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# Promoting SME Finance in the Context of the Fintech Revolution: A Case Study of the UK's Practice and Regulation

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**Abstract:** Small and medium-sized enterprises (SMEs) play a significant role in most European economies. In the UK, SMEs account for 99.9% of the total business population and 60% of private sector employment, as well as 50% of the national GDP. However, they receive merely 17% of total business loans from the banking industry, while 83% of loans go to large corporations, since banks have become risk-averse after the global financial crisis. Meanwhile, the UK has witnessed a so-called ''fintech" (financial technology) revolution in recent years, with the emergence of an alternative finance market channelling billions of pounds to SMEs annually. Arguably, fintech and alternative finance could potentially solve the long-term SME financing dilemma. Against this backdrop, this paper discusses and analyses the online peer-to-peer (P2P) lending market and digital-based challenger banks in the UK, explaining how alternative finance has been bridging the SME financing gap. It also assesses the UK's policies and regulatory framework on the burgeoning alternative finance market.

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## 1. INTRODUCTION

Small and medium-sized enterprises (SMEs) play a significant role in most European economies in terms of generating economic outputs, contributing to tax revenue, and providing vast employment opportunities. According to the UK's Companies Act 2006, a small company has to satisfy at least two of the following conditions: the turnover is no more than £10.2 million, the balance sheet total is no more than £5.1 million, and the number of employees is no more than 50.[1] Similarly, a medium-sized company has to fulfil at least two of the following conditions: the turnover is no more than £36 million, the balance sheet total is no more than £18 million, and the number of employees is no more than 250.[2] A recent official survey suggested that the UK had approximately 5.5 million private businesses in 2016, and the number of SMEs (5,490,470) accounted for 99.9% of the total business population, while the number of large corporations (7,200) took up merely 0.1%.[3] Moreover, British SMEs hired 15.7 million people in the country, or 60% of the total private sector employment, compared with 10.5 million people employed by big companies.[4] These statistics mean SMEs provide the majority of working opportunities in the British economy, which is of great importance to reducing the unemployment rate after the global financial crisis. In terms of business revenue, the combined annual turnovers of British SMEs amounted to £1.8 trillion in 2016, which is equivalent to 47% of the total turnover in the private sector.[5] The percentage indicates that SMEs and large corporations have been generating a similar amount of revenue by delivering products and services for consumers in the UK and globally. Finally, judging by Gross Domestic Product (GDP), an internationally recognised standard, SMEs have contributed 49.8% of the UK's GDP in recent years, showing their critical role in economic recovery after the financial tsunami.[6]

However, in contrast to SMEs' remarkable economic and social contributions, the amount of credit they borrow from the banking sector seems inadequate for their survival and growth. For example, according to the Bank of England's lending data in July 2017, British SMEs borrowed a combined sum of £5.17 billion from banks and building societies (17% of total loans), while large corporations obtained £25.4 billion (83% of total loans).[7] Although SMEs

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1 Companies Act 2006 (U.K.), c. 46, s. 382.

2 Ibid., s. 465.

3 U.K., Department for Business, Energy & Industrial Strategy, Business Population Estimates for the UK and Regions 2016, at 3.

4 Ibid.

5 Ibid.

6 Matthew Ward & Chris Rhodes, Small Businesses and the UK Economy (House of Commons Library Research Paper SN/EP/6078) at 7.

7 Data drawn from Table A8.1, Bank of England, Bankstats tables, online: <http://www.bankofengland.co.uk/statistics/tables>.

account for 60% of employment and 50% of GDP in the country, they have access to only one sixth of bank credit. Obviously, the imbalance of credit provision has resulted in a financing dilemma for millions of entrepreneurs and smaller businesses. Unlike large corporations that are able to utilise global financial markets to raise funds, most SMEs can rely solely on the domestic banking sector to borrow credit. Moreover, in the post-crisis era, there has been a lending squeeze in the British banking industry, for banks have become more risk-averse and thus refuse to lend to risky start-ups. It leaves SMEs to seek alternative finance channels outside the traditional banking industry and capital markets to satisfy their increasing financing needs. Meanwhile, recent times have witnessed the so-called ‘‘fintech” (financial technology) revolution, which combines the financial industry with the latest information technologies such as big data, cloud computing, artificial intelligence, and blockchain.[8] The application of innovative technologies in financial services has brought significant changes to payment, lending, wealth management, and insurance.[9] Accordingly, the author argues that SMEs’ long-term financing problem could potentially be solved by the burgeoning fintech sector.

Against this background, this article discusses and analyses the UK’s ongoing fintech revolution, particularly how fintech service and alternative finance help to bridge the financing gap for British SMEs. It uses the UK’s online peer-to-peer (P2P) lending market and digital-focused challenger banks as two examples to illustrate the radical changes that fintech has brought to traditional business financing. This article will be of interest to law and business scholars researching fintech, alternative finance, and financial regulation. After this introduction, the second section examines the emergence of alternative finance methods for SMEs in the UK and analyses their advantages over traditional banks in terms of cost-effectiveness, mitigating information asymmetry, and funding structure. Next, the third section explores in detail the UK’s booming online P2P lending market, especially its role in promoting business financing for SME borrowers. The fourth section presents the way digital-focused challenger banks rival traditional lenders and provide SME-focused loan services for underserved small-business borrowers. The fifth section continues to evaluate the UK’s policies to promote the development of alternative finance for SMEs, while the sixth section studies the regulation of online P2P lending and challenger banks in the UK.

## 2. IS FINTECH THE PANACEA FOR SMES’ FINANCING DILEMMA?

The fintech revolution has given rise to a variety of novel financial services and products, such as bitcoin, P2P lending, crowdfunding, mobile payment, and insurtech. The UK is leading the way in fintech innovation, as its fintech sector is

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8 ‘‘The fintech revolution”, The Economist (9 May 2015) at 13.

9 Lerong Lu, ‘‘Financial Technology and Challenger Banks in the UK: Gap Fillers or Real Challengers?” (2017) 32 J.I.B.L.R. 273.

estimated to produce an annual revenue of £20 billion.[10] London has become a world-class fintech hub hosting thousands of fintech start-ups, which strengthens the city's status as a major global financial centre. Additionally, the UK has been described as the most fintech-friendly jurisdiction in the world, owing to the Financial Conduct Authority (FCA)'s regulatory sandbox regime and other official initiatives to facilitate the growth of fintech businesses.[11] Among a range of fintech activities, Britain has seen the rapid rise of alternative finance methods employed by SMEs to obtain working capital and credit. In 2015, around 20,000 SMEs in the UK borrowed money through online finance platforms, with a collective volume of £2.2 billion.[12] According to one estimation, the market scale of the UK's P2P business lending equals 13.9% of bank lending to small businesses.[13] Clearly, alternative finance plays an increasingly important role in small-business financing. Moreover, the UK dominates the online alternative finance industry in Europe, accounting for 81% of the entire market in the continent.[14] The availability of alternative financial channels has led to the steady growth of British businesses, as 80% of SMEs made a profit in 2016, up from 69% in 2012.[15]

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[10] Ernst & Young LLP (Commissioned by UK Trade & Investment), Landscaping UK Fintech at 6, online: <http://www.ey.com/Publication/vwLUAssets/Landscaping_UK_Fintech/$FILE/EY-Landscaping-UK-Fintech.pdf>.

[11] Caroline Binham, ''UK regulators are the most fintech friendly", Financial Times (12 September 2016).

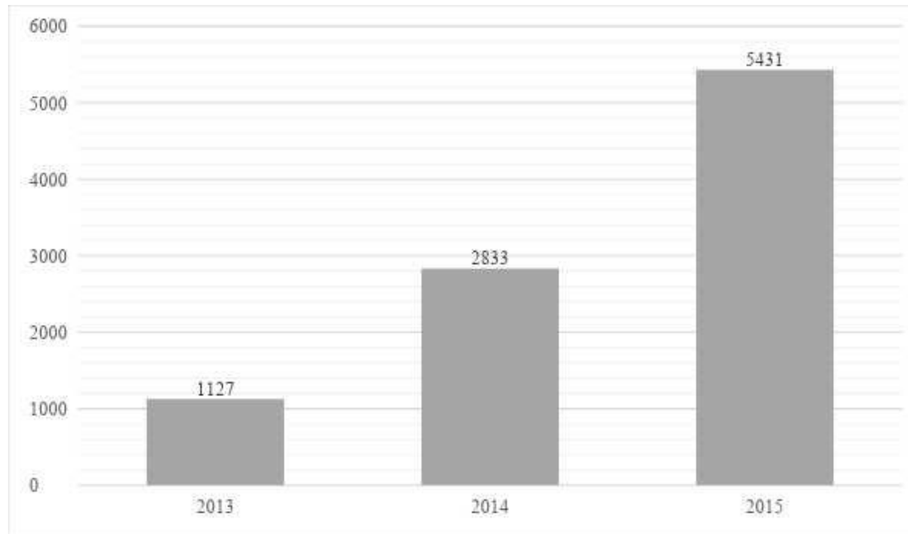
[12] Bryan Zhang *et al.*, Pushing Boundaries: The Third UK Alternative Finance Industry Report (Cambridge Centre for Alternative Finance: 2016) at 11, online: <https://www.jbs.cam.ac.uk/fileadmin/user_upload/research/centres/alternative-finance/downloads/2015-uk-alternative-finance-industry-report.pdf>.

[13] Ibid.

[14] Bryan Zhang et al., Sustaining Momentum: The Second European Alternative Finance Industry Report (Cambridge Centre for Alternative Finance: 2016) at 20, online: <https://www.jbs.cam.ac.uk/fileadmin/user_upload/research/centres/alternative-finance/downloads/2016-european-alternative-finance-report-sustaining-momen-tum.pdf>.

[15] BDRC Group, SME Finance Monitor Q4 2016, online: <http://bdrc-continental.com/ wp-content/uploads/2017/03/BDRCContinental_SME_FM_Q4_2016_Management_-Summary.pdf>.

Figure 1: European Alternative Finance Market Volume, 2013-2015
(in Millions of Euros)[16]




The alternative finance market aided by fintech offers a feasible solution to the SME financing puzzle for three reasons. First of all, the latest information technologies have lent alternative lenders an obvious competitive advantage in terms of saving costs and improving business efficiency. Traditionally, financial institutions have relied on an extensive branch network to operate their businesses, which requires heavy investments in properties, personnel, and IT systems. For example, the Lloyds Banking Group incurred an operating cost of £8.09 billion in 2016, which amounted to 48.7% of their annual revenue.[17] This high level of operating costs is due to the fact that Lloyds has over 75,000 full-time employees and 2,000 branches throughout the UK.[18] In sharp contrast, some fintech platforms do not even have physical stores, as they depend solely on digital distribution channels, cutting operational costs to a minimum. In the absence of brick-and-mortar branches, fintech companies need only a small number of staff to perform core tasks, such as credit checking and loan approval. For instance, the online-only Aldermore Bank has just 569 employees, and it serves its customers online, by phone, or face-to-face in 12 regional offices.[19]

16 Ibid. at 25.

17 Lloyds Banking Group, Helping Britain Prosper: Lloyds Banking Group Annual Report and Accounts 2016 at 33, online: <http://www.lloydsbankinggroup.com/globalassets/documents/investors/2016/2016_lbg_annual_report_v2.pdf>.

18 Lloyds Banking Group, Fast Facts About Lloyds Banking Group, online: <http://www.lloydsbankinggroup.com/media/media-kit/faqs/lloyds-banking-group-fast-facts>.

19 Shawbrook, Annual Report and Accounts 2016 at 130.

Likewise, Funding Circle, a P2P lending platform based in the UK, allows borrowers to file loan applications online and submit relevant materials digitally.[20] The cost-effective strategy not only increases the potential profits for fintech companies but also benefits their customers who can borrow money at lower rates or invest their money with higher returns.

Secondly, alternative lenders are largely able to mitigate the problem of information asymmetry in the loan-making process. One reason for banks' unwillingness to lend to SMEs is that they are unable to gather enough information to evaluate the creditworthiness of these borrowers, as a large proportion of them cannot provide a record of trading history or fail to offer valid collateral to secure a loan. However, fintech platforms are in a better position than conventional lenders to check the credit background of potential borrowers, as they are equipped with big data technology and artificial intelligence. Fintech allows online lenders to design bespoke risk models to calculate a great number of variables relating to business borrowers and their owners, including their gender, age, marital status, educational level, working years, company size, monthly payment, loan amount, debt-to-income ratio, and delinquency history.[21] The use of big data gives online lending platforms the power to accurately evaluate the size of the credit risk relating to SME borrowers. Some P2P portals have even devised new algorithms to assess business borrowers' credit situation by considering their owners' personal financial information (e.g., cash flow and deposit amount) and social media information, as well as the general industry trend. [22] All relevant data will be taken into account when alternative lenders judge the creditworthiness of SME borrowers who, by bank standards, might not qualify to obtain a loan. Additionally, the credit evaluation process of fintech companies is more efficient than that of banks; for example, business borrowers at Funding Circle can expect a loan decision within 24 hours after they submit the online application.[23] Despite the benefits of using big data, it also raises some legal issues relating to the protection of personal data, for personal information should only be collected and used with the full consent of its owner.[24]

Thirdly, compared with traditional banks, fintech lenders can draw on more diverse sources of funding to expand their loan businesses quickly. Most

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20 Funding Circle, Business Loans & Funding in the UK, online: <http://www.fundingcir-cle.com/uk/businesses>.

21 Xuchen Lin, Xiaolong Li & Zhong Zheng, ''Evaluating Borrower's Default Risk in Peer-to-Peer Lending: Evidence from a Lending Platform in China" (2017) 49 Applied Economics 3538.

22 Karen Mills, ''Use Data to Fix the Small Business Lending Gap", Harvard Business Review (16 September 2014).

23 Ibid.

24 Information Commissioner's Office, Big Data, Artificial Intelligence, Machine Learning and Data Protection (2017), online <https://ico.org.uk/media/for-organisations/docu-ments/2013559/big-data-ai-ml-and-data-protection.pdf>.

commercial banks regard the money of their depositors as the primary source of funding, though an increasing number of financial institutions have started to raise funds from the interbank market and money-market funds.[25] By contrast, online P2P lending platforms have no geographical limitations, for they can obtain funds from individual investors, institutional investors, and government agencies from different parts of the world. Funding Circle is an example. Since its opening in 2010, the P2P lending portal has received £2.8 billion from 72,000 investors and paid out £135 million in interest.[26] It should be noted that most P2P lending investors have been savers who were dissatisfied with the interest rates offered by their banks and thus sought better returns for their money. The financial crisis undermined many savers' confidence in traditional banks, making them more willing to test new investment methods with a better yield. Apart from individual investors, there are a large number of institutional investors, hedge funds, and wealth management funds in the P2P lending marketplace. In the United States, nearly 80% of funds in online P2P platforms come from institutional investors.[27] Moreover, the UK government plays an important and proactive role in the P2P lending industry, as both regulator and investor. In 2017, the government-owned British Business Bank agreed to lend a further £40 million to small businesses through Funding Circle, following a £60-million early investment.[28] The European Investment Bank also promised to lend £100 million to smaller companies in the UK through the same P2P platform.[29] Therefore, the UK's online P2P lending market has attracted funding from both private and public investors on a global scale, resulting in a large amount of credit supplied to SME borrowers.

## 3. P2P BUSINESS LENDING IN THE UK

This section examines the rapid growth of the UK's online P2P lending market, particularly the peer-to-business (P2B) lending segment, which clearly demonstrates the way in which the fintech revolution benefits SME borrowers. In 2005, Zopa, the first online P2P lending platform in the world, was launched in the UK.[30] Since then, online lending activities have proliferated in various jurisdictions, including the United States and China. According to the

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25 John Carney, ''Basics of Banking: Loans Create a Lot More Than Deposits'', CNBC (26 February 2013).

26 Funding Circle, Lend to UK Businesses, online: <http://www.fundingcircle.com/uk/investors>.

27 Amy Cortese, ''Loans that avoid banks? Maybe not'', New York Times (4 May 2014).

28 Emma Dunkley, ''Funding Circle: Small business backing'', Financial Times (6 January 2017) at 17.

29 Emma Dunkley, ''Funding Circle to allocate £100m of EU loans'', Financial Times (21 June 2016) at 21.

30 Judith Evans, ''Zopa to Target Retirement Savers Market'', Financial Times (3 January 2015) at 3.

Economist, P2P lending refers to the practice of lending to unrelated individuals or businesses through online portals, without the involvement of traditional financial institutions such as banks.[31] Because it removes banks from the lending chain, P2P lending is often dubbed as ‘‘banking without banks,” which is said to bring a better deal for both sides of a lending contract, for P2P loans not only reduce transactional costs for borrowers but also provide more investment opportunities and better returns for lenders. The UK's P2P Finance Association defines P2P finance as ‘‘a debt-based funding arrangement facilitated by an electronic platform that comprises, to a significant extent, direct one-to-one contracts between a single recipient and multiple providers of funds, where a significant proportion of lenders are generally retail consumers and where borrowers are generally retail consumers or small businesses.”[32] P2P lending has been labelled ‘‘loan-based crowdfunding” in the UK, as the concept was put forward by the FCA as financial regulator.[33]

In the online lending market, the majority of borrowers are either consumers or small businesses with limited access to traditional financial institutions, while most lenders are individuals or businesses who hold spare savings and capital to invest. When applying for a P2P loan, borrowers file the application online and upload relevant materials. Then, their P2P lending platforms conduct identity check, credit assessment, and other tasks relating to due diligence on behalf of lenders. A large proportion of the revenue of P2P portals comes from service charges over the loan-making process and the following loan collection. If borrowers satisfy relevant criteria, their loans will be approved and listed on the P2P platform's e-marketplace. Finally, the loan will be funded by registered investors on the platform. Sometimes a loan will be divided into hundreds of portions funded by different investors, while the money of individual investors is automatically allocated to several loans. This is a common practice in online lending that P2P platforms use to diversify investment portfolios and spread the credit risk evenly.

After the launch of Zopa in 2005, the UK's online lending sector has been on an expansive trajectory. Zopa has helped thousands of British investors lend out £2.65 billion to approximately 277,000 borrowers in the country.[34] Currently, there are 80 P2P lending platforms in the UK, channelling billions of pounds each year to cash-starved small businesses. Evidently, the P2P lending industry

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31 ‘‘Peer-To-Peer Lending: Banking Without Banks”, The Economist (1 March 2014) at 70.

32 P2PFA, Rules of the Peer-to-peer Finance Association at para. 2.1, online: <https://p2pfa.org.uk/rules>.

33 According to the FCA, crowdfunding is a way for individuals and businesses to raise money from the public, to support a business, project, campaign, or individual. The term applies to a number of internet-based business models, including donation-based crowdfunding, rewards-based crowdfunding, loan-based crowdfunding, and invest-ment-based crowdfunding. See FCA, Crowdfunding, online: <http://www.fca.org.uk/consumers/crowdfunding>.

34 Zopa, About Zopa, online: <http://www.zopa.com/about>.

has been moving towards the mainstream and now constitutes a vital part of the financial industry.

Table 1: Top 20 P2P Lending Platforms in the UK
(by Accumulated Loan Amounts)[35]

| | P2P Lending Platform | Loans to Date | Loans Outstanding |
|---|---|---|---|
| 1 | Zopa | £1,608,059,280 | £770,264,000 |
| 2 | Funding Circle | £1,433,051,760 | £828,555,429 |
| 3 | RateSetter | £1,367,177,643 | £630,681,615 |
| 4 | LendInvest | £723,989,618 | £400,000,000 |
| 5 | MarketInvoice | £690,342,200 | £32,896,796 |
| 6 | Wellesley & Co | £345,042,066 | £143,039,863 |
| 7 | ThinCats | £188,502,000 | £60,000,000 |
| 8 | Lendy | £176,630,969 | £126,547,762 |
| 9 | Platform Black | £137,852,936 | £15,000,000 |
| 10 | Assetz Capital | £130,351,275 | £75,000,000 |
| 11 | Folk2Folk | £109,397,051 | £74,000,000 |
| 12 | BridgeCrowd | £68,574,000 | £8,000,000 |
| 13 | FundingSecure | £53,186,818 | £2,000,000 |
| 14 | Landbay | £42,780,000 | £35,000,000 |
| 15 | Lending Works | £32,652,960 | £10,000,000 |
| 16 | FundingKnight | £31,105,000 | £18,146,000 |
| 17 | Lendable | £25,000,000 | £20,000,000 |
| 18 | MoneyThing | £23,953,779 | £14,485,228 |
| 19 | Abundance | £20,877,829 | £20,000,000 |
| 20 | ArchOver | £20,277,000 | £15,000,000 |

Table 1 lists the largest P2P lending platforms in Britain. The UK's online lending market has some special characteristics. For instance, the online lending industry has evolved into a relatively mature market with a significant lending volume and various market players. So far, the largest 38 P2P lending platforms in the UK have extended a combined £7.3 billion to borrowers.[36] However, the aggregated lending quantity of all P2P platforms accounts for only 2% of total bank lending.[37] Although the percentage seems modest at the moment, the

35 p2pmoney.co.uk, Peer-to-peer company loans, online: <http://www.p2pmoney.co.uk/statistics/size.htm>.

36 Ibid.

37 British Business Bank, Small Business Finance Markets 2014 at 5.

industry has been expanding constantly and is expected to exceed 10% of bank lending by 2020. The UK's P2P lending market is also perceived as highly concentrated, for it has been dominated by the ''Big Three" (Zopa, Funding Circle, and RateSetter), which collectively take up 60% of market share. Whether this high level of market concentration is beneficial for the industry or not remains unknown.

What's more, P2P lending platforms can be divided into different categories, in terms of how the interest rate is determined.[38] In one business model, lenders offer loans at a pre-defined interest rate set by their platforms, which take into account the risk factors of potential borrowers and the overall market trend. Another lending model is called reverse auction (or listing), where lenders have to bid on loans and those who offer the lowest interest rates will win the bid. The latter model is more favourable for borrowers, who are able to obtain credits at the cheapest price. Furthermore, P2P lending platforms can also be classified according to their customer focus. Most P2P lending platforms in Britain, including Zopa and RateSetter, primarily target individuals or consumer borrowers, while an increasing number of lending portals, such as Funding Circle, tailor their lending businesses to SME borrowers (P2B lending).

Compared with the lengthy and uncertain bank lending procedure, P2B lending allows SMEs to acquire credits swiftly from a large pool of investors (individuals, companies, and public institutions).[39] The advantages of P2B loans over bank loans include fast speed, flexible terms, greater transparency, and ease of use.[40] For example, Funding Circle has a vision to revolutionise the outdated banking system and secure a better deal for everyone. Since 2010, it has provided loans worth £2.9 billion to over 30,031 British businesses.[41] It has become a leading P2P lending platform worldwide, with a presence in countries such as the US, Germany, Spain, and the Netherlands. Funding Circle also attracts investors from different backgrounds. Apart from individual investors, it has the UK government, local councils, universities, and a number of financial organisations on its client list, who have invested billions of pounds into the P2B lending market. For example, in 2013, under the Business Finance Partnership, the UK government lent £20 million in P2B loans to SMEs through Funding Circle. In 2014, the British Business Bank granted £40 million in loans to smaller businesses through the same platform.[42] The P2B lending market has diverted a large volume of credits to SME borrowers, contributing to economic growth in the post-crisis era and helping to fostering entrepreneurship and innovation in society.

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[38] Supra note 35.

[39] Robert Wardrop *et al.*, Moving Mainstream: The European Alternative Finance Benchmarking Report (Cambridge Centre for Alternative Finance: 2015) at 18.

[40] Ibid.

[41] Supra note 20.

[42] Ibid.

## 4. SME-FOCUSED CHALLENGER BANKS IN THE UK

This section explores the second example of alternative finance for small businesses in the UK, SME-focused challenger banks. In recent years, a number of these challenger banks have been established in the UK, attempting to grab market shares from the ‘‘Big Five” banks (HSBC, Barclays, Lloyds Banking Group, Royal Bank of Scotland, and Santander). At present, the retail banking business in Britain is almost controlled by the Big Five lenders, which collectively hold 85% of all personal current accounts.[43] According to the RelBanks' ranking, HSBC is the seventh-largest bank in the world in terms of total assets ($2,492.44 billion), Barclays is 20th ($1,476.10 billion), Lloyds is 24th ($1,059.53 billion), and RBS is 25th ($1,017.58 billion).[44] Market concentration hinders competition, innovation, and market efficiency in the British banking industry. Consequently, the FCA was founded in 2013 with an operational objective to promote competition in the interest of consumers.[45] Encouraging more competitors to join the banking industry is what the financial regulator intends to achieve, given that financial stability can be ensured.

Challenger banks in the UK have adopted a multiplicity of business models. Firstly, some of them are smaller versions of large banks and offer traditional banking services similar to that of the Big Five; for example, Virgin Money. In January 2011, Virgin Money acquired the failed Northern Rock, and it listed its shares on the London Stock Exchange in November 2014.[46] Secondly, some challenger banks are backed by high street retailers and supermarkets, such as Asda Money, Tesco Bank, Sainsbury's Bank, and M&S Bank. They offer reward point credit cards, low-cost personal loans, current and saving accounts, and other financial products to lure customers.[47] The final category of challenger banks has a distinctive business model compared with most existing banks, as they are fintech-driven digital lenders providing specialised financial services for customers who are underserved by incumbent lenders. They are the focus of this section. Despite being authorised by the Prudential Regulation Authority (PRA) and regulated by both the FCA and the PRA, digital-based challenger banks have changed the way we use banks in several ways, which will be explained below. Thus, they are categorised under alternative finance rather than traditional finance. Some prominent examples of fintech challenger banks in the UK include Aldermore, Shawbrook, OneSavings, Atom, Monzo, Starling, and Tandem.

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[43] Elaine Moore, ‘‘Challengers line up to take on the big banks”, Financial Times (14 July 2012) at 3.

[44] RelBanks, Top 100 Banks in the World, online: <http://www.relbanks.com/worlds-top-banks/assets>.

[45] Financial Services and Markets Act 2000 (U.K.), c. 8, s. 1E.

[46] Andrew Bolger and Emma Dunkley, ‘‘Branson makes £70m as Virgin Money floats”, Financial Times (14 November 2014) at 26.

[47] KPMG, The Game Changers: Challenger Banking Results (2015) at 2.

According to an industry report published by KPMG, four major differences can be observed between the businesses of the Big Five and challenger lenders, in the areas of branding, products and services, culture and customer service, and distribution.[48] In terms of branding, established lenders suffered severe reputational damage during the recent financial crisis. Therefore, the new lenders try to distance themselves from established banks by creating their own brands, giving them the advantage of having no historical legacy. As for products and services, in order to solicit marginal customers, most challenger banks offer products and services differentiated from those of existing lenders, filling the niches of the UK's banking industry. For example, some challenger banks concentrate their businesses on providing specialised financing services for SMEs, which not only helps smaller businesses to obtain funding, but also wins these banks a large number of clients ignored by the Big Five. According to Andy Golding, who is the chief executive of OneSavings, challenger banks are dancing in the gaps left by major players.[49] When it comes to culture, challengers have depicted themselves as customer-centric ventures, underlining the fairness and ethical culture in their respective banking activities and drawing sharp contrasts with the business culture of existing lenders with the singular goal of making profits. Last but not least, challenger banks have employed distinctive systems of distribution, as they are reliant on brokers and online platforms to reach customers, rather than the traditional branch networks that dominant banks have been using for several decades.

Generally speaking, like other banking institutions, challenger banks take deposits from the public and then make loans to potential borrowers. However, in terms of where they are lending money, challenger banks tend to offer tailored financing services to SMEs, including asset finance, invoice finance, and SME mortgage. Asset finance, including leasing and hire purchase, refers to the funding for capital (asset) investments in machinery, plant, and equipment.[50] By exploiting asset financing, the business does not need to make large one-off payments to buy relevant assets upfront. Instead, it can break down the payments into affordable monthly instalments or rent, while having the right to use the asset until the end of the contract. When the asset finance agreement expires, the business may have the option to purchase the asset at a nominal price (hire purchase). Invoice finance means lending to SMEs against their outstanding invoices, which includes factoring and invoice discounting.[51] When utilising invoice financing tools, the business will be advanced the value of the invoices they have created. With factoring, the factoring lender rather than the business

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[48] Ibid.

[49] Ashley Armstrong, ''One Savings Bank Targets IPO Valuation of Up to £600m", Telegraph (7 May 2014).

[50] Startups, What Is Asset Finance?, online: <http://startups.co.uk/what-is-asset-fi-nance>.

[51] Startups, Invoice Finance: What Can You Raise?, online: <http://startups.co.uk/ invoice-finance-what-can-you-raise>.

collects the debt. Invoice discounting allows the business to maintain credit control and the collection facility to receive the payment from its customer. SME mortgage refers to specialised lending to SMEs to fund their purchase of new or second-hand properties, or the refinancing of properties from other banks for better business cash flow.[52]

Take Aldermore as an example. Aldermore Bank describes itself as ‘‘an SME-focused bank which operates with modern, scalable, and legacy-free infrastructure.”[53] Founded in 2009, Aldermore has grown rapidly since then and has become a leading alternative lender in Britain. In 2014, its pre-tax profits doubled to £50 million, from £26 million in 2013.[54] In March 2015, Aldermore launched a successful IPO and listed its shares on the London Stock Exchange by raising £75 million from subscribers.[55] Now, Aldermore has 850 employees and 177,000 customers in the UK.[56] The swift success of Aldermore can be attributed to its unique customer and operation strategies. Aldermore’s business centres on commercial finance, mortgage, and saving services for British SMEs, homebuyers, and savers. It attracts deposits from British savers, and then extends loans in four specialised areas: asset finance, invoice finance, SME commercial mortgage, and residential mortgage. Discarding the traditional branch network, Aldermore offers financial services online, by phone, or face-to-face at a dozen regional offices around the UK. The online operation leads to lower costs and higher profit margins. Moreover, Aldermore aims to deliver banking with good service, full transparency, and community focus.[57] Good service, coupled with more credit available for smaller businesses, lends Aldermore its competitive edge. Aldermore is also known for customer-focused innovation.[58] For example, the bank allows its customer to post comments about its products and services without any editing, providing valuable suggestions for other customers. In 2015, its asset finance business

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52 Standard Chartered, SME Mortgage, online: <http://www.sc.com/th/en/business-banking-sme/business-expansion-sme-mortgage.html>.

53 Aldermore, Who We Are, online: <http://www.aldermore.co.uk/about-us/who-we-are>.

54 Emma Dunkley, ‘‘Aldermore Shares Soar on Stock Market Listing”, Financial Times (10 March 2015).

55 Ibid.

56 Aldermore, Fact Sheet, online: <http://www.aldermore.co.uk/media/1781/aldermor-e_factsheet.pdf>.

57 Aldermore aims to support the communities in which they operate. For example, the deposits received by Aldermore are loaned only within the UK; their premises and staff are all located in the UK, close to the communities they serve; they support UK government policies and programs, such as Help to Buy; their corporate culture mirrors that of other UK SMEs, so they can appreciate the needs of SME communities; and they actively support young entrepreneurs in UK schools to develop business skills. See Aldermore, Community, online: <http://www.aldermore.co.uk/about-us/commu-nity>.

58 Supra note 56.

accounted for 3% of the £14 billion market, its invoice finance took up 0.9% of the £19 billion market; and its SME commercial mortgage represented 1% of the £44 billion market.[59]

The significance of digital-based challenger banks is twofold. On the one hand, these innovative lenders play a critical role in channelling credit from depositors to smaller business borrowers through bespoke loan services such as asset financing, invoice discounting, and commercial mortgages, providing necessary credit and operating cash for SMEs. On the other hand, by exploiting their market niche, challenge banks have enjoyed rapid growth and have quickly become profitable businesses themselves. In 2014, the listed challenger banks outperformed the FTSE All Share Banks Index, as new lenders generated substantial returns for investors.[60] Their cost-effective operations, in combination with their specialised market target, enable challenger banks to compete with established banks. Recently, the lending assets of British challenger banks have seen a year-on-year increase of 16%, while the assets of the Big Five fell by 2.1%.[61] Challenger lenders have also started to make considerable profits: the return on equity ratio of Aldermore and Shawbrook reached 18.2%, which is much higher than the industry average.[62] Challenger banks bring more competition into the UK's banking sector, and help the public to realise the importance of SME financing. They represent the true spirit of entrepreneurship and innovation, as challenger banks dare to challenge existing players as well as manage to help small businesses in the UK to grow and prosper.

## 5. THE UK'S POLICIES TO PROMOTE SME FINANCE AND THE FINTECH INDUSTRY

In response to the fintech revolution, governments and financial regulators around the world have been formulating new industry policies as well as reforming the existing regulatory regime to accommodate financial innovation. The policy-making process should aim to maximise the economic and social benefits of fintech activities, such as providing financial services for customers underserved by mainstream banks, while minimising relevant risks associated with novel business practices. The UK plays a leading role in the fintech revolution, owing to its favourable policies to encourage fintech innovation and promote SME finance. In April 2017, Philip Hammond, the UK's Chancellor of the Exchequer, made a speech at the inaugural International FinTech Conference in London, where he described the upcoming fintech age as the ''fourth industrial revolution.''[63] This section provides a brief overview of the UK's official policies to promote SME finance and fintech innovation.

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59 Ibid.

60 Richard Stovin-Bradford, ''Get Rich Quick with UK Challenger Banks'', Financial Times (11 October 2015).

61 Supra note 47 at 3.

62 Ibid.

There is no denying that financing difficulties prevent entrepreneurs from starting new businesses and impede further growth for existing SMEs. In response, the UK government has put forward a series of policies in recent years in order to improve the availability of credit for SMEs. For instance, in 2012, the Treasury and the Bank of England initiated the Funding for Lending Scheme (FLS), which enables banks and building societies to borrow credit from the central bank at a discounted rate and then extend loans to SMEs at an interest rate lower than the market level.[64] Backed by the central bank's liquidity, the FLS has provided considerable credit for cash-strapped SMEs. Moreover, the government set up an independent body called the British Business Bank (BBB) with the aim of making finance markets work better for small businesses in the UK at all stages of their development.[65] The BBB is not a real bank, so it does not lend directly to smaller businesses. However, it has the mandate to manage all government-related programs relating to SME finance. Working with 80 partners, including banks, leasing companies, venture capital funds, and online lending platforms, the BBB is able to provide substantial funding supports for entrepreneurs to start a new business, grow their business to the next level, or stay ahead of the competition. As of the end of 2015, the BBB programs had supplied funding worth £2.3 billion to over 40,000 smaller businesses, and planned to facilitate a further £2.9 billion in funding to British SMEs in the following years.[66] Over the 2016/2017 financial year, 94% of the BBB's funding opportunities were provided by non-Big Five banks, showing its efforts in creating a more diverse finance market for British businesses.[67]

In addition, the UK government has introduced a series of projects to encourage the private sector to invest in smaller businesses, including the Business Finance Partnership (BFP), the Start Up Loans scheme (SLS), and the Angel CoFund. The UK government has invested £1.2 billion into the BFP, with at least an equal amount to be contributed by private investors.[68] This money will be directed to smaller businesses through non-bank financing channels, such

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[63] Philip Hammond, ‘‘‘FinTech will transform the way we live and do business’, says the Chancellor” (Speech delivered at the inaugural International FinTech Conference in London, 12 April 2017), online: <http://www.gov.uk/government/speeches/fintech-will-transform-the-way-we-live-and-do-business-says-the-chancellor>.

[64] Bank of England, Funding for Lending and Other Market Operations, online: <http://www.bankofengland.co.uk/markets/funding-for-lending-and-other-market-opera-tions>.

[65] British Business Bank, What We Do, online: <http://british-business-bank.co.uk/what-the-british-business-bank-does>.

[66] British Business Bank, Annual Report and Accounts 2015, online: <http://annual-report2015.british-business-bank.co.uk/issue/14>.

[67] British Business Bank, Annual Report and Accounts 2017, online: <http://annual-report2017.british-business-bank.co.uk/uploads/documents/BBB_AR_2017_Tag-ged.pdf>.

[68] Kylie MacLellan, ‘‘UK channels business lending via alternative financiers”, Reuters (12 December 2012).

as fintech platforms and P2P lenders (e.g., Zopa and Funding Circle). The SLS started in September 2012, offering £82.5 million to young British entrepreneurs aged 18 to 30.[69] The program is operated by a state-owned organisation that offers initial capital of approximately £2,500 to each young entrepreneur who plans to start a business. The UK government has also promoted tax-advantaged venture capital schemes so as to provide financial supports for SMEs, including the Enterprise Investment Scheme (EIS), the Venture Capital Trusts (VCT), and the Seed Enterprise Investment Scheme (SEIS).[70] Such programs aim to incentivise private equity funds to inject more money into smaller businesses, as tax relief is given to investors to compensate for the extra risks they encounter when investing in less-established and smaller businesses. Going forward, it can be expected that more venture capitalists will be willing to direct a certain proportion of their funds to SMEs.

Apart from encouraging both public- and private-sector players to invest in SMEs, the UK government also urges more individuals to put their savings into innovative finance markets. In April 2016, George Osborne, the former Chancellor of the Exchequer, launched the Innovative Finance ISA (Individual Savings Accounts), which offers tax-free returns for British savers who wish to invest their money in the online P2P lending market.[71] Clearly, the inclusion of P2P investments into the official tax-free ISA scheme is stimulating the development of the P2P lending industry. On the one hand, an increasing number of ordinary investors will opt for P2P lending since they can enjoy the same tax-free return as if they saved money in a traditional cash ISA account or purchased securities under an investment ISA account. On the other hand, the Innovative Finance ISA creates a level playing field for P2P lenders. Both P2P investors and bank savers are now entitled to the tax-relief program, which means traditional banks will no longer have a competitive advantage over online lending platforms. However, it should be noted that P2P investments are not covered by the UK's Financial Services Compensation Scheme (FSCS), so investors have to bear potential losses if online borrowers default.

Finally, the UK has been viewed as the most fintech-friendly jurisdiction globally, due to its various industry policies to support fintech businesses.[72] Two examples are the FCA's ''regulatory sandbox" and the Bank of England's ''fintech accelerator." The regulatory sandbox allows fintech businesses to test innovative products, services, business models, and delivery mechanisms in the real market with real consumers.[73] It is open to authorised financial firms, unauthorised financial firms that require authorisation, as well as technology

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69 Start Up Loans, Start or grow your own business ..., online: <http://www.startuploan-s.co.uk>.

70 U.K., HM Treasury, Tax-Advantaged Venture Capital Schemes: Ensuring Continued Support for Small and Growing Businesses (Consultation Paper, 2014).

71 Emma Dunkley, ''P2P Isa Investments Confirmed for Next Year", Financial Times (10 July 2015).

72 Supra note 11.

businesses. The regulatory sandbox offers multiple supports to fintech companies, including the ability to test products and services in a controlled environment; reduced time-to-market at potentially lower cost; support in identifying appropriate consumer protection safeguards to build into new products and services; better access to finance; and other tools such as restricted authorisation, individual guidance, informal steers, waivers, and no enforcement action letters.[74] The UK's regulatory sandbox leads to a win-win situation for the fintech business, the regulator, and financial consumers. Under such arrangements, fintech companies are able to test their products in a safer and more flexible environment without the overhaul of current regulatory systems.[75] It has been the most cost-effective regulatory method for fostering fintech innovation while reducing relevant risks and problems. Similarly, the Bank of England's fintech accelerator enables the central bank to have a better understanding of the fintech industry and accordingly regulate it more effectively and efficiently.[76] The initiative also aims to support industry development by providing expert supports. The BOE has created a community of fintech-related businesses and organisations to share developments, trends, and insights so that firms across the sector can learn from each other, and the BOE in turn can learn from them; to ensure that the BOE is engaging with a variety of fintech firms from across the sector; to increase networking across firms; and to help the sector develop.[77]

## 6. THE REGULATION OF ALTERNATIVE FINANCE IN THE UK

Fintech and alternative finance involve new financial risks compared to those raised by traditional financial activities. Therefore, the disruptions caused by fintech businesses and their pioneering services and products merit attention from global financial regulators. This section evaluates the UK's regulatory practices over the P2P lending market and digital-based challenger banks.

### (a) The Regulation of P2P Lending Platforms

In response to the dramatic growth of P2P lending transactions, the UK's financial authority established a regulatory regime for the online lending market in 2014. It falls within the FCA's existing financial supervisory framework. The FCA has included loan-based crowdfunding (P2P lending) in the scope of its regulated activities, which can be found in Article 36H of the Regulatory Activities Order.[78] Therefore, anyone operating an online P2P lending platform

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[73] FCA, Regulatory Sandbox, online: <http://www.fca.org.uk/firms/regulatory-sand-box>.

[74] Ibid.

[75] Supra note 9 at 282.

[76] Bank of England, Fintech Accelerator, online: <https://www.bankofengland.co.uk/news/2017/july/fintech-accelerator-results-of-latest-round-of-pocs>.

[77] Ibid.

in the UK has to obtain the FCA's authorisation and follow relevant regulatory rules. Currently, the regulation of P2P lending is a combination of industry self-regulation and the FCA's official regulation.

Prior to the establishment of the FCA's official regulatory regime, the industry association had played a major role in setting standards for the UK's P2P lending market. In 2011, Zopa, Funding Circle, and RateSetter (the three largest P2P lenders in Britain) co-founded a self-regulatory body for the UK's burgeoning online lending market, the Peer-to-Peer Finance Association (P2PFA). The P2PFA aims to improve the standard of business conduct in the industry, as well as to enhance the protection of investors on online platforms. The P2PFA has three main goals: (a) to seek to secure public policy, regulatory, and fiscal conditions that enable the UK-based P2P finance sector to compete fairly and grow responsibly; (b) to ensure that members demonstrate high standards of business conduct, to demonstrate leadership and promote confidence in the sector; and (c) to raise awareness and understanding of the benefits and risks of P2P finance.[79] Currently, members of the P2PFA comprise all major P2P lenders in the UK, representing over 90% of market share.[80] The importance of the P2PFA is self-evident, as it forces leading platforms in the country to maintain a high standard of business conduct and a proper level of consumer protection. As a result, the majority of British investors and borrowers will be treated fairly thanks to the strict industry self-monitoring regime.

In order to achieve its objectives, the P2PFA has drafted a series of operating principles for its members to comply with, including high-level principles[81] and more specific rules in areas such as clarity and transparency, risk management, and governance and control. For instance, P2P platforms have to provide adequate information for lenders to make informed decisions, including the expected return, details of fees and surcharges, a clear warning of capital risk (not covered by the FSCS), where the money will be lent, and any ''automatic" functions (auto-lend/auto-bid/auto-reinvest).[82] The P2PFA also asks its members to segregate the money of customers from their own funds and company assets in a separate bank account, which is in line with the FCA's client

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78 Financial Services and Markets Act 2000 (Regulated Activities) (Amendment) (No.2) Order 2013, Article 36H.

79 Supra note 32 at para. 3.1.

80 Members include Funding Circle, Landbay, Lending Works, LendInvest, Madiston LendLoanInvest, MarketInvoice, RateSetter, ThinCats, and Zopa. See P2PFA, Our Member Platforms, online: <http://p2pfa.org.uk/platforms>.

81 P2PFA, Peer-to-Peer Finance Association Operating Principles, Article 3: ''P2PFA members must comply with the following high-level principles in all their undertakings:

a) operate their business with technical and professional competence; b) run their business with integrity; c) transact with customers in an honest and fair way; d) be transparent about how their platform works; e) promote and maintain high standards of business practice; and f) commit to provide good value financial service products to retail consumers."

82 Ibid., Article 7.

money rules.[83] Additionally, the P2PFA has imposed an obligation on its members to submit data regarding their lending volume and customer complaints on a quarterly basis.[84] The P2PFA's operating rules are of great importance in ensuring a fair and competitive marketplace. However, after the FCA's official regulation came into effect, these industry guidelines have played a more supplementary role in the regulation of the online lending sector.

The UK is not only the first country to have an online P2P lending platform, but also the first jurisdiction to establish a regulatory regime for the P2P lending industry. In October 2012, the FCA issued a consultation paper entitled CP13/

13: The FCA's regulatory approach to crowdfunding (and similar activities), which proposed a set of regulatory rules to protect investors at P2P lending portals and other crowdfunding platforms. In March 2014, the FCA released a policy statement called PS14/4: The FCA's regulatory approach to crowdfunding over the internet, and the promotion of non-readily realisable securities by other media: Feedback to CP13/13 and final rules, which summarised relevant responses to the previous consultation paper and outlined detailed rules for regulating P2P lending platforms. The articles in the PS14/4 marked the formation of an official regulatory framework over P2P lending activities in the UK, which came into force on 1 April 2014.

Generally speaking, it is a disclosure-based regulatory system that intends to protect P2P investors through promoting information transparency for online lending platforms and transactions. The new regime aims to improve competition in the sector, help smaller businesses have more access to the alternative finance market, and enhance the protection of financial consumers. It contains rules for P2P platforms to follow in seven areas: capital adequacy requirement, client money rules, cancellation rights, information disclosure rules, FCA reporting requirements, administration in the event of failure, and dispute resolution process.

*(i) Prudential capital requirement*

The capital requirement or capital adequacy requirement refers to the amount of capital that financial institutions are asked to hold. As required by the financial regulator, a financial firm has to maintain a certain level of capital against its assets, which can prevent the firm from undertaking excessive risks and reduce the possibility of falling into insolvency. In practice, banks and other deposit-taking institutions are subject to stringent capital requirements set by the Basel Accords. After the global financial crisis, Basel II has been replaced by the latest, Basel III, which must be implemented by banks between 2013 and 2019.[85] In a similar fashion, the FCA requires P2P lending platforms to hold compulsory

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[83] Ibid., Article 13.

[84] Ibid., Articles 26 and 27.

[85] BIS, Basel III: A global regulatory framework for more resilient banks and banking systems (2011).

regulatory capital in order to withstand potential financial shocks and cover operating losses. At present, the financial resource requirement for all UK P2P platforms will be the higher of the following two standards:

- A fixed minimum amount of £20,000 (transitional arrangement between 1 April 2014 and 31 March 2017) or £50,000 (from 1 April 2017); or
- 0.2% of the first £50 million of total value of loaned funds outstanding + 0.15% of the next £200 million of total value of loaned funds outstanding + 0.1% of the next £250 million of total value of loaned funds outstanding + 0.05% of any remaining balance of total value of loaned funds outstanding above £500 million.[86]

In short, the amount of required capital depends on the amount of client money that a P2P platform is holding. As a micro-prudential regulatory tool, the capital requirement is able to safeguard the safety and soundness of individual P2P lending platforms. Moreover, the requirement can protect the benefits of investors to some extent, as their platforms have to possess enough prudential capital to cope with potential financial difficulties. The differentiated standard for platforms with different sizes of loans also encourages competition in the online lending industry, reflecting the principle of proportionality.

*(ii) Client money rules*

According to the FCA, financial firms that hold money for their clients relating to investment business are subject to the client money rules contained in the FCA's Client Assets Sourcebook (CASS).[87] It asks relevant firms to have sufficient protection in place for their clients' money that they are looking after. As the P2P lending market has become an important and indispensable part of the UK's financial industry, the FCA requires P2P lending platforms to comply with the CASS rules, such as segregation of client money, statutory trusts in terms of client money, and retrieving information in the event of insolvency in order to achieve a timely return of client money.[88] All of these rules should be taken into consideration when P2P lending platforms design their lending and repayment procedures.

*(iii) Cancellation right*

The EU Distance Marketing Directive (DMD) requires that, if any financial contracts are made at a distance, customers shall be able to withdraw their money within the first 14 calendar days, without a penalty and without an explanation.[89] This rule clearly applies to the P2P lending market, as most P2P

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[86] FCA, PS14/04 at 20.

[87] FCA, FCA Handbook, online: <https://www.handbook.fca.org.uk/handbook/ CASS>.

[88] Supra note 86 at 22.

[89] E.C., Directive 2002/65/EC of the European Parliament and of the Council of 23 September 2002 concerning the distance marketing of consumer financial services and

loan agreements are concluded online, which meets the definition of a financial contract made at a distance. Thus, P2P platforms that do not have a secondary market[90] must comply with one of the following two standards:

- A P2P firm may allow consumers to invest in loan agreements immediately, but when requested within the first 14 days it should repay consumers' money; or
- A P2P firm may have a policy that consumers are not be able to invest money in loan agreements within the first 14 days of registering with the platform.[91]

*(iv) Information disclosure rule*

Information disclosure is a vital regulatory tool to protect financial consumers. Financial firms are supposed to provide accurate and adequate information for their consumers to make informed investment decisions. They should illustrate both the benefits and the risks of an investment; in particular, financial institutions should not downplay the risk of potential loss. Accordingly, the FCA requires P2P lending platforms to disclose relevant information to investors, including but not limited to information about the firm, information about the service, financial promotion rules, performance information, guarantees, protections and security mechanisms, comparative information, and periodic reporting information.[92] Investors on P2P platforms are susceptible to different types of financial risks, such as credit risk, market risk, operation risk, and systemic risk. They might encounter potential financial losses when borrowers default or the platform encounters financial trouble. Hence, P2P investors should be given enough information and risk warnings before they decide whether to put their money into the market.

*(v) FCA reporting requirement*

Apart from the P2PFA's reporting requirements, the FCA has imposed mandatory reporting obligations on P2P lending firms regarding information such as financial position reports, client money reports, regular reports on investments, and complaints reports.[93] The information enables the regulator to monitor the lending trend of the market, to analyse potential risks of the whole industry, and to check whether consumers have been treated fairly. Having sufficient data about the industry lays a sound foundation for an effective and efficient regulatory system. Gathering information from P2P lenders is the

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amending Council Directive 90/619/EEC and Directives 97/7/EC and 98/27/EC, [2002] O.J., L. 271.

[90] If the platform has a secondary market and allows investors to sell their loans to other investors at market price, it would be unreasonable to allow them to have withdraw rights.

[91] FCA, CP13/13 at 28.

[92] Ibid. at 29.

[93] Ibid. at 34.

prerequisite for achieving both conduct and prudential regulation. Most recently, the FCA is under a consultation process with major P2P lenders, which could lead to new reporting obligations in terms of information such as the past performance of loans and how much due diligence P2P platforms have done on the borrowers' past performance.[94]

*(vi) Administration in the event of failure*

Although the new regulation aims to lower the possibility of platform failure, the insolvency of some P2P lenders seems inevitable in a highly competitive market. Therefore, it is necessary to set out a procedure for insolvent platforms to follow when liquidating their businesses, in order to protect customers as well as reduce the negative impact on the economy. In practice, P2P loan agreements are entered into by lenders (investors) and borrowers, and the P2P platform serves only as an information intermediary who is not a contractual party. Accordingly, the failure of a P2P lending company will not cause direct financial loss to lenders using its platform. However, it will be difficult for individual investors to administer their loans if their online platform fails, since all contracts have been made in an electronic form and most investors do not even know who their debtors are. In some cases, one investor owns only a small percentage of a particular P2P loan, as loans have been crowdfunded by hundreds of people. Therefore, in order to protect investors' interests in the event of platform failure, the FCA requires P2P lenders to have the following arrangements in advance regarding the administration of loans if the platform collapses:

- Client money should be distributed to investors under the client money rules;
- A new client bank account should be set up to receive ongoing payments for existing loans under the client money rules;
- No new loans should be made, and existing loans will remain valid under their original terms; and
- The firm's arrangements to manage those existing loans, apportioning repayments to the right investors and following up on late repayments or borrower defaults, should come into effect.[95]

*(vii) Dispute resolution process*

Finally, it is necessary to have a complaint procedure for customers who feel discriminated against or unhappy about the financial service they have received. It is of particular importance for P2P investors who have limited access to official protection compared to financial consumers using services provided by traditional institutions. Accordingly, the FCA requires P2P firms to establish a complaint handling process, under which investors should make complaint to the

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[94] Laura Noonan, ''UK's peer-to-peer lenders to be asked to reveal past defaults", Financial Times (6 August 2017).

[95] Supra note 91 at 26.

firm in the first instance. After the internal procedure has been followed, if they are not satisfied with the firm's complaint handling outcome, investors are entitled to take their complaint further to the Financial Ombudsman Service.[96]

### (b) The Regulation of Digital-Focused Challenger Banks

The UK adopts a twin-peak regulatory model for its banking sector, comprised of the FCA and the PRA, which are responsible for conduct regulation and prudential regulation respectively. After the global financial crisis, both regulators were created by the Financial Services Act 2012 to replace the former single regulator, the Financial Services Authority (FSA). During the crisis, the UK witnessed the failure of Northern Rock in September 2007, the first bank run in Britain since Victorian times.[97] Banks including the HBOS and the Royal Bank of Scotland were nationalised by the government to stop the banking crisis. The previous banking regulatory system paid most of its attention to the business conducts of banks and the micro-prudential operation of individual institutions, while ignoring the macro-prudential aspect of financial regulation. The post-crisis regulatory reform and relevant institutional arrangements tend to address this problem.

In order to monitor the solvency of large financial institutions and maintain the financial stability of the whole industry, the PRA was established; it is in charge of the prudential regulation of 1,700 banks, building societies, insurers, and credit unions in the UK. The PRA has a general objective of promoting the safety and soundness of PRA-authorised entities.[98] It has the administrative power to make detailed rules for its regulated firms, which are contained in the PRA Rulebook. In the past, the FSA was considered to perform light-touch financial regulation. For instance, even though the FSA was sceptical about Northern Rock's funding model, it failed to take effective measures to change the situation.[99] By contrast, the PRA plays a more active role in banking supervision than its predecessor did. In recent years, the PRA has carried out several rounds of stress-testing, working with the Bank of England and its Financial Policy Committee to evaluate whether the balance sheets of British lenders can withstand hypothetical situations of economic shock.[100] In 2014, the Co-operative Bank failed the first round of stress-testing and was required to recapitalise, while Lloyds Banking Group and the Royal Bank of Scotland were found to be at risk when encountering the worst economic conditions in the

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96 Ibid. at 33.

97 ''Britain's Bank Run: The Bank That Failed", The Economist (20 September 2007) at 1.

98 Supra note 45, s. 2B(2).

99 U.K., H.C., ''The Run on the Rock: Fifth Report of Session 2007-08".

100 Alex Brazier, ''The Bank of England's Approach to Stress Testing the UK Banking System" (Speech given by the Executive Director for Financial Stability Strategy and Risk, 30 October 2015).

test.[101] Clearly, the PRA has a wider mandate and more useful regulatory tools than the FSA to prevent bank insolvency and safeguard financial stability.

Although there are significant distinctions between challenger banks and traditional lenders in terms of operational methods and customer base, all banks incorporated in the UK have to comply with a similar set of regulatory rules set by the PRA. First of all, any companies that plan to conduct deposit-taking businesses in the UK have to apply for Part 4A permission from the PRA, which it will grant with consent from the FCA.[102] The only exception is that a bank authorised in any state within the European Economic Area (EEA) can exercise its ‘‘passporting” right to offer services and open branches in the UK. (This route could face some uncertainties depending on outcome of the current Brexit negotiation.) After obtaining the authorisation, a bank will be subject to prudential regulation from the PRA as well as conduct regulation from the FCA. In early 2017, the PRA and the FCA set up the New Bank Start-up Unit in order to smooth the process of filing an application to become a bank.[103] The financial regulators provide detailed information and support for establishing a bank, split into the following five steps: early stages, pre-application, application, mobilisation, and after authorisation. This support is beneficial for entrepreneurs who plan to set up new challenger banks.

A vital aspect of the PRA’s prudential regulation is the capital adequacy requirement for financial institutions. The current capital regime is said to favour traditional lenders rather than digital-focused challenger banks.[104] The controversy lies in the PRA’s regulatory method regarding Pillar 2A capital, which requires lenders to hold extra capital beyond the sector-wide minimum standard. According to the rules of Pillar 2A, challenger banks have to employ the PRA’s standardised model to calculate their own capital requirements based on the riskiness of each loan they are making. Obviously, new challenger banks lack long-term business data and loan records, and possess a more radical business model. As a result, their businesses have been perceived as having more risks, leading to a higher risk rating and thus higher capital add-ons by the PRA’s standard. By contrast, traditional lenders that have rich historic lending data are able to utilise self-designed models to calculate the riskiness of their loans, resulting in a lower capital requirement compared to that under the standardised model. The difference in holding capital based on the two models can be as much as 960% for residential mortgages.[105] These rules mean that more of a challenger bank’s capital will be held in reserve rather than being lent out,

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[101] ‘‘Co-op Bank Fails Bank of England Stress Tests”, BBC News (16 December 2014).

[102] Supra note 45, s. 55A.

[103] PRA & FCA, New Bank Start-up Unit: What you need to know from the UK’s financial regulators, online: <https://www.bankofengland.co.uk/prudential-regulation/new-bank-start-up-unit>.

[104] Supra note 47 at 17.

[105] Kathryn Gaw, ‘‘Bank of England relaxes regulations for challenger banks”, FT Adviser (27 February 2017).

giving rise to a significant competitive disadvantage. That's why the current regulatory practice seems to prejudice the further development of emerging lenders. In response, the British Bankers' Association (BBA) urged the regulators to introduce a more flexible risk-assessment framework so as to reduce the impact of a negative rating on challenger banks.[106] In February 2017, the PRA issued a consultation paper pledging to alter the Pillar 2A capital requirements to allow challenger banks and small lenders to provide more competitive mortgage services for UK consumers.[107]

In addition to the PRA's prudential regulation, the FCA was launched to regulate the business conduct of over 26,000 financial firms in Britain as well as the prudential behaviour of more than 23,000 firms not covered by the RPA's regime. The FCA has three operation objectives: protect consumers, enhance market integrity, and promote competition.[108] After assuming power, the FCA has played an important role in protecting British financial consumers by correcting the wrongdoings of banks. For example, over the past decade, a large number of financial consumers in the UK have been sold financial products they do not really need, such as payment protection insurance (PPI). In 2015, the FCA imposed a fine of £117 million on Lloyds Banking Group for its unfair practices when handling customers' complaints about PPI.[109] In so doing, the FCA defends the interests of financial consumers and promotes fair and ethical practices in the banking industry. Encouraging competition remains another top working priority for the FCA, which can be achieved by giving consumers more options for their service providers. For instance, if customers are allowed to switch accounts easily between different banks, banks will be incentivised to improve the quality of their services to keep existing customers and attract new ones.[110] To achieve this goal, the regulators introduced the Current Account Switch Service (CASS) in 2013. CASS is operated by BACS Payment Scheme Limited[111] and is available to 99% of UK depositors, which has shortened the time needed to switch current accounts to no more than seven days. It has already helped over three million customers to switch accounts, enabling challenger lenders to solicit new customers from existing lenders. Finally, the regulatory sandbox, discussed above, is another tool initiated by the FCA to help

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[106] James Barty & Tommy Ricketts, Promoting competition in the UK banking industry (BBA, 2014).

[107] PRA, Refining the PRA's Pillar 2A capital framework — Consultation Paper CP3/17 (2017), online: <http://www.bankofengland.co.uk/pra/Documents/publications/cp/2017/cp317.pdf>.

[108] Supra note 45, s. 1B.

[109] FCA, ''Final Notice to Lloyds Bank plc, Bank of Scotland plc and Black Horse Limited" (together Lloyds Banking Group, "LBG") (4 June 2015).

[110] FCA, Making current account switching easier: The effectiveness of the Current Account Switch Service (CASS) and evidence on account number portability (2015).

[111] BACS, What is the Current Account Switch Service?, online: <http://www.currentaccountswitch.co.uk/Pages/Home.aspx>.

fintech businesses grow — including challenger banks — and to bring more competition to the financial industry.

## 7. CONCLUSION

The importance of SMEs to the national economy is self-evident. In the UK, SMEs account for 99.9% of the total business population, 60% of private-sector employment, and 50% of the national GDP. Despite their vital economic and social functions, SMEs have faced a long-term financing dilemma due to their inability to borrow sufficient credit from the traditional banking industry. The problem has been compounded after the global financial crisis, for financial institutions have become reluctant to lend to smaller businesses amidst the risk concerns. Recent data suggested that only 17% of business loans in the UK were given to SMEs, whilst 83% were made to large corporations. Clearly, finding the best way to promote SME finance has remained an important issue for governments and financial regulators around the world. In response, this paper has critically analysed the way in which the alternative finance market in the UK manages to supply a large amount of credit to SMEs, in the context of the ongoing fintech revolution.

The online P2P lending market and digital-based challenger banks are the two examples used to demonstrate that alternative lenders are in a better position than traditional banks to solve the SME financing puzzle, as fintech companies aided by the latest information technologies are able to reduce operation costs and access a wider customer base. Moreover, most online lenders employ big data and artificial intelligence to evaluate the credit risk of potential borrowers, which overcomes the information asymmetry of the conventional loan-making process. Additionally, fintech platforms draw on a variety of sources to obtain funding, including the government, individual investors, and institutional investors. All these factors have contributed to the rapid growth of alternative financing in the UK. In 2015, around 20,000 British SMEs borrowed a combined total of £2.2 billion from different alternative finance platforms. The UK has one of the largest P2P lending industries in the world, with over 80 active P2P lending platforms, including some (e.g., Funding Circle) specialised to satisfy SMEs' financing demands. It has also seen the emergence of digital-focused challenger banks (e.g., Aldermore and Shawbrook) that provide bespoke loan services for SME borrowers, such as asset finance, invoice finance, and SME mortgage. Clearly, the UK experience suggests the possibility of utilising fintech innovation to solve the lasting SME financing crisis.

After introducing the alternative finance market in the UK, this paper considered the official policies in the UK to promote SME finance and the fintech revolution, as well as the regulatory framework supporting alternative finance. The fintech revolution has been viewed as the fourth industrial revolution, drawing lots of attentions from the government. As a result, there exists a series of official policies and institutions to facilitate the development of alternative finance, including the Funding for Lending Scheme, British Business

Bank, Business Finance Partnership, and the Start Up Loans scheme. Moreover, the government initiated the Innovative Finance ISA in 2016, allowing British savers to invest their money into P2P loans and enjoy tax-free returns. Additionally, the UK government has tried to create a friendly and supportive business environment for entrepreneurs running fintech companies. For instance, the FCA's regulatory sandbox enables fintech businesses to test new ideas and innovative business models in a less regulated setting, and the Bank of England's fintech accelerator provides expert support for the rising fintech sector.

In its final section, this paper investigated the UK's efforts to regulate the alternative finance market to maximise its economic benefits while protecting financial consumers and maintaining financial stability. The regulation of the online P2P lending industry is composed of industry self-regulation and official regulation. In 2011, the three largest P2P lending platforms in Britain co-founded the P2PFA, which promulgated certain operating principles for the entire industry to follow. Later, the FCA's policy statement PS14/4 outlined detailed rules for regulating P2P lending platforms, covering seven areas from capital requirements to dispute resolution. The regulation of digital-focused challenger banks remains similar to that of traditional lenders under the twin-peak financial regulatory system. Challenger banks have to seek authorisation from the PRA before starting operation. An important topic within the PRA's prudential regulation focuses on capital adequacy, which is said to favour traditional banks that can use their rich loan data to design their own risk-assessing models, while challenger banks can only use the standardised risk model and therefore have to hold much more capital. In addition to the PRA's prudential regulation, challenger banks are subject to the FCA's conduct regulations in terms of business conduct and consumer protection. In summary, the UK's regulatory practices teach us an invaluable lesson that financial regulators can strike a fine balance between encouraging financial innovation, protecting financial consumers, and safeguarding financial stability.