New UK peer-to-peer lending rules catch up with innovation

Within a decade, the UK's peer-to-peer (P2P) financial services sector has moved from an offbeat outsider to an increasingly significant and permanent player in loan and equity markets as **Jonathan Rogers**, **Carsten Lösing**, and **Kristen DiLemmo** explain.

Total lending facilitated by UK P2P platforms during the past 12 months was £6.7 billion, according to data provider Brismo. On the equity side, P2P platforms have notably been used to allow an issuer's customer base to participate in funding rounds alongside institutional capital. The growing cheer of the market in the UK has found its echo internationally, too, with platforms now established in multiple jurisdictions. However, the expansion both in scale and business model complexity has inevitably attracted regulatory scrutiny. On June 4, the UK's Financial Conduct Authority (FCA) published Policy Statement 19/14, which set out a package of rule changes to apply to the UK loan and equity P2P markets. The changes focus on remedies for the several potential harms that the FCA identified:

- Confidence and investor participation could be threatened by poor performance or the disorderly failure of a platform;
- Investors buy products that are not suitable for them;
- Poor customer treatment;
- Asset prices that are too high, or where the asset quality is too low.

£6.7bn

Total lending facilitated by UK P2P platforms during the past 12 months
Source: Brismo

This article focuses on three of the remedial measures that the FCA has imposed.

Holding business model evolution to account

By way of evolution from the original P2P premise of privately negotiated lending/borrowing terms, many platforms now include an element of intermediation, whether by setting the price of P2P investments, advertising a target rate of return or determining a 'basket' of loan assets.

While permitting these investor friendly enhancements, it seems the FCA considers they should come with a responsibility for platform operators to deliver on what has been sold. Accordingly the new rules are designed to ensure that operators price loans fairly and appropriately, invest assets within advertised parameters, and achieve target rates of return. These new rules are prescriptive in areas such as credit risk assessments, basis of pricing, timing of revaluations and provision of information on portfolio parameters.

In implementing all of this, those firms that set prices will doubtless have in mind the new requirement for an annual 'outcome report' that will have to report default rates and actual performance against target rates of return.

Despite the new rules, the overall impression on reading CP19/14 is that the FCA has reconciled itself to innovation and for example decided not to ban target return rates or transfers of loans in default. This allowance comes however at the price of an enhanced rule book and a level of investor disclosure that will better enable firms to be held to account for their business models.

Marketing restrictions and appropriateness

The FCA has determined that loan based P2P platforms should in respect of retail investors face the same marketing restrictions and conduct 'appropriateness assessments' as already apply to certain non-readily realizable investments such as unlisted stocks, unregulated funds and life policies.

Broadly speaking, this means that a P2P firm will only be able to offer products to retail investors if they have passed an appropriateness test and also qualify as either high net worth, sophisticated investors or restricted investors. The latter, broadly speaking being investors who have certified that they won't invest more than 10% of their net assets in P2P loans over a 12 month look back and 12 month look forward period).

This proposal appears to have generated a large response to the FCA's consultation, but the FCA has sided with consumer protection and dismissed claims that P2P loans have a different risk profile to other investments, or that these restrictions would reduce competition and accessibility.

> **"The great speed of expansion in the P2P market inevitably prompts the need for greater regulatory scrutiny**

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The FCA wants to see contingency funds being better managed within a firm’s risk management framework

However, the FCA has in the face of responses received conceded that the marketing restriction will not prevent the provision of preliminary marketing information about the loan based P2P asset class, provided it falls short of being an offer that can be accepted. This information could include specifics of what is offered in terms of target rates/price, term, risk categorization, security or mitigation measures.

Managing over reliance on “contingency funds”

One of the innovations of the loan based P2P market is the use of contingency funds to compensate borrower defaults, whether funded by contributions derived from borrowers, investors or a platform’s own funds. Perhaps in recognition of the law of unintended consequences, the FCA has concluded that this innovation designed to benefit investors, could have the effect of distorting their understanding the market’s true risk. For example, a strong marketing statement such as, ‘no investor has ever lost any money’ is likely to be underwritten in part by the operation of a contingency fund alongside the performance of the underlying assets. The FCA’s concerns are that:

- Actual default rates are not being reported;
- Investors can come to see a target rate of return as effectively guaranteed; and
- In reliance on their contingency fund, platforms do not take enough care in calculating target rates of return.

To address these concerns, the FCA has determined a package of measures that focus principally on greater transparency around the application of contingency funds. Despite some push back through the consultation process, the trigger point for the new rules is strict and will include contingency payments used to smooth over delayed or enforced borrower repayments. These measures include mandatory pre-investment disclosures such as risk warnings and a policy statement setting out the detail of how a contingency fund will operate, as well as post-investment measures such as investor notifications of a contingency pay out, past performance data not being adjusted for contingency payments and a quarterly report on how much a contingency fund has been used.

On the prudential side, the FCA wants to see contingency funds better addressed within a firm’s risk management framework – and warns that offering enforceable rather than discretionary contingency cover will likely be insurance.

The new package is good news

The overall package of rules presented by the FCA in PS19/14 is a significant step forward in terms of regulatory expectations on P2P firms and will raise the barrier for new entrants. This should be seen in a positive light, with the FCA seeking to support the ongoing resilience and consumer proposition of this fast-developing market.

FCA published Policy Statement 19/14 setting out a package of rule changes to the UK loan and equity P2P markets

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