

Chapman Client Alert

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Current Issues Relevant to Our Clients

U.S. Treasury Department Issues White Paper on Marketplace Lending

On May 10, 2016 the U.S. Department of the Treasury (the “*Department*”) published a white paper entitled “Opportunities and Challenges in Online Marketplace Lending” (the “*White Paper*”).¹ The White Paper follows the “Request for Information” (the “*RFI*”) which the Department published in July 2015 to solicit public input on various topics concerning marketplace lending. In the White Paper, the Department (i) provides an overview of marketplace lending operations in several market segments, (ii) summarizes the comments made by RFI respondents on a number of operational or regulatory issues, (iii) makes specific recommendations for certain regulatory and/or industry actions, and (iv) identifies certain current trends and developments in marketplace lending which it intends to monitor. The White Paper states that marketplace lending can provide both consumer and small business borrowers with expanded access to credit but may also create risks which existing regulatory structures do not adequately address.

Summary of RFI Comments

In the RFI, the Department solicited public input on the various business models and products offered by marketplace lenders to small businesses and consumers, the potential for marketplace lending to expand access to credit to underserved communities, and how the regulatory framework should evolve to support the safe growth of the industry. The Department accepted comments on the RFI through September 2015 and received approximately 100 responses from marketplace lenders, trade associations, consumer and small business advocates, academics, investors and financial institutions. In the White Paper, the Department states that many commenters raised the following common themes:

1. *Use of Data in Underwriting Decisions.* RFI commenters agreed that the expanded use of data for credit underwriting is a core element of marketplace lending. By reviewing data beyond the information that has been traditionally been included in customer credit files, marketplace lenders may be able to reduce customer acquisition costs, enhance creditworthiness assessments, expedite credit approvals and extend credit to a broader range of borrowers. At the same time, some commenters noted that the use of new data sources and credit models could create risks for consumers, including risks that the data may be inaccurate, may be used for purposes contrary to consumer expectations (e.g., using social media information in underwriting) and/or could lead to disparate impact, fair lending violations or predatory lending.
2. *Expanding Access to Credit.* A number of commenters stated that marketplace lending is expanding access to credit by providing loans to certain borrowers who might not have received capital from traditional financial institutions. Commenters further noted that referral partnerships between marketplace lenders and depository institutions can provide both consumers and small business borrowers with expanded access to credit. At the same time, the facts that the largest consumer and student marketplace lenders have to date focused on prime and near-prime borrowers, and that most such loans have been made for purposes of debt consolidation or refinancing, has limited the amount of new credit actually created by such lenders.
3. *New Credit Models Remain Untested.* Many commenters noted that the new underwriting models used by marketplace lenders have not been tested through a complete credit cycle. Commenters also expressed concern that many marketplace lenders are relying heavily upon a limited number of servicing and collections firms. Certain investors stated that they consider backup servicing arrangements to be a prerequisite to investing in marketplace lending loans.
4. *Regulation of Small Business Lending.* Many commenters argued that small business borrowers need enhanced safeguards as small business lending is not subject to all of the consumer protection laws that apply to personal loans. Consumer advocates argued that many small business borrowers should be treated as consumers and that the standard of regulation should be the same whether the lender is a traditional financial institution, a marketplace lender or another nonbank entity. Some commenters also stated that cost of credit disclosures to small business

borrowers should be standardized so that borrowers may better understand the cost of credit and compare the terms offered by different lenders.

5. *Greater Transparency.* RFI commenters largely agreed on the need for greater transparency. The Department stated that it considers “transparency” to mean “clear, simple, and consistent terms that borrowers and investors can understand.” The Department stated that although some lenders are disclosing extensive loan-level data, clear rates and terms and transparent loan performance metrics, other companies are not clearly or systematically disclosing information to borrowers and investors. In this regard, many commenters argued strongly for standardized and clear terms and disclosures to borrowers. Investors and lenders also called for the creation of a centralized registry to track both loan-level data and transactions. Certain commenters noted that the Securities and Exchange Commission (“SEC”) disclosure rules for securitization transactions apply only to publicly-registered offerings, and suggested that such rules be extended to marketplace lending securitizations (all of which to date have been privately placed and not publicly offered).
6. *Secondary Market Remains Undeveloped.* Commenters agreed that an active secondary market for marketplace lending loans does not exist and noted several factors that have impeded secondary trading, including smaller loan sizes and underdeveloped trade and portfolio management infrastructure. Among other benefits, commenters noted that an active secondary market would enable more accurate valuations of loan portfolios. Commenters on this topic also agreed that the development of an active secondary market will depend upon the growth of the securitization market and stated that a well-functioning securitization market with active repeat issuances could reduce funding risks for marketplace lenders as economic conditions change.
7. *Regulatory Clarity is Needed.* Commenters expressed different views as to the need for increased federal regulation of marketplace lending. Some commenters argued that the federal government should play a greater role in regulating marketplace lenders (and possibly should consolidate regulatory responsibilities into a single agency) while others contended that the existing regulatory regime is sufficient. Commenters did agree, however, that the industry would benefit from greater regulatory certainty. Among other issues, commenters noted the uncertainty concerning the application of the “true lender” doctrine to marketplace lenders who fund loans through partner banks and stated that regulators should evaluate the fragmented nature of regulatory oversight for consumer marketplace lenders (including the lack of federal supervisory oversight

for certain nonbank lenders). The Department did resolve one significant issue facing the industry by confirming that the federal risk retention rules will not apply to marketplace lenders in relation to the issuance of borrower payment dependent notes.²

Recommendations for Regulatory or Industry Action

Building on the RFI responses and its own market research, the Department makes a number of recommendations in the White Paper for regulatory and/or industry actions. The Department stated that its recommendations are intended to facilitate the safe growth of marketplace lending while fostering affordable access to credit for consumers and businesses. The Department’s recommendations include the following:

1. *Enhanced Protection for Small Business Borrowers.* Citing a 2015 survey which found that only 15% of small business borrowers from online platforms were satisfied with their experience, the Department stated that more effective regulatory oversight could enable greater transparency in small business marketplace lending and lead to better outcomes for borrowers. In particular, the Department noted that small business loans under \$100,000 share common characteristics with consumer loans but are not entitled to the same consumer law protections. The Department stated that focusing regulatory initiatives on these smaller loans could protect self-employed individuals and microbusiness owners while minimizing the compliance burden for larger loans and that it is willing to work with Congress to consider legislation that addresses both oversight and borrower protection. The Department took note of industry efforts at self-regulation — including the Small Business Borrowers’ Bill of Rights that has been adopted by various small business lenders³ — and stated that industry efforts already undertaken to promote transparent pricing, responsible underwriting, fair debt collection practices and similar borrower protections suggest that new regulations in these areas would not impose an undue burden on small business lenders.
2. *Protecting the Borrower Experience.* The Department stated that the servicing capabilities of marketplace lenders have not been fully tested because, to date, the lenders have been operating under a favorable credit climate and that it is uncertain whether, under less favorable conditions, the current servicing infrastructure of marketplace lenders would respond adequately to increased delinquencies. The Department stated that all marketplace lenders — whether they perform debt collections themselves or contract collection services to third parties — should exercise prudence when engaging with borrowers in financial distress and should have in place comprehensive

arrangements (including back-up servicing plans) to provide for the continued servicing and collection of loans in the event the platform fails. More generally, the Department stated that the industry should adopt standards designed to provide a sound borrower experience at all stages of the lending and collection process including strong customer service capabilities that provide for quick turnaround times for customer inquiries and error resolution. The Department further recommended that depository institutions who partner with marketplace lenders (including through referral, white label or co-branding arrangements) work with those lenders to adhere to industry standards and to identify back-up servicing options.

3. *Promoting a Transparent Marketplace.* Certain RFI commenters stated that to improve its access to the capital markets the industry will need to develop a wider investor base, an active and stable secondary market and transparent securitization activity. The Department stated that the industry should therefore adopt (i) standardized representations, warranties and enforcement mechanisms, (ii) consistent reporting standards for loan origination data and ongoing portfolio performance, (iii) loan securitization performance transparency, and (iv) consistent market-driven pricing methodology standards. The Department further recommended the creation of a private sector registry for tracking data on transactions, including the issuance of notes and securitizations, and loan-level performance. The registry should be available to the public. The Department also encouraged financial services industry groups to independently establish loan-and-pool level disclosure and reporting standards.
4. *Expanding Access to Credit for Underserved Borrowers.* The Department stated that its review of the industry demonstrated that marketplace lenders are primarily servicing prime and near-prime borrowers. The Department stated that for technology to truly expand access to underserved markets, more must be done to serve borrowers who may be creditworthy, but may not be scoreable under traditional credit scoring models. These borrowers include so-called “no file” or “thin file” consumers, or small businesses with less than three years of operations. The Department therefore recommended that marketplace lenders consider partnering with Community Development Financial Institutions (“CDFIs”). CDFIs are specialized financial institutions certified by the Department as servicing economically distressed communities and low income individuals. The Department stated that both CDFIs and marketplace lenders could benefit from such partnerships — the CDFI by using the lender’s technology and back-end operations to lower costs and the lender by gaining access to the CDFI’s knowledge of local credit markets. The Department emphasized that CDFIs,

marketplace lenders and prudential regulators should work together to ensure the safety and soundness of any such collaboration.

5. *Expanded Access to Government Data.* The Department stated that use of “smart disclosure” by the industry could facilitate the ability of third-party companies to create comparison shopping sites for loans (in much the same manner as online travel sites allow permit comparison shopping of airline and hotel fares). Consumers could then access those sites to more easily compare terms and determine which offered loan best fits their needs. The Department defined “smart disclosure” as “the release of information in standard machine readable formats that can be easily processed by third-party software” and recommended that the Consumer Financial Protection Bureau (“CFPB”) and Federal Trade Commission (“FTC”) include the use of smart disclosure in their guidance and standards for consumer disclosures. The Department also noted that marketplace lenders will be able to make more accurate credit assessments (and therefore will be less likely to make loans that the borrowers cannot repay) if they verify the borrower’s financial capacity before approving the loan but that, at present, such lenders do not have access to comprehensive data sources that would enable them to conduct capacity verifications in real time. The Department therefore recommended that Internal Revenue Service and other federal agencies work with the Department to develop automated programs that would allow borrowers to voluntarily provide lenders with government data related to the borrower’s financial capacity.
6. *Standing Working Group for Interagency Cooperation.* Various aspects of marketplace lending and related financing activities by lenders are subject to regulation by a number of different federal and state agencies. The Department therefore recommended that regulators organize an interagency working group consisting of representatives of the Department, the CFPB, the FTC, the SEC, the Federal Deposit Insurance Corporation, the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, the Small Business Administration and a representative of a state banking regulator. The working group would enable the member agencies to coordinate efforts in relation to the regulation of marketplace lending, including the identification of areas where additional regulatory clarity is needed. Among other topics, the Department stated that the working group could consider the applicability of existing regulations to marketplace lenders, whether there are any gaps in the current regulatory structure and the impact of nontraditional data on credit scoring models.

Issues for the Future

At the close of the white paper, the Department identified certain issues and trends in marketplace lending which it intends to monitor. These include:

- The opportunities and risks created by marketplace lenders' use of new variables and more complex algorithms. In particular, the Department stated that the impact of increasingly sophisticated models on overall credit access and outcomes for disadvantaged groups should be carefully monitored.
- The impact of changing market interest rates on loan performance. The Department stated that because marketplace lenders have developed their credit models during a period of near zero short-term interest rates, it will be critical to monitor how marketplace lenders test and adapt models in a less favorable credit environment.
- The liquidity of marketplace lenders. The Department stated that although the lending model of marketplace lenders requires them to raise funding continuously from institutional investors, certain such investors are becoming reluctant to invest in marketplace loans due to the lenders' lack of predictable cash flow, untested credit risk assessments and increasing competition with high yield products.
- The need for marketplace lenders to adopt appropriate baseline protections and best practices to prepare for and reduce the risk of cybersecurity incidents and to protect consumers.

- Whether marketplace lending creates potential risks for money laundering and terrorist financing and whether additional regulation is needed to address such risks.
- The entry of marketplace lenders into mortgage and auto lending and the performance of such loans as the sector matures.

For More Information

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- 1 The White Paper is available at <https://www.treasury.gov/connect/blog/Pages/Opportunities-and-Challenges-in-Online-Marketplace-Lending.aspx>.
 - 2 The federal risk retention rules were adopted pursuant to the Dodd-Frank Wall Street Reform and Consumer Protection Act and (subject to certain exceptions not relevant here) require a securitizer to retain not less than five percent of the credit risk for any asset that the securitizer, through the issuance of an asset-backed security, transfers, sells or conveys to a third party. The risk retention rules will become effective in relevant part in December 2016. The Department's statements in the White Paper confirm that marketplace lenders who sell pass-through notes representing fractional interests in individual consumer loans will not be required to retain credit risk against those loans as if such notes were asset-backed securities. The risk retention rules will nonetheless apply to any actual securitizations of marketplace loans.
 - 3 The Small Business Borrowers' Bill of Rights is available at <http://www.responsiblebusinesslending.org>.

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