A Guide to Peer to Peer Lending

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Executive Summary

Peer to Peer (P2P) should not be compared to traditional savings accounts. The P2P market has seen exponential growth in recent years, fueled by demand from investors attracted by rates of return that appear favourable in comparison to savings accounts.

There is concern that the way in which P2P is marketed and the fact that there is no capital protection, means that many investors are unaware of the risks.

The risk and reward associated with P2P is aligned with that of equity investments. This does not suggest that P2P is not suitable for investors but Savings Champion would encourage anyone unsure of the suitability of the risks for their personal circumstances, to seek independent financial advice.

If you wish to speak to an independent financial adviser please call Savings Champion on **0800 321 3581** for a recommendation.

Introduction

In simple terms, Peer to Peer (P2P) lending is all about finding people or small businesses who want to borrow money and linking them with people who want to lend (savers).

This is similar to the basic business model of a bank or building society, however unlike putting your savings with a bank, critically with P2P, savers are not protected against bad debts if some of the borrowers are unable to pay back their loan. This means savers may not earn what they were expecting and even more critically their cash is not protected by the UK Financial Services Compensation Scheme (FSCS).

P2P may look like a savings account, but is not and savers should be aware of the risks. Unfortunately the way in which P2P lending is promoted means that for many people the extent of the risks are not fully understood.

In August 2013 the FCA reviewed 21 Peer to Peer websites and found that many "downplayed" the risks and used "misleading and potentially unfair" comparisons with bank and building society accounts. The regulator warned that some sites were emphasising a headline rate of return "that is often in double figures, without an explanation of the impact of charges, default rates and taxation". It added: "In some cases it appears the actual returns to customers can be substantially less". To read the full report please click on the following link http://www.fca.org.uk/static/documents/consultation-papers/cp13-13.pdf.

You are not alone

If you are unaware of the risks associated with P2P, then you are not alone.

Yorkshire Building Society undertook a survey and found that of those surveyed 42% of respondents were aware of Peer to Peer lending, but of that 42%;

60% were not aware that P2P was not protected under the Financial Services Compensation Scheme	53% were not aware P2P is a type of investment, rather than a savings product	44% were not aware investors in P2P can lose money.

We believe these figures support the opinion of Savings Champion, which is, that a high proportion of people are using P2P without being aware of the risks involved.

This guide has been produced to help provide a clearer understanding of P2P, however if in doubt please call Savings Champion on **0800 321 3581**.

Why is Peer to Peer lending so popular?

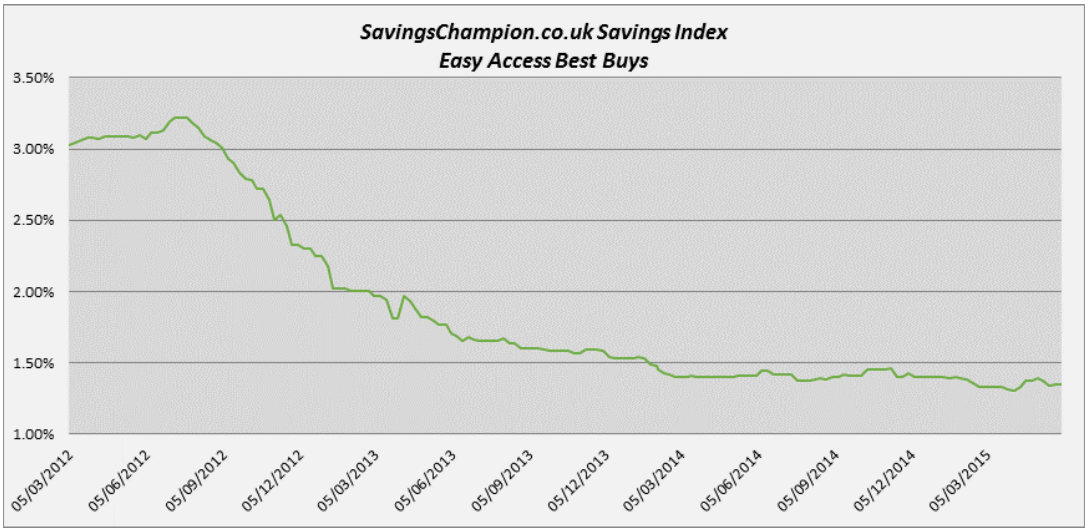
P2P has received significant media coverage in recent years and there is no doubt that it is growing in popularity.

Demand

There is strong appetite for P2P from both private investors as well as businesses, which has driven the demand for this product.

- **Private Investors**

The Savings Champion savings index (see below) highlights how the rates available on best buy easy access accounts have more than halved in recent years, following the introduction of the government's Funding for Lending Scheme (FLS) in August 2012. The scheme, introduced to improve lending, has had a devastating effect on savings rates.



Without the desire to raise capital, banks have slashed the rates on savings accounts and accordingly savers have become increasingly frustrated by the returns offered by savings accounts. This has led them to seek alternative investments such as P2P.

- **Business Loans**

The Funding for Lending Scheme, mentioned above, was introduced after the financial crash in 2008 to help ensure small and medium businesses were still able to access loans from banks. However in effect what happened is that the banks took the money as it represented low cost liquidity and failed to pass this on to those looking for loans, which left many desperately looking to raise finance, to consider alternative options.

P2P business lending is relatively fast and easy compared to other types of borrowing. Interest rates are often lower than are available through other types of finance and fees and other costs can be the lowest on the market.

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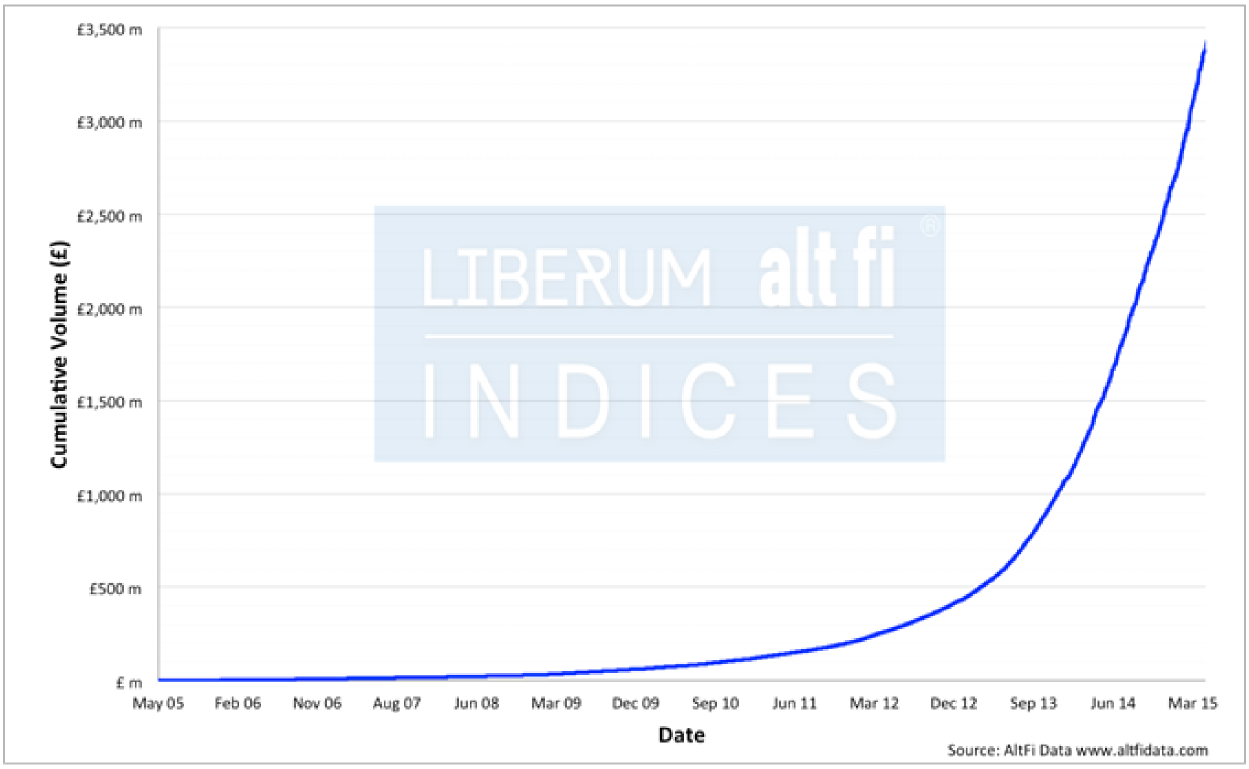
Following the FCA's decision to regulate the P2P lending market in April 2014, it is now considered a viable alternative to other types of loan.

According to Nesta, the average growth of the P2P business lending market was 250% between 2012 and 2014.

The phenomenal growth in the P2P market is best illustrated in the graph below.



Supply

There is no doubt that due to macro-economic conditions, there is significant demand for P2P, which is fuelling growth and as many will know, in the finance industry, where there is demand, supply is never far behind.

The banking crisis saw some banks collapse (i.e. Lehman Brothers) but almost all have been forced to consolidate. The impact of this was the loss of many banking jobs with many being forced to identify how to utilise their finance experience in non-traditional banking positions, such as P2P, which has enabled the supply of P2P to keep in pace with demand.

In addition the government is supporting the rising popularity of P2P, no doubt because it is allowing many small businesses to access loans, which the high street banks no longer provide, which is crucial to economic recovery. In an HMRC Technical Note dated March 2015 it states "At Autumn Statement 2014, the Chancellor announced support for P2P and crowdfunding platforms through a package of measures to modernise regulation and tax rules to remove barriers to their growth."

Accountancy firm Ernst & Young predicts the industry will grow to five times its current size in the next three years.

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How does P2P differ from Savings Accounts

In short the answer is P2P is vastly different from savings accounts not least because capital is at risk and returns are not guaranteed. The issue as we have seen, is that too often P2P is being promoted in such a way that investors simply do not understand the risks associated.

Comparison Table

	Bank & Building Society Savings Account	P2P
Protection	Provided your funds are held with a bank or building society that is authorised by the Prudential Regulation Authority (PRA) and regulated by the Financial Conduct Authority (FCA) and the PRA, then you have protection under the Financial Services Compensation Scheme (FSCS). The first £85,000 per person, per banking licence is protected in the event the provider collapses. It is wise to ensure you're not under protected as some providers share a banking licence. (Click Link to FSCS)	P2P lenders are not protected in the same way. If something goes wrong with the P2P investment, you could end up losing some or all of your money. Your money is not guaranteed and not protected by the Financial Services Compensation Scheme. As highlighted previously, many P2P adverts have been identified by the FCA as being misleading.
Timing	With the majority of savings accounts, your money is deposited as soon as the application is received. And at that point you should start earning the interest, even though it could take a few days for money to clear i.e. paying in by cheque.	P2P platforms have to match lenders with borrowers, which can take some time – and during that period there is no interest being earned.
Return	What you see is what you get. Although the rates can be variable, the provider will tell you the interest rate you're receiving. Any debts that are not repaid (bad debts) are absorbed by the provider.	The interest rate quoted may not be the amount you actually earn if any of the borrowers default on their loans. Therefore you may not receive the interest you expect – and your capital could be also be at risk.
Taxation	With the exception of cash ISAs, interest paid on savings accounts is paid net of basic rate tax, so after the deduction of 20% tax, unless an Inland Revenue form R85 is completed to declare that you are a non-tax payer. However this will all be changing from April 2016 when the new Personal Savings Allowance is expected to be introduced. As a result all interest will be paid gross and savers will need to declare their interest should it exceed £1,000 for a basic rate taxpayer or £500 for a higher rate taxpayer.	Returns on P2P loans are paid without any tax deducted, so it's up to you to let the taxman know that you have some tax to pay. Currently bad debts cannot be deducted from tax returns before income tax is calculated. So, if as a P2P lender you were expecting to earn £1,000, but only received £950 due to bad debts, the taxable amount is still £1,000. The good news for P2P is that this is expected to change and any bad debts incurred by individual lenders will be deducted against tax.

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ISAs	You can put the full allowance of £15,240 in a cash ISA. Or, invest the whole lot in an investment ISA. You may also split the amount between cash and stocks & shares ISAs. If you wanted to, you could invest £1,500 in a cash ISA, and £13,740 in a stocks & shares ISA. Or do it the other way around. The only rule is that, combined, your tax free ISA savings in the 2015/16 tax year don't exceed £15,240.	It was announced in the March 2014 Budget, that P2P was to be included in ISAs. However, formalisation of this has yet to occur.

History of P2P

P2P is a relatively new method of investing money. It was pioneered in the UK in 2005 and according to the Peer 2 Peer Finance Association, in 2014, P2P platforms have enabled lenders to provide over £1.2billion of funds to UK consumers and businesses, with expectations that the sector will continue to double in size every six months going forward.

How does P2P work?

P2P is regulated by the Financial Conduct Authority (FCA) and all P2P lenders must adhere to FCA regulation.

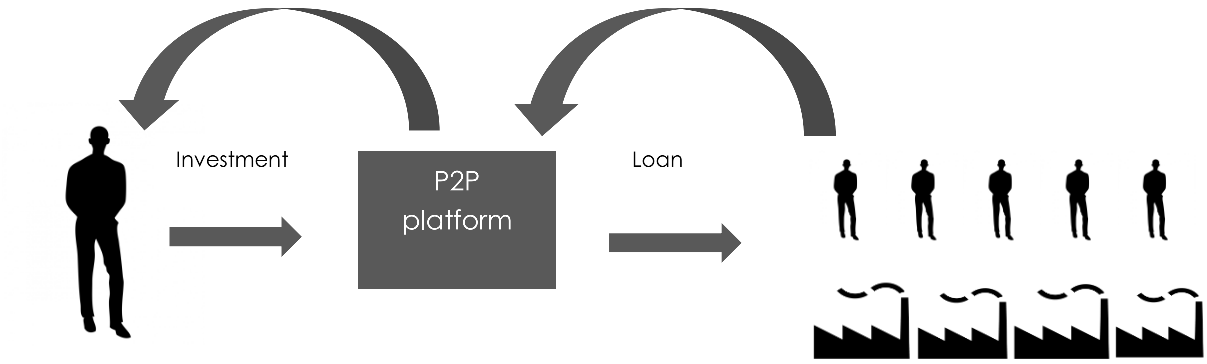
The following illustration shows how P2P works.

Investor (saver)

The investor places their money via the P2P platform and will expect to receive their capital plus interest, less any fees or bad debt.

Borrower (individual or business)

The borrower receives the money from the P2P platform and is expected to repay the capital borrowed plus interest.



The investor (saver) places their money with a P2P platform, which matches the investor (saver) to individuals or businesses that need to borrow money.

The platform charges a rate of interest to the individuals or businesses that wish to borrow the money and passes a proportion of this back to the investor (saver).

There is no guarantee for the investor and no control over what the borrower uses the money for, which means that if the borrower defaults there is no recourse to the investor other than legal action.

As lending and borrowing is matched it means that it may not be possible for an investor to access their funds early, or if they do there may be high costs to do so.

It's not all bad news though

The returns on P2P can be very attractive although this is reflective of its risk/reward profile.

Although P2P is not covered by the FSCS they are required to hold capital reserves of at least £20,000, increasing to £50,000 by April 2017 to help protect against financial instability. Many of the more established P2P platforms have their own protection schemes in place which are greater than the requirements set out by FCA regulation.

The majority of P2P platforms diversify investor's money across a large number of borrowers to minimise risk against any one borrower defaulting and some platforms will allow investors to select who they lend to.

When the P2P platform lends the money it undertakes credit checks on the borrower, just as a bank would do, to mitigate the risk involved.

Is P2P right for you?

Savings Champion would strongly encourage anyone that is unsure of the appropriateness of P2P to seek independent financial advice and you may find the following check list helpful.

- **Understand the risks**

With P2P, your capital is at risk and this means that it is not a substitute for a savings account. If you're not comfortable with this, it may not be for you.

The most obvious risk is that a borrower fails to repay your loan. However, several of the P2P platforms operate a fund or similar scheme that will cover a lender's losses in the event that a borrower is unable to repay. But this is not guaranteed.

Another risk to capital would be if the platform itself went under because these are not covered by the FSCS.

Many of the sites insist that funds not on loan are held in a ring-fenced account and that in the event that the site went under, investors contracts with the borrowers would remain in force, and they would be contractually obliged to repay you.

One way to overcome this would be to consider spreading an investment between several P2P platforms.

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- **Understand the impact of fees and charges**

The charging and fee structure varies between the different P2P platforms. Some platforms charge a 1% annual fee on the amount lent to borrowers, whilst others charge investors 10% of the interest they receive.

- **Remember the Taxman**.

Returns are currently paid without any tax deduction, so investors would need to declare tax by completing a tax return. And remember, there is no relief for bad debts or platform fees at the moment, although hopefully this will be changed for any investments made in the current tax year.

Conclusion

The P2P sector is rapidly rising and there is no doubt that many are simply attracted by the rates that are promoted.

There is evidence that not enough people are aware of the risks of P2P, which is certainly consistent with our experience at Savings Champion based on enquiries made by customers and clients alike.

As well as individuals not understanding the risks, we also believe that another cautionary note should be made on the P2P sector, which is based on previous experience within the finance industry.

In the run up to the financial crisis, there was an abundance of irresponsible mortgage lending in America. Loans were made out to "subprime" borrowers with poor credit histories who struggled to repay them.

These risky mortgages were manipulated by investment banks to create what were supposedly low-risk securities.

How was this done? By aggregating large numbers, which were then used as securities known as collateralised debt obligations (CDOs). These CDO's were then divided according to risk and investors bought those perceived as safer based on credit ratings assigned by agencies such as Moody's and Standard & Poor's. It is worth noting that these credit agencies were paid by the banks that created the CDOs, which distorted the true evaluation of risk.

Critically investors bought these securitised products because they appeared to be relatively safe and provided attractive returns in comparison to global interest rates.

There are many comparisons that can be made from the above experience with P2P and whilst this does not mean that P2P is not right for some people we strongly believe that the risk profile is far greater than is commonly accepted and how P2P is marketed.

If you remain unsure of the appropriateness of P2P we strongly recommend you should call Savings Champion on **0800 321 3581.**