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Setting up an Alternative Lender in the UK

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This article is an introduction to the legal issues to consider when setting up an alternative lender in the UK. In this context, "alternative lender" means any business providing credit which is not regulated by the Prudential Regulation Authority (the PRA) as a deposit taker.[i]

Is the lending business regulated or unregulated?

The threshold question for any alternative lender is whether its lending business will involve a "regulated activity" in the UK. If so, it will need to be authorised[ii] and regulated by the Financial Conduct Authority (the **FCA**). This perimeter analysis is fundamental to the structure of any financial services business being established in the UK or involving UK customers.

Making a loan to a company for its own business purposes does not in itself constitute a regulated activity and therefore does not require authorisation.

Carrying on the business of lending to individuals (or otherwise making credit available to them) will be a regulated activity unless an exemption applies. The main exemption relied upon by alternative lenders is the "business purpose exemption" which applies where the loan is for more than £25,000 and is entered into by the borrower wholly or predominantly for the purposes of a business carried on, or intended to be carried on, by the borrower[iii]. If the loan is secured on land, where at least 40% of which is used as a dwelling, it will also be necessary to consider whether the loan is a "regulated mortgage contract": carrying on the business of entering into regulated mortgage contracts as lender is also a regulated activity as is administrating a regulated mortgage contract[iv]. Again, certain exemptions apply and the main ones relied upon by alternative lenders in relation to regulated mortgage contracts are the investment property exemption and the second charge

i The only institutions authorised to undertake deposit-taking by way of business in the UK are banks, building societies, credit institutions and friendly societies.
ii Section 19 of the Financial Services and Markets Act 2000
iii Article 60C(3) of The Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 as amended (the "RAO")
iv Article 61(1) and (2) of the RAO.

business loan exemption[v]. In relation to buy-to-let business, there may be a requirement to register with the FCA even if there is no requirement to be authorised.

If the alternative lender is not strictly speaking lending, but is instead providing another type of financial product to individuals, other regulated activities may apply such as entering into regulated consumer hire contracts [vi] or regulated home reversion plans[vii] by way of business. Depending upon the corporate structure of the alternative lender's group, other group companies may also be conducting regulated activities, for example, administering a regulated mortgage contract, credit-broking[viii] or debt administration[ix] .

The relevant provisions of the Financial Services and Markets Act 2000 and the related secondary legislation are complicated and this is the first area in which a start-up alternative lender will need to take legal advice. It is also the first area which any external funder providing debt or equity will test; to be credible, the alternative lender will need to show that it has undertaken a robust regulatory analysis.

Money laundering registration

With very limited exceptions, an alternative lender will be categorised as a "financial institution" under the UK money laundering regime[x] and therefore will be subject to its provisions, regardless of whether the alternative lender is authorised by the FCA or the PRA. The alternative lender will need to register with the FCA as an "Annex 1 financial institution" using its online system "Connect". The requirement to register via Connect applies to all alternative lenders, even if the alternative lender's business does not involve it carrying on regulated activities which would require it to be authorised by the FCA and/or PRA.

Amongst other things, this means that an alternative lender must have appropriate systems and controls in place to assess its exposure to money laundering and terrorist financing risk, and will need to undertake satisfactory customer due diligence and keep compliance records. The alternative lender will also need to establish who within the organisation has overall responsibility for AML compliance and ensure that those individuals are familiar with the detailed provisions of the Money Laundering Regulations and the Proceeds of Crime Act 2002.

Intellectual property and privacy

Like any other business with a website, an alternative lender will need website terms and conditions, an acceptable use policy, cookie consent management tools and a privacy notice. The website must contain prominent links to this information, ideally on the home page. The privacy notice should take into account the likely information requirements of potential equity and debt funders. Additional consideration will be required if the alternative lender intends to transact business online.

A new alternative lender will also need to clear and register its domain name with an appropriate registrar. Any applicable trademarks should be registered with the UK Intellectual Property Office and, where appropriate, the EU Intellectual Property Office and other overseas registries. A watch service may be required to check for applications for registration by third parties of similar marks.

The requirements of UK GDPR[xi] affecting businesses generally are beyond the scope of this article, but it is important to note that an alternative lender will usually process personal data even if none of its borrowers are individuals. For example, an alternative lender will obtain personal data relating to the ultimate beneficial owner(s) of its corporate borrowers (such as KYC information) and a variety of other personal data. The alternative lender will need to implement appropriate technical and organisational measures to ensure compliance with data protection principles when processing personal data. The alternative lender should also consider which companies within its corporate group require a Data Protection Officer (DPO) and, if applicable, register the DPO with the Information Commissioner's Office. Additionally, the alternative lender should consider the grounds upon which it will be permitted to share personal data relating to its customers with its funders. A range of other privacy considerations will apply.

v Article 61A of the RAO.
vi Article 60N of the RAO.
vii Article 63B of the RAO.
viii Article 36A of the RAO.
ix Article 39G of the RAO.
x Money Laundering, Terrorist Financing and Transfer of Funds (Information on the Payer) Regulations 2017 (SI 2017/692) (as amended).
xi General Data Protection Regulation ((EU) 2016/679) as it forms part of the domestic law of the United Kingdom (UK GDPR).

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Documentation

Each alternative lender will have its own standard legal documentation for customer loans. Developing standard form documentation is important for a number of reasons. For new customers, it can form their first impression of the alternative lender: if the standard legal documentation is concise and easy to understand with the key commercial terms in one place, that first impression will be positive. Most alternative lenders will use external firms of solicitors to document their loans (this is always the case where the loan is secured against real estate). Once an alternative lender has reached critical mass, it will typically have a number of firms of solicitors on its lending panel and having standard documentation ensures uniformity. It will also be a requirement of any third party debt provider that all underlying customer loans are originated using approved standard documentation.

The list of standard legal documentation will vary accordingly the product type, but for loans secured on real estate at the minimum it will include a loan agreement and a security document such as a debenture or legal charge. Many alternative lenders will also have other standard form legal documents such as personal guarantees, subordination and intercreditor documents and, when dealing with corporate customers, share security.

Institutional third party debt providers will almost always require legal due diligence on standard documentation. The due diligence report will cover issues such as the assignability of the underlying customer loans, the economic terms (interest rate basis, fees and default interest provisions), whether there is any obligation to make further advances to the underlying borrower, confidentiality provisions (and, in particular, whether there is any contractual prohibition which would restrict the sharing of information with the funder), events of default, exclusions against set-off and whether customary covenants and representations are included. For unregulated loans to individuals, the report will comment on whether the documentation includes appropriate declarations from the underlying borrower in relation to the business purpose exemption. If the loans are intended to be consumer credit agreements or regulated mortgage contracts, the report will confirm whether the documentation complies with regulatory requirements[xii].

xii The consequences of not complying can be severe. For example, consumer credit agreements which do not contain all the prescribed particulars are unenforceable without an order of the court under the Consumer Credit Act 1974.

In practice, it is likely that many of the loans being funded will already have been originated before the funder's counsel starts its due diligence on the standard legal documentation. If the funder's counsel uncovers an issue with the standard documentation, it may therefore be too late to put it right.

In addition to the standard legal documentation, a third party funder will also due diligence the alternative lender's internal policies and procedures dealing with underwriting criteria, customer KYC and AML and servicing (including enforcement). A number of the covenants in the funding documentation will refer to the policies and procedures: for example, the alternative lender will be required to service the underlying customer loans in accordance with the servicing policy. The policies and procedures should therefore build in any required flexibility in relation to the origination and servicing of the customer loans.

Portfolio Funding

An alternative lender will need funding to meet its operating costs in the same way as any other business. In addition, the alternative lender will also need funding for its loan pool.

There are potentially many ways in which that funding can be raised and, in addition to considering the regulatory implications of its lending activities, the alternative lender will also have to understand the regulatory implication of its proposed funding structure. For example, if investors are providing equity funding for the purpose of originating a loan portfolio, it will be necessary to analyse whether those arrangements give rise to a collective investment scheme or result in the asset holding vehicle becoming an alternative investment fund. If investors are providing debt funding, it may be necessary to consider whether the alternative lender is engaging in the regulated activity of deposit taking[xiii]. If securities are issued, the issuer will need to consider whether there is a requirement to issue a prospectus which is compliant with the UK Prospectus Regulation and ensure that any invitation to subscribe for securities complies with the financial promotions regime[xiv]. If the structure involves the investors making loans themselves, then the alternative lender may be providing a P2P platform and therefore undertaking the regulated activity of operating an electronic system in relation to lending[xv].

However, while many different funding models exist, the current market for funding portfolios of loans originated by alternative lenders largely consists of debt funding lines provided by banks, funds and other institutional investors.

Introduction to Funding Lines

Funding lines for loan portfolios generally involve the sale of the underlying loans to a special purpose vehicle which acts as the issuer or borrower. Alternatively, or in addition, the special purpose vehicle may itself advance loans to the underlying borrowers. The funding line will feature a revolving period during which the facility can be drawn to fund the purchase or origination of new loans which will be followed by an amortisation period during which any principal receipts from the underlying pool will be used to amortise the funding line. The credit agreement will contain a list of eligibility criteria which determine which loans can be funded and an advance rate applicable to each eligible loan which will be used to calculate a borrowing base for the facility. In addition to the credit agreement and security documentation, the documentation for the funding line will include a servicing agreement under which the alternative lender will administer the pool and collect payment from the underlying borrowers.

The technique of selling assets to a special purpose vehicle which issues debt and appoints the sponsor as servicer is not new: it has been the basis for most public securitisations for a long time. However, while much of the documentation for this type of funding line is borrowed from the public securitisation market, it is also similar in some ways to general corporate loan documentation. For example, the senior credit agreement will generally be based on standard LMA documentation[xvi] and the special purpose vehicle will often be a group company as opposed to an orphan vehicle. In addition, the transactions are generally private

xiii Access to deposit funding, particularly retail deposits, is one reason why a new lender might choose to become regulated as a bank rather than going down the alternative lender route. The specified activity of accepting deposits under Article 5 of the RAO is, of course, reserved to deposit-taker such as credit institutions. A broad range of other commercial factors will be relevant including the target depositor market and the nature of the asset to be funded.

xiv Section 21 of the Financial Services and Markets Act 2000 provides the basic restriction on unauthorised persons communicating financial promotions: a person must not, in the course of business, communicate an invitation or inducement to engage in investment activity or to engage in claims management activity (that is, make or issue a financial promotion) unless it is authorised, the content is approved by an authorised person in accordance with the FCA Rules or an exemption under the Financial Services and Markets Act 2000 (Financial Promotion) Order 2005 (SI 2005/1529) (as may be amended from time to time) is applicable.

xv The provision of a P2P lending platform is a regulated activity under Article 36H of the RAO: operating an electronic system in relation to lending.

xvi Although a standard form LMA Credit Agreement will typically be used as the starting point for the facility documentation, for tax reasons it will often be amended so that it operates as a debt security issuance facility rather than a loan facility.

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deals and do not involve the issue of rated debt.

To the extent that the funding line involves the provision of junior funding by a member of the alternative lender's corporate group or by another entity such as a third party mezzanine provider, it will typically be a securitisation for the purpose of the EU Securitisation Regulation[xvii] and the UK Securitisation Regulation. This means that a material net economic interest of not less than 5% must be maintained in the transaction by the originator, sponsor or original lender in accordance with Article 6[xviii]. The transaction must be notified to the FCA using the appropriate annex of PRA/FCA – Private Securitisation Notification Template and a transaction summary must be produced for investors. Regular reports on the underlying exposures under Article 7(1)(a) and regular investor reports under Article 7(1)(e) will be required. These reports contain detailed information, but they tend to be of limited value to investors in private securitisations. Most alternative lenders will accept the requirement to produce the reports (and the other consequences which flow from the funding line being categorised as a securitisation) as a cost of doing business, but some alternative lenders will look for ways in which to structure the transaction so that it falls outside the EU Securitisation Regulation and the UK Securitisation Regulation.

An alternative to entering into a funding line is to enter into a future flow transaction where the funder acquires the loan asset instead of financing it. In this case, the role of the alternative lender is to originate the asset and act as servicer, but it is the funder which takes all of the risk and reward in the asset. The alternative lender will advance monies to the underlying borrower and then assign the loan to a special purpose company controlled by the funder. Some of the commercial issues to be negotiated include the consequences of a loan being advanced in breach of eligibility criteria, the extent of the alternative lender's liability (and any caps on liability) and whether the funder is obliged to purchase a loan which fits the eligibility criteria or retains an ability to decline it. It is also sensible for both the alternative lender and the funder to agree upfront on the scope of the alternative lender's role if the funder chooses to on-sell or securitise the pool: will the alternative lender be obliged to continue to service the assets and/or give any warranties?

xvii "EU Securitisation Regulation": Regulation (EU) 2017/2402 of the European Parliament and of the Council of December 12, 2017, as amended by Regulation (EU) 2021/557 of 31 March 2021. "UK Securitisation Regulation": Regulation (EU) 2017/2402 of the European Parliament and of the Council of 12 December 2017, as it forms part of UK domestic law by virtue of European Union (Withdrawal) Act 2018, and as amended by the European Union (Withdrawal Agreement Act) 2020 and Securitisation (Amendment) (EU Exit) Regulations 2019.

xviii Identifying a suitable party to act as the sponsor, originator or original lender is not always straightforward, particularly where the special purpose issuer advances the loans itself, rather than taking an assignment from the original lender. In particular, external funders will need to be confident that the relevant entity has the necessary substance for the purposes of the EU Securitisation Regulation and the UK Securitisation Regulation.

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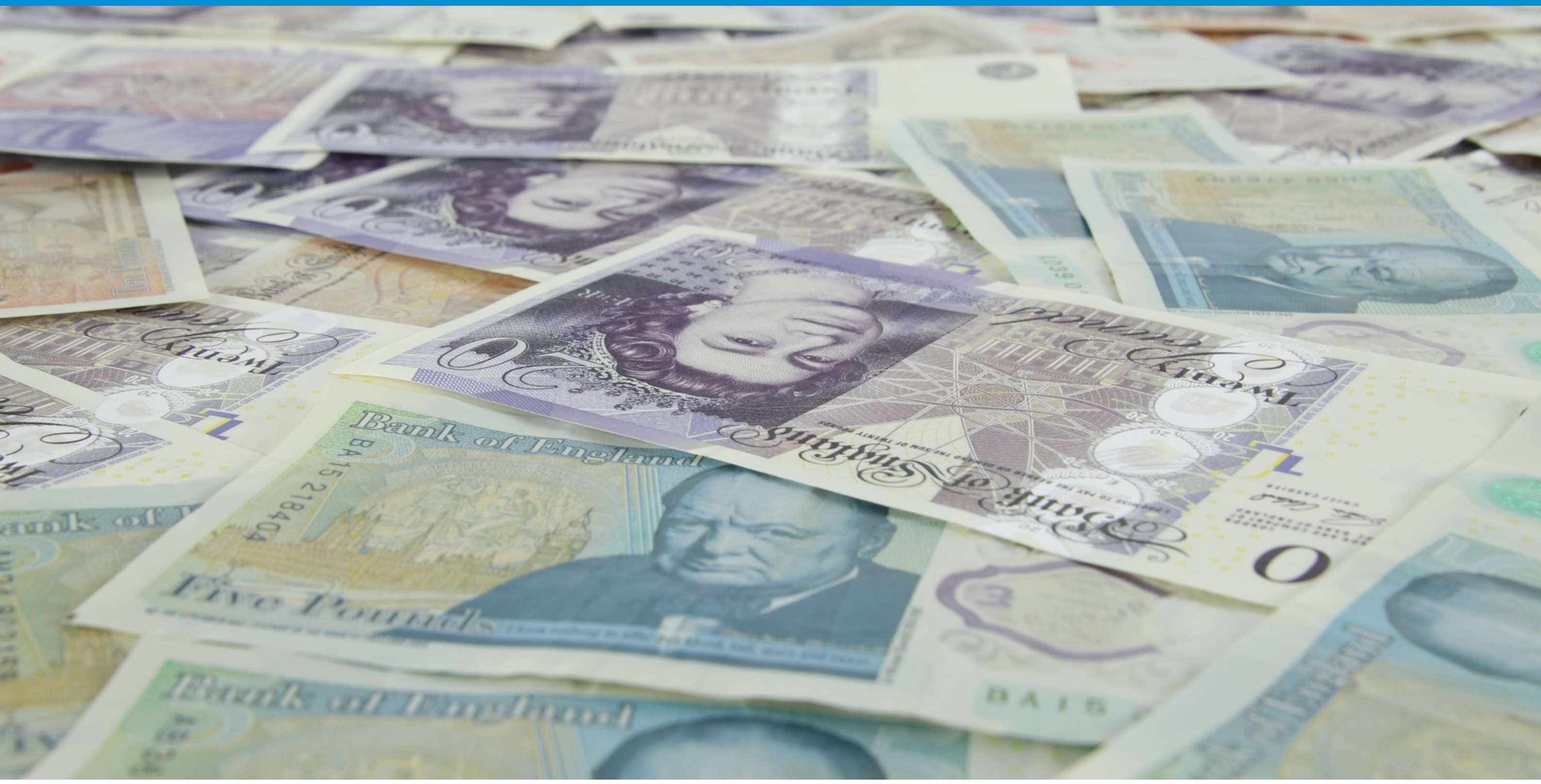

Corporate structure

The alternative lender's corporate structure will often consist of at least two companies: an asset company to own the customer loans and a servicer. Third party debt providers will require the customer loans which they finance to be legally segregated from customer loans financed by other funders. Therefore, as the alternative lender's business grows and it enters into funding lines with a number of different funders, the corporate structure may feature a number of different asset companies and/or trusts, or use other techniques to achieve legal segregation. Ideally, the servicer should not itself be the borrower or a guarantor under any of the funding lines; if a third party debt provider has the ability to put the servicer into liquidation or administration in the event of a loan default, that would compromise the servicer's ability to service customer loans funded by other external debt providers.

In addition to taking security over the present and future assets of their asset company borrowers, third party debt providers will also often require a share charge over the asset company's share capital. An alternative lender group will therefore often feature one or more companies to act as the direct parent of the asset companies and provide the share charge. If the alternative lender is private equity backed, there will also need to be a shareholders' agreement in place between the private equity investment vehicle and management (or a company representing management interests).

Other Issues and Further Reading

Of course, there are a number of other issues to be considered when setting up an alternative lender, including employee incentives, tax, insurance requirements, outsourcing arrangements and any cross-border aspects. There is also the question of whether the alternative lender would, in fact, be better off being authorised and regulated as a bank/credit institution. For further reading, please see our article Becoming a UK Authorised Bank | Fieldfisher .

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