ISA Peer to Peer Consultation
Pensions and Savings Team
HM Treasury
1 Horse Guards Road
London
SW1A 2HQ

By email to: ISAPeertoPeerConsultation@hmtreasury.gsi.gov.uk

12 December 2014

Dear Sirs,

ISA qualifying investments: Consultation on including peer-to-peer loans

The Investment Management Association (IMA) represents the asset management industry operating in the UK. Our members include independent asset managers, the investment arms of retail banks, life insurers and investment banks, and the managers of occupational pension schemes. They are responsible for the management of around £5trn of assets, which are invested on behalf of clients globally. These include authorised investment funds, institutional funds (e.g. pensions and life funds), private client accounts and a wide range of pooled investment vehicles.

While the majority of our members no involvement in alternative finance platforms such as peer-to-peer lending and crowdfunding, we recognise the growing significance of this sector and the new investment opportunities these provide, as well as providing alternative sources of funding for sectors of the economy where funding from traditional sources (e.g. bank lending) has proved more difficult to secure. In principle, the IMA supports initiatives that provide greater flexibility to investors, provided this is balanced by suitable investor protection measures. As such, we note and cautiously welcome the government's decision to give greater flexibility to investors by allowing peer-to-peer loans to be held within an ISA.

We do, however, believe it is important that the potential risks and limitations of such investments are recognised and addressed within the ISA framework. There needs to be an appropriate balance between enabling investors for whom peer-to-peer loans are an appropriate form of investment to benefit from the tax efficiencies of holding such loans within an ISA while ensuring suitable safeguards are in place to prevent less knowledgeable investors from taking risks with their capital that they do not understand.

65 Kingsway London WC2B 6TD

Tel:+44(0)20 7831 0898 Fax:+44(0)20 7831 9975

www.investmentuk.org

Investment Management Association is a company limited by guarantee registered in England and Wales. Registered number 4343737. Registered office as above.

While to date engagement by retail investors in peer-to-peer lending has largely been confined to more experienced and knowledgeable investors, the availability of peer-to-peer lending is likely to broaden the appeal of peer-to-peer lending to a wider range of investors, including those who may lack understanding of the nature of such investment and the risks involved. In the current low yield environment, there is a danger that investors may view peer-to-peer lending as an alternative to the low rates of interest available on traditional Cash ISA accounts without fully appreciating the risk to their capital and limitations on access to their capital. It is therefore increasingly important that the regulatory framework for peer-to-peer loans is sufficiently robust, and where appropriate, is of an equivalent standard to the regulatory framework for other financial products particularly in key areas such as investor disclosure.

We therefore strongly support the government's proposal to make advising on peer-to-peer lending a regulated activity. We also believe that, given the characteristics of peer-to-peer loans differ significantly from other investments that are eligible for stocks and shares ISAs that a separate label should apply for peer-to-peer loans in the form of a third ISA type so they can be more easily recognised and distinguished from other types of ISA investments, accompanied by robust risk disclosures. In addition, we suggest that only peer-to-peer loans on peer-to-peer lending platforms where there is an active secondary market or an alternative early redemption mechanism should be eligible for ISAs, to ensure the principle of liquidity and transferability of ISAs can be maintained.

As peer-to-peer lending becomes more established as an alternative form of investment (a process that is likely to be accelerated when such loans become qualifying ISA investments), further consideration should be given to investor protection measures in order to promote investor confidence in the UK financial system. It may therefore be appropriate to reassess whether peer-to-peer lending platforms should remain outside the scope of the Financial Services Compensation Scheme (FSCS).

Attached are our responses to the questions raised in the consultation paper that we consider are most relevant to our members. If you would like to discuss the issues raised in more detail, please contact Peter Capper (Peter.Capper@investmentuk.org).

Yours faithfully

Peter Capper
Adviser, Product Regulation
Investment Management Association

IMA response to ISA Peer-to-peer loans consultation

Question 2 Do respondents agree that the government's proposed approach provides sufficient clarity as to which peer-to-peer loans will be eligible for ISA inclusion?

Yes

Question 3 Do respondents agree that the proposed regulatory requirements strike the correct balance between investor protection and a proportionate regulatory regime?

We agree that a proportional regime should apply to peer-to-peer lending as well as to other forms of regulated activities. While there will inevitably be differences across the regulatory regimes due to different features of products, we believe the same principles should be applied when determining the regulatory regime for all regulated activities. Investor protection should be the primary consideration.

In this respect, we welcome the proposal by the government to make the provision of advice to investors on loans made through peer-to-peer platforms a regulated activity. The government's proposal in relation to firms currently holding FCA authorisation to advise on investments is reasonable. Such firms are already subject to a high standard of regulation and should not be subject to further requirements in order to advise on peer-to-peer lending. It is however important that firms seeking authorisation to provide advice to investors on loans made through peer-to-peer platforms, particularly those who operate a peer-to-peer platform and therefore may have a conflict of interest, are subject to the same regulatory standards as those required by firms advising on other types of investment.

Question 6 Do respondents have any concerns regarding FCA-authorised firms operating peer-to-peer platforms being allowed to act as ISA managers? If so, what are they?

There are potential issues that should be considered which may apply to some (although not necessarily all) FCA-authorised firms operating peer-to-peer lending platforms. Firstly, these firms should be able to demonstrate they have adequate operational and administrative capabilities in order to manage ISAs and have adequate capital resources, and in particular can manage a significant increase in demand that is likely to arise when peer-to-peer loans can be held within ISAs. Secondly, firms should be able to demonstrate that they have suitable mechanisms in place to enable ISAs to be transferred out within an acceptable timeframe (our responses below discuss these in more detail).

Finally, such firms should rigorously comply with the FCA's financial promotion rules, given that peer-to-peer loans are likely to be more attractive to retail investors when these are available within ISAs. In particular, prominence must be given to clear and unambiguous warnings advising investors that their capital is at risk, and that peer-to-peer loans are not covered by the Financial Services Compensation Scheme. We note that in a recent adverting campaign one prominent the warning given by one peer-to-peer lending platform was "Capital is at risk, although no customer has ever lost a penny" - in our view the second part of the warning downplayed the potential capital risk. In respect of financial

promotions, the same regulatory standards should be applied to peer-to-peer lending platforms as for other ISA managers in order to protect investors.

Question 7 Do respondents see any risks arising from firms operating peer-to-peer platforms approved as ISA managers not being required to have legal ownership of peer-to-peer loans held within ISAs?

We believe it would be preferable for firms operating peer-to-peer platforms approved as ISA managers to have legal ownership of these loans, for the purposes of withdrawals and ISA transfers. Such transactions will be easier to facilitate if the ISA manager has legal ownership of the loans.

Question 8 Are there any drawbacks to the proposed withdrawal procedure for peer-to-peer loans? If so, what are they?

Our concern is that this procedure is likely to be open to misunderstanding by investors. It is unusual for an investor to choose to remove their investment from the tax protection offered by an ISA wrapper without them wanting the investment to be liquidated and to receive the cash proceeds. If an investor gives an instruction to the peer-to-peer platform to withdraw loan from the ISA, with the intention that the loan is liquidated, and the loan is merely removed from the ISA, if the investor subsequently has to liquidate the loan this will no longer enjoy the tax protection of the ISA wrapper and hence the investor may incur tax liabilities (such as Capital Gains Tax) which they might not otherwise have incurred. However, we agree that if the investor has the legal ownership of the loan rather than the ISA Manager, it is difficult to envisage a procedure other than the one proposed.

In our view it would be preferable for the ISA Manager to have the legal ownership of the loans. This would enable the ISA Manager to liquidate the loan on receipt of the ISA withdrawal instruction, which is likely to be the intention of the investor, unless the investors states otherwise.

Question 9 If the transfer requirement is applied to peer-to-peer loans – do respondents foresee any risks or detriment for consumers resulting from the proposed modification of the current ISA requirements? If so, what are these?

Yes. We believe the outlined process introduces additional complexities for investors. It has to date been a key principle that an ISA provides prompt liquidity, so an investor can withdraw or transfer their ISA within a reasonable time frame. We note that on the basis of this principle, investment products that would otherwise be qualifying investments for an ISA have been excluded, e.g. authorised funds with limited redemption facilities. We believe it should in theory be possible for a peer-to-peer loan platform to be able to offer a structure where timely liquidation and transfer is feasible, and such a facility should be a condition of the loans of a peer-to-peer platform being qualifying investments.

In the process outlined, the investor will need to arrange the sale of the loan to a third party before the ISA transfer can take place. If so, there is the possibility the sale instruction might be misinterpreted as a withdrawal and the sale proceeds removed from the ISA. Secondly, there will be additional complexity for the ISA manager if they receive an ISA transfer request, but the sale of the loans has not been completed by the investor. They would presumably need to contact the investor to initiate the sale of the loans, hold the instruction and would need to monitor the account to ensure the ISA transfer request

was promptly completed on completion of the loan sales by the investor. In the event of a delayed sale, it is likely the ISA transfer request would need to be rejected. This process could result in confusion as to what stage the transfer was at. Such a process could prove a deterrent to investors transferring their ISAs, thereby creating a barrier to an investor switching products (a breach of Principle 6 of the FCA's Treating Customers Fairly Principles).

As stated above, we believe it will be preferable for the ISA manager to be required to have the legal ownership of the loans. This would ensure that the ISA manager would have full end-to-end ownership of the ISA transfer process, including finding a buyer for the loans. We believe this process would be in the interests of ISA investors and ultimately be less complex for both the investor and the ISA manager.

Question 10 Following the sale of the peer-to-peer loan and transfer instructions from the investor, what would be the most appropriate time period within which the cash realised should be transferred?

We do not believe that a transfer of the realised cash should reasonably take any longer than 10 business days from receipt of the transfer instruction.

Question 11 Is the proposed modification to transfer requirements likely to present any difficulties or administrative obstacles for ISA managers (including those receiving transfers)? If so, what are these?

Yes. The proposed modifications could result in additional administration for the receiving ISA manager in dealing with an increase in rejections from the current ISA manager and uncertainty as to the timing of receipt of the ISA transfer proceeds.

Question 12 What are respondents' views on requiring the existence of a secondary market in order for a peer-to-peer loan to qualify for ISA eligibility? Would such a requirement provide a useful degree of reassurance to investors?

Requiring the existence of a secondary market in order for a peer-to-peer loan to qualify for ISA eligibility is one option. It is important that ISA investors are confident that they can cash-in or transfer their ISA when they want to, and the existence of an active secondary market would be the preferable route to achieving this. However, where an active secondary market is not available, then as suggested in section 5.4 the existence of a contractual arrangement with firms to buy any unsold loans held within ISAs may also achieve this aim.

As loans may be difficult to liquidate, it is likely that in the event of early liquidation or an ISA transfer, the value realised or transferred will be significantly less than the capital invested and the expected maturity value of the loan. It is important that ISA investors are made aware of this risk before they enter into investments in peer-to-peer loans through appropriate investor pre-disclosure.

Question 13 Would a requirement to offer a secondary market pose any problems or difficulties for peer-to-peer platforms and if so, what are these? Could secondary market arrangements of this type be easily defined?

We believe any difficulties in platforms providing a secondary market or a contractual buyer would be outweighed by the benefit of early ISA liquidation and transferability. We believe these factors are critical to maintaining the confidence of the public in the ISA brand.

Question 14 Do respondents think that a guarantee of a sale at market value within a given period would be desirable in addition to the proposed requirement of a secondary market?

Yes. Provided the conflicts of interest could be appropriately managed, this could in theory be an alternative to a secondary market being provided by the platform. This arrangement should ensure that the investor receives a fair price for the loan based on market rates (eg. based on secondary loan transactions on the same peer-to-peer platform or, if not available, those on comparable rival platforms).

Question 15 Is there merit for investors in requiring that there must be a mechanism by which loans can be sold at market value within a given period? What period should this be, taking account of the times taken at present to achieve sales on existing secondary markets?

Yes. We believe the period should be no longer than 10 business days in order to facilitate a timely ISA transfer.

Question 17 Overall, do respondents feel that the benefits to investors from applying transfer requirements to peer-to-peer loans held in ISAs outweigh the possible risks of doing so?

We believe it is critical for the reputation of the ISA brand that all ISAs are transferable, and therefore the transfer requirements should be applied to peer-to-peer loans held in ISAs. The failure to apply such a requirement would put other ISA managers at a competitive disadvantage vis-à-vis peer-to-peer platform ISA managers, whereby an investor could transfer their ISA from an ISA manager to the peer-to-peer platform ISA manager, but an investor would not be able to transfer an ISA from the peer-to-peer platform ISA manager to the ISA manager. Such a restriction would in our opinion be anti-competitive.

Question 19 How important is it that investors should be able to mix peer-to-peer loans with other eligible investments within their ISA in a single tax year? Do respondents believe most investors wishing to place peer-to-peer loans into an ISA account will additionally want to invest in other types of non-cash ISA investments within the same tax year?

We believe it is important that investors have the flexibility to invest in other eligible investments alongside peer-to-peer loans for the purposes of risk diversification. Peer-to-peer loans are a relatively new development and have yet to be tested in adverse market conditions. It is uncertain how these loans will perform in rising interest rates or an increase in loan defaults. In addition, the majority of peer-to-peer lending platforms have only been in existence for a relatively short period, are loss making and hold less capital than the providers of other eligible investors. In the absence of FSCS protection, peer-to-peer loans should be considered high risk investments. It is therefore critical that investors have the opportunity to hold other eligible investments in addition to peer-to-peer loans in order to diversify their risks.

Given that current investors in peer-to-peer loans tend to be relatively experienced and knowledgeable investors, we believe it is likely that they will want to invest in other types of non-cash investments within the same tax year, as they are likely to be using peer-to-peer loans within a wider investment strategy.

Question 20 Would a third ISA type be helpful in alerting investors to the different rules which will apply to peer-to-peer loans within ISAs? Overall, would a third ISA type aimed specifically at alternative finance products such as peer-to-peer loans be a good thing – and if so, why?

Yes, we believe a third ISA type would be helpful in order for investors to differentiate between the specific risks of alternative finance products and other eligible investments. In addition, we believe it is unlikely that many peer-to-peer loan platforms will be able to (or will want to) offer a wider range of investment products, and we do not believe many existing ISA managers are likely to offer peer-to-peer loans as part of their ISA package in the short term.

We believe that such an approach may also be beneficial for the peer-to-peer lending platforms, as investors may be more likely to use their ISA allowance for such loans if that does not preclude them from using their ISA allowance to invest in other eligible investments in the same tax year.

Question 21 What potential difficulties or challenges might the creation of a third ISA type present for savers, investors, ISA managers or others?

We believe such challenges should be limited, provided the label chosen is clear. It is unlikely that many existing ISA managers will choose to offer peer-to-peer loans within an ISA, and as such implementation will largely be restricted to new ISA managers in the form of peer-to-peer lenders, who would have to implement system and process requirements to accommodate ISAs in any case.

The main challenge will be for investors to understand their need to look across three ISA types in order to assess their ISA limit. However, we do not believe this will be materially different to the current position, where investors already have to look across two ISA types in order to assess their ISA limit.

Question 22 If the government decides not to introduce a third ISA type, how can we best ensure that customers are clear about the special characteristics associated with peer-to-peer loans, for example that they are not covered by the FSCS, and that they may be difficult to liquidate?

We believe the characteristics of peer-to-peer loans differ significantly from other investments that are eligible for stocks and shares ISAs, and as such we would urge the government to introduce a separate label for peer-to-peer loans in the form of a third ISA type so they can be more easily recognised and distinguished from other types of ISA investments. If the government decides not to do this, then strict disclosure requirements must apply in respect to holding peer-to-peer loans in respect of their capital risks, the fact neither the loans nor the peer-to-peer lending platforms are covered by the FSCS, that the loans may be difficult to liquidate and that in the event of early liquidation or an ISA transfer, the value realised or transferred may be significantly less than the capital invested and the (expected) maturity value.

Question 23 Do respondents have any concerns about offering a tax advantage where loans made by or on behalf of children might be made without knowledge of the intended recipient(s) or usage of the loaned funds? If so, what are they?

At minimum, the following issues should be considered before allowing peer-to-peer loans to be made by or on behalf of children within Junior ISAs or CTFs:

- Who will have responsibility for debt recovery in the event a borrower defaults?
- The length of a loan relative to the child's age, i.e. should a loan be permitted that will mature after the child's 18th birthday, when they will assume control of the account?
- What happens to the proceeds when a loan matures?

Question 24 Do respondents agree that if peer-to-peer loans are made eligible for CTFs and Junior ISAs, these loans should be in the legal ownership of the ISA manager? If not – what alternative approach might be considered?

Yes.