
The economics of peer-to-peer lending

Prepared for the Peer-to-Peer
Finance Association

September 2016

Strictly confidential

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Executive summary

With the UK Financial Conduct Authority (FCA) commencing its post-implementation review of the crowdfunding market, including both peer-to-peer (P2P) lending and equity-based crowdfunding, the Peer-to-Peer Finance Association (P2PFA) asked Oxera to conduct an independent economic assessment of P2P lending.

This report presents the findings of this economic assessment. It aims to explain how P2P lending works as well as present evidence on the benefits that it delivers to its users and to the wider economy. The report considers the appropriate regulatory framework following an assessment of the key issues that have been raised by the FCA and other parties. The focus of the report is on the eight members of the P2PFA.

How peer-to-peer lending works

At a basic level, P2P lending platforms provide a facility creating a marketplace where investors who wish to lend funds can find potential borrowers and provide credit through P2P Agreements. These marketplaces are made possible by online technologies, which provide investors with high-quality direct lending opportunities that would otherwise not be possible. Platforms may provide additional value-adding services to their users—the investors and the borrowers—to ensure that the loan or investment characteristics best meet their needs.

From the borrower's perspective, P2P lending offers a competing source of finance to the banks. From the investor's perspective, it is a new investment opportunity, similar in nature to corporate bonds but with a focus on small and medium-sized company (SME), consumer and property loans. P2P lending provides a new, effective form of financial intermediation.

Ensuring good investor outcomes

This study looks in detail at how P2P platforms manage risk for their investors (as well as their borrowers), including their credit risk assessments, management of liquidity risk, and the policies for minimising platform risk. This includes an assessment of both the approaches adopted by platforms, and the outcomes that they have achieved so far. The evidence considered in this report indicates that:

- P2P platforms are incentivised to conduct effective credit-risk assessments, employ industry best practice, and deliver outcomes that are consistent with those of traditional lenders;
 - 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;
 - the underlying risk characteristics of P2P lending are comparable to those of other retail investment asset classes, which does not suggest that this investment should be considered to be 'non-mainstream' and thereby not readily available to retail investors;
 - P2P platforms have put in place controls to ensure the fair treatment of different types of investor (e.g. retail and institutional);
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- P2P lending does not distort competition in the lending market—indeed, it is most likely that it *increases* competition;
 - P2P platforms are well placed to weather shocks to their business models, and that they have in place resolution plans to ensure that the existing loan book will continue to be serviced for investors even if the platform fails;
 - platforms have developed their business models to help ensure that interest rates are appropriate for the credit risks being faced, moving away from interest rates being determined through auctions;
 - P2P lending poses little risk to the wider financial system, not just due to its small size but also due to P2P platforms facilitating longer-term investments to investors rather than instant access current accounts to the wider public.

The appropriate regulatory regime

The evidence in this study supports the view that the current regime is well targeted and proportionate. There is little to indicate significant market failures that would require new regulation to be put in place. Effective supervision is, of course, required to ensure compliance with the current regulation by all platforms.

Although the existing regulatory regime already contains the main elements of regulation that would be required from an economics perspective, this does not mean that there is no need to develop it further. When business models and practices continue to evolve and the market continues to grow, the regulatory regime may need to evolve as well.

The analysis in this report, and in particular as summarised in section 6, points to a number of areas where future development of the regulation could be considered, including:

- ensuring continued effective communication with investors, including the provision of clear and standardised information across platforms;
- ensuring appropriate credit-risk management across all platforms;
- implementing additional standards of business conduct. The P2PFA has developed a number of standards and practices some of which could be incorporated into the existing FCA regulatory framework so that they can be applied to all platforms. These are in relation to loan book run down plans and transparency, equal treatment of different investor types and a regulatory prohibition of maturity transformation.

The objective of this would be to ensure that P2P lending is best placed to continue to develop as an alternative source of finance for borrowers and an investment opportunity for investors for a wide base of users in the UK economy.

1 Introduction

With the UK Financial Conduct Authority (FCA) commencing its post-implementation review of the crowdfunding market, including both peer-to-peer (P2P) lending and equity-based crowdfunding,¹ the Peer-to-Peer Finance Association (P2PFA) asked Oxera to conduct an independent economic assessment of P2P lending.

This rapidly growing and developing form of financial intermediation, which channels funds from investors to borrowers, requires a regulatory debate that is informed by a thorough economic assessment of the business models of P2P lending platforms.

This report presents the findings of such an economic assessment. It aims to explain how P2P lending works, as well as present evidence on the benefits that it delivers to its users and to the wider economy. Importantly, it also discusses, from a public policy perspective, the different types of risk that are relevant to P2P lending, and their implications for investors. The report considers the appropriate regulatory framework and, from the perspective of the regulator, the risks to the FCA's statutory objectives.

1.1 Objectives of the study

The primary objective of this study is to explore the development of the P2P lending business models, assess the evidence on the performance of the sector from a public policy perspective, and thereby inform the debate on the appropriate regulatory framework. The study looks mainly at the eight members of the P2PFA, as listed in Table 1.1. These represent a sub-set of all P2P lending platforms, but they are also eight of the longest-standing and largest platforms in the UK (accounting for over three-quarters of the overall UK P2P lending market²). For simplicity, any references to the P2P lending market in this report therefore refer to the P2PFA members, unless otherwise stated.

¹ See Financial Conduct Authority (2016), 'Call for input to the post-implementation review of the FCA's crowdfunding rules', July, <https://www.fca.org.uk/news/call-input-post-implementation-review-crowdfunding-rules>.

² Oxera estimates market share to be approximately 80%, based on the platform loan books and the overall market data provided in Nesta (2016), 'Pushing Boundaries: the 2015 UK alternative finance industry report', February, p. 13.

Table 1.1 Overview of the eight P2PFA members

	Borrowers	Investors	Platform loan volume 2015 (£m)
Funding Circle	Business and property loans	Retail, institutional and investment fund	531
ThinCats	Business loans (secured)	Retail and institutional investors	57
RateSetter	Consumer, business and property loans	Primarily retail investors*	518
Lending Works	Consumer loans	Retail and institutional investors	14
Zopa	Consumer loans	Retail and institutional investors	532
MarketInvoice	Invoice finance	Retail and institutional investors	264
Landbay	Property loans (buy-to-let mortgages)**	Retail and institutional investors (under separate systems)	19
LendInvest***	Property loans	Retail, institutional and investment fund	301

Note: * 'Primarily' refers to over 90%. ** Landbay only offers buy-to-let mortgages and not other types of property loan, such as development or bridging finance. *** LendInvest does not currently operate a 36H product, albeit has submitted an application to the FCA detailing how the company proposes to do so in the future.

Source: Oxera analysis of platform websites and P2PFA data.

1.2 Structure of the report

This report is set out as follows:

- section 2 provides an overview of how P2P lending works. It aims to describe the fundamental economics of the market and address some potential misperceptions;
- section 3 looks at the benefits of P2P lending, in terms of what it offers to borrowers and investors;
- section 4 looks at how P2P platforms manage risk on behalf of their investors, including credit risk, liquidity risk and platform risk; as well as the role of P2P lending in the wider financial system;
- section 5 explores evidence on investor understanding of P2P lending;
- section 6 reviews the regulatory regime for P2P lending, and considers implications for how the regulatory regime may need to be further developed in the future.

The study is not a direct response to the FCA's call for inputs,³ but does provide information of relevance to the FCA's questions.

³ Financial Conduct Authority (2016), 'Call for input to the post-implementation review of the FCA's crowdfunding rules', <https://www.fca.org.uk/your-fca/documents/call-input-crowdfunding>.

2 How peer-to-peer lending works

At a basic level, P2P lending platforms provide a facility creating a marketplace where investors who wish to lend funds can find potential borrowers and provide credit through P2P Agreements.⁴ Platforms use online technologies to facilitate efficient interactions between investors and borrowers that would be difficult or costly to achieve in other ways, hence opening up the feasibility of direct lending to a wider range of investors and borrowers than before. In this way, P2P lending has some similarities with other 'sharing economy' platforms that link together consumers to engage in mutually beneficial exchanges.⁵

To facilitate the successful operation of the marketplace and the financial transactions between investors and borrowers, P2P lending platforms undertake a set of operational functions (in addition to the core service of matching borrowers with investors and putting the loan contract in place). These include:

- verifying borrower identity and characteristics;
- assessing credit quality to ensure that interest rates for borrowers are risk-reflective;⁶
- processing payments from borrowers and forwarding them to investors;
- making data available to investors to inform their investment decisions, such as details about loan book performance;
- collecting debt in cases of arrears or default;
- conducting anti-fraud and anti-money laundering checks, and 'know your customer' assessments;
- legal compliance and reporting.

P2P lending platforms may provide additional value-adding services to their users. These include:

- **determining the interest rate for investors**, which platforms generally set themselves and will vary depending on the risk profile of the loan (which is measured by conducting a credit-risk assessment). In the case of some platforms, investors can participate in an auction in which they indicate the interest rate at which they would be willing to fund a loan;⁷
- **auto-allocation of investments to loans**, to help ensure portfolio diversification within the remit or product selection set by the investor. Some platforms always automatically allocate investors' funds to a portfolio of loans, while others provide the option of automatic allocation;⁸
- **buffer funds**, designed to cover default losses in 'normal' times, with 'tail' risks of more extreme events (e.g. a very severe recession), where the fund

⁴ As defined in the FCA Handbook, <https://www.handbook.fca.org.uk/handbook/glossary/G3218.html>.

⁵ The term 'sharing economy' refers to services delivered by web-based platforms that allow consumers to exchange with other consumers (or firms) directly. For a more general discussion of 'sharing economy' platforms, see Oxera (2015) 'A fair share? The economics of the sharing economy', December.

⁶ Such as providing a score for credit quality that investors can then base their judgements on, or estimating default risk in order to inform the risk-adjusted interest rate offered.

⁷ A distinction can be made between non-uniform auctions and uniform actions. With non-uniform auctions, the bidder, if successful, receives what they bid, even if others bid differently. With a uniform auction, all bidders receive the best price (in this case, the highest interest rate) accepted.

⁸ In addition, most investors also use these facilities to recycle their loan repayments into new loans. This service helps investors to maintain a diversified portfolio of loans over time.

is depleted and so no longer covers new losses to investors. Buffer funds may also provide a form of portfolio diversification;

- **secondary markets**, where investors can exit their investments by selling the remaining loans to another investor;
- **services to borrowers**, including innovative loan features or assisting borrowers in putting appropriate propositions forward on the P2P lending platforms.

2.1 How the market has grown and developed

P2P lending business models and practices have evolved over time as platforms have developed innovative approaches and sought market opportunities, building upon the core function of platforms in providing digital lending marketplaces. This has resulted in a diversity of business models, as different platforms seek different types of investor (in terms of the size of their investment and their preferences) and different types of loan (e.g. consumer, business, invoice financing, property). Borrower type, in particular, has been a key distinguishing feature between business models, as consumer credit has different risk characteristics and different regulation (e.g. FCA regulation of consumer credit) than business lending or property-related lending.⁹

Within this diverse range, however, there have been some common developments in what many consider to be ‘best practice’. These developments have been driven by the needs of users, in many cases pre-dating FCA regulation, and highlight how the P2P lending approach has developed to better meet the needs of a growing investor base.¹⁰ Key elements of current good practice include the following.

- Platforms conduct sophisticated credit assessments of borrowers and have put in place mechanisms to ensure that interest rates appropriately reflect credit risk. All members of the P2PFA have developed credit risk models (similar to those that traditional lenders have in place), and use these to credit-score borrowers and to take decisions about whether to facilitate the loan on their platform and to determine the risk-reflective interest rate. The impacts of these measures are explored further in section 4.2.
- Ensuring a fair spread of loans across different investor types, so that no group of investors is disadvantaged. With increasing interest from institutional investors,¹¹ platforms have put in place mechanisms to ensure that loans are allocated fairly across investor types, given the operation of tools to help diversify portfolios. This typically means that loans are allocated randomly between different groups of investors in cases where some form of auto-allocation process is used. The evidence for this is considered in section 4.3.

⁹ Most platforms have tended to focus on one particular borrower (and therefore loan) type, although some of the larger platforms have now diversified, for example RateSetter.

¹⁰ The P2PFA has, as a self regulatory step, consolidated many elements of good practice into its Operating Principles, which are reviewed and updated on a regular basis.

¹¹ Nesta reports that, across the sector in 2015, some 26% of P2P business loans and some 32% of P2P consumer loans were funded by institutions. See Nesta (2016), ‘Pushing Boundaries: the 2015 UK alternative finance industry report’, February, p. 7.

- Platforms do not engage in maturity transformation, and have adopted measures to avoid the potential misperception that maturity transformation is available¹² (see section 5).
- Ensuring that platforms are well-placed to continue to provide core services even in the most severe market conditions. The P2PFA members' policy is to collect enough ongoing fees from the existing loan book to fund continued servicing of the loans without any other income being required, so that loan book servicing can be split off into a viable business in an event of platform failure. This is considered further in section 4.6.
- Providing warnings to investors about the underlying risks of investing on the platforms, including with regard to credit risk, buffer funds and secondary markets. The evidence on investor understanding is considered in section 5.

The market is expected to continue to evolve as more users, including potentially new customer segments (both as borrowers and investors), become engaged with P2P platforms, and P2P lending grows in significance. To understand how the market is likely to develop, and therefore the appropriate regulatory framework going forward, it is important to understand the economics underlying P2P lending.

2.2 What is the role of P2P lending in financial intermediation?

Fundamentally, P2P lending platforms channel funds from investors to borrowers. They are part of a much wider spectrum of financial institutions channelling funds, including banks, non-bank lenders, asset managers, hedge funds and venture capitalists—this is referred to as financial intermediation. See Figure 2.1 below for a description of some of the main types of financial institution that P2P lending platforms compete with.

As financial intermediators, platforms are two-sided markets¹³ that meet the needs of both borrowers and investors. The nature and role of P2P lending differs between the borrower side and the investor side.

From the perspective of borrowers, P2P lending platforms provide sources of finance that primarily compete with those offered by banks.¹⁴ In these competitive markets, P2P lenders can typically be expected to be 'price-takers', in that they lend at the going rate,¹⁵ as discussed further in section 3.1.

Some P2P lending platforms also provide additional, value-adding services to borrowers, such as guidance to SMEs taking out a loan on how to structure their proposition, or facilities to repay the loan before term at no extra charge. In addition, P2P platforms have developed innovative approaches and are not constrained by legacy systems, given their relatively recent entry to the market,¹⁶ and so are able to introduce changes more quickly and at lower cost than

¹² In this context, maturity transformation refers to allowing investors to invest money in loans on a shorter timeframe than the length of the loans themselves—for example, if investors were offered a one-year investment product while all loans were for three years. Hence, in order for loans to be maintained, new investment would be required when the period that investments are initially made for ends. We understand that products that would appear to provide maturity transformation were offered in the past, but are no longer offered by P2PFA members. For example, platforms no longer offer products that indicate availability of funds after a fixed period of time, unless that coincides with the underlying loan parts.

¹³ In economics, 'two-sided markets' refer to economic platforms with two distinct user groups that provide each other with network benefits.

¹⁴ Although there is also a growing presence of non-bank lenders.

¹⁵ Although there is some variation in the rates offered by different types of lender due to differences in their assessment of credit risk and risk appetite, and the relative supply of funds.

¹⁶ Zopa, the world's first P2P lending platform, was launched only in 2005. The other members of the P2PFA launched their platforms between 2010 and 2014.

traditional lenders. However, this is also observed with other non-bank lenders that have been recently founded. Overall, the main impact is an increase in competition and choice for borrowers.

The investor side, on the other hand, is more distinct and novel. P2P lending platforms give retail and institutional investors the opportunity to fund loans directly. Investors therefore essentially own a part of the cash flows of a lending business, tied to specific loans through the P2P Agreement. For the investors, this represents a novel asset class (as discussed further in section 3.1). The closest comparison may be the ownership of a portfolio of corporate bonds, except that P2P platforms facilitate loans mainly to individuals and SMEs.

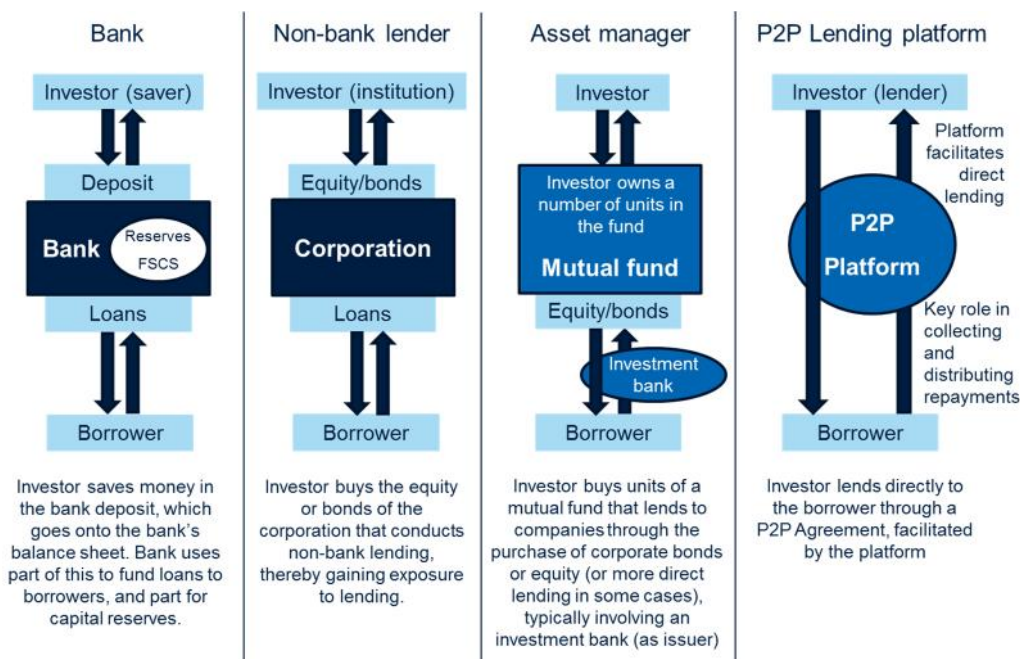
In addition, P2P lending platforms provide a new distribution channel for investors, and are different from existing financial institutions such as banks and asset managers. The extent of investor engagement (discussed further in section 3.2) varies by platform, with some allowing investors to consider the characteristics of the borrower in some detail, and others providing less information about individual borrowers. In contrast, there is no relationship between investor and borrower in the banking model, as described in Figure 2.1 below.

Platforms channel funds from investors to borrowers without being directly exposed to capital loss from the performance of the loans, which is comparable to asset management.¹⁷ The revenues and reputations of both P2P platforms and asset managers are reliant on the returns produced for investors by the investments,¹⁸ which means that they do have the right incentives to act prudently and conduct proper credit risk assessments (see section 6.3 for further discussion). The role of facilitating direct lending from investors to individuals or SMEs makes the platform more directly responsible for servicing loans than is typically the case with the financial securities held by asset managers. The shares and bonds of companies (held by asset managers) are typically issued by an investment bank, whereas it is the P2P platform itself which essentially 'issues' the P2P Agreement by preparing the contracts setting up the direct relationship between investor and borrower (see Figure 2.1). P2P lending has focused on relatively small loans compared to asset managers (which primarily have focused on corporate bonds for larger companies).

¹⁷ P2P lending platforms remain exposed to the performance of loans through a loss of loan servicing fees if loans default—i.e. if the total volume of loans in operation reduces. This is comparable to a loss of annual servicing fees for asset management (charged as a percentage of assets being managed) if the investments managed do poorly.

¹⁸ Asset managers running 'tracker funds' are less exposed, however. This is because in this case the performance of the portfolio is not due to investment choices made by the 'passive' asset manager, but is entirely down to market conditions and cost minimisation on behalf of the asset manager. In the case of tracker funds, minimisation of both management costs and tracker errors (rather than maximising returns) is the main competitive dimension from an investor point of view.

Figure 2.1 Value chains for four main forms of investor exposure to lending



Source: Oxera.

Investor understanding of the nature of risk is therefore very important to P2P platforms, due to the implications of potential misunderstanding and disappointment not just to investors but to the reputation of the platform itself and its ability to attract business. In other words, it is in the platforms' own interest to ensure that investors understand that the platform offers direct lending through P2P Agreements, and not, for example, through the deposits that banks offer. Platforms do not practice maturity transformation, and investors are able to access funds outside of the terms of the loan only if there is another investor willing to take the remaining loans.

The risks and liquidity constraints inherent in direct lending offer the investor considerable advantages in terms of returns. Providing maturity transformation and deposit guarantees is costly for banks (and, indeed, for wider society, when tax payers are called upon to bail out banks), in terms of capital reserves and payments to the Financial Services Compensation Scheme (FSCS, which provides a guarantee for individuals' deposits of up to £75,000 per firm). P2P investors are thus able to earn a higher return, on average, than from products such as bank saving accounts, which are therefore not comparable.

The evidence for investor outcomes from P2P lending relative to other related forms of financial intermediation is considered in section 3 of this report.

3 Benefits of P2P lending

From the perspective of the users of P2P lending, both borrowers and investors, its economic role can be assessed in terms of the outcomes that users have experienced. This evidence provides an introduction to the functioning of the sector, before subsequent sections of this report explore a number of topics in more detail: risk management (section 4); investor understanding (section 5); and regulation (section 6). The current section considers:

- the competitive offering of P2P lenders to borrowers (section 3.1);
- investment characteristics in the context of the risk–return trade-off offered by P2P lending as an investment (section 3.2); and
- the efficiency of P2P lending as a form of financial intermediation (section 3.3).

Box 3.1 Key findings

- P2P lending has added additional competition and choice to the lending market, with borrowers reporting benefits in terms of speed, simplicity and product features.
- While P2P platform borrowing rates are competitive, there is no evidence that P2P platforms are consistently offering the best rates, which suggests that they are 'price takers' in a competitive lending market.
- P2P lending has provided a new option for retail investors, and has investment characteristics in terms of liquidity, risk and return that are not easily available to investors elsewhere in the market.
- The returns to investors in P2P platforms are broadly consistent with the typical yields of BB and B rated corporate bonds.
- Platforms offer new forms of interaction with users, and have been able to do so relatively efficiently, particularly when considering the large number of small users involved (on both the investor and borrower sides).

Source: Oxera.

3.1 Competitive offering to borrowers

From the borrower's perspective, the loans facilitated through P2P platforms offer additional choice in terms of service offerings, but are broadly comparable to loans provided by banks and non-bank lenders in terms of interest rates. The P2P lending products provide competition to more traditional lenders.

First, in terms of the service offering, borrowers have been found to emphasise additional choice in terms of speed, simplicity and product features. A recent report drawing on evidence from a survey of 531 Funding Circle business borrowers found that the main reasons for a small business to borrow through Funding Circle were the speed of the process (31% of respondents), followed by the simplicity of the loan application process (28% of respondents).¹⁹ Platforms such as Landbay and LendInvest have developed businesses in bespoke parts of the property lending market, including buy-to-let and bridging loans.

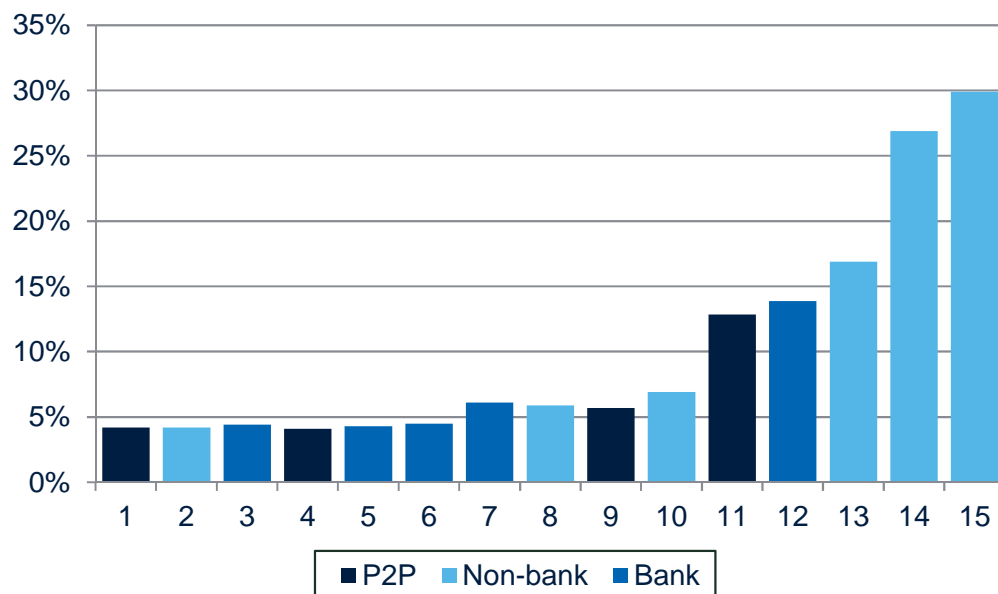
Typically, however, borrowers have many other funding options available to them. This is apparent when examining the market offerings through price-comparison websites. For example, Figure 3.1 provides a summary of the rates offered on moneysupermarket.com for a personal unsecured loan, by presenting

¹⁹ CEBR (2016), 'Small business, big impact – The changing face of business finance', August.

the APRs offered by P2P lenders and more traditional types of lender. It is clear that P2P platforms offer competitive loans across much of the ‘prime’ lending space. P2P lending platforms are less present in the higher-risk subprime space (where certain non-bank lenders are active).

While their rates are competitive, there is no evidence that P2P lenders are consistently offering the best rates, which suggests that they are basically ‘price takers’ in this competitive market,²⁰ and their credit risk assessments are comparable (based on the same datasets, albeit with some innovation as would be expected in a competitive market).

Figure 3.1 Sample of personal loan rates (APR)



Note: APRs quoted for first 15 providers listed. Quotes for a £5,000 unsecured loan for a three-year period, for ‘home improvements’ for a customer with a mortgage. The higher APRs are typically on offer to customers with poorer credit scores than the lower APRs. Credit score information was not available to the lenders when providing these indicative quotes through the price-comparison website.

Source: moneysupermarket.com. Data collected on 15 August 2016.

There is less publicly available information about the interest rates for loans in the SME market than in the personal loan market, but similar trends can be expected. The recent CMA market investigation into retail banking considered SME use of P2P lending platforms, and found that their key reasons for doing so were to access finance, in particular when P2P lenders offered innovative approaches not available from banks, and to achieve fast access to loans or particular loan conditions.²¹ SMEs using P2P lenders on the whole considered interest rate terms to be similar.

3.2 Investment characteristics

As explained in section 2, on the investor side, P2P lending is offering an investment opportunity that is arguably more distinct and novel than the services provided to borrowers. By giving investors the opportunity to fund loans directly,

²⁰ ‘Price taker’ is an economics term for a business that must accept the prevailing prices in the market of its products, its own transactions being unable to affect the market price. In this context, it points towards P2P lenders competing on similar terms to banks and non-bank lenders, including in terms of credit risk assessments.

²¹ See Appendix 8.2 of Competition and Markets Authority (2016), ‘Retail banking market investigation: Final report’, August.

investors essentially receive the cash flows (after costs/fees) of a lending business, tied to specific loans through the P2P Agreement. This investment has a specific combination of features that is not directly comparable to other standard investment opportunities, in terms of both the risk–return trade-off and liquidity. The following observations can be made.

- The risk–return trade-off may be seen as somewhat similar to a portfolio of corporate loans, such as provided by a corporate bond investment fund, except that P2P platforms facilitate loans mainly to individuals and SMEs rather than large companies.²²
- The level of risk (and return) varies across P2P lending opportunities, with some facilitating secured loans, such as buy-to-let mortgages, and others facilitating unsecured lending to individuals and businesses (with typically higher risk than secured loans).
- From the investor perspective, the risk level is also affected by additional services that may be provided by the platforms. For example, buffer funds help to smooth returns in ‘normal’ times, with the tail risk remaining (the risk of the buffer fund being depleted during a severe recession).
- The liquidity of P2P lending investments is restricted by the direct lending approach, although secondary markets provided by platforms can make investments relatively more liquid in ‘normal’ times, when there are other investors willing to take on the loans (although often with charges and other costs).

Figure 3.2 provides an illustration of how different investment types could be characterised in terms of liquidity and the risk–return trade-off (with the assumption that a diversified portfolio of each asset is being held)²³. It also indicates where P2P lending may be considered to fit into this picture. However, there is considerable variation between different P2P platforms in terms of the types of loans being facilitated and the services provided by the platforms. Similarly, variations would also occur between different securities within other investment types. Therefore, there is room for debate about exactly where investments may lie within these dimensions.

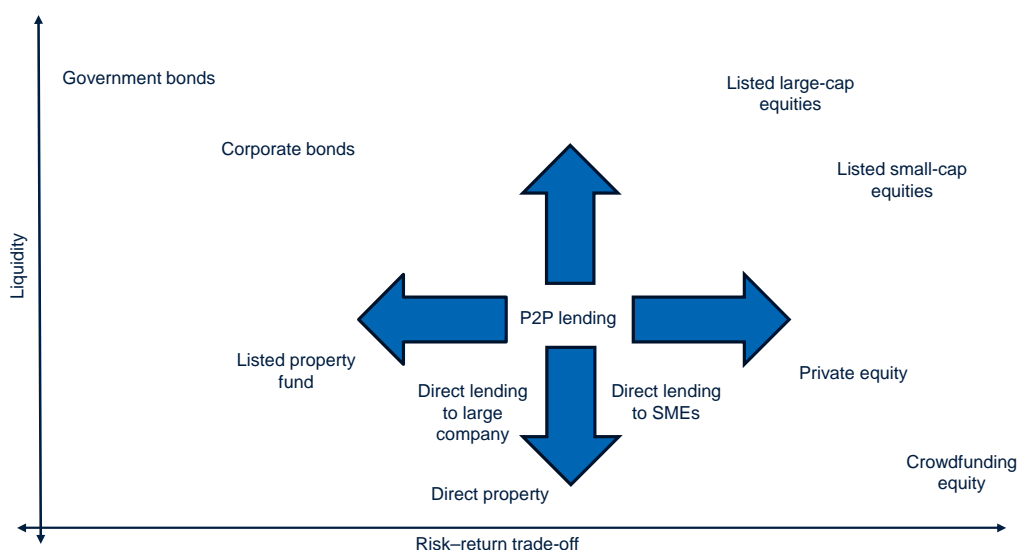
As examples, government bonds are typically low risk but also low return, so have a low risk–return trade-off, whilst also being highly liquid as investors are very unlikely to have problems in selling (developed economy) government bonds. At the lowest-risk end of this spectrum are also savings accounts, which provide immediate liquidity with a virtually risk-free return profile (within the £75,000 limit for the FSCS deposit guarantee), but with consequently low rates of return. At the highest-risk end are liquid investments such as publicly listed equities of large companies (‘large cap’), which can be sold at any time but are subject to significant fluctuations in value and consequently a higher return. More direct forms of asset ownership tend to be less liquid. For example, direct investment into property with a low loan-to-value ratio and good security would be an example of a low-risk and low-liquidity asset, with property potentially taking months or even years to sell. Examples of low-liquidity, high-risk investments include private equity and crowdfunding equity-based investments.

²² Apart from the high street banks no other lenders have identified a route to these markets, particularly for small business loans.

²³ Diversification reduces the risk of any portfolio of assets, so the comparison assumes that, for each asset class, a diversified portfolio of that asset class is held.

To put it rather simplistically, P2P lending fits somewhere in the middle of this range, in terms of the risk–return profile and also in terms of liquidity.

Figure 3.2 Illustration of relative liquidity, and risk–return trade-offs for selected investments (diversified portfolios only)



Note: The risk–return trade-off of P2P lending is affected by the services offered. A buffer fund, for example, involves funds being held in low-yielding assets, which will naturally reduce the average return of the asset over time, while also reducing the average volatility of returns (and hence risk). This is the case with most financial ‘hedging’ products.

Source: Oxera.

P2P lending can also be considered in terms of ways to finance lending activities. Banks are financed through deposits, which give the investor a very high degree of protection against both credit losses and liquidity, at least within the £75,000 limit. Indeed, much of the ‘tail risk’ falls on society, as was made clear during the financial crisis. But the cost of this protection is very significant, and not typically seen as appropriate for longer-term investment purposes. Investors can also fund lending through the equity and bonds of lenders (including banks and non-bank lenders). P2P lending provides a new and additional form of investing in lending operations, and a new opportunity for investors, both large and small.

3.2.1 Investor returns

The performance of P2P lending as an asset class can be considered in terms of what it has actually delivered to investors in returns, net of all fees and default costs. Estimates of the net rates of return are presented in Figure 3.3 and Figure 3.4, with a comparison to the estimated costs to the borrowers, to indicate the ‘spread’ (which comprises both the platform fees and the bad debt). Figure 3.3 and Figure 3.4 present estimates separately for consumer lending and business lending over the 2013–16 period.²⁴

Over the 2013–15 period, the platforms focusing on business lending (including invoice finance) delivered higher net returns, on average, although the range was wider between platforms. Investor rates of return were all notably stable over this (relatively short) period. The spread between borrower and lender rates

²⁴ There was not sufficient comparable data to present the borrower rate estimates for property lending, as the relevant platforms offer insufficiently similar products to one another—primarily buy-to-let mortgages and bridging loans—to make such a comparison.

was relatively stable at around 4% for business lending. The spread for consumer lending is also currently around 4%, although it appears to have increased to this level over time from lower levels of around 2%.

Figure 3.3 Consumer lending: estimated average borrower rate of interest and investor rate of net return, 2013–16

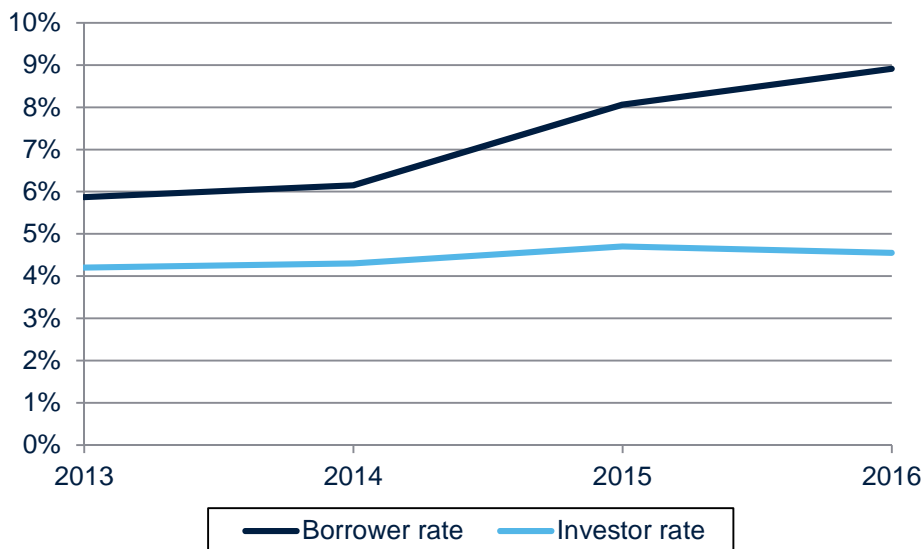
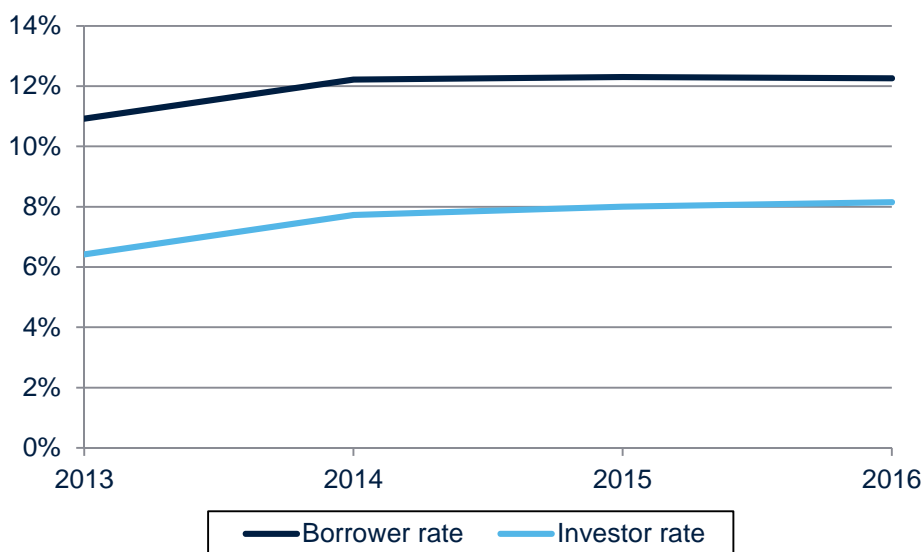


Figure 3.4 Business lending: estimated average borrower rate of interest and investor rate of net return, 2013–16



Note: The estimates required Oxera to estimate the impact of loan origination fees on the borrower rate of interest, using assumptions about the average length of loans. Platforms do not provide estimates of the total borrower cost of debt in this fashion, and the estimates presented here should be considered to be indicative only.

Source: Oxera estimates, based on information provided by the P2PFA members.

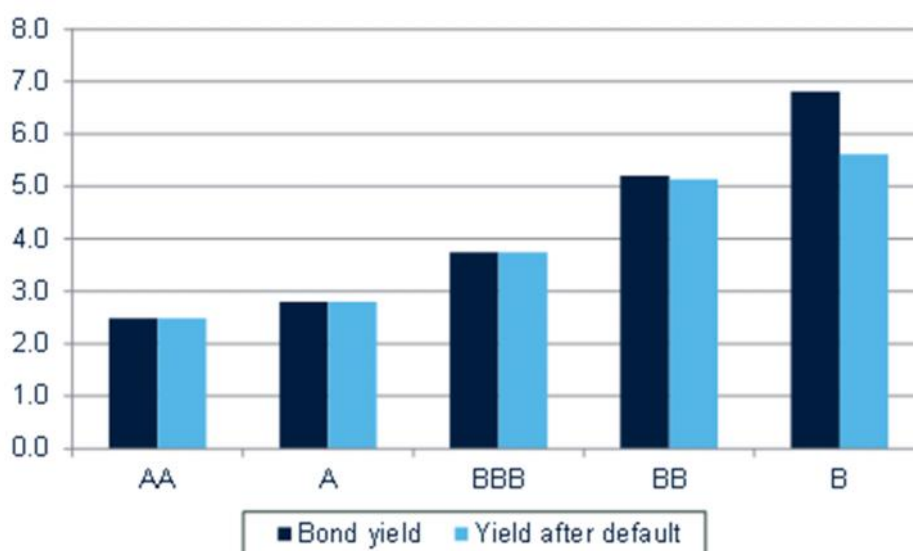
To properly assess the risk–return trade-off provided by an asset class, it is necessary to have a long time series of data that covers one or more full economic cycles. In the context of credit risk in the UK, the last full economic

cycle is arguably 1992–2009.²⁵ Data for Zopa does go back to before the last recession (2008–09), but for the other platforms this is not available.²⁶

To provide some form of context for these rates of return, Figure 3.5 shows estimates for the rates of return from other debt-based asset classes in recent years, by credit rating. It shows averages of the bond yields before default losses, and then estimates for the yields after taking account of default losses witnessed in the 2013–15 period. These estimates provide an indication of the net returns to investors, for comparison purposes.

It should be noted that these estimates are for the average returns of the financial securities, and so are not net of the fees charged by asset managers, investment platforms and financial advisers, which might reduce the returns by one or two percentage points per annum (or more in some cases). These fees are also considered in further detail in section 3.3 below. Nor are these the full amounts paid by the borrower, as they do not include the cost of bond issuance, which is also discussed in section 3.3 below.

Figure 3.5 Average corporate bond yields by credit rating: 2013–16



Note: US rates are shown because high-yield bond data was available, as the market is broader. UK corporate bond yields (for ratings AA, A and BBB only) were slightly higher during this period, by around 0.2% to 0.4%. Estimates of yields after default were derived from data on global corporate bond default rates²⁷ and an assumption that the loss given default, in the case of bond default is 75%.²⁸ Note that there were no AA, A or BBB corporate bond defaults in this relatively benign period, according to the data.

Source: Oxera analysis using Bank of America data on the average yields to redemption of corporate bonds in the USA, by credit rating.

The returns to the investors in P2P platforms are broadly consistent with the typical yields of high-yield corporate bonds with ratings of BB or B. This is broadly in line with what one might expect given the risk–return trade-off described in Figure 3.2.

²⁵ This represents the period between the two recession-related peaks in credit default observed in the UK.

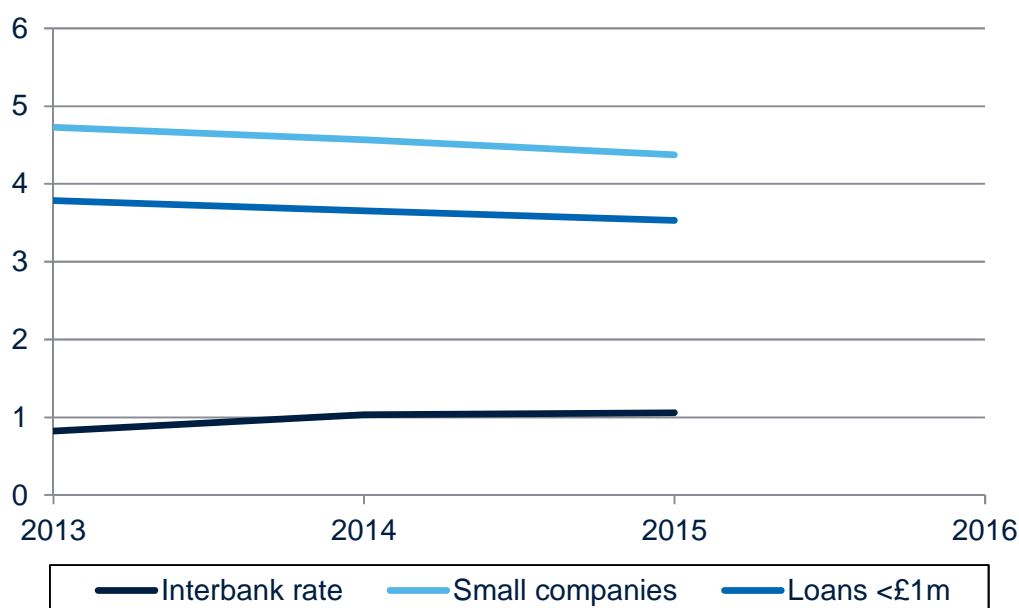
²⁶ The distinct lack of volatility in P2P investor returns (compared with most other asset classes) cannot, at this stage, be taken as evidence that returns will remain that stable going forward.

²⁷ See S&P Global (2016), '2015 Annual Global Corporate Default Study And Rating Transitions', <http://www.spratings.com/documents/20184/774196/2015+Annual+Global+Corporate+Default+Study+And+Rating+Transitions/6d311074-5d56-4589-9ef8-a43615a6493b>, Table 3.

²⁸ Oxera assumption based on the analysis presented in Moody's (2004), 'Credit loss rates on similarly rated loans and bonds', <https://www.moody.com/sites/products/DefaultResearch/200300000439818.pdf>.

Another potential comparison is with banking. Banks have access to funds from different sources, including customers' deposits (which are protected by the FSCS deposit guarantee) and funding from other banks (which is not). The latter is perhaps more relevant in this case as it is not covered by the FSCS (although it is still likely to benefit from some form of implicit government guarantee). Figure 3.6 presents the spread between interbank lending rates and the average bank interest rates for loans to small companies and for loans of less than £1m (for any company), which show broadly similar spreads of around 3–4% as observed with the P2P lenders. It should be noted that much of the bank lending to small companies is secured, often on property, which is why the interest rates are much lower than that of the mainly unsecured loans of P2P platforms such as Funding Circle.

Figure 3.6 Interest rate spread for bank lending to SMEs, 2013–16



Note: This includes the one-year interbank lending rate, the average bank interest rate for 'smaller' companies (described as businesses with annual debit account turnover on the main business account of less than £1m), and the average bank interest rate for loans of less than £1m (to any non-financial corporation, including large corporations). Additional fees charged by banks for loans e.g. arrangements fees, renewal fees are not included in the calculation, but are understood to not be significant.

Source: Oxera analysis using Bank of England data.

A longer time series of data is required before risk–return observations can be confirmed. To provide additional insight into the economics of P2P lending, additional perspectives are provided in this report, including in:

- section 3.3, which looks at the efficiency of P2P lending by benchmarking against other financial institutions that have existed for longer periods of time;
- sections 4.1 to 4.3, which look at the riskiness of the loan portfolios relative to those of other lenders, and the potential performance in economic recessionary environments (see section 4.2 in particular);
- sections 4.4 and 4.5, which consider liquidity risk and platform risk, and how they are managed.

This additional evidence provides further indication that P2P lending should perform over longer periods of time in line with the expectations on the risk–return trade-off and liquidity discussed above.

3.3 Efficient financial intermediation

From the perspective of the investor, the efficiency of financial intermediation can be considered in terms of the fees that the financial institution charges, as the key driver of the wedge between what the borrower pays (after accounting for default losses) and what the investor receives.

Comparison of the fees charged faces challenges, as financial institutions provide different services. Credit card companies and banks,²⁹ for example, provide payment services that P2P platforms do not. P2P platforms provide services to investors that other lenders do not. There are more pure non-bank lenders, although many of these focus more on small loans to subprime customers, which creates additional costs perhaps not faced by most P2P platforms. Furthermore, as P2P lending platforms are mostly in a ‘growth phase’, operating costs recorded in the most recent account (2014 or 2015) do not provide a good indicator of ongoing operating costs, due to investment in growth.

It is possible, however, to make a comparison with asset management, in terms of the fees charged. On this basis, P2P lending appears to be a relatively cost-efficient form of financial intermediation, particularly when considering that the users (both borrowers and investors) tend to be relatively small in scale.

3.3.1 Asset management comparison

The cost of P2P lending can be estimated by the fee revenues of the platform divided by the loan book, as this indicates the difference between what the borrower pays and what the investor receives. These fee revenues come mainly from loan origination fees (charged once at the beginning of the loan) and ongoing platform fees (which are ongoing fees relating to the outstanding loan size of performing loans).

These fees have parallels in asset management. For example, loan origination fees can be compared to the issuance fees of investment banks issuing corporate bonds.³⁰ The ongoing fees of P2P lenders are broadly equivalent to the asset management and investment platform fees paid by investors using asset managers, in particular as follows.

- Loan origination fees vary considerably across P2P platforms, depending on the business model, from around 1% of loan value for larger business and mortgage loans to some 6% of loan value for smaller loans.³¹
- Similarly, considerable variation is noted in bond issuance costs. Investment grade corporate bonds have issuance costs of around 1% of bond value,³²

²⁹ Research has pointed to a modest operating cost advantage for P2P platforms relative to banks, due to having newer online systems without legacy costs faced by many banks. This is an area that would benefit from further research, as P2P platforms mature from their current growth phase. See Deloitte (2016), ‘Market lending: a temporary phenomenon?’.

³⁰ There are also parallels with the IPO and listing fees for equities, although the focus here is on bonds as they are more similar in structure to P2P lending. See also Oxera (2006), ‘The Cost of Capital: An International Comparison’, prepared for the City of London Corporation and the London Stock Exchange, June.

³¹ Estimates based on confidential data provided by the P2P platforms.

³² Bank of England.

although costs can be much higher for smaller and higher-yielding bonds, to as much as 5–6% of bond value.³³

- Ongoing servicing fees of P2P platforms are less variable, and are mainly around 0.7% to 1% per annum to ensure sufficient funds to cover the ongoing costs (as discussed further in section 4.6).
- These fees are comparable to the combined fees of asset managers. The typical cost of holding a bond investment fund is around 0.4% per annum for the investment platform,³⁴ and 0.6% per annum in ongoing charges for the average bond investment fund.³⁵ This totals 1% per annum.

The similar ranges in fees are notable, as P2P lenders typically deal with much smaller investors and borrowers than asset managers do. Even the smallest bond issuance will be in tens, if not hundreds, of millions of pounds, whereas the largest P2P loans do not even come close to this scale.³⁶

This points to P2P platforms providing an efficient form of financial intermediation, based on a comparison with asset management.

³³ Oxera (2004) 'Is debt replacing equity in regulated privatized infrastructure in developing countries' August 12, working paper for the World Bank.

³⁴ For example, the service fee (which is applied on top of the ongoing charges figure of the investment fund itself) is currently 0.35% for Fidelity and 0.45% for Hargreaves Lansdown.

³⁵ The average of the ongoing charges figures of all 161 bond funds listed on the Fidelity investment platform on 15 August 2016 was 0.62%.

³⁶ Up to around £3m in the platform loan book data. The average Funding Circle business loan is £60,000.

4 Managing risk

This section considers how platforms ensure that risk is properly managed for investors, and their incentives for doing so, in terms of individual loan default risk, liquidity risk and platform risk. P2P platforms operate a selection of functions designed to help manage risk for investors in different ways. These include:

- credit risk assessments and interest rate management (section 4.1);
- diversification (section 4.2);
- smoothing returns (section 4.3);
- providing liquidity (section 4.4);
- managing platform risk (section 4.5).

This section considers not just effective risk management during 'normal' market conditions, but also management of potential risks in more severe market conditions. Investors need to understand the inherent risks with P2P investments that remains with them, and this is explored further in section 5.

Box 4.1 Key findings

- P2P platforms are effectively incentivised to manage risk due to both direct revenue impacts and reputational impacts affecting their viability longer term.
- P2P platforms operate credit risk assessments in line with those used by traditional lenders, and these produce similar outcomes in terms of losses due to default.
- P2P platforms manage interest rates to ensure that rates are appropriate given risk levels, and there would need to be very significant increases in default rates required (compared with past recessions) to produce negative investor yields.
- Platforms have put in place mechanisms to ensure that there is a fair distribution of loans to different types of investor.
- Auto-allocation is widely used by retail investors, and is also popular with institutional investors.
- Buffer funds are provided by some platforms to reduce return volatility in 'normal' times, altering the risk–return profile with some additional costs from maintaining the fund.
- Most platforms provide secondary markets so that investors can exit early if there is another investor willing to take on the loan, but relatively low usage of secondary markets suggests that, on the whole, investors treat P2P lending as a long-term investment.
- Platforms have in place measures to manage the risk to investors in the event of platform failure. For example, loan contracts involve sufficient ongoing fees to fund loan servicing even if the platform were to fail.
- P2P lending poses little risk to the wider financial system, not just due to its small size but also due to P2P platforms facilitating long-term investments to investors, rather than instant-access current accounts to wider public.

Source: Oxera.

The main risk-management functions in place at P2PFA members at the time of writing are summarised in Table 4.1.

Table 4.1 Overview of P2PFA members: functions to manage risk

P2PFA member	Output of credit-risk assessment	Secured	Automatic diversification	Buffer fund	Ongoing fee covers servicing cost
Funding Circle	Assigns each loan to a risk band based on a credit assessment and sets interest rate	Some loans	Optional—c. 50% investors use	No	Yes
Landbay	Assesses whether loans meet requirement for credit threshold, and sets interest rates	Yes	Yes	Yes, discretionary	Yes
Lending Works	Interest rates are fixed for both products (three-year/five-year)	No	Effectively yes*	Yes	Yes
LendInvest	Assesses risk and sets the interest rates	Yes	Optional—c. 15% investors use	No	Yes
MarketInvoice	Assesses risk and sets the interest rates	Yes	Optional—c. 75% investors use	No	Yes
RateSetter	Assesses credit risk to determine contribution to buffer fund on top of market-determined interest rate	Some loans	Effectively yes*	Yes	Yes
ThinCats	Credit assessments to inform auction rate-setting process	Yes, so far	No	No	Yes
Zopa	Assesses risk and sets the interest rate	No	Yes	For some products	Yes

Note: * Diversification does not occur at the time of lending, but default is covered by a buffer fund and if the fund runs out the residual risk is diversified.

Source: Oxera, on the basis of information provided by platforms. MoneyComms (2014), 'UK peer-to-peer lending – an independent overview', 8 December, <http://s3-eu-west-1.amazonaws.com/landbay/CDN/downloads/UK-P2P-Independent-Review-MoneyComms.pdf>.

4.1 Incentives to manage risk

P2P platforms have incentives to manage risk due to both direct revenue impacts and reputational impacts affecting their viability in the longer term.

Even though P2P platforms do not typically invest in loans directly (see Box 6.3 on the debate about 'skin in the game'), they are directly affected by their credit risk assessments since borrower defaults result in the loss of ongoing servicing fees. These fees, at a rate of around 0.7% to 1% per annum, make up a significant proportion of the income of platforms (varying from around one-third to well over a half of revenue), since they are required to cover at least the ongoing costs of servicing loans.

In addition, the ability of P2P platforms to attract investors depends on them delivering strong net returns to a relatively risk-averse investor base. There is a relatively rapid feedback loop from increasing default losses to loss of reputation due to the transparency of default data (see section 5.1). Due to the competitive

nature of the lending market and the fact that traditional lenders already have sophisticated credit score models, a P2P lending business would simply not survive in this market without conducting effective credit score assessments. As with asset managers, P2P platforms rely on demonstrating to investors that they offer sound investments, not just in terms of matching investors with borrowers but in matching them with borrowers that are creditworthy and paying risk-reflective interest rates.

4.2 Credit risk assessments and interest rate management

The evidence suggests that, as well as having the right incentives, P2P platforms do indeed operate credit risk assessments in line with those used by other lenders (including banks and non-bank lenders), and produce similar outcomes in terms of losses due to default. The P2P platforms act to manage interest rates to ensure that rates are appropriate given risk levels, and there would need to be very significant increases in default rates to produce negative investor yields.

This section considers the evidence on:

- **credit risk assessments** conducted by the P2PFA members;
- outcomes for borrowers, in terms of **default losses**;
- **interest rate management**, to help manage outcomes for investors;
- **potential outcomes in a recession scenario**.

4.2.1 Credit risk assessments

To help ensure that the returns that investors receive are appropriate given the credit risk of the borrower, all members of the P2PFA have developed credit risk models³⁷ that are broadly similar to those which traditional lenders have in place, using data from credit reference agencies (CRAs) and other sources.³⁸ These assessments are used to credit-score borrowers and to take decisions about whether to facilitate loans to them, and in determining the risk-reflective interest rate.

For the assessment of credit risk, P2PFA members generally rely on a qualified risk team, as well as investments made into dedicated computerised systems to conduct certain parts of a loan's screening and assessment. Platforms reported that a significant number of staff work on risk, although the size of the risk team differs by platform and by the risk assessment model chosen. Platforms place a high value on their risk team's qualifications and experience—hiring staff with relevant experience from banks and other types of lender.

The platforms have a multi-stepped process to assess each loan, at the end of which a loan may be accepted to fundraise through the platform, or may be rejected. Most of the platforms report approval rates (for both business and consumer loans) of around 10–25%, with the majority of applications failing to pass the credit assessment.³⁹ The platforms that facilitate lending to SMEs generally offer loans only to companies with at least a couple of years of trading

³⁷ The ThinCats model is somewhat different, in that 'Sponsors' put forward information about borrowers and loans, although ThinCats is also now developing a credit risk assessment approach that is consistent with those of the other platforms.

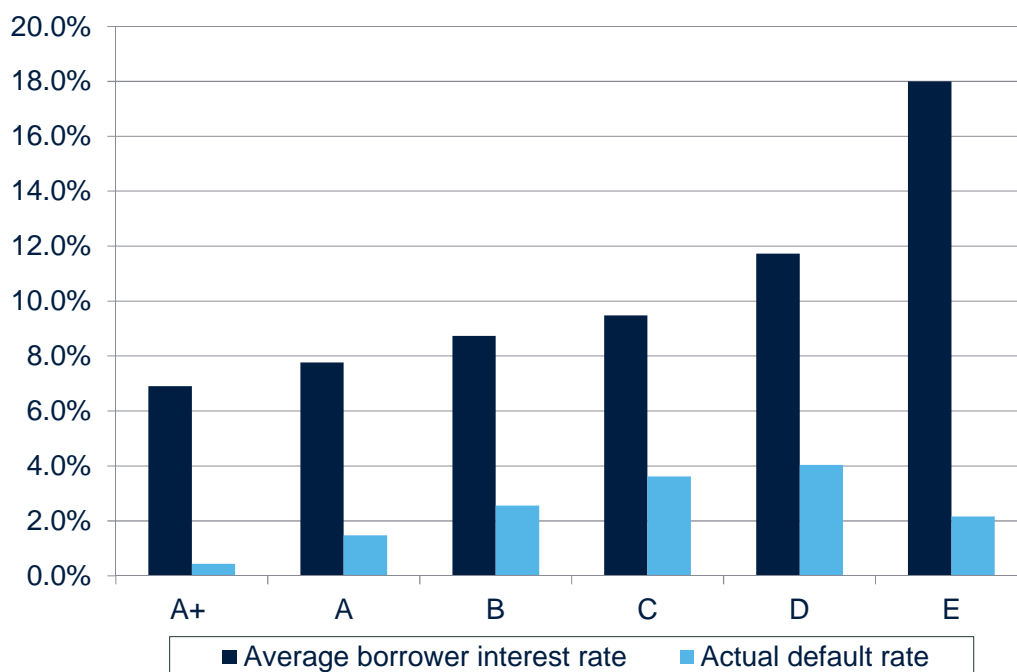
³⁸ For instance, sources such as Call Credit, Experian, Equifax, Cifas, Graydon and loan-specific information provided by the borrower.

³⁹ One exception is MarketInvoice, where the nature of invoice finance means that most businesses can be accepted while maintaining a relatively low level of losses.

experience and a (positive) credit history; the default rates seen are therefore in line with those at banks offering similar loans (see Figure 4.2).⁴⁰

The range of credit scores accepted varies across platforms, depending on the business model. For example, Funding Circle identifies six credit risk bands in its risk assessment process. To determine these risk categories, the platform has designed a statistical model ranking potential borrowers in terms of the risk they represent, based on thousands of criteria drawing from publicly available information (from CRAs, for instance) and Funding Circle’s own databases, which have been populated and enhanced over the years. In parallel to the statistical model, a member of the risk team assesses each loan applicant individually.⁴¹ The credit bands that Funding Circle allocates loans to at the end of this process are used to determine interest rates, as shown in Figure 4.1. This figure also gives an indication that this risk assessment process has performed relatively well given the relationship between average borrower interest rates and actual defaults rates. Further evidence of the predictive performance of these models is provided in Table 4.2 and Figure 4.3.

Figure 4.1 Average borrower interest rate and actual losses due to default per credit band for all Funding Circle loans



Note: Default losses are calculated as the losses due to default (taking account of any recoveries) over the total value of loans for each score band. E rated loans were introduced in 2015. Given the short history of this risk band, the actual default losses reported in this figure are informative only. The actual defaults observed so far are lower than expected, and this may change as more of these loans are facilitated by the platform.

Source: Oxera calculations using the Funding Circle loan book, data from the launch of the platform to July 2016.

Among the P2P lending platforms that facilitate lending to consumers (Lending Works, Zopa and RateSetter), the maximum interest rates charged to individuals

⁴⁰ Hence it is not necessary for these platforms to have specialist credit underwriting procedures that are suitable for new start-up firms.

⁴¹ For further details on Funding Circle’s risk assessment processes see, for example, Funding Circle, ‘Digging into the Data: The evolution of the assessment process’, <https://www.fundingcircle.com/blog/2016/07/digging-data-evolution-assessment-process/>.

are low.⁴² This indicates that none of these platforms are involved in the sub-prime consumer lending sector, with corresponding implications for the credit underwriting procedures required.

Some of the platforms have commissioned credit reference agencies to assess the effectiveness of their credit risk assessments, to ensure that they meet industry best-practice standards.⁴³ These reports find that the credit risk assessments are in line with those of other lenders, such as banks.

4.2.2 Default losses

Actual loan losses due to default compared to estimated loan losses provide an indicator of the effectiveness of credit risk assessments. P2PFA members publish data on default rates and loan losses, by year of loan origination, on their websites and through publicly available loan book data, as summarised in Table 4.2 below. As most of the loans have maturities stretching into a number of years, the table focuses on the percentage losses of loans issued in 2013 and 2014 so that there has been time for default to occur.

For the platforms that focus on secured property loans (Landbay and LendInvest), default rates have been very low, close to zero, although it should be noted that these platforms are relatively young.⁴⁴ Loan losses for platforms facilitating mainly business loans (Funding Circle, ThinCats) or mainly consumer loans (RateSetter, Zopa) have generally been higher, at around 3–4% for business loans and 2–3% for consumer loans, over the lifespan of the loans so far (up to two to three years for loans originated in 2013–14). The default losses provide an indication of the riskiness of the borrowers using the platforms.⁴⁵

Table 4.2 Actual total loan losses so far (and expected loan losses), as a percentage of value by platform for loans that originated in 2013 and 2014

	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. (n.a)**	0.6% (1.5%)
Zopa	Consumer loans	0.7% (1.3%)	1.5% (2.1%)
MarketInvoice	Invoice finance	0.2% (n.a.*)	0.5% (n.a.*)
Landbay	Property loans (buy-to-let mortgages)	n.a. (n.a)**	0.0% (0.1%)
LendInvest	Property loans	0.0% (0.0%)	0.1% (0.1%)

Note: Loan losses show the value of losses so far as a proportion of the value of the loans. The figures in brackets show the expected loan losses at the time of issuing the loan. * MarketInvoice do not provide comparable data in terms of expected losses, so their estimates are not included here. ** n.a. for Lending Works and Landbay indicates that the platforms had not yet facilitated any loan in 2013. Loan losses are calculated as the total outstanding amount of the loans that defaulted over the total value of loans.

Source: Platform loan books and websites.

⁴² For instance, in 2015, the maximum interest rate (including fees) charged to Lending Works borrowers was 17.4%, with an average of 5.8%. For Zopa, the maximum risk-reflective component of the interest rate charged was 24.8%, and the average was 8.6%.

⁴³ The detailed reports are confidential but available for FCA supervision.

⁴⁴ Data is available mainly from 2014 onwards.

⁴⁵ To understand the implications for investor returns, the loan losses would be compared to gross rates of return, as they are on the platform websites.

The actual default rates are in line with, or lower than, the expected loan losses in nearly all cases, as shown in the figures in brackets in Table 4.2 (see also a longer time series of the two values for Zopa in Figure 4.3). For the longer property loans in particular, default will still not yet have been fully realised for this period, so actual default rates can be expected to rise somewhat further.

These default rates are also broadly in line with what might be expected given the type of loans. To compare with the default rates of other lenders, it is necessary to translate P2P platform default rates into annual losses, which produces a range from zero to around 2.5% per annum amongst the platforms in Table 4.2 above, with an average of 1.4%. Looking at various comparators among banks and non-bank lenders:

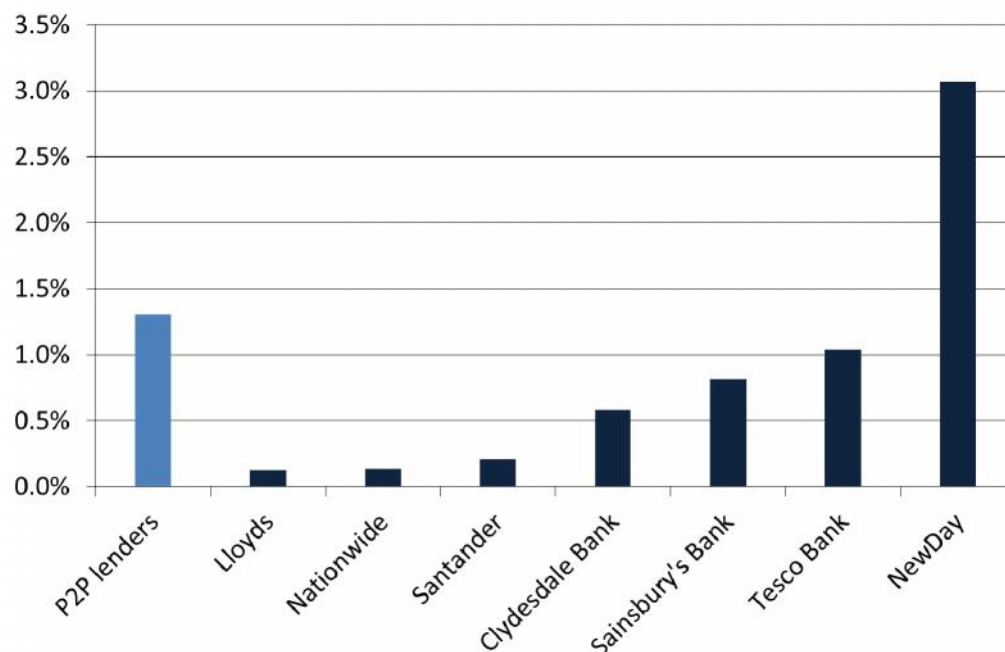
- banks with large mortgage books tended to have low loan losses of around 0.1–0.2% per annum in the 2013–14 period (see, for instance, Lloyds, Nationwide and Santander in Figure 4.2).⁴⁶ In addition, recent buy-to-let mortgages results for Aldermore, a specialist lender and savings bank with a similar buy-to-let mortgage service to some P2P lenders, indicate non-performing loan ratios of between 0.15% and 0.2%;⁴⁷
- banks that were focused more on (mainly unsecured) consumer lending had higher loan losses of around 1% per annum, while loan losses for non-bank lenders range from 1% per annum to much higher levels for those more focused on sub-prime customers (see, for instance, Clydesdale Bank, Sainsbury's Bank, Tesco Bank and NewDay in Figure 4.2 below);
- recent invoice finance results for Aldermore, a specialist lender and savings bank with a similar invoice finance service to P2P lenders, indicate non-performing loan ratios of between 1% and 3%.⁴⁸

⁴⁶ Data on the default rates for comparator companies providing bridging loans was not collected for this study, as these are typically provided by bespoke companies rather than the main mortgage providers.

⁴⁷ See Aldermore (2015), 'Full year results', <http://www.investors.aldermore.co.uk/system/files/press/full-year-results-2015.pdf>, p. 18.

⁴⁸ See Aldermore (2015), 'Full year results', <http://www.investors.aldermore.co.uk/system/files/press/full-year-results-2015.pdf>, p. 16.

Figure 4.2 Loan losses of selected comparator lenders, latest year of data (loss in the given year as a proportion of loan book value)



Note: These estimates are not directly comparable with the P2P platform estimates, as this figure shows losses in one year as a proportion of the loan book value in that year, rather than the total losses during the lifespan of the loan as a proportion of the original value of the loan.

Source: Oxera analysis of annual accounts.

4.2.3 Interest rate management

P2P platforms use the credit risk assessments, along with other mechanisms, to help manage the interest rates that are set to produce appropriate rates of returns for investors (i.e. ensuring that rates cover at least expected loan losses). The platforms have different approaches to interest rate management, which depend on both the nature of the loans being issued and the types of investors.

A number of platforms have shifted from an original approach of non-uniform auctions, where investors determined interest rates for individual projects,⁴⁹ to processes where the platform sets the interest rates, reflecting the credit risk assessment. For example, Funding Circle has made this change, and now sets rates according to its assessment of borrower risk and the platform's own costs. Rates will, in the medium term at least, need to balance supply and demand, but will not be affected by short-term fluctuations in the supply of investment for particular projects, which could be the case with individual project auctions. Other platforms, including Zopa, Lending Works, Landbay, MarketInvoice and LendInvest, apply similar approaches to setting interest rates.

RateSetter has developed an alternative approach. This platform controls for the different credit risk of different projects through setting the contribution to the buffer fund, so only the base interest rate (i.e. the rate after taking account of expected loan losses) is determined by the market clearing mechanism provided by the platform. While this base interest rate is determined by the market

⁴⁹ The platform would typically provide guidance on credit risk and set a range or minimum level for the interest rate in the auction model. This was the approach of Funding Circle.

clearing price, most investors choose to invest at the current rate. This process has led to a base interest rate that is relatively stable.⁵⁰

Only in platforms where there are higher barriers to becoming an investor (such as ThinCats, which requires a £1,000 minimum investment in any single loan) are interest rates set through auctions.

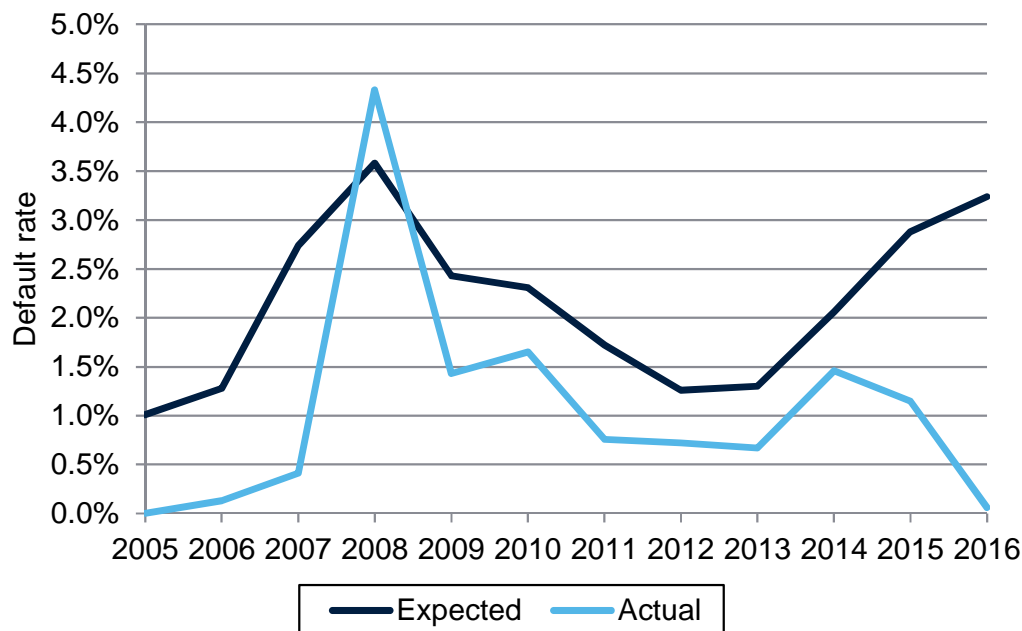
It should also be noted that the growing interest of institutional investors in P2P lending also has implications for interest rate management, as the demand from these investors can be expected to help to restrain interest rates to ranges that are in line with the wider market for investment opportunities.⁵¹

4.2.4 Potential outcomes in a recession scenario

The motivation for platforms managing interest rates (as described above) is to ensure that the current rates offered to investors (which they will generally be locked into for a number of years) are appropriate, given the potential risk of default rates increasing above their current levels under certain future scenarios—in particular, to ensure that rates are appropriate given potential default outcomes in a recession scenario.⁵²

There is only limited data on the performance of P2P loans in a recession scenario. This is limited to Zopa, which was in operation in the last recession, of 2008–09. Figure 4.3 provides the expected and actual loan losses (as a percentage of loan value) of Zopa loans over the 2005–16 period. There was a sharp increase in Zopa default rates during the recession, as expected, to an average rate of 2.9% for the two year period 2008–09, which is more than double the average for the two year period 2013–14 (1.1%).

Figure 4.3 Expected and actual loan losses of Zopa loans: 2005–16



Source: Data provided by Zopa.

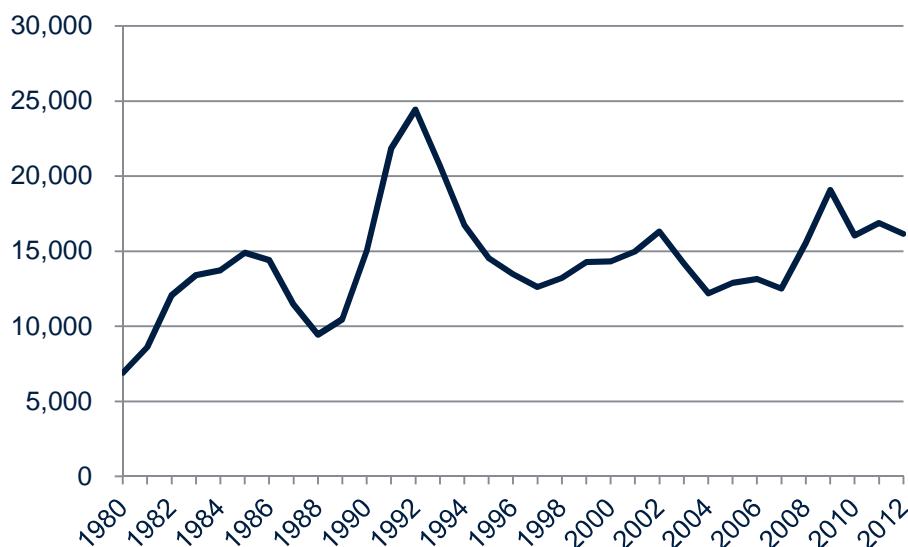
⁵⁰ For data and analysis, see RateSetter statistics, <https://www.ratesetter.com/aboutus/statistics>.

⁵¹ For example, if interest rates fell to levels that were not appropriate given the risk, presumably institutional investors would withdraw—while they should also limit the upward movement of rates through increased demand.

⁵² Rates of credit default are currently considered to be at low levels. For the latest data, see Bank of England, 'Credit Conditions Survey', produced quarterly, <http://www.bankofengland.co.uk/publications/Pages/other/monetary/creditconditions.aspx>.

This more-than-double increase in default, compared with more ‘normal’ levels, is broadly in line with what happened to other consumer credit markets in the same period.⁵³ One might also expect a similar increase in SME lending default during a recession, as past recessions have seen similar increases in company liquidations⁵⁴ (see Figure 4.4) and debt write-offs.⁵⁵ Data on mortgage arrears and repossessions suggests that a similar increase in default would be expected in recessionary environments, although the increase in mortgage write-offs, was particularly pronounced in the 2008–09 recession.⁵⁶

Figure 4.4 Number of corporate insolvencies per year, 1980–2012



Source: Office for National Statistics.

All of the eight P2P platforms considered in this study have been producing recent net returns to investors that are more than twice the current default rate—referred to as the interest cover ratio (see Table 4.3). This shows that there is also considerable variation in the interest cover ratios across platforms. Note that these interest cover ratio estimates require the usual estimates of annual returns to be calculated as total returns over the lifetime of the loan, as expected loan losses are calculated as losses over the lifetime of the loan. This calculation is done using the average loan duration for each platform. Results for the interim calculations shown in the table⁵⁷ are therefore not suitable for comparisons across platforms, due to the different average loan lengths involved.

Note that the interest cover ratio estimates calculated do not take account of how buffer funds, where they exist, operate, as these funds could be run down to maintain positive returns in the short run.⁵⁸ Estimates also should be treated with caution for those platforms that have been operating for a relatively short period

⁵³ The write-offs on credit card debt almost doubled during the recession (Bank of England data).

⁵⁴ ONS data indicates that company liquidations increased by 50% between 2007 and 2009, and by 160% between 1988 and 1992, the last two major recessions. The historic data is available from the National Archive,

<http://webarchive.nationalarchives.gov.uk/20140311023846/http://www.insolvencydirect.bis.gov.uk/otherinformation/statistics/historicdata/HDmenu.htm>.

⁵⁵ Bank of England data suggests write-offs of loans to non-financial companies and unincorporated businesses approximately tripled due to the recent recession. Bank of England data.

⁵⁶ Bank of England data. For instance, see series with code RPQTFHD. Also Paragon buy-to-let loan arrears data.

⁵⁷ In particular ‘Total expected lifetime return before losses’ and ‘Loan losses required to reduce lifetime returns to 0%’. These are only included in the table to show how the interest cover ratios were calculated.

⁵⁸ For this reason, the RateSetter analysis presented in Box 4.3 suggests a higher default rate, of 11%, required to *both* deplete the fund and reduce returns to zero.

of time. Overall, these interest cover ratios suggest that the returns on existing loans would remain positive in most recessionary scenarios—unless the increase in the rate of default is much greater than the average increases in default seen in previous recessions.⁵⁹

Table 4.3 Interest cover ratio, 2015

	Expected lifetime loan losses	Expected annual net return at origination	Average loan length (months)	Total expected lifetime return before losses	Loan losses required to reduce lifetime returns to 0%	Interest Cover Ratio
Funding Circle	3.6%	7.1%	46	16.9%	14.5%	4.0
ThinCats	3.5%	9.0%	33	15.7%	13.6%	3.9
RateSetter	2.8%	4.8%	26	8.0%	7.4%	2.7
Lending Works	1.5%	5.6%	42	11.3%	10.1%	6.9
Zopa	2.9%	4.8%	44	11.7%	10.4%	3.6
MarketInvoice	2.8%	10.8%	1.5	10.8%*	10.8%*	3.8
Landbay	0.1%	4.0%	78	13.1%	11.6%	116
LendInvest	0.1%	7.2%	10	7.2%*	7.2%*	61

Source: Oxera calculations based on data from platform loan books and websites.

Note: The calculation is conducted as follows. The total expected return over the lifetime of the loan, before losses (column 5 of 7), is equal to the expected net return over the loan (which in turn is calculated from columns 3 and 4) plus the expected loan losses (column 2). The total expected return before losses is calculated for the full length of the loan (*not an annual rate of return*), assuming that the loan is an instalment loan for all platforms except LendInvest (as bridging loans are typically repaid in full at the end of the loan). Column 6 then presents the loan losses that would be required, at the start of the loan period (the prudent assumption here) to fully offset the total expected return and produce a final net return of zero. This estimate divided by the expected loan losses at the time of issuance produces the final ratio. The calculations do not take into account the existence of any buffer funds, other specific features of loan products and should not be used to compare across platforms.

* MarketInvoice and LendInvest estimates have been calculated on the basis of the annual return, as the short term nature of lending makes the same methodology not applicable.

This result has also been reported by platforms in their own stress-testing analysis, as described further in Box 4.2 and section 4.3 below.

Box 4.2 Loan book stress-testing

Platforms have conducted analysis to assess their own loan books in recession scenarios. Funding Circle periodically stress-tests its loan book with the same methods used by the Prudential Regulation Authority (PRA) to test banks. This involves using data of recessions from the period 1990–2013. The most recent analysis of Funding Circle's loan book found that, in the most extreme economic conditions that the PRA set, average annualised returns for Funding Circle's existing investors would remain above 5.7%.

Source: Funding Circle, 'Digging into the data: stress testing the Funding Circle loanbook', <https://www.fundingcircle.com/blog/2014/12/digging-data-stress-testing-funding-circle-loanbook/>, updated with more recent loan book data.

⁵⁹ Past financial crises have produced some increases in default that were greater than expected, such as with subprime mortgages in the USA in 2007–08, so this possibility cannot be ruled out. But for regular types of consumer and business lending, the data indicates relatively wide buffers before there is a risk of negative investor yields due to default.

4.3 Diversification

A key benefit of P2P lending is that it enables even relatively small investors to benefit from risk diversification by, first, offering a new asset class for them to invest in and, second, enabling them to spread their total invested amounts over a large number of loans through the P2P platform. To encourage risk spreading, a number of P2P platforms are employing auto-diversification tools, some of which are optional (typically with business lending) and some mandatory (typically with consumer lending).⁶⁰ Those platforms that operate a buffer fund in most situations also deliver a high degree of portfolio diversification in a different way (see further discussion of this in section 4.4). The platforms that allow investors to choose loans if they wish report that auto-allocation is not just the most popular option among retail investors, but that it is popular with institutional investors as well.

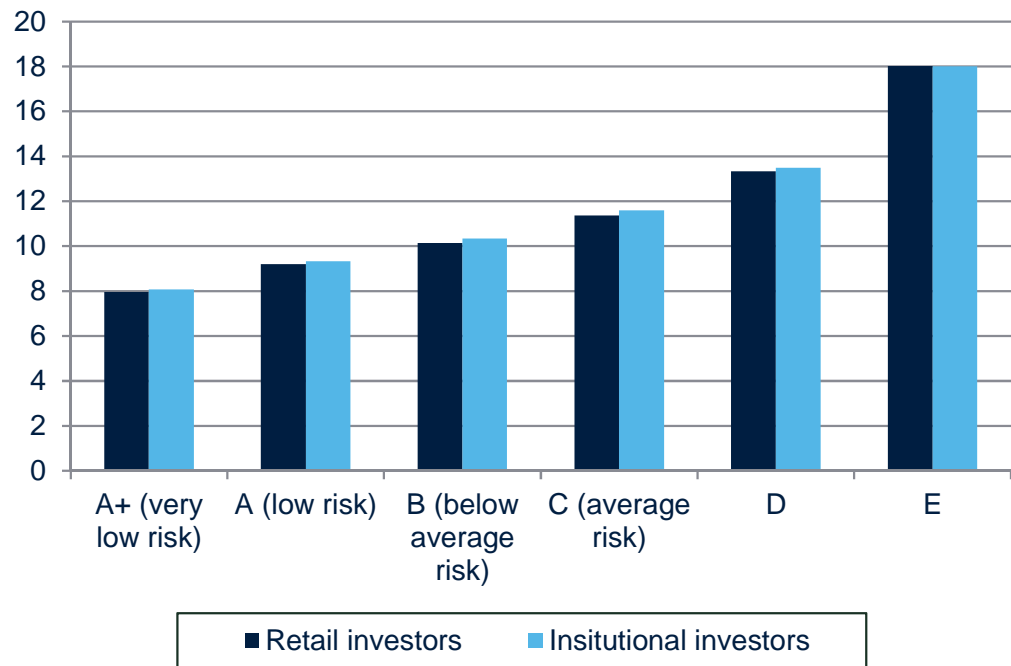
The ability to select the deals you want to invest in and the interest rate you want to earn is arguably a 'pure' P2P approach. It may suit the original P2P investors well, but scaling this model has proved to be challenging, as even institutional investors may not have the capacity to make individual lending decisions when they are trying to deploy large sums. For these reasons, the continued growth of the P2P market required ways of deploying funds automatically against pre-determined criteria including credit risk, industry sector, security cover and interest rate. Each of the platforms has developed their own strategy for enabling this 'auto-bidding'.

Platforms have also put in place mechanisms to ensure that there is a fair distribution of loans to auto-allocation investors, by randomly allocating loans to portfolios available to different types of investor (so that it is not possible for investors actively choosing loans to be able to cherry-pick the best loans). Loans are (randomly) allocated to institutional investors separately from those allocated to retail investors. For instance, Figure 4.5 below illustrates that the same (gross) interest rates are received by Funding Circle institutional and retail investors—i.e. Funding Circle does not offer preferential interest rates to one type of investor. To provide a complete analysis of fair distribution, the default rates of loans allocated to each investor type should subsequently be compared, once a suitable time series of data is available.⁶¹

⁶⁰ Allowing for investor choice of loan does not make sense with consumer lending, where limited information can be provided to the investor, which is why RateSetter, Zopa and Lending Works all have automatic diversification of investments.

⁶¹ Initial figures for the net returns to institutional and retail investors at Funding Circle indicate that these are also comparable. Both retail and institutional investors who started lending between 01/10/2014 (when institutional investors were first allowed to use the platform) and 30/06/2015 have so far received an average net return on their investments of 7.7%.

Figure 4.5 Gross interest rates received by Funding Circle institutional and retail investors, 2015–16

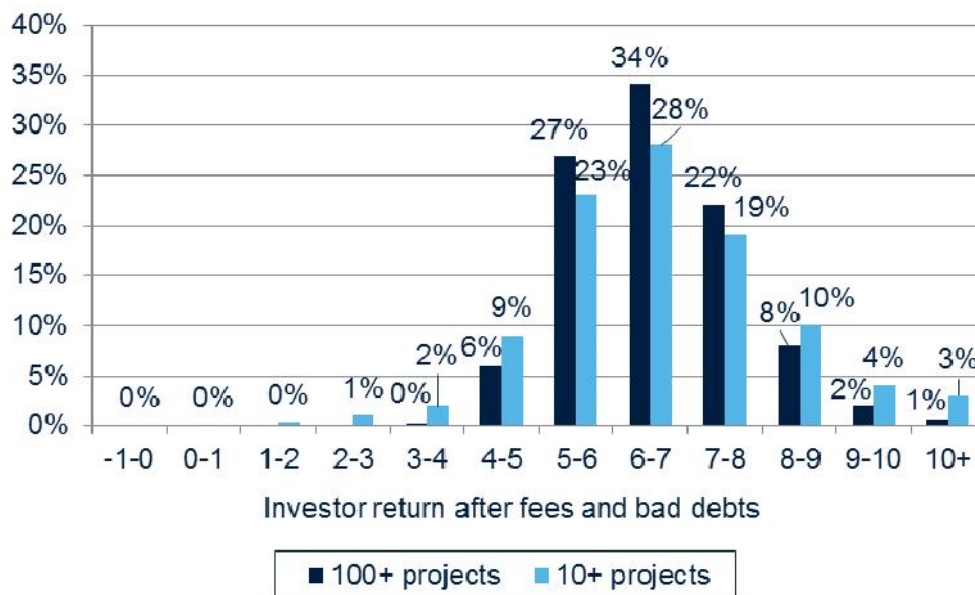


Source: Funding Circle loan book.

Platforms also promote the use of diversification and other forms of risk management to their investors through the use of educational tools such as informational videos.⁶² It is in the interests of platforms to encourage diversification in this form, to help ensure consistent investor outcomes, and to avoid poorer outcomes. For example, to inform its investors, Funding Circle illustrates the advantages of diversification on its website using its own historical data on investor returns. Figure 4.6 below illustrates the results.

⁶² For example, see Zopa, 'How Zopa minimises risk', <https://www.zopa.com/lending/risk-management>.

Figure 4.6 Distribution of returns for investors who have lent to at least 100 projects with a maximum exposure of 1%, or to at least 10 projects with a maximum exposure of 10%



Note: The returns are for investors lending for at least one year, and do not include future expected losses. The category '100+ projects' is a subset of the category '10+ projects'; hence the variance for investors lending to 10–99 projects would be higher than that shown for the '10+ projects' category.

Source: Oxera using data from Funding Circle, <https://www.fundingcircle.com/statistics>.

This shows that investors who invest in at least 100 projects are more likely to achieve intermediate returns (i.e. between 5% and 8%), while investors who invest in at least ten projects are more likely to achieve more extreme returns (i.e. less than 5% or more than 8%).⁶³ Similarly, for investors investing in at least ten projects, the proportion of investors that earn a return of less than 4% is 4%, while for investors investing in at least 100 projects the proportion of investors that earn a return of less than 4% is close to nil.

4.4 Buffer funds

A number of P2P platforms have developed buffer funds to help cushion investors against default losses that may arise. Buffer funds can therefore change the risk profile faced by investors. These funds can be expected to reduce or remove the uncertainty created by default during 'normal' times (at the cost of lower return rates),⁶⁴ but in more severe economic scenarios could become depleted and no longer cover default losses.

As is normally the case with financial 'hedging' that reduces volatility,⁶⁵ there will be an implicit cost for this reduction in volatility during 'normal' times. The buffer fund will earn only low rates of return, and this opportunity cost ultimately falls on investors.⁶⁶

⁶³ This is also reflected in the fact that the standard deviation with at least 100 projects is 1.16 percentage points, or 37% lower than the standard deviation with at least ten projects, which is 1.59 percentage points.

⁶⁴ Similar to other risk-smoothing instruments, such as derivatives and hedging.

⁶⁵ For example, by using derivatives to provide a minimum guarantee for an equity fund, or by investing in counter-cyclical assets, or by buying insurance.

⁶⁶ The platform may treat this opportunity cost as a cost that it bears, but it can ultimately be expected to fall on investors through the platform charging a slightly higher fee.

Investors may have different preferences for the predictability of the rate of return on their investments. To accommodate these different preferences, a range of tools have been developed by P2P platforms to provide investors with a choice over the extent to which their returns are smoothed over the performance of individual loans and over different market conditions.

Diversification of loans, as described earlier (section 4.3), provides one option for smoothing returns over the performance of individual loans (but not over different market conditions). Buffer funds help provide smoothing of returns over the performance of individual loans and, to some extent, over a broader range of market conditions over time, although not to such an extent as to guarantee a fixed return.

An alternative reason for providing a buffer fund is to remove credit risk from the interest rate-setting equation (from the perspective of the investor—the platform still assesses credit risk). This has been the approach of RateSetter, which allows for market determination of interest rates but without the complexity of credit risk, which is already accounted for in the payments to the buffer fund (which then covers potential investor losses in ‘normal’ times).

4.4.1 How buffer funds work

Buffer funds provide a degree of protection to investors against individual loan default risk, delivering smoothed returns to investors at the cost of a lower return rate from the cost of holding capital in a buffer fund. The idea is that for every P2P Agreement a small amount of money is paid into the fund, usually in the form of a borrower fee. The fund then covers payments to investors if borrowers miss payments or go into default. Buffer funds can cover both interest and principal.

The loan default risk to a single investor is, in part, transformed into the risk (to all investors) that the fund will run out. Typically with buffer funds, the investor should not face default losses directly unless the fund runs out.⁶⁷ If that happens, then in some models⁶⁸ the investor faces the loan default risk of their portfolio, while in other models⁶⁹ the loan default risk for individual loans is shared across all investors (after buffer fund depletion). Given this detachment between individual investor returns and individual loan default risk, the use of a buffer fund makes it important that investors properly understand the risks of the pool of underlying assets that they are lending against, and the corresponding impacts of this on the profile of their returns.

4.4.2 Buffer fund resilience

The following case studies from platforms’ websites provide an indication of the resilience of their buffer funds. One of the main metrics measured is the coverage ratio, which calculates the ratio of the fund size to the value of expected losses. Current estimates for the coverage ratios of a number of funds are provided in Table 4.4.

⁶⁷ The investor may face losses indirectly, however, as the contributions to the fund made by the platform are related to default losses, and one would expect in the long term for these contributions to impact on investor returns.

⁶⁸ For example, with Zopa and Landbay.

⁶⁹ For example, with RateSetter and Lending Works.

Table 4.4 Coverage of platform buffer funds

	Fund size	Coverage ratio (target)
Landbay	0.6% of outstanding loans	600%
RateSetter	Over £17m, with a further £5m in contributions from borrowers due to come in over the lifetime of existing loans	128% (125–150%)
Zopa	Almost £13m*	120% (110%)

Note: * Zopa's buffer fund applies only to its lower-risk products (i.e. Zopa Access and Classic, not Zopa Plus).

Source: Landbay, 'The reserve fund', <https://landbay.co.uk/reserve-fund>. Landbay (2015), 'Landbay macroeconomic stress test: An overview', October, <http://s3-eu-west-1.amazonaws.com/landbay/CDN/downloads/Landbay-Stress-Test-Results-2015.pdf>. RateSetter, 'The provision fund', <https://www.ratesetter.com/invest/everyday-account/protection>. Zopa, 'Expected and actual defaults', <http://www.zopa.com/lending/risk-data>. Zopa, 'Introducing Zopa's risk markets', <http://www.zopa.com/lending/risk-markets>.

A number of P2P platforms have also undertaken stress-testing in order to check the robustness of their buffer funds to a deterioration of the economy. Some examples of the test processes and results are provided in Box 4.3.

Box 4.3 Buffer fund stress-testing

Landbay

Landbay asked MIAC Academetrics Ltd, independent asset valuation service provider, to perform macroeconomic stress tests using Bank of England criteria for stress-testing banks.⁷⁰ This involved testing the resilience of its buffer fund. This resulted in a 'fair weather scenario' with a default rate of 0.03%, and a 'bad weather' ('key stats: GDP down by 3.5%, unemployment rising to 9% and UK house prices falling by 20%') scenario with a default rate of 0.48%.

Lending Works

Lending Works notes that, in addition to its buffer fund, its investors are protected by stress-tested A and B rated UK household-name insurers.⁷¹

RateSetter

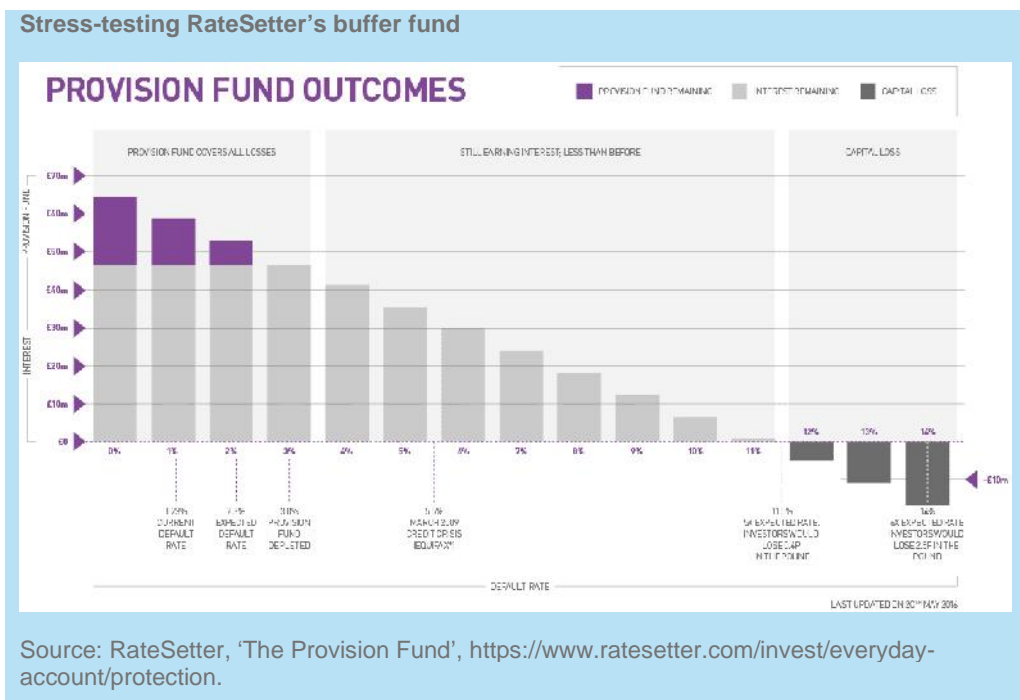
RateSetter carries out stress-tests in the form of 'scenario testing' of its buffer fund.⁷² It has calculated what would happen to the buffer fund under various assumptions about future default rates, as illustrated in the figure below. This suggests that the critical default rate to deplete the buffer fund is 3%, compared to the current expected default rate of 2.3%. At a default rate of 11%, investors would lose their interest. At a rate of 14%, investors would lose 2.5p to the pound.

To put these numbers into context, RateSetter provides an estimate of what the default rate would have been in the 'March 2009 credit crisis': 5.5%. At this rate, investors would lose part of their interest.

⁷⁰ Landbay (2015) 'Landbay macroeconomic stress test: An overview', October, <http://s3-eu-west-1.amazonaws.com/landbay/CDN/downloads/Landbay-Stress-Test-Results-2015.pdf>

⁷¹ Lending Works, 'Protecting your money', <https://www.lendingworks.co.uk/peer-to-peer-lending/safe>.

⁷² RateSetter, 'RateSetter 2015 lender drinks' <https://www.ratesetter.com/blog/article/ratesetter-2015-lender-drinks>.



Source: Oxera analysis using platform information.

4.5 Providing liquidity

Most P2P platforms are facilitating loans with durations of a number of years.⁷³ Investors therefore value mechanisms put in place by platforms that create the possibility to sell their remaining loans to another investor (if there is another investor willing to take on the loans), to allow them to access their funds before loans are repaid. Most platforms therefore provide secondary markets where investors can sell their remaining loans to other investors.

The purpose of these secondary markets is *not* to provide liquidity transformation—the underlying asset remains the key determinant to the liquidity of the investment, and the ability to sell the remaining loans is not guaranteed. Most platforms charge for the use of the secondary market, and investors may also face additional costs or losses when they sell their remaining loans if interest rates have moved against them.⁷⁴ These charges for using the secondary market and variations in loan value are broadly comparable to what a bond investor would expect if selling bonds before redemption.

The use of secondary markets is rather limited, with annual secondary market transactions less than one-quarter of the size of the loan book in all cases (see Table 4.5), and much lower than one-quarter on some of the platforms. This level of transactions is arguably lower than (and at least broadly comparable to) the average rate of transactions in retail equity investment funds,⁷⁵ suggesting that investors are using P2P investments in a similar way to other long-term investment options.

⁷³ Exceptions include the invoice finance provided by MarketInvoice, which is usually only for a few months and the bridging loans provided by LendInvest, typically less than a year.

⁷⁴ Different mechanisms are used by different platforms. In one approach, if the interest rate rises, the value of the loan decreases, as the value of a bond decreases if the interest rate increases.

⁷⁵ On average, retail investors hold equity investment funds for 4.4 years. Investment Association (2015), 'Asset management in the UK 2014-2015', September.

Table 4.5 Use of secondary markets

	Size of secondary market (proportion of total loans)
Funding Circle	18%
Landbay	23%
Lending Works	5%
LendInvest	n.a.
MarketInvoice	n.a.
RateSetter	10%
ThinCats	12%
Zopa	19%

Note: MarketInvoice reports having no secondary market, as given the short duration of the transactions investors are happy to hold invoices to maturity. LendInvest reports that the length of the investment matches the length of the loans so that there is no secondary market. Figures for RateSetter and Funding Circle are based on an estimate of the total transactions ever made on the secondary market in relation to the total amount ever lent. The figure for Zopa is based on an estimate of the monthly transaction value on the secondary market. Figures for Lending Works, ThinCats and Landbay are estimated using only the period for which data was available.

Source: Oxera analysis using platform information.

Limited use of the secondary markets is consistent with the majority of investors treating the investment as long-term. This does not mean that investors do not value the *option* of using the secondary market, but it does suggest that the investor approach to the investment is in line with the characteristics of the underlying asset.

4.6 Managing platform risk

For investors, another key risk factor is likely to be platform risk—in particular, what would happen to their investment if the platform were to fail.

This was found to be an important, albeit not the most important, risk factor considered by potential investors in a RateSetter survey of the general population, with 59% of respondents indicating that they thought that the P2P provider going out of business was one of the main risks of investing in a P2P lending account.

This is also an area of importance for regulators, in terms of both ensuring that financial markets work well and in the interests of consumers, and in ensuring financial stability. To this end, FCA rules require that firms ‘have arrangements in place to ensure that existing loan contracts will continue to be managed and administered in accordance with the contract terms if at any time a firm ceases to carry on the activity (The Living Will)’.⁷⁶ This section considers the measures that platforms have put in place to manage platform risk and comply with the FCA’s requirements, the key issues arising in past cases of platform closure, and lessons for the focus of regulation.

4.6.1 Platform measures to manage risk

P2P lending platforms have in place policies to manage the risk to investors in the event of platform failure. They include:

- ensuring that ongoing fees applied to loans are sufficient to cover the cost of servicing loans, either by a function of the platform or by a third-party service

⁷⁶ Financial Conduct Authority (2016) ‘CP16/5: Handbook changes to reflect the introduction of the Innovative Finance ISA and the regulated activity of advising on peer-to-peer agreements’, February, <https://www.fca.org.uk/static/fca/article-type/consultation%20paper/cp16-05.pdf>.

provider. All of the platforms have ongoing service fees of between 0.7% and 1% of the outstanding loan amount, which is sufficient to support loan servicing even if all other functions of the platform were to cease (including new loan origination);⁷⁷

- resolution plans describing how loan repayments will continue to be collected (as required by the FCA rules for a 'Living Will'). These include features such as fully funded run-off plans, contracts with back-up services providers, and the setting-up of bankruptcy-remote vehicles/special purpose vehicles that these providers can administer in order to wind down portfolios of loans;
- ensuring that minimum capital requirements are met by firms as specified by the FCA, which reflect the risk to investors from potential platform failure, not capital losses due to credit default.⁷⁸

The potential implications of platform failure are explored further in section 4.6.2 in terms of past experience of platform failure and, in section 4.7, in terms of implications for the wider financial market.

4.6.2 Past experience of platform closure in the UK

While P2P lending is a relatively new phenomenon, there has been considerable diversity in this sector and, as one would expect in any new, diverse market, a number of platforms have closed down. Some less profitable P2P lenders have ceased operations, while others have consolidated. This provides case studies for examining why platforms have closed down, and the consequences of them doing so.

Between 2011 and 2016, 16 platforms were identified as having closed their UK operations (some were not headquartered in the UK). 2014 saw a comparatively high number of closures, with seven platforms exiting the market. Most platforms exited as they were unable to comply with new regulatory requirements from the FCA. Some failed due to not developing sufficiently effective credit risk assessments, or through possible misconduct.

The reasons for exit include:

- failing to develop sufficiently effective credit risk assessments, notably in the case of Quackle, Yes Secure and Big Carrots;
- failing to develop an effective business model for reaching the market for borrowers and investors, in the case of the Lending Well and Fruitful;
- acquisition by a competitor, in the case of MayfairBridging and Gradurates;
- in one case, that of 'be the lender' (btl), there were concerns about possible misconduct.

In only two cases was there evidence that investors may have made losses on their investments when the platforms exited.

More detail is provided in Appendix A2.

⁷⁷ This amount of fees is believed to be sufficient as it is sufficient for the third party service providers of two of the platforms that use such providers.

⁷⁸ This is discussed in Financial Conduct Authority (2014), 'PS14/4: The FCA's regulatory approach to crowdfunding over the internet, and the promotion of non-readily realisable securities by other media. Feedback to CP13/13 and final rules', March. See 'Client Money Rules' section from para. 3.13, <https://www.fca.org.uk/static/documents/policy-statements/ps14-04.pdf>.

4.7 Role in the wider financial system

Even with the rapid growth witnessed to date, P2P lending remains only a small component of the wider financial system, which limits its potential systemic importance. However, if the rapid growth continues, and P2P lending becomes more of a 'mainstream' investment product, then the issue of systemic risk is likely to grow in salience. This section considers the evidence on:

- the current scale of the sector relative to the wider financial system;
- the potential for contagion risk.

The evidence considered here suggests that P2P lending poses little risk to the wider financial system, not just due to its small size but also due to P2P platforms facilitating long-term investments to investors, rather than instant-access current accounts to the wider public. The 'worst case' scenario for P2P platforms, in which investors have to wait the lifetime of the loans (typically two to five years) for the return of their money, does not point to the catastrophic economic implications of a bank run.

4.7.1 Current scale of P2P lending

At this time, P2P lending remains only a small component of the financial system. The value of outstanding P2P loans in the UK, at £2.4bn,⁷⁹ compares to some £5.5trn of assets under management by UK asset managers.⁸⁰ Overall, P2P loans represent only 3.6% of total UK loans to SME businesses and individuals, with the highest market share held in loans to consumers (excluding mortgages), at 6.3%. This is shown in Table 4.6.

Table 4.6 Scale of new P2P lending relative to total new UK lending, 2015

	New P2P loans (£bn)	Total new UK loans (£bn)	New P2P loans as a proportion of total new UK loans
Consumer lending (excluding mortgages)	0.9	69.9	1.3%
Mortgages	0.6	223.3	0.3%
SME business lending (including invoice financing)	1.2	27.8	4.3%
Total (SMEs and consumer)	2.7	321.0	0.8%

Source: BBA 2015 data on bank support for SMEs, <https://www.bba.org.uk/news/statistics/sme-statistics/bank-support-for-smes-1st-quarter-2016/#.V8IGFTW-WW4>; Nesta (2016) 'Pushing boundaries: the 2015 UK alternative finance industry report'; and Bank of England lending data for 2015 (LPQB4TX data series and MLAR statistics).

4.7.2 Risk of contagion

Contagion in the financial system occurs when a shock to one market participant spreads to other institutions in the system.⁸¹

⁷⁹ P2PFA lending data.

⁸⁰ Investment Association (2015), 'Asset management in the UK 2014-2015', September.

⁸¹ A typical example is that of the bank run, in which savers become concerned about the liquidity of a bank, so attempt to withdraw their savings, which in turn further worsens the liquidity of the bank and encourages other savers to withdraw. The consequence is not only that this particular bank runs out of liquidity and can no longer function, but also that savers lose confidence in other banks. The importance of this for the wider economy is due to the importance of the continued operation of banking, as it is used by both savers and borrowers for their immediate expenditure requirements (e.g. through current accounts). As witnessed in

In terms of P2P lending, loss of confidence in a platform could result in investors attempting to sell their investments on the secondary market, which would be likely to quickly stop functioning (as no one would be there to buy the loans). This could cause investors to lose confidence in other P2P platforms, as was recently observed with property investment funds following the Brexit vote.⁸² However, the end result is simply that existing investors will have to wait for their investments (at most the duration of the P2P loans—typically two to five years—but possibly much less if confidence returns to the platforms), which they probably would have done anyway (as most P2P investors do not sell out early). The resolution plans put in place by platforms would ensure that this could be done in an orderly fashion.

The contagion from a shock faced by one P2P platform is therefore only likely to spread as far as other P2P platforms—it would not spread any further in the financial system. The analogy with the risk of contagion that exists for banks therefore ends there, as the wider consequences are not the same as with the banking sector. This localised impact is caused by the absence of maturity transformation in the P2P lending sector. Due to this, a scenario in which all P2P investors were unable to access their investments until maturity would have very limited impact, since transactions elsewhere in the financial system should not be dependent on this money in the interim.

2008–09, the loss of credit availability when the banking system is impaired has severe economic consequences.

⁸² A number of property funds suspended withdrawals by investors following the Brexit vote, which resulted in a temporary loss of confidence in the property market and hence a flood of withdrawals. These suspensions are proving to be only temporary, however. For example, see BBC News (2016), 'Aberdeen lifts property fund suspension', 13 July, <http://www.bbc.co.uk/news/business-36783428>.

5 Investor understanding and behaviour

Consumer understanding and behaviour have become a core part of regulators' assessments of financial services markets, and behavioural economics is now a firm part of the FCA toolkit in market studies. In the context of P2P lending, this is of most relevance for investors, as P2P lending is a relatively new form of investment. The behaviour of borrowers is, of course, relevant, but the issues here are broadly the same as for other credit markets. This section therefore focuses on investor understanding and behaviour.

There are two broad ways of examining investor understanding: first, in terms of the understanding that investors report in surveys (section 5.3); and second, in terms of what their observed behaviour implies for their understanding (described in section 5.4). For context, Section 5.1 provides an overview of the profile of the retail investors that use P2P lending platforms; and section 5.2 summarises what platforms communicate to investors, and the main elements of data that they make available.

Box 5.1 Key findings

- P2P investors have, on average, higher annual income and savings levels than the UK average, with P2P lending making up only a small proportion of their total investments.
- P2P lending platforms' websites provide investors with information about product features, fees, risks and risk management, complying with rules set out by the P2PFA to encourage transparency and comparability.
- Investor surveys suggest that investors generally perceive P2P lending to be a risky investment. Surveys also suggest that most investors appreciate key points around liquidity. Survey evidence does, however, show that there is some confusion about the role of particular features, such as the FSCS.
- Observed behaviours also indicate that investors generally understand the characteristics of P2P lending, in particular in relation to the level of risk, liquidity, and the importance of diversification.

Source: Oxera.

5.1 Investor profiles

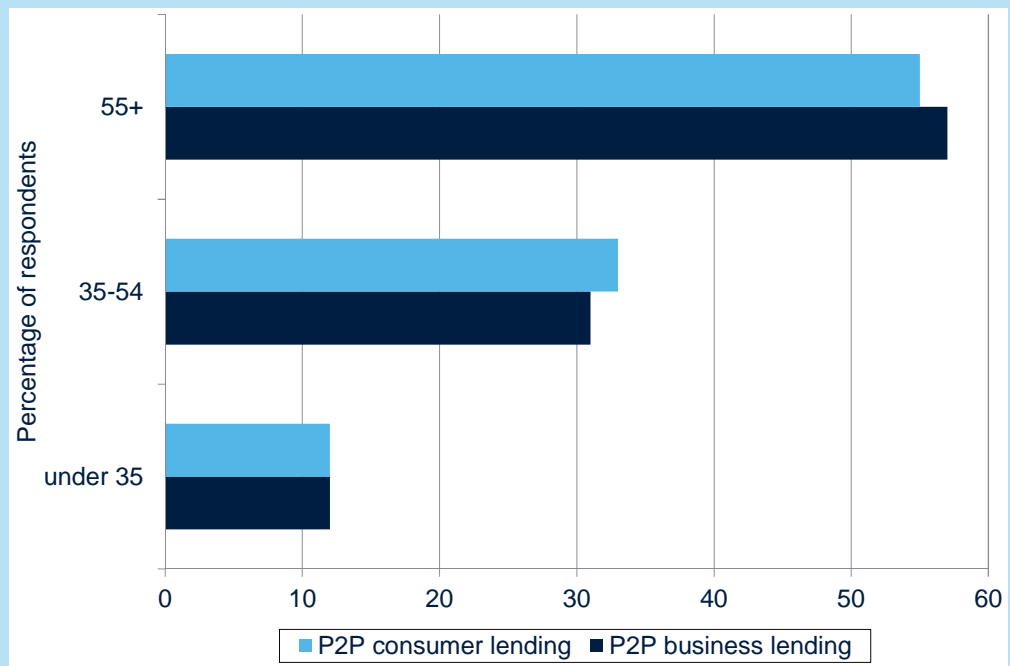
Evidence on investor characteristics indicates that the average investor is male and above the age of 50. P2P lending typically makes up only a small proportion of their total investments. They also spend a relatively significant amount of time each month managing their investment portfolio. Further details on investor characteristics are provided in Box 5.2.

Box 5.2 Profile of P2P investors

In 2014, Nesta conducted an online survey of 2,007 consumers, representative of the general UK population, to understand the awareness of alternative finance among the general population as well as to assess user characteristics and behaviour.

Of the Nesta survey respondents who were investors in P2P lending, more than half were found to be above 55 years of age, as illustrated in the figure below.

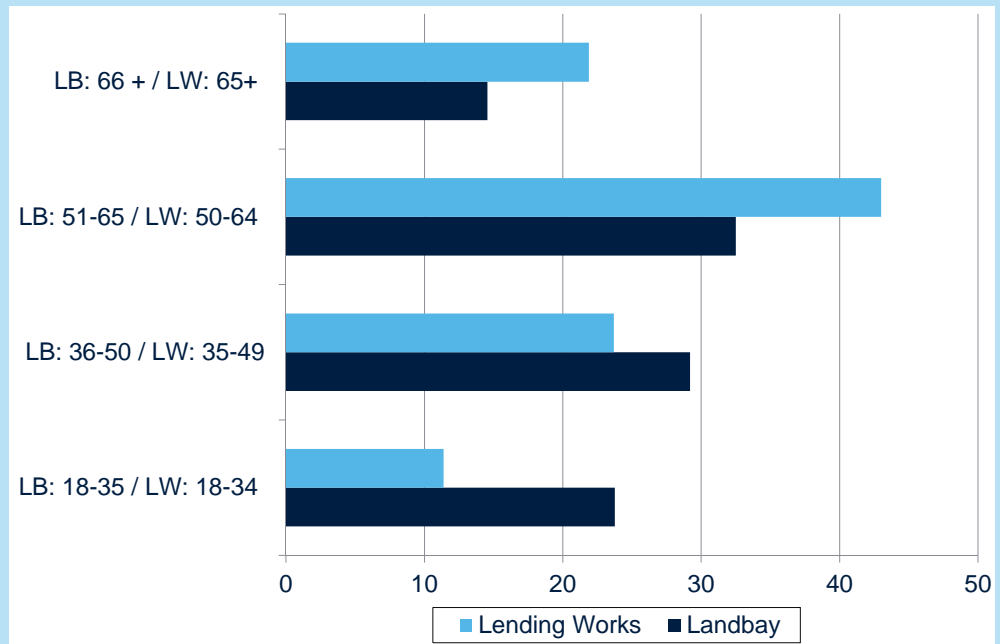
Age of investors in P2P lending



Source: Nesta.

Evidence from the P2PFA members shows a similar pattern. The figure below presents the proportions of Landbay and Lending Works investors by age band. Approximately 47% of Landbay investors are above 50, and 65% of Lending Works investors are above 49. Conversely, 11% (Lending Works) to 24% (Landbay) of investors are between 18 and 34/35. Data available for RateSetter shows that 61% of RateSetter investors are above 44, with a particularly large proportion (24%) falling into the age bracket 55–64.

Proportions of Landbay and Lending Works investors by age band



Note: Figures for Landbay and Lending Works are based on an estimation of the profile of current investors.

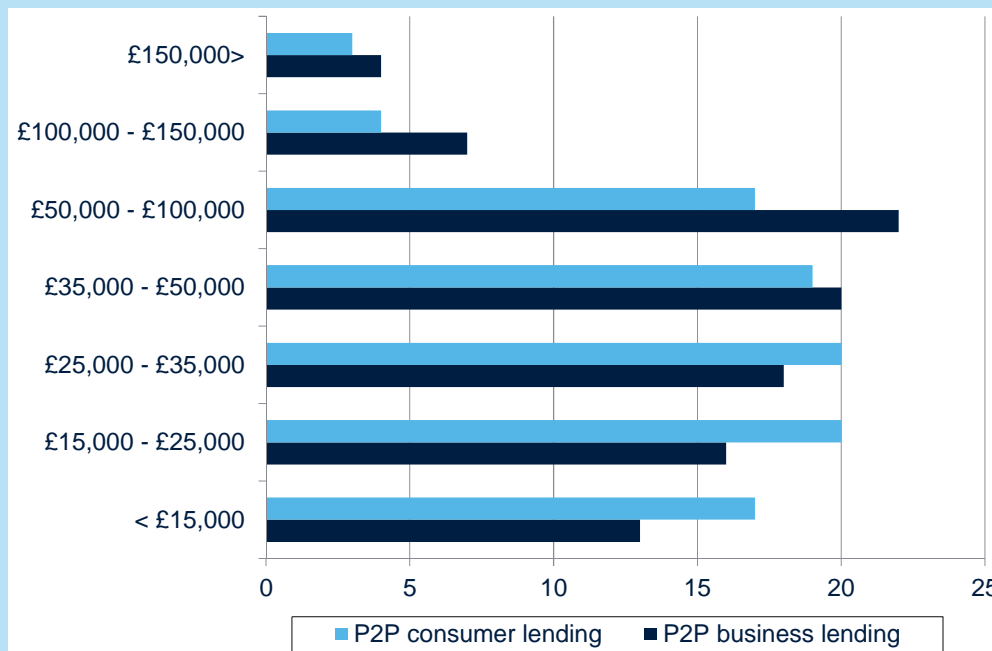
Source: P2PFA members.

Regarding gender, both RateSetter and Lending Works consider that one-third of their investor base is female and two-thirds is male. This is also consistent with the results of the

Nesta survey, which highlights that a greater proportion of males tends to use this form of finance compared to females.

On annual income, about two-thirds of P2P lending investors from the Nesta study reported having an annual income above £25,000, as illustrated in the figure below.

Annual income of investors in P2P lending



Source: Nesta.

In terms of total investor savings and investment levels, a survey of retail investors run by Funding Circle found that investors on the platform had an average of £115,000 in savings and investment across a number of products (bank/building society, shares, P2P lending, investment trusts and bonds). Of this, only 21% was invested in P2P loans. Funding Circle investors were also likely to spend a significant amount of time looking after their investment portfolio, with more than 60% of investors spending over ten minutes a week on this task and 25% spending over an hour a week.

Source: Nesta, P2PFA members.

5.2 Investor understanding: information provided by platforms

P2P lending platform websites inform potential investors about product features, fees, risks and risk management. Platforms have employed various methods to ensure that information is accessible to different customer groups. These include hosting a separate webpage dedicated to these topics, producing dedicated disclosure documents, and other methods such as producing explanatory videos.

Platforms have adjusted the way that information is provided in response to evidence on consumer understanding. For instance, in a recent survey by RateSetter,⁸³ the extent to which investors were able to understand various phrases with regard to risk were explored. The term ‘Your capital is at risk’ was found to be most easily understood by investors (94% of RateSetter investors and 69% of the general public). Other phrases considered were ‘Repayment is not 100% guaranteed’, ‘Return on your investment is not guaranteed’, ‘You might get back less money than you put in’, ‘Past performance is not a

⁸³ 2016 survey involving online interviews with a nationally representative sample of 2,113 members of the public and 1,104 RateSetter investors.

guarantee for future success', and 'Your money is not protected by the Financial Services Compensation Scheme (FSCS)'.

As an illustration of the types and volume of information made available by P2P lending platforms, the P2PFA requires members to adhere to a number of operating principles, which include making available certain types of information. This includes information to investors and prospective investors on processes and risk as well as historical loan performance. A similar amount of information is therefore provided to that required for other investment forms. In particular, there is very high transparency of default data giving a significant level of detail on past performance.

A full description of the P2PFA's requirements is provided in Box 5.3. In addition, some citations from the websites of P2PFA members, which give further details on the information provided by individual platforms on risks and risk management, are provided in Appendix A2.

Box 5.3 Information requirements of P2PFA Operating Principles

P2PFA members are required to provide the following information to investors and prospective investors, as listed under point 7 of the P2PFA's Operating Principles:

- expected returns net of fees and defaults and the circumstance under which this rate is achievable;
- details of any fees and charges that may be payable;
- a clear warning that capital is at risk and that there is no FSCS cover;
- where lender money will be lent in general terms (e.g consumer loans, SME loans, property loans, UK/non UK loans, or if mixed how the loan book is constituted);
- how money is treated after a lender transfers it to the platform;
- how any 'automatic' function works such as 'auto-lend/auto-bid/auto-reinvest';
- the typical time taken to lend out money and the ease and process for withdrawing money;
- the operation of any 'provision fund' and the risks involved;
- the proportion of individual consumer funds deployed in the loan book (i.e money that's not from institutions or platform's own money);
- an overview of the checks the platform performs on borrowers and a clear explanation of how risk rates are calculated;
- any conflict of interest in any of the loans and how conflicts of interest are managed;
- any minimum level of investment and whether non UK lenders are accepted; and
- the applicable tax treatment.

In addition, the P2PFA requires members to publish the following information on historical loan performance:

- annual summaries of bad debt rates (Actual arrears >45 days; Actual lifetime default rate; Expected lifetime default rate; Projected lifetime default rate; Realised %; Actual bad debt fund usage);
- annual summaries of returns performance (Amount lent; Actual annual return to date of loans in original year, after fees and bad debts; Estimated annual return at origination, after fees and bad debts; Realised %);
- for platforms with a fund to cover bad debt, also: Actual investor return to date, after fees and bad debt fund compensation; Bad debt fund usage;

- full loan book data.

Members are also required to make publicly available:

- details of the full complaints procedure;
- details of the senior management team;
- the legal form of the business, location of head office and date of launch;
- details of the arrangements in place in case of business failure; and
- any material changes to their business which impacts customers.

Source: P2PFA, 'Peer-to-Peer Finance Association Operating Principles', <http://p2pfa.info/wp-content/uploads/2016/06/Operating-Principals-vupdate2016.pdf>.

5.3 Survey evidence on investor understanding

Investors' understanding of P2P lending has also been explored in a number of surveys among users (retail investors) of P2P lending platforms and the general population, commissioned both by the platforms themselves⁸⁴ and by other researchers.⁸⁵ There is some variation in survey results, but the key findings of these surveys (as explored further below) include the following:

- investors generally perceive P2P lending to be a risky investment, broadly in line with corporate bonds, and suitable only for longer-term savings;
- most investors appear to understand that liquidity is required to be able to exit P2P investments early through secondary markets;
- however, investor understanding of some areas, such as the FSCS and Innovative Finance ISAs, does appear to be limited.

Evidence from investor surveys suggests that investors generally perceive P2P lending to be a risky investment. For example, results from a Zopa survey⁸⁶ suggest that 100% of its investors understand that they are exposed to credit losses. The RateSetter survey similarly found that 'a borrower defaulting on their payment' was highlighted by the highest number of respondents as one of the main risks in investing in P2P lending accounts (despite individual borrower default being covered by the buffer fund in 'normal' conditions in the case of RateSetter), with 60% of the general population indicating this as one of the main risks.⁸⁷

In terms of risks compared to alternative investments, the RateSetter survey found that its investors think that P2P lending is significantly more risky than saving in a bank deposit account or cash ISA, more risky than investing in bonds, and at a similar level of risk to investing in property (e.g. buy to let).

⁸⁴ P2P lending platforms frequently survey existing and potential investors to ensure that there is a high understanding of their products. For instance, Zopa currently conduct monthly face-to-face user testing sessions, sampling 12 investors; monthly online user tests, sampling between 5 and 30 investors; monthly NPS surveys, sampling approximately 2,000 investors; and additional ad hoc surveys where required. Similarly, Lending Works notes that it receives frequent feedback from investors via its customer service function; regular Net Promoter Score surveys to assess customer opinions; infrequent 'all customer' surveys; and a 'Hero lenders' group of around 50 investors with whom it engages regularly in relation to product improvements, research of trends and changes in the market, and drivers of behaviour.

⁸⁵ For a review of the existing literature, see Oxera (2015), 'Crowdfunding from an investor perspective', prepared for the European Commission Financial Services User Group.

⁸⁶ 2016 survey of 158 investors.

⁸⁷ Other risks identified by the general population as 'main risks' included 'The peer to peer provider going out of business' (59%), 'Investment not being covered by the Financial Services Compensation Scheme (FSCS)' (58%), 'Peer to peer lenders are too small/too new to cope with tougher economic conditions' (32%), 'Your peer to peer account being hacked into' (21%) and 'Other' (1%).

Investors thought that P2P lending was less risky than investing in foreign exchange markets, commodities, stocks and shares, fundraising platforms or stocks and shares ISAs. This pattern was in the main also mirrored by respondents from the general population.⁸⁸

A similar result was found in a survey of the general population undertaken by Deloitte.⁸⁹ Of those respondents who were aware of P2P lenders, only 10% thought P2P lenders were less risky than a savings account and only 9% thought they were less risky than government bonds.

To complement the results above, a Nesta survey⁹⁰ found that, in people's budgeting for lending through P2P lending platforms, money was sourced mainly from the pots of money used for investments (54–57%) or savings (45–64%), with very little sourced from money people would otherwise use for day-to-day spending (2–3%). People are therefore correctly interpreting P2P lending as playing a role somewhere between savings and investments, rather than as a current account or instant-access savings account.

Evidence from surveys also suggests that most investors appreciate key points around liquidity. For instance, surveys commissioned by platforms indicate that a clear majority of investors understand that the use of the secondary market requires liquidity.⁹¹

Survey evidence does show that there is some confusion about the role of features such as the FSCS. Although investors in P2P platforms are likely to understand that they are not covered by the FSCS, they do not necessarily correctly interpret what this means. For instance, the results from the Zopa survey suggest that 96% of its investors understand that they are not covered by the FSCS. However, the RateSetter survey of the general population found that 16% of people thought that the FSCS protected investors against the capital risk of their investments, rather than just money held as a deposit with P2P platforms while waiting to be invested.

Understanding around Innovative Finance ISAs remains particularly low, although this is likely to be related to their very recent introduction. For instance, a RateSetter survey found that only 58% of its investors thought that they would probably or definitely be able to explain the term 'Innovative Finance ISA' to a friend. Among the general population this proportion was even lower, at 13%. Education around this new feature will therefore be important to ensure that investors properly understand the risks involved.

5.4 Indicators of investor behaviour

Observed behaviours also indicate that investors generally understand the characteristics of P2P lending, in particular in relation to the level of risk, liquidity, and the importance of diversification. Furthermore, the level of complaints is relatively low, which also suggests that investors have a sufficient level of understanding of P2P lending.

⁸⁸ The two exceptions were stocks and shares ISAs and investing in property (e.g. buy to let), both of which the general population thought were less risky than P2P lending.

⁸⁹ 2016 YouGov survey of a sample of 2,090 nationally representative adults. Subsample of 1,168 for those aware of P2P lenders.

⁹⁰ Nesta (2014), 'Understanding alternative finance', November, <https://www.nesta.org.uk/sites/default/files/understanding-alternative-finance-2014.pdf>.

⁹¹ There is some variation between surveys, with one survey suggesting that 99% of the platform's investors understood that liquidity was required, while another survey for a different platform suggested that 77% understood this requirement.

5.4.1 Return risk

With most financial securities, investors' perceptions of risk are judged from the gross returns that the investors demand, relative to a 'risk-free' rate of return. So, for example, the margin between the yield of a (risky) corporate bond and that of a ('riskless'⁹²) government bond provides an indication of the perceived risk of the former.

From this perspective, retail investors appear to consider most P2P lending opportunities to be relatively risky, based on the significant margin of gross returns relative to riskless returns, as indicated in section 3.2.1. In addition, the fact that *institutional* investors see P2P lending as an attractive proposition based on the interest rates offered indicates that *retail* investors are not underestimating the risk involved.

5.4.2 Liquidity risk

The low use of the secondary markets provided by P2P platforms, as shown in Table 4.5, is consistent with the theory that retail investors understand the long-term nature of P2P investments. As discussed in section 4.5, retail investors appear to be using P2P investments in a similar way to other long-term investment options, consistent with a comparable level of consumer understanding on product term lengths.

The low use of the secondary market is also likely to be an indicator that investors understand the fees involved in exiting investments early. A case study of Zopa, which offers products both with and without a secondary market fee,⁹³ indicates that investors are correctly factoring secondary market fees into their investment decisions. Zopa offers a 'Zopa Access' product, with a secondary market fee of 0%, and a 'Zopa Classic' product, with a secondary market fee of 1%. It finds that investors in the Access product use the secondary market more than those invested in the Classic product.

5.4.3 Diversification

The use of auto-allocation tools at platforms, as set out in Table 4.1, indicates that investors are aware of the benefits of diversifying their portfolio. In particular, for LendInvest, Funding Circle and MarketInvoice, where investors can opt in to using auto-allocation, 15%, 50% and 75% of investors do so respectively. In addition, investors who do not use auto-allocation still generally choose to spread their investments over a number of loans. For instance, most retail investors at ThinCats have between 5 and 15 loan parts. This indicates that investors are aware of the benefits of diversification from spreading their money over more than one loan, and are acting on this accordingly.

5.4.4 Complaints

Data on the number of complaints regarding P2P lending is limited in availability, as the Financial Ombudsman Services (FOS) do not provide separate figures for P2P lending in their annual review of complaints data.⁹⁴ Data collected directly from the platforms, regarding the number of complaints received by the platforms, indicates that the total number of complaints from both borrowers and

⁹² Government debt is not riskless, and may face inflation risk even if the risk of the government defaulting is very low, but it is commonly treated as the 'riskless' benchmark.

⁹³ For all products, Zopa customers would still be subject to a charge if interest rates had increased since their loans were originally made, so the loans held were worth less than on the open market.

⁹⁴ Financial Ombudsman Service (2016), 'Annual review of consumer complaints about...insurance, credit, banking, savings, investments', <http://www.financial-ombudsman.org.uk/publications/annual-review-2016/types-of-problems.html#C1>.

investors received by the platforms was no more than a thousand or so in the past year.⁹⁵ While P2P lending is relatively small, the number of complaints related to P2P lending do not point to possible issues regarding consumer satisfaction.

Ensuring that investors have a good understanding of P2P lending is a key ongoing challenge for the sector, and the driver for the provision of clear and effective information by platforms. Existing survey evidence and investor behaviours suggest that the current investor base does have a broadly appropriate understanding of risk and liquidity, although this is less the case in terms of some of the specific mechanisms (e.g. the FSCS and Innovative Finance ISAs). The key challenge going forward will be to ensure that new investors, perhaps including new investors drawn in by Innovative Finance ISAs, continue to have appropriate understanding. This issue is explored further in section 6.4.

⁹⁵ The number of complaints received by financial companies can be expected to be greater than the related number of complaints received by the FOS. The FOS received a total of 340,899 complaints in 2015/16, of which some 106,327 regarded banking and 14,576 regarded investments.

6 Regulatory review

When the FCA introduced the current P2P regulation in April 2014, it faced the challenge of finding the right balance between protecting consumers and allowing for innovation. The FCA enacted its new outcomes-based approach to regulation, which also provides the context for the forthcoming FCA post-implementation review—to see if the right balance was achieved.

This section considers the appropriate regulatory framework for P2P lending, including:

- the appropriate **framework for assessing the need for financial regulation** of P2P lending (section 6.1);
- the **current regulatory regime** and the rationale for its development (section 6.2);
- an **assessment of potential ‘market failures’**, based on the key issues raised by the FCA and other commentators, and whether there is a case for additional regulation (section 6.3) to ensure that the FCA can meet its statutory objectives;
- initial thoughts on the **development of the regulatory regime** going forward, to ensure that it is best placed to ensure continued good outcomes from the P2P lending sector.

Box 6.1 Key findings

The evidence in this study supports the view that the current regime is well targeted and proportionate. There is little to indicate significant market failures that would require new regulation to be put in place. Effective supervision is, of course, required to ensure compliance with the current regulation by all platforms.

Although the existing regulatory regime already contains the main elements of regulation that would be required from an economics perspective, this does not mean that there is no need to further develop it. When business models and practices continue to develop and the market continues to grow, the regulatory regime may have to evolve as well. Potential areas for consideration include:

- ensuring continued effective communication with investors, particularly if new types of investor are attracted to P2P lending;
- ensuring appropriate credit risk management across all platforms; and
- implementing additional standards of business conduct; The P2PFA has developed a number of standards and practices some of which could be incorporated into the existing FCA regulatory framework so that they can be applied to all platforms; These are in relation to on loan book run down plans and transparency, equal treatment of different investor types and a regulatory prohibition of maturity transformation.

Source: Oxera.

6.1 Framework for assessing the need for financial regulation

Effective financial regulation delivers benefits in the form of improvements in market outcomes. Financial regulators can therefore identify the requirements for financial regulation on the basis of addressing concerns with the functioning

of markets (referred to as addressing 'market failures'), and thereby delivering benefits to users of financial services and the wider economy.⁹⁶

The FCA has adopted this approach to help it meet its statutory objectives. Specifically, the FCA states that:⁹⁷

Our strategic objective is to ensure that the relevant markets work well. To advance our strategic objective we have three operational objectives. These are to secure an appropriate degree of protection for consumers, to protect and enhance the integrity of the UK financial system, and to promote effective competition in the interests of consumers.

The FCA explains that to achieve these objectives there is a need for 'in-depth analysis of outcomes at the level of the market, as well as of the drivers of poor market outcomes and what can be done about them'.⁹⁸ Effective regulation is considered to require three key stages.⁹⁹

- **Stage 1: problem diagnosis**, to develop an understanding of how the market works and build an overview of the drivers of poor outcomes resulting from the interaction of different underlying market imperfections.
- **Stage 2: design of interventions** that are closely linked to identified problems and may require a combination of complementary measures where multiple underlying imperfections are causing a market not to work well.
- **Stage 3: impact assessment**, which considers how the preferred intervention will change how market participants interact with each other and how these changes in behaviour will deliver improvements in outcomes (and measures these effects to the extent reasonably practicable in the circumstances).

There is a wide array of potential market failures, including misaligned incentives of firms, consumers failing to act in their own best interests, poor competitive dynamics, and regulatory failures. Almost all financial services firms are subject to some sort of regulation to address potential issues, although major elements of regulation do vary by types of activity or types of institution. For example, banks must meet stringent capital requirements, whereas capital requirements for asset managers are much lighter, as for the latter they only need to ensure protection of client money and address operational risks, as opposed to guaranteeing deposits. There are also multiple elements to the regulatory approach, not just in terms of the rules set by regulation, but also through authorisation and supervision, to ensure compliance with the rules as well as ongoing conduct risk management.

In the context of regulating P2P lending, this approach to regulation emphasises the need to:

⁹⁶ See: Financial Conduct Authority (2016), 'Occasional Paper 13: Economics for Effective Regulation', <https://www.fca.org.uk/news/occasional-paper-no-13>; Oxera (2006), 'A framework for assessing the benefits of financial regulation', September, <http://www.oxera.com/Oxera/media/Oxera/Framework-for-assessing-benefits-of-financial-regulation.pdf?ext=.pdf>. See also the recent literature on behavioural economics, including: Financial Conduct Authority (2013) 'Occasional paper no.1: Applying behavioural economics at the Financial Conduct Authority', April; Oxera (2013), 'Behavioural Economics and its Impact on Competition Policy: A Practical Assessment with Illustrative Examples from Financial Services', May, undertaken for the Netherlands Authority for Consumers and Markets (ACM).

⁹⁷ See Financial Conduct Authority (2015), 'The FCA's approach to advancing its objectives', <https://www.fca.org.uk/your-fca/documents/approach-to-advancing-its-objectives>, para. 1.2.

⁹⁸ See Financial Conduct Authority (2016), 'Occasional Paper 13: Economics for Effective Regulation', <https://www.fca.org.uk/news/occasional-paper-no-13>, p. 3.

⁹⁹ See Financial Conduct Authority (2016), 'Occasional Paper 13: Economics for Effective Regulation', <https://www.fca.org.uk/news/occasional-paper-no-13>, p. 3.

- explore how the P2P market works in order to assess whether there might be potential market failures that could lead to poor outcomes;
- assess the evidence on how the P2P market works, based on the behaviour of platforms, investors and borrowers, in order to assess whether the potential market failures are resulting in, or could result in, poor market outcomes;
- identify potential interventions that could address the potential causes of poor market outcomes;
- assess the potential impact of these interventions to ensure that they are well placed to deliver improvements in outcomes.

This section draws on the evidence presented in this report to assess the first two bullet points above, starting with an overview of the current P2P regulatory framework and then assessing potential market failures and whether there is a need for additional interventions.

6.2 Current regulatory regime

The FCA introduced rules for ‘loan-based crowdfunding platforms’ in April 2014. Box 6.1 provides a summary of the key elements of the regulatory framework for P2P lending. P2P lending became subject to all of the main elements of regulation that other types of financial intermediary are subject to, including with regard to client money, minimum capital standards, money laundering, ‘living wills’ and other requirements. The FCA explained that in the case of P2P lending, it focused in particular on ensuring that investors have access to clear, fair and balanced information and the application of core consumer protection requirements.¹⁰⁰ In doing so, P2P platforms must meet a wide range of elements of the FCA Handbook, including, if they lend to consumers, the Consumer Credit Sourcebook (CONC).

P2P lending was a new form of financial intermediation that required its own regulatory regime fitting the nature of the P2P Agreement. The regulation includes the relevant elements of regulation for long-term investing and the provision of loans (particularly to consumers), but differs from that of banks as it is a different business model (and notably does not guarantee deposits).

Box 6.2 Key elements of the regulatory framework for P2P lending

P2P lending is regulated by the FCA as the regulated activity of ‘**operating an electronic platform in relation to lending**’, which was introduced in 2014 to the Financial Services and Markets Act 2001. The activity applies only to loans where either: the lender is an individual; or the borrower is an individual and either: (a) the loan is £25,000 or less; or (b) the individual is not borrowing for business reasons. As most P2P platforms target individual lenders, the status of the borrower does not affect the requirement for the platform to be authorised, although additional rules relate to consumer credit.

All of the main elements of the FCA Handbook apply to P2P lending in some form. This includes:

- Principles for Businesses (PRIN)—the fundamentals that the FCA expects all regulated firms to meet;

¹⁰⁰ As described in FCA (2015), ‘A review of the regulatory regime for crowdfunding and the promotion of non-readily realisable securities by other media’, February, <https://www.fca.org.uk/static/documents/crowdfunding-review.pdf>.

- Threshold Conditions (COND) —minimum conditions that all firms must meet if they wish to be authorised;
- General Provisions (GEN)—the standards that apply to all firms in terms of their interaction with the FCA, including statutory disclosure statements and use of the FCA name or logo;
- Senior Management Arrangements, Systems and Controls (SYSC)—how the FCA expects senior management in firms to take responsibility for the running and oversight of their firm, as well as the systems, controls and compliance arrangements that should be in place;
- Statements of Principle and Code of Practice for Approved Persons (APER) —the standards that the FCA requires of individuals who hold ‘controlled functions’ in a firm;
- the Fit and Proper Test for Approved Persons (FIT)—the criteria for assessing the fitness and propriety of a candidate for a controlled function;
- Fees Manual (FEES)—providing details around firms’ liabilities to pay fees;
- The Disputes Resolution Sourcebook (DISP)—the detailed requirements for handling consumer complaints against firms and the Financial Ombudsman Service arrangements;
- Client Assets Sourcebook (CASS)—rules on holding a customer’s money (client money rules);
- Prudential requirements (GENPRU/IFPRU)—as relevant to P2P lending;
- Financial Crime: a guide for firms (FC)—how firms can prevent financial crime;
- Consumer Credit Sourcebook (CONC)—the FCA’s rules and guidance on consumer credit (borrower-related);
- Conduct of Business Sourcebook (COBS)—the FCA’s rules and guidance on firms carrying out a ‘designated investment business’, the definition of which includes operating a P2P lending platform (lender-related).

The capital of investments made via P2P platforms is **not covered by the FSCS**. Platforms disclose this lack of coverage and its consequences to potential investors. Client money is effectively covered by the FSCS, as it should be held in FSCS-covered deposit accounts with banks.

P2P lending is subject to the **Consumer Credit Sourcebook (CONC)** when lending to individuals. The CONC requires that, with regard to its relations with borrowers, the P2P platform must provide adequate information to the borrower with regard to the suitability of the loan, the loan payments, and the potential consequences of failing to meet the payments. Also, before a P2P agreement is made, the platform must undertake a creditworthiness assessment of the borrower. The assessment must be based on information from the borrower, and a credit reference agency where necessary. If a loan is in arrears, the platform must contact the borrower, stating the amount of the loan shortfall and encouraging them to discuss the state of their account with the platform.

P2P platforms are required to **seek authorisation from the FCA**. To receive FCA authorisation, the platform must have an operational or close to operational website and adequate financial resources. The platform needs to have minimum capital requirements and a resolution plan in place in case it fails. The minimum capital requirement is currently £20,000, but from 1 April 2017 this will increase to the higher of either £50,000 or a percentage of loaned funds. The resolution plans are put in place in the event of platform failure such that loan repayments will continue to be collected and the loan will be managed until maturity.

Promotions of the product must be fair and clear. This is particularly applicable to comparisons of a P2P loan with a regular savings product. Information must be clearly presented so that it can be easily understood by investors to ensure they can make informed investment decisions. Furthermore, platforms must not play down risks or warnings.

Innovative Finance or P2P ISAs were launched in April 2016. They allow investors to put a tax-free wrapper on their P2P investments, which means that they will not pay tax on the interest they earn. It is set up as a third type of ISA (not a cash or stocks and shares ISA) and

investors will have to choose how to apportion their annual ISA allowance between the three options. Equity-based investments are not covered by the Innovative Finance ISA.

Innovative Finance ISAs are expected to become a more common offering across P2P platforms soon, pending authorisation from the FCA. Investors will be able to set up an Innovative Finance ISA with individual platforms.

Source: Oxera.

6.3 Assessment of potential market failures

There has been an ongoing debate about the development of P2P lending and the appropriate regulatory framework. Potential questions have been raised, notably by Andrew Tyrie MP, Chairman of the Treasury Committee,¹⁰¹ and by the FCA in its call for input to the post-implementation review.¹⁰² These questions include the following.

- Do platforms have sufficient incentives to conduct effective credit risk assessments?
- Do investors understand that P2P lending is an investment with capital and liquidity risk, and not a savings deposit account?
- Is P2P lending an appropriate investment for retail investors?
- Is P2P lending distinct from collective investment schemes?
- Are any investor groups put at a disadvantage relative to other investor groups?
- Are there any distortions to competition in lending markets?
- Would P2P lending platforms be resilient to a sharp downturn in credit market conditions?
- What would happen in a worst-case scenario in which a platform went bust?
- Is there a risk of P2P lending interest rates moving to inappropriate levels?
- Does P2P lending create any risks for financial market stability?

These questions are considered in turn below.

6.3.1 Do platforms have sufficient incentives to conduct effective credit risk assessments?

Some have expressed concern that P2P lending platforms may not be properly incentivised to conduct effective credit risk assessments of borrowers, as they are not lending their own money.¹⁰³ In addition, there is a concern that investors are unable to determine whether the credit risk models that are in place are

¹⁰¹ Commons Select Committee (2016) 'Treasury Committee asks about risks and opportunities of P2P', <http://www.parliament.uk/business/committees/committees-a-z/commons-select/treasury-committee/news-parliament-2015/p2p-lending-chairs-statement-16-17>.

¹⁰² Financial Conduct Authority (2016), 'Call for input to the post-implementation review of the FCA's crowdfunding rules', July, <https://www.fca.org.uk/news/call-input-post-implementation-review-crowdfunding-rules>.

¹⁰³ In February 2016, Lord Adair Turner, former chairman of the FSA (now FCA) voiced concerns over the P2P lending industry, in particular with regard to credit risk assessment. He stated: 'You cannot lend money to small and medium enterprises in particular without somebody going and doing good credit underwriting.' See *Financial Times* (2016), 'City grandee Lord Turner warns on peer-to-peer lending risks', 10 February.

effective, due to (most of) the platforms having been in operation only in relatively benign economic environments (i.e. post the 2008–09 recession).

The analysis and evidence in this report suggest that platforms are incentivised to conduct effective credit risk assessments; that they use industry best practice in terms of credit assessments; and that the outcomes are consistent with those of other lenders. Conducting effective credit risk assessments has become a core function of the P2P lending business models examined in this report. The evidence is as follows.

- The success of P2P platforms depends on them delivering strong net returns to a relatively risk-averse investor base. There is a relatively rapid feedback loop from increasing default losses to loss of reputation, due to the transparency of default data (see section 5.1). This gives platforms incentives to continue to conduct appropriate credit risk assessments.
- P2P platforms are directly affected by the effectiveness of their credit risk assessments, even though they typically do not invest in the loans directly (see Box 6.3 below on the debate about ‘skin in the game’). Borrower default results in the loss of ongoing fees that make up a significant proportion of the income of platforms (see section 4.1).¹⁰⁴ Again, this gives platforms incentives to conduct appropriate credit risk assessments.
- Due to the competitive nature of the lending market, and the fact that traditional lenders already have sophisticated credit score models, a P2P lending business would simply not survive in this market without conducting effective credit risk assessments. Indeed, platforms that did not develop effective credit risk assessments have failed relatively quickly and while still at small scale (see section 4.5). As with asset managers, P2P platforms rely on demonstrating to investors that they offer sound investments, not just matching investors with borrowers, but matching them with borrowers who are creditworthy and paying risk-reflective interest rates. This highlights the importance of platforms providing timely and comparable information on actual and expected future default rates, which is part of the P2PFA Operating Principles. This is especially important in times of less benign credit market conditions, when default rates rise.¹⁰⁵
- The evidence indicates that P2PFA members use industry-leading approaches to credit risk assessments, with competent risk teams, including personnel with relevant banking experience, and the use of appropriate data, such as that from credit reference agencies (see section 4.1).
- The observed outcomes are consistent with those from other lenders. P2P platforms offer competitive rates, but they are consistent with other lenders and do not systematically out-perform (see section 3.1). Default rates are broadly consistent with those of other lenders, and are in line with the expected default rates presented by the platforms themselves at the time of loan origination (see section 4.1). There is little to suggest that rates would not continue to follow similar trends to those of other lenders through the economic cycle, as similar procedures are in place (see sections 4.1 and 4.2) and typical increases in default rates during recessions do not suggest that the P2P lending model would fail. In other words, this evidence does not

¹⁰⁴ Ongoing fees are no longer available if a loan defaults.

¹⁰⁵ For example, see the analysis of Zopa in section 4.1, which was the only P2PFA platform to have been operating during the 2008–09 recession.

suggest that the P2P lending business models would be unsustainable in a recessionary environment.

- It is also worth noting that P2P lenders originally targeted mainly retail investors in the UK. The fact that a number of mainstream institutional investors are now also attracted to P2P lending, having undertaken significant due diligence, suggests that their assessments of the credit risk models used by platforms (and therefore the inherent risk) are favourable.

Box 6.3 The debate on the importance of 'skin in the game'

Comments have been made about P2P lenders not having 'skin in the game', in the sense that they do not invest their own capital into the loans that they arrange. As explained in section 6.3.1, this does not mean that platforms are not directly adversely affected by default losses, due to the impact on fee income and reputation. But it is worth reflecting on where the 'skin in the game' debate comes from, and how the situation with P2P lending differs from these origins.

The 'skin in the game' concept was used in the debate about securitisation post the financial crisis. Before the crisis, banks were able to package up loan portfolios and sell them on to investors without have a direct exposure, and this is seen to have resulted in poor credit assessments.¹ Since then, regulation has required banks to have an exposure to asset-backed securities that they issue in order to ensure 'skin in the game'. For example, Article 394 of the Capital Requirements Directive (CRD) provides that a European credit institution will suffer a punitive capital charge if it invests in a securitisation transaction in which the originator, sponsor or original lender does not hold a minimum of 5% of the net economic exposure of the transaction.

The key difference with P2P lending is that, before the crisis, the originating banks perceived (at least) that they were not exposed to default losses of the underlying loans after issue. P2P lenders are, however, exposed to default losses, as explained in section 6.3.1. With ongoing fees representing around a third to over a half of the revenues of the different P2PFA members, it would seem very likely that these fees, and therefore default risk, would directly influence the platforms financially.

Note: ¹ For a summary of the debate about 'skin in the game' and the financial crisis, see Federal Reserve Board (2010), 'Mortgage-Backed Securities: How Important Is "Skin in the Game"?', *Economic Letters*, 13 December, <http://www.frbsf.org/economic-research/publications/economic-letter/2010/december/mortgage-backed-securities/>.

Source: Oxera.

This suggests that P2P platforms do have appropriate incentives to conduct credit risk assessments. However, there could still be, in principle at least, a risk that a platform facing difficulties could be encouraged to delve 'deeper into the market' (in the sense of accepting lower-quality loans at higher interest rates) in order to boost loan origination revenues. This risk is very much limited by transparency on default losses and the types of loans being made, which underlines the importance of effective communication. If a platform were to relax its credit risk assessment to bring in riskier loans, the resultant gross interest rates and default rates would soon be apparent to investors, warning them of increasing risk. There is a clear need for standards on credit risk assessments to be met by platforms in order to avoid this sort of short-term misconduct risk.

Consequently, there is a need for supervisors to consider whether platforms are managing credit risk appropriately as part of their ongoing supervision of the sector, and for proper regulatory diligence on this and as part of the authorisation process for new platforms. There does not, however, appear to be an issue here of misaligned incentives that would require further regulatory interventions to change the way the market operates.

6.3.2 Do investors understand that P2P lending is an investment with capital and liquidity risk, and not a savings deposit account?

The FCA has noted concern that the development of P2P platform products with buffer funds and ‘notice periods’ (after which the fee for using the secondary market to exit the investment is waived) could create the risk that P2P lending would be confused with deposit accounts offered by banks.¹⁰⁶ The FCA, and indeed the P2PFA, are clear that P2P lending is an investment product and that investors must be clear on the implications of that in terms of risk and liquidity.

The evidence examined in this study suggests 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. Platforms are developing best practice to ensure that confusion over product features does not arise with regard to risk and liquidity. In particular:

- survey evidence suggests that investors classify P2P lending as being relatively high-risk, potentially in line with equity investments (see section 5.3), which, if anything, could suggest that they overestimate the risk involved in P2P lending. The number of households that invest in P2P lending is still relatively small, in spite of the fact that platforms have achieved relatively high net returns so far (see section 5.2), which may also suggest that many households are considering P2P lending to be very risky;
- investors tend to hold P2P investments to maturity, which matches their behaviour with other long-term investments, rather than behaviour with (instant access) deposit accounts (see section 5.2). For example, the use of secondary markets, where investors can sell existing P2P loans, is limited to less than a quarter of the value of the loan book per annum (and much less in a number of cases), which is broadly in line with how investors hold other long-term assets such as bonds;
- platforms have changed the design and presentation of products to help avoid possible misperceptions about the liquidity of investments. This is particularly to avoid misperceptions about maturity transformation that could arise from offering access after certain time periods (which differ from the actual maturity of the underlying loans) (see section 5.1).

The evidence therefore does not suggest that P2P platforms benefit from some form of regulatory arbitrage with banks.¹⁰⁷ There would potentially be regulatory arbitrage if retail investors preferred P2P lending over savings accounts simply because they were attracted by the higher returns and did not appreciate the different risk profile of P2P lending. The evidence does not suggest that this is currently the case, although it will be important to ensure that this remains the case going forward if new investors are drawn to P2P lending. This is discussed in section 6.4.

6.3.3 Is P2P lending an appropriate investment for retail investors?

Some commentators have expressed concern about the degree of risk involved with P2P lending, suggesting that this degree of risk is not appropriate for retail investors. This includes not just the risk–return trade-off, but also liquidity risk

¹⁰⁶ See Financial Conduct Authority (2016), ‘Call for input to the post-implementation review of the FCA’s crowdfunding rules’, July, <https://www.fca.org.uk/news/call-input-post-implementation-review-crowdfunding-rules>, paras 2.6 to 2.12.

¹⁰⁷ This is Q1 of the FCA questions in the call for input.

and whether the investment is excessively complex in nature. This issue of appropriateness is, of course, critical in determining the regulatory approach.

The evidence suggests that the underlying risk characteristics of P2P lending are comparable to those of other retail investment asset classes. Although relatively new, the characteristics of P2P lending are not inherently more risky, complicated or illiquid than those of bonds and equities that investors already have access to. In particular:

- the risk profile of P2P loan portfolios appears to be comparable to those of other lenders (including banks), which suggests that the inherent cash flow risk is no different from investing in the equities and bonds of such a lender, which is not treated as a complex or high-risk investment (section 3);
- diversified portfolios of loans are typically only correlated to one another through macroeconomic conditions, as long as there is a good spread of loans across sectors (in the case of business loans) and regions (see discussion in sections 3 and 4). Platforms provide information on this diversification on their websites (see section 5). The approach is similar to that of most diversified equity/bond investment funds;
- platforms manage interest rates to help ensure that direct lending is appropriately priced to reflect risk (see section 4.1).

In addition to the risk characteristics of the underlying asset, there is risk associated with the relevant intermediary. In the case of a retail investment into an equity fund, for example, there will typically be an investment platform (often in conjunction with a financial adviser) and an asset manager involved. In the case of P2P lending, the P2P platform is the intermediary. P2P platforms operate under broadly similar regulation to the equity fund intermediaries with regard to client money, resolution plans and complaints handling, for example. Although P2P platforms are not directly covered by the FSCS, it should be noted that the requirement to hold client money in an FSCS-regulated deposit account does mean that client money can be expected to be covered by the FSCS, as it is with investments in equity funds. Only in cases where the platform has failed to put client money into the appropriate segregated account, and there are insufficient funds available to compensate investors,¹⁰⁸ is there additional risk for the investor.

6.3.4 Is P2P lending distinct from collective investment schemes?

The FCA has questioned whether recent developments in P2P lending, particularly with the development of buffer funds, have blurred the lines between P2P lending and collective investment schemes. While there are some important legal aspects to this question,¹⁰⁹ there is an economic question about whether investors understand the nature of P2P lending relative to other investment opportunities, and whether regulation of P2P lending results in significantly different outcomes than would be the case with collective investment schemes.

¹⁰⁸ In a platform failure situation, it is understood that client money would have seniority over other creditors, with the exception of the insolvency practitioners managing the case. This is discussed in Financial Conduct Authority (2014), 'PS14/4: The FCA's regulatory approach to crowdfunding over the internet, and the promotion of non-readily realisable securities by other media. Feedback to CP13/13 and final rules', March, <https://www.fca.org.uk/static/documents/policy-statements/ps14-04.pdf>. See 'Client Money Rules' section from para. 3.13 onwards.

¹⁰⁹ The FCA noted that, in January 2016, the Treasury amended secondary legislation so that firms carrying on the activity of operating an electronic system in relation to lending are not regarded as operating collective investment schemes (although they may still be Alternative Investment Funds under the Alternative Investment Fund Managers Directive, AIFMD). Financial Conduct Authority (2016), 'Call for input to the post-implementation review of the FCA's crowdfunding rules', July, para. 2.7.

As discussed in section 2, P2P lending represents a new and additional investment asset class, adding to retail investors' options for a diversified portfolio. In particular, the risk characteristics have some similarities with bonds, but provide access to different forms of credit (e.g. consumer credit and invoice finance), while the liquidity is typically more restricted (although not in all cases).

From an economics perspective, collective investment schemes give the investor exposure to a diversified portfolio of assets that is managed on behalf of a group of investors. With P2P lending, on the other hand, there is a continuum ranging from the 'pure' P2P lending model, where the platform offers only core services required to facilitate direct lending by the investor to the borrower, to more sophisticated services, offering investors a diversified portfolio of credit products with risk-management services. From the investor's perspective, services such as auto-allocation and buffer funds may be seen as moving the investment closer to the characteristics of a collective investment scheme (to various degrees), even though important differences remain.

For example, the auto-allocation tool helps investors to build a diversified portfolio, and will typically provide an automatic reinvestment function as well. The result, a diversified portfolio, might appear similar to the service provided by a fund manager, although there are important differences. First, the investor retains some degree of control (to varying degrees across different platforms) of the broad characteristics of the loans in the portfolio. In addition, each portfolio will be different, depending on the loans being funded at that particular moment in time.

With buffer funds, the investment remains tied to the direct loans to borrowers, although it can be expected that platforms will vary the contributions to the buffer fund over time, depending on past and expected default losses. Through this mechanism, default losses are shared across investors in the longer term. This suggests that buffer funds result in some degree of risk-sharing, as long as the buffer fund remains in operation.¹¹⁰

The question then arises as to whether the P2P regulation results in different outcomes relative to what can be expected under collective investment scheme regulation. Many of the differences in the two regulatory frameworks relate to requirements for information disclosure (e.g. producing prospectuses for investment funds) and governance (e.g. requirements for the skilled person), which are addressed through different regulatory approaches with P2P lending, although the fundamental economics remains similar (for example, in the need to provide clear and effective information to investors). The key economic question, however, relates to whether P2P lending should be considered to be a mainstream or non-mainstream pooled investment (in FCA terminology).¹¹¹

The current regulatory regime restricts the distribution of non-mainstream pooled investments to retail investors, as they are deemed to be too complex and/or too risky. Examples include hedge funds, undiversified property funds, traded life insurance policies, and qualified investment schemes.

The economics of P2P lending do not suggest that it should be considered similar to these non-mainstream pooled investments. As discussed in section 6.3.3 above, the characteristics of P2P lending are not inherently more

¹¹⁰ In some cases, when the buffer fund is depleted, the investor's exposure goes back to being their own portfolio of loans. In other cases, such as with RateSetter and Lending Works, a policy is in place that triggers a 'Resolution event', where the loan portfolios are explicitly pooled between investors.

¹¹¹ For a description, see Financial Conduct Authority (2016), 'COBS 4.12 Restrictions on the promotion of non-mainstream pooled investments', <https://www.handbook.fca.org.uk/handbook/COBS/4/12.html>.

complicated than those of other investments that investors already have access to.

The evidence therefore suggests that, irrespective of the legal separation of P2P lending from collective investment schemes, it would not be appropriate to classify P2P lending investments as non-mainstream pooled investments.

6.3.5 Are any investor groups put at a disadvantage relative to other investor groups?

The question here is whether retail investors could be put at a disadvantage with the growth of institutional investors in P2P lending, or alternatively whether investors using auto-allocation could be at a disadvantage relative to investors who directly choose who to lend to. In theory, without any controls in place, this could happen if, for example, more active investors 'cherry pick' the best loans, and the remainder goes to the less active (auto-allocation) investors.

However, P2P platforms have put in place controls to ensure that no particular group is disadvantaged. Auto-allocation is a popular option, including among institutional investors, and is therefore critical to the success of the platform (see section 4.2). Perceptions of net returns are also critical to the success of the platform (see section 3.2), so the reputational damage of auto-allocation investors being seen as being disadvantaged is likely to be an effective deterrent. In addition, the P2PFA Operating Principles include requirements on eliminating conflicts of interest in this regard.

The evidence indicates that the P2P platforms considered in this study indeed act to ensure fair treatment of different groups of investors. The primary method of doing so is by (randomly) allocating loans to different investor groups so that each investor group has equal opportunities (see section 4.2). Investor outcomes therefore reveal no preferential treatment between different investor groups (see section 4.3).

Arguably, the growth of institutional investors offers advantages to retail investors, rather than disadvantages. Institutional investors have been attracted by perceived positive net returns to investors, and the presence of presumably more informed and sophisticated institutional investors helps to ensure that net returns remain at attractive levels (as they would exit if returns fell to unattractive levels) (see section 4.1). In addition, institutional investors conduct due diligence on procedures that could provide additional reassurance to retail investors.

6.3.6 Are there any distortions to competition in lending markets?

Another potential issue is whether the regulatory framework for P2P lending creates (or allows to continue) some distortion in competition between different types of lender who are competing in the same market for borrowers.

P2P lending is a distinct business model for funding loans to consumers and businesses and for property, as described in Figure 2.1 (in section 2). It arose from the development of digital technology that made this form of 'disintermediation' (linking investors directly with borrowers) possible. P2P lending was able to deliver benefits to borrowers in terms of quality of service (e.g. speed of funding, loan features) and access, including at a time when the availability of funding was affected by troubles in the banking sector. P2P lending therefore primarily *increases* competition and choice in lending markets, rather than creating distortions to competition.

Furthermore, P2P lenders are price-takers in a competitive lending market, and there is no clear evidence of an 'unfair' competitive advantage (e.g. due to a market failure, competition issue or unsustainable business practice). In particular:

- there is no evidence that P2P lenders systematically undercut other lenders (including banks and non-bank lenders) in the various lending markets in which they operate (see section 3.1);
- the success of P2P lending has been through innovation and services provided to users, but that success is not guaranteed, and indeed appears to have slowed in 2016;¹¹²
- as explained above, 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. In other words, it is not the case that P2P lending platforms can attract and take advantage of investors that accept low interest rates that would not sufficiently reward investors for the risk they take. Interestingly, other commentators point to specific competitive advantages that banks may have over P2P lending platforms, such as with the access of banks to low-cost deposit funds,¹¹³
- P2P lending remains tiny compared to other forms of financial intermediation (see section 4.6).

In this context, P2P lending increases competition in financial intermediation, but it does not have an 'unfair' advantage. This supports P2P lending having its own regulatory framework, reflecting how the P2P lending market works.

6.3.7 Would P2P lending platforms be resilient to a sharp downturn in credit market conditions?

Would P2P lending platforms be resilient to potential economic shocks, and in particular a downturn in the credit market?

As discussed in section 4, the observed outcomes of P2P lending, in terms of default, have been broadly consistent with those of other lenders. Loan losses have also been in line with, or better than, the expected default rates presented by the platforms themselves at the time of loan origination (see section 4.1). There is little to suggest that rates would not continue to follow similar trends to those of other lenders through the economic cycle, as similar procedures are in place (see sections 4.1 and 4.2, as well as section 6.3.1 above) and typical increases in default rates during recessions do not suggest that the P2P lending model would fail. In other words, this evidence does not suggest that the P2P lending business models would be unsustainable in a recessionary environment.

While the borrower side is broadly similar to that of banking, in that default rates can be expected to follow similar trends in an economic recession (see section 4.1), the funding side of P2P lending is quite different from a bank. P2P platforms do not have to restrict lending during downturns in order to meet capital requirements (as banks did). P2P platforms instead rely on funding from primarily retail investors, with relatively long-term investment positions. This means that, in a future financial crisis, P2P platforms could be in a position to take advantage of the opportunities in lending created by stressed banks, just as

¹¹² For example see *Financial Times* (2016), 'Brexit blamed for fall in crowdfunding deals', 2 August.

¹¹³ See Deloitte (2016), 'Marketplace lending: A temporary phenomenon?'

they did following the recent financial crisis. This, in turn, suggests that P2P platforms are likely to be relatively well placed to weather financial crises.

6.3.8 What would happen in a worst-case scenario in which a platform went bust?

With the relatively benign credit conditions experienced in recent years, it is important that platforms are prepared for less benign conditions. Consequently, P2P platforms have been ensuring that they have sound resolution plans in place and are well placed to weather economic shocks, including being able to service loans even if all other business activities were to cease. In particular:

- the FCA requires P2P platforms to put in place resolution plans to ensure their orderly wind-down in case of businesses no longer being viable. This includes having segregated client money accounts with FSCS-protected banks, and meeting minimum capital requirements;
- the P2P platforms examined in this study all collect sufficient ongoing loan fees to be able to fund loan-servicing for the full lifespan of the existing loan book. The business models of the platform are therefore able to continue to service the loan book even if there is no new business, thereby ensuring that investors will continue to receive loan services even if the platform were to fail (see section 4.5). This provides strong reassurance about the viability of P2P lending.

These developments suggest that P2P platforms have become increasingly resilient to economic shocks, and that this issue is a key focus of the current regulatory regime.

6.3.9 Is there a risk of P2P lending interest rates moving to inappropriate levels?

There may also be concern about whether P2P platforms deliver investments with appropriately risk-reflective interest rates, especially if platforms appeal to a wider 'mass market' where individual investors are less able to judge whether the rate of return is appropriate given the degree of risk involved. In particular, could a surge in the supply of funds to a P2P platform result in interest rates falling to an unsustainably low level, where investors would be likely to face poor (and unexpected) outcomes?

This could be a risk with the P2P lending business models where interest rates are determined through auctions, particularly with the 'non-uniform auction' approach where investors bid their interest rate. Poorly informed investors may bid too low, particularly if there is an over-supply of investors relative to lending opportunities.

Partly due to concern about this possible outcome, the P2P platforms examined in this report have shifted away from this model. A number of approaches to interest rate management have developed over time (as described in section 4.1), including:

- platforms setting interest rates received by investors—with the platform taking account of credit risk in setting the rate. While platforms are likely to take account of supply and demand (of investments) in the long run, this direct management of rates avoids any impact from short term fluctuations in supply and demand (which could otherwise cause inappropriate rates to arise);

- platforms controlling for credit risk separately—where a buffer fund covers credit losses (in ‘normal’ times) and the platform sets risk-reflective contributions to the fund (the approach adopted by RateSetter). This means that only the ‘base’ interest rate is determined by the supply of, and demand for, investments.

In addition, P2P platforms provide information to help investors assess what should be appropriate interest rates, most notably in terms of both expected and actual default rates. Transparency of information indicating future default risk (including past default rates and interest rates being paid by borrowers) is important to maintain the incentives on platforms to conduct effective credit assessments in any economic climate.

Business models for determining interest rates can be expected to develop further over time, as approaches develop for different types of investor and different lending opportunities.

6.3.10 Does P2P lending create any risks for financial market stability?

Finally, there is the potential issue of P2P lending having implications for financial market stability. This could arise either through the potential for contagion within P2P lending, or the exposure of other parts of the financial system to P2P lending, particularly with the growth of institutional investment into this area.

P2P lending is very unlikely to have significant implications for financial stability, as the role of P2P lending in the financial system is much more akin to that of asset management (which generally is not deemed to be systemically important)¹¹⁴ than to banking (which generally is deemed to be systemically important). Interconnections with other parts of the financial system are also very small, and unlikely to become significant in the near future.

In particular, note the following points.

- The dynamics of contagion are fundamentally different for P2P lending than they are for banks. A loss of confidence in banks creates a loss of confidence in many aspects of the economy due to the importance of banks in funding short-term expenditure (liquidity). In contrast, the evidence suggests that investors treat P2P lending as a long-term investment that is not used to support liquidity. So even in the ‘worst-case’ scenario, where investors had to wait for the repayment of loans without access to a secondary market (which, in practice, is what most investors do anyway), this would have little impact on the (short-term) expenditure of those investors except for affecting their perceived wealth level. In this way, the impact is more like a fall in equity prices (which historically has been found to have fairly limited impacts on consumption levels in the economy) rather than a banking crisis (which tends to have significant impacts on the economy).¹¹⁵ The economic implications are therefore more limited (see section 4.6).
- It is also not clear that P2P platforms would face the same extent of contagion as banks typically do (although of course this has not been tested, due to the short history of P2P). The extent to which P2P platforms are

¹¹⁴ For a discussion, see *Financial Times* (2015), ‘Fund managers to escape “systemic” label’, 14 July.

¹¹⁵ As explored in the following academic paper, housing wealth tends to have a stronger impact on consumer spending than financial wealth, including share prices. Case, K.E., Quigley, J.M. and Shiller, R.J. (2013), ‘Wealth Effects Revisited 1975-2012’, *Critical Finance Review*, 2:1, pp. 101–28, July.

invested in other platforms is understood to be very limited, at least among P2PFA members, which is in sharp contrast to the case of banks in 2007.

- Similarly, asset management has not shown the same systemic risk implications as banks. Asset managers were largely unaffected by the 2008-09 financial crisis. Only where there are specific guarantees (money market funds) or leverage has there been concern, and neither of these issues are relevant for P2P lenders.¹¹⁶ Asset managers have not been included in the list of systemically important financial institutions at this time, even though some of them are very large indeed.¹¹⁷

On this basis, it is difficult to envisage P2P lending platforms being deemed systemically important in the foreseeable future.

In addition, interconnections with other parts of the financial system are too small to suggest any additional threats to financial market stability at this time (see section 4.6).

6.4 Development of the regulatory regime

Although the existing regulatory regime would appear to achieve a broadly sensible balance between consumer protection and allowing innovative P2P business models, this does not mean that there is no need to further develop it. P2P business models and practices can be expected to continue to develop and, particularly if the market continues to become more 'mass market', the regulatory regime may have to evolve as well.

The analysis in this report points to a number of areas where future development of the regulation may be considered, including:

- effective communication with investors;
- ensuring appropriate credit risk management;
- additional standards of business conduct.

The potential longer-term role of the FSCS is also considered in section 6.4.2.

6.4.1 Effective communication with investors

Effective communication with investors is essential to ensure good outcomes, particularly for a relatively new form of investment such as P2P lending.¹¹⁸ The

¹¹⁶ In 2015, the Financial Stability Board decided to focus on market liquidity risks rather than identifying asset managers that could be systemically important. This important shift is explained in *Financial Times* (2015), 'Fund managers to escape "systemic" label', 14 July.

¹¹⁷ Asset managers in the UK manage some £5.5trn of assets—see Investment Association (2015), 'Asset management in the UK 2014-2015', September. This compares to £2.2bn of P2P loans in 2015—see Nesta (2016), 'Pushing boundaries: the 2015 UK alternative finance industry report', February.

¹¹⁸ For a discussion on 'effective communication', see: Financial Conduct Authority (2015) 'Discussion paper DP15/5: Smarter consumer communications', June; Oxera (2014) 'Review of literature on product disclosure', October, prepared for Financial Conduct Authority; Oxera (2015) 'Can effective communication empower consumers?', August, <http://www.oxera.com/Latest-Thinking/Agenda/2015/Can-effective-communication-empower-consumers.aspx>.

P2P platforms put considerable emphasis on this, as set out in the P2PFA Operating Principles¹¹⁹ and acknowledged by the FCA in 2015:¹²⁰

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.

This does not suggest, however, that the approach to effective communication should not evolve and improve over time, and there is a potential role for regulation to ensure consistent good practice across platforms, for example in terms of:

- setting standard approaches for calculating key metrics such as default rates and net returns, to ensure easy comparisons across platforms;
- providing guidance or requirements on consistent messaging of key aspects of this type of investment, such as capital being at risk, liquidity through secondary markets not being guaranteed, and the implications of not being covered by the FSCS;
- monitoring how platforms are providing clear information and how investors are using that information appropriately.

There may also be specific reasons why effective communication with investors may need to be adapted to a new audience. For example, if Innovative Finance ISAs were to draw in a significant new population of potential investors, there might be a need to explore and test how this new population responds to and uses information provided.

This would suggest that there would be a benefit in the sector working with the FCA to:

- first, identify the right outcomes for investors, according to their characteristics (e.g. diversification, or exposure to risk);
- second, identify approaches to encouraging investors to make decisions in line with their best interests (while still allowing for individual decision-making);
- third, test and validate approaches before implementing them across the sector.

6.4.2 Ensuring appropriate credit risk management

As discussed in section 2, the development of P2P platforms has seen credit risk assessments become a core component of the service offering. Investors do rely on platforms to operate prudent and robust credit risk management policies, which they can monitor through default losses and net returns. While platforms do have incentives to conduct effective credit risk assessments (see section 6.3.1), there is a case for supervision of platforms to add additional checks to ensure that this is the case everywhere. There is also a case for authorisation to

¹¹⁹ The P2PFA Operating Principles require that 'Platforms should set out in a clear and balanced way the information that enables customers and prospective customers, whether lenders or borrowers, to make an informed decision'. The Principles then specify requirements for showing bad debt rates (actual and estimated over time, to allow assessment of the quality of forecasts), returns performance (after fees and bad debt) and full loan book availability. See P2PFA, 'Peer-to-Peer Finance Association Operating Principles', <http://p2pfa.info/wp-content/uploads/2015/09/Operating-Principals-vfinal.pdf>.

¹²⁰ See Financial Conduct Authority (2015), 'A review of the regulatory regime for crowdfunding and the promotion of non-readily realisable securities by other media', February, para. 49.

ensure that new entrants meet a minimum standard for credit risk assessments, in order to provide investors with some protection from the relatively unknown risk given the lack of past default loss experience.

FCA Rules do already include risk control in various forms. Firms are expected to monitor and control risk factors in their activities,¹²¹ and there are specific rules on credit risk assessments for consumer lending.¹²² The P2PFA Operating Principles also include requirements for operating a 'prudent and robust policy to manage credit risk'.¹²³

Potentially with additional clarification from the FCA on the central relevance of credit risk management for P2P platforms, it would appear that FCA supervision and authorisation processes are well placed to ensure that P2P platforms have appropriate systems in place, alongside transparency of data to investors.

6.4.3 Additional standards of business conduct

The extensive requirements of the FCA Handbook cover a wide array of standards of business conduct, although there are a few additional elements of the P2PFA Operating Principles (aside from effective communication and credit risk assessments) that it might be beneficial for the FCA to enforce across the sector. Examples include:

- having a plan to run down the loan book in the event of platform failure, with ongoing fees set at a level that is clearly sufficient to cover the costs of loan servicing until the loan book is fully run off;¹²⁴
- making available the full loan book, to allow proper analysis of the investment options;¹²⁵
- having policies and procedures that ensure that particular investor types are not put at an advantage or disadvantage relative to others (e.g. retail and institutional investors);¹²⁶
- regulatory prohibition of maturity transformation.

6.4.4 Longer-term inclusion within the FSCS

When putting in place the current regulation of P2P lending in 2014, the FCA concluded that it would not be appropriate to include P2P lending within the FSCS at that time.¹²⁷ The regulatory cost of inclusion would be high, and there are more proportionate ways of providing protection—in particular through client money requirements and minimum capital standards, and through ensuring that loans can be administered even if the platforms fail. The FCA noted that:¹²⁸

¹²¹ For example, FCA Handbook, 'Senior management arrangements, systems & controls (SYSC) sourcebook', Rule 7.1, 'Risk control', <https://www.handbook.fca.org.uk/handbook/SYSC.pdf>.

¹²² For example, FCA Handbook, 'Consumer Credit sourcebook (CONC), Section 5, 'Responsible lending', <https://www.handbook.fca.org.uk/handbook/CONC/5/?view=chapter>.

¹²³ See para. 11 of P2PFA, 'Peer-to-Peer Finance Association Operating Principles', <http://p2pfa.info/wp-content/uploads/2016/06/Operating-Principals-vupdate2016.pdf>.

¹²⁴ See para. 17 of P2PFA, 'Peer-to-Peer Finance Association Operating Principles', <http://p2pfa.info/wp-content/uploads/2016/06/Operating-Principals-vupdate2016.pdf>.

¹²⁵ See para. 6c of P2PFA, 'Peer-to-Peer Finance Association Operating Principles', <http://p2pfa.info/wp-content/uploads/2016/06/Operating-Principals-vupdate2016.pdf>.

¹²⁶ See para. 21 of P2PFA, 'Peer-to-Peer Finance Association Operating Principles', <http://p2pfa.info/wp-content/uploads/2016/06/Operating-Principals-vupdate2016.pdf>.

¹²⁷ See paragraphs 3.2-3.5 of FCA (2014), 'PS14/4: The FCA's regulatory approach to crowdfunding over the internet, and the promotion of non-readily realisable securities by other media. Feedback to CP13/13 and final rules', March. Available at: <https://www.fca.org.uk/static/documents/policy-statements/ps14-04.pdf>

¹²⁸ Paragraph 3.7, Financial Conduct Authority (2014), 'CP13/13: The FCA's regulatory approach to crowdfunding (and similar activities)', October. <https://www.fca.org.uk/publication/consultation/cp13-13.pdf>

In practice, cover might be available in limited circumstances only, for example if either the platform or the bank in which the money is held (prior to investment) failed before the money was invested. Customers affected in these ways should already be protected to an extent.

Even if these costs have come down with the growth of the sector, there remain significant challenges to including P2P lending in the FSCS due to the risk that retail investors may mistakenly think that protection by the FSCS provides protection against capital losses in the case of borrower default. This relates to the fact that the FSCS provides this form of protection for deposit accounts (although of course it does not provide this form of protection for all the other areas of retail financial services that it covers, including other investments such as mutual funds).

In the long run, however, there is an argument for finding a way to include P2P lending within the remit of the FSCS, in a proportionate and effective manner. In particular, this would provide investors with additional protection against fraud and misconduct (and subsequent platform failure), where the regulatory requirements have not been followed (for example, where client money is used for other purposes and not held in a segregated account), but specifically would not cover capital risk due to borrower default in the normal course of business (which is what the FSCS provides for deposit accounts).

To achieve this aim, the key issue would be to ensure that retail investors are clear that the FSCS does not cover capital losses due to borrower default in this case. This is arguably the case with investment platforms, for example, where the FSCS covers client money losses in the case of platform failure, but there does not appear to be significant investor confusion about the FSCS covering declines in asset values.¹²⁹

It may be possible to provide this clarity only if the guarantee for banking deposits is 'branded' and marketed differently, to ensure clarity on the FSCS not being there to cover investment losses.

¹²⁹ The FSCS covers only capital losses in the case of deposits. However, where financial advice has been provided, it is possible for the financial adviser to be legally liable for investment losses, in the case of mis-selling inappropriate investments. The FSCS has paid out for investment losses in the past where a financial adviser has subsequently gone bust and so could not pay redress. For example, see: Professional Adviser (2015), 'FSCS to pay out over Harlequin SIPP investment losses', 18 February, <http://www.professionaladviser.com/professional-adviser/news/2395808/fscs-to-compensate-harlequin-sipp-investors-for-investment-losses>.

A1 Further details on P2P platform exits

Further details of the former UK platforms, their reasons for exit and the impact of this on investors are provided below where available. Where information was not available this is likely to be because the platforms were particularly small and exited for not being able to continue operating profitably.

Table 6.1 P2P lending platforms identified as having closed in the UK

Platform	Launched	Closed	Description	Reason for exit	Impact on investors	Source
Quackle	2010	2011	Quackle was a P2P lending platform providing consumer loans. It was considered one of the smallest platforms on the market for P2P lending in the UK, and is understood to have only lent £16,000 in total.	Its failure is probably due in large part to its different approach to a borrower assessment model, based on group scores 'similar to seller feedback scores on Amazon'. This model led to an ineffective risk-assessment process, and to a significantly low loan repayment performance. Default rates were thus considered to be close to 100%, with many borrowers having made no repayment at all.	It appears that the platform's failure led to 100% investor losses.	(1)
Big Carrots	2009	2012	Big Carrots was considered a very small platform, accounting for less than 1% of the market.	It is however reported that Big Carrots 'failed because they had not invested the time and effort into building the right credit models—they were overwhelmed with the number of bad debts they faced'.		(2)
Yes Secure	2010	2014	Yes Secure (initially called YS and then Encash), a platform focusing on consumer lending, was non-negligible in size. At one point, it was considered fifth on the market, and was ranked 17th at the time of its closure. Investors could lend up to £25,000 on the platform, with a maximum of £500 per project, except for lenders who were members of the 'lender's network'. Borrowers on Yes Secure were often individuals who had been denied funding elsewhere. The platform was thus focusing on high-risk individuals, and consequently offering a relatively high yield to lenders of up to 18%.	Yes Secure exited because it was unable to comply with new FCA rules. However, the platform had been in difficulties for some time because of its focus on high-risk borrowers. The focus on high risk individuals meant that the platform was struggling with a significant proportion of late payments and defaults.	The platform is reported to have dealt very well vis-à-vis its lenders at its closure, quickly informing them that they would be reimbursed on outstanding loans, and thus 'effectively "buying out" lenders so they didn't face uncertainty over whether their money was safe'. It is likely that all Yes Secure investors received their money back.	(2), (3)
YouAngel	2011	2015				
Danesfield	2011	2012				
One Stop Funding	2012	2013				
LendingWell	2012	2013		LendingWell exited the payday loan market because of the difficulties it was facing in finding quality borrowers, as it stated in an email to lenders.	The platform still appears to operate, although uniquely as a form of intermediary that puts lenders in touch with difference lending opportunities across other	(4), (5)

					platforms, as a sort of 'one stop' platform for one to make lending decisions.	
Squirrl	2012	2014				
MayfairBridging	2013	2016			Taken over by Amicus Finance.	(6)
Funding Secured	2013	2014				
btl be the lender	2013	2014		It is reported that btl's parent company, the People 2 People (P2P) Group, announced in March 2014 that it would probably start being unable to pay its debts. There is some indication that the platform may have been lending to at least one of its sister companies.	There is light evidence that lenders might have not been informed or compensated after the platform's closure.	(7), (8)
Evolutis	2013	2014				
Paper Street	2013	2014				
Invest and borrow.com	2014	2015	Set up by Wonga, the payday lender. Provided consumer loans of up to £2,000, repayable over six months at an annual rate of 75% interest. Only 40 loans were ever advanced.	The service was set up as a small pilot programme and closed to allow Wonga to focus on their core business.	Loan agreements were cancelled for all borrowers, with no obligations to make any further payments on their loans. All investors were repaid in full.	(9), (10)
Fruitful	2015	2015	P2P lending platform focusing on mortgages		Fruitful has now become an intermediary, facilitating interactions between borrowers and 'brokers and introducers'.	(11), (12)
GraduRates	2012	2014	P2P lending platform facilitating loans for postgraduate study. Only made a very small number of loans.	RateSetter stated that 'GraduRates has decided to run down its operations ahead of the impending regulation of the industry by the FCA and wanted to ensure uninterrupted service to its customers.'	Loan book bought by RateSetter in 2014	(13)

Source: (1) *Financial Times* (2011) "Peer-to-peer loans company closes", 7 December. (2) Intelligent Partnership (2015), 'Alternative Finance Industry Report 2015-2016', p. 36. (3) *The Telegraph* (2014), 'First peer-to-peer firm fails – but savers are still repaid', 13 June. (4) P2P Money blog (2013), 'The Lending Well withdraws from payday market', 30 March, <http://blog.p2pmoney.co.uk/the-lending-well-withdraws-from>. (5) <http://lendingwell.com/>. (6) Bridging & Commercial (2015), 'Mayfair Bridging rebrands to Amicus', 15 October, http://www.bridgingandcommercial.co.uk/article-desc-5309_mayfair-bridging-rebrands-to-amicus#.V5uTyYN95pg. (7) Alt Fi News (2014), 'P2P Platform Suspends Trading', 13 August, http://www.altfi.com/article/0358_p2p_platform_suspends_trading. (8) Alt Fi News (2015), 'Tales of platform failure and the concerning case of Jennifer Lodge', 14 October, http://www.altfi.com/article/1429_tales_of_platform_failure_and_the_concerning_case_of_jennifer_lodge. (9) P2P Money Blog (2015), <http://blog.p2pmoney.co.uk/wonga-close-down-p2p-offering>. (10) <http://www.thesundaytimes.co.uk/sto/business/Finance/article1516421.ece>. (11) <https://lovefruitful.com/>. (12) Alt Fi News (2015), 'Peer-to-Peer Lender Winds Down Retail Offering', 15 October, http://www.altfi.com/article/1472_peer_to_peer_lender_winds_down_retail_offering. (13) RateSetter (2014), 'RateSetter takes on GraduRates loan book in industry first deal', 11 December, https://www.ratesetter.com/blog/article/ratesetter_takes_on_gradurates_loan_book_in_industry_first_deal.

A1.1 Experience of platforms outside of the UK

There are also cases of P2P platforms outside of the UK, which may be of relevance in terms of cases of misconduct. These include the following.

- **TrustBuddy** was a P2P lending platform facilitating consumer loans in Sweden since 2009. At the time of its closure, it was also making plans to expand into the UK and Spain. TrustBuddy focused on payday lending. It filed for bankruptcy in October 2015, after evidence of misconduct in its operations emerged. It appeared that new funds from lenders were being allocated to existing bad debt.¹³⁰
- **Lending Club** in the USA has been going through difficulties since May 2016. The platform's CEO, Renaud Laplanche, resigned after reports came out that a number of loans were mis-sold and that Laplanche had undisclosed personal interest in a fund in which the platform had considered investing.¹³¹ In particular, it appeared that approximately US\$22m in loans were allocated to lenders whose preferences did not correspond to the loans' characteristics.¹³² Lending Club's stock fell significantly, and the US Department of Justice opened an investigation into Lending Club for potential criminal behaviour.

¹³⁰ *Financial Times* (2015), 'P2P lender TrustBuddy halts operations over "misconduct"', 13 October, <http://www.ft.com/cms/s/0/8342ca10-71a2-11e5-ad6d-f4ed76f0900a.html#axzz4EBKUW1U1>.

¹³¹ *Financial Times* (2016), 'Lending Club taps BlackRock veteran Dunne', 18 July.

¹³² *Financial Times* (2016), 'Lending Club chief executive steps down after internal review', 9 May.

A2 Further details on information provided by platforms on risks and risk management

Table A2.1 Examples of websites informing about risks and risk management

	Risk	Risk management	Source
Funding Circle	'It's important to remember that some businesses will not be able to fully repay their loan. We call this a bad debt.'	'Diversification is the best way to manage risk. This simply means spreading your lending across hundreds of businesses, so you're only lending a small amount to each one.'	(1)
Landbay	'Key risks to your lending: 1. Rental demand (and rents) fall dramatically, resulting in missed mortgage payments by our borrowers, 2. UK rental property values fall dramatically'	'we are able to direct-match your investment to multiple mortgages secured across multiple buy-to-let properties. Diversifying your investment by borrower, property type and geography helps protect your money from the effects of any one borrower missing a payment, defaulting, or if demand falls in a particular area.'	(2)
Lending Works	'The Lending Works Shield has ensured every capital and interest payment due to our lenders has been returned on time, however it does not provide a guarantee against losses on your loans. As with all forms of lending your capital is at risk.'	'The Lending Works Shield offers threefold protection including a meticulous underwriting process, a Reserve Fund which covers missed loan repayments and a unique insurance arrangement which helps protect against losses due to borrowers defaulting.'	(3)
LendInvest	'If the borrower fails to make those payments to LendInvest, you may not receive your repayment from us. As such, your capital is at risk and repayments are not guaranteed.'	'Each loan is required to be secured by property. This means that in the event that a borrower fails to repay, we would seek to recover any shortfall by selling the property and passing the proceeds on to investors.'	(4)
MarketInvoice	'Investing in any investment product places your capital at risk and so does purchasing invoices through MarketInvoice.'	'Building a diversified book of multiple outstanding invoices is the best way to reduce risk. Our automated allocation tool, AutoBid, can help you do this.'	(5)
RateSetter	'The main risk to investors is that borrowers do not repay their loans.'	'RateSetter seeks to mitigate this risk in a number of ways: Excellence in underwriting: robust credit and affordability checks on all borrowers; Portfolio management: Our loan book is diversified across many borrowers of different types and channels; The Provision Fund: if a borrower misses a payment, the Provision Fund reimburses investors; if the loan goes into default, the Provision Fund takes over the loan and repays outstanding capital to the investors.'	(6)
ThinCats	'Remember, you are lending to business and therefore your capital is at risk and ongoing interest payments are not guaranteed if the business borrower defaults	'Whilst we specialise in loans with security it may prove impossible to recover all or part of the loan by calling in the business assets held as security on that loan. Please note Community Chest loans are unsecured.'	(7)

on capital or interest payments.'

'As ThinCats do not offer advice, we would recommend that you take advice from an independent financial adviser before committing your funds to ensure that you fully understand the risks, and are satisfied that peer to peer lending is appropriate for you, and meets your needs and personal financial circumstances.'

Zopa	'When you lend your money your capital is at risk and is not protected by FSCS.'	'Across all products your money is automatically spread across multiple sensible borrowers to diversify risk.'	(8)
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Source: Platform websites: (1) <https://www.fundingcircle.com/uk/investors/>; (2) <https://landbay.co.uk/risk-mitigation/>; (3) <https://www.lendingworks.co.uk/peer-to-peer-lending/safe/>; (4) <https://www.lendinvest.com/invest/due-diligence/>; (5) http://info.marketinvoice.com/hubfs/Investor_FAQ_VApril_2016_V4_CB.pdf; (6) <https://www.ratesetter.com/invest/everyday-account/protection/>; (7) <https://www.thincats.com/risks/>; (8) <https://www.zopa.com/lending>.

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