JONES DAY®

MAY 2016

Treasury White Paper Portends Greater Federal Oversight of Marketplace Lending

On May 10, 2016, the U.S. Department of the Treasury ("Treasury") released a highly anticipated white paper recommending greater transparency and borrower protections for the marketplace lending industry. The white paper, titled *Opportunities and Challenges in Online Marketplace Lending*, describes common themes and comments submitted in response to Treasury's July 2015 Request for Information ("RFI") and portends forthcoming additional federal regulatory oversight of this emerging industry. We previously discussed the RFI and the industry here.

The white paper provides an overview of the evolving online market landscape, reviews the opinions of RFI respondents, and highlights certain purported "best practices" applicable to established and emerging lenders and servicers. Overall, Treasury recognizes the potential value of marketplace lending, highlighting credit access to consumers who may have limited access to traditional credit markets as one of the primary benefits.

In fact, Treasury cautions that the risks and recommendations raised in the white paper "should not constrain efforts to innovate and develop [the online marketplace lending] market." The white paper represents Treasury's view of marketplace lending and expressly acknowledges contributions from the major federal financial regulatory agencies with interests in marketplace lending—the Consumer Financial Protection Bureau ("CFPB"), the Federal Deposit Insurance Corporation ("FDIC"), the Board of Governors of the Federal Reserve System ("FRB"), the Federal Trade Commission ("FTC"), the Office of the Comptroller of the Currency ("OCC"), and the Securities and Exchange Commission ("SEC"), in addition to the Small Business Administration ("SBA") and the Federal Reserve Bank of New York. Some of these federal agencies as well as some state agencies are developing their own responses to the opportunities and challenges of marketplace lending. For example, in March 2016, the OCC issued its own white paper on *Supporting Responsible Innovation in the Federal Banking System*, and the CFPB recently announced it was taking complaints regarding marketplace lenders.

Treasury received approximately 100 responses to the RFI representing several common themes, including the following:

- Use of data and modeling techniques for underwriting is an innovation and a risk;

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- There is opportunity to expand access to credit;
- New credit models and operations remain untested;
- Small business borrowers will likely require enhanced safeguards;
- Greater transparency can benefit borrowers (in the form of clear communication of APRs and lending terms) and investors (in the form of loan-level disclosure and greater resolution into loan-level asset-backed security data);
- The secondary market for these loans is still developing; and
- Regulatory clarity can benefit the market.

Treasury's Recommendations

With the overall aim to "encourage safe growth and access to credit through the continued development of online marketplace lending," and in direct response to most of the major concerns of commenters to the RFI, the white paper provides the following policy recommendations to private sector participants and the federal government:

Support More Robust Small Business Borrower Protections and Effective Oversight. Small businesses cited high interest rates, unfavorable repayment terms, and lack of transparency as the sources of their frustration with marketplace lenders. As a potential sign that more oversight is appropriate in Treasury's view, the white paper refers to a market research study indicating that small businesses approved for financing from marketplace lenders in 2015 reported only a 15 percent lender satisfaction score, as opposed to 75 percent satisfaction with financing obtained from community banks. The white paper suggests that the divergent satisfaction scores are a direct reflection of a lack of transparency that comes from minimal oversight of the industry. In addition, while small business loans under $100,000 share common characteristics with consumer loans, they do not share many of the same consumer protections apart from the protections afforded by the Equal Credit Opportunity Act and the prohibition against deceptive acts or practices under Section 5 of the Federal Trade Commission Act as those afforded to borrowers of loans obtained for personal, household, or family purposes. Effective oversight and borrower protections in the form of legislation, particularly with respect to small business loans under $100,000, will lead to greater transparency and better outcomes for borrowers, according to the white paper.

Ensure Sound Borrower Experience and Back-End Operations. Again signaling increased regulatory oversight, this time in the area of loan servicing, Treasury urges the industry to adopt standards "designed to provide a sound borrower experience from customer acquisition [of a loan] straight through to collections in the event of delinquency or default." Citing to a favorable credit climate that has limited the opportunity for analysis of how servicers of these assets would respond to increased delinquencies, Treasury seems to lack confidence that the industry is well positioned to respond to increased interest rates and corresponding borrower defaults. While not outright calling for more specific federal regulation in this area, the white paper suggests that marketplace lenders provide borrowers, particularly those in distress, with "accurate and actionable" information such as the Fair Debt Collection Practice Act guidelines, dispute resolution options, and credit counseling. In addition, the white paper suggests that marketplace lenders have contingency plans in place to continue servicing loans in the event the platform fails.

Promote a Transparent Marketplace for Borrowers and Investors. Treasury makes specific recommendations to improve transparency because some lenders are disclosing extensive loan-level data, clear rates and terms, and transparent loan performance metrics, and others are not disclosing this information clearly, if at all. In addition, because all of the marketplace lending securitization transactions to date have been conducted as private offerings, the disclosures provided in those offerings, both initially and on an ongoing basis, are not subject to the same disclosure requirements as would apply to an SEC-registered securitization transaction. Noting that transparency means clear, simple, and consistent terms that borrowers and investors can understand, Treasury recommends that the industry adopt:

- Standardized representations, warranties, and enforcement mechanisms;
- Consistent reporting standards for loan origination data and ongoing portfolio performance;
- Loan securitization performance transparency;
- Consistent market-driven pricing methodology standards; and

- A registry, available to the public, for tracking data on transactions, including the issuance of notes and securitizations, and loan-level performance.

Expand Access to Credit Through Partnerships with Community Development Financial Institutions ("CDFIs"). While recognizing that marketplace lending has the potential to provide credit to borrowers who otherwise may have limited access to capital, Treasury posits that there is still much to be done to serve these borrowers. Treasury urges marketplace lenders to partner with CDFIs, which have experience serving this market through flexible underwriting, education, and technical assistance. Treasury sees this as a mutually beneficial relationship where marketplace lenders, through CDFIs, can reach more borrowers in distressed communities, and CDFIs, through these lenders, can gain increased efficiency at a lower cost by utilizing the underwriting technology and back-end operations.

Support the Expansion of Safe and Affordable Credit Through Access to Government-Held Data. Treasury recommends giving marketplace lenders access to comprehensive government-held data sources so that these lenders can conduct capacity verifications with credit applicants in real time. Treasury supports allowing borrowers to voluntarily share government-held data in order to make loans and investments safer and more aligned with risk. The white paper specifically identifies an opportunity for automating the IRS Income Verification Express Services with a data-sharing Application Programming Interface ("API"). The potential API would allow lenders to test prototype loan application interface and back-end system improvements, which would inform the IRS's ultimate API design. The white paper points to the success of existing programs such as the Social Security Administration's income verification program as evidence of the value of allowing borrowers to voluntarily share government data that can verify their financial capacity to make loans and investments.

Facilitate Interagency Coordination Through the Creation of a Standing Working Group for Marketplace Lending. The white paper recommends an interagency working group consisting of Treasury, the CFPB, the FDIC, the FRB, the FTC, the OCC, the SEC, the SBA, and a representative state bank supervisor to facilitate coordination on cross-cutting issues that could improve market efficiencies and to better understand how federal and state regulations apply to new models.

Key Risks

The white paper identifies several key risks that will require ongoing monitoring. These risks include the evolution of credit scoring, the impact of changing interest rates, potential liquidity risk, increasing numbers of mortgage and auto loans originated by online marketplace lenders, potential cybersecurity threats, and compliance with anti-money laundering requirements.

Treasury is also concerned with the risks to consumers caused by industry's use of new data sources and data-driven algorithms to make expeditious credit determinations. For example, marketplace lenders use electronic data sources and technology-enabled underwriting models to automate processes such as determining a borrower's identity or credit risk. While the underwriting programs are largely proprietary, the data sources used to determine a borrower's credit risk, for example, may include traditional underwriting statistics such as income and debt obligations, but they also often include real-time business accounting, payment and sales history, online small business customer reviews, and other nontraditional information. These programs, Treasury warns, have remained largely untested because of recently favorable credit conditions, but as interest rates rise and the potential for defaults increases correspondingly, the efficacy of these algorithms will be tested more rigorously. In addition, the use of "big data" could result in fair lending violations (including disparate impact violations) as well as predatory lending that may harm consumers. Further, the lack of transparency around these quick credit decisions is a concern, including the inability of an applicant to check and correct inaccurate personal data, as the applicant can do with traditional credit. Antonio Weiss, counselor to the Secretary of the Treasury, remarked in a call with reporters, "…just because a lending decision is made by an algorithm doesn't mean it's fair or unbiased."

Unresolved Concerns

The white paper identifies several additional concerns raised by commenters in response to the RFI, although Treasury does not make corresponding recommendations regarding these concerns. They include:

An Underdeveloped Secondary Loan Market. Commenters suggested that a robust secondary market for online marketplace loans would result in lower funding costs for lenders and corresponding lower borrowing costs for consumers. Commenters identified regulatory uncertainty around *Madden v. Midland Funding LLC*, limited ratings from credit ratings agencies, and a lack of visibility into underlying collateral as the primary hurdles for growth.

A Lack of Regulatory Clarity. While Treasury recommends additional federal regulatory oversight in certain key areas such as small business, commenters, although "reflect[ing] a diverse set of viewpoints on the best role of the federal government in the growing market," seem to be generally united in seeking regulatory clarity on the roles and requirements for different market participants, including lenders, servicers, and purchasers. In addition to seeking regulatory clarity with respect to small businesses, commenters also requested that regulators:

- Evaluate the fragmented nature of regulatory oversight in the area of **consumer protection**;
- Consider how regulations in the area of **cybersecurity and fraud** can mitigate these potential threats;
- Consider the lack of uniformity of **Bank Secrecy Act ("BSA") and anti-money laundering requirements** due to the lack of direct oversight of online marketplace lenders by prudential regulators;
- Provide clarity on which entity—the issuing depository institution or the online marketplace lender—is the **true lender** in the platform business model; and
- Consider applying some form of **risk retention**, such as the Dodd-Frank Act's risk retention rules for asset-backed securities, to marketplace loans.

The white paper did not leave all of these remaining concerns regarding the lack of regulatory clarity entirely unresolved. On the question of cybersecurity, Treasury encourages marketplace lenders to develop detailed response and recovery arrangements that set out the roles and responsibilities of the board and management, similar to what is required of banks. In addition, Treasury recommends that marketplace lenders join the Financial Services Information Sharing and Analysis Center in order to share cybersecurity information. With respect to BSA, the white paper says simply that FinCEN, which administers the BSA, will continue to monitor the industry to assess the need for additional regulation.

On the issue of risk retention, Treasury identifies a lack of clarity by the industry as to whether risk retention rules apply to the member payment dependent notes. In the RFI, Treasury asked for comments regarding to what extent, if any, lenders should be required to have "skin in the game" for the loans they originate or underwrite in order to align their interests with investors who have acquired the debt of marketplace lenders though the platform, and asked how the concept of risk retention should apply in a nonsecuritization context for different entities, including those where there is no pooling of loans. The Dodd-Frank Act's risk retention rules generally require sponsors of securitization transactions to retain risk in those transactions. The rule became effective for residential mortgage-backed securities in December 2015 and will be effective for all other securitized asset classes in December 2016. While not making any key recommendations with respect to risk retention, Treasury did take the opportunity to clarify that the requirements of the risk retention rules apply only to the securitizer in the securitization of marketplace lending notes, not to the originator selling the notes.

A Look Ahead

2016 is off to a rocky start for the marketplace lending industry, with waning borrower interest, financing challenges, a capital markets environment that has become less favorable for marketplace lenders pricing securitization transactions, and the recent resignation of a major industry player's CEO. The white paper shines a spotlight on other issues facing the industry and, for the moment, calls for mostly voluntary improvements. It is not difficult to see, however, that additional regulation and supervision of the industry is on the horizon.

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