FINANCIAL CONDUCT AUTHORITY

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Dear Board of Directors,

Loan-based Peer-to-Peer (P2P) crowdfunding platforms

We are writing to:

- set out our view of the key risks P2P platforms pose to their customers or the markets in which they operate
- outline our expectations of P2P firms, including how firms should be mitigating these key risks, and
- describe our supervisory strategy to ensure that firms are meeting our expectations, and harms are being remedied

We have identified 4 areas of potential harm for investors (i.e. lenders) in the P2P sector:

- the secondary markets for loans, and associated risk management obligations
- wind-down plans (WDPs), their triggers, and liquidity monitoring
- disclosure of loan performance during periods of loan forbearance, and the use of contingency funds
- unclear platform fees, charges and priority over recoveries

This letter asks you to take the appropriate action to ensure that your firm is delivering fair outcomes for consumers. We will continue to intervene should we see failures in this regard.

The secondary markets for loans, and associated risk management obligations

As observed in PS 19/14, some P2P platforms operate secondary markets for investors to exit their loans early. This allows platforms to create liquidity in the market for loans. COVID-19 has increased the amount of investor requests to sell their P2P loans, creating liquidity issues across the industry. A number of firms have closed their secondary markets while others have opted to keep them open.

Some platforms with discretionary models provide existing clients a way to exit their loans by using the platform's discretionary powers to transfer the loans of existing clients to new clients wishing to invest. In practice, this has often resulted in a slower release of early exit requests.

A discretionary P2P platform usually takes an active role in the operation of its secondary market. For example, an investor may not be allowed to choose which loans to sell but will indicate what monetary amount they wish to sell. The platform then decides which loans to try to sell, up to this stated amount. The platform also has a significant role in pricing the loans when these change hands.

However, given the impact of COVID-19 on borrowers' creditworthiness, there is a real risk that firms might be either unable to accurately price loans, or incentivised to transfer loans from one client to another at prices that do not reflect the risk profile of the loan. We remind firms that our rules emphasise how firms need to have sound risk management frameworks and credit risk assessment capabilities, particularly the requirements in:

- **COBS 18.12.17 R** that, where a P2P firm that determines the price of P2P agreements is facilitating an exit for a lender before the maturity date of a P2P agreement, it must ensure that the price offered for exiting the P2P agreement is fair and appropriate
- **COBS 18.12.16 R** that a platform must review the valuation of each P2P agreement where it is facilitating an exit for a lender before the maturity date of that P2P agreement

P2P platforms need to suspend secondary trading if they cannot comply with these requirements, and apply to the FCA to formalise this arrangement.

The Senior Manager who holds the Risk Management Function is responsible for the development and oversight of the risk management framework, and for compliance with the above requirements. We will hold them accountable where we find breaches of our rules.

WDPs, their triggers, and liquidity monitoring

In our Dear CEO letter of 7 March 2019 we highlighted how some firms' wind-down arrangements were falling short of the standards required. These included the systems and controls for winddown, platform funding and remuneration models, and third-party permissions. Shortly after, in PS 19/14 of June 2019, we reminded P2P platforms that, even though there are no prescribed rules to conduct scenario analysis or stress-testing, we expect that firms would consider that conducting these tests would be appropriate for their business model and prudent business practice.

In WDPG/App/5/1, we say that the triggers that could prompt a wind-down may be determined by the identification of a firm's 'risk fault lines', those critical areas where failure would severely affect the business. For example, the loss of a key revenue driver, the loss of critical infrastructure, or market volatility in exposed business lines could all trigger a wind-down. We also expect firms to identify an absolute minimum level of liquid and capital resources which, if breached, will trigger a wind-down.

Liquid resources are critical for firms' survival and to help ensure that they can wind down in an orderly manner. Firms should monitor their financial health, e.g. through cash-flow forecasts, as part of appropriate systems and controls and maintaining adequate financial resources at all times. The role of liquidity monitoring is more relevant given the strain the consequences of COVID-19 has put on firms' financial resources, with a heightened risk of firm failures. We set out in Annex 1 an approach to liquidity monitoring that might assist firms.

We also published finalised guidance FG20/01 that provides a framework to help firms ensure they have adequate financial resources and to take steps to minimise harm.

Our recent supervisory work leaves us generally dissatisfied with the WDPs that we have reviewed. All had assumed a voluntary wind-down, and none had adequately identified the triggers that might realistically allow for a solvent wind-down to be invoked. Coupled with a lack of liquidity monitoring and capital adequacy planning, we found little evidence of firms' ability to identify when an invocation of their wind-down plan would realistically ensure an orderly winddown.

We require P2P platforms to prepare wind-down plans. We expect these to consider the firm's ability to generate cashflows in good time across a wind-down period, and for the firm to retain sufficient resources to achieve this at all times.

We will continue to ask firms for their WDPs through our supervisory work. Where we determine that a firm has not adequately prepared for solvent wind-down, we will assess the potential for harm to existing and future investors, and whether it remains appropriate to allow new loans to be originated. Additionally, where a firm's surplus liquid resources are forecast to be lower than the total net costs of wind-down (including any 'buffer'), you should rectify this immediately and provide evidence of how you have done so to the FCA.

As part of your firm's wind-down planning, and to facilitate an orderly wind-down, we consider that funds directly relating to the wind-down should ordinarily be held in cash or another readily realisable form. They should be in a UK bank account under the control of the firm with immediate accessibility. We also consider it is important that there is no right of set-off over the account and, where possible, it should be excluded from charges and debentures. The funds should be available for use only once the decision to wind-down the business has been taken by the Board. More specifically, they should not be used to meet business as usual liquidity needs, and they should be regularly reviewed for sufficiency or when there are changes to your business model or loan books.

After consulting FG20/01, **please confirm to us within three weeks of the date of this letter**:

- the amount you have or intend to ringfence in accordance with the purpose set out above; and
- an explanation of why this is appropriate, given your business model.

This explanation should address the points contained in Annex 1: Liquidity Monitoring and include, but not be limited to:

- the key assumptions upon which it is based;
- the level of funds available when the wind-down is triggered;
- the key timings of most significant actions (particularly disposals of assets and books of business);
- revenues during wind-down; whether it would be a solvent or insolvent wind-down and the wind-down triggers; and the arrangements and terms under which the ringfenced amount will be held.

You should be ready to talk through your assessment with us. We will review your submission and may wish to follow up with you where we have additional questions, or to take further regulatory action as required.

Disclosure of loan performance during periods of loan forbearance, and the use of contingency funds

The impact of COVID-19 may ultimately result in higher than anticipated levels of loans in arrears and default. In response, P2P firms launched forbearance initiatives (e.g. payment holidays and deferrals), either under existing CONC guidance or voluntarily in response to calls from the FCA (P2P platforms were outside the scope of our published guidance on forbearance for personal loans but some are offering payment deferrals nonetheless).

Our supervisory dialogue with trade associations has highlighted uncertainty and an uneven interpretation of, and compliance with, the disclosure requirements for P2P platforms. Firms have been reporting loan status and performance in different ways to lenders, markets and the FCA.

We consider that transparent disclosures that are fair, clear and not misleading remain a high priority, particularly in difficult times.

As explained in CP 18/20 and PS 19/14, diverse business models in the P2P market mean that it is important that investors receive **ongoing disclosures** to ensure that investors can access details of each P2P agreement they have entered into. These ongoing disclosures are detailed in COBS 18.12.31 R and include the price of the P2P agreement, its maturity, valuation, likely actual return, fees paid by the investor or the borrower, and whether a default by the borrower under a P2P agreement has occurred. These disclosures also apply to P2P agreements in a P2P portfolio.

Where a platform sets the price (pricing platforms and discretionary platforms), it must publish an **outcomes statement** within 4 months of the end of the first full financial year and for each financial year thereafter. This must remain publicly available for at least 10 years from publication. COBS 18.12.23 R prescribes that the outcome statement should include:

- the expected and actual default rate of all P2P agreements, by risk category
- a summary of the assumptions used in determining expected future default rates
- the actual return achieved (where a platform offered a target rate)

COVID-19 continues to affect loan performance and we anticipate that firms, taking into account the best interests and information needs of their clients, will try hard to keep investors updated about aggregate default figures. An approach that might help firms to provide these updates would be to present them in the same way as for an outcomes statement.

As part of the last set of rules introduced in December 2019, we now also require P2P platforms to provide the risk warning in COBS 18.12.33 R (tailored as needed) to investors when it offers a **contingency fund**. When offering contingency funds, P2P platforms must also have a contingency fund policy in place which includes an explanation of the source of the money paid into the fund and how the fund is governed. It should also include the considerations the fund operator takes into account when deciding whether to exercise its discretion to pay out from the fund, including examples. The policy must contain an explanation of who the money belongs to, and a description of how the money will be treated in insolvency. This helps investors understand whether the money in the fund will be exclusively distributed to them, or whether someone other than the investors also has a claim over the money. Firms may find it helpful to engage legal counsel to assist with making accurate statements in the policy, having regard to relevant property and insolvency law.

The risk warning, together with a link to the contingency fund policy, must be provided in a prominent place of every page of each website and mobile application of the firm available to lenders that contains any reference to a contingency fund.

Information about the contingency fund's performance must be made public on a quarterly basis and include:

- the size of the fund compared to total amounts outstanding on P2P agreements relevant to the contingency fund
- what proportion of outstanding borrowing under P2P agreements has been paid using the contingency fund

We will take action where we do not see an adequate disclosure of loan performance, or the correct provision of information and warnings in relation to contingency funds.

Unclear platform fees, charges and priority over recoveries

We are concerned that there is a lack of clarity for investors about platform fees and charges (whether payable by investors or borrowers), and of the impact that those fees and charges may have on the amount recovered by investors from borrowers in default. This is often the case if the platform can deduct its fees and charges before passing the amount recovered on to investors.

Firms should consider whether how they set out the information relating to their fees and charges is compliant with:

- Principle 6, requiring firms to pay due regard to the interests of its customers and treat them fairly
- Principle 7, requiring firms to pay due regard to the information needs of its clients, and communicate information to them in a way which is clear, fair and not misleading
- the requirements in COBS 18.12.26 R (10), COBS 18.12.27 R (4) and COBS 18.12.31 R (5) to disclose to investors any investor or borrower fees

In some cases, fees, charges and/or the order of recoveries can change if the platform enters an insolvency procedure, a solvent wind-down, a temporary liquidity event or similar situation. Where this happens, platforms should communicate this clearly to investors, as well as ensuring that they have the legal basis to make the changes.

Firms should review their contractual arrangements to be sure they are compliant, and that investors understand their meaning and application.

Next steps

We ask that you complete and return the wind-down plan funding assessment required above and notify us immediately if you are unable to demonstrate your firm's compliance with any of the specific rules we have outlined in this letter.

Please address your response to P2Pportfolioresponse@fca.org.uk

If you have any questions, please contact your normal supervisory contact on 0300 500 0597. This is the primary point of contact for your firm's day-to-day interactions with the FCA, and further details of how we can be reached are available on our website at https://www.fca.org.uk/contact.

We recognise that there may be times when your firm faces urgent strategic issues. In these circumstances please contact me on 0131 301 2052 or at andrew.kay@fca.org.uk. If I am not available, then please contact one of my Managers, Graham Dorward, at Graham.Dorward@fca.org.uk or on 0131 301 2038.

Yours sincerely,

Andrew Kay
Head of Department, Retail Lending Supervision

Annex 1: Liquidity Monitoring

Approach	Description
	A prudent cash-flow forecast would assume a form of stressed operating environment that entails, for example, marked reductions in cash flowing through the corporate balance sheet and the platform due to, for example, increasing borrower late payments/defaults and increased demands from investors for return of capital when economic conditions are adverse.
	In lieu of a cash-flow forecast, the firm could implement a suitable alternative that delivers effectively the same result.
Wind-down costs	It is important that sufficient liquidity is available to meet the total net costs of the wind down of the firm. It is likely that the firm will already have calculated the costs of a solvent wind-down as part of its wind-down arrangements per the rules in SYSC 4.1.8A R and guidance in SYSC 4.1.8C G.
Liquidity Buffer	As the activation of a wind-down may not instantly follow on from a decision to wind down for logistical reasons, adding a liquidity buffer may be considered prudent. For example, a buffer corresponding to one month's worth of the firm's Fixed Overhead Requirement (FOR) might be considered sufficient, although firms should consider the liquidity buffer required to achieve a wind-down in the context of their own business model. The *total* wind-down costs that firms should be able to cover are the sum of the net wind-down costs and the liquidity buffer.

	Where surplus liquid resources are forecast to be greater than the total costs of wind down (including the buffer), **the firm can trigger the WDP with a greater degree of confidence that it can meet its liabilities as they fall due during the wind-down period.**
	A firm's commitment to invoke the WDP upon hitting or breaching the trigger could be adopted by its Board of Directors, in which case the FCA can ask to see the relevant meeting minutes.
Monitoring and Reporting	Firms can agree with their supervisor how often (and how) they report their current and forecast liquidity position, and that position relative to the total wind-down costs.
Maintaining the currency of the WDP	Firms are reminded that they are required to regularly review their WDPs (SYSC 8.4.1) and may need to re-assess the amounts of liquid resources they require to ensure a solvent wind-down.