely online, face to face meeting with borrowers, visit to their site, analysis of their accounts and business plan?
- Does the team running the site have experience in assessing the creditworthiness of borrowers and lending money?
- What sort of opportunities does the platform offer? Fixed-rate offers, with lenders accepted on a first-come-first-served basis? Competitive "reverse auctions", where lenders bid against each other to offer funding at the lowest rate?
- Is there a minimum rate below which competitive bids cannot fall?
- Does the platform allow lenders to pick individual borrowers?
- Are specific interest rates guaranteed? (Interest rates are never 'guaranteed' despite protections in place such as contingency funds etc.)
- Does the platform complete loans using its own money and then let investors buy portions of these completed loans from it? (Balance sheet lender) Or does it simply link lenders with borrowers without lending any of its own money? (Marketplace lender)
- Is the site run by people with banking/financial services experience who are actually involved in the company operations? Was it founded and run by technology specialists?
- Are the fees, charges and incentives reasonable and competitive?
- Does the platform focus on specific industry sectors such as renewable energy, or is it a generalist?
- What contingency plans are in place should the platform get into financial difficulties?
- Are borrowers asked to provide any type of security to offset potential losses to lenders, such as charges over property?
- How does the site arrive at the returns that it quotes? Does it deduct fees, tax liabilities or likely default rates?
- What information does the platform publish about its track record as a lender? Does it provide figures on the number of loans that have defaulted in the past and how much of the lenders' money was eventually recovered?
- How accurate are the platform's projected versus actual loan default rates?
- Do institutional investors have advantageous access to the best deals?

Advisers' should be considering what this means for their clients - if the platform offers credit to various types of borrowers, are there any they are not comfortable with - buy to let landlords, small companies? If the platform does larger volumes of business, it is likely to mean a greater likelihood of the ongoing operation of the platform as it means more business is written and this is the point at which fees are generally taken. Although volume at the expense of quality in order to gain size for an IPO is unlikely to be beneficial to lenders, so are the risk ratings reasonable and are the platforms interests aligned with retail lenders?

“The FCA is keen to remind advisers of the need for ongoing monitoring of investment portfolios and P2P loans are no exception.”

In the event of the platform having an auto-bid function, the adviser should be thinking about whether or not they feel more at ease to examine each individual loan himself, including who the borrower is, the credibility of the business plan and how secure it? Or, are they confident, perhaps from a review of the platform's historical loan books, to allow the platform's programmed algorithms to make the investment choices?

The platform operating model will also have a bearing on the potential for cash drag in the event of investor funds sitting idle in the lending account before being matched with a borrower or reinvested into new loans. Does the platform demand a large minimum investment in each loan which is above the income that will be received from the initial loan? Does it automatically re-invest the money paid by borrowers into suitable new loans through an auto-bid function? If not, is it too time-consuming for the adviser to do this manually?

Some platforms package up loans and offer them as products with a small range of loan terms and interest rates for investors to choose between. Products and auto-bid functions, which should ensure all underlying loans meet the same criteria, can be helpful with P2P investing via a SIPP where there is a perceived need to carry out due diligence on each individual loan. This could make them more acceptable for IFAs to advise on as they assess the platform, then select the correct risk return profile for their client - like assessing a provider and then their product. It may also provide a less time intensive method for reviewing P2P investments in general as, once the platform due diligence is completed to the satisfaction of the adviser, the auto- bid/reinvestment function can be set to pre-set criteria, meaning there is no need to assess each individual loan invested in.

The FCA is keen to remind advisers of the need for ongoing monitoring of investment portfolios and P2P loans are no exception. It is important to track an overall portfolio to ensure that it matches the specified criteria - e.g returns levels received on time at the correct risk level and over the agreed term. It is also vital to liaise with the client to ensure the investment criteria originally decided are still suitable – this is particularly applicable when automatic reinvestment is selected. And the overall success and risk levels of platforms can change over time, so being able to utilise transparency to review published redemptions rates, bad debt levels and data regarding calls on contingency funds, is a useful feature.

Getting a good overview of the sector, checking platform due diligence, looking at the products available, deciding whether active or passive investment is most suitable for the investor and ongoing review of risks and performance of P2P loan investments involves some work from the adviser. And this is an important way that he or she can show that they have added value and had an influence over a portfolio. For clients who understand that P2P is not just saving, but an investment with the associated risks of loss of capital, who are looking for returns that cash just cannot currently give them, these are justifications for advisers charging for P2P assets under management. Some aggregators and platforms will even collect the adviser fees on their behalf.

REVIEWS

Some websites offer very simple platform reviews with a very limited number of platforms included. MoneySavingExpert.com falls into this category. In addition, some customer reviews are available at P2Pmoney.co.uk, along with basic comparison data taking into account virtually all of the market. Moneysupermarket.com provides simple P2P lending product information as do Fundshare.co.uk and Orcamoney.com which allow users to compare p2p lending rates, but not all platform options are quoted. As previously noted, this information in itself is interesting, but generally more research needs to be done in order to ensure that platforms and products are comparable on a like-for-like basis, which is one of the benefits of the aggregator LendingWell.

4thway.co.uk also publishes P2P platform data on its website for around a quarter of the market, with some also featuring a 4thway Insight Report, giving a more in depth review of the platform.

in:review.

In terms of more detailed analysis, In:review, provides a live comparison of platforms, expected to become fully live in early 2017 with 7 main aspects discussed:

LIQUIDITY. Early repayment, redemption, cancellation, transfer

REGULATORY COMPLIANCE. High level controls, CASS, AML, capital adequacy, client reporting, promotional material and complaints procedure

TAXATION. Only really relevant in the context of SIPP or SSAS

PARTIES. Operator, counter-parties - provenance, experience and regulatory record

SECURITY attached to loans (how and when it can be enforced, operator's process to assess potential borrowers, default, late payment and contingency fund analysis)

BUSINESS CONTINUITY and disaster recovery plan (triggers, costings, timings)

LOANS ANALYSIS. Returns and fees

“It is likely that, as the market continues to grow and become more mainstream, the FCA requirements for advising on P2P investments will change, so that independent advisers are required to do so. If the market size and reach into retail circles keeps rapidly expanding, there is good reason to assume that this will happen sooner rather than later.”

RESEARCH WHOLE OF MARKET

Since the beginning of the 2016 tax year, advisers have had the right to advise on P2P investments. However, in March 2016, the FCA stated “We believe that, with the sector still in an early stage of development, it is not appropriate at this time to oblige firms to have to consider P2P agreements when holding themselves out as independent. This is something we will keep under review.”[187] So currently, even ‘whole of market' advisers have no regulatory obligation to include P2P lending in their considerations for advice to clients.

The present situation may suit some advisers who are concerned about regulatory risk and have had difficulty in accessing P2P lending information to make informed decisions on a whole of market basis. Nonetheless, clients who seek whole of market advice might not benefit from the absence of P2P lending as a strategy possibility; P2P lending can provide a relatively liquid, relatively low risk, near cash asset, achieve better risk adjusted returns than other asset classes and allow clients' money to be put to work in investments they have a strong desire to support.

It is likely that, as the market continues to grow and become more mainstream, the FCA requirements for advising on P2P investments will change, so that independent advisers are required to do so. If the market size and reach into retail circles keeps rapidly expanding, there is good reason to assume that this will happen sooner rather than later.

When that happens the wide appeal and diversity of P2P lending, with models attracting institutions, unadvised consumers, financial advisers, SIPP or SSAS operators, workplace pension trustees or asset managers, the ease of whole of market research may have benefited from some consolidation of the platforms. In the meantime, there is a growing list of resources to assist advisers, particularly platform reviewing resources and aggregators, which may be the drivers of consolidation. These can allow advisers to get their arms around a sizeable chunk, if not all, of the whole of the market. For example, LendingWell intends to provide independent platform due-diligence on its website.

THE INVESTMENT PROCESS

START HERE >

REGISTER on the platform's website with a few personal details such as name and address, to create an account.*

DEPOSIT FUNDS into the chosen P2P platform accounts.

CHOOSE the product or submit the amount to lend and choose the desired interest rate and loan term.

Either the platform will then split the investment across a range of loans, for a set loan term, or it will allow the investor to manually select the loans.

BORROWERS draw -down the loan and repay the debt with interest, under the watchful eye of the P2P platorm.

THE INVESTOR receives the interest on the capital investment and can watch as it matures.

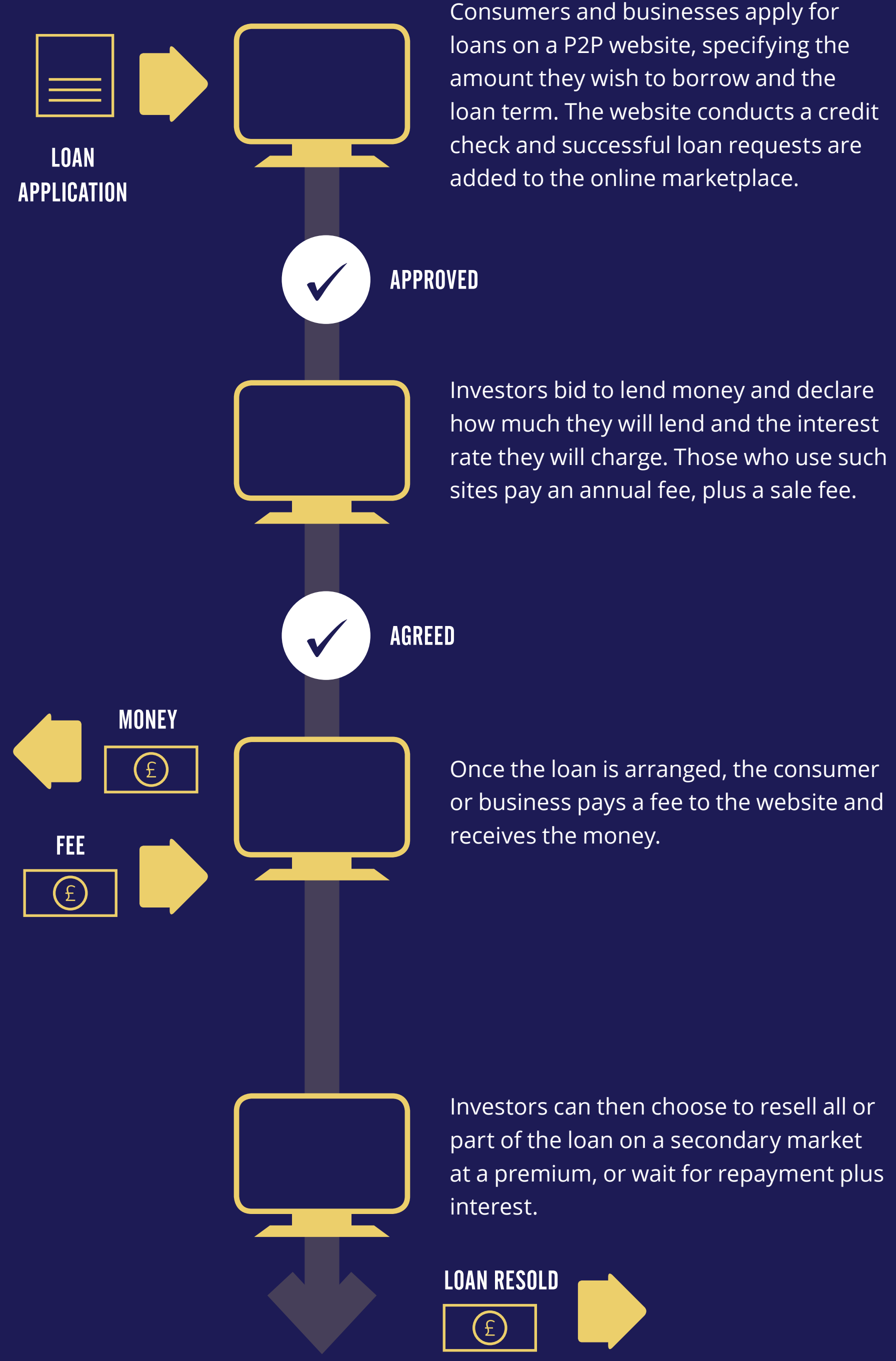
Where a platform has a secondary market, access to the funds may be possible before the maturity of the loan term if a third party is willing to buy the outstanding debt.

This is all likely to take place within a matter of a few days and virtually all of the process can be carried out online.

*(On an aggregator's site, such as LendingWell, this only needs to be done once, regardless of the number of platforms investment is made through.) On over 90%[188] of platforms, basic Know Your Client information is requested in order to verify the account holders' identity. It is a very simple process, good for those looking for fast access, not necessarily so good if those looking for fast access have little investment experience or knowledge.

"The adviser has to charge fees directly to the client for the provision of their advice, but some platforms make this a very straightforward process."

PEER TO PEER LENDING PROCESS



REMUNERATION

Many platforms will facilitate adviser charges when investing their clients into P2P, making the transition from commissions to client charges quite painless. Of course, advisers still need to be able to justify their fees and show that they are actively earning them, but the platforms' or aggregators' involvement can mean that there's no awkward conversation with the client, asking them to write a cheque!

Since the start of the 2016/17 financial year, advisers need a charging model that doesn't require commission as this is now banned by the FCA in transactions which involve the regulated activity of giving personal recommendations to invest in P2P agreements. Consequently, both of the following now apply:

- ban on the payment and receipt of commission by FCA regulated firms in relation to personal recommendations made to retail clients on P2P agreements (see COBS 6.1A; COBS 6.1B; and COBS 6.2A)
- the application of the rule on inducements (COBS 2.3.1R) to personal recommendations involving advice on P2P agreements, in the same way that it is applied to other retail investment business;

This means that the adviser has to charge fees directly to the client for the provision of their advice, but some platforms make this a very straightforward process.

"The market for potential P2P lenders with the right risk appetite and for whom considered financial advice could add significant value, is potentially huge."

The FCA is not proposing to extend the commission ban to other situations, such as unadvised sales arranged on aggregator websites via firms who do not provide regulated advice[189].

The FCA's view is that adviser firms will already have processes in place to meet its requirements for other types of regulated investment, including in relation to adviser charging and record-keeping. As a result, they will not need to develop new processes to use in this sector when advising on P2P agreements[190].

However, the rule changes do prevent the payment of commission to platforms such as those run by self-invested personal pension scheme operators[191].

RISKS OF NOT ENGAGING

When discussing the implementation of its regulatory changes on advice in respect of P2P Agreements, the FCA has stated that, "we expect limited provision of investment advice. The market primarily operates on a non-advised basis and few firms currently provide advice that would constitute a personal recommendation from next April [2016]. From discussions with the industry, there is little expectation that this situation will change rapidly."[192]

For those who see the benefits of growing the industry, this is disappointing, but, to a degree, it is understandable that IFAs are on their guard. They know clients are cautious, having been stung in the past by too-good-to-be-true investment offerings. And the lack of the type FSCS protection afforded to funds held in bank deposit accounts does not help.

However, advisers who continue to dismiss P2P lending out of hand may have some hard questions to answer from increasingly eager clients; in today's low-interest-rate environment, the pressure is on for advisers to add value when it comes to fixed income allocations and the appealing yields are very likely to have an interested audience among a proportion of investors, even after a thorough explanation of the risks involved. As a result, those clients may well be unhappy if they are denied P2P lending opportunities by whole of market advisers who know little about the asset class other than the received wisdom that it is too risky, difficult to assess and clients do not understand it.

The market for potential P2P lenders with the right risk appetite and for whom considered financial advice could add significant value, is potentially huge: A 2015 survey by the Financial Conduct Authority found that savers had £160 billion of cash in savings accounts earning the same as or less than the 0.5% Bank of England interest rate, and over 80% of easy-access accounts had not been switched in the previous three years[193]. Bearing in mind it's likely to be just a matter of time before client demand, P2P growth and resultant FCA regulation bring P2P lending into the investment scope of all independent advisers, perhaps it is time for more IFAs to take a look.

ADVISING ON: CONCLUSIONS

For advisers and their compliance functions, there are practical issues to address before they can recommend P2P lending to their clients, including PI cover, research and due diligence and (not least) client suitability. It seems that there is some work ahead if the P2P industry is to overcome these issues and make it easy for advisers to recommend P2P investments, but none of these obstacles is insurmountable and the benefits to both investors and advisers could be huge.

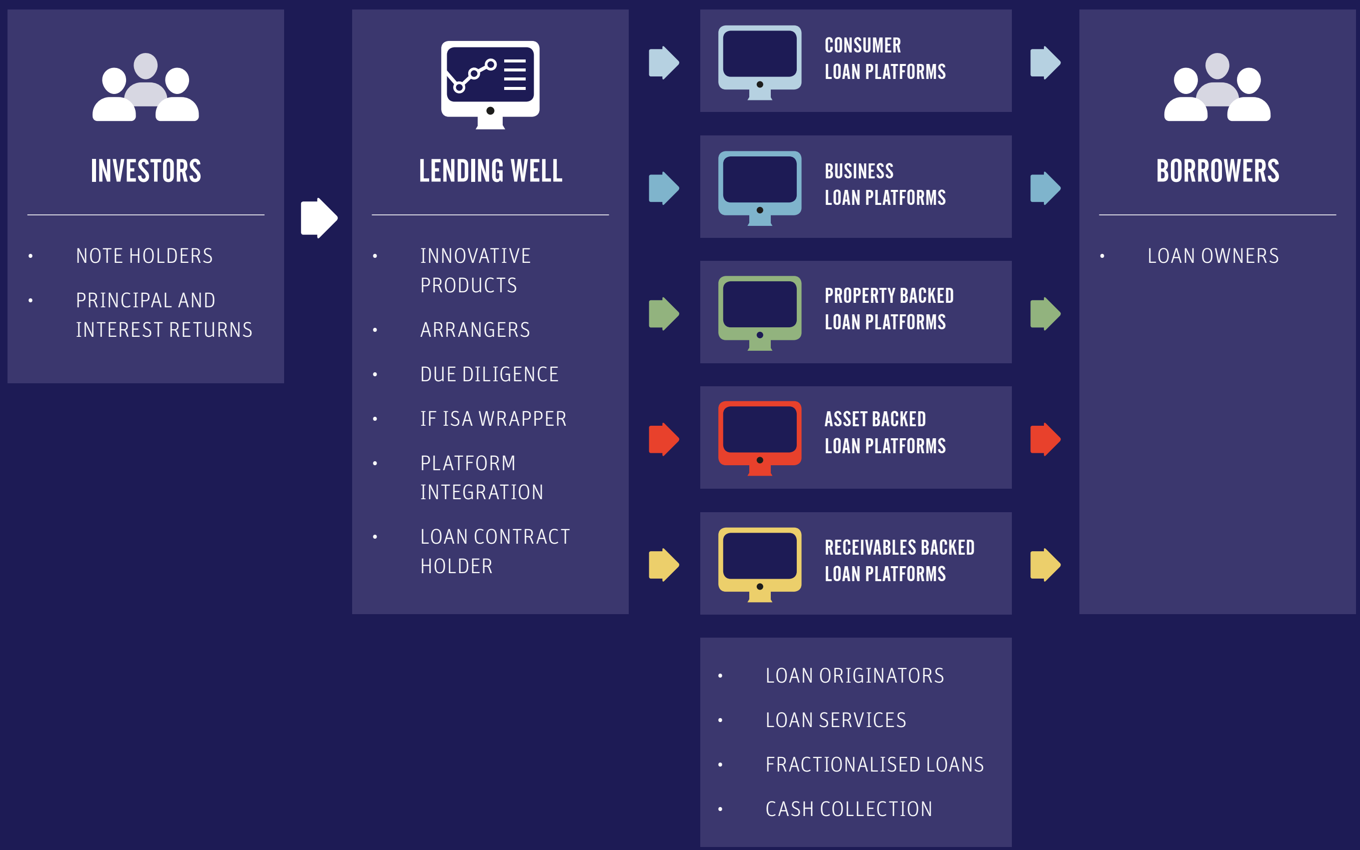
LENDINGWELL

AGGREGATOR

LendingWell is a disruptive financial technology company that aims to provide the most comprehensive solution for financial advisers and private individual investors.

As a P2P aggregator, the streamlined investment process reduces the administrative burden, empowering investors with a single point of access to a curated list of loan originators, due diligence resources, research and data to drive a well-considered approach to decision making in P2P investments. The P2P lending universe has continued to expand although this has come at the expense of increasing difficulty for retail investors to conveniently and confidently diversify their exposure to this new asset class within the much anticipated arrival of the Innovative Finance ISA. LendingWell's simple, innovative structured bonds offer a clear point of access for investors to achieve diversification across sub-asset class verticals, platform loan originators, loan maturities and asset security offered.

LENDINGWELL: HOW IT WORKS



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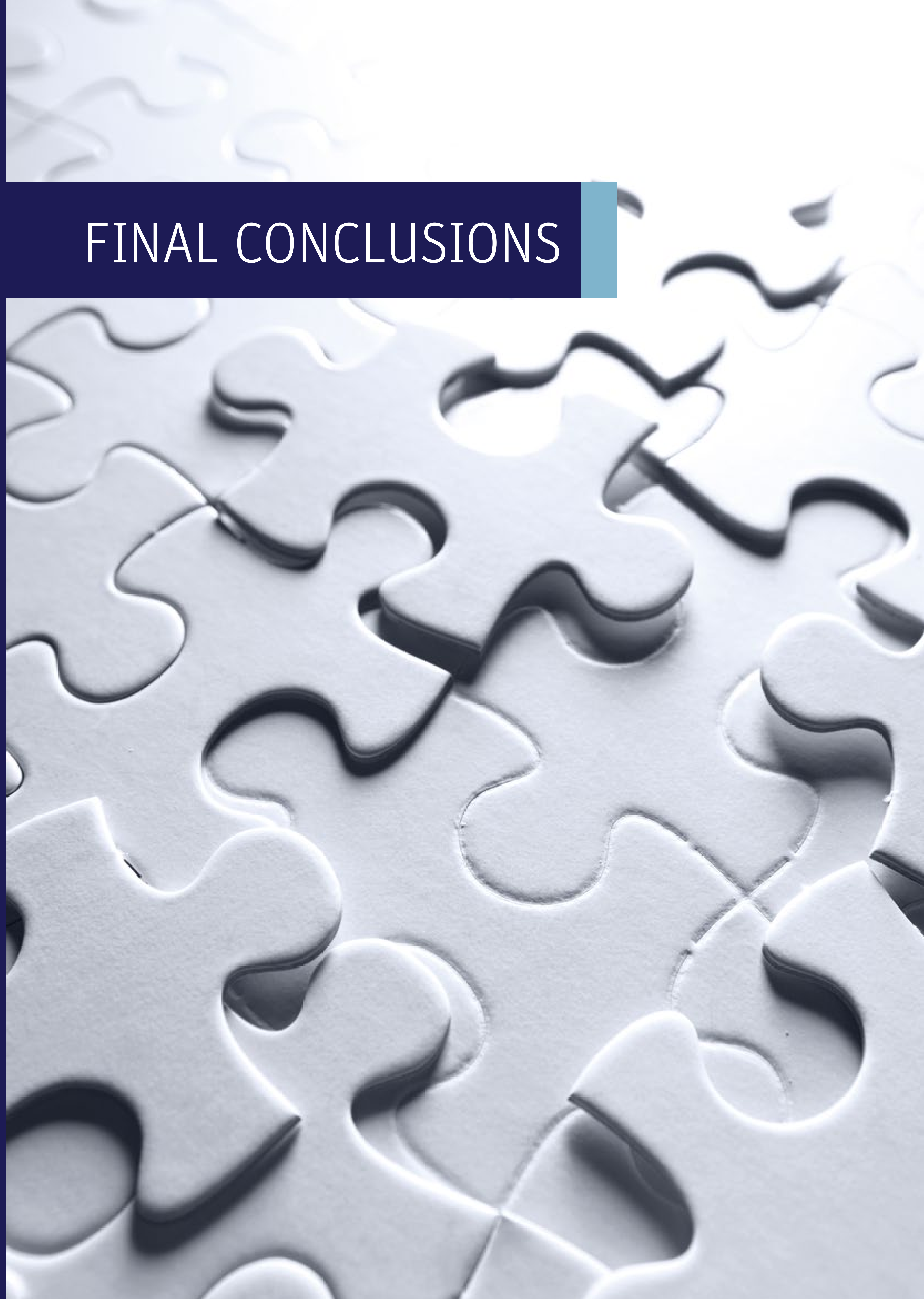
FINAL CONCLUSIONS



FINAL CONCLUSIONS

KEY TAKE AWAYS

There is a compelling case for advisers to consider P2P lending, largely based around the ability to give their clients exposure to risk adjusted returns in a new asset with a range of risk rated investments that offer inflation beating yields currently hard to come by. However, despite being an attractive proposition, as with any new asset class, advisers will naturally be cautious. They will be keen to understand all of the associated risks as well as the benefits, and with several methods of investment, they will need to identify the most appropriate way to invest on behalf of their clients.

One method of investment that is likely to have a particularly strong appeal for advisers is the "aggregator" model. Aggregators, such as the report sponsor LendingWell, will be able to give advisers low cost diversification across a number of the platforms and lending models discussed in this report, whilst also sheltering returns from tax with use of the innovative finance ISA wrapper*. Crucially, they also provide an additional layer of due diligence and allow advisers to manage their client's lending portfolio on an ongoing basis, so advisers can ensure that it remains suitable for the client.

With the favourable prospect of changing regulation, including the eventual requirement for whole of market advisers to consider P2P lending for suitable clients, it would seem sensible for them to evaluate the P2P lending arena and the positives it can deliver, sooner rather than later.

*Tax treatment is dependent on the individual circumstances of each individual and may be subject to change in the future. Availability of the Innovative Finance ISA may vary between platforms.

SAMPLE RISK / RETURN TABLE

LOWER INTEREST PAYMENTS	HIGHER INTEREST PAYMENTS
LOWER EXPECTED LOAN LOSSES	HIGHER EXPECTED LOAN LOSSES
LOWER EXPECTED RETURNS	HIGHER EXPECTED RETURNS
LOWER EXPECTED VOLATILITY	HIGHER EXPECTED VOLATILITY

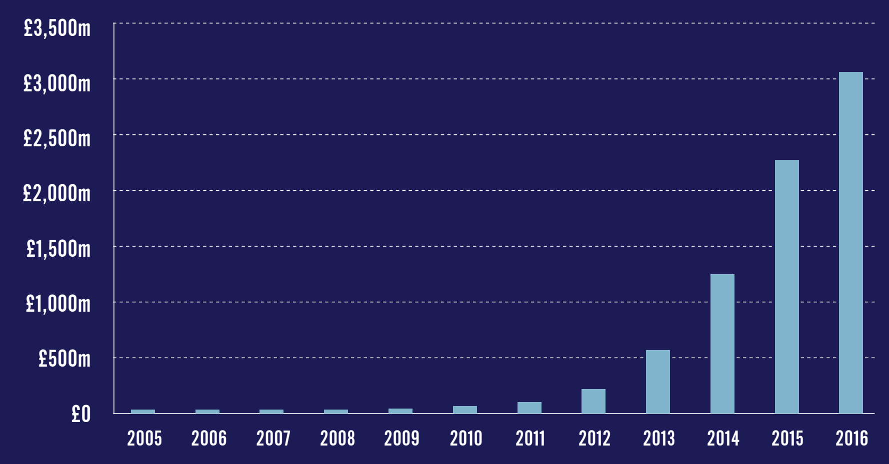
1	2	3	4	5	6	7

← REWARD / RISK →

Each grading will refer to a small range of interest rates that are applicable to that risk grade. The higher the risk grade, the higher the applicable interest rate range.

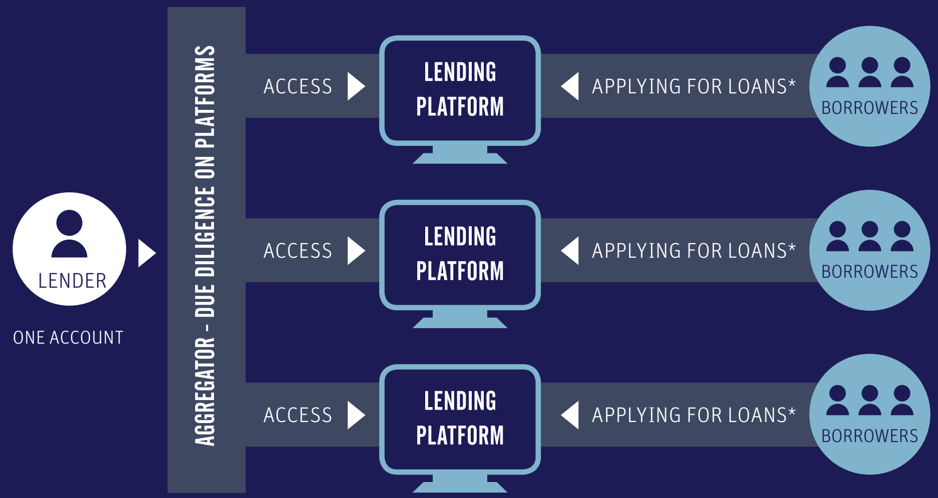
SOURCE: INTELLIGENT PARTNERSHIP

ANNUAL P2P LOAN ORIGINATION (£M)



SOURCE: P2PFA

AGGREGATOR PROCESS



SWOT

STRENGHTS, WEAKNESSES, OPPORTUNITIES AND THREATS

STRENGHTS

- Cost advantage over traditional financial institutions
- Choice of risk levels and associated returns with risk mitigators such as diversification, asset backing and contingency funds
- Attractive/often outperforming rates available to investors and borrowers
- Investors can control what their funds are invested into
- Speed of deployment of investment cash and administration of loans
- Bespoke FCA regulation giving investor's confidence, providing barriers to participation to less serious providers and preventing the types of issues other countries P2P markets ha

WEAKNESSES

- Lack of long term track record
- Lack of independent verification of platform's published loan book information
- Historical monopoly of UK banks over UK borrowers still restricting loan originations
- No automatic FSCS protection for funds invested into P2P loans
- Liquidity disadvantage of P2P platforms when compared to banks which can access money market funding or central bank liquidity provision
- Lack of a simple comparison benchmark for performance of platforms, P2P products and loans

OPPORTUNITIES

- Potential partnerships with traditional banking institutions – increasing awareness and credibility of the sector
- Increasing comfort levels of UK consumers with online finance transactions
- Innovative Finance ISA providing a tax-free wrapper for up to £20,000 of P2P lending investments from 2017 tax year
- Banking regulation such as Basel III (to be phased in up to 2019), causing banks to reign in lending to smaller customers, leaving them to seek finance elsewhere
- Deeper liquidity provided by institutional investment/ fundification
- Bank Referral Scheme requiring banks to refer borrowers they reject to P2P platforms

THREATS

- Potential for deteriorating economic conditions, increasing defaults and negatively impacting returns
- Delays in full FCA authorisation of platforms
- Possibility of institutional investors cherry picking the best P2P investments using their expertise and resources, leaving retail investors at a disadvantage
- Online fraud undermining the security of internet-based loan transactions
- Potential for platform collapse (e.g resulting from lack of loan originations/bad underwriting generating significant defaults), dealing reputational blows to the entire P2P sector
- Investor confusion, (e.g over the difference between P2P lending and deposit account risk profile/limits of protection provided by provision funds), leading to investor detriment

APPENDIX I

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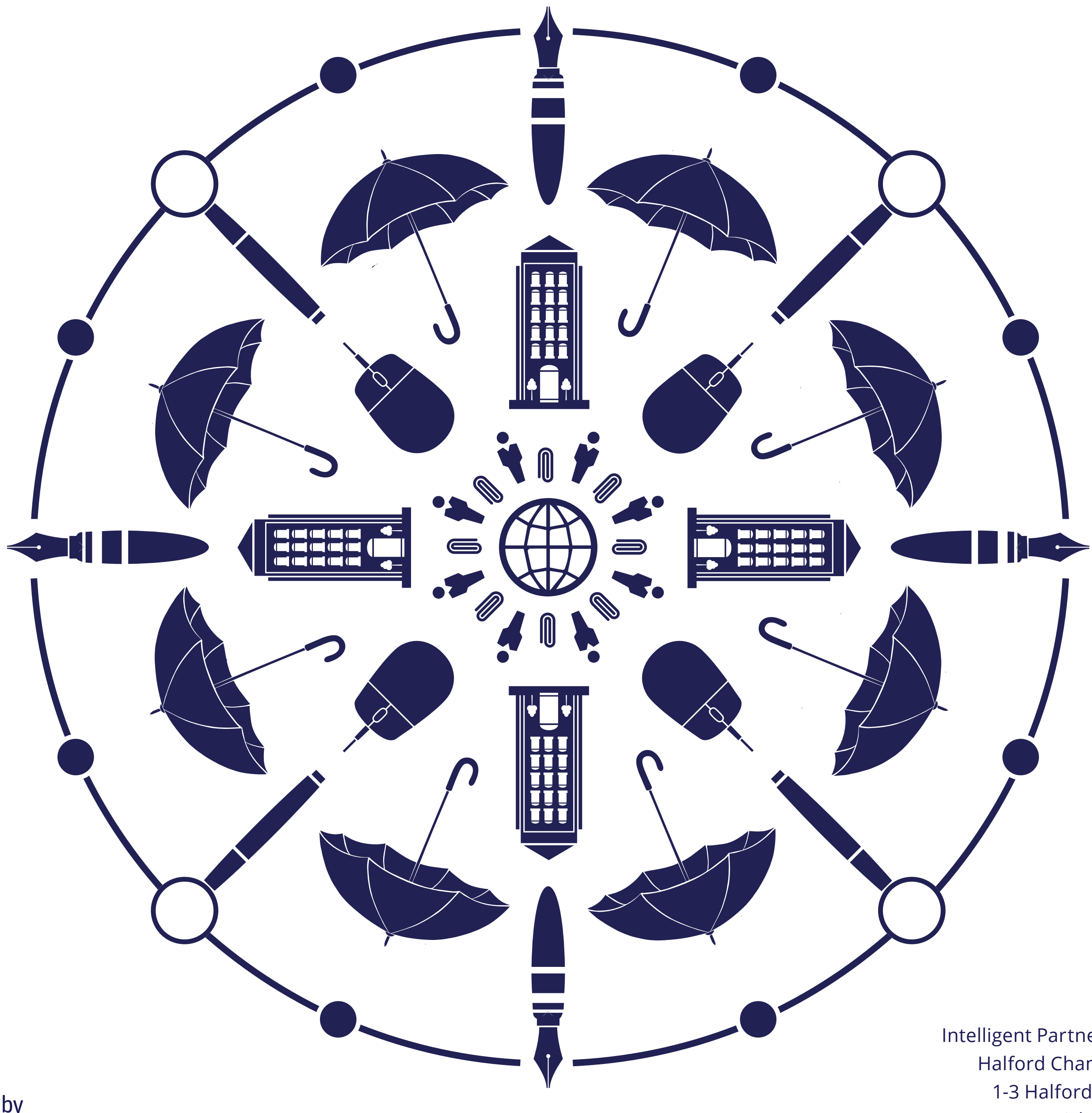
PUBLICATION

“We believe that peer to peer lending is a brilliantly innovative new form of finance – which we want to see continue to grow and evolve. P2P platforms and fintech provide competition, ideas, and technology – making people’s lives better and the markets more effective”. – **Harriett Baldwin, Economic Secretary to the Treasury**



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