Nottinghamshire County Council

Report to Economic Development Committee

28th March 2013

Agenda Item: 8

REPORT OF THE CHAIRMAN OF ECONOMIC DEVELOPMENT COMMITTEE

PEER-TO-PEER LENDING SCHEMES AND FUNDING CIRCLE

Purpose of the Report

1. To request Members' consideration of further detail regarding Peer-to-Peer Funding Schemes and to request approval for a proposal to engage with Funding Circle.

Information and Advice

2. At its meeting in January 2013, this Committee received a presentation on Peer-to-Peer (P2P) funding schemes. The presentation aimed to explain how P2P schemes work, demonstrate the extent to which they were in operation nationally and to offer a Nottinghamshire perspective given the inclusion of the idea within the Nottinghamshire Growth Plan.

3. This presentation was followed by a report presented at the same meeting where the Budget Proposals for 2013-14 were set, including an allocation of up to £50,000 towards a P2P scheme, subject to consideration of the detail to be offered in this report.

4. Since presenting the concept of a P2P scheme to the Committee in January, further discussions have taken place with Funding Circle and this report proposes an engagement with them as well as attempting to address the issues raised in discussion at the January meeting.

Background to P2P Funding

5. P2P works generally through electronic, on-line means as a way of supporting direct lending or investment by individuals or organisations to other individuals or businesses, by-passing what has been the more traditional means of lending such as the banks or other mainstream sources of funding. It is a significant growth area in securing access to finance, particularly over recent years following the credit crunch which has seen a move away from such sources either because of a lack of available finance or a tightening of the approach to credit.

6. This has led to a perceived "stand off" between banks on one hand who were concerned that despite having money available, applications were not forthcoming and on the other, concerns expressed by business that despite the good ideas being put to them, lending was not forthcoming or was only available at uncompetitive rates or at particularly harsh terms.

7. Discussions with the likes of Nottinghamshire Business Engagement Group, business agencies and the theme group brought together to support the development of the Nottinghamshire Growth Plan appeared to validate that access to credit was a real problem locally. Small and medium sized businesses in particular – the backbone of the Nottinghamshire private sector economy – appear to struggle to secure access to finance.

8. A number of P2P platforms have been established, essentially coming under a broad banner of crowd-funding, where many small-scale investors together fulfil a larger scale investment need. It is perhaps worth stressing that some of these platforms are more reputable and have a better track-record than others and some have specific markets or approaches. For example, some are geared towards community or social investment projects; others towards individuals with innovative ideas or technical projects while others are geared towards investment in existing businesses. Some therefore have greater inherent risks associated with them but this report reviews the latter perspective of investment in Nottinghamshire's existing and expanding small and medium sized businesses.

Funding Circle

9. Funding Circle (FC) is amongst the most respected and growing P2P lenders in the UK. FC gears its support to small and medium businesses specifically and has welcomed the interest from and entered into partnerships with both national and local government. FC was the first P2P platform established specifically for business loans and has facilitated to date £78M in loans to UK businesses. It continues to grow apace, currently facilitating between £7M and £8M loans per month. The Government is entering into a partnership arrangement with FC and the implications are reflected upon later in this report. The presentation to this Committee in January reflected on FC's approach and how a partnership with them might be facilitated. Pioneering this approach with local government is Lancashire County Council and as part of the assessment process, links have been made with them to understand how the relationship was established and is progressing.

10. For investors, businesses are graded A+ through to C with A+ businesses having the lowest risk. FC screens all applications and only allows creditworthy businesses onto the platform. Every business that passes FC's credit assessment process is allocated one of these risk bands as a guide on their relative strength. FC also provides expected bad debt rates for each band of businesses, to help guide lending decisions.

11. The risk band that FC allocates to a borrower reflects consideration of the following :

- Financial data from annual returns filed at Companies House including balance sheet data and financial ratios;
- The credit scores and track records of directors of the company;
- Information from high courts and county courts including County Court Judgements
- Data on the how quickly a company pays other businesses, from a wide database of companies in the UK – slow payment being one indicator of financial distress;
- Data on the existing outstanding credit of a business with banks and other investors, and the payment performance of these debt obligations
- Data on previous credit searches by other providers on that business;
- Experienced FC underwriters review all loan applications before they are allowed to list loan requests on the website.

12. The actual borrowing / investor rates are not set by FC but are facilitated via an on-line auction. The business seeking funding can set an ideal or target rate within set parameters depending on the risk band into which the business is placed. Loans are available over a 1, 3 or 5 year period. The investors themselves then set the pace regarding returns on investment they are seeking through a competitive process of an on-line auction. At the time of writing, based on current actual completions, the following average interest rates were secured :

Risk Band	Average Interest Rate
A+	7.5%
A	7.7%
B	8.9%
C	9.4%

13. Appendix A attached to this report offers further insight into FC's origins, its growth and how the process works. Within the context of Nottinghamshire, a partnership with FC looks to offer :

- An opportunity for the County's businesses to secure finance quickly, effectively and at very competitive rates;
- An opportunity for the County Council to demonstrate its commitment to local economic growth and to be seen to do so via joint branding;
- An encouragement to Nottinghamshire's entrepreneurs to invest in local opportunities alongside the Council with positive returns, facilitating a show-piece for Nottinghamshire companies and potentially promoting inter-trading spin-offs;
- With Nottinghamshire being demonstrably open for business, the approach offers the County a competitive advantage – at least in the short / medium term;
- Linkages with existing Nottinghamshire based business support organisations can be facilitated quickly and links with small and medium sized businesses can be readily secured through routes such as the Nottinghamshire Business Engagement Group;
- A minimised exposure to risk with a co-investment approach and potentially securing returns on investment allowing for resources to be re-cycled into further investments. Being demand-led, it may have a slow start but if not needed, the resources are not spent.

14. Perhaps from all the positive perspectives offered to date, the most beneficial testimonies come from businesses who have sourced and secured support for their investment plans through FC. FC's on-line presence – www.fundingcircle.com – and support through the likes of its FAQs, blog and statistics pages offer significant support and further insight into its continued development and conversations with FC demonstrate a continually evolving approach to support both investors and to businesses.

Considerations

15. As part of an on-going dialogue with FC and indeed with insight from Lancashire CC, the following additional information was addressed :

- **Targeting.** Discussions with FC suggest that in scale, the County-level represents a strategic approach to funding. Much less of a geography and clearly the scope narrows. Further, there is the ability to restrict lending to certain types of company, perhaps deploying a sector-based perspective or restricting lending for specific purposes. These too would inevitably restrict the funding's reach. It might be suggested that by default, those businesses using the FC platform are in essence companies seeking to grow and thus any further refinement is unnecessary though the array of statistical monitoring will help with any review and support an assessment the value of a targeted approach. This particular issue is reflected upon in the conclusions below.

- **Fees.** Opening an account with FC is essentially free. However, an investor must register with FC and open an account and by so-doing place a fixed amount with FC before any investment can be made. As with all investors, individual bids are made via the site and only taken up when the auction is completed and agreed. Only then do investors pay a 1% annual fee on lending actually made and is calculated on the amount outstanding of each of the loan parts. The fee is deducted on a proportional basis each time a repayment is received from a borrower. FC only secures payment when the investors get paid. Other requirements such as appropriate promotion may require support but these are expected to be minimal.
- **Risk.** A number of elements merit reference. While no investment is without risk, there are a number of checks and balances within the FC process generally and that the Council could deploy as an investor. In addition to the points offered in the section above and as summarised on page 9 of the Appendix, a number of additional safeguards are employed :

    - It is perhaps self-evident but the fact that investment is only facilitated for established businesses (ie not start-ups) offers the required track-record and evidence to readily secure a good risk assessment;
    - The FC platform is designed to allow investors to easily diversify their portfolio across a wide range of businesses to manage risk. FC confirms that every investor lending to businesses who has followed a diversified approach for at least 12 months is earning a positive return (November 2012 figures). This approach, plus adopting an approach which places a maximum on an amount lent to each business supports a managed approach to risk;
    - It will be noted however that when lending to businesses within one region rather than nationally, a longer time period will be required to reach the suitable level of diversification;
    - Bad debt levels are consistently and openly monitored by FC and remain relatively low, though of course vary across the risk bands. Referencing the estimated life time of bad debt per band (the percentage of all FC loans which are not expected to be repaid over their total lifetime) suggests levels running at 1.1% for band A+ through to 6% for C – an average of 3.7% overall. It might be an option for an investor to only invest in projects deemed lower in risk;
    - Finally, FC typically takes asset security or guarantees from directors on loans to provide further comfort to investors in the form of either a director's personal guarantee, a charge across a company's assets or a security on a specific asset. The security taken is dependent on the size and purpose of the loan.

16. As referenced at paragraph 9 above, the Government has recently announced its intention to lend £20M directly through the FC marketplace to growing businesses in the UK. As its stands, subject to Parliamentary approval, it is proposed that the Government will take part in every loan and will fund each one up to 20% of the total amount. The remaining 80% of a loan will be funded in the normal way and thus all other parties including the County Council in the case of Nottinghamshire businesses will be sought to provide the remaining

amount. Once a loan closes and the average interest rate is set, the Government will fund the remaining 20% based at the average interest rate.

17. The County has some 27,000 businesses, the vast majority of which are small to medium sized. In itself there should be a hungry market for such a partnership approach in Nottinghamshire, notwithstanding the early feedback on need as referenced elsewhere in this report. However, as a marker regarding the present penetration of FC within Nottinghamshire, FC has provided the following information :

- From August 2010 to February 2013, a total of 169 companies with Nottinghamshire postcodes (see note below) have registered on the platform and are at the various pre-live stages. Of these, a total of 28 have secured a loan to the total value of £1.61M (an average sized loan of £57,500);
- As indication of the more recent growth of FC sourced funding, 19 of these 28 were facilitated within the past 12 months;
- Note – by Nottinghamshire postcodes, the first 3 prefixes represent an approximation of the County area.

18. Finally, two points. Firstly, it should be stressed that loans bring a return and thus within the parameters of risk, the Council's investment should see a return for re-investment, potentially into more Nottinghamshire businesses. The current average investor gross yield is 8.9% and average return is 6%. Secondly, FC also allows access to resources by selling parts of the loan portfolio on to other investors at par value, should this be required.

Options and Conclusions

19. As will be seen from page 11 of the Appendix, FC is offering a choice of routes for the Council's investment, being essentially lending on an individual basis and one which makes use of FC's automated bidding system. Either approach has its merits but the individual approach could come with a number of expectations and considerations. Firstly that the authority invests in staff time and expertise to review each Nottinghamshire application – and quickly – as the auction process is facilitated promptly. Secondly, it infers some level of discretion as to which projects are supported – and to what degree – and which are not. An automated approach would allow certain parameters to be introduced (as reflected under the targeting or levels of risk bullet points under paragraph 15) but avoid the possibility of inadvertently introducing an inappropriate degree of arbitrariness into the process.

20. Regardless, a key factor in determining the appropriate approach as far as the County Council is concerned is reflected upon in paragraph 22 below.

21. In discussion with FC and reflecting on their local authority engagement to date, the following investment approach is proposed :

- An account is opened with initially up to £45,000 invested over the course of 2013/14, with the remaining £5,000 retained for fees and any required publicity and promotion;
- An approach of a "flat" figure per loan, lent at a fixed rate by each risk band. This would be set at 50 points beneath the average of all "retail" bids. The average would be monitored and the fixed rate for County Council bids adjusted monthly.

- As a guide, current averages on the marketplace are :

Risk Band	Average Rate as at February 2013
A+	7.5%
A	8%
B	9.1%
C	9.6%

- The flat figure be set at £1,500 per business initially at least, offering support to 30 Nottinghamshire businesses. This figure could be higher but would impact on diversification levels and achievements. This is a diversification rate of 3.3%. FC advise that of all investors currently lending at a 2.5% diversification rate across their portfolio, 97% have achieved positive returns;

22. Given the above, it was initially presumed that an automated approach could be adopted. However, in discussion with FC, the platform is not yet able to respond to a full postcode restriction to determine precisely whether a business is within the County or not. This is being worked on but until that is completed, it is suggested that the Council adopts the individual loan approach to at least ensure the business concerned is within the County, but all other aspects remain as above.

23. A range of permutations are possible but it is suggested this approach is adopted, to be reviewed over the course and at the end of the financial year.

Other Options Considered

24. There are no other options applicable to this report.

Reason/s for Recommendation/s

25. This report is offered to request the Committee’s support for the establishment of a partnership approach with funding Circle to facilitate the development of loans to small and medium sized businesses across the County.

Statutory and Policy Implications

26. This report has been compiled after consideration of implications in respect of finance, equal opportunities, human resources, crime and disorder, human rights, the safeguarding of children, sustainability and the environment and those using the service and where such implications are material they are described in the report.

Financial Implications

27. The financial implications are referenced throughout the report, reflecting on the risk and potential benefits to the County Council of a partnership with FC.

RECOMMENDATIONS

That following their approval of resources towards a P2P scheme in Nottinghamshire, members consider the details of the proposed approach with Funding Circle as set out in the report.

Report of Group Manager, Corporate Strategy
For any enquiries about this report please contact: Geoff George ext 72046

Constitutional Comments (NAB 13.3.13)

28. The Economic Development Committee has authority to approve the recommendation set out in this report.

Financial Comments (NS 6/13/2013)

29. Providing loans to business for investment purposes would be classified as capital expenditure. Consequently, for the proposals set out in the report a variation to the capital programme will be required, with the capital expenditure being financed from the Economic Development revenue budget.

Background Papers
None

Electoral Division(s) and Member(s) Affected
All