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Solving the SME Financing Puzzle in the UK: Has Online P2P Lending Got the Midas Touch?

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Abstract

This article investigates the financing dilemma of small and medium-sized enterprises (SMEs) in the UK. After the global financial crisis, banks have become risk-averse and refuse to lend to small business borrowers. Meanwhile, the recent decade has witnessed the rapid growth of online peer-to-peer (P2P) lending activities, which to some extent substitute bank credit for SME financing. This article analyses the advantages of P2P loans and relevant regulatory issues.

Introduction

SMEs represent 99% of the business population in the EU.[1] Although SMEs are crucial to national economies, they are reported to experience constant financing restraints after the global financial crisis. For example, SMEs account for 58% of the EU's economic outputs and 66% of its jobs but the amount of bank credit they received fell by 35% between 2008 and 2013.[2] Across the Atlantic, the 10 largest banks in the US collectively lent $44.7 billion to small businesses in 2014, down 33% from $72.5 billion in 2006.[3] A similar trend can be observed in the Asia–Pacific region, where SMEs take up 96% of the total business number and produce 62% of employment as well as 42% the region's aggregated gross domestic product (GDP). [4] In sharp contrast, SMEs obtain only 18.7% of total bank loans in the region. There is no denying that the SME financing puzzle in the post-crisis era has become a global phenomenon, drawing intense attentions from the media, policy-makers and scholars. The SMEs' limited access to financing resources results from banks' unwillingness to lend as the current financial regulatory regime seems to discourage risk-taking. A large number of SMEs lacking credit history or effective collaterals have been turned down by mainstream financial institutions. In 2015, 26% of 324,000 SMEs in the UK seeking to borrow a bank loan or overdraft were rejected.[5]

Conventional wisdom holds that addressing the SME financing difficulties can only be achieved by more credit supply from banks. This is because the majority of SMEs, unlike multinational companies which can raise funds from international capital markets, rely solely on domestic banks to borrow money. However, stimulating bank lending to SMEs does not seem to work in the current economic climate as many banks refuse to give loans to what they perceive as risky start-ups. Therefore, bridging the SME financing gap has to be done by the so-called alternative finance markets which comprise financial instruments and distributive channels emerging outside of the traditional financial industry.[6] Among different alternative finance methods, the burgeoning online P2P lending market has been considered as the most feasible financing option for SMEs. P2P lending refers to the practice of lending to unrelated individuals or businesses through online portals without the involvement of traditional banks.[7] In 2005, Zopa as the world's first online lending platform was launched in the UK.[8] At present, the UK has more than 70 active online lending websites which lent £4.4 billion loans to consumers and SMEs in 2015.[9]

Against this background, this article aims to examine and analyse the SME financing difficulty in the UK and answers whether P2P lending can be widely used by SMEs as an alternative financing method in the absence of sufficient bank lending. After this introductory section, the subsequent sections cover the following topics:

- the definition of SMEs and their vital economic importance;
- the debt and equity financing approaches available for British SMEs and the current financing situation of SMEs by the Bank of England's official lending data;
- the growing online lending market in the context of the ongoing fintech revolution, with a particular focus on P2P business lending;

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1 European Commission, "Access to Finance for SMEs" available at: *http://ec.europa.eu/growth/access-to-finance_en* [Accessed 3 October 2018].
2 "Financing Europe's Small Firms: Don't Bank on the Banks", *The Economist*, 16 August 2014, pp.57–58.
3 Ruth Simon, "Big Banks Cut Back on Small Business", *Wall Street Journal*, 27 November 2015, p.A1.
4 Asian Development Bank, *Asia's SMEs Need Growth Capital to Become More Competitive—ADB Report* available at: *http://www.adb.org/news/asia-s-smes-need-growth -capital-become-more-competitive-adb-report* [Accessed 3 October 2018].
5 Martin Arnold, "Alternative Finance Route for Small Firms", *Financial Times*, 5 November 2016, p.2.
6 University of Cambridge and EY, *Moving Mainstream: The European Alternative Finance Benchmarking Report* (February 2015), p.9.
7 "Peer-To-Peer Lending: Banking Without Banks", *The Economist*, 1 March 2014, p.70.
8 Amelia Murray, "Peer-to-peer lending: is it too late to profit?" (13 November 2017), *The Telegraph* available at: *http://www.telegraph.co.uk/money/special-reports/can -still-profit-peer-to-peer-lending/* [Accessed 3 October 2018].
9 P2P Finance Association's Official Website available at: *http://p2pfa.org.uk* [Accessed 3 October 2018]

- the advantages of P2P loans over bank loans from the SME financing perspective, including more diverse sources of funding, better investment returns, the time-efficient procedure and greater transparency; and
- the policy and regulatory frameworks over the P2P lending industry in the UK.

The final section draws a conclusion.

Small and medium-sized enterprises in the UK: definition and economic facts

SMEs are independent and non-subsidiary firms having employees no more than a given number. The classification standard varies across different jurisdictions. In the UK, SMEs refer to any businesses with 0–250 employees. According to the Companies Act 2006, a small-sized company should satisfy at least two of the following standards: 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 should not exceed 50.[10] A medium-sized company should meet at least two of the following standards: the turnover is no more than £36 million; the balance sheet total is no more than £18 million; and the number of employees should not exceed 250.[11] Apart from this criteria, authorities such as the Bank of England have used different methodologies to classify businesses in different sizes. For example, large businesses mean enterprises with an annual debit account turnover over £25 million while SMEs are those with an annual debit account turnover less than £25 million.[12] SMEs are entitled to extra financial support and benefits from governments under various EU and national initiatives, including research funding, competitiveness and innovation funding, lax regulatory requirements and reduced fees for administrative compliance.[13]

Table 1: The number of businesses in the UK's private sector (2017)[14]

	Business number	Employment (thousands)	Turnover (£ millions)
All businesses	5,694,515	26,723	3,739,171
SMEs (0–250 employees)	5,687,230	16,146	1,904,912
Large (over 250 employees)	7,285	10,577	1,834,259

Clearly, SMEs play an important and indispensable role in the UK's economy. As Table 1 above shows, there are approximately 5.7 million businesses in the country's private sector. SMEs (5,687,230) stand for 99.9% of the business population, while large corporations (7,285) take up only 0.1% of the total number. SMEs hire 16.1 million people (60.4%) in the private sector, compared with 10.6 million employees (39.6%) working for large businesses. It is obvious that SMEs offer the majority of working opportunities, which is critical to the Government's policies of promoting employment and economic growth. Most university students (86%) in the UK, despite their preference to join household-name companies after graduation, finally end up working for SMEs and only 14% of graduates will be recruited by large corporations.[15] This suggests that supporting SMEs will create more jobs for the next generation. Moreover, the combined annual turnover of SMEs amounts to £1.90 trillion (50.8% of the private sector), compared with £1.83 trillion (49.2%) for large businesses.

In terms of the economic output, SMEs have contributed to 49.8% of the GDP in the UK.[16] They have been dominating most business sectors, especially three industries: construction (1 million), professional, scientific and technical activities (855,000) and wholesale and retail trade and repair (541,000).[17] Apart from that, owners of SMEs tend to share a more optimistic view about their business prospect. According to the British Business Bank, 46% of SMEs planned to grow turnover while most large businesses just aimed to maintain the current market shares.[18] After the UK's vote to leave the EU (Brexit), small businesses are expected to experience fast growth amidst the overall economic slowdown.[19]

The employees of SMEs generally feel more satisfied with their jobs than those serving large corporations. A survey conducted by the Trades Union Congress indicated that SME employees have the highest job satisfactory rate (21% strongly agreeing and 41% tending to agree) compared with people employed elsewhere.[20] The survey also suggested that SME employees are most committed (64%) and loyal (58%) to their employers.[21] What is more, SME employees have been given more freedom to choose personal working patterns. They encounter fewer cases of bullying at work, lower stress levels as well as have fewer complaints about overtime working. In a nutshell, SME employees are considered as the happiest employees

[10] Companies Act 2006 s.382.
[11] Companies Act 2006 s.465.
[12] Bank of England, "Credit Conditions Review 2017 Q1" (2017) available at: *http://www.bankofengland.co.uk/publications/Documents/creditconditionsreview/2017/ccrq117.pdf* [Accessed 3 October 2018].
[13] European Commission, "What is an SME?" available at: *http://ec.europa.eu/growth/smes/business-friendly-environment/sme-definition_en* [Accessed 3 October 2018].
[14] Department for Business, Energy and Industrial Strategy, "Business Population Estimates for the UK and Regions 2017" (2017), p.3.
[15] University of Kent, "Working for Small Businesses" available at: *http://www.kent.ac.uk/careers/sme.htm* [Accessed 3 October 2018].
[16] Matthew Ward and Chris Rhodes, "Small Businesses and the UK Economy", SN/EP/6078 (House of Commons Library, 9 December 2014), p.7.
[17] Department for Business, Energy and Industrial Strategy, "Business Population Estimates for the UK and Regions 2017" (2017), p.11.
[18] British Business Bank, "Small Business Finance Markets 2014" (2014), p.4.
[19] Tim Wallace, "SMEs Expect to Grow Faster Next Year Despite Brexit Vote", (1 October 2016), *The Telegraph* available at: *http://www.telegraph.co.uk/business/2016 /10/01/smes-expect-to-grow-faster-next-year-despite-brexit-vote/* [Accessed 3 October 2018].
[20] Federation of Small Businesses, "Happiest Employees Work for Small Businesses" (2 September 2008).
[21] Federation of Small Businesses, "Happiest Employees Work for Small Businesses" (2008).

who enjoy a better work–life balance, encouraging more people to start their own businesses or join smaller firms from large corporations.

The financing options and financing situation of UK small and medium-sized enterprises

Theoretically speaking, SMEs are able to draw upon a variety of financing methods to obtain credit or capital to fund their business operation. Bank loans play a principal role in SME financing but there also exist multiple non-bank financing channels.[22] Corporate financing methods can be divided into internal funding and external funding.[23] Internal financing means an enterprise acquiring financing sources inside the business itself, such as raising capital from existing shareholders or using retained profits in previous financial years. In contrast, external financing allows entrepreneurs to gain funds from sources outside the business, such as bank loans, P2P loans, asset financing and venture capital. Moreover, corporate finance theories have categorised financing approaches into debt financing and equity financing.[24] Under debt financing, a business borrows a monetary loan from an individual, a business or a bank, with the contractual promise to repay the principal and interest.[25] Bank loans, overdrafts and private lending are typical examples of debt financing which has certain advantages over equity financing. Bounded by loan agreements, lenders are unable to intervene or control borrowers' business. Also, the costs of financing are more predictable which will be spread through a fixed period of time. The disadvantage of debt financing, however, is that borrowers are obliged to repay funds on a regular basis, even if the economic environment and business conditions deteriorate. On the other hand, corporates can make use of equity financing to raise capital by selling shares to existing or new investors through private equity (PE), venture capital (VC) and public share offering. [26] PE funds target established businesses as they seek acquisition or full control of companies with mature business models, while VC funds limit their investment decisions to early-stage companies and have a strong preference for businesses in the technology sector.[27] Public share issuance, such as initial public offering (IPO), is the process of selling shares to public investors and listing shares on regulated stock exchanges. It is complicated, costly and time-consuming, and involves the work of a group of financial and legal advisers.[28] As a result, accessing securities markets to raise funds has been the preserve of large companies rather than SMEs. Equity financing has some substantial benefits. Equity investors becoming shareholders of the businesses that raise funds will undertake and share all risks of business operation with existing shareholders. The money invested is not allowed to be returned in most circumstances. The downside is that entrepreneurs have to share business profits with new investors (shareholders) who have voting rights and can participate in the corporate decision-making process.

Despite having various financing approaches, SMEs find it difficult to obtain sufficient credits from the banking sector. The situation has gotten worse after the financial crisis and economic slowdown when most UK businesses encountered weakening consumer demand and plummeting sales and profits. As the UK has been keeping a close trading relationship with the rest of the world, its businesses suffered significant financial losses owing to the worldwide economic recession through trade, finance and other channels.[29] In particular, SMEs have been heavily hit by the crisis as they not only faced squeezed revenues and profit margins but also encountered a reducing amount of bank credit. After the financial tsunami, the financial industry has become risk-averse so banks feel reluctant to extend credit to SME borrowers. There has been a continuous decline in the amount of bank loans available for SMEs as banks tightened the lending criteria amidst risk concerns.[30] Prior to the crisis, the financial industry observed intense competition as banks competed to lend money to win greater market share. Thus, at that time, banks had less stringent loan requirements for SME borrowers. Nowadays, however, banks have become cautious about excessive risk-taking owing to stricter regulatory standards imposed by international organisations and national financial authorities, such as Basel III which requires banks to hold extra capital buffers against risky assets.[31] As a consequence, a great number of SMEs not having credit data and valid collaterals have been denied their bank loan applications. In 2007, 90% of SMEs seeking external finance managed to secure funding but the figure fell sharply to 74% in 2010.[32] Access to finance has become a top challenge for European SMEs, along with other urgent issues like customer-finding, the cost of production or labour and the availability of skilled staff.[33]

[22] Bank for International Settlements (BIS), "SME Access to External Finance", *BIS Economics Paper No.16* (January 2012), p.6.
[23] R. Glenn Hubbard, Anil K. Kashyap and Toni M. Whited, "Internal Finance and Firm Investment" (1995) 27 *Journal of Money, Credit and Banking* 683.
[24] David Hillier et al, *Corporate Finance*, 2nd European edn (Maidenhead: McGraw-Hill Higher Education, 2013), p.527.
[25] Tim Parker, "Small Business Financing: Debt or Equity?" available at: *http://www.investopedia.com/financial-edge/1112/small-business-financing-debt-or-equity.aspx* [Accessed 3 October 2018].
[26] Parker, "Small Business Financing: Debt or Equity?".
[27] Small Business Service, "A Mapping Study of Venture Capital Provision to SMEs in England" (October 2015), p.5.
[28] Alan Dignam and John Lowry, *Company Law*, 7th edn (Oxford: Oxford University Press, 2012), p.65.
[29] Bank of England, "How Have World Shocks Affected the UK Economy?" [2014] Q2 *Bank of England Quarterly Bulletin* 167.
[30] BIS, "SME Access to External Finance", *BIS Economics Paper No.16* (January 2012).
[31] BIS, "Basel III: A Global Regulatory Framework for More Resilient Banks and Banking Systems" (2011).
[32] BIS, "Basel III: A Global Regulatory Framework for More Resilient Banks and Banking Systems" (2011).
[33] European Commission, *Annual Report on European SMEs 2015/2016* (November 2016), p.20.

Table 2: Gross bank lending to businesses by size (in £ millions) [34]

	SMEs	Large businesses	Total businesses
JAN 2017	4,285	16,120	20,405
FEB 2017	4,360	12,714	17,074
MAR 2017	5,797	18,463	24,261
APR 2017	4,284	16,031	20,315
MAY 2017	4,692	16,552	21,244
JUN 2017	5,117	18,727	23,844
JUL 2017	5,194	25,474	30,668
AUG 2017	4,577	14,965	19,542
SEP 2017	4,772	14,659	19,431
OCT 2017	4,874	16,897	21,772
NOV 2017	4,515	12,788	17,303
DEC 2017	4,793	17,920	22,713

The Bank of England's lending data above has shown the great inequality regarding the allocation of bank credit towards business borrowers in different magnitude. In December 2017, financial institutions lent £22.71 billion to all businesses. Loans worth £4.79 billion (21.1%) were granted to SMEs while £17.92 billion (78.9%) were given to large businesses. As discussed previously, UK SMEs account for 99.9% of private businesses, 60% of employment and half of the national GDP. By contrast, they only obtain one-fifth of total business loans in the country. Evidently, the amount of bank loans given to SMEs is not commensurate with their economic status or actual demand, giving rise to the financing dilemma of SMEs. The problem has been further compounded by other factors. In terms of the approval rate of bank loan applications, it was 79% for small-sized businesses and 88% for medium-sized businesses.[35] It means that larger businesses have a better chance of securing bank loans. It is because most lending managers assume that the level of credit risk will go down with the increase of business size. Each year, there are 100,000 small businesses in the UK which have £4 billion loan applications being rejected by major banks.[36] Clearly, SMEs need sufficient funding to grow and prosper, otherwise they will lose business opportunities to large corporations or foreign competitors. The unequal credit provision towards different businesses leads to the SME financing puzzle, which could possibly be mitigated by alternative finance methods.

The rising fintech sector and online P2P lending market

Recent times have seen the rapid advance of financial technology (or fintech) across the world. "Fintech" refers to the application of innovative internet technologies in various financial products and services including payment, lending, securities trading, wealth management and insurance. It has given rise to novel financial activities such as mobile banking, Bitcoin, online P2P lending, insurtech and mobile payments. Small businesses and consumers are said to be the primary beneficiaries of the fintech revolution and are able to enjoy high-quality and convenient financial services at a reduced price. For example, an increasing number of shoppers have chosen to use mobile payment facilities instead of cash and credit cards. In 2016, the market scale of China's third-party mobile payment sector reached CNY38 trillion ($5.5 trillion) which is dominated by Tencent's WeChat Pay and Alibaba's Alipay.[37] The mobile payment sector in the US, consisting of major market players like Apple Pay and PayPal, also experienced drastic growth which soared by 39% to $112 trillion in 2016.[38] Fintech has also brought disruptions to the retail banking sector. In the UK, a group of so-called "digital-focused challenger banks" such as Aldermore, Shawbrook and Monzo, have abandoned the traditional branch network and exploit cutting-edge technologies to construct a low-cost banking model without any bricks-and-mortar presence.[39] These online-only (or app-based) banks aim to serve the niche market such as small business lending and smart budgeting.

The UK plays a leading role in the fintech revolution, for its fintech sector was estimated to generate £20 billion annual revenue.[40] London has become a world-class fintech hub hosting thousands of fintech businesses, reinforcing the city's status as a major global financial centre. In addition, the financial regulatory system in the UK has been regarded as the most fintech-friendly owing to its regulatory sandbox regime which strikes a fine balance between encouraging financial innovation and minimising industry disruption.[41] The booming online P2P lending market represents the frontier of the UK's fintech revolution. After the launch of Zopa in 2005, the P2P lending industry has experienced fast expansion over the past decade. Through online platforms, P2P lenders match individual and business borrowers with investors who have spare money and capital, skipping traditional banks which are credit intermediaries. According to the P2P Finance Association, "P2P lending" means

[34] Bank of England, "BankStats (Monetary & Financial Statistics)", Table A8.1 available at: *http://www.bankofengland.co.uk/statistics/Pages/bankstats/current/default.aspx* [Accessed 3 October 2018].
[35] British Bankers' Association (BBA), "Bank Support For SMEs—4th Quarter 2016" (2016) available at: *http://www.bba.org.uk/news/statistics/sme-statistics/bank-support -for-smes-4th-quarter-2016/* [Accessed 3 October 2018].
[36] Martin Arnold, "Alternative Finance Route for Small Firms", *Financial Times*, 5 November 2016, p.2.
[37] Leslie Hook and Gabriel Wildau, "China Mobile Payments Soar as US Clings to Plastic", *Financial Times*, 14 February 2017, p.12.
[38] Hook and Wildau, "China Mobile Payments Soar as US Clings to Plastic", 14 February 2017, p.12.
[39] Lerong Lu, "Financial Technology and Challenger Banks in the UK: Gap Fillers or Real Challengers?" (2017) 32 J.I.B.L.R. 273, 277–279.
[40] EY, "Landscaping UK Fintech" (Commissioned by UK Trade & Investment), p.6 available at: *http://www.ey.com/Publication/vwLUAssets/Landscaping_UK_Fintech /$FILE/EY-Landscaping-UK-Fintech.pdf* [Accessed 3 October 2018].
[41] Aime Williams, "London Fintech Comes Under Pressure", *Financial Times*, 8 October 2016, p.4.

> "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".[42]

P2P lending is also known as "loan-based crowdfunding" in Britain as the concept was invented by the Financial Conduct Authority (FCA).[43] P2P lending belongs to the mushrooming alternative finance markets which include financial instruments and distributive channels operating outside of the traditional financial industry.[44] Moreover, by removing banks from the lending train, P2P lending is dubbed as "banking without banks" which brings a better deal for both sides of lending agreements.[45] It reduces transactional costs for borrowers and provides more investment opportunities for lenders. Most borrowers of P2P loans are consumers and small businesses having restricted access to banks. When making P2P loan applications, borrowers have to submit relevant documents online, and then lending platforms will carry out the identity check, credit risk evaluation and other due diligence works. If borrowers satisfy the relevant lending criteria, their loans will be listed on the electronic marketplace and would soon be funded by registered investors.

In 2015, there were 9,400 European SMEs that collectively raised €536 million through alternative finance methods, up from €201 million in 2014.[46] The UK owns the largest alternative finance market in the EU, representing 74.3% of the total market share.[47] In the US, the online lending industry has gained huge popularity recently which is dominated by fintech giants such as Lending Club and Prosper Marketplace.[48] China also has one of the largest online lending industries as, in 2015, its total P2P lending volume amounted to CNY 975 billion ($141.9 billion).[49] At present, the UK holds over 80 P2P lending platforms underwriting P2P loans in billions of pounds each year. Since 2005, Zopa has made loans worth £2.65 billion to over 277,000 borrowers.[50] Arguably, P2P lending has gradually moved towards mainstream and forms a key component of the UK's financial industry.

Table 3: Top 10 P2P lending platforms in the UK (by loan amounts)[51]

	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	Rate Setter	£1,367,177,643	£630,681,615
4	Lend Invest	£723,989,618	£400,000,000
5	Market Invoice	£690,342,200	£32,896,796
6	Wellesley & Co	£345,042,066	£143,039,863
7	Thin Cats	£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

Table 3 above lists the 10 largest P2P lending platforms in the UK by the total amount of loans they have extended. Clearly, the P2P lending industry has evolved into a relatively mature market with some dominant market players. According to one estimate, the lending capacity of all P2P platforms was equivalent to 2% of banks in 2014.[52] Although currently P2P lending only constitutes a small proportion of total lending, its growth potential should not be underestimated. P2P lending is expected to exceed 10% of bank lending by 2020. In addition, the market has observed a high level of concentration for the top three platforms (Zopa, Funding Circle and Rate Setter) account for 60% of total loans. This could have a negative impact on the industry growth owing to the lack of effective competition.

P2P lending platforms can be grouped into different categories depending on various standards, such as the way that interest rates are calculated. Some P2P platforms allow investors to propose a predefined interest rate, upon agreement with potential borrowers.[53] Other P2P websites adopt the reverse auction model, under which lenders have to take a bid to make loans and those who offer the lowest interest rate will win the bid.[54] Apart from that, P2P platforms can be broadly divided into P2P consumer lending and P2P business lending. While most P2P lending platforms (e.g. Zopa and Rate Setter) principally target consumer borrowers, there are increasing P2P portals like Funding Circle which focus on SME lending. The latter is referred to as peer-to-business lending (P2B lending) which enables SMEs to borrow funds from a

42 P2PFA, "Rules of the Peer-To-Peer Finance Association" (May 2015), para.2.1.
43 FCA, "Crowdfunding" available at: *http://www.fca.org.uk/consumers/financial-services-products/investments/types-of-investment/crowdfunding* [Accessed 3 October 2018].
44 University of Cambridge and EY, *Moving Mainstream* (2015), p.9.
45 "Peer-To-Peer Lending: Banking Without Banks", *The Economist*, 1 March 2014, p.70.
46 University of Cambridge and KPMG, *Sustaining Momentum: The 2nd European Alternative Finance Industry Report* (September 2016), p.20.
47 University of Cambridge and EY, *Moving Mainstream* (2015), p.13.
48 Peter Rudegeair, "Layoffs Mount at Online Lenders", *Wall Street Journal*, 8 July 2016, p.C1.
49 Lingyi Finance, "P2P Lending Industry Annual Report 2015" available at: *http://01caijing.baijia.baidu.com/article/286273* [Accessed 3 October 2018].
50 Zopa, "About Zopa" available at: *http://www.zopa.com/about* [Accessed 3 October 2018].
51 P2Pmoney.co.uk available at: *http://www.p2pmoney.co.uk/statistics/size.htm* [Accessed 3 October 2018].
52 British Business Bank, "Small Business Finance Markets 2014" (2014), p.5.
53 P2PMoney, "Peer-To-Peer Companies" available at: *http://www.p2pmoney.co.uk/companies.htm* [Accessed 3 October 2018].
54 P2PMoney, "Peer-To-Peer Companies".

large pool of retail or institutional investors.[55] Compared with bank loans, P2B lending has been credited for fast speed, flexible terms, transparency and ease of use.[56] Take Funding Circle as an example, as it has a vision to revolutionise the outdated banking system. Since its establishment in 2010, Funding Circle has assisted 34,555 UK businesses in financing their business plans and lent out loans worth £3.3 billion.[57] Now it has presence in the US, Germany, Spain and the Netherlands, and its investors include the UK Government, local councils, universities and other financial organisations. In 2013, under the Business Finance Partnership, the UK Government lent £20 million to SMEs through Funding Circle. In 2014, the government-backed British Business Bank advanced £40 million to smaller business borrowers via the same platform.[58] Apparently, P2B lending portals work as a conduit between prospective investors and money-strapped SMEs, which contributes to the sustainable economic growth.

Financial disintermediation: the advantages of peer-to-peer lending over bank lending

This section summarises some advantages of P2P loans over traditional bank loans for SME borrowers. Traditionally, banking institutions play a central role in the economy as financial intermediaries which take deposits from the public and make loans to individuals, businesses and governments needing funds.[59] Nonetheless, banks have constantly been facing the problem of information asymmetry as it is difficult for them to grasp a full picture of borrowers' credit conditions. This problem is extremely serious in the area of SME lending because many smaller businesses are unable to provide sufficient materials such as trading and credit histories, lowering their chances of passing the banks' credit test. It is getting worse after the financial crisis as banks set higher lending criteria to curtail credit risks. However, the rapid growth of P2P lending is said to bridge the SME financing gap.

Financial disintermediation refers to the process of eradicating different forms of financial intermediaries from lending and investment transactions.[60] One of the enduring interests in the corporate finance literature centres on the ubiquity of intermediaries in financial markets.[61] However, an increasing number of investors, in particular institutional investors, manage to get rid of intermediaries and participate in direct corporate investments through multiple channels such as private equity. The phenomenon of financial disintermediation has been observed in debt financing as well, such as private lending and online P2P lending. The conventional banking model, where banks grant loans to individuals and corporates by leveraging the vast reserve of deposits, has both advantages and weaknesses. The participation of banks in the lending chain pushes up lending costs significantly, for banks are expensive businesses requiring substantial investments in the branch networks, properties and complex IT systems.[62] Ultimately, all expenditures will be borne by banks' customers, namely, savers and borrowers. Besides, it is time-consuming to go through lending transactions—a result of the banks' bureaucratic loan-making practices. However, financial intermediaries do bring some benefits to lending parties and to the economy as a whole. Banks are professional institutions and they are more experienced in assessing credit risks of potential borrowers, which could hardly be done by individual investors. Banks make good use of spare money in the society owing to economies of scale, for banks conduct due diligence over borrowers on behalf of millions of depositors, saving time and money for each saver.[63] Besides, banks operate a uniform lending platform for people searching credit, thus, there is no need for borrowers to seek lenders individually.

Nevertheless, the arrival of P2P lending renders traditional financial intermediaries less favourable. Legally speaking, banks act as credit intermediaries and form a creditor–debtor relationship with both its depositors and borrowers.[64] Prima facie, P2P lending platforms achieve the similar function as banks but in fact they are pure information intermediaries rather than credit intermediaries. The principal function of P2P lending websites is to assist the information exchange between investors and borrowers. In doing so, P2P platforms allow investors to find unrelated borrowers online or vice versa. Prospective borrowers list their funding requests online (e.g. amount of money, purpose of borrowing, term time and interest rate), which will be viewed by thousands of investors. By eliminating banks in the loan-making process, P2P platforms still perform money-matching (banking) activities. P2P portals do not constitute a party of relevant lending contracts that they help to conclude.

[55] University of Cambridge and EY, *Moving Mainstream* (2015), p.18.
[56] University of Cambridge and EY, *Moving Mainstream* (2015), p.18.
[57] Funding Circle, "Fast, Flexible Business Loans" available at: *http://www.fundingcircle.com/uk/* [Accessed 3 August 2018].
[58] Funding Circle, "Fast, Flexible Business Loans".
[59] Federal Reserve Bank of San Francisco, "What is the Economic Function of a Bank?" (2001) available at: *http://www.frbsf.org/education/publications/doctor-econ/2001 /july/bank-economic-function* [Accessed 3 October 2018].
[60] Paul Taylor, "Middle Men Deleted as the Word Spreads", *Financial Times*, 27 October 1998, p.15.
[61] Lily Fang, Victoria Ivashina and Josh Lerner, "The Disintermediation of Financial Markets: Direct Investing in Private Equity" (2015) 116 *Journal of Financial Economics* 160.
[62] Martin Arnold, "Big Lenders Criticised for Slow Take-Up of Technology", *Financial Times*, 14 September 2017, p.14.
[63] Economies of scale are factors that cause the average cost of producing something to fall as the volume of its output increases. See, "Economies of Scale and Scope", *The Economist*, 20 October 2008 available at: *http://www.economist.com/node/12446567* [Accessed 3 October 2018].
[64] Ross Cranston et al, *Principles of Banking Law*, 3rd edn (Oxford: Oxford University Press, 2018), p.190.

Advantage 1: More diverse funding and affordable credit for small and medium-sized enterprises

The simple and efficient business model leads to some significant strengths of P2P lending. Compared with banks, P2P lending websites are able to utilise various funding sources to arrange loans for potential borrowers. Domestic banks rely on deposits as the main source of funds, although, recently, more banks have been raising money from interbank markets and money market funds.[65] In contrast, the funding channels of P2P platforms are more diverse and have no geographical limitation. They can solicit money from individual investors, institutional investors and government agencies. For example, 72,000 individual investors have lent £2.8 billion through Funding Circle and subsequently earned £135 million in interest as investment returns.[66] Most P2P investors have been depositors who feel dissatisfied with interest rates offered by banks and thus move their money to P2P platforms. Aside from this, there are more and more institutional investors, hedge funds and wealth management companies taking part in P2P lending. In the US, almost 80% of funding in P2P platforms comes from institutional investors.[67] In the UK, the Government plays a proactive role in P2P business lending. In 2017, the British Business Bank agreed to lend £40 million to small businesses registered with Funding Circle.[68] The European Investment Bank also promised to advance £100 million to smaller companies in Britain through Funding Circle.[69] P2P lending platforms attract funding from a wide range of private and public investors globally. It breaks the geographical boundary of traditional banking businesses and supplies more funds to SMEs.

In the meantime, the costs of borrowing have been kept at a moderate level. In the P2P lending market, there is no financial intermediary to extract value from both lending parties. Unlike mainstream banks that make huge profits from making loans, P2P lending platforms embrace a cost-saving business structure with limited staff and offices. The cost advantage will be passed to end-users. For instance, Funding Circle only charges 1% of the loan amount as administrative fees.[70] As a result, it leads to a sharp fall in interest rates for borrowers as well as higher returns for investors, creating a win–win situation for lending parties. Small businesses can borrow up to £500,000 for a maximum of five years at 4.50%.[71] The actual cost of borrowing a P2P loan is no more than that of obtaining a bank loan. Furthermore, there is no early repayment fee for P2P borrowers, so small businesses can pay off business loans in one go and pay interest based on the actual period of borrowing.

Advantage 2: Better investment opportunities with higher returns

P2P lending also provides better investment opportunities for ordinary savers. Owing to the limited amount of money and inadequate investment skills, most people have narrow investment options such as saving accounts, mutual funds and pension funds. Traditional wealth management products set a high threshold for customers who have to be high net-worth individuals, which prevents average savers from purchasing such products.[72] However, the rise of P2P lending has given people more investment opportunities. The threshold for buying Zopa's classic P2P lending products is only £10. More sophisticated products of Zopa, like Zopa Plus and Zopa Core, require a minimum capital of £1,000.[73] It results from the crowdfunding nature of P2P lending. Even though the amount of P2P loans can be as large as £1 million, they are funded by a group of investors who will share the loan amount (e.g. there are 1,000 investors and each contributes £1,000). The sharing feature reduces the threshold of P2P investments.

In addition, the safety of P2P transactions has been guaranteed by both technical methods and regulatory requirements. The money of an investor will be divided into small portions and allocated to different loans automatically. The diversification reduces risk exposure to certain borrowers and minimises the impact of potential default. Besides, P2P lending platforms like Lending Works and Landbay have established special reserve funds to recover investors' money in the event of default which adds extra protection for their investors.[74]

P2P investors enjoy good monetary returns on their funds. After the global financial crisis, the interest rates have been kept extremely low by central banks around the world.[75] It leads to even negative interest rates for bank savings, for the savings rate is lower than the inflation rate. In the UK, most saving accounts offer interest rates of 0.01–1.30%.[76] Disappointed by ultra-low interest rates offered by banks, savers have been actively seeking investments that generate satisfactory yields, such

[65] John Carney, "Basics of Banking: Loans Create a Lot More Than Deposits", *CNBC*, 26 February 2013.
[66] Funding Circle, "Lending to UK Businesses" available at: *http://www.fundingcircle.com/uk/investors/* [Accessed 3 October 2018].
[67] Amy Cortese, "Loans that Avoid Banks? Maybe Not", *New York Times*, 4 May 2014.
[68] Emma Dunkley, "Funding Circle: Small Business Backing", *Financial Times*, 6 January 2017, p.17.
[69] Emma Dunkley, "Funding Circle to Allocate £100m of EU Loans", *Financial Times*, 21 June 2016, p.21.
[70] Funding Circle, "Lending to UK Businesses" available at: *http://www.fundingcircle.com/uk/investors/* [Accessed 3 October 2018].
[71] Funding Circle, "Business Loans and Funding in the UK" available at: *http://www.fundingcircle.com/uk/businesses/* [Accessed 3 October 2018].
[72] High net-worth individuals (or HNWIs) refer to people with over $1 million in liquid financial assets.
[73] Zopa, "What is the Minimum Amount that I Can Lend in Each Product?" available at: *http://help.zopa.com/customer/portal/articles/2329337* [Accessed 3 October 2018].
[74] Tara Evans, "Peer-To-Peer Lending: Everything You Need to Know About the Leading Websites" (18 July 2016), *The Telegraph* available at: *http://www.telegraph.co.uk/personal-banking/savings/peer-to-peer-lending-everything-you-need-to-know-about-the-leadi/* [Accessed 3 October 2018].
[75] Jon Cunliffe, "Why Are Interest Rates Low?" (Bank of England, 16 November 2016) available at: *http://www.bankofengland.co.uk/publications/Documents/speeches /2016/speech935.pdf* [Accessed 3 October 2018].
[76] Money Supermarket, "Easy Access Accounts" available at: *http://www.moneysupermarket.com/savings/easy-access-accounts/?goal=sav_easyaccess* [Accessed 3 October 2018].

as P2P lending. Figure 1 below presents average annual returns (5.70–7.20%) for P2P lending investors at Funding Circle from 2012 to 2017.

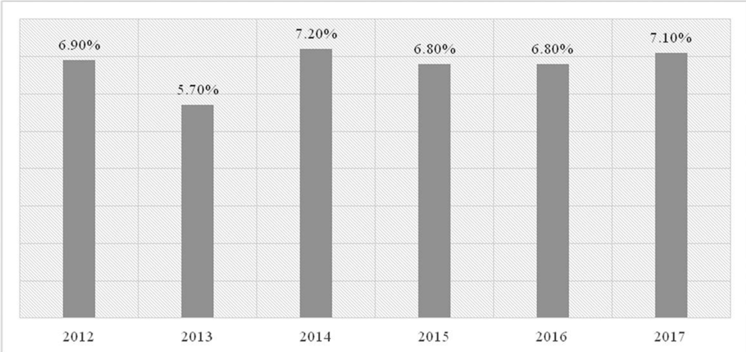

Figure 1: Annual investment return of P2P loans (Funding Circle)[77]

Without doubt, P2P lending is attractive to a large number of savers owing to the good financial return. P2P lending has the potential to become an alternative to bank savings and mutual funds. However, at present, P2P investments are not covered by the Financial Services Compensation Scheme (FSCS). Consequently, when borrowers default, investors will bear financial losses themselves. Investors may also face frauds and other investment risks. During the financial crisis, Zopa experienced its highest default rate of 5.54% of total loans. Fortunately, no P2P lending platform has ever failed in the UK.

Advantage 3: Time-efficient lending procedure

Compared with the lengthy and complicated procedure of bank lending, P2P lending is considered as fast and efficient. Funding Circle runs a straightforward and transparent loan application process for business borrowers who only need to file applications online and upload relevant materials in electronic format.[78] It takes 10 minutes for borrowers to create an application who will be allocated a dedicated loan manager immediately. Within 24 hours, borrowers will be informed of the decision regarding whether their loan applications are approved. It takes no more than seven days for Funding Circle to advertise the loans on its e-marketplace where the loans will be financed by registered investors. After receiving the funds from investors, Funding Circle will deposit the money into the bank accounts nominated by borrowers without any delay. The seven-day lending procedure is unthinkable in the traditional banking industry as it takes several weeks to process a loan application.

Advantage 4: Mitigating information asymmetry and promoting market transparency

P2P lending platforms are more capable of solving the long-lasting information asymmetry problem faced by banks. Equipped with big data and artificial intelligence, P2P platforms can accurately measure the size and location of credit risks of borrowers in few seconds. Some online lenders have employed financial engineers to design innovative risk models to evaluate a large number of variables associated with borrowers, including gender, age, marital status, educational level, working years, company size, monthly payment, loan amount, debt to income ratio and delinquency history.[79] Clearly, the application of big data lends P2P lending platforms a competitive advantage over banks when gauging credit risks of small businesses.

It remains difficult for banks to evaluate the creditworthiness of SME borrowers under the old-fashioned analytical method. In the past, community banks kept a close relationship with businesses in the same district so, when it came to loan-making, community banks had abundant informal materials to assess the credit background of borrowers.[80] Today, most community banks have been consolidated into large banking corporations which tend to rely on financial modelling and credit rating to make loans. Lots of smaller businesses, however, are unable to present sufficient materials about their businesses. Hence, they cannot pass the strict credit test and secure a bank loan.

In contrast, P2P lending platforms have been developing predictive models based on various data sources. Some of them have written algorithms to take into account business owners' personal financial information (e.g. cash flow and deposit amount), social

[77] Figure 1 was created by the author. Funding Circle, "Lend to UK Businesses" available at: *http://www.fundingcircle.com/uk/investors/* [Accessed 3 October 2018].
[78] Funding Circle, "Business Loans and Funding in the UK" available at: *http://www.fundingcircle.com/uk/businesses/* [Accessed 3 October 2018].
[79] Xuchen Lin, Xiaolong Li and Zhong Zheng, "Evaluating Borrower's Default Risk in Peer-To-Peer Lending: Evidence from a Lending Platform in China" (2017) 49 *Applied Economics* 3538.
[80] Karen Mills, "Use Data to Fix the Small Business Lending Gap", *Harvard Business Review*, 16 September 2014.

media activities as well as the general industry trend. All relevant data will be considered to judge the creditworthiness of SMEs, increasing their chances of getting a loan. However, this has raised controversies concerning personal privacy and data security, for all relevant information can only be collected, processed and disseminated by P2P portals with the full consent from owners of such information.[81]

Apart from the enhanced tool to assess credit risks, most online lending platforms conduct lending activities with high transparency as a result of strict disclosure requirements.[82] The FCA has set out detailed disclosure rules for both P2P lending platforms and potential borrowers, which will be examined in the next section. As a result, investors are able to utilise a wealth of information to make informed investment choice. Financial regulators can rely on the data to monitor the industry and identify financial risks beforehand.

Regulating peer-to-peer lending

A sound legal and regulatory framework is a prerequisite for developing the financial industry. The online P2P lending market, which has brought tremendous benefits to market participants, needs government support and well-designed regulatory rules to maximise its economic and social value.

Government policies to promote small and medium-sized enterprise finance and peer-to-peer lending

The financing difficulty of SMEs stops entrepreneurs from starting new businesses and impedes the further growth of existing businesses. To address this problem, the UK Government has promulgated a series of policies to boost SME finance. It has been working closely with the Bank of England to operate the Funding for Lending Scheme (FLS).[83] The FLS, supported by the central bank's liquidity, enables banks and building societies to borrow funds from the central bank at a discounted rate which will then extend loans to SMEs at an interest rate below the market level. The British Business Bank (BBB) was set up by the Government to bring capital from both public and private sectors to establish an effective financing market for smaller businesses.[84] The BBB is not a real bank for it does not lend money by itself but, instead, it has been given the mandate to manage government-related programmes concerning SME finance. Partnering with 80 institutions, including banks, leasing companies, venture capital funds and online lending platforms, the BBB provides extensive funding supports for entrepreneurs. As of 2015, the BBB collected £2.3 billion to finance 40,000 smaller businesses and it planned to offer extra £2.9 billion to SMEs in the upcoming years.[85]

The Government has introduced a series of initiatives to encourage private investments to SMEs, such as the Business Finance Partnership (BFP) and the Start-Up Loans Scheme (SLS). Under the BFP, the Government has invested £1.2 billion in smaller businesses through non-bank financing channels including investment funds and P2P lenders.[86] Aside from the Government's input, at least an equal amount of money will be contributed by private investors. The SLS started in September 2012 with a proposal to offer £82.5 million to young entrepreneurs aged 18–30.[87] It is run by a state-owned organisation which plans to give £2,500 to each young entrepreneur starting a new business. Furthermore, the Government has launched some tax-advantaged venture capital schemes to support SME finance, such as the Enterprise Investment Scheme, the Venture Capital Trust Scheme and the Seed Enterprise Investment Scheme.[88] Such schemes incentivise private equity investors and venture capitalists to divert more capital to SMEs as the tax relief compensates extra investment risks associated with early-stage businesses.

In addition, the Government has spent a lot of effort helping business borrowers to acquire funds from P2P lending platforms and other fintech channels. For example, it urges banks to inform small businesses that they reject of possible alternative finance methods and to pass the information of their clients to certain alternative finance platforms (e.g. Funding Options, Business Finance Compared and Funding Xchange).[89] In April 2016, George Osborne, the former Chancellor of the Exchequer, announced the Innovative Finance ISA which promises tax-free returns for British savers who invest their money into P2P loans.[90] The Innovative Finance ISA had an investment limit of £15,240 per person in the 2016/17 tax year and it was increased to £20,000 in the 2017/18 tax year.[91] The inclusion of P2P lending investments into official ISA schemes benefits the P2P lending industry, for increasing numbers of savers are expected to join P2P lending in order to enjoy the same tax-free benefits as those who save money under a cash ISA or purchase securities under an investment ISA.

[81] Information Commissioner's Office, "Big Data, Artificial Intelligence, Machine Learning and Data Protection" (2017) available at: *http://ico.org.uk/media/for-organisations/documents/2013559/big-data-ai-ml-and-data-protection.pdf* [Accessed 3 October 2018].

[82] Laura Noonan, "P2P Lenders to be Asked to Reveal Defaults", *Financial Times*, 12 August 2017, p.2.

[83] Bank of England, "Funding for Lending and Other Market Operations" available at: *http://www.bankofengland.co.uk/markets/funding-for-lending-and-other-market-operations* [Accessed 3 October 2018].

[84] British Business Bank, "What We Do?" available at: *http://british-business-bank.co.uk/what-the-british-business-bank-does/* [Accessed 3 October 2018].

[85] British Business Bank, *Annual Report 2015* (2015) available at: *http://annualreport2015.british-business-bank.co.uk/issue/14/* [Accessed 3 October 2018].

[86] Kylie MacLellan, "UK Channels Business Lending Via Alternative Financiers" (12 December 2012), *Reuters* available at: *http://uk.reuters.com/article/uk-britain-lending /uk-channels-business-lending-via-alternative-financiers-idUKBRE8BB0E920121212* [Accessed 3 October 2018].

[87] Start Up Loan's Official Website available at: *http://www.startuploans.co.uk* [Accessed 3 October 2018].

[88] HM Treasury and HMRC, "Tax-Advantaged Venture Capital Schemes: Ensuring Continued Support for Small And Growing Businesses" (July 2014).

[89] Martin Arnold, "Alternative Finance Route for Small Firms", *Financial Times*, 5 November 2016, p.2.

[90] Emma Dunkley, "Peer-To-Peer Lending Isa Brings Fresh Set of Risks, Say Experts", *Financial Times*, 11 July 2015, p.4.

[91] The Innovative Finance ISA, *2017 Guide to the Innovative Finance ISA* (2017) available at: *http://innovativefinanceisa.org.uk/the-isa/* [Accessed 3 October 2018].

Obviously, the Innovative Finance ISA levels the playing field between P2P lending platforms and traditional banks and securities brokers.

Peer-to-peer lending industry self-regulation

In 2011, Zopa, Funding Circle and Rate Setter co-founded the Peer-to-Peer Finance Association (P2PFA) as the industry self-regulatory body. The P2PFA will help to to improve the standard of business conduct in the industry and to enhance the protection of investors accessing online platforms. The association has three main goals:
(1) to seek to secure public policy, regulatory and fiscal conditions that enable the UK-based P2P finance sector to compete fairly and grow responsibly; (2) to ensure that members demonstrate high standards of business conduct, to demonstrate leadership and to promote confidence in the sector; and (3) to raise awareness and understanding of the benefits and risks of P2P Finance.[92] Most P2P lending platforms in the UK have been a member of the P2PFA which represents over 90% of market shares.[93] In order to achieve its objectives, the P2PFA promulgated operating principles for its members to follow, including some high-level principles and specific rules relating to transparency, risk management, and governance and control.[94] For instance, P2P platforms are obliged to provide adequate information for investors to make informed investment decisions, including the expected return, details of fees and surcharges, a clear warning of capital risk, where the money is lent and any automatic functions (auto-lend/auto-bid/auto-reinvest).[95] The P2PFA also requires its members to segregate the money of their customers from the P2P companies' own assets, in line with the FCA's client money rules.[96] Furthermore, the P2PFA has imposed an obligation on its members to submit data about lending volume and customer complaints on a quarterly basis.[97] Clearly, relevant operating principles are crucial to ensure a high standard of business conducts and a proper level of consumer protection in the P2P lending industry. However, these industry guidelines have been playing a supplementary role after the introduction of the FCA's official regulatory rules in 2014.

Financial Conduct Authority's official regulation over peer-to-peer lending platforms

The UK is the first country to establish an official regulatory regime for online P2P lending. The regulation of P2P lending falls within the FCA's existing regulatory framework as the FCA has included P2P lending (loan-based crowdfunding) into the regulated activities under art.36H of the Regulatory Activities Order.[98] Therefore, anyone operating P2P lending platforms has to obtain the FCA's authorisation. In October 2012, the FCA issued a consultation paper entitled "The FCA's regulatory approach to crowdfunding (and similar activities)" (CP13/13) which proposed a set of rules to protect investors accessing P2P lending and other crowdfunding platforms. In March 2014, the FCA released a policy statement called "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" (PS14/4), which outlined detailed rules for regulating P2P lending platforms. The PS14/4 came into force on 1 April 2014 and marked the establishment of a formal regulatory framework over P2P lending activities. Generally speaking, it is a disclosure-based regulatory system which protects P2P investors by promoting the information transparency of lending platforms and lending transactions. It contains rules in seven areas for P2P lending platforms, which have been summarised in Table 4 below.

Table 4: The regulation of P2P lending platforms in the UK

(1) Prudential capital requirement	The capital adequacy requirement refers to a certain amount of capital that financial institutions are asked to hold. A financial firm has to maintain a certain level of capital against its assets, which can prevent the firm from undertaking excessive risks and reduces the possibility of becoming insolvent. Banks and other deposit-taking institutions are subject to strict capital requirements under the Basel Accords. Similarly, the FCA requires P2P lending platforms to hold compulsory regulatory capital in order to withstand potential financial shocks and cover operating losses. The requirement for any UK-based P2P platforms will be the higher of the following: • a fixed minimum amount of £20,000 (transitional arrangement between 1 April 2014 and 31 March 2017) or £50,000 (from 1 April 2017); and • (a) 0.2% of the first £50 million of total value of loaned funds outstanding; (b) 0.15% of the next £200 million of total value of loaned funds outstanding; (c) 0.1% of the next £250 million of total value of loaned funds outstanding; plus (d) 0.05% of any remaining balance of total value of loaned funds outstanding above £500 million.

[92] P2PFA, "Rules of the Peer-To-Peer Finance Association" (May 2015), para.3.1.
[93] P2PFA, "Our Member Platforms" available at: *http://p2pfa.org.uk/platforms/* [Accessed 3 October 2018].
[94] P2PFA, "Peer-To-Peer Finance Association Operating Principles" (June 2015), art.3. P2PFA members must comply with the following high-level principles in all their undertakings: (1) operate their business with technical and professional competence; (2) run their business with integrity; (3) transact with customers in an honest and fair way; (4) be transparent about how their platform works; (5) promote and maintain high standards of business practice; and (6) commit to provide good value financial service products to retail consumers.
[95] P2PFA, "Peer-To-Peer Finance Association Operating Principles" (2015), art.7.
[96] P2PFA, "Peer-To-Peer Finance Association Operating Principles" (2015), art.13.
[97] P2PFA, "Peer-To-Peer Finance Association Operating Principles" (2015), arts 26–27.
[98] Financial Services and Markets Act 2000 (Regulated Activities) (Amendment) (No.2) Order 2013 (SI 2013/1881) art.36H.

(2) Client money rule	Financial firms holding money for their clients relating to investment business are subject to client money rules contained in the FCA's *Client Assets Sourcebook* (CASS). It asks relevant firms to have sufficient protection in place for the clients' money they are looking after. As the P2P lending market has become an important part of the UK's financial industry, the FCA requires P2P lending platforms, when designing their lending and repayment procedures, to comply with the CASS rules, such as the 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.
(3) Cancellation right	The EU Distance Marketing Directive (2002/65)[99] requires that, if any financial contracts are made at a distance, customers should be able to withdraw their money within the first 14 calendar days, without a penalty and the need to give any reasons. This applies to the P2P lending market as most P2P loan agreements are concluded online which fit into the definition of distance financial contracts. P2P platforms which do not have a secondary market have to satisfy one of the following two standards: • a P2P firm may allow consumers to invest in loan agreements immediately but, when requested, it should repay consumers with their money within the first 14 days; or • consumers will not be able to invest money in loan agreements within the first 14 days after they register with a P2P platform.
(4) Information disclosure rule	Information disclosure is critical to protect financial consumers as financial firms are supposed to provide accurate and adequate information for their consumers to make informed decisions. Firms have to illustrate both benefits and risks of an investment and, in particular, they should not downplay the possibility of potential losses. Investors on P2P platforms are susceptible to different types of financial risks, including credit risk, market risk, operation risk and systemic risk. Investors could suffer financial losses if their borrowers default or their platforms encounter financial trouble. Thus, investors should be given sufficient information and risk warning before joining the investment. The FCA asks 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.
(5) FCA reporting requirement	The FCA has imposed a mandatory reporting obligation on P2P lending platforms to submit information, such as financial position reports, client money reports, regular reports on investments and complaints reports. It enables the regulator to monitor the lending trend, detect potential risks as well as to ensure that consumers are treated fairly. Apparently, having sufficient industry data lays a sound foundation for effective financial regulation. At present, the FCA is conducting a consultation process with major P2P lenders, discussing potential new reporting obligations regarding the past performance of loans and the amount of due diligence work that P2P platforms have to do on the borrowers' past performance.[100]
(6) Administration in the event of failure	The insolvency of certain P2P platforms will be inevitable in a highly competitive market and, therefore, it is necessary to have an administration procedure in place to protect investors as well as to reduce the negative impacts on the economy. P2P loan agreements are entered into by lenders (investors) and borrowers, while P2P platforms only serve as information intermediaries who are not considered as a contractual party. Accordingly, the failure of a P2P lending platform will not cause direct economic losses to investors using that platform. However, it will be difficult for individual investors to administer their loans if their online platforms no longer exist, for all contracts have been made in an electronic form and in most cases investors do not even know the identity of their debtors. It is common that one investor only owns a small percentage of a P2P loan which has been crowdfunded by hundreds of investors. Therefore, in order to protect investors' interests when a platform goes bust, the FCA requires P2P lenders to set up the following arrangements in advance: • 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 late repayments or borrower defaults should come into effect.
(7) Dispute resolution process	It is imperative to have a complaint procedure for financial consumers who feel prejudiced or unsatisfied about the financial services they are receiving. Thus, the FCA requires P2P firms to establish a complaint handling process for investors. After the internal procedure, investors are entitled to take their complaints further to the Financial Ombudsman Service.

Conclusion

SMEs are of paramount importance to the UK's economy; they account for 99.9% of the business population, 60% of the private sector employment as well as half of the national GDP. Nonetheless, SMEs only obtain one-fifth of total business loans from banks as financial institutions hesitate to lend to smaller businesses after the crisis.

Obviously, the amount of financial resources allocated to SMEs do not match their economic contributions and actual demands, resulting in the longstanding SME financing dilemma. This article has discussed the UK's rising online P2P lending market from a functional perspective and concludes that P2P lending can be utilised by SMEs as an alternative finance method to close the financing gap. P2P lending has multiple advantages over bank lending as financial disintermediation brings extra

[99] Directive 2002/65 concerning the distance marketing of consumer financial services and amending Directive 90/619 and Directives 97/7 and 98/27 [2002] OJ L271/16.
[100] Laura Noonan, "P2P Lenders to be Asked to Reveal Defaults", 12 August 2017, p.2.

value for both savers and borrowers. This article has also analysed relevant policies and regulatory rules relating to the P2P lending sector. The UK Government has launched several projects to promote SME finance like the FLS, the BFP and the Innovative Finance ISA. In a nutshell, the Government has tried to reduce SMEs' reliance on traditional banks and to build a multi-level financing system for smaller businesses. The current regulatory framework is comprised of the industry self-regulation and the FCA's official regulation. Since 2014, the P2P lending market has entered into a new era, for loan-based crowdfunding has been included in the FCA's regulated activities and P2P lending platforms have to comply with a series of regulatory requirements that range from prudential capital requirements to business conduct rules. Arguably, the online P2P lending industry, under effective and efficient regulation, will continue to experience fast growth in the future, supplying more funds to SMEs.