From Peer2Here: How new-model finance is changing the game for small businesses, investors and regulators

Andy Davis
The Centre for the Study of Financial Innovation is a non-profit think-tank, established in 1993 to look at future developments in the international financial field – particularly from the point of view of practitioners. Its goals include identifying new areas of business, flagging areas of danger and provoking a debate about key financial issues. The Centre has no ideological brief, beyond a belief in open markets.

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Preface

In 2012, Nabarro LLP (as we were then) co-sponsored Andy Davis’s first report on non-bank sources of funding for SMEs. That report came as the market was opening up with the launch of new “challenger” banks such as Metro Bank, Shawbrook and Aldermore, and with the development and launch of a number of what were then innovative crowdfunding platforms. The Breedon Report had just been published, identifying the potential scale of the shortage of capital for SMEs, and there was growing confidence that we had left the worst of the financial crisis behind us.

Five years on, we are delighted that Andy has again returned to the topic with this follow-up report. To say that the peer-to-peer (P2P) market has come a long way since 2012 is an understatement. While innovative spirits continue to drive the development and launch of new platforms and products, the market, and some platforms in particular, has matured almost beyond recognition. One area, which might be surprising to some, is the extent to which the P2P platforms are embracing the prospect of regulation.

Today, we are seeing increasing investment through P2P platforms by corporates, institutional investors and public bodies. In some cases, such as ThinCats, there has been significant investment from an institutional investor into both the platform itself and the products it offers. In Funding Circle’s case, it has raised a listed fund with a view to making investments on the Funding Circle platform.

One challenge that most P2P businesses share is ensuring that there are enough products available for those wanting to invest, while at the same time ensuring there is enough investor demand to service the products that are available. It is a classic coach and horses dilemma – if there is capital available, SMEs will come; if there is enough SME demand, the capital will come – and one where we are seeing increasing innovation as products are adapted to suit broader ranges of investor.

The world is constantly changing and evolving – perhaps most significantly since the last report, the UK has voted to leave the EU, with the attendant uncertainty that brings – and it is important for any business to be able to adapt and respond. While Nabarro has merged with CMS Cameron McKenna and Olswang to create a new City powerhouse (and top six global law firm), we remain committed to supporting our clients, embracing new technology and bringing an entrepreneurial and innovative approach to our advice. The P2P sector has developed enormously in recent years and, as this report demonstrates, will continue to do so in the years ahead. We look forward to continuing to support the industry and hope that this report provides an important, and timely, review for all those concerned with and in the P2P sector.

Alasdair Steele
Corporate Partner, CMS

Author’s Disclosures

The author of this report, Andy Davis, is an equity investor in the P2P platforms Sancus Finance (formerly Platform Black) and Relendex, and in the equity crowdfunding platform SyndicateRoom. He and members of his family have lent funds at various times via Sancus Finance, Funding Circle, LendInvest, Relendex and Saving Stream. He is a client of BondMason. As a professional writer, he has undertaken writing assignments for platforms including Funding Knight, Proplend and BondMason. He has provided unpaid writing services to Sancus Finance. He has a personal loan provided by Ratesetter.
Foreword

After the razzmatazz of the Government’s FinTech Week in April, this timely CSFI report by Andy Davis gets our feet firmly back on the ground. It is five years since Andy first reported on UK fintech for the CSFI and, as he acknowledges, a lot has happened since then. This report charts in detail the ‘explosive growth’ of alternative finance, with particular focus on peer-to-peer (P2P) lending as its dominant form. The cumulative lending of P2PFA member platforms, for example, has grown from around £400 million in 2012 to £7.5 billion today. This is strong growth indeed, but it still represents only 3% of the total unsecured SME and consumer lending markets. There is some way to go before platforms seriously start eating the banks’ lunch, and there is room for cohabitation in the wider ecosystem.

The other key developments of the last five years relate to public policy. As Andy notes, the Treasury was sufficiently seized of the competition and innovation benefits of P2P lending that it designated it a new regulated activity under statute. The Financial Conduct Authority was given its marching orders in 2014 and developed a regime based on clear disclosure of risks to investors, together with client money safeguards and wind-up plans in the event of insolvency. Important changes in the tax regime have also been implemented. Of most significance was the creation of the Innovative Finance ISA whereby any authorised P2P or debt securities platform can offer tax-protected investments to retail customers. In addition, consumers investing on platforms are now covered by the personal savings allowance, and any tax on interest received is levied net of loan defaults rather than gross. All these changes make for a supportive public policy environment.

Andy’s report provides further explanations for the sector’s rapid growth. The longstanding lack of effective competition in unsecured lending and related markets (eg bridging loans and asset-backed finance) is well documented; it also left gaps and opportunities that new digital platforms have been quick to exploit. Start-up platforms had none of the ‘baggage’, both physical (systems and bricks and mortar) and cultural (mindset and behaviours), that characterise the incumbents. Platforms have been able to focus relentlessly on one thing – better products and services for customers by means of the smart application of digital technology.

Critically, the low interest rate environment has stimulated an appetite for a new investment opportunity among enough retail investors to compensate for generally low levels of consumer awareness and the absence of familiar longstanding brands. The report rightly notes that the main contribution made by the platforms to date has been the democratisation of access to debt assets in SME (and consumer) markets, thereby creating a valuable new asset class that sits somewhere between bank savings and equity investments in terms of risk and reward. This has to be a positive development, not just for consumers but also for the wider financial system.
The report concludes that the gap between the banks and the platforms is now starting to close, as banks invest more seriously in digital. That is surely good news for bank customers, but we should remember that platforms are not standing still either and will continue to innovate and push the frontier forward. Provided the regulator can embrace its role in promoting competition as well as protecting consumers, and provided it opens its mind to the fact that new forms of finance can exist that are neither banking nor collective investment schemes, then P2P lending – alongside other forms of innovative finance – will continue to strengthen the UK’s financial services market and help it serve the interests of consumers better in future.

The CSFI is to be congratulated for publishing this excellent follow-up report by such an authoritative commentator. Andy’s knowledge, insights and clarity of writing make the report a pleasure to read.

Christine Farnish CBE
Independent Chairman
P2PFA
Introduction

Five years ago, the CSFI published “Seeds of Change: Emerging Sources of Non-Bank Finance for Britain’s SMEs”, an early attempt to catalogue and describe the online peer-to-peer (P2P) lending, supply chain finance and equity crowdfunding platforms that had emerged following the years of financial crisis and recession. Five years later, seven of the nine P2P and equity crowdfunding platforms identified in Seeds of Change are still operating and six of that initial seven are among the leading players in their respective segments. However, it is equally striking that several of the largest P2P and equity crowdfunding platforms operating today, particularly in property-related lending, were not established when Seeds of Change was published. But while platforms have proliferated, profitability has proved more elusive, with the challenger banks having the highest success rate on this measure.

The sector’s explosive growth means that a catalogue of all the fintech companies serving business borrowers would now provide a door-stop. This report instead aims to analyse the impact of the new online sources of finance for small and start-up businesses, to explain where and why they have taken root and to draw out the trends that will determine their future success, or otherwise.

P2P: Business lending (major players) 2014-2016

Total New Business Lending ( Millions)

Source: P2P Finance Association Loan Statistics Q4 2016

Since 2012, much has changed in the UK’s business finance market, but some major elements have not. Far from being swept aside by the new breed of online competitors, as some rashly predicted, today there are more banks serving the small business market, not fewer. Nevertheless, banks and banking have changed under the influence of the online finance providers that inspired *Seeds of Change* – and will continue to do so.

Among the major developments in the past five years:

- P2P finance providers in the UK have written about £4.5bn of term loans to businesses;
- financial institutions have become significant providers of funds to the larger P2P platforms and now account for about half the lending they arrange;
- a separate set of regulations has been created for P2P lending, overseen by the Financial Conduct Authority;
- about £135m of public money has been provided to boost P2P lending capacity via the British Business Bank (which did not exist in its current form five years ago); and
- a new Isa has been created to allow consumers to invest in P2P loans tax-free.

And that is just on the lending side. Equity crowdfunding platforms have multiplied, aided by an expansion of the Enterprise Investment Scheme to include Seed EIS, and have enabled private investors to back hundreds of young, private companies. As with P2P lending, professional investors have become more involved in the sector, with both venture capital firms and syndicates of angel investors backing deals alongside tens of thousands of private individuals.
A couple of the features distinguishing early P2P models have been superseded. The image of DIY investors poring over the business plans of would-be borrowers was never a basis for a commercial lending venture that requires scale. Automation, always a key ingredient for the tech-led start-ups, has been applied to the allocation of funds, based on the criteria specified by lenders. Related to this, the early practice of setting the price of each loan by a reverse auction has settled into transparent indications by the platforms of the interest rates that apply to different “buckets” of risk.

As this report will show, however, two big ideas have endured:

- the opening up of the small business loan market, at last addressing the issue of limited competition; and
- the democratisation of access to debt and equity assets in the unquoted business sector.
Chapter 1: An Explosion of Choice

The period of intense experimentation since the financial crisis has led to an explosion in the number of finance providers serving the small business market. In 2007, the National Association of Commercial Finance Brokers had 84 lenders on its panel. Two years later, in the teeth of the financial crisis, that number had halved. Then, a turnaround began as new providers converged on a market that was widely thought to be dysfunctional and poorly served. By the end of 2016, the NACFB’s panel comprised 142 lenders.

Among them is a cohort of new SME-focused banks, including Aldermore, Shawbrook, OneSavings, Cambridge & Counties, Hampshire Trust, Oaknorth and Masthaven. A market in which, before the crisis, new banks were about as common as unicorns, has seen an unprecedented baby boom, including the plethora of consumer-facing, digital-first banks that have launched more recently. Such has been the appetite among asset managers for new ways to invest in small business banking that Aldermore, Shawbrook and OneSavings are all listed on the stock market and appear in the FTSE 250 index of mid-cap companies. Most operate through a network of regional offices, have few, if any, conventional branches and rely for much of their distribution on the UK’s community of commercial finance brokers.

Direct lending moves online

Apart from the emergence of new banks, arguably the most significant development is the expansion in non-bank direct lending to small companies.

Direct lending has existed for centuries. It used to be a relatively low-profile area of specialist finance, channelling money from wealthy individuals and institutions to niche markets requiring specialist underwriting skills, such as short-term property finance. Since 2009, however, it has undergone a transformation as new entrants have appeared and the range of products has expanded. The move to online distribution has also helped it to reach a much larger group of potential borrowers.

There are now numerous online direct providers of almost every type of small business finance. Companies such as Liberis, Boost Capital and Capify offer merchant cash advances, providing tens or even hundreds of thousands of pounds to small retailers, restaurateurs and publicans. They recoup the money through a fixed percentage levy on the business’s takings via card terminals. Business lenders,
such as Ezbob and Fleximise, provide unsecured loans of up to £200,000 to small companies on flexible terms for periods of up to two years. Others, such as Iwoca, Just Cashflow and Growth Street, offer revolving credit facilities that can be drawn upon and repaid in the same way as a bank overdraft. The list goes on.

As technology-led direct lenders have led the pack in assembling and analysing data to assess creditworthiness, the process of applying for funding online has in some cases become near-instantaneous. Borrowers can expect a decision within an hour, sometimes much less, and see funds in their accounts soon afterwards. It is hard to overstate the impact that innovations such as these have had on the market for small business finance, especially as the new entrants’ pioneering use of technology becomes mainstream. As Rod Lockhart, Managing Director of LendInvest Capital, says: “We won’t be unusual in the future for using technology. We’re just ahead of the competition in using it.”

### Perceived Ease of Obtaining External Funding

![Perceived Ease of Obtaining External Funding](chart)

Source: British Business Bank 2016 Business Finance Survey of SMEs

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2. Growth Street was established as a direct lender but has more recently begun accepting retail funding, operating as an Appointed Representative of Resolution Compliance, which is authorised as a P2P lender by the FCA.

3. Direct lender Ultimate Finance says funding from its digital loans platform has reached applicants’ accounts in as little as 11 minutes 16 seconds. See: [http://bridgingandcommercial.co.uk/article-desc-11690_Ultimate-Finance-launches-12-minute-business-loans](http://bridgingandcommercial.co.uk/article-desc-11690_Ultimate-Finance-launches-12-minute-business-loans)
Peer-to-Peer: a retail-funded subset of direct lending

Easily the highest-profile members of the non-bank cohort are the online P2P platforms serving the business market, including Funding Circle, MarketInvoice, ThinCats, LendInvest, Wellesley, Lendy, Assetz Capital, Abundance, Octopus Choice, Sancus Finance, Archover and RateSetter (although founded as a consumer lender, about a quarter of RateSetter’s new lending now goes to businesses). These platforms are best thought of as a subset of the direct lending market, albeit with some crucial differentiating features. The most important follows from the way in which P2P platforms source their funds.

A traditional direct lender will advance its own money, supplemented with wholesale funding from third parties, which it borrows on its own account to lend on. By contrast, a “pure P2P” platform does not borrow or lend money itself, but simply enables borrowers and lenders to meet and transact directly with each other by agreeing a loan contract. Of course, the reality is often more complex. Some P2P platforms operate a hybrid “direct lending/P2P” model, in which they part-fund each loan alongside other lenders, sometimes promising to take the first loss if a borrower fails to repay in full. However, the outside lenders always have loan agreements directly with the ultimate borrower – the P2P operator is not, therefore, liable to repay their money if a borrower fails to do so.

The other crucial difference between P2P and conventional direct lending is the way in which P2P platforms “fractionalise” single loans, breaking each one down into multiple contracts owned by different investors. This process – made possible by the efficiency gains from automation – is at the heart of the P2P phenomenon. It enables private individuals to own small portions of numerous different loans and so gain diversified exposure, despite having relatively modest sums to deploy. It was this feature of P2P, coupled with the creation of a specialised regulatory regime, that prompted alternative asset manager Octopus to enter the market, says Richard Wazacz, head of Octopus Choice, the P2P property lender. “We recognised that what was exciting about the legislation that was coming in was that technology and regulation were now giving retail investors the opportunity to take a fractional stake in asset-backed loans.”

P2P lenders use the same technology-led approach to gathering financial information on potential borrowers as other online direct lenders. The user experience they offer is frequently indistinguishable. But there are clear differences in business terms between these two versions of direct lending. In particular, P2P platforms generally need to achieve a much higher public profile than conventional direct lenders. This is because they must build trusted brands that will attract not only business borrowers but also retail investors with funds to lend. They normally generate revenue only from the fees they charge lenders and borrowers, rather than from interest income on the capital they lend themselves.
This means their financial success depends heavily on their ability to achieve scale, and on the crucial link between this and their cost of funds. They have to bear down on this cost in order to compete with banks, which benefit from ultra-low-cost retail deposits protected by deposit insurance. Against this challenging backdrop, profitability for many remains marginal or elusive, in part because of continuing investment in technology and origination. For example, Funding Circle, by far the biggest P2P lender to businesses in the UK, says that it achieved its first quarterly profit in the UK only in the final three months of 2016.

A revolution in attitudes

If the huge increase in choice for business borrowers has been one crucial feature of the credit revolution, another has been the speed of change in expectations and behaviour in this market.

P2P and equity crowdfunding platforms – varieties of financial firm that barely existed five years ago – have managed to persuade private individuals to invest several billion pounds in loans to, and in the equity of, small private companies. In most cases this has happened without the investors speaking to anyone at the web-based platforms facilitating the investment. Sceptics might argue that this simply demonstrates how easily people can be persuaded to part with their money when savings rates are close to zero and when an attractive yield, or the prospect of a big capital gain, is dangled before them. Perhaps. But it also speaks volumes about people’s appetite for a broader range of investment choices and their willingness to place trust in online services and processes, where no conventional “relationship” exists.

Services such as these are obviously meant to deliver financial value to their users. But they also deliver less obvious benefits, such as a sense that the individual is in control of the process rather than a passive recipient or, worse, a supplicant. It is the ability of the technology-led entrants to alter the balance of power in centuries-old markets that explains much of their impact today. In just a few years, they have helped to overturn long-established expectations about how quickly and painlessly services should be delivered. Everyone, big and small, has had to respond.

As they have done so, it has become increasingly difficult to discern the outlines of what has been loosely termed “alternative finance”. Boundaries have blurred in every direction. Banks have licensed technology from the new entrants and formed referral partnerships with them, sometimes to offer another option to companies that are outside the bank’s risk appetite and sometimes to provide an additional service to a client that the bank might otherwise lose. The experience of applying for a business loan online has become increasingly uniform, whether the lender is a high-street bank or a P2P platform. And P2P lenders are no longer dominated by founders from
the technology sector, but are increasingly staffed by financial services specialists with long experience in credit.

This report focuses mainly on developments in business lending because it is a much larger and more diverse market than early-stage equity in terms of products and providers. The aim is to show how the arrival of online finance has changed the way this market works and how it prompted a response from the major banks that dominate it. The intention is to highlight some of the most important developments, set out unresolved questions and suggest where things could go from here. Equity crowdfunding is covered in the penultimate chapter. Its development has important parallels with the P2P market that point towards broader conclusions about the significance of new-model online finance.

The past five years have seen the beginning of a revolution in finance for smaller companies. There is no reason to believe that the next five years will see a let-up in the pace of change.
Chapter 2: The Products

Where and why have P2P and direct lenders grown?

Since the emergence of P2P and online direct lending platforms catering for business borrowers, their growth stories have shared a number of common features. One, however, has stood out: these new lenders have gained vital momentum from an environment of extremely low interest rates, leading to a widespread reach for yield among retail and professional investors.

In late 2011, AA Savings was forced to pull its instant access deposit account, paying 3.2%, due to overwhelming demand4. Today, the best instant access deposit rates in the UK are around 1%. Those prepared to lock up their money in a five-year bond with a bank can expect a little over 2%.5 It is, therefore, hardly surprising that for investors prepared to venture beyond the banking system in search of fixed-income-type returns, retail-accessible direct lending has proved attractive. Of the approximately £10bn advanced so far via online business and consumer lending platforms, at least half has come from private individuals.

The development of online platforms accessible to all, during this period of low returns, has played a central role in fuelling the rise of P2P as a retail-funded form of direct lending. Government initiatives such as the Innovative Finance Isa, which allows tax-free returns on P2P lending, are very likely to reinforce the search among retail investors for new sources of yield.

P2P platforms catering for business borrowers have pursued one or more of three main strategies:

- lending in areas of high-yield specialist finance that have grown fast on the back of a buoyant property market;
- expansion into niches where coverage from traditional lenders has decreased since the financial crisis; and/or

4. This is Money: http://www.thisismoney.co.uk/money/saving/article-2078002/What-does-2012-hold-savers-savings-rates.html

5. See Moneyfacts best buy tables: https://moneyfacts.co.uk/savings/best-savings-rates/
• offering products that address mainstream small business borrowers but were not readily available from other sources.

The new platforms are not unique in this, however. Similar approaches have been adopted by both conventional direct lenders and the specialist challenger banks that have sprung up since the financial crisis. By contrast, in segments where the largest banks and other institutions have remained more active, such as conventional commercial and residential buy-to-let mortgages, P2P business platforms have found it hard to make meaningful inroads. (In the consumer credit market, however, leading platforms have shown they can compete head-on with banks.)

Expanding the specialist finance market

Bridging loans

One obvious example of a market in which P2P lenders channelling retail funds have established themselves is short-term bridging loans to small-scale property businesses. This covers, for instance, the purchase of properties to be refurbished for letting, which will be subsequently refinanced with conventional mortgages. LendInvest, a large property-focused direct lender with a retail-funded online platform, has built a substantial business in this specialist market. Other active retail-funded players include Assetz Capital, Lendy, Wellesley and Funding Circle, as well as several of the business-focused challenger banks such as OneSavings Bank, Aldermore and Shawbrook.

Small specialist direct lenders have long been active in bridging loans. But following the financial crisis, fast-rising property prices – especially in the south-east of England – coupled with extremely cheap mortgage finance fuelled a surge in activity in the residential buy-to-let market as investors hunted for rental income and capital growth. This, in turn, fuelled growth in specialist lending linked to residential property. From a market estimated to be worth less than £1bn a year in 2007, bridging lending has seen a surge in new entrants, a growing range of short-term products and plentiful additional capital. Interviewees for this report estimate that the market is now worth at least £4bn a year.

Short-term bridging loans at yields of up to 1% a month, sometimes more, proved attractive to P2P lenders looking to tie their money up for fairly short periods. But the heavy flow of funds into parts of the market that include small-scale residential bridging loans to buy-to-let landlords, particularly from deposit-funded challenger banks, has led to a much more competitive environment and lower lending rates.

6. For an assessment of the bridging market’s growth, see for example: https://www.mortgagestrategy.co.uk/on-fire-as-bridging-lending-reaches-4bn-how-much-further-can-it-grow/
Indeed, such has been the competition that Masthaven, originally a non-bank bridging lender, successfully applied for a banking licence specifically to lower its cost of funds using retail deposits. This is so that it can compete more effectively in specialist property lending markets, including bridging loans. It is a striking indicator of the changes wrought by low interest rates, new entrants and a long-term reach for yield that a leading non-bank bridging lender should have come to see a banking licence as a source of competitive advantage.

Stepping in where major banks have pulled back

Development lending

With Britain consistently failing to build enough homes to meet demand, lending to small-scale property developers and housebuilders has also attracted P2P and direct lenders, including leading names active in the bridging market.

Development lending by banks to small housebuilders all but dried up immediately after the financial crisis and has never returned to its pre-crisis levels, according to Adam Tyler, former chief executive of the National Association of Commercial Finance Brokers. This withdrawal of funding led to the number of smaller housebuilders halving from its level in 2007 and created a gap in the market. P2P platforms that had previously focused on bridging loans have expanded their product range to address this adjacent market. Rod Lockhart, of LendInvest, estimates that the loan market to small housebuilders is worth about £10bn a year. Masthaven Bank is also expanding aggressively into development lending along with other challenger banks, while some of the High Street banks have started to re-enter this arena. As competition has grown, Tyler says that loans equivalent to 75% – and in some cases 100% – of gross development value have become available, compared with a ceiling in the past of 50%.

In a segment that experienced a sustained funding shortfall post-crisis, P2P lending platforms have established a foothold by serving smaller developers and housebuilders. In doing so, they have opened up another high-yield, short-term lending market to their retail investor base. This growth opportunity for P2P platforms has enjoyed a fair wind from a property market experiencing strong demand and rising capital values. Thanks to high annualised returns, these asset-backed lending opportunities have attracted significant quantities of retail money.

7. Foundations are shaky for UK small housebuilders, FT, 27/12/15 See: https://www.ft.com/content/4a5c99c4-a56e-11e5-a91e-162b86790c58. For a useful survey of the decline in UK SME housebuilders, see the policy paper Starting Small to Build More Homes, published by LendInvest in March 2017.
Offering products that were not readily available to SMEs

Unsecured term loans

The third type of business strategy has seen platforms offer products that were not previously available to small business customers.

Easily the most significant market niche for retail-funded direct lending has proved to be the one chosen by Funding Circle: term loans to small companies and micro-businesses (fewer than 10 employees) for periods ranging from six months to five years. Although Funding Circle added a property lending offer in April 2014 targeting small housebuilders, developers® and landlords, its largest business remains its first – loans that are not secured against the assets of the company itself, but rely instead on personal guarantees provided by one or more of the directors. It markets these as unsecured small business loans.

Proportion of Loan Facilities that were Secured (Excl. Commercial Mortgages)

The availability of unsecured loans, backed by personal guarantees, has proved a popular addition to the financing options for many small companies, particularly those for which bank overdraft funding is not accessible, or which have already pledged all their assets as security to their bank. This is a common scenario among the growing number of asset-light service businesses that increasingly dominate the UK economy. Up to March 2017, Funding Circle had lent a total of £2bn to more than 22,000 small companies since its launch in August 2010. Its origination continues to grow rapidly – more than £820m of its total lifetime lending occurred in 2016, with record monthly levels of £100m in its traditionally strong fourth quarter.

Loans backed by personal guarantees prove popular

8. In April 2017, Funding Circle announced it was withdrawing from property development lending in order to concentrate on its core unsecured term-lending business.
According to a recent blog post, the average Funding Circle borrower has just eight employees and was established only in 2009. Although precise figures are not readily available, interviews with a range of market participants indicate that major banks generally cap unsecured lending to businesses of this size at sums ranging from £30,000 to £50,000. By contrast, the average size of an unsecured small business loan from Funding Circle is significantly larger at about £60,000. The company has grown by targeting a niche that the dominant bank lenders to small and micro-business have been less willing to address. Further, it is doing so at a price that compares favourably with the cost of financing from other sources, including online direct lenders that are not funded by retail money. The average cost of borrowing across Funding Circle’s unsecured lending book is about 10 per cent, ranging from 21.9% in its highest risk band, E, down to as little as 4.9% for borrowers rated A+, along with arrangement fees of between 1.5% and 6% depending on the loan term.

Are banks about to attack the unsecured loan market?

Why have banks been reluctant to provide unsecured business loans above about £50,000?

Under the Standard Model of risk weighting for bank assets, unsecured loans of up to €1m to small businesses (revenues of up to €50m) attract a capital charge of 75%. This can be reduced to 57% under the SME Supporting Factor set out in Article 501 of the Capital Requirements Regulation, which also allows for a larger maximum unsecured exposure of €1.5m. So there is no “cliff-edge” at, or near, £50,000 in terms of the capital charge that would make larger unsecured loans much more onerous to provide. Lending limits are, therefore, more likely to be the product of risk appetite and broader decisions over how to allocate regulatory capital between business lines. The relatively high capital charge suggests that banks will require quite high interest rates on these loans to make them economically attractive, but it does not in itself provide an obvious reason for banks to limit the sums they are willing to advance unsecured.

Another possible explanation is that they have limited their unsecured lending to reflect the sum they believe is recoverable through personal guarantees from one or more of the company’s directors. Given that courts will not normally order those in default under personal guarantees to give up the family home, creditors are limited to other available assets. A ceiling of £30,000 to £50,000 per company may, therefore, represent a reasonable rule of thumb based on experience and the remedies available through the courts. By way of comparison, Funding Circle says that as of February 1, 2017, the recovery rate on loans that defaulted between

2010 and 2014 was 44%, which suggests that on an unsecured loan of £60,000, around £26,400 is typically recovered via personal guarantees.

Might the major banks be about to change their approach to unsecured lending? In February 2017, RBS (parent of NatWest) announced the launch of Esme, an online service offering unsecured loans of up to £150,000 to small and medium-sized businesses for periods of up to five years. “Esme Loans gives customers a fast decision on their lending application which, if successful, will result in rapid funding, potentially within an hour. Customers will also benefit from no early repayment charges and competitive rates,” the bank announced. Companies will need to have been trading for at least 18 months when they apply.

RBS licensed the online lending platform for Esme from Ezbob, a UK-based online direct lender that offers unsecured business loans of up to £120,000 for terms of up to two years. Ezbob has agreed licensing deals with other partners, including Alibaba. Its online loan application and underwriting system draws upon publicly available data about borrowers, as well as information that the applicant links to Ezbob’s system such as data from his or her bank account, accounting software package, e-commerce channels and PayPal (if relevant) to allow fast processing of loan applications. “The more data points you link, the better the offer and terms,” Ezbob tells potential applicants that visit its own lending site.

Many of the service features described by RBS mirror the Funding Circle offer: much faster decision-making than a traditional bank credit process, early repayment without penalties and, above all, access to significant sums of unsecured debt. Moreover, the Esme process is bank lending rather than P2P finance, and so does not involve borrowers disclosing their financial details on the website for lenders to see. This could prove attractive to business people who have been put off P2P by its lack of confidentiality. Research carried out by Nesta in 2013 found that for one in six of its sample of Funding Circle borrowers, the main drawback to the process was “making financial details public for Funding Circle lenders”. However, Funding Circle’s rapidly rising loan originations suggest that for many this issue is not an insurmountable barrier.

The arrival of Esme is potentially significant. If RBS concludes that using Ezbob’s technology can allow it to provide a compelling user experience for borrowers, while cutting the costs of assessing their credit applications, this could encourage it to compete harder to lend unsecured. If its risk appetite also shifts (perhaps aided by access to borrowers’ real-time banking data via the Open Banking initiative), leading it to make more and bigger unsecured loans to small businesses, the market niche that Funding Circle has occupied could become considerably more competitive. Once the loan terms are similar between a bank-owned online lending platform and a P2P rival, increasing attention will focus on the relative pricing of the two products.
Invoice trading

New entrants, notably MarketInvoice and Sancus Finance (formerly Platform Black, where I am an equity investor), have built businesses in the short-term invoice finance market by advancing funding for periods of 30 days or more against single invoices at competitive prices. Traditional factoring houses and invoice financiers, including the asset-based finance arms of banks, have historically insisted on funding a company’s entire sales ledger, both to diversify their risks across a portfolio of receivables and to guarantee origination volume. The new entrants have differentiated themselves by offering a more flexible service, which does not commit users to fund all their invoices with a single finance provider on an exclusive basis. In some instances it has been available without the need for security, either over business assets or via personal guarantees from company directors.

For users, this offers an attractive alternative to a traditional invoice discounting facility that allows them to retain greater control over their financing. For some sectors, such as construction, where it may be hard to obtain overdrafts or traditional invoice finance, the new entrants have offered a much-needed alternative source of working capital. But the nature of single-invoice finance means that platforms have little visibility as to future revenues. To grow they must originate a rising number of transactions per client from an expanding client base.

Approval Rates for Applications with Overdraft Facility by Industry

![Graph showing approval rates for applications with overdraft facility by industry from Q4 2012 to Q2 2016.](source: SME Finance Monitor Q4 2016 Report)
Both MarketInvoice and Sancus Finance have added products that promise higher volumes and a more predictable flow of business. Sancus offers supply chain finance for mid-cap companies, advancing immediate funds to suppliers once invoices have been approved for payment. The cost of this short-term funding is based on the creditworthiness of the (typically larger) customer, and so is cheaper than the suppliers could secure on their own account. Supply chain finance is relatively common among multinational companies, where it is provided mainly by the largest commercial banks. Sancus is extending the facility to smaller companies that would not normally have access to these programmes.

MarketInvoice has recently announced MarketInvoice Pro, a revolving credit facility for companies with annual revenues of £1m or more, secured against a pool of receivables. Companies will be able to draw down and repay the funds as required, exactly as they would a traditional bank overdraft.

The initiative is part of a wider move by direct lenders, some of which accept retail funding, to offer revolving credit facilities to small companies, frequently secured against pools of receivables. This flexible working capital facility replicates the benefits of a traditional overdraft.

**The focus of competition starts to shift**

P2P platforms have established themselves in several areas of the market. In short-term, high-yield specialist property lending, for example, the fast-expanding bridging market has proved a fertile area, while in development funding for small housebuilders, the contraction of funding from incumbent banks has opened the field to direct lenders and newer challenger banks. While bridging appears to have become more competitive, regulatory changes affecting banks’ scope to lend in parts of the buy-to-let mortgage market offer further opportunities for non-bank lenders to expand market share.

In the provision of larger unsecured loans to small companies beyond the property sector, it is evident that significant players – notably the incumbent banks – have been reluctant to compete. The possible explanations for their reluctance go to the heart of the debate about the future of P2P and direct lending more broadly.

Some lenders will always price credit risk more aggressively than others. This may simply be a question of risk appetite, but other factors include the growing access to real-time data on borrowers via Open Banking and cloud-based accounting software, and lenders’ improving ability to analyse this data to gain a clearer, more dynamic view of the risks in their lending book. Participants on different sides of the debate will have different interpretations, but the most convincing answers are likely to emerge from the performance of loan portfolios through a complete credit cycle.
There is no doubt that in the niches where they have taken root, non-bank entrants have differentiated themselves by offering a fast and easy user experience to business borrowers. This is thanks to their purpose-built, highly automated platforms, which have also reduced processing costs. However, as the technology gaps between bank and non-bank lenders start to narrow, the focus of competition is shifting. As this happens, the most important issues will be risk appetite (and the extent to which differing regulatory regimes shape differences in risk appetite), the role that data analysis comes to play in managing loan portfolios and, most critically for the P2P and direct lending platforms, their cost of funds.

There has always been a lurking contradiction at the heart of P2P lending. On the one hand, retail investors are reaching for yield and so are seeking returns that imply a relatively high cost of debt finance for the corporate borrowers. On the other hand, the reason retail investors are reaching for yield is that banks are paying almost nothing for retail deposits, which gives the incumbents the ability – if they wish – to lend at extremely competitive rates.

The more similar the user experience from banks and P2P platforms becomes, the more the latter’s success will depend upon their ability to lower their cost of funds to remain competitive. For banks, meanwhile, the challenge will be to reduce their operating costs so that they can match the efficiency of tech-driven P2P platforms and mitigate the drag from regulatory capital charges.
Chapter 3: Market Dynamics

A bigger slice of a shrinking pie

When P2P lending to small businesses began to gain attention in 2011-12, the common fear was that companies faced a huge funding shortage due to the banks’ reluctance to lend. The picture that has emerged since then has been much more mixed, which helps to explain the challenge that P2P lenders now face in finding large numbers of new borrowers.

Demand for bank lending slows

Regular surveys, such as the Bank of England Agents’ Summary of Business Conditions, have found that, since the financial crisis, access to finance for smaller companies has generally been more difficult than for larger businesses. However, conditions seem to have improved recently, partly due to the increased choice of funders. At the same time, figures published by the British Bankers’ Association, covering lending by UK banks to smaller companies, show a steady fall in the stock of outstanding term loans and overdrafts over a period of several years, and a marked increase in smaller companies’ cash deposits.

Stock of SME Overdrafts and Value of Deposits

Source: BBA SME Monthly and Quarterly Aggregate Statistics
This theme of declining demand is also reflected in the findings of the SME Finance Monitor, a rolling quarterly survey of small companies’ experiences of raising finance that started in the first half of 2011. It questions 4,500 businesses in each wave of research, making it the most comprehensive data gathering exercise of its kind in the UK. The Monitor reports that the number of small businesses reporting a “borrowing event”, defined as a new or renewed loan or overdraft facility, has been falling steadily from 11% in 2012 to 5% in 2016.

Overdrafts have long been a vital source of day-to-day funding for smaller companies. The quarterly BBA statistics, for businesses with a turnover of up to £2m, likewise show a decline in the number of overdraft applications approved over the past few years. This is not because approval rates for overdraft applications have collapsed. According to the SME Finance Monitor, they have been steady at around 85% for several years, and on renewal applications success rates have ranged from 98% to 100%. So, rather than more companies being refused overdrafts, it seems that the number entering the application process has dropped.

There could be several factors at play here. As well as a general weakening of demand, there is some evidence that access to overdrafts is becoming more difficult in some sectors, such as construction, where success rates on applications have declined significantly since late 2014. Some companies may also believe they have little chance of success and so never bother to apply, or may become discouraged during the process and drop out in order to avoid the risk of a refusal.

Across the board, however, the picture that emerges from the BBA data suggests a market in which smaller companies are more interested in reducing their bank borrowing than they are in taking on additional debt. This is also reflected in the latest SME Finance Monitor, published in March 2017, in which about 70% of respondents agree with the statement that they would be prepared to accept a slower rate of self-funded growth rather than borrowing to grow more quickly, while 80% say their current plans are based on what they can fund from internal resources. Just 5% of respondents cite access to external finance as a major obstacle to their ability to run the company over the next 12 months, down from 8% in mid-2014.

Rather than operating in a market in the grip of a long-term shortage of funding, therefore, it appears that P2P lenders and other entrants are competing to grow against a background of reduced borrower demand and stiff competition, thanks to the growing number of bank and non-bank funders addressing the small business market.
The entrants gain a foothold

In spite of these constraints, P2P platforms and other direct lenders have established a position in the market and continue to increase their flow and stock of lending. As discussed earlier, some have joined the surge of new entrants into high-margin specialist lending, such as bridging and development finance, while others have grown thanks to their willingness to offer products that are not readily available from banking sources, such as larger unsecured loans or flexible short-term funding.

Conrad Ford, founder of the commercial finance brokerage, Funding Options, says that, in terms of deal volumes, about 20% of the business his company arranges goes to P2P lenders and another 20% to online direct lenders that are not retail funded. “Forty per cent of our market did not exist five years ago,” he notes. Particularly for companies that want short-term funding quickly – either to pursue an entrepreneurial opportunity or to cover a short-term crisis – online P2P and direct lending sources are becoming a more everyday choice, he says. “The businesses using it are typically comfortably profitable…they need money really quickly but [the sums involved are] not that material to their overall business.”

Estimates of the Flow & Stock of External Finance for UK SMEs

<table>
<thead>
<tr>
<th>Source: British Business Bank SBFM 2016/2017 Report</th>
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<table>
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<tr>
<th>Estimate Type</th>
<th>2011</th>
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<th>2013</th>
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<td>Bank lending stock £ billions</td>
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<tr>
<td>Bank of England</td>
<td>189</td>
<td>176</td>
<td>166</td>
<td>167</td>
<td>164</td>
<td>164</td>
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<tr>
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<td>Gross flows</td>
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<td>43</td>
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<td>Outstanding Amount (b)</td>
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<td>to end Nov 16</td>
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<td>Bank lending flows £ billions</td>
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<td>Bank of England</td>
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<td>Other gross flows of SME Finance</td>
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<td>Private external equity investments £ billions</td>
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<td>To end Nov 16</td>
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<tr>
<td>Number of reported deals</td>
<td>462</td>
<td>706</td>
<td>972</td>
<td>1309</td>
<td>1408</td>
<td>880</td>
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<tr>
<td>Asset finance flows £ billions</td>
<td></td>
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<td>Source: FCA (f)</td>
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<td>Peer to Peer Business Lending flows £ billions</td>
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<td>Source: AltFi Data (g)</td>
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<tr>
<td>Source: British Business Bank SBFM 2016/2017 Report</td>
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There is similar evidence that P2P and direct lenders are concentrating on parts of the market where major banks are less active. In analysis carried out by Rolf Hickmann, formerly of the credit scoring specialist pH Group (now part of Experian), on behalf of the Cambridge Centre for Alternative Finance, business borrowers were put into risk grades from A-E, using Experian pH scoring. He found that P2P loan books had a higher exposure to C and D-grade borrowers than banks, both in terms of numbers of borrowers and, more markedly, by loan value, while banks were more heavily exposed to A and B-grade borrowers. This suggested that P2P lenders were finding the core of their market among borrowers with reasonable credit profiles,
particularly the C-grade borrowers located just below the prime segments of the market that banks tend to favour. There was no evidence that their loan books were disproportionately exposed to the highest-risk E-grade business borrowers.

In terms of size, however, the P2P and online direct lenders that entered the market following the financial crisis remain small relative to the banks, their gross lending in 2016 accounting for only around 2.25% of gross banking flows.

In part, this is because awareness of P2P lending remains far from universal among smaller companies. The SME Finance Monitor finds that across all the small companies it surveyed that are open to applying for external finance, just 1% say they are using one or more of P2P lending, equity crowdfunding or online invoice trading; however, 47% are aware of them as a potential source of funds. That said, even among those that are aware of these forms of finance, less than a third would consider using them. This equates to only around 13% of the small companies identified by the SME Finance Monitor as being open to the idea of raising external finance in future.

**Awareness of Funding Sources**

![Bar chart showing awareness of different funding sources](chart.png)

*Source: British Business Bank 2016 Business Finance Survey of SMEs*

The SME Finance Monitor does not explore the reasons for this apparent reluctance among the majority of small companies to consider using P2P/crowdfunding, but the evidence suggests that these providers have a long way to go before they establish themselves among the mainstream funding alternatives for the broad market of smaller companies.
Meanwhile, the landscape continues to evolve. Several interviewees for this report observed that after a long period of retrenchment, banks are once again becoming more active and aggressive in the smaller business market. How far this will extend remains an open question, but it is worth noting the British Business Bank’s estimates that net bank lending to smaller companies was modestly positive by about £2bn in 2015 and £3bn last year. In spite of this, the indications are that demand to borrow remains weak among smaller companies, which means that competition in the lending market is unlikely to ease.

Indeed, data from the most recent SME Finance Monitor show that, while banks generally demanded security for more of their overdraft lending in the years following the crisis, from mid-2015 there seems to have been a marked increase in the proportion of business overdraft facilities of between £10,000 and £25,000 that were agreed without security. This may be coincidental, but it suggests that banks might have become more willing to compete for business in the very area of the market that has seen the greatest inroads made by non-banks offering unsecured funding.

% of overdraft facilities that were secured

<table>
<thead>
<tr>
<th>By application date</th>
<th>H2 2012</th>
<th>H1 2013</th>
<th>H2 2014</th>
<th>H1 2015</th>
<th>H2 2015</th>
<th>H1 2016*</th>
</tr>
</thead>
<tbody>
<tr>
<td>All overdrafts</td>
<td>34%</td>
<td>35%</td>
<td>34%</td>
<td>36%</td>
<td>42%</td>
<td>37%</td>
</tr>
<tr>
<td>Overdrafts of &lt;£10,000</td>
<td>16%</td>
<td>18%</td>
<td>22%</td>
<td>24%</td>
<td>24%</td>
<td>32%</td>
</tr>
<tr>
<td>Overdrafts of £10-24,999</td>
<td>52%</td>
<td>49%</td>
<td>40%</td>
<td>50%</td>
<td>38%</td>
<td>45%</td>
</tr>
<tr>
<td>Overdrafts of £25-100,000</td>
<td>63%</td>
<td>62%</td>
<td>62%</td>
<td>53%</td>
<td>40%</td>
<td>64%</td>
</tr>
<tr>
<td>Overdrafts of more than £100,000</td>
<td>63%</td>
<td>72%</td>
<td>78%</td>
<td>66%</td>
<td>68%</td>
<td>74%</td>
</tr>
</tbody>
</table>

Q 105a All SMEs with new/renewed overdraft, excluding DK

Initial indications for applications made in H2 2016 are that a lower proportion were secured, due to fewer overdrafts of less than £10,000 being secured.

SME Finance Monitor Q4 2016 Report

Competition is intense and businesses’ appetite to borrow has clearly been through a period of weakness in recent years. The biggest strategic question facing any entrant – P2P or otherwise – is, therefore, how to generate sustainable growth in a market where origination is likely to remain challenging. Offering a better, faster service has been a clear early differentiator, but this advantage is being eroded as the market develops.

SMEs’ appetite to borrow has been weak
Chapter 4: Regulation

Timing was everything

The financial crisis of 2007-09 has had such far-reaching effects on the UK economy and business landscape that it is difficult to identify all the changes. Some are obvious, however, and few more so than the emergence of online P2P platforms that allow anyone to earn interest on their money by lending it directly to businesses and consumers. If the emergence of P2P as a branch of direct lending was revolutionary, the creation of a framework to regulate this new activity was no less significant.

Crucially, the moment was right. Such was the unpopularity of the major banks in the wake of the financial crisis, thanks to taxpayer-funded bail-outs and stories of greed and bad faith, that policymakers were happy to see new competitors emerge. They were also prepared to countenance a new and separate regulatory regime that would allow these finance providers to become authorised by the Financial Conduct Authority (FCA). The rules for “operating an electronic system in relation to lending under Article 36H of the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001” set out the essential regime that now governs P2P lending. Although a debate continues between platforms awaiting authorisation and the regulator over the details of implementation, the outlines of the P2P settlement are clear.

These rules establish that P2P is defined by the existence of a direct lending contract between a borrower and each individual lender who provides it with funding. Platforms that can demonstrate to the FCA that they operate on this basis – and can satisfy the regulator on essential issues of process, conduct and disclosure – can become fully authorised.

Emergence of the ‘third way’

This is a big deal. What the government has effectively allowed is the creation of a regulatory “third way” for P2P finance. On the one hand, the new regime establishes that authorised P2P platforms are not banks. Therefore, they do not need permission to accept deposits, they are not covered by deposit insurance under the Financial Services Compensation Scheme, and they are not subject to the same rules on regulatory capital and liquidity that cover the banking industry. On the other hand, neither are P2P platforms viewed as asset managers.
In December 2015 the Treasury issued a statutory order making clear that P2P lending platforms that gained authorisation by the FCA, under Article 36H, would not be regarded as operating collective investment schemes. Authorised P2P platforms do not, therefore, manage pooled funds that invest in direct lending assets. This is a huge benefit to P2P platforms since without this assurance the risk would remain that regulators could ultimately decide that they were operating forms of Unregulated Collective Investment Scheme. Under existing regulation, such schemes cannot be offered to the P2P sector’s key source of funds – mass-market retail investors.

The existence of this “third way” between banking and asset management makes authorisation an extremely valuable prize for the established P2P operators. Becoming fully authorised gives their businesses official validation that will undoubtedly help potential investors view them as legitimate and safe to use. Authorisation will also open the door approved by HMRC as an Isa provider, which will enable P2P platforms to start allowing retail investors to lend tax-free inside the Innovative Finance Isa wrapper. Once P2P platforms are fully authorised by the FCA and can offer a version of the hugely popular Isa product to their retail investors, they can expect to attract significantly more funding from consumers looking to improve on very low savings rates.

However, at least as important is the prize that authorisation will deliver to the P2P platforms in terms of their competitive position in the lending markets. Authorisation effectively signals the official birth of “capital-light alt-banking” – a regulated way of intermediating retail funds (that might otherwise exist as bank deposits but are not classified as such once invested via a P2P platform) into loan assets. Regulation will allow this to occur without the obligation to hold capital to reflect the risks of the lending that is facilitated, and without the responsibility to act as the investment manager of the assets that individuals place with the platform.

The government’s willingness to sanction a third way for regulation of P2P platforms is open to a variety of interpretations. One is obviously that in the aftermath of the financial crisis, the implications of having permitted the UK’s banking market to become extremely concentrated, over a period of several decades, were painfully clear. With only a handful of major banks, the UK economy was vulnerable to any crisis that affected their stability. A more diverse and competitive market was, therefore, a priority - which helps to explain official moves such as the British Business Bank’s provision of public money via a number of P2P and direct lenders to increase funds available for small business borrowing. 


11. For details of British Business Bank Investments’ funding for P2P and fintech lending platforms, see: http://bbbinv.co.uk/tech-enabled-or-p2p/
Another interpretation is that if the intention was to drive some of the risk out of the banking system, there was an implicit official recognition that it would have to be accommodated somewhere else, specifically in the non-bank ecosystem. Given that the new entrants were funded by retail investors, who were seeking a better return than that offered by deposit accounts, leaving them unregulated was not a realistic option. Better, therefore, to set out the conditions under which the P2P platforms could allow retail investors to risk their capital in the direct lending markets.

Choosing a bespoke regulatory regime allowed the government to pursue the policy objective of creating a more diverse and competitive lending market, without imposing such a heavy regulatory burden on the new entrants that they would find it difficult, or impossible, to establish themselves.

The P2P movement’s founders recognised the realpolitik of their situation from the beginning. Anyone who wants to build a business that allows retail investors to put their capital at risk by lending money directly to other individuals and businesses should expect and welcome regulation. This has been the stance of the main P2P platforms through the P2P Finance Association. However, it is probable that without the impact of the banking crisis, they would have stood little chance of achieving a regulatory settlement as tailor-made as the UK’s appears to be. Timing was everything.

### Hold-ups at the FCA

As with other areas of regulation, real life is messy. Since April 2014, around 45 of the longer-established P2P platforms, such as Funding Circle, ThinCats, Ratesetter and Zopa, have operated under interim FCA permissions. But some 18 months after the final deadline for them to apply to the regulator for authorisation, fewer than 20, including Lending Works, LandBay and Proplend, have completed the process – and none of the industry’s biggest names is among them.

Many reasons are offered for the hold-up. Part of the explanation lies in the challenge the FCA faces in establishing the details of the new P2P regime and applying it to the wide variety of operating models adopted by the platforms. It has as its guide the relatively simplistic formulation set out in Article 36H: operating an electronic platform to facilitate direct lending contracts between individual investors and borrowers.

If the investor uses an automatic tool, provided by the platform, to allocate funds to loans that meet the criteria he or she has set, is that a genuine P2P transaction, or does the automated tool constitute some kind of collective investment scheme? If investors place money into fixed-term accounts with a P2P platform (offering liquidity after periods
ranging from one month to five years), and the platform then spreads their funds across a blind pool of people seeking to borrow, does that process veer too far towards deposit-taking? If a provision fund exists to help cover any losses, does that mutualise risk across the users of the platform, much as a collective investment scheme would, and in the process obviate the direct contractual relationship between individual lenders and borrowers? Questions such as these have provoked lengthy debate between platforms and the FCA, as the regulator decides whether they will need to make changes to their models to conform with Article 36H.

To observers such as *FT Alphaville’s* Kadhim Shubber\(^1\), these questions call into doubt the whole notion that “there is something called ‘peer to peer lending’ that is different from the rest of finance in a meaningful sense”. He argues that “for perfectly ordinary reasons, like efficiency, these companies are run rather like asset managers, which is to say that in effect they manage other people’s money in return for a fee”. The regulators are clearly taking their time to decide exactly where the differences lie between P2P lending and other regulated activities.

In some areas, however, the FCA does seem to have reached firm conclusions. Several platforms pre-fund loans (often larger property-related transactions) to enable swift completion and drawdown, and then allow investors to buy fractions of the debt. Where this has been achieved by the platform simply assigning the original loan to the ultimate investor, the FCA appears to have decided that this does not constitute a P2P loan under Article 36H because there is no “straight through” contract between the borrower and the ultimate lender. Where the transaction is executed via novation, which replaces the initial loan contract with a new one between the borrower and each individual lender, however, pre-funding has been allowed to continue.

Authorisation under the P2P lending rules is the goal that all the major platforms continue to pursue – although ultimately there are other ways to operate, such as applying for a banking licence. Zopa announced that it would do so in late 2016. This would allow it to accept retail deposits – diversifying its funding sources – and could represent a way to hedge the risk that the regulator ultimately decides that its operating model does not conform with the P2P regime.

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\(^1\) The curious state of UK ‘peer to peer’ lending, Kadhim Shubber, FT Alphaville, 11/2/16. See: [https://ftalphaville.ft.com/2016/02/11/2152940/the-curious-state-of-uk-peer-to-peer-lending/]
Similarly, it is possible to accept retail investment into transactions that look like P2P lending by using a structure based on a receivables agreement. This is the operating model that property platform LendInvest employs. It enables investors to purchase parts of completed property loans on the basis of a receivables agreement with the platform. Since receivables are not regulated, operating in this way does not require authorisation from the FCA – although agreements structured like this cannot be included in the Innovative Finance Isa, which effectively closes off an important source of funding from the retail market.

All of that aside, authorisation under the P2P regime, and the aura of official validation that it will bring, remains the ultimate prize.
Chapter 5:  
The Retail Investor’s Perspective

Not yet a mass-market pursuit

P2P platforms increase the range of options available to private investors. Until their arrival, direct lending was the preserve of institutions and the very wealthy: the closest investment opportunities open to all were specialist retail loan funds that gave investors little or no visibility over who the borrowers were. Once technology provided an efficient way to break down loans into separate parts, easily accessible to private individuals with modest sums to invest, direct lending in the traditional sense – where a contract exists between every borrower and lender – became an alternative asset class open to all.

Yet, for all the excitement this innovation has generated over the past few years, P2P lending remains a minority pursuit. The three largest online platforms – Zopa, Ratesetter and Funding Circle – claim individual user bases of between 40,000 and 60,000 each. If we assume that they account for 75% of the market and that there is a degree of overlap between them, it seems reasonable to estimate that no more than 180,000-200,000 retail investors in the UK lend money via P2P platforms.

Two groups dominate: individual DIY investors running their own portfolios and a fairly small circle of professional investors and fund managers, including those managing stockmarket-listed investment trusts that specialise in direct lending assets originated via P2P platforms. For reasonably confident self-directed investors battling the problem of collapsing deposit rates, P2P has provided a welcome alternative, where yields of 5%, 10% or even more are available on certain types of lending. But the P2P investment revolution remains embryonic. It has a long way to go before it achieves acceptance in the broad personal finance market.

Challenges of turning P2P into a mainstream alternative investment

Arguably the key challenge facing the P2P evangelists is to explain to the public exactly what this new retail asset class is. Just as the regulation of P2P plots a third way between banking and asset management, so attempts to explain P2P lending must help investors and their advisers to locate it somewhere between cash savings, on the one hand, with protection under the Financial Services Compensation Scheme,
and traded securities such as equities and bonds on the other, where capital is at risk and the market price of an asset can change rapidly.

P2P loans are a largely illiquid fixed-income-type asset class, where the holder receives an interest premium over cash in return for accepting credit and liquidity risks, among others. The risk of capital loss is ever present, but thanks in part to the relative illiquidity of the assets, it also exhibits less price volatility than listed equity investments. There is good evidence that people already investing in P2P loans understand the risks to their capital: some 91% of Ratesetter users who responded to a recent survey by the platform indicated that they understood their capital was at risk.

On this basis, it is clearly possible to make a case that direct lending assets can play a distinct and useful role in a retail investor’s portfolio. But for that to become accepted wisdom, a variety of pieces need to fall into place. Among the most important is to establish trusted brands that are subject to regulation by the FCA; without this, all but a small minority of more adventurous retail investors will steer well clear.

Aside from the key elements of trusted brand and regulation – both works in progress – it is possible to discern the outlines of the sort of investment ecosystem that will be required for P2P to make the transition into the broad retail market.

**Tools to provide automated diversification**

There will always be people who want to decide for themselves which individual loans to invest in, and there will probably be P2P platforms that allow them to do so. But like the retail stock-pickers who frequent the public markets, these confident self-directed investors will never represent the majority. If P2P lending is to achieve real scale, it will have to follow the pattern that has played out in other areas of retail investment. This means providing people with a quick and easy way to achieve broad exposure without the labour of “loan-picking” – something similar to a fund structure.

This is already established. Funding Circle’s Autobid tool, for example, allows users to set basic criteria that define which types of loan they wish to invest in, and then leaves the system to allocate their funds automatically to loans fitting the criteria. About 80% of new investors who open accounts on Funding Circle’s platform opt to use Autobid to build a diversified portfolio of loans automatically. Quick and easy automation of the loan selection process, leading to effortless portfolio diversification, is essential for P2P to grow.
Building credibility in the retail adviser market

Just as commercial finance brokers have played a crucial role in bringing corporate borrowers to the P2P platforms, so retail financial advisers have the potential to channel their clients’ money into P2P lending – once the platforms have come through the authorisation process. However, even then advisers are likely to approach the asset class with caution. Many will want to see a longer record of successful lending from P2P platforms through a complete credit cycle before they will feel comfortable in recommending this option to their clients. Anecdotally, concern that P2P will fall outside their professional indemnity insurance cover may also discourage others.

However, the arrival in the P2P market of Octopus, an alternative asset manager with strong existing relationships with financial advisers; could open up this market for P2P lenders more generally. Octopus’s established brand gives it an advantage over P2P start-ups in the market for advised funds, but even so progress is unlikely to be rapid. Advisers must carry out due diligence to ensure that P2P loans are suitable for individual clients before making an investment recommendation. In practice, the most likely first step is that advisers will invest on their own account to see how the product performs before recommending it. P2P lending is a long way from being an established asset class for the advised retail market, but the launch of Octopus Choice, backed by Octopus’s established relationships, could prove a turning point.

Replicating funds of funds

Some DIY investors are prepared to manage accounts with several P2P platforms, in order to diversify across different types of lending and to avoid over-exposure to a single platform’s credit underwriting capabilities. However, achieving this level of diversification across multiple platforms is labour and time intensive.

In response, services are emerging that enable users to invest in P2P lending assets across multiple platforms through a central account, in effect replicating the fund-of-funds structures that are a common feature of other investment markets. Services such as Goji and LendingWell (still in development) are aimed at both individual investors and financial advisers, offering tools that enable them to research and compare P2P lending opportunities across the market, as well as giving them the ability to invest. BondMason provides a single, automated account through which users can invest across a range of direct lending activities, including P2P loans.
The emergence of services such as these will ultimately make it easier for retail clients to invest in P2P loans and direct lending as a broad asset class, as opposed to investing in loans of a particular type – residential bridging, short term receivables, unsecured term loans etc – originated by individual P2P platforms.

**Institutional investment in P2P lending**

Since 2013, a variety of institutions have started lending via P2P platforms in the UK, including the British Business Bank, local authorities, family offices, alternative asset managers and a group of stock market-listed specialist investment trusts. Appetite among institutions for direct lending remains strong, and P2P platforms have provided another set of opportunities for them to deploy capital, although it took sustained early support from retail investors to create a market large enough to interest institutions.

Collectively, institutions probably account for around half the overall gross flow of lending via P2P platforms today. While some people complain that their growing presence risks displacing the retail investors on which the P2P sector was built, there is no sign so far of this happening. As institutional presence among the lenders on P2P platforms has grown, their due diligence activities have become an important source of external validation for the quality of the platforms' credit underwriting. This has helped the platforms to make the case to the retail investor market that they are well run and can withstand professional levels of scrutiny. It seems highly likely that the symbiotic relationship that has existed up to now between retail and institutional investors in P2P lending will continue and grow.
Tax-advantaged savings vehicles – the Innovative Finance Isa

Amounts Subscribed in Stocks and Shares ISAs

For authorised platforms, the opportunity to gain approval from HMRC to become an Isa manager is an important prize. The Innovative Finance Isa (IFIsa), launched in April 2016, allows anyone to open one of these familiar, government-endorsed tax-exempt accounts, and earn tax-free interest income on their P2P lending portfolios. The creation of a dedicated Isa for P2P loans (among other alternative assets) represents a vote of official confidence in the sector from the Treasury and is likely to enhance P2P platforms’ credibility in the eyes of investors who are not familiar with their offering. There has, however, been concern that under the current framework, investors must open an IFIsa connected with a single P2P platform and that this will force them to concentrate their risk with one P2P operator. Some have lobbied to amend this element of the rules so that investors can diversify their Isa holdings across a group of P2P platforms, so far to no avail.13

The IFIsa has got off to a slow start because the largest P2P platforms have yet to be authorised by the FCA, and so cannot become Isa managers. The early experience of smaller platforms that have launched IFIsas is nevertheless interesting. For example, Abundance Generation, which focuses on ethical and sustainable investments, such as renewable energy, said in March that it had attracted £9.5m in Isa subscriptions

13. However, Goji has recently launched the Goji Diversified P2P Lending Bond, which can be held within Goji’s IFIsa wrapper and will invest in P2P loans across a group of P2P platforms. For details, see: https://investments.gojip2p.com/investments/guide/lending-bonds
from 1,600 customers since April 2016\textsuperscript{14}, some £3m of which remained uninvested. Lending Works opened its IFIsa in February 2017, but had to suspend subscriptions temporarily after receiving about £2m in 24 hours\textsuperscript{15}.

In both cases, the platforms attracted flows of Isa money that were large enough to outweigh, at least temporarily, their ability to originate opportunities to deploy the funds. In the context of the retail investment market, however, these flows were minuscule. The IFIsa could ultimately prove a vital asset to the P2P platforms, but there is an obvious risk that subscriptions might overwhelm their ability to match them to suitable investments. Regulators will expect to see plans to manage the influx of IFIsa money and, in particular, will need reassurance that P2P platforms are not accepting lower quality borrowers in order to deploy an increased flow of funds from the public.

The IFIsa could undoubtedly help P2P lending become a mainstream retail investment choice, but it is likely to prove a double-edged sword for the platforms. It might help to give a wider group of people confidence to invest in P2P loans. But if the flows are significant, it might equally leave them frustrated when they find that, in practice, they cannot deploy their money, or that the time it spends waiting to be invested results in significant “cash drag” – leaving their overall returns looking little better than they could have achieved through more conventional routes.

**Origination – the key obstacle to making P2P mainstream**

Important elements of the ecosystem needed to turn P2P into a mass-market phenomenon are in place, although it is still early days. None of these developments, however, addresses the real challenge that faces the P2P platforms: how to generate a much greater flow of lending opportunities of high enough quality to accommodate the large amounts of retail money that could try to enter this asset class.

According to the P2P Finance Association, the industry’s main umbrella group, its members’ total stock of lending stood at just under £3.1bn at the end of Q4 2016, about £1.73bn of which was lending to businesses\textsuperscript{16}. That total is growing fast,

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\textsuperscript{14} Abundance receives £10m boost from IFISA, 06.03.17 See: http://www.p2pfinancenews.co.uk/2017/03/03/abundance-receives-10m-boost-from-ifisa/

\textsuperscript{15} Lending Works Isa suspended, 09.02.17 See http://blog.p2pmoney.co.uk/lending-works-isa-suspended abundance-receives-10m-boost-from-ifisa/

\textsuperscript{16} In a report commissioned by the P2PFA, Oxera estimates that its eight members account for approximately 80% of the overall P2P lending market in the UK. See: The Economics of Peer-to-Peer Lending, p3 http://www.oxera.com/getmedia/9c0f3f09-80d9-4a82-9e3f-3f5feco450b2/The-economics-of-P2P-lending_308ep_.pdf.aspx?ext=.pdf
having risen almost 44% during 2016, but it remains tiny in the context of the broad Isa market. In the 2015-16 tax year (the most recent for which HMRC figures are available), 12.66m adult Isas received subscriptions (10.12m of them Cash Isas) and a total of £80.2bn of new money flowed in.

This problem is by no means confined to the P2P sector. Origination challenges exist everywhere in the direct lending market, right up to the large private funds that compete with bank syndicates to finance leveraged buy-outs. In this part of the market, especially in Europe, large insurers have considerable appetite to increase their allocations to direct lending, as a high-yielding alternative to traditional fixed-income assets. But they continue to find that they cannot deploy as much money as they would like. For direct lenders, large and small, origination in heavily banked markets is the key hurdle.
Chapter 6: Equity crowdfunding

A few weeks before the publication in July 2012 of Seeds of Change, the CSFI’s first report on alternative sources of finance for small business, Seedrs became the first equity crowdfunding platform in the world to achieve authorisation by financial regulators. It was not the first to launch – that distinction belongs to Crowdcube – but it was the first to work out how to obtain regulatory approval to allow non-sophisticated retail investors to buy shares in early-stage private companies, a market that until then belonged to wealthy business angels and professional venture capitalists.

From these beginnings, a regulated equity crowdfunding market has grown in the UK that has now funded perhaps 1,000 small companies, transforming the level of participation in early-stage investment. “Before crowdfunding came along it was estimated that about 20,000 people in the UK were or had been angel investors,” says Jeff Lynn, co-founder and chief executive of Seedrs. “We’ve now had significantly more than that just on our platform.” Crowdcube says it has more than 360,000 registered users, although not all have made an investment.

As in P2P lending, the efficiency gains of automation, combined with the reach of online distribution, have been the fundamental enablers of equity crowdfunding. These innovations made it economically feasible to source and process individual equity investments of as little as £10, opening up angel investing to the mass market. For the first time, anyone, no matter what his or her wealth, could achieve diversified exposure to early-stage equity. Helped by the UK’s unusually generous tax incentives – the Enterprise Investment Scheme and Seed EIS – this has turned equity crowdfunding into an established feature of the retail investment landscape and a favoured way for young companies to raise finance.

Over the past five years, investment rounds carried out on crowdfunding platforms have tended to increase in size: five years ago a £200,000 funding round was considered large, whereas scores of companies have now raised sums of more than £1m in this way. As in P2P lending, the participation of traditional angel investors and venture capital funds has grown. These trends will play an increasingly important role in the future of equity crowdfunding.

In common with P2P lending, crowdfunding platforms operate differing models: some use nominee structures that group all crowd investments under a single legal entity, others allow direct shareholdings by each individual; some take part of their remuneration via “carried interest” in the profits on successful exits, others take only a fee on successful fundraisings. Unlike P2P lending platforms, however, these differences in business model have not proved a barrier to platforms becoming
authorised by the Financial Conduct Authority. This is probably because they have not been attempting to gain authorisation under an entirely new set of rules, with the regulator having to make many decisions on how to interpret and implement them. Instead, equity crowdfunding platforms have been authorised to carry out established asset management activities, such as arranging and managing investments, and administering client assets.

Equity crowdfunding has undoubtedly democratised access to angel investment opportunities. But although it has succeeded in becoming fully regulated, it continues to pose serious challenges for regulators, and it remains controversial.

The challenges facing equity crowdfunding

One of the biggest issues for equity crowdfunding platforms is the public nature of the activity. Investing in early-stage businesses is extremely risky – on average about 10 per cent of companies cease trading every year and failures of crowdfunded businesses tend to become public knowledge quickly. These failures are often taken to reflect the quality of the due diligence carried out by the platform on the business plan presented to it, rather than poor execution by the entrepreneurs. However, this rather obvious assumption is not necessarily true or fair.

This is not to say that due diligence is not an issue. In many ways, alongside valuation it is the issue. A fundamental part of the original equity crowdfunding proposition was that it would largely remove the costs of formal, professional due diligence from the fundraising process. In doing this, it would address the problem that dogged most early-stage equity investments: that these costs were so high that most small opportunities were uneconomic for professional investors to pursue, and there were too few informal angel investors to fill the gap. If these issues could be overcome, it was felt, more companies would be able to raise money.

The theory was that online platforms would provide the conduit through which the “wisdom of crowds” could be channelled, creating an effective replacement for professional due diligence. But this glossed over a basic problem of economic incentives. By reducing ticket sizes to the point where retail investors could easily become involved, equity crowdfunding platforms also removed much of the incentive for them to spend more than a short time evaluating any proposition. An investment of £500 is very unlikely to command the same level of scrutiny as an investment of £10,000 or £20,000.

Given that the wisdom of crowds is not the answer to the problem of expensive
due diligence – and that the public nature of crowdfunding failures will perpetuate
questions about platforms’ due diligence standards\(^{18}\) – the sector needs a better answer
to the question of who is to bear the costs of scrutinising entrepreneurs’ pitches.

Similar problems exist around valuation. If platforms allow companies to set their own
valuation, they leave retail investors exposed to one of the biggest single risks in equity
investing: paying too much. Interviewees produced several examples of crowdfunded
companies that later tried to raise money from professional investors and were forced
to accept a lower valuation. In particular, the first British IPO of a crowdfunded
company, FreeAgent, on the Alternative Investment Market in November 2016 took
place at a valuation below its previous crowdfunding round (on Seedrs) in July 2015.\(^{19}\)

The financial forecasts that companies produce with their pitches – generally
showing rapid revenue growth followed by profitability – are another source of
controversy. Platforms have become nervous about publishing these forecasts,
fearing that they could fall foul of the FCA’s Conduct of Business Sourcebook
because information of this sort cannot be verified.

But as Goncalo de Vasconcelos, chief executive of SyndicateRoom (where I am
an equity investor), points out, professional investors are used to discounting the
information contained in performance forecasts and yet still want access to them:
“The first thing professional investors want is a forecast. They don’t believe it. As
a forecast, the only thing that is guaranteed is that it won’t be accurate, but it gives
them a sense of scale. They look at the assumptions to see if they make sense. They
make assumptions of their own and then they can judge whether this is a £100m
revenue company or a £1m revenue company.” This is undoubtedly true, but how is
a regulated equity crowdfunding platform to go about telling retail investors that any
forecasts they might read are guaranteed to be wrong?

Ultimately, issues such as these raise questions about the financial viability of equity
crowdfunding platforms. Their business model was never intended to bear the cost of
conventional due diligence and the more platforms take on this role, the more their costs
will rise. This will erode the economies of scale that online distribution gives them to the
point where sustainable profitability becomes difficult or impossible to achieve.

Part of the answer to this is for platforms to broaden their businesses, by offering
more products (as Crowdcube has done with minibonds), entering international
markets (as Seedrs has done), or addressing more areas of equity investment (as
SyndicateRoom is doing). But another part of the answer lies in evolving the way
that equity crowdfunding happens, and there are signs that this is under way.

\(^{18}\) To help address this issue, Crowdcube published a due diligence charter in 2016 that sets out what its investors
should expect from it. See: https://www.crowdcube.com/pg/due-diligence-charter-1745

\(^{19}\) ‘Seedrs delivers sector’s first IPO: a down round for investors’, Altfi. See: http://www.altfi.com/article/2412_
seedrs_delivers_sectors_first_ipo_a_down_round_for_investors
The route to sustainability

The most likely way for equity crowdfunding to develop a sustainable and scalable business model is for it to move further towards a co-investment structure, in which private individuals invest alongside experienced, professional investors on equal terms. This is the model developed by SyndicateRoom: every funding campaign has a lead investor, either a business angel or a specialist fund, that negotiates the terms and valuation of the deal and then allows outsiders to invest on the same basis.

Although the other major equity crowdfunding platforms were not originally based on this model, all are gradually moving in this direction. Jeff Lynn, of Seedrs, says: “What I don’t think we anticipated was the degree to which we would be co-investing with Venture Capitalists, not replacing them.” According to figures from Crowdcube, reported in the FT, the number of deals on its platform in which professionals participated alongside retail investors has quadrupled in the past two years.20

Of course, simply having professional investors at the table does not guarantee that all the problems with equity crowdfunding will be addressed – much depends on establishing the right structure and ensuring there is full transparency of the terms on which everyone is subscribing. This should be an area of close attention for regulators as the crowdfunding sector evolves. Equally, this model may never prove suitable for the smallest, earliest-stage investments, where the risks are greatest and the sums involved very small.

Nonetheless, a model in which the public invest alongside professionals, who have undertaken due diligence and negotiated the valuation, has several benefits:

• it provides reassurance about the quality of the due diligence;
• it helps overcome the suspicion that platforms are accepting sub-standard pitches to boost the volumes on which they depend for profitability;
• it helps to cap the platforms’ due diligence costs;
• it focuses platforms’ business more firmly on their most valuable asset: their investor database;
• it enables professional investors to boost the funding available to the businesses they back without having to commit the full sum themselves; and

20. Professional investors join the crowdfunding party, March 16, 2017. FT.com. See: https://www.ft.com/content/235b5198-08ce-11e7-ac5a-903b21361b43?desktop=true&segmentId=dd5c99e9-30be-ddd0-c634-df3a0e2b738
• for certain consumer-facing businesses, it enables professional investors to harness the promotional benefits of having a large group of retail investor advocates for the company.21

Co-investment that guarantees retail investors access to early-stage opportunities on the same terms as the professionals offers the most promising route to a sustainable future for equity crowdfunding. It creates the most coherent and best-aligned community of interest between platforms, professional investors and the retail crowd. The main benefits of crowdfunding are its ability to give companies access to a deeper pool of capital and to open up investment opportunities that have never before been freely available to private investors. These are important gains, but they have brought with them serious issues: well-structured co-investment offers a solution.

21. For example the recent £2.5m crowdfunding round announced by the digital challenger bank Monzo, alongside a £19.5m investment from three institutional investors.
Conclusions: Something old, something new

The past seven years have seen the beginnings of a revolution in small business finance. This includes the emergence of P2P lending, but it extends well beyond this new form of retail-funded direct lending. Equally important in the borrowing market, although lower profile, is the arrival of a host of conventional direct lenders using online distribution to provide specialist financial products. Between them, these groups have helped to bring a more diverse and competitive financing market into being, which will ultimately provide businesses with a better set of choices about how to manage their finances. What, then, are the ingredients and implications of this nascent revolution?

Technology, efficiency and the user experience

The clearest lesson of the revolution’s early stages is the huge effect that applying technology can have on many aspects of the lending market. At its most basic, simply replacing traditional paper-based processes with electronic systems for originating, underwriting and servicing loans can create substantial efficiency gains. Platforms’ ability to assemble and integrate huge volumes of data on individual companies allows them to speed up the application process by pre-populating online forms. They can also draw instantaneously on tens of thousands of publicly available data points on each company to accelerate the decision-making process.

Freedom from legacy technology and operating models has also allowed the new entrants to build and utilise credit models much more quickly than is possible in a banking environment. Funding Circle says that the central role that technology plays in its operations means that teams such as technologists and statisticians, which would be separate in a bank, are effectively melded together in its set-up. Together, its technology, data and risk teams make up more than half the platform’s UK headcount.

What technology has not done so far, however, is to replace human judgment in the credit underwriting process, which leads ultimately to the decision to lend. Experienced credit underwriters still play a central role at almost all new lenders – the big difference is in the quality and speed of the electronic tools they have at their disposal.
The other key impact of applying leading-edge technology has been felt in the user experience. Many business borrowers, applying for a loan online, are now able to receive a decision, in principle, on their application very rapidly, instead of waiting weeks or even months for their bank to process the paperwork.

This shift in user experience has changed the competitive landscape for everyone in this market. Major banks are now offering business borrowers decisions in one hour on loans of up to £50,000 – and in the case of RBS’s Esme lending platform, loans of up to £150,000. Only a few years ago, this speed of service was unheard of. It is becoming standard practice as a direct result of the technological innovation and competitive pressure brought to bear by the P2P and online direct lending entrants that have emerged since about 2010.

The next wave of innovation

Technology has already transformed the user experience of business borrowers, but there is much further to go. For example, despite all their investment in technology, P2P and online direct lenders still need to obtain copies of bank statements from the businesses that apply to them for a loan. But this, too, is about to change. The roll-out of the Open Bank API (application programming interface) signals a big step forward in the free flow of financial data that was previously confined within the banks’ systems. It will allow any business borrower to grant selected lenders direct access to its banking information, giving them a much more detailed and timely view of its financial situation than was previously available. This will make it quicker and easier to assess applications to borrow. Within a short time it is likely that any online application for finance by a small business will involve granting the potential lender access to its banking records. At this point, the information advantage that banks have traditionally held over other lenders will begin to disappear.

Similarly, several technology-led lenders are already requiring borrowers to grant them access to the cloud-based accounting packages that manage their finances. Again, the lender obtains a real-time view of the business’s transactions and, therefore, its financial health.

An increasing flow of real-time financial information will make possible the next wave of innovation – not only in how finance is provided to businesses, but also in the management of existing loan books. This more dynamic approach will give lenders better visibility on risk, as well as the opportunity to create more flexible and competitively priced funding lines. Overall, compared with the first decade of this century, small businesses will have much more choice over the provider of funds, the type of credit they can access and its terms.
A shift in borrower expectations and behaviour

One of the major effects of this technology-based approach to smaller company lending is that, from the borrower’s perspective, it increasingly resembles consumer finance. As technology-enabled lenders, including P2P platforms, help to turn borrowing by smaller companies into a rapid, frictionless and standardised process, this will change the expectations of borrowers about the ready availability of finance and about who controls the process. Alan Morgan, an early investor in Funding Circle and a backer of numerous fintech businesses, says: “Does an SME that’s been lent money by Funding Circle have a trust-based relationship with Funding Circle? I think the answer is no. It is fundamentally a transaction-based relationship, but what they’ve got is trust in the repeatable nature of the process that Funding Circle provides, and that it will be available to them subject to them performing against certain criteria.” That sounds remarkably similar to the relationship most of us have with our electricity or gas supplier.

Reasons for Choosing a Provider

![Bar chart showing reasons for choosing a provider.](chart)

*Source: British Business Bank 2016 Finance Survey of SMEs*

This is not to say that trusted brands no longer matter – quite the opposite. The more like a utility finance becomes, the more important trusted brands become in helping users to choose between similar services offered at similar prices. In a
market of scores of competitors, familiar and trusted brands are crucial as proxies for operational excellence, quality of service and the ability to respond effectively if something goes wrong.

However, although brands are vital in underpinning our willingness to pay for a utility-like service, the pricing power they confer is limited. Technology, and the efficiency and transparency it helps to create, are likely to create a world in which activities such as small business lending will have structurally lower margins. This, in turn, suggests that large players with high legacy overheads and expensive obligations – including high regulatory capital charges, the need to handle cash and cheques, and the cost of large branch networks – are going to find it hard to lift their returns on equity back to the levels they enjoyed a decade or more ago. Technology tends to drive down margins for legacy operators in virtually every market it touches: there is no reason to suppose that small business lending will prove an exception.

What sets P2P apart in this new world?

The issues touched on so far are central to the future shape of small business finance, but none of them is unique or intrinsic to P2P, or to direct lending more broadly. New technologies that can make the lending process faster and more efficient are already available to everyone prepared to invest in them. The obligation to meet the changing customer expectations that these new technologies create falls equally on everyone. P2P platforms have stood out as early adopters of these technologies, others are starting to catch up.

Instead, the enduring features of P2P lenders, distinguishing them from other operating models, ultimately derive from the fact that they rely on retail investors to provide a significant proportion of their funding, even if no longer the majority. Three features in particular stand out:

- **Fractional ownership of loans**: Automation has made it economically feasible to split large loans into hundreds, or thousands, of separate parts of as little as a few pounds each, underpinned by individual loan contracts between borrower and lender. This central innovation has reduced ticket sizes to the point where direct lending is accessible to individual retail investors, forming an asset class in which they can achieve a good level of diversification within modestly sized portfolios. The advent of this corporate fixed-income asset class for the retail market is, incidentally, paralleled by the London Stock Exchange’s launch of the Orderbook for Retail Bonds in February 2010. This enabled retail investors to overcome the problem that government and corporate bonds were sold only in large lot sizes, often £50,000 or £100,000 each. Using ORB, they could instead buy fractional holdings of some bonds in the size they wanted. Fractionalisation has allowed...
individuals to invest directly in assets they could previously only have owned via a fund. Both of these developments represent major gains for private investors.

- **The funding process moves into the public domain:** One of the most striking features of the P2P market is that would-be borrowers must disclose financial information in a public forum. Some of this information is publicly available in any case to those who choose to look, but some is not. By the same token, if a company fails to raise the sum it is seeking from a P2P platform, it fails in public. Transparency of this sort is obviously necessary if members of the public are to invest in largely illiquid loans to small, private companies, but a question remains over how big a barrier it is to the wider acceptance of P2P as a source of finance. According to the *SME Finance Monitor*, even among smaller companies that are aware of online P2P finance, the propensity to consider using it remains relatively low, at about 30%. This proportion does not appear to have increased as awareness of P2P has grown. How big a factor in this is the need to disclose financial information publicly? Perhaps more importantly, how big a factor does it become when others can offer a near-identical product and user experience without such public disclosures?

- **The regulatory settlement:** The third intrinsic feature of P2P lending is its regulatory status. The authorisation regime for P2P lending establishes it as a separate activity, distinct from banking and asset management – although it shares some similarities with both. Authorised P2P platforms can compete in lending markets alongside banks and other direct lenders using retail funding without the obligation to hold the regulatory capital and liquidity buffers required of a bank. Equally, the funds invested by retail lenders are not legally pooled, and so the platforms do not require authorisation as asset managers in order to operate. Not only does this framework give authorised P2P platforms a unique status in regulatory terms, it determines their ability to offer investors access to tax-free returns via the Innovative Finance Isa.

P2P lenders have had an impact on the business lending markets over the past five years that far outweighs their financial scale and lending volumes, although they have clearly helped to broaden the choice of funding sources and products available to small business owners. Partly, this has been a result of opportunistic public relations at the expense of a hugely unpopular banking sector. But in the longer term other factors have been more important, particularly the platforms’ concentration on specific niches, their pioneering application of technology and automation to different aspects of the lending process, and the huge shift in customer expectations that they have helped to create right across the market. These successes have allowed them to establish a small but growing share of lending and a much bigger “share of voice” in the lending market. However, it will take sustained profitability (and authorisation by the FCA) for their presence to become irreversible.

Some, such as LendInvest, which operates a hybrid model that includes both retail funding and balance-sheet lending, are already solidly profitable. Others that operate...
“pure P2P” models with no element of balance sheet lending must achieve significant scale if they are to make meaningful profits. This is because their revenue derives entirely from fee income on completed loans. Funding Circle is the clearest example so far of a P2P platform that shows signs of achieving the necessary scale. As and when it does, the attractive financial characteristics of a large P2P lending business – low capital intensity and high return on equity – will become obvious.

Where are we going? A possible future for P2P business lending

Authorisation creates a distinct legal space in which P2P platforms can operate. But it also creates potential opportunities for conventional direct lenders, such as bridging lenders, to change the way they fund their activities. Having an established legal framework for P2P lending makes it feasible to create an authorised P2P operation alongside an existing direct lending business. Octopus has done this by launching the Octopus Choice platform to allow investors to purchase loans originated by Octopus Property. It also enables the platform operator to offer investors tax-free access via the IFIsa.

This is significant because it provides a legally robust way to syndicate direct loans into the retail market inside a tax-free wrapper, and so changes the available funding mix. A direct lender that operates this model can take a spread on every loan part it syndicates through the P2P channel. Moreover, because of the contractual structure of P2P loans, the loss exposure passes from the direct lender to the investor. In effect, the direct lender syndicates the entire liability, but retains a portion of the return as a fee for originating and servicing the loan.

This could provide the direct lender with return characteristics more akin to those of an asset manager – lower capital intensity, higher return on equity – without necessarily requiring it to become authorised as an asset manager. The virtue of a hybrid direct lending/P2P model is that it is structurally more profitable than a “pure P2P” operation of the same size. It collects fee and interest income on its balance sheet lending and syndication income from its P2P operation, as well as being able to recycle capital more quickly into fresh loans.

A structure in which a direct lender syndicates its loans, but retains a portion of each, also answers some of the trickier issues over potential conflicts of interest in the “pure P2P” model. P2P platforms that undertake no lending on their own account are always vulnerable to accusations that they do not “eat their own cooking”. The commonest answer to this among most leading platforms, including those that make up the P2PFA, is to take a percentage of their fee income through the life of
Aligning platforms’ interests with their lenders

each loan as a servicing fee. In Funding Circle’s case, these ongoing servicing fees account for 30% of the platform’s overall revenue stream. As well as serving to align the P2P platforms’ interests better with their lenders, this structure also has the advantage of providing better revenue visibility than if they took their entire fee at the point the loan is drawn down.

However, a hybrid direct lending/P2P model offers the opportunity to go further and create a more obvious alignment of interests between the direct lender that originates the loans and the retail investors who subsequently buy them, while at the same time retaining the regulatory advantages of authorisation under the P2P rules.

P2P lending is likely to continue in a variety of forms, depending on the markets to which it is being applied. However, there is clear potential for a model that combines balance-sheet lending with retail syndication of loan parts, using the framework of P2P authorisation, to emerge as one of the dominant forms of the future. If this were to happen, it would mirror closely the developments that are unfolding in the equity crowdfunding market, where an increasing proportion of fundraisings involve a “lead investor” – be that an individual business angel or a venture fund – and a tranche of shares that are reserved for “the crowd”.

From this perspective, terms such as co-investment and syndication offer a better description of where P2P may be heading. Ultimately, providing the opportunity to invest alongside the professionals – rather than attempting to replace them – may represent the most sustainable future for P2P finance.

Some things never change

Among all the things that are changing in the small business funding markets, there are plenty that are not. Here are a few of the more important constants:

- **Risk appetite and pricing**: Numerous factors help to decide whether a loan is agreed or not. Regulation may make it difficult, or even impossible, for certain types of organisation to operate in a market. But the most important factors for investors in P2P loans are the risk appetite the platform sets for itself and the pricing of the risks it accepts. Technology can help with the calculations, but the decision ultimately rests on human judgment. By the same token, valuation is the key risk in equity crowdfunding – paying a high price for a very risky proposition is unlikely to end well.

- **Human beings still matter**: Much of the talk is about technology and automation, but humans remain crucial to the P2P lending
process. Credit underwriting is still mainly undertaken by teams of experienced professionals, although the tools available to them have improved enormously. Brokers are also extremely important in directing borrowers to online platforms – human contact has proved an enduring part of the origination process. Indeed, P2P platform Folk2Folk is creating a network of High Street branches, and recently announced plans to open its fourth, in Harrogate. Assetz Capital is hiring a network of local relationship directors to give it an alternative to sourcing loans from independent commercial finance brokers. Several of the business-focused challenger banks base their relationship managers in regional offices. Even for all the prodigious online origination capacity of a platform such as Funding Circle, human beings are not yet an endangered species in small business lending.

• **Cost of acquisition versus lifetime value**: This issue lies at the heart of the P2P platforms' long-term profitability challenge. They are operating in a lending market where demand is far from strong and costs of acquisition remain stubbornly high, including the need to pay introducer fees to commercial finance brokers. This eats into the margin on lending, eroding the lifetime value of a borrower. In the P2P model, where the only income is from fees on completed loans, the squeeze is more pronounced than it would be if the platform were also generating income by lending off its own balance sheet. Equally, if a platform has only one product to offer, the challenge of increasing the lifetime value of a customer increases again.
Appendix: P2P: Business Lending (major players) 2014 - 2016

Total Base Stock of business loans (£) = Total amount of principal at end of period.

<table>
<thead>
<tr>
<th></th>
<th>Q3 2014</th>
<th>Q4 2014</th>
<th>Q1 2015</th>
<th>Q2 2015</th>
<th>Q3 2015</th>
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<tbody>
<tr>
<td>Funding Circle</td>
<td>£263,390,000</td>
<td>£333,606,000</td>
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<td>Landbay</td>
<td>£317,000</td>
<td>£1,784,000</td>
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<td>£97,603,000</td>
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<td>£177,294,000</td>
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<td>£0</td>
<td>£0</td>
<td>£0</td>
<td>£0</td>
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<tr>
<td>MarketInvoice</td>
<td>£22,944,000</td>
<td>£21,596,000</td>
<td>£17,908,000</td>
<td>£25,140,000</td>
<td>£31,335,000</td>
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<tr>
<td>RateSetter</td>
<td>£50,936,000</td>
<td>£61,048,000</td>
<td>£96,405,000</td>
<td>£121,785,000</td>
<td>£145,551,000</td>
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<td>Thincats</td>
<td>£59,880,000</td>
<td>£61,954,000</td>
<td>£64,458,000</td>
<td>£77,142,000</td>
<td>£86,418,000</td>
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<td>Zopa</td>
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<td>£0</td>
<td>£0</td>
<td>£0</td>
<td>£0</td>
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<tr>
<td><strong>Total</strong></td>
<td>£480,227,000</td>
<td>£577,571,000</td>
<td>£751,724,000</td>
<td>£884,804,000</td>
<td>£1,015,286,000</td>
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Total New Business Lending (£) = Amount originated in period

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<th>Q4 2015</th>
<th>Q1 2016</th>
<th>Q2 2016</th>
<th>Q3 2016</th>
<th>Q4 2016</th>
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<td>£241,745,000</td>
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<tr>
<td>MarketInvoice</td>
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<td>RateSetter</td>
<td>£178,527,000</td>
<td>£201,851,000</td>
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<td><strong>Total</strong></td>
<td>£1,176,673,000</td>
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<td>£1,549,423,052</td>
<td>£1,725,925,626</td>
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Total New Business Lending (£) = Amount originated in period

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<th>Q3 2014</th>
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<th>Q1 2015</th>
<th>Q2 2015</th>
<th>Q3 2015</th>
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<tr>
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<td>£26,877,000</td>
<td>£83,478,000</td>
<td>£70,078,000</td>
<td>£71,783,000</td>
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<tr>
<td>LendingWorks</td>
<td>£0</td>
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<td>£0</td>
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<td>MarketInvoice</td>
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<td>RateSetter</td>
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<td>£8,506,000</td>
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<td><strong>Total</strong></td>
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<td>£297,180,000</td>
<td>£304,976,000</td>
<td>£370,331,000</td>
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Source: P2P Finance Association Loan Statistics Q4 2016
Interviewees

The author wishes to thank interviewees who have been generous with their insights and advice during the preparation of this report. They include:

John Battersby  
*Head of Communications*  
Ratesetter

Louise Beaumont  
*Co-Chair*  
Open Bank TechUK, and Open Bank, SapientRazorfish

Shiona Davies  
*Director*  
BDRC Continental  
and author of the *SME Finance Monitor*

David De Koning  
*Director of Group Communications*  
Funding Circle

Stephen Findlay  
*Chief Executive*  
BondMason

John Finnemore  
*Partner*  
CMS

Conrad Ford  
*Founder*  
Funding Options

Dan Kiernan  
*Head of Research*  
Intelligent Partnership

Rod Lockhart  
*Managing Director*  
LendInvest Capital

Jeff Lynn  
*Co-Founder and Chief Executive*  
Seedrs

Alan Morgan  
*Chairman*  
Adfisco

Rahul Pakrashi  
*Chief Risk Officer, UK*  
Funding Circle

Stephen Pegge  
*Director of Special Projects*  
Lloyds Banking Group

Modwenna Rees Mogg  
*Founder*  
AngelNews

Jonathan Segal  
*Partner*  
Fox Williams LLP

Adam Tyler  
*Former Chief Executive of the National Association of Commercial Finance Brokers, and Founder*  
Financemybusinessonline.co.uk

Goncalo de Vasconcelos  
*Chief Executive*  
SyndicateRoom

Richard Wazacz  
Head of Octopus Choice

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125. “From Peer2Here: How new-model finance is changing the game for small businesses, investors and regulators”  
£25/$45/€35

124. “Reaching the poor: The intractable nature of financial exclusion in the UK”  
£25/$45/€35

123. “Getting Brussels Right: “Best Practice” for City firms in a post-referendum EU”  
£25/$45/€35

122. “Financial services for all: A CSFI ‘Banana Skins’ survey of the risks in financial inclusion”  

121. “Banking Banana Skins 2015: The CSFI survey of bank risk”  

120. “THE DEATH OF RETIREMENT: A CSFI report on innovations in work-based pensions”  

119. “INSURANCE BANANA SKINS 2015: the CSFI survey of the risks facing insurers”  

118. “THE CITY AND BREXIT: A CSFI survey of the financial services sector’s views on Britain and the EU”  

117. “SETTING STANDARDS: professional bodies and the financial services sector”  

116. “FINANCIAL INNOVATION: good thing, bad thing? The CSFI at 21”  
November 2014. Free

115. “NEW DIRECTIONS FOR INSURANCE: Implications for financial stability”  

114. “MICROFINANCE BANANA SKINS 2014: Facing reality”  

113. “BANKING BANANA SKINS 2014: inching towards recovery”  

112. “INSURANCE BANANA SKINS 2013: the CSFI survey of the risks facing insurers”  

111. “CHINA’S BANKS IN LONDON”  

110. “BATTING FOR THE CITY: DO THE TRADE ASSOCIATIONS GET IT RIGHT?”  

109. “INDEPENDENT RESEARCH: because they’re worth it?”  

108. “COMBINING SAFETY, EFFICIENCY AND COMPETITION IN EUROPE’S POST-TRADE MARKET”  

107. “SEEDS OF CHANGE: Emerging sources of non-bank funding for Britain’s SMEs”  

106. “MICROFINANCE BANANA SKINS 2012: the CSFI survey of microfinance risk”  

105. “GENERATION Y: the (modern) world of personal finance”  

104. “BANKING BANANA SKINS 2012: the system in peril”  

103. “VIEWS ON VICKERS: responses to the ICB report”  

102. “EVOLUTION AND MACRO-PRUDENTIAL REGULATION”  

101. “HAS INDEPENDENT RESEARCH COME OF AGE?”  

100. “INSURANCE BANANA SKINS 2011: the CSFI survey of the risks facing insurers”  


98. “INCLUDING AFRICA - BEYOND MICROFINANCE”  

97. “GETTING BRUSSELS RIGHT: “best practice” for City firms in handling EU institutions”  
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Bank of England
Bank of Italy
CGI
Chartered Insurance Institute
Content Capital
Council of Mortgage Lenders
Eversheds
Fidelity International
Financial Conduct Authority
Financial Reporting Council
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Bank of Japan
Berenberg Bank
Better Markets
Brigade Electronics
Brunswick Group
C. Hoare & Co.
CISI
Cognito Media
EBRD
Embassy of Switzerland in the United Kingdom
Endava
ETF Securities
Fairbanking Foundation
Farrer Law
Finance & Leasing Association
Gate One
Granularity
Guy Carpenter
HM Treasury

HSBC
JP Morgan
Lafferty Group
Moody’s
Prudential
PwC
Royal Bank of Scotland
Ruffer
Teneo Blue Rubicon
KPMG
Legal & General
Lloyds Banking Group
Lombard Street Research
Morgan Stanley
Nomura Institute
Oliver Wyman
OMFIF
PA Consulting
Payments Council
Record Currency Management
Santander
Schröders
Standard Chartered
The Law Debenture Corporation
Thomson Reuters
UBS
WMA
Z/Yen
ICIS
Intrinsic Value Investors
Investment Association
Kreab Gavin Anderson
Lansons Communications
LEBA and WMBA
Lending Standards Board
MacDougall Auctions
Morgan Rosseter
NM Rothschild
Nutmeg
Obillex
Oxera Consulting
Raines & Co
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Skadden, Arps
Skandinaviska Enskilda Banken
SWIFT
Taiwan Financial Supervisory Commission
The Share Centre
The CityUK
Zopa

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Grant Thornton
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Kemp Little
King & Wood Mallesons SJ Berwin
Linklaters
Norton Rose Fullbright
TPG Design
Andy Davis is a UK-based writer on investment, finance and business. He was previously a journalist on the Financial Times, where he worked for 15 years and held a series of senior roles including editor of FT Weekend.

Andy’s work appears in a range of financial publications and he is the author of several research reports on non-bank finance for small businesses, for organisations including Nesta, the CSFI and the ACCA. He is a contributor and investment columnist for Prospect, the monthly current affairs magazine, and was named Personal Financial Journalist of the Year in the 2012 Wincott Awards.