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RATESETTER SUBMISSION

The Financial System Inquiry
Online submission

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Dear Panel Members

FINANCIAL SYSTEM INQUIRY - RATESETTER SUBMISSION

1. EXECUTIVE SUMMARY

Retail Money Market Limited (United Kingdom company number 7075792) is a London-based peer-to-peer (or "P2P") lending business that operates under the trademarked name "RateSetter". RateSetter is one of the world's leading P2P lending companies, and operates in Australia through RateSetter Australia Pty Limited.

Ratesetter is pleased to provide this submission to the Financial System Inquiry. RateSetter's business model and offerings to consumers are highly relevant to the scope of the inquiry in seeking recommendations that will "foster an efficient, competitive and flexible financial system, consistent with financial stability, prudence, public confidence and capacity to meet the needs of users".

The P2P lending industry has developed primarily as a consequence of the proliferation of the internet, improved availability of borrower credit information and the inefficiencies in traditional retail banking. The industry is small relative to the size of global debt markets, with only circa US$3.5 billion in loans facilitated by P2P lending in 2013. However, the industry is growing quickly in a number of markets, including in the United Kingdom and the United States, where it is achieving growth in excess of 100% annually. This growth has been supported in part by the support of various governments and regulators, given a general acceptance of the benefits P2P lending can bring to financial systems.

RateSetter expects to be the first company to provide P2P lending services to retail consumers in Australia when it launches in the middle of 2014.

RateSetter believes that any review of the Australian financial system should recognise the benefits that P2P lending can bring to the Australian financial system, including:

i. Providing competition to mainstream retail banks, for both investors (a term which for the purposes of this submission equally includes lenders and savers) and borrowers;

ii. Providing an alternative to mainstream retail banks, for both investors and borrowers;

iii. Increasing the range of asset classes to which investors have access; and

iv. Reducing systemic risk in the banking sector.

RateSetter believes that any recommendations from the Financial System Inquiry should:

i. Ensure that P2P lending in Australia remains appropriately regulated, and that such regulation should continue to apply high thresholds on operators in evidencing their ability to competently provide P2P lending services to customers;

ii. Ensure that there are no amendments to any legislation or regulations that restrict the growth of the P2P lending industry in Australia; and

iii. Recognise the substantial differences between P2P peer lending and equity crowdfunding, and that the regulatory regime for each category should remain distinct.

RateSetter would welcome the opportunity to contribute further to the Financial System Inquiry and enhancement of Australia's financial system.

2. RATESETTER

RateSetter was founded in 2009 by Rhydian Lewis, its Chief Executive Officer, and Peter Behrens, its Chief Operating Officer. It has since grown rapidly to become the fastest growing P2P lending business in the United Kingdom, and one of the largest and most successful P2P lending businesses globally.

RateSetter's primary business activity is to manage and operate the RateSetter P2P lending platform, which matches lenders with highly credit worthy borrowers to facilitate personal loans that are attractive to both lender and borrower.

RateSetter's rapid growth has been driven in part by RateSetter introducing an innovation that has made P2P lending simpler and safer for investors, being its Provision Fund, a pool of money funded by borrowers, but which helps protect lenders in the event of a borrower's default.

Since its launch RateSetter has achieved numerous milestones, including:

i. Attracting over 10,000 investors and 25,000 borrowers and matching over £200 million in personal loans;

ii. Managing credit risk and its unique Provision Fund such that every investor has received every amount of principal and interest monies due to them;

iii. Co-founding the P2P Finance Association in the United Kingdom, and introducing related stringent rules of membership and operating principles; and

iv. Successfully campaigning for the United Kingdom Government to regulate the P2P lending industry, and helping to shape the form of P2P lending regulation that will be introduced to the United Kingdom in April 2014.

RateSetter has won a number of significant industry awards, reflecting the positive impact it has had on the United Kingdom consumer loan market for both investors and borrowers, including:

i. Best Peer To Peer Savings Provider, Moneynet Personal Finance Awards, 2014

ii. Most Trusted Specialist Finance Service Provider, Moneywise, 2013

iii. Most Trusted Loan Provider, Moneywise, 2013

iv. Best New Savings Provider, Moneynet Personal Finance Awards 2013

Further, RateSetter has been recognised for providing exceptional customer service, and according to a number of sources, it achieves the most positive consumer reviews of any financial services business in the United Kingdom.

RateSetter has had a local team in Australia working on its launch to consumers for over 18 months. RateSetter anticipates being Australia's first P2P lending operator with an Australian Financial Services licence and Australian Credit Licence providing services to retail consumers, and intends to commence its services to Australia consumers in the middle of 2014.

3. PEER-TO-PEER LENDING

3.1 P2P lending concept

P2P lending can be effected in a number of ways, although it is generally defined as a loan contracted between previously unrelated individuals (or "peers") without the intermediation of a traditional financial institution, such as a bank.

The practice of P2P lending takes place on online platforms and is ordinarily facilitated by, *inter alia*, sophisticated borrower identification and credit-checking, investor and borrower matching, and customer support capabilities.

Loans matched between borrowers and lenders on a platform are administered by the P2P lending operator, including the credit assessment process, the establishment of loan contacts, the facilitation of payments between borrower and lender, and any enforcement/collection processes in cases of late payment of default by borrowers.

3.2 Benefits of P2P lending

P2P loans can deliver attractive financial outcomes to both investors and borrowers by, *inter alia*:

i. Introducing more efficient loan application and maintenance processes, which reduce the costs associated with effecting loans;

ii. Introducing robust credit checking processes and charging borrowers interest rates reflective of their credit quality, therefore allowing premium credit borrowers to achieve substantially more attractive borrowing rates, as they avoid having to subsidise the greater risk of default of higher risk borrowers; and

iii. Allowing investors and borrowers to avoid having to fund the substantial profits generated by banks and other financial institutions.

In addition, P2P lending can provide systemic benefits to financial markets by, *inter alia:*

i. Increasing competition for retail investors and borrowers in markets traditionally dominated by large banks, through a combination of:

   - providing more attractive interest rates for investments and loans than existing offerings; and

- enhancing customer experiences, for example, through streamlined online loan applications, user friendly loan reporting and management and superior customer service;

ii. Reducing risk in the banking sector by diversifying financial resources away from a concentrated core of 'too big to fail' institutions; and

iii. Introducing risk-based pricing for loans, which increases credit availability in credit-worthy sectors and reduces the inefficiencies brought about by requiring more credit-worthy borrowers to effectively subsidise lesser-quality borrowers.

3.3 Development of P2P lending

The P2P loan industry was established in 2006 with the launch of Zopa Limited (www.zopa.com) in the United Kingdom. Since that time a number of other players have been launched and are now well established:

i. In the United Kingdom, as well as Zopa Limited, the major players are RateSetter (www.ratesetter.com) and Funding Circle (www.fundingcircle.com). These three operators have to date matched circa £1.0 billion in loans, and are together currently matching approximately £80 million in new loans each month;

ii. In the United States the major operators are Lending Club Inc. (www.lendingclub.com) and Prosper Marketplace Inc. (www.prosper.com), which have together matched over US$5.0 billion in loans, and are currently matching over US$300 million in new loans each month; and

iii. Other P2P loan businesses are gathering momentum in Germany, Spain, China, Korea and a number of other geographic markets.

The development of the P2P loan industry has been described as one of the most significant aspects of innovation currently taking place in the financial services sector globally and is expected to drive a transition leading to significant improvements in retail banking:

i. Various market commentators, analysts and indeed some central bankers believe P2P loan businesses may gain a substantial share of loan markets over the next 15-20 years. Andrew Haldane, Executive Director for Financial Stability, Bank of England, in March 2012, notes:

> *"With open access to borrower information, held centrally and virtually, there is no reason why end-borrowers and end-investors cannot connect directly. The banking middle men may in time become the surplus links in the chain. Where music and publishing have led, finance could follow".*

ii. This transition is underpinned by proliferation of the internet, greater propensity for consumers to use the internet to manage finances, greater availability of credit information on borrowers (including in an Australian context the introduction of comprehensive credit reporting), and the continued development of businesses that are challenging the traditional retail bank model and more effectively meeting consumer needs;

iii. This transition has accelerated following the global financial crisis as banks globally face higher costs of capital, are generally focused on reducing leverage and are the focus of significant consumer frustration and resentment in situations where they either require government support or are maintaining what some consider to be excessive levels of profitability.

3.4 Growth of P2P lending

The total value of loans facilitated by P2P loan businesses globally was around US$3.5 billion in 2013, and historical industry growth rates over 100% per annum are expected to be maintained, implying over US$20 billion in P2P loans will be facilitated in 2016.

It is expected that future growth of the P2P lending industry will come from the geographic expansion of existing operators, an increased number of operators and the development of new P2P lending products and models. A number of financial market segments have already benefited from operators launching with new P2P lending products, including small-medium business lending, secured personal lending, property financing, asset purchasing and student loan financing. The growth of P2P lending into these markets can bring many benefits, as some exhibit limited competition from existing participants and provide relatively poor consumer experiences.

3.5 P2P lending in Australia

Despite the success of the industry offshore, to date there has not been a regulated P2P loan business launch in Australia in a form that can accept investment from retail consumers. RateSetter expects to be the first such operator.

A number of characteristics of the Australian financial system would indicate that P2P lending should be successful in Australia, including:

- A deficit of competition in loan markets, mostly as a consequence of a high level of banking market concentration;
- A substantial spread between saver and borrower interest rates;
- The recent introduction of comprehensive credit reporting, which will provide greater borrower information to new market entrants and will facilitate the introduction of risk adjusted credit pricing;
- A high propensity for consumers to use the internet to manage their finances; and
- P2P lending operators being regulated by ASIC (refer below), adding credibility to the industry.

In anticipation of the further development of the Australian P2P lending sector, RateSetter is currently in discussions to establish an Australian P2P Finance Association, which will be an industry body charged with producing and monitoring a set of guidelines and standards for best-practice P2P lending platform operation in Australia, as well as engaging further with other parts of the financial sector to build awareness of P2P lending and its potential benefits to the Australian financial system.

4. OVERSEAS REGULATORY SUPPORT

The P2P lending industry has generally received strong regulatory support internationally, on the basis it can bring significant benefits to both investors and borrowers, and also to society through reducing systemic risk in the banking sector, increasing banking sector competition and improving consumer credit availability.

The United Kingdom provides an important case study in terms of regulation of P2P lending, as over the last year a specific P2P lending regulatory regime has been designed by the United Kingdom's Financial Conduct Authority ("FCA"), which will come into effect in April 2014. There are a number of important observations and learnings that can be taken from the review by the FCA and the regulatory regime consequently being implemented, including:

i. The new regulatory regime will supportive of P2P lending, and will not result in any of the main three operators, RateSetter, Zopa and Funding Circle, having to substantively alter their business models;

ii. The new regulatory regime requires that any P2P lending operator can evidence their capacity and competency in terms of:

    - Conduct of business (in particular, around disclosure and promotions);
    - Minimum operating capital requirements;
    - Client money protection; and
    - Dispute resolution;

iii. The new regulatory regime is largely consistent with the principles of the UK P2P Finance Association, which RateSetter was instrumental in designing;

iv. The new regulatory regime might be considered 'light-touch' relative to the regulatory requirements that apply to any P2P lending business in Australia. This is because P2P lending in Australia falls within the Corporations Act 2001 definition of operating a 'Managed Investment Scheme', and therefore operators must comply with the comprehensive requirements of Chapter 5c of the Corporations Act 2001; and

v. The regulatory regime for P2P lending will be distinct from equity crowd funding. The FCA recognised that the two industries provide quite different functions, and represent considerably different benefits and risks for consumers.

Further, it should be noted that this P2P lending regulatory regime has been developed in the context of strong support from the United Kingdom Government, Treasury and the Bank of England. Most notably, the United Kingdom Treasury is investing ~£50 million into the sector as a lender. This support is also evident from the most comprehensive review of the banking sector to be undertaken in the United Kingdom, which was a House of Lords/House of Commons report titled "*Changing banking for good - Report of the Parliamentary Commission on Banking Standards, Volume II*", released in mid-2013, which included the following observations:

> *"Peer-to-peer and crowdfunding platforms have the potential to improve the UK retail banking market as both a source of competition to mainstream banks as well as an alternative to them. Furthermore, it could bring important consumer benefits by increasing the range of asset classes to which consumers have access. This access should not be restricted to high net worth individuals but, subject to consumer protections, should be available to all. The emergence of such firms could increase competition and choice for lenders, borrowers, consumers and investors."*

5. FINANCIAL SYSTEM INQUIRY RECOMMENDATIONS

To the extent that the Financial System Inquiry deems that regulation specific to P2P lending should be developed, RateSetter would make the following observations:

i. A bespoke P2P lending regulatory regime would not need to be created for some time, given the infancy of the sector and the very small size of operators;

ii. Any new regulatory regime should ensure that high thresholds are maintained for operators evidencing competence for providing P2P lending services, including specific requirements in relation to:

   - Senior management experience and competency;
   - Minimum operating capital requirements;
   - Segregation of participants' funds and auditing of the segregated bank account;
   - Appropriate credit and affordability assessment;
   - Clear rules governing use of the platform;
   - Marketing and customer communications that are clear, fair and not misleading;
   - Secure and reliable IT systems;
   - Fair complaints handling; and
   - The orderly administration of contracts in the event a platform ceases to operate;

iii. Any new regulation should maintain an emphasis on the operator making full disclosures as to any risks relevant to investors, however, it should also ensure all parts of the Australian market are able to access to P2P lending, including both wholesale and retail investors.

6. CLOSING STATEMENTS

RateSetter would like to thank the Financial System Inquiry panel for providing the opportunity to express views on the development of the Australian financial system, especially in relation to P2P lending.

RateSetter would welcome the opportunity to speak directly with Financial System Inquiry panel members, Government or ASIC to discuss P2P lending and also the current and future regulation of this very important industry.

Yours truly

Daniel Foggo

Daniel Foggo
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RateSetter Australia Pty Limited

ANNEXE 1: FURTHER READING

IOSCO – *Crowd-funding: An Infant Industry Growing Fast*
http://www.iosco.org/research/pdf/swp/Crowd-funding-An-Infant-Industry-Growing-Fast.pdf

United Kingdom Financial Conduct Authority Policy Statement for Crowdfunding and P2P Lending
http://www.fca.org.uk/your-fca/documents/policy-statements/ps14-04

UK Parliamentary Select Committee Report – *Changing for Good – Report of the Parliamentary Commission on Banking Standards, Volume II*
http://www.publications.parliament.uk/pa/jt201314/jtselect/jtpcbs/27/27ii.pdf

Ernst & Young – *Global Banking Outlook 2013-2014*
http://www.ey.com/Publication/vwLUAssets/Global_banking_outlook_2013-14/$FILE/Global_banking_outlook_2013-14.pdf