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COMMENTARY

Rapid Growth in Online Lending Prompts Information Request from U.S. Treasury

The U.S. Treasury Department (the "Treasury") has issued a Request for Information ("RFI") on online marketplace lending, including peer-to-peer lending ("Online Lending") in the U.S. 80 F.R. 42866-68 (July 20, 2015). The RFI seeks a broad range of information regarding:

- The business models and products offered by online lenders ("Online Lenders") to small businesses and consumers;
- The potential for Online Lenders to expand access to credit to historically underserved market segments; and
- How the financial regulatory framework should evolve to support the safe growth of this industry.

Responses to the RFI are due by August 31, 2015.

Background

Online Lending is growing rapidly, with an estimated $12 billion in new loan originations by all Online Lenders in 2014. In "From the people, for the people," *The Economist* (May 9, 2015) ("*The Economist*") stated that the five largest Online Lenders have made more than one million loans and are generating new loans at a rate exceeding $10 billion annually. These lenders grew rapidly from a small amount of loans in 2009. A May 2015 Morgan Stanley report estimates that unsecured consumer Online Lending totalled $7.4 billion in 2014, and it may grow at a 47 percent compound annual rate through 2020. *Bloomberg* (July 23, 2015).

The RFI states that Online Lenders provide convenient online applications, most have no retail branches and rely more on electronic data sources and automated underwriting models and processes. As a result, Online Lenders may provide credit more quickly and more cheaply than traditional lenders.

Online Lending primarily has been used by prime or near-prime consumers to refinance existing debt. The RFI notes that Online Lenders are developing product structures and underwriting models for non-prime customers that also reduce costs and allow loans to be made to such borrowers at lower rates than those provided by traditional banks, which are subject to regulatory restrictions on such loans. The RFI further states, "it can cost the same amount to underwrite a $300 consumer loan as a $3,000 loan." Bank loans to such customers, if made, may bear higher rates than rates charged by Online Lenders, according to the RFI.

The RFI also illustrates the small business and start-up lending markets that Online Lenders serve. The

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Treasury acknowledges that small business lending can be unattractive to banks because of their high origination and underwriting costs relative to potential revenue. For example, the Treasury cited a recent Goldman Sachs Report, "The Future of Finance" (March 3, 2015), which estimated that it costs a bank approximately the same amount to underwrite a $5 million loan as a $200,000 loan. Federal Reserve data indicates that more than half of small businesses that applied for credit in 2014 sought only $100,000 or less. Moreover, in a recent survey, a majority of small businesses and startups reported they were unable to secure any credit in the prior year. Still, small businesses may receive up to 90 percent of their financing from banks. Larger businesses are estimated to rely on banks for 30 percent of their financing. In contrast, most Online Lenders provide loans with lower principal amounts to small businesses with potentially better terms.

The Federal Reserve Board's 2104 Annual Report discusses two research studies it commissioned from outside organizations. The first survey of 60 bankers noted that small business customers are savvier today in assessing their banking needs and options, but that banks were becoming more conservative in underwriting small business loans. A separate study of 22 small business borrowers indicated that small businesses find it difficult to compare and evaluate the costs and benefits of various online small-dollar products. Potential borrowers also expressed concerns about safeguards to protect their personal and business information, if they borrowed funds from online sources.

Information Sought by the Treasury

The Treasury seeks to better understand the benefits and risks of Online Lending and how the regulatory framework should evolve to support the industry's "safe" growth. In particular, the RFI seeks the following information.

Market Segmentation and Access to Credit. Information is sought as to how regulators and policymakers should consider market segments among Online Lenders, including:

- Business model type (e.g., "peer-to-peer," balance sheet, and bank-affiliated);
- Type of borrower (e.g., small business, subprime borrower, borrowers who are "unscoreable"); and
- Borrower need (e.g., new small business, mature small business, debt consolidation, new credit).

The Treasury is interested in the competitive advantages and disadvantages, if any, that exist for banks and non-banks to participate in this market. Additionally, the Treasury seems keenly interested in whether Online Lending expands access to credit to historically underserved market segments.

Role of Electronic Data and Innovative Lending Practices. The role of electronic data sources in enabling Online Lending is explored, including how these automated decision-making processes compare to manual processes, and their risks and opportunities compared to traditional loan underwriting. The RFI specifically asks about Online Lending's privacy, cybersecurity, and consumer protection risks. Additionally, the RFI asks how the federal government can facilitate positive innovation in lending, such as by making it easier for borrowers to share their own government-held data with lenders.

Operations of Online Lenders. The RFI seeks details regarding Online Lenders' operations, including:

- How customers are acquired (e.g., marketing channels, partnerships with traditional financial institutions, etc.);
- How borrowers' creditworthiness and repayment ability are assessed;
- The accuracy of Online Lenders' models at predicting credit risk;
- Whether a borrower's stated use of proceeds affects loan underwriting;
- Online Lenders' reliance on traditional lending institutions;
- How the credit environment affects Online Lenders;
- How Online Lenders manage loan servicing, fraud detection, credit reporting, and collections, and whether they do so differently from traditional lenders;
- Steps Online Lenders take to comply with regulations, including when lending across state lines; and,
- Whether Online Lenders should be subject to "risk retention" or "skin in the game" requirements, as mandated by the Dodd-Frank Act for bank securitizations.

The Role of Investors. The roles of investors in Online Lending are explored as follows:

- How investors evaluate different Online Lending platforms and different assets on these platforms;
- What are the operational arrangements between investors and the Online Lending platform
- How investors may finance Online Lending platform assets;
- Who are the ultimate investors;
- The types and amounts of financial leverage used by such investors;
- The availability of secondary liquidity for assets generated by Online Lending; and
- The advantages and disadvantages of an active secondary market, including securitizations, derivatives, and benchmarks.

Key Takeaways

The RFI should produce information that is useful generally in understanding, and potentially facilitating, the growth of Online Lending. The Treasury seems particularly intrigued by the potential for Online Lenders to provide loans to small businesses and subprime borrowers, whose access to credit may be limited. While the benefits of Online Lending are noted, the RFI also seeks more about the credit and other risks of Online Lending, including legal risks, borrower privacy, cybersecurity, consumer protection, potential conflicts of interest, lender “risk retention” requirements, investors’ use of financial leverage, and the secondary market for loans originated by Online Lenders.

The RFI raises of number of interesting issues, but the short comment period of five weeks may be insufficient to obtain the wide range of data sought by the Treasury. Many sources may be reluctant to provide sensitive data. The data collected, however, should be provided to the public and may be useful information regarding the Online Lending industry’s opportunities and issues.

Online Lending offers some significant benefits, although a number of existing laws pose hurdles that require careful evaluation and planning, including:

- Compliance with the Securities Act of 1933 and state securities laws. Online Lenders privately and publicly offer equity and debt interests in loans selected by investors (“peer to peer” lending), corporate borrower dependent notes whose payments depend on borrower performance or conventional debt. As loan volumes increase, it becomes increasingly difficult to finance Online Lenders through private placements of debt, including under SEC Regulation D and the Uniform Limited Offering Exemption under state law.
- Compliance with broker-dealer requirements under the Securities Act of 1934 is important to consider as loans or interests in loans, or other securities, are regularly offered by Online Investors to investors. Online Lenders may find it advantageous to have their own broker-dealer subsidiary to reduce the costs of a third-party broker-dealer.
- Utilizing exemptions under the Investment Company Act of 1940 (the “1940 Act”). Exemptions again are difficult where the Online Lender seeks to raise funds from numerous small investors as opposed to a group of “qualified purchasers” under Section 3(c)(7) of the 1940 Act, or other exemptions that may be available for loan pools. Loan pools relying on the 1940 Act, Section 3(c)(1) or Section 3(c)(7) exemption, like collateralized loan obligations (“CLOs”), can be “covered funds” under the Volcker Rule unless properly structured. Banking institutions cannot invest in covered funds under the Volcker Rule.
- Online Lenders are subject to state laws where they make loans. State laws regulate, among other things, licenses, interest rates, loan brokering, money transmission, debt collection, and consumer protections. Additionally, if the Online Lender is selling loans, its return may be limited by loan broker laws. *See,* e.g., New York General Obligations Law, Section 5-531.
- Cybersecurity, data protection, customer privacy, and model validation are high-profile issues, especially for business models like Online Lending, which rely on the internet and automated business models.
- Loan sales and securitizations are important sources of funding and liquidity. Generally, robust secondary markets and securitizations permit a greater amount of loans to be made at reduced funding costs. Derivatives allow market participants to take views on both sides of the market and facilitate hedging of positions, along with

enabling more robust price discovery. However, securitizations and derivatives also subject Online Lenders and their investors and counterparties to a panoply of Dodd-Frank Act regulation, such as reporting requirements, mandatory derivatives clearing, risk retention requirements, and Volcker Rule limits. Even though loans that are sold for investment rather than commercial purposes are generally "securities," derivatives referencing these assets could be subject to CFTC jurisdiction.
- Moody's Investors Service ("Moody's") has noted continued uncertainty for Online Lenders, who originate loans through arrangements with banks. Moody's "Legal Uncertainty Over 'True Lender' Status Continues for Marketplace Lenders" (June 1, 2015).

There is some evidence that the largest investors in Online Lenders and their loans are institutional investors, including banks. According to *The Economist*, Citibank announced earlier this year that it would lend $150 million through an Online Lender. Funding from such persons is efficient, as well as most easily structured to comply with applicable securities-laws and may facilitate securitization by these loan purchasers. Several of the Online Lenders have gone public, and this is probably needed to support growth consistent with federal and state securities laws, and the capital required by lenders and counterparties.

Online Lending is relatively new, and its models and activities, including servicing and loan sales/securitizations have not been tested in a credit and economic downturn, or in a high interest rate environment where funding may be more difficult and costly than in recent years. Additional consideration ought to be given to the quality of underwriting, the underwriting models' predictability and accuracy, and the capital needed to support loan origination and servicing in the event of an economic downturn. Stress testing could provide useful estimates about potential losses but, given the relatively short history of Online Lending, should not be overly relied upon. Investors, loan purchasers, and derivatives counterparties should have a strong interest in Online Lenders' capital, liquidity, and credit quality, as well as their legal compliance.

In addition, the RFI specifically excludes many Consumer Financial Protection Bureau ("CFPB") initiatives that affect consumer credit. Similarly, the RFI does not consider the Department of Defense's latest regulations under the Military Landing Act regarding lending to military personnel. 80 F.R. 43559-43612 (July 22, 2015). The CFPB's broad mandate to define and regulate consumer financial products exists regardless of the means of delivering these products, and it could inhibit consumer Online Lending.

Indirect lending through Online Lenders to smaller businesses and to less creditworthy borrowers would be an ideal vehicle for banks to provide such credit where it may be impractical to provide such credit directly. Participation could also benefit banks' Community Reinvestment Act performance and support the convenience and needs test for bank acquisitions. The quality of an investment or loan to Online Lenders and their origination and servicing platforms must be established in order to facilitate bank participation in this market. Potential regulation of "shadow banking" and regulatory views of subprime consumer lending may cloud banks' participation in segments of Online Lending, however.

The growth and size of the Online Lending market has attracted interest from investors and borrowers. The Treasury's RFI should result in information useful to the markets. The RFI appears to seek economic growth, especially for small businesses that are the engines of employment growth and for underserved consumers. At the same time, the RFI raises the possibility of new government scrutiny for the Online Lending industry, which, until now, has operated with little government oversight and enforcement. The financial services regulators should respond to the RFI and take as balanced an approach as the RFI. Hopefully, information collected from the RFI will encourage U.S. lawmakers and regulators to evaluate the costs and unintended or impractical regulation of lenders. Similarly, the SEC and state securities regulators should reconsider the application of Depression-era securities laws on Online Lenders and their structure and costs, and consider new approaches, including possible legislation that, with appropriate disclosures and oversight, could facilitate Online Lenders' ability to improve the availability and cost of credit.

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