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# Journal

THE CAPCO INSTITUTE JOURNAL OF FINANCIAL TRANSFORMATION

Transformational

The Un-Level Playing Field for  
P2P Lending

Alistair Milne

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# FINANCIAL TECHNOLOGY

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# The Un-Level Playing Field for P2P Lending

**Alistair Milne** – Professor of Financial Economics, Loughborough University

## **Abstract**

This paper considers how regulation affects competition between traditional banks and new peer- to-peer (P2P or marketplace) lenders employing a platform-based business model to directly connect borrowers and investors. Such platform-based lending has the potential to dramatically reduce the need for banks to use their own equity capital to support credit risks and substantially increase the supply of credit to smaller and less credit worthy borrowers that are unable to directly access security markets. The impact of P2P lending has to date been quite modest, however, and may struggle to achieve the scale necessary to cover platform costs. For example, while P2P lenders have been active in the U.S. and the U.K. for more

than a decade, they still hold less than 1% of the total stock of unsecured consumer lending and most platforms are losing money. P2P lending in other countries is still very much in its infancy. Only in the U.K. – not elsewhere – has P2P lending become an important source of loans for smaller companies. One reason for this modest market impact is that prudential regulation – in particular government sponsored and backed 100% insurance on all bank deposits under deposit insurance limits, even when held for investment rather than transaction purposes – gives banks a substantial advantage in the market for savings deposits, forcing P2P lenders to rely instead on unstable sources of wholesale funding and limiting their ability to compete with banks in the provision of consumer and small business loans.

## INTRODUCTION

A wide range of “peer-to-peer” (P2P) financial platforms have emerged in the recent years, providing personal loans (Zopa, Prosper, Lending Club), small business lending (First Circle, Kabbage), invoice discounting (The Receivables Exchange, Market Invoice), and foreign exchange transactions (Currency Cloud, Currency Fair, Transferwise). The volume of these activities has grown rapidly from a relatively low base. For example, P2P lending in the U.K. has doubled every year over the past four years, with the stock of loans exceeding £1 bln in 2014 and £2 bln in 2015 [Peer-to-Peer Finance Association (2016)].

A number of commentators have suggested that the development of these new P2P platforms will overturn the existing organizational and institutional structure of banking, much as there has been disruptive transformation in other industries, such as in recorded music distribution, in telephony, or in air and travel reservations [King (2010)]. The perception that P2P lending can “reinvent” the bank has prompted ambitious projections of P2P lending growth over the next five to ten years (with a suggestion that the stock of lending taken from banks by P2P platforms could be as high as U.S.\$1 tln globally [Moldow (2015)]). P2P or marketplace lending is also seen as a way of providing credit to a range of personal and small business borrowers inadequately served by conventional banks and, by removing the intermediary role of banks, providing much better returns than are available from bank deposits, especially in today’s low growth low interest rate economic environment.

The purpose of this paper is to review the development of P2P lending (we do not investigate other forms of P2P finance such as alternative foreign exchange) and address the question of the appropriate comparative regulatory treatment of banks and P2P platforms when they compete for medium term finance to fund loan products with a corresponding medium term maturity. It raises the question of whether, as a result of the differential treatment of banks and P2P lenders by law and regulation in the U.K., the U.S., and other countries, these new lenders are competing on an “un-level” playing field, struggling to capture market share from banks. In particular, it is argued here that banks have an unfair advantage over P2P lenders because they are able to take term deposits with the benefit of a deposit insurance guarantee.

Banks provide essential financial services, the payments services that support all economic exchange and also – through maturity transformation – the opportunity for customers to realize value from investments in longer term assets. Banks are, therefore, closely regulated and further supported by government-sponsored deposit insurance schemes, both to protect customers who may not fully understand the risks taken by banks and to avoid disruption of payments in the event of a bank failure or a systemic banking crisis.

Providing this protection to bank customers does not, however, come without costs. Regulation of bank risk exposures may reduce the supply of credit to some bank customers. Taxpayers are exposed to risk through the provision of the bank safety net. The costs of regulatory compliance, especially capital requirements since the industry regards these as onerous, may be passed onto customers through a widening of interest rate spreads (lower deposit rates and higher loan interest rates) and – to the extent that regulation acts as a barrier to entry – inhibit competition and discourage innovation that would improve customer pricing and services. Protected by regulation, banks have little incentive to make the necessary steps and investments in information technology and bank systems to make their portfolios and the risks they take transparent to outsiders. Banks must be regulated to protect customers but not so heavily regulated that customers and taxpayers pay an excessive cost for this protection.

P2P lending also requires regulation, to ensure that investors who put money into P2P lending platforms as an alternative to an interest bearing bank deposit properly understand the risks they are taking and the prospective returns; and also that the platforms themselves are effectively run with minimal risk of operational problems that would impose unanticipated losses on customers.

Both banks and P2P lending platforms must be regulated. But is the development of P2P lending – and the opportunity this offers for increased competition with banks that will benefit both borrowers and investors – being handicapped by an unfair regulatory regime and level of protection relative to that enjoyed by banks? It will be argued that – especially to the extent that bank regulation allows banks to offer term-deposits protected by deposit insurance – there is indeed an un-level playing field in the competition between P2P lenders and banks. This imbalance can be corrected by removing or reducing deposit insurance on term deposits. This will moreover motivate banks to respond by developing their own platform-based lending products, in which term funding is obtained by shifting their loans off balance sheet and directly funding them through peer-to-peer investment in diversified loan pools. This will provide banks with welcome additional risk absorption that will substantially reduce their own need for capital and incentivize the transparent recording of loans in a manner that will facilitate orderly resolution of failing banks.

The paper is organized as follows. Section 2 presents a brief review of the development of P2P lending in the U.S., the U.K., and other countries. Section 3 discusses the regulatory response to P2P lending, as it has developed in the U.K., the U.S., and Australia from the perspectives of consumer protection, prudential safety, and competition policy, arguing that these responses have failed to treat banks and P2P lenders on a comparable basis. Section 4 concludes, with a short discussion of the practicalities of limiting current arrangement for bank deposit insurance to put banks on a more even footing with P2P lenders.

## AN OVERVIEW OF P2P LENDING

This section provides a brief review of P2P lending, focusing on developments in the U.K. and the U.S. The analysis draws on a longer research paper [Milne & Parboteeah (2016)] and on various reports on the growth of the alternative finance sector by the Cambridge Centre for Alternative Finance [Wardrop et al. (2016); Zhang et al. (2016)]. It begins by reporting some of the available statistics on P2P lending. It then reviews the variations in business model used by platforms, including the allocation of investor funds and the assessment of the credit worthiness of borrowers.

### The development of P2P lending

In recent years, the U.K. has witnessed rapid development of an active “alternative finance” sector, supplying loans and other types of funding outside of conventional banks or established financial markets. P2P lending – i.e., debt finance in which the platform or intermediary does not have to take on credit risk or open positions – accounts for more than three-quarters of this flow of alternative finance (Figure 1).

Most of this P2P lending is provided by the members of the U.K. Peer-to-Peer Finance Association, which according to its website represents over 90% of the U.K. peer-to-peer and invoice trading market (see <http://p2pfa.info/>). The business models of their members vary considerably; two, Zopa and LendingWorks, provide only unsecured consumer loans, Funding Circle and ThinCats, in contrast, provide only unsecured lending to small businesses and lending secured on residential property. Two other platforms, LendInvest and Landbay, support only lending secured on property. RateSetter is the only platform supporting lending to all three categories of lending. While most attract retail investment, with the required minimum investment as low as £25.00, Market Invoice is for professional and wholesale investors only.

With the exception of Market Invoice, the other seven platforms all provide a simple and easy-to-understand portal for retail investors. Market Invoice, on the other hand, provides business lending secured on invoices (note there are a number of other invoice-lending finance companies in the U.K. that are not members of the P2P Finance Association). As Market Invoice makes clear on its website, they do not accept investment from retail lenders – instead all their investments come from sophisticated investors, such as asset managers, who are expected to understand fully the risks of this form of lending.

While these platforms account for the bulk of P2P lending in the U.K., there are many other providers. The U.K. regulator reports that as of March 2016, a total of 86 firms had applied for authorization as P2P platforms in the U.K. [FCA (2016)] and that 52 had full or interim authorization.

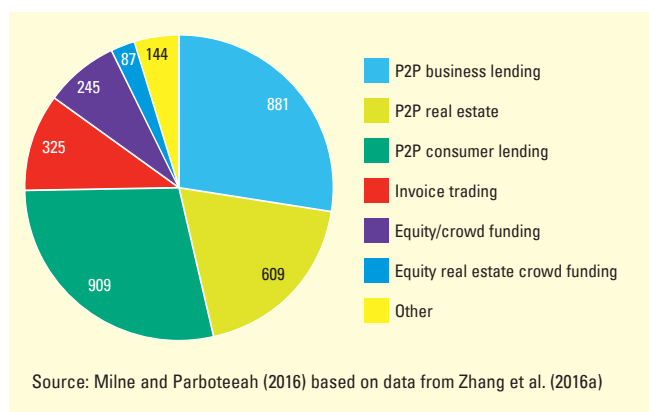


Figure 1 – The £3.2 billion alternative finance market in the U.K., 2015 (£ million)

Table 1, using data from the P2P Finance Association, reports the 2015 share of the members of the association in the total flow of U.K. lending during the year to the three market segments in which they operate and in the end-year outstanding balance for all market segments (the association does not publish data on end-year balances by market segment). Even though P2P lending has been taking place in the U.K. for more than a decade, since the launching of Zopa in 2005, it still accounts for less than half a percent of the total balance of loans outstanding when combining these three lending segments.

Table 1 also reports the share of P2P lending measured on a flow basis (columns three through six). This allows the comparison to be made separately for each of the three market segments in the U.K. It is a tricky comparison to make, however, since lending flows go in both directions, first the initial loan then its subsequent repayment, and as a result the outcome is different according to whether the comparison is made on a gross or net basis. On the net flow basis shown in the table, P2P lending in 2015 was 3% of total unsecured consumer lending. It also appears to be a similar proportion of lending on buy-to-let property (3.6% with the caveat that the numerator and denominator used in this calculation are not entirely comparable, P2P lending including some other forms of property lending such as short-term bridge loans and finance of property development).

On this net flow basis, P2P lending to SMEs (invoice trading and unsecured business lending) is a comparatively high 12.6% of total lending including that by monetary financial institutions. But this figure has to be treated with caution. The net flow of P2P lending to businesses is relatively small (only £2.3 bln) but the denominator is also small because most bank lending to small business is repaid relatively quickly, within a few months (in the previous years the denominator was negative with substantial net repayment by SMEs to monetary institutions).



	<b>Balance</b>	<b>Net lending flow, 2015 (£m)</b>				<b>Number of:</b>	
	<b>End-2015 (£m)</b>	<b>Unsecured consumer</b>	<b>SME</b>	<b>Secured on property (mainly buy-to-let)</b>	<b>Total</b>	<b>Lenders '000</b>	<b>Borrowers '000</b>
<b>Total P2P</b>	2,155	456	332	246	1,033	128.3	273.6
<b>All lenders</b>	522,620	14,606	2,294	6,784	21,380		
<b>P2P (% of total)</b>	0.4%	3.0%	12.6%	3.6%	4.8%		

Notes. All P2P data were calculated from tables in the press releases of the U.K. Peer-to-Peer Finance Association (2016b, 2015a, b, c). The data on all lenders is computed by adding in lending data obtained from the Bank of England: BankStats Table 5.2 for stock and flow of consumer credit from monetary financial institutions (banks and building societies); BankStats Table A8.1 for the stock and flow of lending to small- and medium-sized enterprises (SMEs) by monetary financial institutions. Lending secured on property is calculated using Bank of England MLAR Table 1.33 to compute stock and flow for buy-to-let residential mortgage lending only and deducting P2P. We restrict comparison in this way because most U.K. P2P lending secured on property goes into the buy-to-let market, itself about 15% of total U.K. stock and flow of residential mortgage lending. All figures given here on lending flows are net of repayments.

**Table 1 – P2P lending volumes compared with other credit markets in the U.K.**

Another way of estimating the share of P2P business lending is to calculate its share of gross rather than net lending to the smallest companies in the U.K. On this basis, the gross P2P platform lending to SMEs in 2015 reported by the P2P Finance Association (£881 mln, excluding invoice finance and debt securities) represents 13.1% of the £6.7 bln of gross new loans to the smallest companies, as reported in the quarterly survey conducted by the British Bankers Association (BBA) [BBA (2016)] (these are loans to companies with turnover of less than £1-2 mln, the precise threshold varying from one reporting bank to another). However, the gross lending shares do not differ much for unsecured consumer lending.

In the U.S., marketplace lending (as P2P lending is referred to there) has also been active for a decade. The oldest and largest platforms, Prosper and Lending Club, were established to offer consumer lending and refinancing of student loans. Other well established platforms competing with them are Avant (focusing on personal loans) and SoFi (specializing in refinancing of student loans). There also a number of providers of marketplace loans for small business, including OnDeck, CAN Capital, and Kabbage. GroundFloor and Lending-Home provide short-term bridge mortgage finance, though their total lending is still small. Wardrop et al. (2016) report that the amount of consumer marketplace lending in the Americas (predominantly in the U.S.) is about ten times the amount of small business marketplace lending.

Marketplace lending in the U.S., just as in the U.K., has not yet succeeded in capturing a substantial share of the loan markets in which they compete. Morgan Stanley Research (2015) puts the level of marketplace lending at U.S.\$12 bln at the end of 2014. This is still only a very small fraction – 0.36% – of total U.S. unsecured consumer lending of U.S.\$3.3 tln (this statistic is from Frame (2015), who also provides a succinct overview of the development of marketplace lending in the U.S.).

In other countries, P2P lending appears to be at a much earlier stage of development than in the U.K. or the U.S. Data from Wardrop et al. (2015) reveal that the U.K. is the clear leader in the alternative finance market in the E.U. For the year 2014, €2.9 bln was the size of the entire alternative finance market in the E.U., but only €620 mln was outside the U.K. Alternative finance as a whole, however, grew 144% in 2014 in the E.U., other than in the UK, compared with 2013. It does appear, however, that interest in P2P lending is spreading rapidly across much of the E.U. One indicator of this is the index of P2P lending constructed by the website AltFi. According to this index, 2015 P2P loan volumes across continental Europe (other than the U.K.) amounted to some €674 mln [Shoker (2016)]. These figures seem to involve some underreporting, when compared to the data cited in Wardrop et al. (2015), but they suggest rapid growth of more than 100% per annum with many new platforms being established.

Another jurisdiction where P2P lending now appears to be quite active and is receiving the close attention of regulators is Australia. While at least eight P2P platforms are now licensed in Australia, including two – RateSetter and ThinCats – that also operate in the U.K., the Australian market is still somewhat behind the level of development reached in the U.K. or the U.S.

Brief mention can also be made of P2P platform lending in China, mainly to small businesses, which is reported to have nearly quadrupled to an astonishing U.S.\$150 bln in 2015, more than ten times the size of U.S. marketplace lending originations [Xinhua (2016)]. There are apparently more than 2,000 online P2P lending platforms in China [Williams-Grut (2015); Deer et al. (2015)]. At the same time, however, there are substantial concerns about fraud, especially since the early 2016 failure of the platform Ezubo, which lost some U.S.\$11 bln of investors' money [Wu (2016)]. The development of P2P lending in China has, however, been so different from that in the U.K., the U.S., and other countries that it will not be considered further in the present paper.

### **The variation in P2P business models**

The common feature of P2P lending platforms is the matching of investors and borrowers without the platform itself needing to take a direct loan exposure. An analogy can be made with other “sharing economy” ventures such as AirBnB for temporary accommodation and Uber for taxi rides. Similar to those sites, P2P platforms match an individual demand for a service (the borrower) with the supplier of that service (a lender). The analogy, however, is oversimplified and P2P platforms must play a greater role in the exchange than in these other examples. An investor in a P2P unsecured consumer or business loan is committed to an exposure that extends for two or three years. It is difficult to assess the potential for losses until the loans are repaid. P2P platform investments are moreover subject to cyclical risks, an economic downturn can be expected to lead to increased losses (in the jargon of credit risk management a rise of “unexpected losses”), which do not affect returns on insured bank deposits. It is true that P2P lenders offer substantially higher returns than bank deposits in order to attract investors but it is difficult for customers to assess the risk return trade-offs of P2P lending. For this reason, platforms take responsibility, employing a variety of different approaches, for assessing creditor risk and for matching investors to loans.

The range of possibilities is wide and varies substantially, between platforms, across countries, and over time. Only a relatively shallow summary can be given here, in this and the following paragraphs. It would be a substantial research project to fully document and summarize all of the different approaches taken to classify borrower risk and matching borrowers and lenders on the large number of P2P lending platforms now active in many countries.

Beginning first with the allocation of investors to borrowers, a feature common to all P2P lending platforms is using technology to diversify exposure by spreading investments across a large number of loans, typically two hundred or more. However, this still leaves a great deal of variation in how these allocations are made. Davis and Murphy (2016) and Murphy (2016) draw a helpful distinction between active and passive investment on P2P platforms. Active investment mechanisms allow investors to select or bid for individual loans or more commonly for loans within narrowly defined risk classifications (these bids may still be made for many hundreds of loans). More often, retail investment in P2P lending is based on passive investment mechanisms, with the investor making a broad choice over their risk preference (e.g., for lending within a range of platform risk categories, such as A-C, A-E, and/or a particular lending segment, such as unsecured consumer lending or real estate) and the platform automatically allocating the funds to a large number of borrowers according to this choice. Zopa in the U.K., for example, offers its retail investors a choice between only three different broad products, in order of increasing risk, Zopa Access, Zopa Classic, and

Zopa Plus, with only Zopa Access giving an option for resale without a fee [Milne and Parboteeah (2016)]. It is usual also with passive investment mechanisms for repayments of interest and principal to be automatically reinvested in new loans.

The distinction between active and passive is not clear cut. Different platforms offer a range of approaches, some more active and other more passive, depending upon how much choice of investment allocation the platform gives to the investor. For example, some platforms allow investors to choose individual risk categories and set minimum levels of return, borrower lending requests within that category are then allocated in small amounts, with the platform supporting an auction that sets the final loan rate at the lowest interest rate at which the loan can be fully funded.

This auction process for loans, in some cases, supports a secondary market in which loans within a particular risk category can be resold at the current best rate available on the platform. This approach is more common in the U.S., hence the preference there for the name “marketplace lending.” Other platforms – this is more common in the U.K. – may be willing to buy loans directly from investors, but sometimes only for a relatively large fee and at a price related to current interest rates for that particular risk category on the platform. In either case – active or passive – the interest rate on lending has to be set to balance the supply and demand for loans on the platform, either administratively (the platform setting loan rates and adjusting them periodically to clear any imbalance between supply and demand in different risk categories) or through loan auctions.

A further difference is the extent to which platforms draw funding from institutional investors. Zhang et al. (2016) report a growing share of investment in U.K. P2P lending platforms from institutional investors. They report that in 2015 institutional investment accounted for 32% of gross lending in peer-to-peer consumer lending, 26% of peer-to-peer business loans, and 25% in peer-to-peer lending secured on real estate, with all these proportions rising steadily through the year. By year-end, about one-third of all P2P lending in the U.K. was from institutional investors (see their Figure 18, p. 29).

The U.S. industry has evolved even further away from the concept of directly linking individual lenders and borrowers, becoming instead largely a mechanism for the sale of loans to institutional investors. For example, in the third quarter of 2015, only 15% of the originations of Lending Club, the largest U.S. marketplace lending platform, were financed by individual investors; 85% were taken by institutional investors, such as banks, asset managers, and hedge funds [Wack (2015)]. The major U.S. platforms have also used loan securitizations as a source of funding, by transferring loans into special purpose vehicles that issue asset-backed securities and sell these to institutional investors.

While it has helped raise funding, this reliance on institutional investor funding has also created problems, most notably in the first half of 2016, when a moderate rise in default rates, concentrated amongst the highest risk borrowers, led to a decline in investor confidence in this asset category, a substantial drop in the flow of institutional funding onto the platforms, and, as a result, quite substantial increases of platform interest rates [Demos and Redegeiar (2016); Wack (2016a)]. This slowdown in funding is a particular problem for U.S. platforms because of their practice of relying on one-off origination fees, built into the loan, for revenue. As a result, platform revenues and profits can be volatile because of their dependence on lending flows. In the U.K., the usual practice is to obtain revenue through a small per annum deduction from investor returns, making a more stable revenue stream that is less affected by the current volume of lending.

Another difference between countries are the sources of credit information used by the platforms. In the U.K., the credit classifications are based on detailed credit information from credit referencing agencies: the most important being Experian, Equifax, and Callcredit. In the U.S., credit bureaus, Experian, Equifax, and Transunion provide the same service (so two companies operate in both countries while CallCredit in the U.K. has a technical co-operation agreement with Transunion). They provide credit scores and credit histories for most persons and incorporated businesses in the U.K. and the U.S. This credit referencing is the main source of information used by U.K. P2P lenders to assess borrower credit risk and place them into different risk categories. The allocation of risk categories is proprietary to each platform, making it difficult to compare risk of borrowers on different platforms. In the U.S., as well as information from credit bureaus platforms may use the FICO score (an overall numerical credit assessment computed by the Fair Issacs Corporation using information from the credit bureaus) and also further credit analytics based on additional data, such as transaction histories, mobile phone contracts, and other sources of "big data." Many U.S. marketplace lenders claim substantial improvements in understanding and pricing credit risk from these sophisticated methods, but they, of course, have no monopoly on such techniques, which can equally well be used by banks or other lenders.

Many of the U.S. platforms, in contrast to the U.K., have developed partnerships with U.S. banks [PwC (2015); Aranoff (2016)]. Marketplace lending is increasingly seen in the U.S. not as competition to banks but rather as an opportunity, providing a new source of investment assets for banks with surplus funds, as an alternative way of financing loan assets for those in need of funds, and as a model for improved technology offering to both deposit and loan customers. Another institutional difference between the U.S. and the U.K. is the well-established U.S. practice of third-party servicing of bank loans. It is standard practice for U.S. banks to outsource such servicing of the loans. This outsourcing plays an important role in the

securitization of U.S. lending, allowing loans to be sold between institutions with no impact on the process of collection. This, in turn, means that there is a clear identification of servicing costs for platforms. As we suggest below, in Section 4, achieving similarly clear identification of servicing costs may be a potential challenge for U.K. P2P lenders. An issue in the U.S. is the regulatory limits on consumer loan interest rates applicable in many states. To deal with these controls, U.S. marketplace lenders work with partner banks, who formally grant loans once they are agreed on the P2P lending platform (for example Lending Club works with WebBank, a Utah-chartered financial institution) before selling them back to the platform investors. This practice, however, has been thrown into doubt by rulings on a case currently before the U.S. Supreme Court and the industry awaits clarification of its legal position [Wack (2016b)].

A final point that needs to be made about the business models of P2P platforms is that, to date, all the extant platforms are either loss making or only marginally profitable. As documented in Milne and Parboteeah (2016), the major U.K. platforms for which accounts are available operate with substantial losses, amounting to as much of 2% or more of the stock of outstanding loans. In the U.S., Lending Club, the largest P2P platform in the world, has reported profits of a little over U.S.\$4 mln for first quarter of 2016, less than 0.05% of its outstanding loan stock, and because of the dependency on origination it is unclear that these can be sustained at the same level for the full year. In fact, Lending Club reported a second quarter loss of U.S.\$80.1 mln. Lack of transparency on revenues, costs, and strategic expenditure decisions makes it difficult to analyze fully the prospects for the platforms becoming sustainably profitable, but it appears that lack of sufficient scale to cover platform costs is a serious challenge that no P2P platform has yet adequately overcome.

## REGULATION OF P2P LENDING

This section summarizes the regulation of P2P lending in the U.K., the U.S., and Australia. P2P lenders do not themselves take deposits or issue loans and are thus able to operate without requiring a banking license. They do, however, still fall within the scope of financial regulation: both for their function as loan servicers (managing the initial loan provision and the repayment of interest and principal) and as providers of an investment service (assessing the credit quality of borrowers and providing investors with mechanisms for portfolio allocation and for loan resale).

In the U.K., the regulation of P2P lenders has attracted relatively little public attention. Platforms must be authorized by the Financial Conduct Authority (FCA) (until March 2014 they operated with licenses from the Office of Fair Trading). FCA regulation aims to ensure

that platforms provide investors with access to clear information to assess risks, comply with core consumer protection requirements, such as protection of client money, holding of sufficient capital, and having in place a resolution regime that can ensure investors continue to be paid even if a loan platform collapses [FCA (2015)]. The FCA stress that P2P investments are not deposits and that it must be made clear to investors that there is risk of loss and that these investments are not covered by deposit insurance (the U.K. Financial Compensation Scheme). The Prudential Regulation Authority (PRA) does not, as yet, perceive any substantial systemic risk from the growth of P2P lending and so has left all regulation of the sector to the FCA. In the March 2015 budget, the U.K. government announced that P2P lenders would be able to offer tax exempt investment products (ISA investments) and subject to FCA approval they have been able to offer these since April 2016. The FCA is currently engaged in a consultation on regulation of the sector.

The U.S. has seen a much more active public discussion of marketplace regulation. There have been information hearings by Congressional Committees [Alois (2016)], and the U.S. Treasury has conducted and reported on a public consultation on the industry [U.S. Treasury (2016)], reviewing the benefits and risks of marketplace lending. This report highlights the potential of the new online lending technologies to better serve the financial needs of the American public, in particular through providing credit to some borrower segments who are underserved by the traditional lending channels; but also expresses concern about a number of risks, including insufficient transparency of the marketplace and the performance of novel techniques of credit assessment in unfavorable credit conditions.

There has also been a somewhat greater focus in the U.S., compared to the U.K., on the need for consumer and prudential regulation. The U.S. Consumer Financial Protection Bureau is increasingly involved in the oversight of marketplace consumer lending, including a well-publicized enforcement action against Lending Club for lack of clarity on interest rates paid by one group of borrowers [Adler (2015)]. The Federal Deposit Insurance Corporation (FDIC) has stated that it wishes to keep a close watch on developments in marketplace lending, including potential risks to insured banks partnering with marketplace lenders.

For these reasons, and also the relative complexity of the U.S. framework of financial regulation with its multiplicity of agencies, marketplace lending in the U.S. is subject to a wide range of regulatory requirements. Manbeck and Franson (2015) summarize the regulations applicable to marketplace lenders in the U.S. These include securities laws (they list no less than 10 different requirements, including securities law, private placement rules); lending laws, including state level usury laws, state level registration and licensing requirements, and limitation on third-party use of bank charters; and

a wide range of consumer protection laws, including fair lending, debt collection practices, privacy, and electronic commerce laws.

In Australia, regulation of marketplace/P2P lending comes under the scope of the Australian Securities and Investment Commission. These regulations are summarized by ASIC (2016). Platforms are required to hold an Australian financial services license and also, if the loans include consumer loans, an Australian credit license. Schemes offered to retail investors must also be registered with ASIC. A range of further regulations apply, including, for example, following good practice guidelines for advertising of products, for disclosure of the details of their operations, such as how interest rates are set and the matching of borrowers to investors, and for ensuring that investors adequately understand marketplace lending products and the relevant risks.

Davis and Murphy (2016) provide a critical review of the Australian regulation (though their analysis also has implications for regulation in other jurisdictions), arguing that marketplace lenders combine the functions of market operators and investment management. They are market operators because their platforms provide a primary market for assets that determines the interest rates/prices for loan assets, while they are at the same time investment schemes because they assess the credit worthiness of borrowers and then assist investors (in active investment arrangements) with allocation of investments amongst loans. Australian regulation treats marketplace lenders under the existing regulations for other investment schemes, such as mutual funds, even though the platforms do not share the features of collective investments, where each participant has a pro-rata share in a pool of assets. This approach, however, ignores several other possibilities. Marketplace lending also bears comparison with securitization structures used for selling tranching claims on pools of loans on financial markets (although many of the features of loan securitizations, such as tranching and credit enhancement, are not provided and the marketplace platform also undertakes loan origination). Marketplace platforms could also be viewed, like credit bureaus and credit rating agencies, as assessors of credit risk in return for fees. There is a substantial regulatory challenge because the novel business model of marketplace lenders cuts across all the conventional regulatory categorizations. This suggests that the regulation of marketplace lenders, along with that of other new technology based financial services, may require substantial regulatory reform, placing what are currently treated as different activities within a single regulatory framework and rethinking the current separate legislative treatment of financial products and credit.

Does regulation of P2P lending – in the U.S., the U.K., or Australia – treat P2P platforms and banks on an equal footing? This brief review suggests that it does not. The two activities are treated as being almost entirely distinct from a regulatory point of view. The FCA in the U.K. and other regulators emphasize the need for platforms to make

clear that P2P investments are subject to risk of loss. This, in turn, has led to an emphasis on the responsibilities of platforms as investment advisers, ensuring that retail customers are given appropriate information on risks and prospective returns. The treatment of banks and P2P platforms also differs in other ways; for example, in that U.S. regulation imposes a very complex regime on what can be a relatively simple investment product.

Little of the regulation or public discussion of P2P lending, if any, has focused on the question raised in this paper, ensuring that the bank product that most closely competes with retail investment in P2P loans, the bank term, or time deposit, is regulated in a way that puts P2P lenders and banks on an equal competitive footing. Regulators understandably insist on platforms making clear to retail investors that P2P investments are not deposits, returns are not fixed, and they have neither the support of an intermediary balance sheet nor protection from deposit insurance. Still, from the perspective of retail investors, P2P investments are substitutes for time deposits with banks. They have provided investors, over the decade they have been available, much better returns than bank deposits of a similar medium term maturity of one to three years.

The assets that bank deposits fund are not risk free, but the deposits that fund them are effectively risk free because banks benefit from a variety of risk mitigations that guarantee repayment. The risk of loss has been transferred, away from depositors to shareholders, to wholesale investors and ultimately to the tax payer. It is, of course, appropriate to give banks protection of this kind. The role of banks in payments systems is an essential economic infrastructure that must be protected. Their role of maturity transformation, which supports the provision of short term liquidity to sight and overnight depositors or through lines of credit is also a critical economic function, whose interruption could have damaging economic consequences. But the question is not “Should banks be regulated and protected?” but rather “What is the appropriate regulation and protection?”. This should be designed to provide to protect their essential economic functions, but not allow other banking functions and services to be insulated from competition with new non-bank providers using business models built on financial technology.

Term deposits – where money is left with a bank for a period of a few months to two or three years – are a widely used bank product. These, however, are investment not banking services. They are, of course, a valued source of stable funding for banks, but they do not involve maturity transformation, or only to a limited extent, and they are unrelated to other core services such as payments. Consequently, it must be questioned whether bank term deposits need to benefit from deposit insurance in the same way as transaction and sight deposits. Removing, or reducing, this protection would put banks and P2P platforms on a much more level competitive playing field.

## **CONCLUSION: THE PRACTICALITY OF A BALANCED REGULATORY TREATMENT OF BANK TIME DEPOSITS AND P2P PLATFORM INVESTMENT**

This paper has reviewed the development of P2P (or marketplace) lending and argued that regulation creates an un-level playing field in the competition between banks, who enjoy deposit insurance on term deposits, with P2P platforms, where investment of a similar term is not similarly supported.

A brief look at the statistics for the U.K. indicates that this is a significant issue. According to Table A6.1 of Bank of England Monetary and Financial Statistics, interest bearing time deposits held by households with U.K. monetary financial institutions amounted to £187.2 bln at the end of 2015. This is about two orders of magnitude, or one hundred times, greater than the £2.2bn stock of U.K. P2P lending at that date, as reported in Table 1 above. Even if P2P lenders were able to capture only an additional one percent of household time deposits, this would nearly double outstanding P2P lending in the U.K.

The means of correcting this regulatory bias is at hand, removing at least in part the 100% deposit insurance offered on U.K. bank and building society time deposits up to the insurance limit of £75,000. There are, of course, challenges. The justification for this being that time deposits are not used for the bank service of maturity transformation that provides customers with liquidity on underlying illiquid loan portfolios and, therefore, should be regulated and insured *pari-passu* with P2P platform investments.

There are practical objections. There is a degree of maturity transformation service involved in, for example, a three months or six months time deposit that might need protection. But this could be addressed by a sliding scale of deposit insurance, starting at 0% for time deposits with an original maturity of say two years and above and then rising linearly as original maturity falls, to 50% for one year deposits, 75% for 18 month deposits, etc. Reduction of deposit guarantees, when the costs fall as they currently do not on depositors but on others, will not be easy to sell politically. But the potential benefits, in terms of increased competition and opportunities for the development of the efficient P2P model of lending, are substantial. If withdrawal of deposit insurance can establish P2P lending on a sustainable scale, in turn widening access to credit and helping provide retail investors with better returns than are available on bank deposits, then it is a step that merits serious consideration, especially in an era that seems to be set to continue for some years to come of low growth and low real interest rates.

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**Prof. Philip Treleaven**  
Centre Director  
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**Yonita Carter**  
Centre Manager  
[y.carter@ucl.ac.uk](mailto:y.carter@ucl.ac.uk)

[financialcomputing.org](http://financialcomputing.org)

+44 20 7679 0359

Layout, production and coordination: Cypres – Daniel Brandt, Kris Van de Vijver and Pieter Vereertbrugghen

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