Lending to small businesses

Key features and risks

By lending through Funding Circle you are supporting the backbone of the UK economy, providing businesses with the finance they need to grow while earning an attractive, stable return.

This document covers the key features and risks involved when using the Balanced or Conservative lending option to lend to small businesses through Funding Circle, along with a number of features and risks specific to the ISA account. In addition to small businesses, you may also lend to experienced property professionals. The key features and risks for property finance loans can be found here.

By lending to businesses, your capital is at risk.

Who are the businesses you're lending to?

The businesses you lend to through Funding Circle are established companies. They come from all walks of life and may be manufacturers, butchers, bakers, shopkeepers and restaurateurs. A typical Funding Circle borrower:

- Has been trading for 8 years
- Has a turnover of £420,000
- Employs 5-10 people

They may use the money you lend them to manage their cashflow, expand their premises or hire new staff.

How are small businesses assessed?

Every business you lend to must first pass our robust credit assessment process. We use a balanced mix of risk tools to ensure we create a full picture of each borrower's financial health:

1. **Policy criteria** – Policy criteria help filter out businesses that have a low likelihood of being approved for finance. For example, we only consider businesses that have been trading for at least two years and whose directors live in the UK.
2. **Statistical credit models** – Businesses are assessed using statistical credit models that we have developed over many years of small business lending. We regularly upgrade our models with information from publically available data sources (like credit reference agencies) and our own database of historical data (including performance data on tens of thousands of UK companies).
3. **Expert judgement** – Alongside our credit models and policy criteria, businesses are manually assessed by our team of specialist small business credit assessors. They reference multiple sources of data; including financials provided by the borrower and leading credit reference agencies, plus the company directors' own personal finances.

The outcome of the assessment process helps determine the interest rate given to each business, and businesses that fall outside our risk criteria are rejected. More information on how our assessment process works can be found on our blog.

Key features of lending to small businesses

Lending option – When building your portfolio you will be able to choose one of two lending options, depending on your personal preference. As the risk of each business not being able to repay their loan helps determine the interest they are given, your choice of lending option allows you to target a projected return at a level of risk you are comfortable with:

i. **Balanced** – Lend to the full range of businesses looking to access finance with the aim of earning an attractive, stable return. This option has a higher projected return, with a higher estimated bad debt rate.

ii. **Conservative** – You will focus on lending to businesses who have been assessed as lower risk. This option has a lower projected return, with a lower estimated bad debt rate.

The interest rates and default risk (risk of non-payment) of the businesses you lend to through each lending option may change in line with changes to both the overall Funding Circle loanbook and the number of investors who have chosen each option. You can only choose one lending option at any one time.

Minimum initial transfer - To help you build a well-diversified portfolio for a more stable return (see below), we suggest lending £2,000 or more. If you'd like to start with less, there is an initial minimum transfer of £1,000 when opening a new Classic or ISA account. This transfer must be made by debit card and only applies to the first transfer made into a new Funding Circle account.

Diversification – To help you earn a stable return, you will lend small amounts to many different businesses. This is called diversification. If one of your borrowers is unable to repay their loan, the overall impact on your portfolio will be much smaller than if you had only lent to a handful of businesses.

You will aim to lend no more than 0.5% of your total portfolio to each business, providing you have at least £4,000 in your account. However, it is important to remember that the minimum you can lend to each business is £20, so if you have less than £4,000 in your Funding Circle account you will lend more than 0.5% of your portfolio to each business.

Investors with larger accounts will see their 0.5% of lending split into smaller parts no larger than £100 each. For example, an investor lending £100,000 would lend £500 to each business (0.5% of their portfolio). That £500 is then split into five separate loan parts of £100 each, making each loan part easier to sell to other investors. You may still purchase existing loan parts from other investors that are larger than £100, providing they are less than 0.5% of your portfolio.

More information on the benefits of diversification can be found on our statistics page.

Matching your funds to businesses – Once you have turned lending on, you will begin lending to businesses. Our lending tool will begin to match your funds to both businesses looking for finance and existing loan parts being sold by other investors. Your funds will be matched to businesses taking into account your chosen lending option, your individual projected return and the amount of available funds in your account. Repayments (see below) you receive from borrowers will be lent to more businesses. You can stop lending your funds to businesses at anytime by turning lending off.

Loan term – Loan terms for each business range from six months up to five years. In some cases, loans purchased from other investors may have less than six months of repayments remaining. You can access funds before the end of the loan term by selling your loans to other investors (see accessing your money).

Loan contract – You will enter into a separate contract with each individual business you lend to. This is done automatically so you will not have to sign any documents. As the contract is held between you and the borrower, the business will still be liable to repay you even in the unlikely event of Funding Circle going out of business.

Repayments – Each business you lend to will make a monthly repayment of both principal (the original loan amount) and interest. Funding Circle will collect your repayments from each business and distribute them to your Funding Circle account. If you have lending turned on, these will then be automatically matched with more businesses. Each business has their own repayment date depending on when the loan was taken, so you will receive different repayments each day.

Businesses have the option to repay their loan early in full at any time. If this happens you will receive all outstanding principal plus one full month's interest. Repayments on property finance loans work differently, please refer to the property finance Key features and risk document for more information.

Personal Guarantees and security – Small business loans will typically be covered by a Personal Guarantee. This is a guarantee from the director/s taking out the loan that they are personally liable to repay the loan if the business is unable to. This means that if the business is unable to repay and the loan is defaulted, Funding Circle has the option to pursue the guarantor/s through the courts.

In some instances, we may require a business to provide formal security, for example a first charge over an asset. If the business is unable to repay, Funding Circle could take control of the asset and use it to repay investors. It is important to remember that taking formal security or a personal guarantee does not guarantee repayment and it can take time, potentially months or even years, before recovery payments are received. By lending to businesses your capital is at risk and in some instances we may not be able to recover any funds lent to a defaulted business.

Fees – Your projected return includes the 1% annual servicing fee. It is calculated monthly on the outstanding loan amount and taken directly from loan repayments.

This means that by the time the interest reaches your account, the servicing fee has been applied. No servicing fee is taken from recoveries on defaulted loans.

There are no fees or charges to withdraw funds or access your money early.

Accessing your money – Any funds that have not been lent out to businesses can be withdrawn to a nominated bank account held in your name via the Transfer money page. Funds that have been lent out to businesses may be accessed before the end of the loan term by selling loans to other investors. When a loan part is sold, a 1.25% transfer payment will be paid to the buyer by the seller. For example, when selling a £20 loan part, you would receive £19.75 from the buyer. More information on selling your loans can be found in our Investor Guide.

Risks involved when lending to small businesses

Lending to businesses can provide you with attractive, stable returns. However, as with any form of investment there are risks involved:

Late payment – In some cases, a business may be late with their repayments. When this happens our Collections and Recoveries team will work closely with the business to get them back on track with their repayments as soon as possible. Loans that are late can't be sold to other investors until the borrower is up to date with their repayments.

Bad debt – When lending to businesses, there will always be a proportion that are unable to repay their loan. This is a normal part of lending and we call it bad debt. We account for an expected level of bad debt in your projected return.

If a business is unable to repay we may default the loan, which allows our Collections and Recoveries team to begin formal recovery proceedings against the guarantor/s of the loan (see Personal Guarantee). When a loan is defaulted the outstanding amount is deducted from your Funding Circle account and counts as a loss, and the loan can't be sold to other investors. Our Collections and Recoveries team will then work to recover as much of your funds as possible. Any money recovered from a defaulted borrower is distributed to your Funding Circle account as a recovery. More information on bad debt and our recoveries process can be found on our blog, and you can see our bad debt performance on the statistics page.

Downgraded loan – Although a businesses may be on time with their repayments we may have received information that may affect their future ability to repay their loan, for example where a County Court Judgment (CCJ) has been registered against the business. When this happens we temporarily downgrade the loan until we are confident the issue has been resolved. Loans that have been downgraded can't be sold to other investors until the issue is resolved.

Breach of contract – If the borrower breaches the conditions set out in their loan contract, for example by providing incorrect information, we may default the loan (see bad debt).

Accessing your money when selling loans – You can access you money before the end of the loan term by selling your loans to other investors. When a loan part is sold, a 1.25% transfer payment will be paid to the buyer by the seller. For example, when selling a £20 loan part, you would receive £19.75 from the buyer.

There are restrictions that may prevent you from selling some of your loans (see late payment, bad debt, and downgraded loan). To sell a loan, there must be sufficient demand from investors to purchase the loan from you. Although Funding Circle works hard to manage the level of supply and demand on the platform, there is a risk of there being insufficient demand, so you may not be able to access your money as quickly as you would like.

Platform failure – In the unlikely event that Funding Circle were to fail or become insolvent we would transfer the servicing and administration role we perform to a third party backup servicer. All loan contracts are held directly between yourself and the businesses you lend to, so our appointed backup provider would be able to collect and distribute repayments on your behalf.

ISA account - Key features and risks

There are a number of features and risks that are only applicable to an ISA account.

ISA account features

Tax-free returns – All interest earned by investors from loans held within an ISA account is tax free, and you do not need to declare any income earned to HMRC.

Eligibility requirements - To open an ISA account you will need to:

- Be at least 18 years old
- Be a permanent UK resident
- Have not subscribed to another Innovative Finance ISA in the same tax year

Subscription limit – Each tax year you will have a subscription limit, which you can split across a Cash, Stocks and Shares, Lifetime and Innovative Finance ISA. You can only subscribe to one of each ISA type per year, so it's important to choose your ISA provider and product carefully. Although we will reject transfers that exceed your overall subscription limit in a tax-year, it is your responsibility to keep track of how much you have subscribed to across all your ISAs.

Transferring existing ISA subscriptions to your ISA account – You can transfer any existing ISAs you hold to a Funding Circle ISA, subject to any restrictions set by your current provider. To transfer an ISA, navigate to the Transfers page and follow the instructions. More information on ISA transfers can be seen here.

Transferring your ISA account to another ISA provider – If you want to transfer your ISA to another provider, you must first sell your loans and transfer the funds raised. There are restrictions that may prevent you from selling some of your loans (see late payment, bad debt, and downgraded loan). Any loans that can't be sold will be transferred over to a new Classic account and will no longer be eligible for tax-free interest.

Cancelling your ISA account – You have 14 days from the date on which your ISA is opened to cancel your agreement with us and close your ISA – you can only cancel your agreement and close your account if you have not lent (or committed to lend) any money to businesses. If you wish to cancel your ISA, please email us at contactus@fundingcircle.com, or give us a call on 0207 401 9111. After 14 days you must close your ISA account in the same way as you would close a Classic account.

ISA account risks

Tax treatment can change – Remember that tax rules and relief can change in future, and for advice on your own tax position please contact HMRC or an independent financial advisor.

The tax advantages of an ISA only applies to interest you earn – By lending to businesses through Funding Circle your capital is at risk, so it's important to understand the tax disadvantages if you make a loss on your investment. When transferring funds into an ISA account, you will use your tax-free subscription regardless of the earnings you make. If your loan parts do not earn interest or are not repaid, then you will not receive any tax benefit from them.

Only authorised ISA managers can offer ISA accounts – As an authorised ISA manager, Funding Circle can offer you tax-free returns. In the unlikely event of Funding Circle ceasing to trade your investments could lose their tax-free status. Our current back-up servicer, who would step into our shoes if this event occurred, is an authorised ISA manager.

You may not be able to transfer all of your loan parts to another ISA provider – There are restrictions that may prevent you from selling some of your loans (see late payment, bad debt, and downgraded loan). Loan parts that can't be sold won't be transferred and will no longer be eligible for tax-free interest.

Investment through Funding Circle involves lending to businesses, so your investment can go down as well as up.
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