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Forecasting Regulation of Online Marketplace Lending After Treasury's Request for Information

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Financial Institutions

On September 30, 2015, the comment period closed on the U.S. Department of the Treasury's ("Treasury's") Request for Information ("RFI") on online marketplace lending.[1] Treasury's request attracted more than a hundred comments from marketplace lenders, bankers, and trade groups. Treasury had sought comments on, among other things, the financial regulatory framework applicable to online marketplace lending and how it should evolve to support the safe growth of the industry. The comments submitted are likely to have implications not just for marketplace lenders themselves, but also for financial institutions that both compete and partner with them.

Current and Future Areas of Regulatory Focus

Marketplace lenders currently are required to comply with Federal consumer regulation under, among other things, the Truth in Lending Act, Equal Credit Opportunity Act, Fair Debt Collection Practices Act, and Gramm-Leach-Bliley Act.[2] Peer-to-peer lenders that fund loans through third party investors (rather than from their own balance sheets) may also be subject to securities regulation in the course of securitizing loans.[3] Marketplace lenders are not, however, subject to federal supervision in the same way as banks and other insured depository institutions, nor are they regulated for safety and soundness under federal law. Commenters representing banks and other competitors raised concerns to Treasury on both of these grounds:

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

[2] Qualifying marketplace loans may also be covered by pending CFPB rules on payday 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 non-bank 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).

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

- **Extent and Depth of Regulatory Oversight.** 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 and enforcement regime to ensure their compliance. One key area to watch is the regulation of loans to "micro-businesses"—sole proprietors and other small business borrowers who, at least in their level of sophistication, closely resemble individual consumer borrowers. Such businesses are a particular target for marketplace lending platforms, which view them as underserved by traditional lenders.
- **Financial Stability and Asset Quality.** Significant marketplace lending did not begin until after the financial crisis, and some commenters questioned whether marketplace lenders have access to sufficient financial resources to survive a spike in consumer defaults accompanying 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.

  Many of the same commenters also queried whether marketplace lenders—which often employ new, largely automated underwriting processes that rely on "big data" not typically evaluated as part of bank underwriting processes—are adequately ensuring the quality of the loans they originate. One concern that banks raised even prior to the RFI is that peer-to-peer marketplace lenders may not retain sufficient "skin in the game" when selling loans to incentivize proper underwriting.[4]

Anticipating these objections, the largest marketplace lenders in the United States pointed out that many marketplace lenders rely on banks to originate loans and merely purchase those loans for resale to platform investors. Therefore, borrowers from a marketplace lender may indirectly receive the same regulatory protections as any bank customer. In addition, marketplace lenders that act as service companies to banks may be examined by bank regulatory agencies in connection with the functions they perform for banks.[5]

Marketplace lenders also confronted several of the concerns expressed in connection with their business models. 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."[6]

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 ("OLA," a trade group) took a different approach.

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[4] *See* Todd Baker, "Marketplace Lenders Are a Systemic Risk," in American Banker (August 17, 2015).

[5] *See, e.g.*, "Third Party Relationships," OCC Bulletin 2013-29 (October 30, 2013).

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

Using the development of the national credit card market as its point of departure, 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, which would establish national standards for their regulation.

Likelihood of 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 non-profit lenders, like Accion and Kiva; and lenders like Prosper and Lending Club that market their products to traditional consumers and small businesses. As a result, even the definition of marketplace lending is contested.[7]

Moreover, it is difficult to assess whether the industry presents substantial prudential risks for the broader economy, let alone how best to manage such risks, in part because the industry has not yet experienced stressed economic conditions.

As a consequence, a formal rulemaking or even detailed published guidance specific to marketplace lending is unlikely in the short term. Instead, to the extent regulators decide to focus on the marketplace lending industry, they are likely to do so through enforcement of existing laws and regulations on a case-by-case basis.

Such an approach holds risks not just for marketplace lenders themselves, but also for banks and other traditional financial institutions. Without a standalone regulatory regime in place, regulators may leverage their oversight of banks and other traditional financial institutions that do business with marketplace lenders, requiring them to vouch for the regulatory compliance of the marketplace lenders they do business with. Already, one senior Federal Reserve official has cautioned that banks should "carefully consider regulatory compliance" in purchasing loans or otherwise dealing with marketplace lenders.[8]

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[7] For example, comments 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.

[8] Governor Lael Brainard, "Community Banks, Small Business Credit, and Online Lending," Speech at the Third Annual Community Banking Research and Policy Conference (September 30, 2015).

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