UK peer-to-peer (P2P) lending – an independent overview

This is an overview commissioned by peer-to-peer provider Landbay, which looks at the UK P2P sector from the view of a prospective lender (investor).

The report content, comparison tables and analysis is provided by Andrew Hagger, Independent personal finance analyst and commentator from Moneycomms.co.uk.

UK P2P lending – a ten point snapshot

1. Zopa was the first P2P provider to launch in the UK back in 2005 but now we are seeing the number of new platforms in this ‘alternative finance’ sector increasing rapidly, although the majority are in their infancy with a lending track record of 2 years or less.

2. UK P2P lending is currently growing at around £100m per month with lending to consumers and SME’s is expected to reach a combined total of £1.29bn for 2014 (source - Nesta).

3. 2015 will present three potentially ‘game changing ‘opportunities for new business growth – namely the new pension drawdown rules, the possibility that P2P could be included in ISAs and that high street banks may be forced to refer declined SME loans and customer data to the P2P sector.

4. Increased transparency and honesty regarding arrears and losses is essential as the sector grows and more new entrants appear – there should be at least as much emphasis on the risks as there currently is regarding the potential rewards.

5. Information regarding arrears, defaults and losses, both actual and predicted, should ideally be shown in a common format by all P2P platforms – similar to the summary box example used in the UK credit card market.
6. Although all are talked about as being part of the same category, there is a wide variety across the different P2P lenders based on where the money is being lent, each offering distinctly different risks/rewards. The first P2P lenders focused on lending to consumer, and then SMEs, but now there are also other options including buy-to-let mortgages, bridging finance and property development, each offering different levels of risk and reward.

7. There is a requirement for greater awareness (amongst the media and consumers) that not all P2P lending is the same – that risks can vary from platform to platform and consequently some are less suitable for the mainstream consumer audience looking for a first move away from cash savings.

8. Some P2P platforms don’t automatically diversify lender funds across multiple borrowers whilst others have high minimum investment levels, both elements that make them more suited to high net worth clients and the more experienced investor.

9. Protecting lenders capital remains the number one priority if P2P platforms are to increase consumer confidence in the sector and to become a credible investment option. Providers currently employ a range of different measures to achieve this, some take tangible security and/or guarantees from borrowers, some offer protection funds whilst others include insurance as part of their offering.

10. Examples of consumers losing money through P2P are quite rare up to now, however it’s still early days for many platforms that have had the luxury of always operating against a stable economic backdrop. Providers should look to give investors additional reassurance by highlighting the potential impact that a future economic down turn could have on returns and bad debt levels.

The volume of UK P2P lending and choice of platforms is growing fast

It’s nine years since Zopa started operating as the first peer to peer (P2P) platform in the UK.

In that time it has lent over £670 million, however the fact that £250 million of this has been advanced in the last 12 months is an indication of just how rapidly this particular consumer P2P business is growing.

The picture is similar for the wider alternative investment market (including P2P, crowd funding and invoice finance).

According to the recently published UK Alternative Finance Report from Nesta, lending in the sector has more than doubled in size year on year from £267 million in 2012 to £666 million in 2013 to £1.74 billion in 2014
With more than 45 providers now operating in the alternative finance arena there’s no shortage of competition and choice for borrowers and would-be lenders looking to secure better returns than offered by bank savings accounts.

Zopa started it all with its consumer lending to consumer model. This was followed by RateSetter doing similar and Funding Circle adding SMEs as a new category of borrower. More recently various kinds of property P2P lending models have been launched offering a very wide range of risk/reward options from consumer loans and buy-to-let mortgages (low) through to non-diversified loans for bridging finance and property development (higher).

However, if P2P is to be adopted by a wider audience it is essential that the high standards of loan underwriting and operational risk management exhibited to date are maintained and that rapid growth is not undertaken at the expense of increased risk to investors capital.

The sector is playing an increasingly significant part in the UK economy and therefore every effort should be made by individual platforms to provide clarity and transparency to ensure that the hard earned reputation of the P2P industry is maintained as the volume of lending and customer numbers accelerate.

**Three big reasons why 2015 could signal a major increase in P2P lending activity**

The growth of P2P and alternative finance over the last couple of years has been impressive; however there is a potential triple whammy on the horizon which could deliver an increase in investment on a much larger scale and prove to be a real ‘game changer’ for the sector in 2015.

The three distinct but potentially very substantial sources of increased demand for P2P products next year and beyond are:

1. **Pension freedom changes**

   From next year pension savers with defined pension contributions will no longer need to take out an annuity to provide retirement income.

   People will have far greater control over their retirement finances and will be able to make multiple withdrawals from their pension pot with the first 25% of each tranche being tax free.

   It is inevitable that the freedom of choice and being able manage their own retirement income will see some people turning to alternative investment options.

   With traditional cash savings rates at rock bottom and the volatility of stock market investments less attractive for those in later life, it’s likely that P2P will see a sizeable knock-on effect including a sharp increase in new business.

   The attraction will be even greater if P2P platforms can create innovative products solutions giving consumers flexibility to draw a monthly income that they need – perhaps providing the option to choose to receive either full or partial monthly interest or a combination of
interest plus a percentage of capital. This development is also likely to bring into greater focus the relative risk/reward levels provided by the different P2P platforms.

2. **The requirement for banks to share SME customer data and refer declined borrowing requests to a P2P hub**

Currently around 90 per cent of the SME banking market is dominated by the big five banks (RBS, Lloyds Banking Group, HSBC, Barclays and Santander).

The Government recognises the stranglehold that the banks have over the SME population and has published draft legislation to address this, which is being introduced through the Small Business Enterprise and Employment Bill.

This legislation includes new measures to support smaller businesses get the finance they need to grow, including helping them seek out alternative lenders if the big banks turn them down for loans.

The new measures will help bridge the gap between SMEs not knowing that other lending options, such as P2P, could meet their needs, and alternative lenders not knowing these businesses need a loan.

The results of Small Business, Enterprise and Employment Bill report stage and third reading are imminent and it is widely anticipated that the government intends it to be passed into law before the May 2015 General Election.

Even without the forthcoming legislation, there is already evidence that mainstream banks are recognising the value of working more closely with P2P platforms.

In June for example, Funding Circle announced a tie up with Santander where the bank will proactively refer small customers looking for a loan to Funding Circle. As part of the arrangement Funding Circle has, in return, pledged to signpost borrowers to Santander for relationship banking support and international banking expertise.

3. **The intended inclusion of P2P lending in ISAs**

On 17th October the Government kicked off a two month consultation to help decide the best way to include P2P loans within tax free Individual Savings Accounts (ISAs).

Financial Secretary to the Treasury, David Gauke recently told the Daily Telegraph; “P2P lending is an exciting, innovative new sector and it’s right that investors who want to lend money via P2P platforms should be able to hold these loans in their ISA alongside more traditional investments.”

There are currently many disgruntled consumers dismayed at the pitiful interest returns on offer from bank and building society cash accounts, some of whom will undoubtedly be tempted to consider alternative, more rewarding tax free options.
Data included in the Financial Conduct Authority (FCA) Cash savings market study (interim report) in July 2014 suggests there are around 26 million cash ISA accounts in the UK with combined balances of approximately £184 billion.

This is split between 17 million variable rate/easy access ISAs with balances totalling £93 billion and 9 million fixed rate ISAs accounting for a further £91 billion.

It’s clear that even if only a small percentage of this money is moved to P2P platforms the inflow of funds could move the development of the sector to a new level in one fell swoop. As this money will be moving from the security of cash ISAs, the lower risk P2P platforms will be likely to be the biggest winners.

**It’s vital that robust risk management procedures are maintained as the sector expands**

With rapid expansion for the sector on the cards it’s important that platforms don’t lose sight of the fact that it is someone else’s money they are lending, and therefore risk needs to continue to be accepted intelligently and managed effectively.

Whether a platform caters for multi-millionaire high net worth investors or retail consumers, remaining true to key traits such as clarity, openness and transparency are essential if P2P is not end up with a similar murky reputation as the established banking giants.

It’s also important that any P2P new entrants, particularly in the specialist and more niche areas of development finance should have a raft of practical expertise in their field.

Success of businesses dealing in complex financial transactions require more than just a clever mid 20’s whizz kid who may be a master when it comes to spread sheets.

The regulator should ensure this sort of situation doesn’t arise and weed out would-be new entrants that are not fit for purpose and would threaten the reputation of the P2P sector.

**Increased transparency is a key component for all P2P platforms**

In the absence of an FSCS style safety net, most prospective P2P lenders understandably need convincing that they are making a wise choice before handing over their capital to a platform.

It would be beneficial to the wider industry if all players dedicated as much effort and website space explaining the safety of funds and loss prevention measures as they currently do to promote the size of potential returns.

No matter how complex the state of the art algorithms or depth of experience of the underwriting team, there will be unforeseen events which mean that some borrowers won’t repay their borrowings in full.

No platform will get 100% of money back every single time and if and when a loss occurs providers shouldn’t hide it.
People accept this will happen to a degree and are quite right to be slightly cautious if a provider seems too good to be true and claims to have had no incidence of or fails to display details of arrears or defaults.

In fact I’m sure a prospective lender would rather see evidence that a platform has managed cases of non-payment but still delivered a competitive net return.

**Default and arrears data should be shown in a common format by all P2P providers**

A common format for illustrating past performance in relation to arrears, defaults and losses both actual and predicted should be shown by all platforms.

Platforms that are part of the Peer to Peer Finance Association already provide basic information, however the whole market should adopt this in the same way as summary boxes are now mandatory for UK credit card providers.

Such uniformity of this key data will make it easier for lenders to make informed choices.

At present, some platforms provide very scant information in this area but there are excellent and very comprehensive examples too such as the [data provided by Funding Circle](#) and this similarly detailed [breakdown from FundingKnight](#).

Recently, both Zopa and Landbay have confirmed they will publish full data on all loans past and present, and all P2P lenders should ideally follow suit.

**Key elements a P2P lender needs to understand before committing funds**

- **Their capital is at risk**
  
  No matter what steps a platform takes to protect investors’ money, there remains an element of risk to their capital that they wouldn’t be exposed to in an FSCS protected bank or building society account.

  The investor has to weigh up the additional risk and decide whether the rewards on offer are sufficient to warrant them becoming a lender with a P2P platform.

- **Who does their chosen platform(s) lend to?**
  
  A lender needs to appreciate that P2P providers lend to different borrower markets with different levels of risk and return e.g. – consumers, buy-to let landlords, large development and bridging finance projects, small business lending or provision of invoice finance. Lenders need to understand that not all P2P lenders are the same and remember that higher rewards on offer sometimes involve a greater risk, and should make appropriate decisions accordingly.

- **What measures does a platform take to protect lenders’ funds?**
Is there’s a protection fund to offer a buffer against late payments and small defaults? – How much is in it? - What is the coverage against expected defaults/losses? – This type of information should be easily available to help prospective P2P lenders make an informed decision.

There are good examples of protection fund explanations currently shown by Lending Works and RateSetter and at the time of writing, Landbay is about to take the same approach with a full disclosure of protection fund details and explanation.

- **Greater risk reduction through Auto diversification**

You’ll see from the comparison table accompanying this research that some platforms mitigate risk by automatically spreading lenders capital across a large number of borrowers so that an isolated default has minimal financial impact.

Other providers offer this facility but not as the default option, whereas others don’t offer it at all.

Experienced investors may be happier to seek higher returns via less diversification but this is not something that consumers looking for an alternative to bank and building society savings should consider without appreciating the potential consequences.

- **Access to funds – secondary markets - penalties**

With most P2P providers a lender will have the opportunity to access their funds, either by using a secondary market provided by the platform or by paying a fee to redeem their investment ahead of schedule or both.

This is an area that a potential investor should take into consideration, particularly the potential financial costs of doing so, before committing their capital.
An overview of the market for first time P2P Investors

<table>
<thead>
<tr>
<th>P2P Provider</th>
<th>Is lending secured?</th>
<th>Auto diversification to spread risk as default?</th>
<th>Protection fund?</th>
<th>Potential exposure due to ability to lend to single borrower/project?</th>
<th>Member of P2P Finance Association?</th>
</tr>
</thead>
<tbody>
<tr>
<td>Landbay</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td>Lending Works</td>
<td>No</td>
<td>Yes</td>
<td>Yes</td>
<td>No</td>
<td>Yes</td>
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<tr>
<td>RateSetter</td>
<td>No</td>
<td>Yes</td>
<td>Yes</td>
<td>No</td>
<td>Yes</td>
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<tr>
<td>Zopa</td>
<td>No</td>
<td>Yes</td>
<td>Yes</td>
<td>No</td>
<td>Yes</td>
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</tbody>
</table>

Lower risk/return
More suitable for first time P2P lender (Moving away from cash savings)

<table>
<thead>
<tr>
<th>P2P Provider</th>
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<th>Member of P2P Finance Association?</th>
</tr>
</thead>
<tbody>
<tr>
<td>Rebuilding Society</td>
<td>Yes</td>
<td>No</td>
<td>No</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>Funding Circle</td>
<td>Yes</td>
<td>No (Autobid is optional)</td>
<td>No</td>
<td>Yes</td>
<td>Yes</td>
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<td>Thincats</td>
<td>Yes</td>
<td>No</td>
<td>No</td>
<td>Yes</td>
<td>Yes</td>
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<tr>
<td>Assetz Capital</td>
<td>Yes</td>
<td>No</td>
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<td>No</td>
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<td>LendInvest</td>
<td>Yes</td>
<td>No</td>
<td>No</td>
<td>Yes</td>
<td>Yes</td>
</tr>
</tbody>
</table>

Higher risk/return
More suitable for experienced investors

One of the first things a prospective lender will notice when considering P2P investing for the first time is that there are a wide range of returns being offered, some even in double figures.

However the decision as to where to put their money should never be on the basis of which provider is promising to pay the highest interest rate.

If an investor is new to this market but simply looking for a more rewarding alternative to a bank or building society cash savings account, there are a number of areas to consider regarding the safety of their capital.

For example does the provider reduce the risk of defaults and losses by automatically spreading funds across multiple borrowers or will all the money be invested in a single project.
If it’s the latter, even though the P2P provider may take security from the borrower, there’s no guarantee that if the security has to be realised that there will be sufficient money to repay the investor in full – this could be more of an issue in situations where money is lent for more complex property development projects.

If I was asked to choose a provider for a less experienced investor with virtually no appetite for risk, I would explain that their capital is never going to be 100% guaranteed as with FSCS backed savings accounts, but would point them in the direction of what I consider the four lower risk providers i.e. Landbay, Lending Works, RateSetter and Zopa (incidentally all members of the P2P Finance Association).

Landbay is currently the only P2P platform that offers a protection fund, auto diversification of funds, security of tangible assets and doesn’t permit investing money with a single borrower or project. The returns on offer from Landbay may be lower, but the overall risk management initiatives to protect customers’ money are the most comprehensive in the market.

Zopa, RateSetter and Lending works are also providers that I feel are more suitable for first time P2P investors – the funds are well spread, protection funds are in place and the lending is purely to credit worthy personal borrowers – no bridging loans or development finance projects.

That’s not to say that other players in this market should be discounted, however those lending to businesses for bridging or development finance that give you the option to put all your lending eggs in one basket are not for the novice P2P customer but more suited to experienced investors happy to accept more risk in return for greater rewards.

Summary

The alternative investment market is growing at such a rate that it may not be long before it loses the ‘alternative’ tag.

2015 looks as if it could present massive new opportunities for the sector, particularly if the green light is given for P2P loans to be included in ISAs and legislation forces banks to share SME customer data and to signpost declined loan applications.

The increased demand from new lender and borrower markets sounds like a match made in heaven. However, platforms need to be mindful of the reasons that they have been successful so far and to continue to adhere to their sound practices.

It would only take one bad apple to knock the industry back a few years, so all providers need to maintain their strict lending and robust underwriting criteria whilst not shying away from displaying comprehensive data regarding arrears and defaults and the impact this has had on advertised rates of return.

By sticking to the original game plan whilst also developing innovative new alternatives to cater for the potential new business streams (pension freedoms and ISAs), P2P has the potential to become a much bigger thorn in the side of the traditional banking sector.
The information contained in this report is intended solely for journalists and should not be used by consumers to make financial decisions.

Consumers have a range of different financial needs and requirements and as such should always seek independent professional financial advice before making an investment decision.