



To Marketplace, To Marketplace*

Katie Wechsler

November, 2015

On July 16, 2015, the U.S. Department of Treasury requested public input on marketplace lending (RFI).¹ Treasury received about 100 comment letters in response. Commenters represent a broad array of interested parties including marketplace platforms, marketplace lenders, investors in marketplace lending, traditional banks, consumer advocacy groups, and research organizations. This article summarizes the key policy and regulatory issues raised in those comment letters, divided into three categories: (1) comments on the business models; (2) comments on policy and regulatory issues; and (3) recommendations for governmental actions.

It seems possible that Treasury will release a paper which summarizes the results of the RFI, but it is unlikely that there is any immediate regulatory action taken in this space. Treasury is not itself a regulator and cannot impose standards or requirements on participants in marketplace lending. Instead, it will have to rely on federal and state regulators to implement any policy recommendations that Treasury makes in response to comments received. For example, Treasury may recommend that the CFPB investigate whether marketplace lenders are adhering to the Electronic Fund Transfer Act, which applies to consumer loans. According to Antonio Weiss, Counselor to Treasury Secretary Lew, Treasury's

Guiding principle will remain to seek the broadest possible access to safe, affordable and sustainable credit. [Treasury] will be mindful to preserve and promote the American entrepreneurial spirit in the growing financial technology industry. However, . . . [Treasury] must not allow innovation to undermine consumer protections, privacy concerns, and other important policy priorities.

*The information contained in this newsletter does not constitute legal advice. This newsletter is intended for educational and informational purposes only.

¹*Public Input on Expanding Access to Credit Through Online Marketplace Lending.*

[Treasury] will need to find a balance.²

Comments on the Business Models

Types of Models: Many of the comment letters described the various business models in marketplace lending. In brief, there are two main types of marketplace lending models: (1) state-licensing model, and (2) bank-origination model. Under the state-licensing model, the marketplace operator is licensed as a lender under state law, if applicable, and originates loans without a relationship with a bank. The marketplace operator then sells the loan in whole or through asset-backed securities to investors. In the bank-origination model, the marketplace operator, such as Lending Club, acts as a third-party vendor of a bank. The bank originates and issues loans to borrowers. The bank then sells these loans to the marketplace operator, who may issue securities to investors to raise capital to purchase the loans or who may sell the whole loans to investors. It seems that the majority of marketplace lenders use the bank-origination model. Additionally, it seems that most marketplace lenders serve prime and near-prime borrowers.

Sustainability: Sustainability of marketplace lending was raised as a concern by some commenters. For example, the American Bankers Association noted the infancy stage of this field to emphasize that sustainability is a concern, as is the success of alternative credit scoring models that some marketplace lenders are using. Alliance Partners³ noted that models that rely on third-party investors to fund loans may have financing issues in the event of an inevitable cyclical downturn. Alliance Partners emphasized that partnerships with banks can help maintain stable capital to the marketplace. Much of the consumer business in marketplace lending is refinancing outstanding debt at a lower rate. This raises sustainability questions if and when interest rates rise. Separately, some models rely heavily on origination fees. The success of that model depends on new business, which is likely why some marketplace lenders are expanding into other types of products, such as mortgages, and increasing the maximum loan amount for small businesses.

Impact of Madden Decision: Many commenters representing banks, marketplace lenders, and investors noted the potential troubling implications of a recent decision by the U.S. Court of Appeals for the 2nd Circuit. In *Madden v. Midland Funding*, the court found that a debt collector that purchased charged-off consumer loans from a national bank could not rely on that bank's federal preemption of New York's usury law. The court failed to recognize the "valid when made" doctrine. This case potentially has significant implications for the bank-origination model of marketplace lending. That model relies on the ability of investors to receive interest income at the rate set by the national bank, who is not subject to state usury laws.

² *Treasury Official Discusses Marketplace Lending Industry at NYC Event.*

³ Alliance Partners is an advisory firm to community banks. Alliance Partners manages BancAlliance Inc., "a collaborative, community bank-controlled network," which pools "the individual capacity of each bank in the network to generate the collective scale necessary to deliver product and service solutions that support the mission and purpose of community banks."

Comments on Policy and Regulatory Issues

Level Playing Field: Several commenters emphasized the need for regulators to establish and maintain a level playing field. These commenters emphasized that regulations should be based on the activities of an entity, not the type or charter of the entity. One banking trade association The Independent Community Bankers Association (ICBA) called for national origination and servicing standards for loan products offered by online marketplace participants. ICBA also advised that regulators examine the relationships between funding banks and platform operators to ensure parties are observing banking regulations such as limits on loan concentrations and necessary oversight of third-party service providers. Others emphasized that the same protections should exist for all borrowers, regardless of whether the borrower is a small business or a consumer.

Borrower Protections: Organizations such as CFSI, Lending Club, Fundera, and Funding Circle, emphasized the Small Business Borrowers' Bill of Rights.⁴ Several lenders and other interested parties have signed or endorsed those principles. Commenters used the principles as proof that the industry is already doing a significant amount of work to protect small businesses. Some said that, if the government is to impose more regulation in this area, those principles should be a starting point. Separately, consumer advocacy groups voiced several concerns regarding the lack of borrower protections such as privacy, and fees and APRs charged. These groups also were concerned that some marketplace lenders are potentially in violation of the Electronic Funds Transfer Act as some require automatic electronic withdrawals for payments. They also flagged possible implications under the Fair Credit Reporting Act for data brokers.

Use of Data/Enhanced Transparency: Some commenters expressed concern regarding the use of data in marketplace lending while others supported using data as a means of expanding credit. CFSI highlighted the fact that data and technology hold the potential to provide credit access to more borrowers than ever before. Several others, such as Kabbage and Intuit, focused on the ability to use online data sources to determine credit risks and provide a comprehensive view of a borrower. Consumer advocacy groups expressed concern regarding the use of Big Data and whether consumers are fully consenting and understanding the implications of the use of that data.

Risk Retention: Risk retention entails the loan originator to maintain a portion of the risk of the loan, thereby keeping "skin-in-the-game." The policy argument is that risk retention ensures that lenders' interests are aligned with those of the borrower, because if the borrower defaults, the lender also is negatively impacted. While there was much discussion of risk retention, as Treasury asked about it, there seemed to be confusion on how it would be applied to marketplace lending. There was a general consensus that risk retention should, and likely does, apply to platform operators and investors if they are securitizing loans by issuing asset-backed securities. For other funding arrangements, the marketplace lending industry and investors argued that risk retention

⁴*Small Business Borrowers' Bill of Rights.*

was inappropriate and that the industry's interests are already aligned with those of the borrowers. Some consumer advocacy organizations argued that skin-in-the-game should be required for all online platforms, either through risk retention or informational reporting to investors about borrower characteristics. Those letters did not provide much detail on how risk retention could be applied to these business models.

Recommendations for Governmental Actions

Several commenters had recommendations for actions the Federal Government could take in regards to marketplace lending. Those recommendations include the following:

Harmonization of State Requirements: Many marketplace lenders noted the difficulty in adhering to fifty different laws, regulations, and licensing and certification requirements. They asked the Federal Government to assist in harmonizing these state requirements and helping to provide clarity on what license is required for certain activities. Some, including Opportun, advocated for a federal charter for marketplace lenders.

Regulatory Framework: Some commenters asked Treasury and other federal regulators to establish an extensive regulatory risk framework for nonbank lenders who provide loan products to consumers and small businesses.

Adopt United Kingdom (U.K.) Approach: Some commenters focused on the U.K.'s new regulations of peer-to-peer lending as a possible model for the U.S. The U.K. requires peer-to-peer lenders to have backup servicing provisions in case a platform fails. Additionally, the U.K. has a quasi-government organization that is a central register for all companies, which helps reduce fraud and increase accuracy and efficiency of information verification. Funding Circle and others suggested the Federal Government have a similar database. The U.K. provides tax benefits to those that lend or invest in small businesses. Also, under new regulations, if a bank does not approve a small business loan, it must refer that small business to an alternative lender. OnDeck and Funding Circle encouraged the U.S. to adopt that referral requirement.

Adoption of the Small Business Borrowers' Bill of Rights: Some urged Treasury to encourage the full industry to adopt those principles. As noted above, others said that the principles should be the starting point for regulations on marketplace lending. Some, including consumer advocacy organizations, while not naming or endorsing the principles, recommended standards for marketplace lending. Those standards include assessing the borrower's ability to repay and providing clear disclosures of key terms.

Publish Data: Commenters stated that the CFPB should implement the Dodd-Frank Act requirement to collect small business data lending and should publish that data. Additionally, commenters urged the Federal Government to release government data on small businesses, such as the data from IRS and the Small Business Administration. Investors asked the government to encourage

marketplace lenders to provide loan-level details to investors.

More Efficient Income Verification: Many marketplace lenders urged the IRS to automate the 4506-T request for transcript of tax returns. The lenders argued that would increase efficiency in providing loans to small businesses.

Tax Incentives: Lending Club recommended that investors who provide capital in defined underserved areas and to low- and moderate-income small businesses should be taxed at the capital gains tax rate, rather than the current marginal income tax rate, if the loan is held for over 12 months. Lending Club also suggested that investors be able to offset losses directly against interest income and gains and have tax-free returns on the first \$5,000 of investments.

Federal regulatory action on marketplace lending likely is not imminent. However, at the federal level, the conversations about this field and how it should be regulated, have begun. And all participating or considering to participate, should pay close attention.

Katie Wechsler is an associate with the law firm of Barnett Sivon & Natter, P.C.