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BNA INSIGHTS: Signs of Forthcoming Regulation of Online Marketplace Lending

Marketplace Lending

Recent actions by the U.S. Department of the Treasury (Treasury), banking regulators and lawmakers may foreshadow changes to the existing regulatory environment for marketplace lenders. These changes have implications not just for marketplace lenders, but also for financial institutions that compete or partner with them.



By Michael Nonaka, Nikhil Gore and Randy Benjenk

In recent months, U.S. policymakers have scrutinized the online marketplace lending industry, including business relationships between marketplace lenders and traditional banks. This article examines these developments and considers the future prospects for regulation of the online marketplace lending industry.

Online marketplace lending is an emerging segment of the financial services industry that uses online platforms to lend directly or indirectly to consumers and small businesses. Online marketplace lenders tend to use one of two business models, or a combination of these business models, to fund loans.

First, ''peer-to-peer'' platforms sell securities to third-party investors to fund individual borrowers. Due to the borrower-dependent nature of the payment obligation on such securities, peer-to-peer lenders do not retain credit risk in the event that the borrowers do not pay. Second, so-called ''balance sheet lenders'' are typically funded by venture capital, hedge fund, family office investments and/or loans from insured depository institutions and retain credit risk in their own loan portfolios or sell all or a portion of the loans to banks or investors. Lenders in either category may partner with insured depository institutions that act as the originating lender to borrowers on the online lender's platform, and some depository institutions may also retain loans post-origination.

Marketplace lenders often employ new, largely automated underwriting processes. Some lenders purport to rely on ''big data'' not evaluated as part of traditional bank underwriting processes.

Marketplace lenders currently are required to comply with federal consumer financial protection laws such as, among others, the Truth in Lending Act, Equal Credit Opportunity Act, Fair Debt Collection Practices Act, and Gramm-Leach-Bliley Act.[1] Peer-to-peer lend-

[1] Qualifying marketplace loans may also be covered by pending Consumer Financial Protection Bureau rules on pay-

 ISSN 0000-0000

ers that fund loans through third-party investors (rather than from their own balance sheets) may also be subject to securities regulation.[2] Failure to comply with the federal consumer financial protection laws or securities laws could subject a marketplace lender to enforcement action by the Federal Trade Commission (FTC), Consumer Financial Protection Bureau (CFPB) or Securities and Exchange Commission (SEC). Marketplace lenders are not, however, subject to comprehensive federal or state supervision and examination in the same way as are banks and other insured depository institutions, nor are they subject to safety and soundness regulations, including minimum capital and liquidity requirements, under federal law.[3]

Recent actions by Treasury, guidance and statements from bank regulators such as the Federal Deposit Insurance Corporation (FDIC) and the Federal Reserve, and intensified congressional attention after reports surfaced that an online lender made a loan to one of the San Bernardino, Calif. shooters may foreshadow changes to the existing regulatory environment for marketplace lenders. These changes have implications not just for marketplace lenders themselves, but also for financial institutions that compete or partner with them.

U.S. Department of Treasury's Request for Information

Last summer, Treasury issued a request for information on online marketplace lending.[4] Treasury received more than 100 comments from marketplace lenders, banks and trade groups by the close of the comment period on Sept. 30, 2015. Of particular interest, commenters representing competitors of marketplace lenders raised concerns to Treasury over the scope and extent of regulatory oversight with respect to marketplace lending:

- **Examination and Enforcement Regime.** Noting that marketplace lenders are subject to many of the same consumer protection and equal credit opportunity laws as banks, commenters suggested that marketplace lenders should be subject to a comparable examination regime designed to ensure their compliance.
- **Small Business Lending.** Many commenters believe that the regulation of loans to ''micro-businesses'' — sole proprietors and other small business borrowers who may closely resemble individual consumer borrowers in terms of their level of experience with financial products and services — is especially critical. Because micro-businesses are often regarded as being underserved by traditional lenders, they may more frequently turn to marketplace lenders.
- **Financial Stability.** Significant growth in the marketplace lending industry did not start until after the financial crisis. Some commenters questioned whether marketplace lenders have access to sufficient financial resources to survive a spike in consumer defaults that may accompany a future recession. These commenters suggested that, as marketplace lenders become a more significant source of credit to consumers and small businesses, the failure of one or more lenders could restrict credit in the midst of a downturn.
- **Asset Quality.** Many of the same commenters also queried whether marketplace lenders have adequate loan underwriting policies and procedures. One concern that banks raised prior to Treasury's Request For Information is that peer-to-peer marketplace lenders may not retain sufficient ''skin in the game'' when selling loans so as to incentivize proper underwriting.[5]

Anticipating these objections, the largest U.S. marketplace lenders pointed out that many marketplace lenders rely on banks to originate loans and merely purchase those loans for resale to platform investors. Therefore, for these lenders, a borrower may indirectly receive the same regulatory protections as any bank customer. In addition, a marketplace lender that acts as a service provider to one or more banks may be examined by bank regulatory agencies in connection with the services provided to the bank.[6]

Marketplace lenders also responded to several of the other concerns about their business models expressed by commenters. For example, with respect to concerns about ''skin in the game,'' one marketplace lender argued that over 20 percent of its revenue is ''subject to loan performance over time,'' while another marketplace lender noted that it ''knows of no reason why the Risk Retention Rule [under section 941 the Dodd-Frank Act] . . . would apply any less to securitizations of marketplace loans than it would to securitizations of other types of loans.''[7]

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day loans, vehicle title loans, deposit advance products, and certain high cost installment loans and open-end loans. Further, marketplace lenders may also be subject to state-level regulation including, notably, with respect to usury. A recent decision of the Court of Appeals for the Second Circuit suggested that loans held by nonbank entities may be subject to state usury laws even where the loans were originated by national banks for whom such laws are preempted; the decision is likely to be appealed to the Supreme Court. *See Madden v. Midland Funding*, 2015 WL 2435657 (2d Cir. May 22, 2015).

[2] The two largest U.S. marketplace lenders have registered their payment-backed notes with the Securities and Exchange Commission.

[3] A marketplace lender may be subject to regulation by a state regulatory agency, if, for example, the lender is licensed by the agency. In addition, the CFPB has indicated in its most recent Unified Regulatory Agenda that it intends to engage in ''pre-rule activities'' in September 2016 regarding a rule to supervise larger participants of installment lending in title lending markets, including possibly through the registration of nondepository lenders. *See* CFPB, Supervision of Larger Participants in Installment Loan and Vehicle Title Loan Markets, *available at* http://www.reginfo.gov/public/do/eAgendaViewRule?pubId=201510&RIN=3170-AA07. These activities eventually may affect the regulatory framework applicable to certain marketplace lenders.

[4] U.S. Department of the Treasury, Public Input on Expanding Access to Credit Through Online Marketplace Lending, 80 Fed. Reg. 42866 (July 20, 2015).

[5] Todd Baker, *Marketplace Lenders Are a Systemic Risk*, American Banker, Aug. 17, 2015, *available at*http://www.americanbanker.com/bankthink/marketplace-lenders-are-a-systemic-risk-1076047-1.html.

[6] *See, e.g.*, ''Third Party Relationships,'' OCC Bulletin 2013-29 (Oct. 30, 2013).

[7] The risk retention rule generally requires securitizers of asset-backed securities to retain 5 percent of the credit risk of any securitized asset. *See* 17 C.F.R. § 246.4.

   ISSN 0000-0000

While these marketplace lenders generally disfavored the specific regulation of marketplace lending as an industry, preferring that lenders instead be covered by rules of general applicability, the Online Lenders Alliance trade group (''OLA'') took a different approach. Using the development of the national credit card market as its analogy, OLA argued that true innovation in financial services can only be achieved on a national scale, and advocated for the creation of a federal charter for online lenders that would establish national standards for their regulation.

FDIC Advisory on Purchased Loans

The federal bank regulatory agencies have also shown increasing interest in marketplace lenders and, in particular, their business relationships with banks.

Most notably, on Nov. 6, 2015, the FDIC issued a Financial Institution Letter warning FDIC-supervised banks of the risks of purchasing and participating in loans originated by nonbank third parties, particularly loans that are unsecured, made to out-of-territory borrowers or borrowers in industries unfamiliar to the bank, or underwritten using proprietary models that limit the bank's ability to assess underwriting quality.[8] According to the advisory letter, the FDIC has seen several instances where ''it is evident that financial institutions have not thoroughly analyzed the potential risks arising from third party arrangements.''

The advisory letter instructs banks to underwrite any loan purchase or loan participation ''in the same diligent manner as if they were the originator,'' meaning that banks must perform a complete analysis of collateral and credit risk of each loan or participation and must have a complete understanding of the borrower's market and industry. The FDIC emphasized that, ''this assessment and determination should not be contracted out to a third-party.'' The agency also advised banks to conduct an independent analysis and validation of any credit models used by third-party originators and emphasized that any third-party arrangements to facilitate the purchase of loans and loan participations should be managed by an effective third-party risk management process.

The FDIC's advisory letter is likely aimed in part at loans originated by marketplace lenders. It has been widely reported in the press that banks (including many smaller banks) are purchasing or participating in loans issued by marketplace lenders to diversify their credit risk. The day before the FDIC issued the advisory letter, Rae-Ann Miller, the FDIC's associate director of risk management supervision, specifically referenced marketplace lending in remarks to the FDIC Advisory Committee on Community Banking on emerging trends and risks.[9] She and some members of the committee expressed concerns about consumer protection, the stability of funding sources, the high cost of credit to small businesses, the transparency of small business loan disclosures, and the limitations of ''algorithmic'' and ''model-based'' lending in times of stress. Other Committee members expressed concern over the competitive threat posed to community banks, arguing that bank examiners should permit community banks to innovate in similar ways to marketplace lenders.

The advisory letter could increase the costs incurred by marketplace lenders and those banks who partner with marketplace lenders. Among other things, it contemplates banks conducting significant diligence not only into particular loans originated by marketplace lenders, but also into marketplace lenders' underwriting platforms and other proprietary lending technologies. Such diligence may pose challenges for marketplace lenders concerned about exposing proprietary processes and algorithms to potential competitors. Requiring this diligence also may place a burden on smaller banks that may lack the technological expertise to evaluate marketplace lending algorithms.

The FDIC letter does not apply to all banking organizations, only to state non-member banks and their subsidiaries. Holding companies and other types of banks may have greater flexibility to invest in marketplace loans, as will nonbank financial investors such as asset managers and institutional investors. However, Federal Reserve Governor Lael Brainard has cautioned that banks should ''carefully consider regulatory compliance'' in purchasing loans or otherwise dealing with marketplace lenders, suggesting that the Federal Reserve also is scrutinizing the third-party risks from marketplace lending.[10]

Federal Reserve and Congressional Concerns Over Small Business Lending

While the majority of marketplace loans are consumer loans, small and medium business loans comprise a significant portion of the market[11] and have been a focus of recent scrutiny.

First, on Aug. 25, 2015, the Federal Reserve Bank of Cleveland released a study of online ''alternative'' lenders based on an online focus group survey of 44 small businesses. While the results of the survey were positive in some respects — showing generally favorable attitudes toward marketplace lenders among small businesses that were familiar with them — the survey also suggested that:

- participants were concerned about data security and privacy arising from lenders' collection of applicants' financial information for marketing and underwriting purposes; and
- after viewing mock product offers, participants suggested that product features and loan terms should be stated more clearly and in a standardized manner.

[8] FDIC, Advisory on Effective Risk Management Practices for Purchased Loans and Purchased Loan Participations, FIL-49-2015 (Nov. 6, 2015).

[9] Rae-Ann Miller, Morning Session - Advisory Committee on Community Banking Webcast (Nov. 5, 2015), *available at*https://fdic.primetime.mediaplatform.com/#!/video/125/Morning+Session+-+Advisory+Committee+on+Community+Banking+Webcast.

[10] Lael Brainard, Governor, Federal Reserve, ''Community Banks, Small Business Credit, and Online Lending,'' Speech at the Third Annual Community Banking Research and Policy Conference (Sept. 30, 2015), http://www.federalreserve.gov/newsevents/speech/brainard20150930a.htm.

[11] *See* Morgan Stanley Blue Paper, Global Marketplace Lending: Disruptive Innovation in Financials (May 19, 2015), *available at*http://static1.squarespace.com/static/54120896e4b04f3b28c2f6c7/t/559852c9e4b04425d93cf624/1436046025597/MS+White+Paper.pdf.

Following the release of the Cleveland Reserve Bank's study, Democratic Sens. Sherrod Brown of Ohio, Jeff Merkley of Oregon and Jeanne Shaheen of New Hampshire sent a letter to Treasury and the Small Business Administration (SBA) on Nov. 3, 2015, asking questions about the regulation of online lending to small businesses.[12] The senators' letter raised significant questions, including:

- whether online lenders provide clear and transparent information about their products;
- whether federal regulators should have a greater role in supervising nonbank companies' lending to small businesses;
- what steps Treasury and the SBA are taking to communicate the risks community banks face in partnering with online small business lenders;
- whether Treasury and the SBA have recommendations for data security and privacy practices; and
- how Treasury and the SBA ensure that online small business loans are made in compliance with fair lending laws.

In addition, Rep. Nydia M. Velazquez (D-N.Y.), the ranking member of the House Small Business Committee, wrote a letter to the SEC and CFPB on Nov. 12, 2015, requesting information on the following issues relating to marketplace lending:

- which federal laws under the SEC's and CFPB's jurisdiction apply to small business borrowers and retail investors participating in the online lending marketplace;
- the agencies' current role in regulating or overseeing online marketplace lending for small business lending and extensions of credit;
- resources devoted by the agencies to regulating online marketplace lending;
- whether the SEC and CFPB have the necessary legal authorities to protect small business borrowers from online marketplace lenders; and
- what statutory changes, additional legal authorities, and resources are necessary to support the SEC's and CFPB's roles in regulating online marketplace lending as it relates to small business loans and extensions of credit.[13]

These letters reflect congressional interest in online marketplace lending to small businesses. The ongoing dialogue between Congress and regulatory agencies over marketplace lending may drive further regulatory developments in this area.

Likelihood of Further Regulatory Action

The marketplace lending industry is new and diverse. It encompasses lenders that make loans to higher-risk, lower income borrowers; micro-finance and nonprofit lenders; and larger-scale lenders that market their products to traditional consumers and small businesses. As a result, the definition of marketplace lending is not settled.[14]

Moreover, there are few indications that the industry presents substantial prudential risks for the broader U.S. economy. Indeed, Treasury Deputy Assistant Secretary for Financial Institutions Anjan Mukherjee recently acknowledged that ''[i]t's safe to say that the industry is not yet at a point where it poses a safety and soundness risk to the financial system.'' In addition, the industry's specific safety and soundness risks have not been clearly established because the industry is so new, having not yet experienced stressed conditions on a broad basis, and because its participants are diverse with unique risks that may not be shared by all participants.

There does not appear to be a consensus view of the best approach to monitoring and assessing safety and soundness risks of online marketplace lenders. As a consequence, a formal rulemaking or even detailed published guidance that applies directly and specifically to marketplace lending is unlikely in the short term. However, it is likely that information gathering by Congress and the regulators will continue in the short term as the industry takes shape.

Indeed, the Task Force on Terrorism Financing created by House Financial Services Committee Chairman Jeb Hensarling (R-Texas) has asked Treasury to provide information about the regulation of online lenders in light of reports that one of the San Bernardino shooters, Syed Rizwan Farook, borrowed $28,500 from an online marketplace lender.[15] In addition, on Dec. 10, 2015, the California Department of Business Oversight began an inquiry into the marketplace lending industry by sending an online survey to 14 marketplace lenders requesting information on their business models and online platforms.[16]

Federal regulators already have substantial authority to enforce existing laws, including sometimes malleable prohibitions against unfair deceptive and abusive practices. For example, the CFPB could seek to take action against a particular marketplace lender for violating the federal consumer financial laws that apply to the lender, or for engaging in unfair or abusive market conduct. Similarly, the FTC has not been shy when it comes to bringing enforcement actions against companies that mislead small businesses — including the same independent sales organizations (ISOs) that some market-

[12] Letter from Senators Sherrod Brown, Jeff Merkley and Jeanne Shaheen to Jacob Lew, U.S. Secretary of the Treasury, and Maria Contreras-Sweet, Administrator of the U.S. Small Business Administration (Nov. 3, 2015), *available at*http://www.merkley.senate.gov/news/press-releases/merkley-brown-shaheen-press-for-information-on-financial-technology-markets-impact-on-small-businesses-and-consumers.

[13] Letter from Representative Nydia M. Velázquez to Mary Jo White, Chair of the U.S. Securities and Exchange Commission, and Richard Cordray, Director of the Consumer Financial Protection Bureau (Nov. 12, 2015), *available at* http://velazquez.house.gov/images/onlinelendingletter111215.pdf.

[14] For example, comments to Treasury by a marketplace lender and by an industry website both distinguished between ''true'' marketplace lenders, which provide markets for third-party investors to lend money to borrowers, and so-called ''balance sheet lenders,'' which make loans from their own funds.

[15] Hensarling also has announced his intent to propose anti-terrorism financing legislation in early 2016, and it is possible this legislation may include related restrictions on online marketplace lenders.

[16] Press Release, California Department of Business Oversight, California DBO Announces Inquiry into 'Marketplace' Lending Industry: Seeks Data, Information from 14 Online Companies (Dec. 11, 2015), *available at*http://www.dbo.ca.gov/Press/press_releases/2015/DBO%20Inquiry%20Announcement%2012-11-15.pdf.

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place lenders use to offer loans and cash advances to small businesses.[17]

This approach has consequences not just for marketplace lenders themselves, but also for banks and other traditional financial institutions. Without a standalone regulatory regime in place, regulators may regulate marketplace lenders indirectly using their supervisory mechanisms for banks and other traditional financial institutions that do business with marketplace lenders, as the FDIC has done with its advisory letter. Other regulators may send similar messages to the institutions they regulate in the form of published guidance or individualized supervisory communications.

Conclusion

The increasing interest in marketplace lenders from a regulatory perspective corresponds to the growth in the industry over the past few years. As Congress and regulatory agencies continue to gather information on the industry, it is unlikely that a comprehensive initiative seeking to regulate marketplace lenders will be issued by the agencies, although this observation is subject to change, especially in the event Congress passes federal legislation following the San Bernardino shooting or a particular online lender experiences financial distress.

Michael Nonaka is a partner in the Washington, D.C., office of Covington & Burling LLP, where he advises banks, financial services providers and nonbank companies on a broad range of compliance, enforcement, transactional and legislative matters. He has worked extensively with federal and state banking regulators and with other federal agencies authorized to regulate financial services.

Nikhil Gore is an associate in the Washington, D.C., office of Covington & Burling LLP, where he is a member of the financial institutions and international practice groups. His financial institutions practice encompasses the representation of foreign and domestic financial institutions on a wide variety of bank regulatory and enforcement issues.

Randy Benjenk is an associate in the Washington, D.C., office of Covington & Burling LLP, where he represents domestic and foreign financial institutions and trade associations on a variety of bank regulatory issues, including compliance, government affairs and transactional matters.

[17] See, e.g., *FTC v. Merchant Services Direct LLC* (2013 enforcement action alleging that ISO misled small businesses into purchasing or leasing new point-of-sale credit card terminals), *available at* https://www.ftc.gov/news-events/press-releases/2013/07/ftc-charges-marketers-deceiving-small-businesses-buying.