Peer today, GONE TOMORROW?

An extract from Perspective:
The affordability and responsible lending issue

Essential insights into the issues facing your industry today
Peer today, gone tomorrow

Peer-to-peer lending has come a long way since its inception 10 years ago, but does the recent appearance of institutional lending in the UK threaten to end true peer-to-peer before it has reached its true potential?

**Karl-Magnus Wadsack, Principal Consultant at Equifax, talks to Perspective about what the future may hold.**

**Happy Birthday**

On March 11, 2015, there was a lavish party held at ‘The Forge’ in the City of London.

Whilst lavish parties in the City aren’t that unusual, this one was a thank you to all those that helped and supported Zopa to create and grow a new asset class called peer-to-peer (P2P) lending, 10 years ago.

Little could the founders of Zopa have known in 2005 – when they first got together to discuss ‘Internet Lending’ as a challenge to the inertia and bureaucracy of the high street banks – that a decade later, 50,000 investors would have used their platform to lend £750m to 100,000 borrowers requiring affordable unsecured loans.

These investors have made £50m of returns (as of April 2015).

The tenth year anniversary of Zopa proves that P2P lending is no ‘flash in the pan’. In December 2014, Lending Club – a P2P lender in the US that started lending via Facebook – listed publically via an IPO which valued the company at $8.5bn. Prosper, another US P2P lender, recently completed a funding round that valued the company at $8.5bn.

In the UK, Landbay secured £250m of institutional investment securing £2bn in new loans in the UK during 2015 shows that the industry has the potential to explode and see a ten-fold growth in the next few years.

**What is peer-to-peer lending?**

P2P lending (also known as social lending) is just that – people lending directly to other people (or to small to medium (SME) businesses).

The P2P companies themselves don’t actually lend the money; they facilitate a lending platform to link lenders / investors to borrowers.

They do, however, engage credit reference agencies such as Equifax for critical intelligence to fully understand the risk and affordability of each loan.

Typically, lenders / investors put in anything between £100 and £1m to directly fund loans for individuals who have either been refused loans by high street banks, or are looking for a better deal than those that more traditional banks are willing to offer.

The individual investments are usually split across multiple loans to spread the investment risk, with each individual loan consequently being funded by money from multiple investors.

In return, investors can typically expect 4-6% returns depending upon how long they are willing to commit their investment, compared to less than 2% currently for high-street savings accounts.

Returns can be even higher (more than 10%) from specialist P2P platforms.

**So, what’s not to like?**

It is these returns that have grabbed the attention of specialist institutional investors.

In the US, the likes of Lending Club and Prosper are predominantly funded by institutional investors, where this variation of the P2P lending model is known as Marketplace Lending. Whilst still classified as P2P lending, it is actually more akin to broking, as the institutional funds are used to fund whole loans or portfolios. The nature of these loans limits the extent to which the investments can be used to disrupt the UK lending landscape.

In the UK marketplace, P2P lending is still in its infancy, but institutional investment is increasing rapidly. This is driven mainly by the current shortfall in available investment funds needed by the P2P platforms to fund the demand for borrowing, and to grow into new areas of borrowing.

When coupled with the attractive potential returns, we can expect this to be a key driver of growth within the UK P2P sector. For example, Zopa has just announced a groundbreaking partnership in the UK with Metro Bank allowing the retail bank to receive a return by lending millions of pounds each month to UK consumers via the Zopa platform.

**Too good to be true?**

It sounds too good to be true, so why doesn’t everyone invest their savings into P2P?

Because there’s a risk, and that’s why the associated returns are so good in comparison to traditional lending. All P2P platforms must be completely transparent when highlighting the risks to interested lenders by making it clear that “while no one has ever lost money in the past, there is no guarantee that this won’t happen”.

Investors appreciate this transparency and understand that, while there are risks, the potential benefits outweigh...
them: they’re fully informed of the risks involved, but appreciate that the resulting returns are much greater than traditional high street savings rates.

To this end, the established P2P lenders in the UK actually make their loan books available for scrutiny online, thereby underlining the transparency of the P2P sector in the UK. Could you ever imagine the traditional banks following suit?

Currently P2P deposits / investments are not covered by the Financial Services Compensation Scheme guarantee scheme, hence why you won’t find P2P loans recommended in Best Buy tables in the financial press.

To address this concern, RateSetter pioneered their Provision Fund as a solution to protect their lenders in the event of borrower defaults, with Zopa subsequently offering their ‘Safeguard fund’ equivalent. Both solutions factor into their borrower fee structure an amount to cover the risk of the loan not being repaid, which is in turn paid into a contingency fund. If a borrower defaults or cannot repay, the lender / investor can make a claim against the fund for principal and interest due. As an alternative, LendingWorks ‘Shield’ innovatively uses part of the borrower fee to insure against the borrower missing payments, defaulting or against fraud.

With the exception of a few specialist lenders such as eMoneyUnion, Lendable and QuidCycle, P2P lending in the UK is typically very prime, with loans only being offered to those with the cleanest credit histories. There are enough individuals (and small businesses) with excellent credit profiles that still struggle to get a competitive loan from the banks – and it is this segment that is the focus for the major P2P lenders in the UK.

Institutional investors pushing for bigger returns will undoubtedly lead to pressure being put on the P2P lenders to offer loans to those with less than perfect credit histories (particularly with the depth and granularity of financial history and affordability information available on individuals in the UK – but there are enough prime prospects to feed the sector for the next few years. There is also a concern that the institutions will use their financial clout to ‘cherry pick’ the best loans ahead of retail investors.

In the US, Lending Club recently announced a relationship with CitiBank to use P2P lending to fund loans to the ‘underbanked’ – those with less than perfect credit histories who can’t get a loan from the banks.

Regardless of the amount being invested, or whether it’s by an individual or business, a comprehensive credit risk policy is fundamental to the P2P sector to ensure the returns on investments remain good and the positive reputation of the sector is maintained.

The leading P2P lenders use Equifax bureau insights to help grade the quality and associated level of risk of each loan. This drives the rate offered to the borrower and the associated risk-based return for the investor.

In addition, online affordability and indebtedness assessments have now become industry standard to immediately gauge the risks of repaying the loan, as well as to improve the customer journey and experience by reducing the requirement for manual verification of income.

**Under the radar**

As highlighted above, the UK P2P industry is increasingly turning to institutional investors to meet the demand for affordable loans.

Whilst all of the leading UK P2P lenders remain committed to the original ‘social-lending’ model, the fact is that the awareness of P2P is still remarkably low, with the result that there is not enough retail investment to meet existing borrower demand.

When Lee Birkett, MD and founder of eMoneyUnion, presented at the CCTA conference in Nottingham in October 2014 and asked a room of more than 200 finance industry experts who had heard of P2P lending, only half put their hands up. When he then asked who had actually invested their own money in P2P lending, only four hands remained.

To address the investment shortfall, mainstream lenders are starting to advertise, to raise awareness of both the potential returns and risks that P2P offers to canny and informed investors.

As awareness increases, retail investment will follow suit and better meet the demand for better value loans, preserving the integrity of the UK P2P sector.

Recently, however, Zopa have bucked the trend by advertising the preferential rates afforded to borrowers – is this to meet the growth demands of their institutional investors?

**Idea in brief**

**THE SITUATION**

Peer-to-peer lending has come a very long way in the 10 years since it started, but with institutional lending threatening to dominate the model as it has in the US, what does this mean for the future of peer-to-peer lending in the UK?

**THE CHALLENGE**

How can the UK peer-to-peer sector remain true to its ‘social-lending’ roots against the market pressure of institutional investment?

**THE TAKE AWAY**

With continued government support, peer-to-peer lending looks set to fulfil its promise to be a major disruptor across all forms of traditional lending.
The UK government role

The UK government is critical to the future success and integrity of the P2P sector in the UK. It is extremely supportive of P2P lending and sees it as a key driver to kick-starting the economy and improving consumer confidence. As such, it’s progressing a number of initiatives to support the industry including:

- British Business Bank. This is a development bank wholly owned by HM government with the main objective of increasing the supply of finance available to smaller businesses where markets don’t work well. In other words, where banks refuse existing applications for business loans, they have to pass the applications on to a panel of lenders (including P2P) to assess and consider the loans. Some P2P lenders already have a direct relationship with the high street banks. For example, both Santander and Royal Bank of Scotland refer refused business loan applications to Funding Circle for potential funding.

- The government has now introduced bad debt relief, allowing individuals lending through P2P to offset any losses incurred through defaulted loans against other P2P income.

- The recent budget also announced the introduction of a tax-free allowance of up to £1,000 of interest on all investments including P2P. However, following recent pension reforms, the more savvy P2P lenders are positioning P2P investments as a compelling alternative to traditional annuities. For example, LendingWorks has recently launched a range of new features to help those over the age of 55 to use their savings to generate a regular income.

Due to the nature of true P2P lending, P2P lenders are classed as Intermediaries. As such, this opens up the potential for P2P lending to cause massive disruption in other lending marketplaces. Already eMoneyUnion have been first out of the blocks to pilot P2P Guarantor Loans and Secured Lending. Peer-to-peer mortgages cannot be far away…

If you’re interested in finding out more about peer-to-peer lending, please contact Karl-Magnus Wadsack, at karlmagnus.wadsack@equifax.com or on 07826 945645.

So where else can peer-to-peer have an impact?

To date, retail P2P investments have been predominantly used to fund unsecured loans for things like home improvements, car finance, holidays and the consolidation of existing unsecured debts.