

Insights

Peer-to-Peer (P2P) Lending and The Innovative Finance ISA



"Peer-to-peer looks like saving, tastes like saving, but as there's no savings safety guarantee, it smells like an investment."

Martin Lewis – Money Saving Expert

Peer-to-peer lending is an interesting innovation worth keeping an eye on, but it won't be mainstream any time soon and is higher risk than it might at first appear.

Banks beware – crowdfunding is here (and here to stay)

Something quite remarkable is going on in the world of finance, in the form of the disintermediation of traditional financial services providers. As such, the internet and changing behaviours and attitudes are revolutionising the way in which consumers access traditional financial services; for example, fewer people use bank branches because of online banking; more people now wish to bank with more modern 'challenger banks' and many – perhaps even the majority of people – buy their basic insurances via the internet using comparison websites.

'Crowdfunding' is another such area where the status quo is being replaced – and perhaps even enhanced – by internet-based models and changing attitudes and opportunities. Put simply, crowdfunding is the act of raising money by matching those who need it with those who have it and wish to supply it for some sort of reward, using an internet-based platform to do so. Of course, this kind of money lending 'market-making' has traditionally been the preserve of the banks, not just in the UK but all over the world.

Something quite remarkable is going on in the world of finance; people are now lending to and borrowing from one another, instead of dealing with banks

Not newfangled – and not always regulated

Many will not be familiar with crowdfunding and accordingly could be forgiven for thinking it is a brand new concept, although, in fact, it has been around for quite a while now (more than a decade).

As such, a number of crowdfunding models already exist: donation-based crowdfunding is where individuals make donations to good causes they want to support without the expectation of a financial reward, while pre-payment or rewards-based crowdfunding is where individuals provide funding to a company, for example to fund the development of a technology gadget, in return for the gadget once it is finally manufactured. Neither of these models is regulated by the Financial Conduct Authority (FCA) and deploying your capital in these vehicles should carry a base expectation of a zero return, both on and of your money.

Two regulated models do exist, however. The first is investment-based crowdfunding, where individuals purchase shares in a business that is looking for equity capital. Whilst this model has received quite a bit of press coverage, it actually represents a very small proportion of the overall crowdfunding market and is very high risk, usually representing early or start-up finance for very small businesses and accordingly, is best avoided by most.

The other, and perhaps most interesting model, is loan-based crowdfunding, which is also known as peer-to-peer lending (P2P). This is where individual lenders i.e. those seeking a return on their money, are matched with individuals and companies seeking debt financing and this paper focuses specifically on this area.

It important to note that any Peer-to-Peer (P2P) platforms mentioned in this paper are simply used to provide examples and insights into the P2P world. References to them are most definitely not recommendations to either invest this way or to use any specific providers. These are really early days in a new and largely untested area of finance. Caveat emptor!

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The new 'Innovative Finance ISA'

The crowdfunding or peer-to-peer lending concept will become much and widely known from 6th April 2016 and probably more mainstream in time as well, with the introduction of the new 'Innovative Finance ISA'. These vehicles will, for the first time, enable savers / investors to receive their interest payments free of Income Tax, which is no doubt a welcome development for many and will help to make peer-to-peer lending more attractive. It will also, however, possibly make it seem safer than perhaps it really is – more of which below.

A bit of background

The first peer-to-peer lender in the world was Zopa, which set up in 2005. The UK now has a legal definition of what constitutes a P2P loan (Regulatory Activities Order 36H) and since 1 April, 2014, P2P has been regulated by the FCA. The industry also has an industry body to promote it called the Peer to Peer Finance Association (www.p2pfa.info).

More than £3 billion has been lent so far in the UK and in the past 4 years lending has grown by over 150%¹. Industry estimates suggest that P2P lending will double in size every six months going forward, with the UK currently dominating the alternative finance space in Europe, representing around 75% of the market.

Current major players (definitely not recommendations!) include Zopa, RateSetter and Funding Circle. A quick look at the P2PFA website (above) provides a brief oversight of who the key players are and what they do.

The Innovative Finance ISA may make peer-to-peer lending seem safer than it really is

How does it work?

The reality is that each P2P platform has its own, slightly different way of doing things. In essence, individual borrowers are matched directly, on a contractual basis, with individual lenders, using an online platform. Borrowers can choose the amount and term that they wish to borrow for and the rate of interest that they will ultimately be charged is related to these two factors, along with their perceived creditworthiness. The borrower's motivation (if an individual) might be, for example, to refinance their credit card debt, consolidate other debts, make home improvements, buy a car or a buy-to-let residential property, or to finance invoices or expansion plans (if a business).

Lenders get to choose how much and how long they will lend for, while some platforms will also allow lenders to choose the risk category of borrowers they wish to lend to, all of which will impact on the rate of interest lenders will receive. P2P providers take a fee for matching borrowers and lenders, sometimes from both parties. Different platforms tend to focus on different types of borrower, providing the opportunity for lenders to diversify by lending strategy, which makes very good sense.



¹ Robert Wardrop, Bryan Zhang, Raghavendra Rau and Mia Gray (2015), Moving Mainstream: The European Alternative Finance Benchmarking Report (2015 University of Cambridge and EY, February 2015).

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P2P positioned as an (attractive) alternative to a savings account

Although P2P has something of the look and feel of a deposit arrangement about it, it most certainly is not one. Loans made are not covered by the Financial Services Compensation Scheme (FSCS) and lenders are contractually linked directly to specific borrowers, with the consequent risk of default on interest, principal or both. Contrarily, in the case of bank deposits, loans are on the institution's balance sheet as assets and deposits as liabilities, while shareholder capital acts as a buffer between aggregate losses and depositors, with FSCS compensation standing as the line of last resort.

What are the risks?

The reality of P2P is that it is sub-investment grade lending, where the risk of default is real. Individual default rates will rise at times of economic crisis and investors are directly linked to any losses. Understanding the protections in place and how losses are distributed, or not, between lenders is important, difficult and may only be truly clear and provable with the passage of time.

Some of the key risks and questions are:

- Defaulting borrowers: defaults will generally be covered provided they fall within the level of assets in the loss reserve pool. What happens when this pool is exceeded? Who bears the risk? Is it collectively shared or individually suffered?
- Reliance on the operational capability of the platform: A lender is entirely beholden to the processes and systems of the platform to allocate his/her capital as requested and to complete all the formalities accurately and in a timely manner. How can you know that this is robust? What happens if the system fails? What protection of records exists? How can a lender make sure that there is a permanent trail to their assets (loans)?

- A lack of true insight into default risks: current default rates look low, but what will they look like when another market event (e.g. credit crisis or economic downturn) happens? How will the less sophisticated lender know what risks they are taking? How robust are the credit rating capabilities of the platform?
- Hacking / internet fraud: How strong is the cyber security? What happens if money / details are hacked? Are they insured?
- Fraud: This is a possibility as many firms are starting up. The possibility of fraudulent sites or a lack of strong client asset ring-fencing is real. How can this be minimised? Looking at the FCA register is a start.
- Bankruptcy and closure of the platform: This is a capital intensive and competitive market. Bankruptcy cannot be ruled out. Firms must have a resolution plan in place to ensure loans continue to be serviced on behalf of lenders (this is an FCA requirement). How robust are these plans? Will they work in reality?
- Scalability: as the P2P market grows, will the supply of borrowers of reasonable credit quality match the supply of possible lenders? If not, there is a danger of money being lent to lower quality borrowers. That may be fine, provided these risks are adequately compensated, and lenders understand and accept this higher risk-return proposition fully.

As you can see, it is evident that there are many more risks to be concerned about relative to placing a deposit, so you mustn't be tempted by the media or marketing spin into thinking otherwise.



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Is it all bad news then?

No, because while it is certainly important to be aware of the realities and risks inherent in this nascent area of finance, there have been positive experiences to date (see below) and a number of mitigants are in place to minimise the risk and impact of default for lenders:

- The first level of protection is the screening of borrowers using various credit checking services and in-house processes.
- The second level of protection is the diversification of risk, upfront, across a broad number of borrowers, either selected individually or by some sort of auto-allocation by the platform. Zopa, for example, restricts borrower exposure to a maximum of 2% to any one borrower.
- The third level is by the provision of a loss reserve pool, which is normally funded by part of the fee paid by borrowers. Net returns to lenders are obviously reduced, but this pool – hopefully large enough to cover the estimated loan default rate with a buffer margin – can be called upon by lenders to pay up if any of their individual loans default. The pool then holds the bad debt and seeks to recover it using some form of collection agency. Some platforms share losses across all lenders in the event that the loss reserve pool is insufficient to cover losses.
- The fourth level is the purchase of insurance in the form of default cover by the platform. This is only offered by some and again, will reduce net returns to lenders, but offers greater certainty of the return of principal.
- Finally, some loans are backed by security of some sort. In the case of buy-to-let, for example, this would be the property mortgaged.

To date, many lenders will have earned a favourable rate of return on their assets

Outcomes to date

Fortunately, there appears to be a commendable tendency towards considerable openness and transparency in the P2P space. As an example, Zopa – the longest standing UK P2P lender – provides data on its website relating to the complete loan book outstanding, default targets versus actual defaults and historical data on assets and defaults since inception. Default rates have been low in recent times and below the expected default rate, except for 2008 when default rates rose to 5.54% against an expected 3.68%, at which time some investors are likely to have lost capital.

Looking at the loan book today, around £610m in capital repayments on the original loans of c£1.2bn have been made, leaving around £610m outstanding. Zopa's 'Safeguard Trust' – the loss reserve pool funded by part of the borrowers' fee – stands at £12.2m (at the start of March 2016) or around 2% of outstanding balances. On their current estimates they will need £10.2m to cover loan defaults.

So, to date, many lenders (which include, at a moderate level, some of Chamberlyns' clients) will have earned a favourable rate of return on their assets and without loss to capital, particularly when the income received is taken into account. Although no industry numbers are available, the returns will undoubtedly have been above the returns delivered by deposits.



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Conclusion

Peer-to-Peer lending and The Innovative Finance ISA are interesting developments, seemingly supported by the Government and here to stay. Our conclusion is that P2P lending is definitely not the same as placing a deposit with a bank; it is a high yield fixed income play with real risks to both capital and interest, operating through new companies and new technology, with very little track record. That said, lenders who do their homework, understand the risks, undertake good due diligence and diversify between providers, strategies and borrowers stand to obtain a higher return on their capital than they are (currently at least) receiving from traditional bank and building society accounts.

Peer-to-peer lending is therefore an area of finance that for most should be put on a watching brief to see how the market develops and if at some stage you feel keen to deploy some of your capital in this way, it should likely only ever form a moderate part of your savings / non-investment mix.

Best regards

Michael

Peer-to-Peer lending and The Innovative Finance ISA are interesting developments, but should be approached with caution and kept under review



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In addition to being a Chartered Wealth Manager, Michael is a Chartered Financial Planner and holds the globally recognised Certified Financial Planner qualification. He is also a Fellow of both the Personal Finance Society and the Chartered Institute for Securities & Investment and as such, is one of the most highly qualified financial planning professionals in the UK. Michael also sits on Chamberlyns' Investment Committee and helps to produce the firm's regular series of in-depth 'Insights' articles, which explore, explain and demystify often complex wealth planning issues.

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