An Adviser’s Guide to

Peer to Peer Lending

Find inside:

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2.0 P2P Business Models
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An up to date and comprehensive resource that contains the information required to make informed decisions

First Edition
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P2P lending and financial advisers aren’t the most obvious of bedfellows. For all the sector’s impressive growth, it’s fair to say that the advice community has remained largely sceptical. Advisers are naturally cautious of new developments. And with a wide range of more established investment options to choose from, recommending alternatives may not be high on the agenda.

But in today’s challenging landscape, where inflation threatens to outstrip returns and market volatility rocks the confidence of even the most experienced investor, the need for alternatives may never have been greater. The Personal Investment Management & Financial Advice Association’s (Pimfa) private investor index series even has a 17.5% allocation to alternatives in its conservative investor benchmark – higher than the 10% allocated to government bonds (source: FT Adviser, September 2017).

Against this backdrop, P2P lending could play an important role in meeting common investor problems – problems like generating attractive returns, creating an income, protecting from volatility or staying well diversified. And the market has continued to go from strength to strength. As section 1 of this guide highlights, UK P2P lending is expected to grow to £30 billion by 2025 – while, according to Yorkshire Bank’s (admittedly regretful) prediction, half a million new investors will try their hand at P2P as a result of the tax incentive and mainstream approval brought by the Innovative Finance ISA (IFISA).

This influx makes the role of financial advice so important. In spite of its relative infancy, the P2P universe is already hugely diverse, spanning everything from unsecured credit card debt to secured residential property lending. It’s complex and confusing. With a vast array of products out there, each one offering a different risk-return profile, it’s important that investors know exactly what they’re getting into. And advisers have a powerful role to play.

At Octopus, we work day-in, day-out with thousands of financial advisers – many of whom have asked for some additional support in getting to grips with this new, potentially attractive investment option. This guide aims to do just that. As well as providing insight into the market’s regulatory framework and exploring some of the key areas of difference between offerings, the guide will explore different client profiles for whom P2P could prove beneficial – and outline key considerations to bring to bear when performing due diligence of products and providers. We hope you find it useful.
P2P lending (also sometimes referred to as marketplace lending), is the practice of using technology to connect those who are seeking finance with those who have money to invest. The idea is that both sides receive a better deal by cutting out the financial intermediaries – typically banks and building societies – through which those seeking finance have traditionally only been able to access money.

The benefit to the lender is a potentially higher rate of return than would typically be seen on a bank deposit - certainly higher than has been achievable in the low interest rate environment since 2008.

The risk of course is that borrowers default and do not pay the money back, although there are several ways this risk can be mitigated that we’ll discuss elsewhere in the guide.

The benefit to the borrower is that the cost of borrowing can often be cheaper and the whole process, from application to receiving the money, is quicker. It is also the case that some borrowers who have been rejected by banks can borrow from P2P platforms.

The platforms typically have very low minimum investments – sometimes from as little as £5 – and the loans issued are often comprised of scores or even hundreds of different investors, from individuals to institutional investors.
Returns

Typical net annual returns range between 4-10%, depending upon the business model and level of risk. At 28 February 2018, AltFi data recorded UK net one year returns at 6.0% and three year returns at 18.5%.

How do P2P platforms do all of this?

• As online businesses with no branch networks to maintain and fewer staff, their cost base is lower, allowing them to pass on saving to borrowers and lenders in the form of better rates.

• As high tech businesses without the legacy systems that banks work with, they have developed more efficient processes for assessing loans.

• Some P2P platforms are specialists, for example focusing on lending to property professionals. Specialist knowledge helps them source higher quality borrowers and optimise their loan books to maximise risk adjusted returns.

Typical net annual returns range between 4-10%, depending upon the business model and level of risk. At 28 February 2018, AltFi data recorded UK net one year returns at 6.0% and three year returns at 18.5%.

Methodology

The AltFi Data UK Lending Returns Index measures the returns available from tech enabled lending in the UK. Index values are published as an annualised return, measuring what an equal time-weighted exposure to every loan originated by the participating platforms would have generated over the preceding 12-month period. The return has been calculated after fees and is expressed net of losses. Index calculations are based on loan level data from Funding Circle, Market Invoice, RateSetter and Zopa.

1.2 Evolution

The world’s first P2P lending platform was Zopa, launched in the UK in 2005 with a simple consumer lending model.

The period after the 2008 financial crash has seen banks reducing their lending activity and the EU Basel regulatory frameworks, including Basel III, currently in an implementation period due to last until 2019, continue to encourage this trend: they require banks to hold significant amounts of capital against risky assets as security against potential financial shocks and asset failures.

This has increased the cost of lending, making it increasingly unprofitable for banks to make small ticket loans of £250,000 or less, or higher risk transactions, such as loans to consumers.

This has continued to drive deal flow for P2P platforms with increasing numbers of borrowers seeking loans and investors (lenders) looking for higher returns than those offered by a low interest rate environment.

Since Zopa’s launch, a great many P2P lending platforms have sprung up around the world, and the UK and US are the market leaders in terms of the number of platforms and lending volumes. In the UK, £13.69 billion has been lent to date (December 2017, AltFi Data). £4.99 billion of that was lent in 2017.

In the US, the comparative figures are $68.09 billion and $21.04 billion. There are now over 50 FCA authorised platforms in the UK (P2P money), all with slightly different operating models (see the P2P Business Models section). However, the biggest 2-3 platforms in each P2P sub-sector account for the vast majority of lending volume (Zopa, RateSetter, Funding Circle, Assetz, Octopus Choice and Market Invoice).

Lower cost base  Efficient assessing loans  Specialist knowledge

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

HMRC, GUIDANCE PEER TO PEER LENDING, 6 APRIL 2016

Government Support

In the UK, P2P benefits from government support designed to widen the routes to finance for UK businesses:

- Over £100 million has been provided to P2P platforms by the British Business Bank for onward lending to SMEs (BBB).
- The bank referral scheme was launched in 2016 as a method for the government to track firms and their requests for business finance. Banks that turn down business applications ask for permission to pass on the financial information of the failed applicant to designated P2P finance platforms. The platforms can contact the business in a regulated timeframe.
- The Innovative Finance ISA was launched in April 2016, initially with only P2P loans eligible to be held within it.

SOURCE: ALTFI DATA, 28 FEBRUARY 2018
P2P Business Lending Flows

SOURCE: ALFTIDATA.COM

2012 2013 2014 2015 2016 2017

£2bn

£1bn

£0

P2P Business Lending as a Proportion of Total

SOURCE: CAMBRIDGE CENTRE FOR ALTERNATIVE FINANCE, ENTRENCHING INNOVATION, UK ALTERNATIVE FINANCE. INDUSTRY REPORT, DECEMBER 2017

P2P Lending Growth

Santander starts referring small businesses to P2P

FCA took over P2P regulation

P2P Business Lending growth

over £5bn lent to date

Global financial crisis

2005

Zopa established

2008

Zopa.net IRR 5.3%

2011

P2PFA founded

2013

20 new platforms launched (UK)

2014

£5bn lent through P2P in this year alone

2015

P2P minimum capital adequacy requirements increase

2016

P2P loan interest treatment changed to match any other interest received

2017

Bank Referral Scheme launched

2018

IFISAs commenced

P2P is eligible

£5bn

British Business Bank continues to support marketplace lending through its Investment Programme.

BRITISH BUSINESS BANK, SMALL BUSINESS FINANCE MARKETS 2017/18

£5bn lent to date

P2P Property Lending growth

% = %

more than 50 P2P authorised platforms

BRITISH BUSINESS BANK continues to support marketplace lending through its Investment Programme.
### Key Developments

There have been a number of developments that should give advisers confidence that the P2P sector is here to stay.

<table>
<thead>
<tr>
<th>DEVELOPMENT</th>
<th>IMPORTANCE</th>
</tr>
</thead>
<tbody>
<tr>
<td>Innovative Finance ISA</td>
<td>Launched in April 2016, apart from allowing P2P investors to earn tax-free returns, the IFISA shows that the UK government is committed to the sector.</td>
</tr>
<tr>
<td>Regulation</td>
<td>The P2P sector has been overseen by the FCA since April 2014 when rules such as ring-fencing client money and putting runoff plans in place were introduced. The regulatory framework is still being developed, but investors can have confidence that the sector has regulatory oversight. Publication of the FCA’s changes further to its review of crowdfunding rules, which include P2P as ‘loan-based crowdfunding’, is due in 2018.</td>
</tr>
<tr>
<td>Market Data</td>
<td>AltFi Data provides a meaningful comparison between platforms by analysing loan level data to a consistent methodology. Inreview provides key sector-wide metrics such as lending volumes, returns and individual platform due diligence reviews.</td>
</tr>
<tr>
<td>Institutional Involvement</td>
<td>Institutional investors have invested in both the P2P platforms themselves, and the loans that they originate. These investors include mutual funds, pension funds, asset managers, family offices, broker-dealers and banks. This is a significant indication of the credibility of the P2P sector, and also brings the added benefits of institutional levels of scrutiny, expertise, due diligence and increased liquidity. But, platforms should not allow institutions to cherry pick the best deals.</td>
</tr>
</tbody>
</table>

**P2P lending is becoming more popular with people looking for alternative ways to invest their pension savings before and after retirement. In fact, investments in peer-to-peer are now as frequent as investing in shares and bonds in the UK, showing that this form of investment is becoming more mainstream when compared with more traditional products.**

**Daily Telegraph, Radio Times Money, July 2017**

### Pros and Cons Summary

<table>
<thead>
<tr>
<th>PROS</th>
<th>CONS</th>
</tr>
</thead>
<tbody>
<tr>
<td>Attractive rates for investors and borrowers.</td>
<td>Loans are not covered by the FSCS Bank Deposit Guarantee Scheme and FSCS Investment Protection Scheme and lenders’ capital is at risk.</td>
</tr>
<tr>
<td>Uncorrelated to equity markets and less volatile.</td>
<td>Potential for platform collapse (e.g. resulting from lack of deal originations/bad underwriting generating significant defaults) through FCA regulated platforms must have a living will plan for an orderly runoff of their loan book.</td>
</tr>
<tr>
<td>Choice of a range of risk adjusted returns to choose from.</td>
<td>Lack of long term record, demonstrating performance through full economic cycle.</td>
</tr>
<tr>
<td>Invested funds can often be deployed and redeployed very quickly.</td>
<td>Potential for online fraud undermining the security of internet-based loan transactions. Many platforms use technology and undergo independent professional security testing to combat this issue.</td>
</tr>
<tr>
<td>P2P platforms must be FCA authorised and advising on P2P agreements is an FCA regulated activity.</td>
<td>Interest rate rises could lead to a spike in borrower defaults.</td>
</tr>
<tr>
<td>Same platforms offer asset backing to provide security for loan repayment defaults.</td>
<td>Potential for offline fraud – platform malpractice as a result of breakdowns in corporate governance or outright fraud.</td>
</tr>
<tr>
<td>Same platforms offer provision funds that will pay out when loans default, but only up to their anticipated % bad debt rate.</td>
<td>Potential for insufficient access to loan originations, leading to the acceptance of more risky loans and higher default rates.</td>
</tr>
<tr>
<td>Predictable, fixed returns.</td>
<td>Possibility of institutional investors cherry-picking the best P2P investments using their expertise and resources.</td>
</tr>
<tr>
<td>A degree of liquidity – most major platforms offer redemptions and resale of loan parts via a secondary market. Some banks are also partnering with P2P platforms, and increasing liquidity.</td>
<td>Liquidity disadvantage in comparison to banks. Some P2P loans do not allow exit until the end of the term, secondary market volumes are thin and these markets have not been tested in sector-wide sell off.</td>
</tr>
<tr>
<td>Government support – IFISA eligible and the Bank Referral Scheme requires banks to refer borrowers they reject to P2P platforms.</td>
<td></td>
</tr>
<tr>
<td>IFISA eligibility gives access to tax free earnings.</td>
<td></td>
</tr>
<tr>
<td>Transparency: opportunity for investors to choose their underlying loan to give them control over what their funds are invested into (unlike bank deposits).</td>
<td></td>
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</tbody>
</table>
For Platforms

Naturally, most of the regulatory output in the P2P sector has been focused on the platforms themselves.

Initial regulations

The initial regulations were set out in CP13/3 in 2013 and came into full effect in April 2016. The overarching objectives of the initial regulations were to:

- Provide additional protection for consumers.
- Promote effective competition within the P2P lending industry.
- Allow the growth of the industry to continue in a controlled way.
- Ensure platforms provide clear and not misleading information and have appropriate procedures for handling client money.
- Ensure firms deal appropriately with customers in financial difficulties and complaints.
- Ensure platforms maintain a stable financial position and have contingency arrangements in place in the event of a platform failure.

A post-implementation review was carried out with preliminary findings published in December 2016, where the FCA highlighted concerns over the way some platforms portrayed the level of risk and potential returns on offer. In April 2017 the minimum capital adequacy requirement for platforms was raised from £20,000 to £50,000.

A further review is ongoing and a consultation on new rules was delayed by the 2017 snap general election. The FCA has indicated that it will recommend new rules that strengthen investor protections and:

- Improve standards of disclosure.
- Strengthen the rules around wind-down plans.
- Extend mortgage-lending standards to platforms.
- Enforce additional "requirements or restrictions" on cross-platform investment.

"Cross-platform investment" refers to a consumer investing via a single platform, but across loans that have been originated by a number of other platforms.

For Advisers

Firms that held permission for the regulated activity of ‘advising on investments’ automatically had their permissions extended to include the new regulated activity of ‘advising on peer to peer (P2P) agreements’ from 6 April 2016 (timed to coincide with the launch of the IFISA). This is also sometimes referred to as ‘advising on article 36H agreements’.

Consequently, unsuitable advice to invest in P2P lending may now be covered by the FSCS up to £50,000, provided the adviser cannot meet claims for compensation, the advice was given on or after 16 April 2016, and the loan agreement meets the FCA’s definition of a P2P agreement.

In short, P2P lending will be treated as any other investment from the perspective of adviser regulation. The key for advisers is to ensure that they have properly considered suitability and carried out due diligence. This means: i) knowing how P2P lending maps to more conventional assets so that they can form a clear opinion why P2P is the best option for a particular client; ii) understanding the particular business models of the major platforms so that they can form a clear opinion why one platform was chosen over another; and iii) understanding the operating models of the platform so that they can form a clear opinion on the risks involved.

*You can find the full text of the policy statement here: https://www.fca.org.uk/publication/policy/ps16-08.pdf*
Development of P2P Lending Regulations

- **OCTOBER 2013**: FCA published consultation paper 13/3 which outlined the FCA’s proposals to regulate loan-based and equity-based crowdfunding.
- **1 APRIL 2014**: FCA took over regulation of consumer credit from the OFT and implemented new rules for crowdfunding based on policy statement 14/4.
- **1 OCTOBER 2014**: FCA started considering applications for full authorisation from firms with interim permissions.
- **1 APRIL 2016**: Full FCA consumer credit regime came into effect, replacing the interim permission regime.
- **MARCH 2016**: Policy statement PS16/18 published setting final rules re. the segregation of client money on loan-based crowdfunding platforms, the innovative finance ISA, and the regulated activity of advising on peer-to-peer agreements.
- **FEBRUARY 2015**: FCA published a review of the regulatory regime for crowdfunding and the promotion of non-readily realisable securities. It decided no further rule changes required but it would continue to monitor the growing market.
- **8 JULY 2016**: FCA called for input to the scheduled post-implementation review of the FCA’s crowdfunding rules by 8 September 2016.
- **DECEMBER 2016**: FCA published interim statement re. feedback to the call for input, highlighting concerns and stating that in Q1 2017 there would be a consultation on new rules to address them.
- **1 APRIL 2017**: Minimum capital adequacy requirement for firms running loan-based crowdfunding platforms increased from £20,000 to £50,000.

A review of the regulatory regime for crowdfunding and the promotion of non-readily realisable securities by other media: [https://www.fca.org.uk/publication/thematic-reviews/crowdfunding-review.pdf](https://www.fca.org.uk/publication/thematic-reviews/crowdfunding-review.pdf)
Call for input to the post-implementation review of the FCA’s crowdfunding rules: [https://www.fca.org.uk/publication/call-for-input/call-input-crowdfunding-review.pdf](https://www.fca.org.uk/publication/call-for-input/call-input-crowdfunding-review.pdf)

**Exceptions**

The following two are strictly speaking NOT P2P lending sectors in our view, but are often confused with P2P lending.

- **DEBT BASED SECURITIES (DBS)**: A related sector. DBS are issued by some platforms to raise money for specific projects such as renewable energy installations.
- **EQUITY CROWDFUNDING**: A related sector where investors can invest in the equity of unquoted companies via an online platform. This is a much riskier activity than P2P lending and the two should not be confused! (It’s worth noting, though, that the FCA refers to P2P lending as loan-based crowdfunding.)

**Value of Peer to Peer Business Lending**

- **2016**
- **2017**

**+51%**

**SOURCE**: BRITISH BUSINESS BANK, SMALL BUSINESS FINANCE MARKETS REPORT 2017/18
2.1 Investment Options

**Individual Loan Selection**
Lenders select suitable loans from the ones listed on the platform’s website.

**Automated Discretionary Loan Selection**
Similar to above, however, the lender sets their investment criteria and the website automatically purchases loans that meet the criteria.

**Direct**
The lender does not choose individual loans (either manually or with pre-set criteria), but selects a predetermined investment amount, term, interest rate etc., and then is given diversified exposure to new loans within the platform’s loan book that meet those conditions.

**Discretionary Managed Portfolio of Loans**
The lender does not choose individual loans (either manually or with pre-set criteria) and can’t select term/interest rate. Instead, the platform only puts loans on the platform which meet its agreed risk profile. Lenders are given diversified exposure to the loans within the platform’s loan book.

There are two other investment options that help investors diversify across platforms:

- **AGGREGATORS PLATFORMS** that allow investors to access loans from across the P2P market on a single wrap platform.
- **PURCHASING SHARES** in investment companies that are investing in P2P loans.

Finally, some platforms also issue their own bonds to investors as an alternative vehicle to get exposure to large segments of the loan book.

**2.2 Main Methods of Risk Mitigation**

**Credit Assessment**
Undertaken by all platforms, borrowers’ creditworthiness is assessed and scored using proprietary methodology.

**Security**
Loans are secured against property or other items of value. Typical in the P2P property sector, but used elsewhere too, e.g. business assets.

**Provision Fund**
(Reserve fund or Contingency fund)
All borrowers pay a small levy which is used to build up a provision fund to cover any losses. The depth of coverage offered by a provision fund varies from platform to platform (around 1%-7%) as do the circumstances that trigger its use.

**Co-Investment**
Some platforms invest their own money alongside their investors’, an indication of their confidence in the strategy plus a strong alignment of interests, and an additional layer of protection in the event of default.

**Diversification**
Most P2P platforms make diversification simple, fast and cheap to achieve.

**At a time when the approach of more traditional lenders, particularly to small businesses, comes under increasing scrutiny, the peer-to-peer lending sector has a positive story to tell which continues to drive marked levels of growth in borrower and lending volumes.**

ROBERT PETTIGREW, P2PFA, JANUARY 2018
P2P Lending platform examples

Here is a small sample of how lending platforms mix and match the different components to construct their business model. Note that these three components are by no means the only points of differentiation between platforms - they are just the major three.

<table>
<thead>
<tr>
<th>PLATFORM</th>
<th>UNDERLYING LOANS</th>
<th>INVESTMENT OPTIONS</th>
<th>RISK MITIGATION</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>CHOICE</strong> by octopus investments</td>
<td>P2P property lending</td>
<td>Discretionary Managed Portfolio of Loans</td>
<td>Security (Property) and Co-investment</td>
</tr>
<tr>
<td>Funding Circle</td>
<td>P2P business lending</td>
<td>Direct (Balanced or Conservative options)</td>
<td>Credit Assessment</td>
</tr>
<tr>
<td>RateSetter</td>
<td>P2P consumer lending, P2P business lending, P2P property lending</td>
<td>Direct</td>
<td>Provision Fund and Security for some loans</td>
</tr>
<tr>
<td>Zopa</td>
<td>P2P consumer lending</td>
<td>Direct (Core and Plus options)</td>
<td>Credit Assessment</td>
</tr>
</tbody>
</table>

Peer-to-peer lending has brought about real benefits, not only for the UK’s small and medium sized business community, but our economy at large.

STEPHEN BARCLAY MP, THE ECONOMIC SECRETARY TO THE TREASURY, DECEMBER 2017

### 2.3 Risk Comparison to other asset classes

<table>
<thead>
<tr>
<th>CASH</th>
<th>BONDS</th>
<th>P2P LENDING SECURED</th>
<th>EQUITY</th>
<th>P2P LENDING UNSECURED</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Liquidity</strong></td>
<td>Completely liquid - although some liquidity has to be sacrificed to earn higher returns</td>
<td>Dependent on secondary market depth for that bond type. Corporate bonds may be essentially illiquid</td>
<td>Dependent on loan term and secondary market depth</td>
<td>If listed, liquid, highly liquid for large caps</td>
</tr>
<tr>
<td><strong>Volatility</strong></td>
<td>Not volatile although inflation can erode its purchasing power over time</td>
<td>Very sensitive to interest rate movements especially longer dated bonds</td>
<td>Lower risk rated than equity</td>
<td>Subject to market sentiment so very prone to volatility of market movements</td>
</tr>
<tr>
<td><strong>Security</strong></td>
<td>Not subject to loss other than the effects of inflation on purchasing power. Cash is protected by FSCS if deposited within an institution with a banking licence - up to £85,000 per banking group</td>
<td>Government bonds generally very secure, corporate bonds depend on the financial condition of the bond issuer</td>
<td>None if the business fails. The FSCS applies to financial advice and investment firms, not shares</td>
<td>None, if the borrower fails, although insurance coverage and provision fund may be available</td>
</tr>
<tr>
<td><strong>Yield</strong></td>
<td>0% unless deposited with bank. (April 2018 around 1%-2%)</td>
<td>Can be negative to double digit returns in higher risk corporate bonds in alternative investments</td>
<td>4%-6%</td>
<td>3%-4% for UK equity income (with the possibility of capital gains)</td>
</tr>
</tbody>
</table>
Suitability, due diligence & further considerations

3.1 Suitability

Clearly P2P lending isn’t going to be for everybody. It’s riskier than cash, has lower levels of liquidity than equities and is still a relatively new asset class for retail investors.

We don’t think it’s suitable for advisers to recommend to clients who have not started to develop conventional investment portfolios.

However, we do think that P2P lending can be a suitable supplemental investment for clients who do already have a conventional portfolio in place. For these clients, P2P lending can provide additional income and diversification, without taking on excessive levels of risk.

Suitability for P2P lending is not just a top-level consideration though – with so many platforms offering so many different ways of investing, advisers need to determine which platforms are suitable for which clients. Lower risk, asset-backed options will appeal to clients with a lower risk tolerance, or clients who do not plan on taking much risk with this portion of their portfolio.

The FCA emphasises that advisers must consider suitability for P2P lending in the context of other asset classes, so we have included a summary guide below – however exactly where P2P maps onto conventional assets is of course dependent upon the type of P2P lending being considered.

The FCA applies its Conduct of Business suitability rules to firms making a personal recommendation involving advice on P2P agreements. Its 2016 regulatory review of crowdfunding (results due for publication in 2018), including loan-based crowdfunding, is also considering whether P2P platforms should carry out suitability checks before investors can invest. This is already the case for investment-based (equity and debt based securities) crowdfunding platforms.

With inflation eating away at deposit accounts, savers who are prepared to increase the level of risk may wish to consider peer to peer lending as a diversifier from the fluctuations of equity markets.

RICHARD NUTTALL, SIMPLYBIZ

P2P comparison with...

Cash
Higher returns than cash, with the additional risks of borrower default or platform failure. In addition, no coverage from FSCS deposit guarantee scheme.

Equity
Lower returns than equity over longer (5+ years) periods and lower levels of liquidity. Much lower levels of volatility and more certainty about levels of return.

Fixed income
Higher returns than most fixed income investments with the exception of riskier high-yield bonds.

P2P property lending with a low Loan to Value (LTV)

P2P business lending spread across the market leaders conservative direct investment options with short term durations

P2P business lending and P2P consumer lending spread across the market leaders more aggressive investment options with longer term durations

P2P business lending and P2P consumer lending ‘stock-picking’ loans from the entire range of UK platforms.

Suitability, due diligence & further considerations

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RICHARD NUTTALL, SIMPLYBIZ

P2P risk tolerance and possible strategies

LOW
LOW MEDIUM
HIGH MEDIUM
HIGH

P2P property lending with a low Loan to Value (LTV)

P2P business lending spread across the market leaders conservative direct investment options with short term durations

P2P business lending and P2P consumer lending spread across the market leaders more aggressive investment options with longer term durations

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Higher returns than most fixed income investments with the exception of riskier high-yield bonds.

Lower returns than equity over longer (5+ years) periods and lower levels of liquidity. Much lower levels of volatility and more certainty about levels of return.

The FCA applies its Conduct of Business suitability rules to firms making a personal recommendation involving advice on P2P agreements. Its 2016 regulatory review of crowdfunding (results due for publication in 2018), including loan-based crowdfunding, is also considering whether P2P platforms should carry out suitability checks before investors can invest. This is already the case for investment-based (equity and debt based securities) crowdfunding platforms.

With inflation eating away at deposit accounts, savers who are prepared to increase the level of risk may wish to consider peer to peer lending as a diversifier from the fluctuations of equity markets.

RICHARD NUTTALL, SIMPLYBIZ

P2P risk tolerance and possible strategies

LOW
LOW MEDIUM
HIGH MEDIUM
HIGH

P2P property lending with a low Loan to Value (LTV)

P2P business lending spread across the market leaders conservative direct investment options with short term durations

P2P business lending and P2P consumer lending spread across the market leaders more aggressive investment options with longer term durations

P2P business lending and P2P consumer lending ‘stock-picking’ loans from the entire range of UK platforms.


### 3.2 Due Diligence

Advisers have rather onerous due diligence obligations when it comes to any investment, but particularly when investing in something new and alternative.

What follows is a checklist for advisers to refer to when conducting due diligence on P2P lending platforms.

#### PLATFORM OPERATOR

- Analysis of the operator, its trading and lending history, directors and key stakeholders. If it exists, be sure to consult any third party due diligence into the provider, to help you better assess how robust they are.

#### INVESTOR ALIGNMENT

- What does the platform operator have at stake? Some P2P platforms maintain a ‘provision fund’ – a pot of money that can be used in the event of default as a sort of insurance policy. How big is it, and what level of cover does it provide? But more importantly, what does the platform operator suffer if a loan goes bad? For example, in the case of its product, Octopus Choice. Octopus Investments contributes 5% to each and every loan – which would be lost first in the unlikely event that anything was to go wrong. It aligns their interest with investors.

#### FINANCIALS & CONTINUITY

- Analysis of the platform operator’s financial strength, its capital adequacy and its business continuity and disaster recovery plan (including its triggers, castings and timings). What sort of systems and controls do they have in place? Will the platform be here in 3/5/10 years, time?

#### LIQUIDITY

- Analysis of the conditions attached to the loans including early repayment, redemption, cancellation and transfer. Is access to the loaned funds allowed at all during the term of the loan and, if so, is there any cost or penalty? How is any early access facilitated – is there a secondary market in which investors can sell their loan parts, or can the product provider or platform repay back loan parts before the end of the loan term? What are the associated arrangements?

#### SECURITY

- Examine the security attached to the loans if there is any. Are there assets that can be used to fund repayment of the debt if the borrower defaults? How are they valued, is the valuer reputable and independent and what is the loan to value? Is there headroom for potential falls in value of the security over the course of a loan? How and when can any security be enforced, and what are the platform operator’s assessment procedures on default, late payment and provision fund analysis?

#### COMPLIANCE

- Consider the platform operator’s regulatory compliance, including its high level controls, CASS compliance, AML, capital adequacy, client reporting, promotional material and its complaints procedures.

#### PARTIES

- Review of any ongoing counterparties, including their provenance, experience and regulatory record.

#### BORROWERS

- Who are they? This will inform their risk profiles – are they individuals or businesses and what are they planning to do with the money that’s lent to them? Does the lender know?

#### PAST PERFORMANCE

- Analysis of past performance to determine if the platform has delivered returns as expected and if there is any evidence of a decline in the quality of the loan book or changes in the underlying business model (such as pivoting from P2C to P2B lending for example). If the loss rate isn’t openly published, it could be cause for concern.

#### SELECTION & DIVERSIFICATION

- Who is picking the loans? Does the investor take some responsibility or is the process controlled automatically by the platform? If it’s the former, is the investor suitably qualified to do so? If it’s the latter, are they an experienced lender, well-versed in building a loan portfolio and how well spread are the loans across sectors, loan terms and underlying borrowers?

#### UNDERWRITING

- How are the borrowers assessed? What sort of credit profiling is undertaken? Does the product provider have an experienced underwriting team and a robust process to analyse every loan application? What is that process?

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**Further Considerations**

Of course, typical key metrics must also be included in any due diligence review, including what is the expected term of the investment, what fees are levied and when (on both lender and borrower) and whether adviser charging is facilitated.

Advisers must also ensure that they have appropriate Professional Indemnity cover in place.

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Much of this work can be outsourced to independent review providers such as in:review. Many platforms (and all members of the P2P Finance Association) also publish full details of their loan books online (and some send loan-by-loan cash-flow data to AltFi Data to construct the analytics AltFi Data make available to their customers). Advisers will find that most P2P platforms are very transparent compared to other alternative investment options.
Main P2P Platforms
a starting point

<table>
<thead>
<tr>
<th>PLATFORM</th>
<th>UNDERLYING LOANS</th>
<th>CUMULATIVE TOTAL LENT*</th>
<th>MINIMUM INVESTMENT</th>
<th>SECONDARY MARKET</th>
<th>ESTIMATED DEFAULT RATE**</th>
</tr>
</thead>
<tbody>
<tr>
<td>Octopus Choice</td>
<td>P2P property lending</td>
<td>£175.41m</td>
<td>£10</td>
<td>Yes</td>
<td>0%</td>
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<tr>
<td>Funding Circle</td>
<td>P2P business lending</td>
<td>£3.3bn</td>
<td></td>
<td></td>
<td>0%</td>
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<tr>
<td>Ratesetter</td>
<td>P2P consumer lending</td>
<td>£2.36bn</td>
<td>£10</td>
<td>Yes</td>
<td>0%</td>
</tr>
<tr>
<td></td>
<td>P2P business lending</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>P2P property lending</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Zopa</td>
<td>P2P consumer lending</td>
<td>£3.07bn</td>
<td>£1,000</td>
<td>Yes</td>
<td>4.52%</td>
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<tr>
<td></td>
<td>P2P business lending</td>
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<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>P2P property lending</td>
<td></td>
<td></td>
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<td>Lending Works</td>
<td>P2P consumer lending</td>
<td>£93.7m</td>
<td>£10</td>
<td>Yes</td>
<td>4.3%</td>
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<td>Assetz Capital</td>
<td>P2P business lending</td>
<td>£434.8m</td>
<td>£1</td>
<td>Yes</td>
<td>0.28%</td>
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<tr>
<td></td>
<td>P2P property lending</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Proplend</td>
<td>P2P property lending</td>
<td>£100m</td>
<td>£1,000</td>
<td>Yes</td>
<td>0%-3%</td>
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<tr>
<td>Lending Crowd</td>
<td>P2P business lending</td>
<td>£27.6m</td>
<td>£20</td>
<td>Yes</td>
<td>1.49%</td>
</tr>
<tr>
<td>ThinCats</td>
<td>P2P business lending</td>
<td>£274.6m</td>
<td>£1,000</td>
<td>Yes</td>
<td>2%</td>
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<td>Archover</td>
<td>P2P business lending</td>
<td>£60.4m</td>
<td>£1,000</td>
<td>No</td>
<td></td>
</tr>
</tbody>
</table>

*Figures sourced 1 March 2018  **Figures sourced 7 March 2018

SOURCE: IN:REVIEW AND IP RESEARCH

For more information about the P2P providers and the products available, in:review publishes reviews and market metrics:

in-review.com

Innovative Finance ISA
Advisers and most investors will be familiar with the Individual Saving Accounts, the UK’s most popular savings and investment tax wrapper. However, there are four unique features of the new Innovative Finance ISA (IFISA):

1. Lenders are only able to access one platform per IFISA, although aggregator platforms are also acceptable and present a way around this restriction.
2. Investors and their advisers should also beware that in a given tax year, withdrawing money from an IFISA opened that year and reinvesting in another platform would reduce one’s annual ISA allowance by that amount. However, any interest gained from the former platform would still be free from tax.
3. In-specie P2P investment transfers are not accepted into an IFISA wrapper, so it means selling the investment but buying it back within the wrapper is subject to conditions.
4. However, it is possible to switch money in pre-existing ISAs into an IFISA.

Dash from Cash
Every year, the vast majority of new ISA subscriptions are for cash ISAs (typically 3/4 of all new ISA subscriptions), driven by investors’ aversion to stock market volatility. The total of ISA subscriptions in 2016/17 was £396bn.

However, cash ISAs expose investors to the risk of the purchasing power of their savings being wiped out by inflation: interest rates have been so low for so long that the returns on cash ISAs are tiny.

CPI VS. CASH ISA RATES (2017)

<table>
<thead>
<tr>
<th>CPI</th>
<th>Cash ISA</th>
</tr>
</thead>
<tbody>
<tr>
<td>2.5%</td>
<td>0.9%</td>
</tr>
</tbody>
</table>

People are waking up to this and last year’s new ISA subscriptions fell by £18bn compared to the previous year. The inference is that savers are ditching low-paying cash ISAs, which is bad news for those seeking tax-free returns.

Use of an IFISA wrapper also means that the income for P2P investments won’t impact a client’s personal saving allowance, which can be used to ensure other sources of income are also tax efficient.

expected inflows 2017/18
Up to £1bn
Case Study:

Loan Underwriting – Residential Property Loan

We’ve used our sponsor, Octopus Choice, as a case study of the underwriting process for P2P property loans. Of course different platforms will have different processes, but we think this is instructive of just how safe the lower-risk end of the P2P sector can be.

THE LOANS

The loans originated for lenders in Octopus Choice are carefully selected by their dedicated lending team, Octopus Property. They do all sorts of lending, but the loans that are made available for investment through Octopus Choice have a few things in common:

1. Octopus Choice co-lends 5% of each loan in the first loss position. This aligns their objectives with those of the other investors.
2. They’re all secured. All loans are secured against bricks and mortar with a first charge, and the focus is currently on residential property, although commercial property is also available.
3. They’re all conservative. The maximum ‘loan to value’ (LTV) ratio is 76%. This means that, if a borrower were to fail to repay their loan, the property taken as security would have to fall in value by 24% before any capital would be lost.
4. They’re typically short term. Octopus Choice generally make loans of between nine months and two years, although they can extend beyond this.

THE BORROWERS

The borrowers tend to be property professionals who require a level of speed, flexibility and certainty that traditional lenders can’t provide.

They may use the money for a variety of reasons, for example:
- To add to a buy-to-let portfolio.
- To diversify their funding away from one bank.
- To renovate a property.
- To buy a property at auction, where full payment is required within 14-28 days.
- To raise short-term capital.
- To secure a discount on a property by buying it quickly.

TYPES OF LOAN

- BRIDGING RESIDENTIAL: bridging loans with terms of up to 18 months.
- BUY-TO-LET LOANS to landlords, with terms of between two and five years.
- BRIDGE-TO-LET: a hybrid bridge and buy-to-let loan in one - loans last either two or three years, with the option to exit within the first seven months.
- COMMERCIAL and longer-term buy-to-let.

UNDERWRITING PROCESSES

THE ASSET: Octopus commission an independent RICS valuation, and assess the location, condition, rental possibility and alternative use value of the property.

THE BORROWER: Octopus don’t rely on credit scores, but instead undertake full credit profiling looking at the borrower’s track record, exit strategy, the equity in the deal, additional security of offer and their total exposure to borrowing. This process is not automated and instead relies upon careful, expert scrutiny.

THE EXIT: If the proposed exit is via a sale, Octopus look more closely at the valuation of the asset. If the exit is via refinancing, Octopus place more emphasis on the strength of the borrower and their creditworthiness.
Case Study:

Loan Underwriting – A corporate borrower (SME loan)

The sophistication of underwriting procedures will vary across platforms and is often aided by technology that assists with the process of checking records in relation to the potential borrower.

For companies looking to borrow, there are typically some minimum initial requirements to allow the credit assessment team to begin its work. For example, Funding Circle requires the most recent filed accounts of the company and a copy of the up to date management accounts (no more than three months old). Where management accounts are not available (for instance where the borrower is a non-limited business) three months’ bank statements must be provided.

Borrowers can be limited companies and non-limited companies, LLPs, sole traders or partnerships, but at a minimum Funding Circle requires an annual turnover of at least £50,000 and more than two years of filed or formally prepared accounts.

Funding Circle states that the internal risk model when deciding whether, and at what risk band, to accept a loan request is based on 3,000 different data points, including but not limited to:

- Affordability of the loan, including coverage ratios.
- Business net worth.
- Profitability.
- Trends.
- Age of business and management team.
- Use of loan.
- Credit history of directors.
- Days beyond term, and vs sector average.
- Cash flow indicators such as searches.


| % OF P2P LOAN APPLICATIONS APPROVED (2016) |
|-----------------|-----------------|
| PROPERTY        | CONSUMER        | BUSINESS       |
| 0%              | 20%             | 40%            |
| 10%             | 30%             | 50%            |

Source: CCAF

For business loans, unsecured loans up to limits set by each individual platform are common, typically secured by a personal guarantee from one or more directors. Clearly, in the absence of security, the underwriting process is crucial in identifying the companies which are likely to be in a position to fully repay funds lent, and/or directors whose personal guarantees provide a real opportunity for collection of outstanding amounts.

A personal guarantee puts the director’s personal assets at risk in the event of default on loan repayments, so a platform will usually undertake an examination of what those assets are, including their value and any other potential claims on them.

Nevertheless, where security is available, a fixed or floating charge may be put in place over the business’ assets and it is the ownership and value of that asset that must be verified to judge the level of protection that can be provided to lenders (investors).

5.1 Provision funds and loan defaults

The basic premise of a provision fund is that borrowers contribute payments into a segregated fund, which pays out if a borrower defaults.

There are two main types of provision fund:

- **FULLY INTEGRATED PROVISION FUNDS:** automatically pay out when a borrower defaults and therefore there is no time lag for investor repayments. By making the return more predictable, these funds can reduce the volatility of investor returns.

- **DISCRETIONARY PROVISION FUNDS:** pay out at the discretion of the directors of the platform.

The level of provision funds, in terms of the proportion of the loan book that they cover, depends on the platform and a fairly wide range exists from less than 1% to 7%+. This figure is related to the risk profile and projected default rates of the loans issued and is decided by the platform.

While it might seem that the best policy is to have a large provision fund to cover as much as possible of the value of any defaults, too much cash sitting idle in a segregated account will cause cash drag. That means it will reduce returns and cost investors money, so there is a delicate balance to be struck here.

Although past performance is not an indicator of future performance, it is also useful to review the size of a reserve fund in relation to the platform’s past bad debts. The critical statistic is whether the reserve fund has easily survived any and all bad debts. Obviously, the larger the loan sizes, the more chance there is that the reserve fund could be affected or even wiped out if one or two borrowers default on most or all of their repayments. This means that platforms that approve very large individual loans put their reserve funds at higher risk than those that approve the same overall loan value across multiple borrowers.

HOW A PROVISION FUND WORKS

Lenders receiving full returns are more likely to reinvest

Borrowers (small fee % of loan) Provision Fund Not making any loan interest

Lenders (investors)
5.2 The effect of loans defaulting in a diversified portfolio

It is not unusual to see recommendations that P2P lenders invest in between 100 and 200+ loans to offset the negative effects of defaults within the portfolio.

Analysis of US P2P lender, Lending Club, which offers personal loans, auto refinancing loans, business loans, and medical financing and Prosper, which offers personal loans, endorses these figures.

P2P in action: LENDER CASE STUDIES

The three key ways to diversify your portfolio

- Platform
- Sector
- Borrower
1  
Tax Efficiency

Client in 50s who wants to use their IFISA to build a tax efficient pot of investments that are diversified away from their conventional portfolio.

Trevor has a large portfolio of conventional investments split between his pension and ISA, but tighter pensions allowances mean he now has £10,000–£20,000 spare cash to invest annually.

He transfers some of his existing ISA portfolio out of low-yielding cash to his growing IFISA portfolio.

Trevor is earning 4%-5% on his IFISA portfolio each year.

2  
Starting to invest

Professional client in 30s who wants full control of what she is investing in – looking for something worthwhile and initially shorter term.

Carla is looking for an ethical investment that allows her a higher return than cash, but wants to access her capital again in the next 4-5 years as she is saving for the deposit on a buy-to-let property.

She intends to invest her ISA allowance conventionally, and therefore only has £11,000 set aside for this investment initially.

She invests in a portfolio of P2P loans that have been issued to finance renewable energy installations.

The platforms offer returns of 5%-6% over terms of 2-5 years.

Tax

Since Carla is a basic rate taxpayer and does not use any of her Personal Savings Allowance on her ISA returns, the interest she receives on her P2P investment annually of up to £660 is within her £1,000 Personal Savings Allowance and no tax is due on it.
Considering later life

Client in 40s looking for a kick start to later life saving, setting aside a portion for higher yield opportunities with automatic reinvestment.

Max is a pharmacist satisfied with his efforts at saving so far but concerned that poor market performance could impact his final pension pot.

He discusses this with his adviser and together they agree to open an account with a P2P aggregator platform.

Max then invests a small amount each month across a diversified range of P2P loans originated by several platforms and covering several different types of underlying borrower.

The aim is to achieve a return of 6%-7% per year and the plan is to keep growing this portfolio alongside the SIPP as a diversifier.

Approaching retirement

Clients in their 60s looking to reduce their exposure to equities, while maximising their returns in the last years that they are earning.

John and Joan are in their 60s and both semi-retired, working as independent consultants in their respective industries, considering full retirement for the first time.

They need to reduce their exposure to stock market volatility.

They like property as an investment as they have had success in the past, but they do not want the additional responsibilities of being a landlord or to be over exposed to one or two properties.

Their adviser recommends that they invest in P2P property, rotating some of their existing portfolio out of equities and into the new asset class.

John and Joan invest across a range of properties with different LTV ratios, looking for low to medium risk opportunities, targeting 4%-5% per annum.

Adviser Portal Options

When their IFA sets up the investment on the adviser portal, he sets the interest to be automatically reinvested, knowing that once they retire fully, he can change this so that it is paid out as income.
Case Study:

Max Spurgeon
Director, Legal and Medical Investments

Max Spurgeon is a financial adviser and director at Legal and Medical Investments, a financial advisory business focused on doctors and dentists. The firm provides whole of market advice and, as such, it is currently not required to advise on P2P agreements. But it does.

Max’s explanation is simple: “clients at the moment are facing inflationary headwinds, returns on deposits are relatively low and also many of our clients already have fairly high exposure to equities. So, P2P really filled a void for us. It has low correlation to equities and clients don’t have to commit to the sort of timeframes that you do with equity. They can invest for shorter terms and volatility can be very low.”

Many of Legal and Medical’s clients have pensions, have used ISAs, and may have structured product investments, so, P2P is a great complement to that mix as a diversifier. It’s particularly useful as many of Max’s clients still have quite high cash reserves, including company owners looking for a better return.

That doesn’t mean there aren’t risks. The P2P loans Legal and Medical uses are asset backed residential loans and any fall in the housing market could lead to the failure of those loans. With no financial services compensation scheme cover, Max feels that, however low the chance is of something happening, these investments are at least in the medium risk category.

Legal and Medical prefers asset backed P2P investments, even if they may not offer the highest returns. The company likes platforms with some pedigree, like Octopus Choice which has been carrying on its lending trade for approaching ten years and has lent over £2.5 billion with a very low default rate. “You have to go and do your due diligence”, says Max, “and we took a lot of confidence from their track record”.

Max says, “The entry levels are very low. I put my own money in first to get a feel for it. With time, I introduced clients I felt it was appropriate for, and some of them have put in relatively small amounts just to see how it feels. As they’ve got more confident with it they’ve topped up as they’ve seen fit.” Of course, explaining in detail the liquidity of the investment and how that impacts their access is vital.

He feels that the level of work that advisers need to do to carry out the necessary due diligence and gain confidence in P2P could put some of them off. But, “for us, particularly in 2017 when the equity markets were very, very strong, to have P2P as an option, was really very helpful.”

It can also be used in varying circumstances; there may be times when clients have a much higher percentage than 10% of their portfolio in P2P loans; perhaps they want their money in two years, are happy to accept some risk but don’t want to go into equities. They want a slightly higher return for a shorter period of time.

Max views P2P as just another tool that can be used to get the right results for his clients, provided, as with any investment, they fully understand the risk profile.
Case Study: 

Gary Neild is managing director and chair of Blue Sky’s Investment Committee, as well as an experienced financial planner.

Gary admits to being very wary about P2P before starting to recommend P2P loans to his clients. He was concerned with the sustainability, the risk profile, whether clients were protected under the Financial Services Compensation Scheme and the regulatory status. But, in his view, education and due diligence are essential for all advisers, before they start to recommend any offer; “If advisers can’t explain it to someone, they shouldn’t be doing it.”

He says, “we have to do our due diligence to make sure we’re very confident in what we’re recommending.” That’s why he chose a well-established property backed loan service with first charge security.

But, the firm only uses P2P that has strong asset backing.

It’s clear that there is a lot going on for financial advisers at the moment, from MiFID II to PRIIPs, GDPR to SM&CR. And new asset classes can be threatening for advisers; they have to be mindful of their reputation, especially when the asset class has a reputation for high risk, even if that isn’t the whole story. But for Gary, the needs of clients come first and he thinks, “it’s remiss of an adviser not to consider it, particularly in this low interest rate environment.”

And, with a cash management service that researches bank accounts, Blue Sky is well-placed to judge how hard cash is working and how long it might be locked in to low-yielding accounts. Like Max, Gary’s view is that P2P is, “a complement to what you’ve already got and for us, it’s really about cash-beating, inflation-beating secured investing.”

Gary continues, “is risk leaving your money languishing in latent deposit accounts, guaranteed to lose money against inflation?”

Blue Sky uses P2P as a risk management tool, under the right circumstances, with the right clients. They can be wealthy retired clients who like the steadiness of the returns or those with less money, trading some liquidity for better returns than cash, probably at a maximum of 10% of their portfolio.

8.1 Adviser Portals

The Personal Finance Society has stated that platforms have a greater focus on consumers than on advisers. This is part of the reason for retail investors engaging directly with P2P more quickly than advisers. But there are now adviser portals available, including those provided by Octopus Choice and Ratesetter.

The OCTOPUS portal was designed specifically to assist IFAs in signing up and managing their clients’ investments on the P2P platform more easily. Its adviser-friendly features include:

- Client investments can be set up facilitating both upfront and ongoing charges paid out of client returns each month.
- All client investment accounts can be viewed – allowing monitoring of their individual loan portfolios, rate, earnings to date.
- Advisers can view all their aggregate earnings across all clients.
- Advisers can determine how their clients take their interest – i.e. automatically reinvested or paid out as an income.

The RATESETTER portal also notifies IFAs as their clients’ funds mature and allows reinvestments to be set. It also facilitates the benchmarking of the advisers’ clients and gives some flexibility in terms of how the adviser takes their fees.

8.2 Tips to include P2P in adviser propositions

Start slow

With some very low minimum investment amounts, it is entirely possible to start slowly and to allow you and your investor to become comfortable with P2P investing before moving more funds into this solution. These low entry levels also allow for decent levels of diversification, often available more easily and quickly via automatic loan allocation.

IFISA benefits extend to PSA

IFISA prevents returns from P2P impacting on a client’s Personal Savings Allowance (PSA) as they are tax-free within the wrapper.

Make the most of technology

Some platforms allow for automatic reinvestment of returns into new loans and this can be a very good way to compound yields.
Monitor investments

However, it is prudent to carry out regular reviews of clients’ P2P investments, returns and defaults to maintain an ongoing awareness of success or otherwise and rising risks, identify any default trends (perhaps sector or platform related) and to decide on any relevant course of action (e.g. liquidate the loan on a secondary market, change clients’ favoured loan types/terms/risk profile or perhaps stop automatic reinvestment).

Incentives and offers

It is not uncommon for P2P platforms to offer ad hoc bonuses and deals. These can be interesting and make initial returns very attractive, but shouldn’t be the main component of any decision to invest. Instead, they may be a nice little extra on top of a robust investment proposition, but they still require a review of the terms and conditions to understand how your client may be eligible.

Britain’s P2P lending sector has fared well so far as a result of a regulatory approach that is pragmatic and flexible; the Financial Conduct Authority puts P2P lenders through a rigorous process before granting them full approval, but is keen to let it be known that it is here to help, not hinder.

P2P Lending process

- Loan application on a P2P website, specifying the amount to borrow and the loan term
- Credit check
  - The platform conducts a credit check and adds successful requests to the online marketplace
- Investors bid to lend money and declare how much they will lend and the interest rate they will charge.
- Investors auto-lend
  - Platform picks a portfolio of loans that aims to meet lenders’ appetite for risk and return criteria
- Loan is arranged
  - The business pays the fee to the platform and receives the money
- Investors can resell the loan on a secondary market at a premium, or wait for the repayment plus interest

8.3 What if?

Advisers can mitigate the risk of something going wrong by taking the following steps:

- Invest in the lower-risk underlying loans, via the bigger platforms in each P2P sub-sector, mitigating investment risk.
- Diversity across 2-3 of these platforms, mitigating the risk of a platform failing.
- Only invest small amounts at first, and only after conventional financial planning needs (pension contributions, insurance premiums, conventional investment) have been met, mitigating the risk of a bad investment having wider impacts on the client.
- Fully document any research and education activities and download reviews of platforms, to evidence your due diligence in the event of any challenge.
- Fully document any recommendation to invest in P2P lending, including an explanation of why P2P was chosen instead of more conventional investments and why a particular platform was chosen over and above another, to evidence suitability in the event of any challenge.

Whether or not you need an innovative finance ISA will depend on the rate of tax you currently pay, how much you are prepared to invest and the rate of return you expect to receive.
8.4 Taxes & P2P loans

Although it wasn’t always the case, the way loan interest from P2P lending is taxed and tax is reclaimed is the same as it is for any other interest received. Provided the P2P lender is liable to UK Income Tax, makes loans through FCA authorised P2P platforms and is the legal lender when the loan goes bad, they can set any loss from P2P repayment defaults against the interest they receive on other P2P loans, before the income is taxed. Additionally, any interest earned on P2P loans can be offset against any unused Personal Savings Allowance.

However, P2P lending losses cannot be offset against gains from other types of savings and investments, although the loss relief can be carried forward for up to four years.

Lenders who do not normally need to submit a tax return will only need to declare any P2P interest that they receive through the same platform after bad debts to HMRC. This can be done by contacting their local tax office.

If the investor pays tax under Pay as You Earn (PAYE), their tax code will then normally be adjusted to collect the tax due on the interest earned. If tax has already been deducted on the full amount of P2P interest received, without a deduction for bad debts, the lender can make a claim for repayment.

Any claims to set relief for P2P bad debts from one platform against P2P interest received through another platform, or to carry relief forward against P2P interest received in future years, must be made through a tax return.

Platforms are required to report to HMRC on their investors’ regular accounts once a year, and within 60 days from the end of the tax year on IFISA accounts. It is important for investors to correctly declare their P2P earnings to HMRC (where appropriate) as we know that HMRC does look at this. In the last two years it has contacted P2P investors who appeared to have under-declared untaxed interest, after reviewing platform information and individual tax return filings.

For more guidance on reporting interest and claiming losses from loans that default, go to: https://www.gov.uk/guidance/peer-to-peer-lending

Personal Savings Allowance

Since April 2016 basic rate taxpayers have been able to earn up to £1,000 in savings income tax-free, while higher-rate taxpayers get a £500 allowance. This equates to a maximum potential annual saving of £200. But, additional rate taxpayers are not eligible for any relief.

Case Study:

Graeme Stewart
Compliance Partner, Paradigm Group

P2P loans are currently not classified as Retail Investment Products (RIP), so firms offering an Independent proposition are not obliged to offer advice on them. Those that do have the option to offer advice on the basis of whole of market, single product, panel or from a range of products and they need to decide which is most likely to meet the needs of their clients.

Paradigm’s regulated consultancy view is that new products bring new opportunities which in turn bring new risks. So, before any advice is given, advisory firms should put in place systems and controls to mitigate this potential new risk and evidence that advisers are competent to give advice on such arrangements.

That means verifying that suitable professional indemnity insurance is in place and, in certain cases, firms may be asked to let the insurers know what processes and procedures have been established to mitigate new potential risk.

DUE DILIGENCE

When it comes to products to recommend, robust due diligence must be undertaken on both the product and providers which will include challenging the provider to ensure their risk description is the same as the understanding the advisory firm has of it.

In addition, firms need to build a picture of the provider to confirm they are who they say they are and to get an understanding of their experience and track record.

NEW SYSTEMS AND CONTROLS

Firms should establish a process which shows the research and due diligence process that will be followed when making a recommendation. It is also essential to clearly disclose at the start of the advice process what range of advice is on offer in standard disclosure documents and for a considered explanation of these products to be included within Suitability Reports, including clarity regarding FSCS coverage.

ADVISER COMPETENCE

Before an adviser begins to provide advice in this area, they should be assessed to ensure their knowledge, experience and skills are sufficient. Paradigm would suggest that the firm review its own Training & Competence scheme to make sure there is a person with sufficient skills and experience of their own to assess and supervise an adviser in this area.

We suggest that an adviser’s CPD and qualifications should be taken into account. A knowledge check may be undertaken in the form of a role play, checking the adviser’s understanding of the risk profile in comparison to other asset classes and their presentation of P2P products. It is also recommended that a pre-sale check is completed on the first few cases just to verify that all is well with the advice.
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Find out more at:
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