DRN-4003181

The complaint

Mr A complains that Retail Money Market Ltd ("RateSetter") unfairly reduced his interest returns on his crowdfunding investments and didn't return any of this following a third party ("TP") acquiring the platform's loan portfolio.

What happened

RateSetter is a peer-to-peer crowdfunding platform which was acquired by TP in September 2020. However, for ease, I shall refer to both parties separately throughout this decision.

RateSetter provided several types of investment accounts in which investors could lend money to third party individuals and/or businesses in return for interest. While each of these accounts had a set "Going Rate" - a market interest rate determined by RateSetter - investors could also decide to set their own target interest rates. The actual interest earned was based upon the loan contracts contained within an investor's account.

RateSetter operated a contingency fund called the "Provision Fund". The Provision Fund was used to automatically reimburse investors their outstanding capital and interest in the event this wasn't paid by a borrower. This in effect mutualised risk for all investors by diversifying their exposure across the entire loan portfolio. Although payments from the Provision Fund weren't guaranteed, payments would be made provided there were sufficient funds available in it.

The adequacy of the Provision Fund was expressed by the "Interest Coverage Ratio" - calculated by dividing the size of the Provision Fund by the "Expected Future Losses" (the total amount of missed and unrecovered borrower repayments expected over the lifetime of active loans). RateSetter also published a "Capital Coverage Ratio" - calculated by adding the size of the Provision Fund and all the future interest from active loans and then dividing by the Expected Future Losses.

Historically, the Provision Fund was funded through borrowers as part of their loan fees and not by investors. But RateSetter says that, due to the impact of the Covid-19 pandemic, it saw a decrease in new lending and in turn, a decrease in borrower fees going into the Provision Fund. RateSetter has told us that in April 2020 the Interest Coverage Ratio had dropped below 74% and in May 2020, in response to this, it introduced a "Stabilisation Period" – a 50% reduction to the interest rate investors received on their investments. RateSetter says that was introduced to replenish the Provision Fund. It also says the Capital Coverage Ratio was around 154% at the time and so a capital rate reduction wasn't necessary. RateSetter says this was all implemented in line with the terms of the investment. TP acquired RateSetter in September 2020, but the entire loan portfolio remained with RateSetter. RateSetter has explained that the Interest Coverage Ratio had returned above 100% by December 2020 and the Stabilisation Period ended in January 2021. In February 2021 RateSetter announced that TP was acquiring the entire loan portfolio which then completed in April 2021. As a result, investors received their capital back, plus any interest due.

Mr A complained to RateSetter in June 2021 as he felt it was unfair for TP to retain the entire Provision Fund considering he and other investors had partly financed it through halving their interest payments during the Stabilisation Period. Mr A said he'd expect RateSetter to pay him not only his capital but also the interest he'd missed out on during the Stabilisation Period.

RateSetter considered Mr A's complaint but didn't uphold it. In summary, it said:

- Since the Covid-19 pandemic struck, it had focused on strengthening the Provision Fund and protecting all investors equally.
- The interest rate reduction introduced in May 2020 was a necessary part of ensuring that all investors were fully protected – and a necessary step towards the outcome of investors getting their money back in full in April 2021.
- Had it not increased its Provision Fund, investor capital would have been at risk.
- The interest rate reduction naturally ended when the Interest Coverage Ratio returned to 100% and investors were fully protected.
- There is no surplus in the Provision Fund and no surplus is expected in the future.
- The Provision Fund operated in line with its Investor Terms and it was able to close investors' accounts after the portfolio purchase under these Investor Terms.
- The loan portfolio purchase meant that investors received their money back in full despite the economic uncertainty.
- The Provision Fund goes with the loans as TP is taking on the risk of the loans.

Mr A remained unhappy with RateSetter's response and so he referred his complaint to this Service for an independent review.

An investigator at this Service looked into Mr A's concerns and originally upheld the complaint but later revised her view based upon new information provided by RateSetter. In summary, she said:

- She was satisfied that RateSetter's Investor Terms gave it a broad discretion to introduce the Stabilisation Period.
- She was persuaded that RateSetter's decision to implement the Stabilisation Period was fair, and consistent with maintaining the Interest Coverage Rate above 100% to ensure continued mutualisation of risk across the loan portfolio.
- She also commented on RateSetter's decision to close Mr A's account following the sale of the entire loan portfolio to TP. She felt RateSetter had the power to do so under the Investor Terms and she felt that, by receiving a return of his capital and interest accrued up to that point, Mr A had received what he was entitled to.
- RateSetter had accepted that it delayed providing all available evidence for the complaint and had it not done so, she wouldn't have reached the same outcome as she did in her initial opinion. She said RateSetter had offered £250 in recognition for the unnecessary delay caused and any distress and inconvenience caused by this, which she felt was fair and reasonable in the circumstances.

RateSetter didn't provide a response to the view.

Mr A didn't accept the investigator's findings. In summary, he said:

- The Provision Fund and the subsequent sale of the entire loan portfolio to TP were in the interest of Ratesetter and its shareholders, but the risk associated with the loans was borne by small investors, like him.
- The Provision Fund was "a juicy part of the sale package" TP, of which the interest loss was borne by small investors, like him.

- This contravenes section the Financial Conduct Authority's ("FCA") principles that a firm must pay due regard to the interests of its customers, and treat them fairly.

As no agreement could be reached, the complaint has been passed to me to decide.

What I've decided – and why

I've considered all the available evidence and arguments to decide what's fair and reasonable in the circumstances of this complaint.

Having considered RateSetter's comments and the evidence provided, I'm now persuaded the decision to implement the Stabilisation Period was fair and in line with the Investor Terms. I'll explain why.

When considering what is fair and reasonable in the circumstances, I've taken into account the relevant rules and regulations FCA regulated firms, such as RateSetter, are required to follow. These are set out in the FCA's Handbook of rules and guidance. The FCA Principles for Business ("PRIN") "are a general statement of the fundamental obligations of firms under the regulatory system" (PRIN 1.1.2G) The Principles themselves are set out in PRIN 2.1.1R. The most relevant principles here are:

- PRIN 2.1.1R (2) "A firm must conduct its business with due skill, care and diligence."
- PRIN 2.1.1R (6) "A firm must pay due regard to the interests of its customers and treat them fairly."

RateSetter was also required to act in accordance with the rules set out in the Conduct of Business Sourcebook (COBS). And the most relevant obligation here is:

- COBS 2.1.1R (1) "A firm must act honestly, fairly and professionally in accordance with the best interests of its client."

<u>Fairness of the implementation of the Stabilisation Period</u>

I understand RateSetter has relied upon the following term in its Investor Terms to introduce the Stabilisation Period:

> *"19.1. If at any time, RateSetter reasonably believes the Provision Fund does not have sufficient funds (including expected future inflows) to cover current or expected borrower defaults, RateSetter may implement a "Stabilisation Period"."*

While I think the term gave RateSetter a broad discretion to introduce the Stabilisation Period, I must also consider whether in doing so RateSetter treated Mr A fairly and acted with his best interests in mind.

RateSetter has explained that that prior to April 2020, the Interest Coverage Ratio was and had only ever been above 100% and that the objective – as disclosed to investors – was to maintain it to this level. The Provision Fund Policy on RateSetter's website explained:

> *"Future economic uncertainty is currently not factored into the Expected Future Loss calculation but this is taken into account by managing the Interest Coverage Ratio to a figure greater than 100%."*

It's also clear that the Provision Fund was a vital mechanism in ensuring mutualisation of risk across the loan portfolio. And if this was not sufficiently maintained, investors would likely be exposed to risk beyond that which they'd accepted when agreeing to invest on a platform that mutualised risk across the whole loan portfolio. The Provision Fund policy explained:

> *"The Provision Fund exists to protect RateSetter investors. It protects all investors equally and so has the effect of mutualising the risk for all investors by diversifying their exposure across the whole loan portfolio. This means that it is the performance of the whole loan portfolio that matters for RateSetter investors."*

RateSetter has also explained that expected future losses were estimated each month-end by RateSetter's Executive Credit Committee, based on historic losses in the portfolio as well as independent macroeconomic forecasts produced by Oxford Economics. And that the impact of Covid-19 in March 2020 caused a sharp spike in expected future losses which, when tested at month end April 2020, caused the Interest Coverage Ratio to drop to 74%. It was this level of drop in the Interest Coverage Ratio which RateSetter says meant it was necessary to implement the Stabilisation Period – ensuring investors were protected equally and that their risk was fully mutualised.

Understandably, there was a lot of uncertainty during the Covid-19 pandemic, and I think it would be unfair to scrutinise a firm's decision taken during this time where it's clear it has taken precautionary steps having relied upon independent forecasts. It's also apparent from the information provided that RateSetter had lengthy discussions regarding what was the best action to take in these circumstances. So I'm satisfied RateSetter took reasonable steps to take account of independent views and there was a reasonable basis to its assessments of the coverage level.

I've also considered whether there was any potential conflict of interest at play in RateSetter's decision to implement the Stabilisation Period. However, I'm persuaded there wasn't any here. I say this as RateSetter has demonstrated that its decision to implement the Stabilisation Period was made prior to discussions about the potential platform and loan portfolio purchase. RateSetter has explained that the first communication it had with TP in relation to a possible sale – which was a communication from TP to RateSetter – was on 10 May 2020, a month or so after the decision to implement the Stabilisation Period was taken and nearly a week after it took effect.

So, on balance, I'm persuaded RateSetter's decision to implement the Stabilisation Period was fair, as it was consistent with the objective of maintaining the Interest Coverage Rate above 100% - ensuring continued mutualisation of risk across the loan portfolio - and allowing investors to continue to benefit from protection whilst still receiving interest (albeit less than expected) during a period of economic uncertainty. I'm also are satisfied the Provision Fund shortfall estimates were reasonably assessed, as RateSetter considered relevant factors from independent sources. It's also important to consider these decisions were made in unprecedented circumstances and it wouldn't be fair or reasonable for me to consider these with the benefit of hindsight.

<u>The price received for the loan portfolio</u>

I understand Mr A believes he ought to have received more from the loan portfolio sale – essentially receiving more than a 'par value' for his loans and receiving a percentage of the funds available in the Provision Fund which he sacrificed in interest during the Stabilisation Period. I've thought very carefully about this, however I think RateSetter's actions were fair and in line with the terms on which the investment was made. I'll explain why.

The Investor Terms explained that:

> *"By agreeing to these Terms, you're appointing RateSetter to act as your agent in all matters relating to the origination, negotiation, administration and management of*

> *your loans. This includes:*
> *[…]*
> *negotiating and executing on your behalf any agreements relating to your loans;*
> *[…]*
> *entering into any transfer arrangements on your behalf in order to transfer the benefit of any loans (or part thereof) to the Provision Fund, another RateSetter investor, RateSetter itself or a third party; and*
> *anything else RateSetter reasonably considers necessary to manage your loans, including terminating those loans."*

Therefore, RateSetter had the power to make the sale on Mr A's behalf and transfer the arrangements – including the Provision Fund – to TP. So the sale and transfer was a legitimate exercise of the rights given to RateSetter by Mr A when he invested.
It was also able to close Mr A's account with two months' notice under the Investor Terms:

> *"16.1 We can end our agreement with you, close or suspend your RateSetter account and stop providing any services by giving you at least two months' notice."*

I've also considered how RateSetter explained how the Provision Fund would operate, the circumstances in which Mr A has a call on it and what he was entitled to receive on withdrawing his investment.

The Provision Fund Policy provides clarity as to how the fund would operate. This explains:

> *"If a borrower misses a repayment, the Provision Fund automatically reimburses the outstanding capital and interest to the investor.*
> *[…]*
> *These assets are ring-fenced from the other assets of RateSetter. The Provision Fund's assets can be used only to reimburse RateSetter investors and to cover the operational costs of the Provision Fund*
> *[…]*
> *If the Provision Fund accumulates a surplus relative to losses, this surplus ultimately belongs to RateSetter."*

From this, it's clear from this that the Provision Fund is a separate, ring-fenced, sum of money on which Mr A would only have a call to it in the event of borrower default. It would appear that investors had no right to a return from the Provision fund in any other circumstances. This was also explained to Mr A in the Investor Terms:

> *"10. The Provision Fund*
> *10.1 To provide protection to RateSetter investors, RateSetter sets aside funds as a provision against borrower defaults for the benefit of all RateSetter investors (the "Provision Fund").*
> *[…]*
> *10.3 If a payment becomes due under the terms of any of your loans and is not paid by the borrower, the Provision Fund will automatically make payment to you on the borrower's behalf, provided it has the funds to do so."*

There's also nothing in the Investor Terms which suggested investors had a call on the fund if, at the point of withdrawal from the investment, it was estimated to be more than was required to provide protection. So I'm persuaded Mr A cannot have invested with that expectation. Rather, the Investor Terms explained that in the event of withdrawing from the investment, an investor would only ever receive their capital and the interest which had accrued. I've seen nothing in the terms which suggests the amount paid to those withdrawing from the investment should be adjusted by reference to the level of protection afforded by the Provision Fund. So as Mr A was essentially withdrawing from his investment, I don't think the fact that he was withdrawing by virtue of the loan portfolio sale changed anything contractually and that by him getting a return of capital and interest accrued meant he received what he was entitled to as per the terms of the investment.

Having considered all of the above, I'm satisfied Mr A was only entitled to money from the fund in the event of a default and, on withdrawing, was only entitled to a return of capital and accrued interest. Therefore, Mr A received what he was entitled to under the terms when RateSetter sold the loan portfolio to TP. I'm also satisfied that the Provision Fund Policy made it clear the Provision Fund was intended to protect investors and so once Mr A withdrew as an investor I'm satisfied he no longer had a right to it.

Determining what Mr A was entitled to under the terms of the investment is the starting point when scrutinising the price he received for his loans. However, I've also considered whether it's fair and reasonable to say Mr A should have received more than he was entitled to as per the terms of the investment, given the position with the Provision Fund at the time of the sale.

At the point in which Mr A withdrew from his investment by way of the loan portfolio sale, he was no longer exposed to any risk. This risk was transferred to TP and so I don't think it would be fair for him to benefit from any protection the Provision Fund provided. The Provision Fund is part of the package which TP receives when it purchased the loan portfolio and aims to protect the current investor (TP) against default.

The Provision Fund may be bigger than it would have been, had the interest rate reduction not been applied during the Stabilisation Period, but I'm not persuaded that meant Mr A should have been paid something in addition to what he was contractually obliged to receive up until the point of exiting from the investment. Rather, I'm persuaded that the period of reduced interest, which effectively reflected the increased default risk during a period of economic uncertainty, was simply part of the overall risk of the proposition which is rightly reflected in the returns paid. I say this as there was always a risk that borrower fees would not be adequate to fund the level of protection needed, meaning either defaults would hit investors due to inadequate cover or returns would be reduced in order to ensure adequate cover. This was all clearly explained to Mr A in the Investor Terms and I'm persuaded he invested on the basis that he was aware his interest may be reduced. As such, receiving his capital back and some interest seems to be a fair reflection of how the investment has performed during the Covid-19 pandemic and up until the point in which the loan portfolio was sold.

I'd also consider that any additional payment made to Mr A, to reflect the value of the Provision Fund at the point of the loan portfolio being sold, would be effectively putting him in a position is if the Covid-19 pandemic hadn't happened. As such, I don't think it would be fair to award redress for reduced returns arising from inherent risks in the investment during this period.

I understand Mr A doesn't think TP should benefit from the protection the Provision Fund provides beyond that which investors contributed towards during the Stabilisation Period. Whilst estimations at the point of the loan portfolio sale suggested that the Provision Fund offered more than needed for capital protection, I don't think this means all or part of the interest investors sacrificed during the Stabilisation Period ought fairly be refunded. As I've explained, the Interest Coverage Ratio is the level of cover against capital and future interest losses (i.e. all losses) whereas the Capital Coverage Ratio is the level of cover against capital losses only (i.e. it accounts for the future interest payable when considering the degree of coverage). I think it's difficult, against that background, to say it was fair for TP to pay more than 'par value' when the loan portfolio being purchased was estimated to have an

Interest Coverage Ratio of around 100%. I think a more reasonable interpretation is that the loan portfolio was adequately 'insured', and so paying 'par value' is a fair and reasonable reflection of that. I say this as, if the Provision Fund offered less protection, the value of loan portfolio would be arguably worth less, as there would be no buffer to protect TP from future economic changes which increase the risk of default.

RateSetter says the offer of 'par value' for investors' loans and accrued interest was fair given that it was reasonable to expect TP to receive the same level of interest on the portfolio that the current owners (i.e. the old investors) were earning. I think this is a valid point considering that the risk TP has taken on in purchasing the loan portfolio hasn't changed and so it follows that the reward for doing so should remain the same as what investors were receiving.

Whilst I appreciate that some investors, may have wanted to continue to invest on the platform, the loan portfolio purchase did result in investors getting liquidity of capital and interest to cover a two month notice period, in a timely and orderly way during a period of economic uncertainty. So I'm persuaded the price Mr A received was fair and reasonable in all the circumstances.

<u>RateSetter's delay in providing a full response</u>

RateSetter has made an offer of £250 to recognise the inconvenience caused to Mr A by its delay in providing all available evidence for the complaint. Whilst I've not found a failing in terms of introducing the stabilisation period, the sale to TP or the delay in withdrawing, I think this offer fairly reflects the distress or inconvenience caused to him by not providing this information at the earliest opportunity.

Putting things right

RateSetter has made an offer of £250 to recognise the inconvenience caused to Mr A by its delay in providing all available evidence for the complaint and I think this offer fairly reflects the distress or inconvenience caused to him by not providing this information at the earliest opportunity.

My final decision

My final decision is that I uphold this complaint and instruct Retail Money Market Ltd to pay Mr A £250 for the distress and inconvenience it caused him.

Under the rules of the Financial Ombudsman Service, I'm required to ask Mr A to accept or reject my decision before 5 April 2023.

Ben Waites
Ombudsman