YORKSHIRE BUILDING SOCIETY

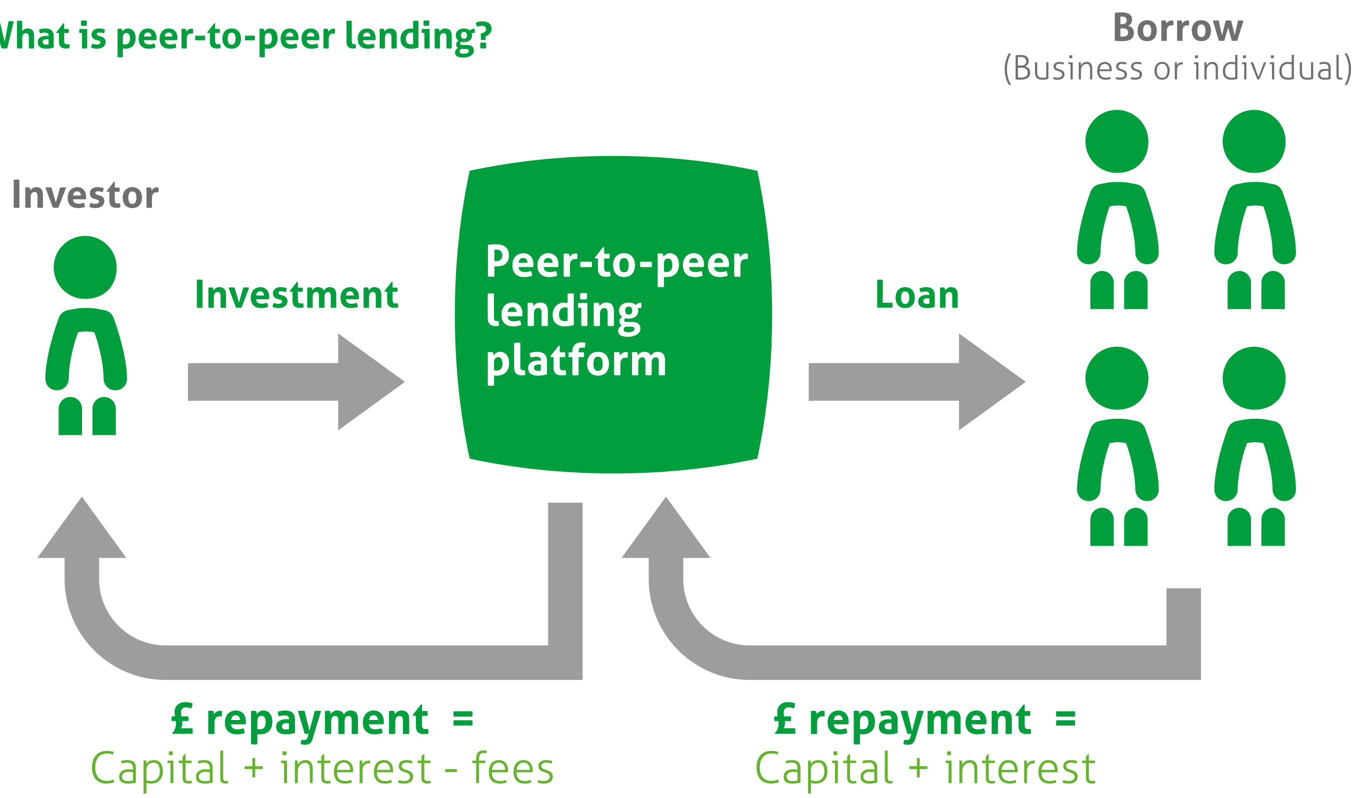
PEER-TO-PEER LENDING EXPLAINED

Peer-to-peer lending is increasingly talked about in the media and is rapidly growing in popularity, with consumers investing £1.3bn in peer-to-peer lending in 2014, almost three times the £480m invested in 2013*.

From April next year, consumers will be able to invest in peer-to-peer lending in a tax-free ISA, after the Government announced it would create a third type of ISA, an Innovative Finance ISA, separate and distinct from both Cash ISAs and Stocks and Shares ISAs.

With this in mind, we thought it was important to give you our overview of what it's all about and tell you about what we see as the advantages and possible risks associated with this type of investment, to help you to better understand and make your own informed choices about what is right for you.

What is peer-to-peer lending?



Peer-to-peer lending, also known as P2P, is a relatively new way to invest your money. Peer-to-peer firms allow you to invest your money by lending it to individuals or businesses which need to borrow it and charging the borrower interest, a proportion of which is passed on to the investor.

Peer-to-peer lending matches investors directly with borrowers via peer-to-peer lending sites, known as "platforms". This is different to other business lenders or loan companies in that money invested in peer-to-peer goes directly to a single borrower rather than into a wider fund shared between lots of borrowers.

Many peer-to-peer lending platforms promise investors larger returns on their money over five years compared to traditional savings accounts but, like all investments, there are risks associated with these potential gains.

The loans are typically administrated through websites, with the investor able to transfer money into their peer-to-peer lending account and choose the amount, a target interest rate and length of the loan, and in some cases, who they are lending the money to.

***Source: Peter Baeck, Liam Collins and Bryan Zhang: Understanding Alternative Finance; Cambridge University/Nesta, November 2014.**

Risks and things to consider

Our research has shown that there is a lack of awareness amongst consumers about what peer-to-peer lending is, its status as an investment, and the risks associated with it.

1. Unlike money deposited in a savings account, money invested in peer-to-peer lending is unsecured, which means the debt is not guaranteed against property or other assets, in the same way a mortgage or a finance agreement on a car would be. This means that if the borrower defaults on the loan, the lender may have no way of recouping their money other than pursuing the borrower through the courts, but with no secured asset to take possession of, this could prove fruitless. This means that if a borrower or borrowers default, the lender could earn less than the advertised interest, earn no interest at all, or even in extreme cases, lose the original money they invested.

2. Investments in peer-to-peer lending are not protected under the Financial Services Compensation Scheme (FSCS), which guarantees eligible deposits in building society and bank savings accounts, including cash ISAs, of up to £85,000 per institution (£170,000 on joint accounts). This will be reduced to £75,000 from 1 January, 2016, following a review by the Prudential Regulation Authority (PRA) to reflect the falling value of the euro against the pound, as this figure is a EU standard based on 100,000 euros.

3. Peer-to-peer platforms charge fees, which will reduce the interest an investor earns. Some peer-to-peer platforms take this deduction into account in the interest rate communicated to investors, but others do not. If you are considering investing, it's worth finding out how the platform you're looking at operates before you hand over your money.

4. As an investment is lent, it can be difficult and expensive for investors who need to access their money sooner than expected to withdraw it before the end of the term. To enable them to do this, there must be another lender to take on the loan. The platform may charge an extra fee for this and if there is a shortfall in interest because the new lender is demanding a higher rate of interest or market rates have risen, this money must be made up by the lender transferring the loan. This issue will also affect the Innovative Finance ISA, as the Government will not extend the maximum 30-day access period to money which has been lent and is yet to be repaid. This means investors may only be able to access within 30 days money and returns which have been repaid.

Statistics – YouGov, January 2015 (base: 1,541)

42% were aware of "peer-to-peer lending" Of that 42% (689 respondents):

23% would consider investing in P2P

44% were unaware investors in P2P can lose money as well as gain it (eg if the borrower defaults on the loan or the platform fails)

53% were unaware P2P is a type of investment, rather than a savings product

60% were unaware P2P investors had no protection under the Financial Services Compensation Scheme

73% were unaware platforms arranging P2P charge a fee or commission

How the regulators and peer-to-peer lenders have tried to lessen these risks

In 2014, the Financial Conduct Authority (FCA) introduced regulations which all peer-to-peer lenders must adhere to. The regulation governing peer-to-peer investments set to be reviewed by the FCA in 2016.

The regulations peer-to-peer platforms must abide by are:

1. They must present information about peer-to-peer lending to investors clearly and be honest about the risks associated with the investment
2. They must place customers' investments and loan repayments in a fund which is completely separate from the company's own assets and have a third party to take over loan administration to protect customers' money in the event the platform suffers financial problems
3. They are required to hold capital reserves of at least £20,000, rising to £50,000 by April 2017 to help guard against financial instability.

In addition, some peer-to-peer lending platforms have their own safeguards in place which go beyond the regulations to help protect investors from defaults on loan repayments by borrowers.

On most peer-to-peer platforms, investors' money is split across a large number of borrowers to reduce the risk should a borrower fail to meet their repayments on the loan. How this is done varies from website to website. Some platforms allow lenders to choose who they lend to, but others will have a facility which chooses the borrowers for the lender, depending on the lender's attitude to risk.

Peer-to-peer lenders also carry out credit checks on borrowers, in the same way a bank would when you apply for a loan, to try and ensure only borrowers who have good records of repaying credit are considered.

Some of the larger peer-to-peer platforms also have funds set up specifically to refund investors who have experienced defaults on their loans.

The Yorkshire's view on peer-to-peer

We have no plans to enter the peer-to-peer market because, as a mutual organisation with a history of more than 150 years, our first priority is to help people to become home-owners and save for the future in a safe and sustainable way. While it may suit some investors, anyone thinking of investing in peer-to-peer lending should understand the risks involved and how these differ to putting money into savings accounts such as bonds or tax-free ISAs.

We would always recommend that anyone considering any type of investment should seek independent financial advice. Anyone who has invested in peer-to-peer lending and is concerned about their investment should seek independent financial advice and contact the platform they have invested through in the first instance. Investors in peer-to-peer now also have access to Financial Ombudsman in cases where the platform does not resolve a complaint to the investor's satisfaction. You can read the full detail of the Government's paper on the Innovative Finance ISA here:

View Innovative Finance ISA document

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