Financial Services Consumer Panel
AN INDEPENDENT VOICE FOR CONSUMERS OF FINANCIAL SERVICES

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By email to: cp18-20@fca.org.uk

Dear Janet and Marta,

CP18/20: Loan-based ('peer-to-peer') and investment-based crowdfunding platforms: Feedback on our post-implementation review and proposed changes to the regulatory framework

The Financial Services Consumer Panel welcomes the opportunity to respond to the FCA's consultation CP18/20: Loan-based ('peer-to-peer') and investment-based crowdfunding platforms: Feedback on our post-implementation review and proposed changes to the regulatory framework.

The Panel's main points are:

- Discretionary platforms should be subject to the requirements of a banking licence.
- The FCA should address conflicts of interest between platforms and their customers, through a duty of care[1] or a robust reframing of principles for business 6 and 8.
- The FCA should introduce rules on insider trading/market abuse concerning the valuation of loans on a platform and any secondary market.
- Platforms should not be permitted to offer target rates of return as many consumers believe these are guaranteed rates. They should also be prohibited from using phrases which underplay the potential risks associated with the investment.
- Contingency funds give investors the misleading impression they are protected from risk of default. Disclosing more information will help, but not resolve, this issue.
- The FCA should enforce vigorously against poor practice. If there is any suggestion of fraud then this should be referred to the police.

Answers to the questions posed in the Consultation Paper are set out below.

Yours sincerely,

Sue Lewis
Chair, Financial Services Consumer Panel

[1] https://www.fs-cp.org.uk/sites/default/files/duty_of_care_briefing_-_jan_2017_2.pdf

Answers to questions

Q1: Do you have any comments on our assessment of the equality and diversity considerations?

No.

Q2: Do you have any comments on the description of the business models in this section?

Crowdfunding and peer to peer platforms perform a useful function for both individual investors and those seeking to borrow funds (both individuals and small and medium enterprises).

We accept that, provided individuals understand the nature and risks of the assets in which they are investing, they should be able to choose to make such investments.

The descriptions and conclusions related to conduit and pricing platforms are broadly accurate and are in line with the original intentions of the regulation of the sector.

However, discretionary platforms present a problem, both for consumers and for the regulatory boundary. Consumers placing funds on these platforms:

- do not know the identities of the individuals or companies they are lending to
- are unable to choose to whom they will lend (or not lend)
- have no means of verifying the platform's assessment of the risk profile of borrowers
- have no control over the duration of the loans they are investing in
- never actually see the loan contracts even though the contracts are supposed to be between them and the borrowers
- have no means of knowing whether loans in their portfolio have defaulted
- are unable to withdraw their funds when they choose as they will have been assigned loans of different durations

Platforms operating this model are undertaking business that is in almost all ways indistinguishable from banking, but they are able to avoid the cost of holding prudential reserves in the way that banks have to. Individual consumers place cash on platforms and the platforms (not the individual depositors or investors) lend the cash to individuals and companies who want to borrow. The main difference is that platforms generally do not have their own capital at risk (although there are examples of platforms or their associated companies taking on some loans). So, while banks' own capital is at risk where a borrower defaults, in the peer-to-peer lending world only the consumers' capital is at risk, even though the consumers are unable to assess the risk of borrower default as they never have the relevant information. Platforms are also making claims that by spreading consumers' funds between several different borrowers the investments are 'diversified' even though this might not be the case in practice. Some P2P platforms are taking assets that are correlated, risky and illiquid and making claims to consumers that the returns are diversified, safe and liquid.

We do not believe that the discretionary platform model is operating within the intention of the peer to peer regulatory regime. Given the risks faced by investors, and, in the longer term, the potential risks to financial stability of under-capitalised lending operations, discretionary platforms should be subject to the requirements of a banking licence. Our responses to subsequent questions should be taken in this context.

Q3: Do you have any comments on the analysis of harm in this section?

Paragraph 4.3 summarises the key potential harms faced by consumers, namely that they may not:

- be given clear or accurate information, leading to the purchase of unsuitable financial products;
- understand or be aware of the true investment risk they are exposed to
- be remunerated fairly for the risks they are taking;
- understand what might happen if the P2P platform administering their loan(s) fails
- understand the costs they are paying for the services the platform provides; or
- may pay excessive costs for a platform's services.

The analysis identifies other potential sources of harm, which may pose an even greater risk to consumers. These are:

- the platform may not be able to assess and price the risks faced by investors if they do not collect and check the right information about borrowers. The platform might not pass on any subsequent information that comes to light about a borrower. In the case of discretionary platforms borrowers are not given this information at all, which is why we have argued in response to Q2 that these platforms' operations are not consistent with the intended framework for peer to peer lending;
- material changes related to borrowers or investments are not always passed on to investors or lenders;
- valuation of assets against which a loan is "secured" may not be done competently or independently of the platform. The extent of the security provided may also be exaggerated;
- the secondary market may not operate in the best interests of investors and some individuals connected to the firm or the firm itself may use inside information to trade in these secondary markets. The FCA has decided that the P2P sector should not be subject to rules on insider trading/market abuse. This means that insiders could take advantage of non-public information about the health of the firms/individuals lent to by the platform or the stability of the platform itself to disadvantage other investors.

The analysis of harm also identifies several areas of conflict of interest between platforms and their customers (e.g. pushing lenders towards higher risk loans that provide the platform with larger margins; passing pre-funded loans on to lenders; passing loans already in default on to lenders). The FCA should address these conflicts through a duty of care or a robust reframing of principles for business 6 and 8. This would enable the FCA to tackle practices where a firm puts its own interests above those of the client.

Q4: Do you agree with our proposals to make clearer that P2P platforms that set the price of a loan must have an enhanced risk management framework that as a minimum, allows the platform to;

> **a) gather sufficient information about the borrower to be able to competently assess the borrower's credit risk,**
> **b) categorise borrowers by their credit risk in a systematic and structured way, and**
> **c) price the loan so it adequately and fairly reflects the credit risk determined in a)? If not, please explain why.**

As we said in our response to Q2 we believe that discretionary platforms are actually operating as banks and should be regulated as such. However, these proposals improve on the current situation and if discretionary platforms are allowed to continue within the existing regime, then we support these changes.

Q5: What else do you think might be needed to ensure an appropriate risk management framework for a P2P platform that sets the price of a loan?

The FCA should introduce rules on insider trading/market abuse concerning the valuation of loans on a platform and any secondary market.

Q6: Do you agree that when choosing P2P agreements on behalf of the investor, the platform must only facilitate those that are in line with the risk parameters advertised to the investor?

Yes, although we question whether not allowing the investor to choose their own agreements is consistent with the intention of P2P regulation.

Q7: Do you agree with our proposals that P2P platforms that offer a target rate of return must be able to determine, with reasonable confidence, that a portfolio will generate the advertised target rate? If you do not agree, please explain why.

Q8: Do you agree that this means only exposing investors to loans that a platform has determined, with reasonable confidence, will contribute to achieving the advertised target rate of return and, that at the time of investment fall within the risk parameters first advertised to the investor? If you do not agree, please explain why.

Q9: Do you agree that a P2P platform's risk management framework must be adequate to assess price and value over time, ie for newly originated and, for example, for loans that have defaulted? If you do not agree, please explain why.

Platforms should not be permitted to offer target rates of return at all. Many consumers will believe that these are guaranteed rates, yet the platforms are only using their own estimates of charges to borrowers and default rates. Improving the quality of these estimates is only a minor step forward.

It is also important that platforms are prohibited from using phrases like "zero capital losses" or investors have "never lost a penny" or "exceptional protection" which underplay the potential risks associated with the investment. We are also concerned that platforms are exaggerating the security available against loans or implying that as the loans are secured against assets then there is a limited risk of losses.

A number of platforms have been exaggerating the potential returns available and underplaying the risks. Panel members have made several complaints to the FCA about financial promotions which we considered to be misleading. There are also claims made about the potential returns available when it is not clear how they have been calculated, whether they are based on actual performance or are merely aspirations, or whether they take into account potential default rates. These claimed returns pose risks where P2P loans/platforms are included in the same comparison tables as FSCS-protected savings accounts. This practice should be banned.

Q10: Is the high-level approach proposed the right one to allow the industry flexibility but ensure good standards? What else do you think might be needed to ensure an appropriate risk management framework for a P2P platform that chooses P2P agreements on behalf of investors?

The only adequate risk management framework is for the platforms' own funds to be at risk. This would require them to hold suitable levels of reserves. At present all the risk is transferred to the investors.

Q11: Do you agree with our proposals that P2P platforms should have an independent compliance function and, depending on the nature, scale and complexity of its business, platforms should have independent risk and internal audit functions?

Yes.

Q12: Do you agree with our proposals that P2P platforms that have risk management frameworks should allocate responsibility for the development and oversight of that framework to a person approved to hold a significant influence function, such as a director?

Yes.

Q13: Do you agree with our proposals to apply marketing restrictions to P2P platforms? If not, please explain why.

The current definition of a high net worth investor is someone with investible funds of £250,000 or an annual income of at least £100,000. So someone with assets of £250,000 could put all of them onto P2P platforms and risk losing a significant proportion. As we have said before, it makes no sense to assume that someone is 'sophisticated' just because they have a lot of money. We suggest that the 10% rule should apply to any investor not using an adviser. This wouldn't cause any harm to high net worth individuals, it may actually prevent it.

Q14: Do you agree with the proposed modification to the systems and controls rules regarding wind-down arrangements? If not, please explain why.

Yes.

Q15: Do you agree that P2P platforms must have a P2P resolution manual containing information that would assist in resolving the firm in the event of the firm's insolvency?

No comment.

Q16: Have we correctly identified the information that should be included in the P2P resolution manual? If not, what other information should be included?

No comment.

Q17: Do you think additional prudential requirements are needed, to provide for the availability of ring-fenced capital in the event of platform failure? To ensure that loans continue to be managed and administered during wind-down?

Yes. We believe that additional prudential requirements are necessary anyway. This represents a further reason.

Q18: Do you agree with our proposals to clarify the information that a P2P platform should provide regarding its role?

We agree that the list in paragraph 5.69 is comprehensive and appropriate. But as we have indicated in our response to Q2, we do not believe that the rules specifically related to discretionary platforms should be necessary as platforms operating this model should be regulated as banks.

Q19: Do you agree with our proposals to make rules requiring a P2P platform to disclose its wind-down arrangements and to warn investors/prospective investors of the risk to their P2P agreements should the platform fail?

Yes. In particular, investors need to be aware that future loan repayments due to them after a platform has entered into winding up are not protected as client money but are treated as platform assets. This means that creditors of the platform will be first in line, and investors may not get any of their money back.

Q20: Do you agree with our proposals for additional requirements for disclosure of investment information to investors? Is there any additional information that platforms should be required to give to investors? If you disagree with our proposals, please explain why.

Yes, although subject to our view that the discretionary platform model is inappropriate.

Q21: Although not proposed in this CP we invite feedback on whether it would be helpful to consumers and industry to have a standard format for P2P disclosures about the services they provide and investment opportunities?

This would be useful, and consistent with the requirements in other parts of financial services.

Q22: Do you agree with standardising the definition of default? If so, do you agree with the proposed definition? If not, please explain why.

Yes. It makes sense to be consistent with the definitions in other areas.

Q23: Do you agree with our proposals to require disclosure of information about contingency funds? If not, please explain why.

Q24: Are there other measures that we should consider to address the harm that can arise from contingency funds obscuring underlying risk to investors, or from investors mistakenly believing a contingency fund provides a guaranteed rate of return on loans (similar to a fixed rate savings account)?

Disclosing more information about contingency funds is potentially useful. However, we believe that the fundamental problem with contingency funds is that they give investors the impression that their money is protected in the event of defaults. As we note above, platforms should be prohibited from advertising claims or using phrases like "zero capital losses" or investors have "never lost a penny" or "exceptional protection" which underplay the potential risks associated with the investment.

The paper points out that contingency funds are not insurance (or if they are the platforms are operating unauthorised insurance businesses). Rather they are a limited first-come first-served recourse for lenders whose borrowers have defaulted. The riskiest borrowers are likely to default first, so that by the time prudent lenders come to make a claim on the contingency fund it is likely to have been exhausted. Contingency funds thus encourage excessively risky lending and transfer the risk of actual financial loss to more prudent lenders who have chosen lower risk portfolios. Yet they are based on a charge across all loans, risky or prudent. They are an incentive towards more risky lending by both the platform and by individual investors, and represent a transfer of resources from more prudent lenders to those who are choosing higher risk. This both represents a conflict of interest between different types of investor, but also skews the relationship between risk and reward, providing a perverse incentive.

Q25: Do you agree with our proposal for a six 6-month commencement period? If not, please explain why.

No comment.

Q26: Do you agree with our proposal to apply MCOB 11 to platforms facilitating home finance products, where one or more of the investors is not an authorised home finance provider? If not, what amendments would you suggest?

Yes.

Q27: Do you agree with our proposal to apply MCOB 13 to platforms facilitating home finance products, where one or more of the investors is not an authorised home finance provider? If not, what amendments would you suggest?

Yes.

Q28: Do you agree with our proposal to apply offer stage and post-contractual disclosure rules to platforms facilitating home finance products, where one or more of the investors is not an authorised home finance provider? If not, what amendments

Yes.

Q29: Do you agree with our proposed changes to pre-contractual disclosure rules for platforms facilitating home finance products, where at least one of the investors is not an authorised home finance provider? If not, what amendments do you suggest?

Yes.

Q30: Do you agree with our proposal to apply other MCOB rules to platforms facilitating home finance products, where one or more of the investors is not an authorised home finance provider? If not, what amendments do you suggest?

Yes.

Q31: Do you agree with our proposal to apply our data reporting rules to platforms facilitating home finance products, where one or more of the investors is not an authorised home finance provider? If not, what amendments do you suggest?

Yes.

Q32: Do you have any comments on the application of our other (ie not MCOB) rules to platforms facilitating home finance products, where one or more of the investors is not an authorised home finance provider?

No comment.

Q33: Do you have any comments on our cost benefit analysis for the proposals arising from the post-implementation review?

No comment.

Q34: Do you have any comments on our cost benefit analysis for the P2P mortgage and home finance proposals?

No comment.