



Financial Industry Alert

ALERT

Treasury Request for Public Input on Expanding Access to Credit through Online Marketplace Lending

“Online marketplace lending refers to the segment of the financial services industry that uses investment capital and data-driven online platforms to lend to small businesses and consumers.”¹

On July 20, the Department of the Treasury published a [Notice and Request for Information](#) (“RFI”) seeking comment on various aspects of online marketplace lending, including –

- the business models and products offered to small businesses and consumers
- the potential to expand access to credit to underserved market segments
- how the financial regulatory framework should evolve to support the growth of the industry

Treasury asks for comment on [14 categories of questions](#), some of which include multiple specific questions, which we summarize and, with respect to some, offer initial thoughts on below.

1. **Policy/ Regulatory Concerns** What are the policy or regulatory concerns that should be addressed for platform lenders, balance sheet lenders and bank-affiliated lenders.

Overview Treasury acknowledges the significant benefits to consumers and small businesses, and specifically to underserved market segments, of marketplace lending products provided by online lending platforms. Treasury also recognizes that traditional bank and other brick-and-mortar credit providers have organizational, underwriting and cost structures that are in many cases not well-suited for making small consumer and business loans. There is an acknowledged need for and benefit to the broader U.S. economy in promoting increased access to these loan products. However, as marketplace lending has developed so rapidly, there has not been adequate study by regulators of any

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¹ 80 Fed. Reg. 42866 (July 20, 2015)

risks that may affect the smooth functioning of the credit markets, particularly during times of economic stress.

Some of the issues that may pique the interest of Treasury and other financial regulators include the following:

- *Market Segmentation* Should different asset classes be considered differently? For example, there are likely different concerns for small business loans than for subprime consumer or student loans. Treasury notes that the CFPB is contemplating rules for payday, auto and certain installment loans targeted at the least financially viable segments of the U.S. economy, and which are not covered by Treasury's RFI.
- *Credit Underwriting* Are the underwriting methods of marketplace lenders, including new data gathering and algorithmic assessments, accurate predictors of credit quality? In particular, how does the underwriting methodology utilized by marketplace lenders compare to traditional underwriting in identifying fraud and credit risk?
- *Prudent Lending* What safeguards are employed to ensure prudent lending practices, including appropriate operational practices (servicing, fraud detection, credit reporting, collections)?
- *Credit Risk* Who is bearing the ultimate credit risk for these new products? How is marketplace lending broken down among lenders who bear balance sheet risk and those that sell the risk to others, and who are the other market participants who take this risk?
- *Privacy and Security* What privacy and security concerns may arise from the collection and use of personal data about consumers, students and other individuals for marketplace loan products?
- *Bank Lenders* What role, if any, do or can traditional lenders play in the development and efficient functioning of marketplace lending? What convergence or competition may evolve over time and how would borrowers and the market segments be effected?

Market participants are encouraged to consider the RFI carefully and to provide thoughtful responses that will help guide a pragmatic and measured approach to marketplace lending as it matures into a key segment of the U.S. financial markets.

2. **Electronic Data Risk** What role are electronic data sources playing in enabling marketplace lending, and what opportunities and risks are presented.

Balancing Security and Convenience Enabling an online market place depends on balancing security and convenience. More and more businesses are transitioning to using online and cloud-based services to collect, process, and store data. These stores of sensitive data are virtual treasure troves for criminal hackers. Thus, there is an emerging need for providers of online tools or services to create secure environments that protect this sensitive data. Security, however, comes at a price; often the more secure the data, the more inconvenient it is to access and use. For small and entrepreneurial businesses who could most take advantage of online marketplace lending, convenience and ease are essential. Because these are the key business drivers, security must adapt, and players must develop novel solutions to solve age-old problems of data security and repurposing traditional measures that leverage their sophistication to build speed and agility. This is no easy task, but one that will certainly be a business differentiator for organizations that can effectively sell both security and convenience in their products and services.

The current patchwork of data security laws offers organizations a ripe opportunity. The few data security standards do not universally proscribe specific measures or processes that must be employed to protect data. While some consider this lack of regulatory guidance a problem, companies will be well-positioned if they can address the minimal legal data security standards that do exist, while contemporaneously thinking ahead to how those standards are going to change as cyberattacks become more and more common.

3. **Market Segments** Are lenders focused on market segments, specifically small businesses, subprime borrowers, consumers who do not have credit history.

Improved Business Models Marketplace lenders are designing their business models and products in such a way that they can be more responsive to unserved and underserved market segments, and there are lenders currently who focus on borrowers who do not have traditional credit histories. Harnessing in just minutes thousands of facts on each applicant from online data, marketplace lenders can screen applicants effectively and efficiently, with the intention of better calibrating risk and default rates. This allows marketplace lenders to extend loans (regardless of the market segment) to persons and entities that have previously been unserved or underserved.

Business models differ to some extent based on the market segment. For example, certain small business lenders require permission to monitor a company's bank and credit card accounts, as well as monitor the company's cash flows from operations. Lenders to subprime borrowers in addition to short terms and low principal balances, may require more frequent repayment schedules (weekly, or in some instances daily). But in all instances the baseline premise remains the same – expansion of credit due to improved analytics.

One of the most recent segments of marketplace lending focus is real estate (both residential and commercial). By using improved analytics via available online data, marketplace lending platforms seek to provide greater confidence about the value of the collateral beyond the traditional analysis done by a local appraiser.

4. **Underserved Markets** Is access expanding for underserved market segments.
5. **Customer Acquisition** What is the customer acquisition process and what partnerships do lenders have with banks, community development financial institutions and others.
6. **Credit Evaluation** How is credit evaluated and how accurate is the process.
7. **Bank Relationships/ Regulatory Compliance/ State Law Considerations** Are banks or others relied on for servicing or relationships. What focus is there on regulatory compliance in the lending process. What issues are raised by lending across state lines.

State Usury Law Considerations The Second Circuit Court of Appeals in *Madden v. Midland Funding, LLC* recently held that the National Bank Act's preemption provision did not apply to a non-national bank that had purchased loans in default from a national bank. This decision potentially subjects such loans to claims under state usury law. That decision also raises additional issues related to recent rulings and enforcement efforts challenging whether a bank was the "true lender" in a marketplace or payday finance arrangement. The Department of Justice has recently shown an interest in investigating instances where the identity of the "true lender" in the preemption scenario was purposefully and fraudulently obscured. *US v. Rubin*, 15-Cr-238-ER (June 9, 2015, EDPA). Together, developments in preemption and "true lender" law raise important questions about appropriate transaction structures and disclosures between lender, purchaser and servicer, the regulatory framework applicable to loans and securities, and the possibility of exposure under the various states' usury or other laws.

Bank Secrecy Act Considerations; AML, etc. Banks and other financial institutions subject to the Bank Secrecy Act's reporting, record keeping, and anti-money laundering programmatic requirements should consider how an expansion in online marketplace lending impacts the financial institution's current customer due diligence and suspicious activity reporting procedures, as well the financial institution's anti-money laundering program overall. The banking regulators, the Financial Crimes Enforcement Network, and the Department of Justice have been increasingly enforcing expectations that financial institutions subject to the Bank Secrecy Act's obligations analyze each product and service offered independently for anti-money laundering risks and Bank Secrecy Act compliance and to make resulting programmatic changes as appropriate. While most non-bank entities are not currently subject to the Bank Secrecy Act's requirements, such non-bank lenders may nevertheless want to consider implementing an anti-money laundering program that mirrors the Bank Secrecy Act requirements, or at a

minimum, review its customer diligence procedures with an eye toward identifying suspicious behavior and transactions so that it is not unwittingly a conduit for moving criminal proceeds.

State Consumer Protection Law Considerations State consumer protection laws generally are enforced by the state attorneys general (AGs). Over the past decade, the AGs have rapidly and aggressively expanded their enforcement activities with regard to consumer lending. Subprime mortgage lending, mortgage servicing and foreclosures, payday loans, debt collection, and consumer debt buying have all been investigated by multistate AG committees. Resulting court-enforceable settlements have ranged from a few million to many billions of dollars in consumer restitution, penalties, and costs. Equally significant, AG settlements have in some cases produced major new regulations governing these activities. As marketplace lending expands, consumer complaints inevitably will arise, drawing the AGs' attention and likely triggering investigation of the complaints and possibly additional regulation at the state level.

8. **Operations** How is loan servicing, fraud detection, credit reporting and collections handled.
9. **Federal Government Role/ Change in Credit Environment** Is there a role for the federal government to play to facilitate positive innovation in lending. What are the relative competitive positions of banks and non-banks, and can policymakers address the disadvantages for each segment. What impact would a change in the credit environment have?
10. **Skin In The Game** Risk retention for platform lenders who sell loans or debt backed by loans they originate, or for others in the "distribution chain." Risk retention for other syndicated or participated loans.

Risk Retention The sponsor of a securitization backed by marketplace loans will be subject to the credit risk retention requirements finalized in October 2014 by the OCC, the Fed, the FDIC, the SEC, the FHFA and HUD.² Compliance is required with respect to non-RMBS securitizations beginning in December 2016, when sponsors will be required to retain an economic interest of at least 5% of the credit risk of the securitized assets.

A critical issue will be whether a financing transaction backed in any way by marketplace loans is a "securitization transaction." The rules only require risk retention for "securitization transactions." The rules define a "securitization transaction" as "a transaction involving the offer and sale of asset-backed securities by an issuing entity," and the term "asset-backed security" is defined in relevant part to mean "a fixed-income or other security collateralized by any type of self-liquidating financial asset (including a loan . . . or a secured or unsecured receivable) that allows the holder of the security to receive payments that depend primarily on cash flow from the asset."³ Financing transactions, including asset sales, not involving the issuance of fixed income or other securities would not be subject to the existing risk retention rules.

Where a marketplace loan financing transaction is determined to be a "securitization transaction," another critical issue will be to identify the "sponsor," which is the entity required to retain skin in the game. "Sponsor" is defined under the risk retention rules as the "person who organizes and initiates a securitization transaction by selling or transferring assets, either directly or indirectly, including through an affiliate, to the issuing entity." In certain marketplace lending securitizations, the sponsor may be neither the originator of the loans nor the lending platform, but rather a third-party that has purchased the loans with the intent to organize and initiate a securitization.

11. **Data Privacy and Cyber Security, etc.** Possible harm to consumers and small businesses, including privacy considerations, cybersecurity threats, consumer protection concerns. Are these issues addressed by existing regulation.

² [79 Fed. Reg. 247](#) (December 24, 2014)

³ Section 3(a)(79) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(79)).



Holistic, Contextual Approach Required The expansion of online marketplace lending carries the potential for significant innovative change that enhances access to credit by creating better, faster tools for credit assessment and matching of lenders and borrowers – a decidedly pro-consumer and pro-business confluence in a single platform. In addition, integrated electronic data sources can utilize “Big Data” analytics engines to optimize, in real time, the flow of relevant information, marketing of products, and decision making.

However, while online ecosystems drive efficiencies by bringing together key players like originators, borrowers, investors, and support vendors (like credit score providers), the privacy and security implications for data collection, use, sharing and storage may be challenging. When a dozen entities touch personal information as part of the lending chain, the key questions that drive privacy and security concerns become more complex, such as who “owns” the data, what disclosures must be made to consumers/borrowers, how can the data be used or shared, and whose duty it is to protect the data – all to ultimately ensure that consumers and small businesses are getting the data points necessary to make informed (protected?) decisions.

The existing legal regime in the U.S. is a patchwork of notice/disclosure, security and conduct rules that apply to defined types of entities (e.g., financial institutions under the Gramm Leach Bliley Act), types of data use-cases (e.g., credit reports under the Fair Credit Reporting Act), types of conduct (e.g., prohibition against hacking under the Computer Fraud and Abuse Act), and dozens of other often disparate factors. A holistic, contextual approach to privacy, security and consumer protection compliance that builds trust in the ecosystem will be critical to a sustainable marketplace.

12. Investor Considerations What do investors in notes funding loans consider, including with regard to the originating entity. Financing alternatives. Identity of investors. Leverage for investors.

13. Secondary Liquidity/ Securitization Current availability of liquidity for loans, issues re development of a secondary market, current efforts to develop a market, regulatory or other hurdles, prospects for such a secondary market and for securitizations.

Expansion Through Securitization The prospects for marketplace lending to continue to utilize the securitization market to fund its growth, thereby enabling the provision of credit to a greater number of borrowers in historically underserved markets, are significant. The first securitization by a marketplace lender was in 2013 and in the short period since then marketplace lending securitizations have grown to approximately \$1 billion for 2014 and \$1.5 billion for the first half of 2015.⁴ It is well established that consumer loan securitization has benefited lenders and borrowers alike by reducing funding costs for the lenders, which facilitates the ability of these lenders to offer their product to a greater number of borrowers and at a lower cost to these borrowers. The credit card securitization market has functioned successfully for nearly three decades and the marketplace lending providers have been able to borrow from highly developed securitization structures, including protections to mitigate investor risk, to help fund their business. As marketplace lending issuers continue to incorporate securitization techniques to fund their business, we expect the use of this funding source to continue to grow rapidly and to effectively facilitate the continued expansion of marketplace lending to an ever greater number of borrowers obtaining credit in historically underserved market segments.

14. Other Policy Considerations What other key trends and issues should be considered.

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Comments to the RFI are due no later than **August 31, 2015** and may be submitted through the Federal Rulemaking Portal (www.regulation.gov) or via U.S. mail or commercial delivery to Laura Temel, Attention: Marketplace Lending RFI, U.S. Department of the Treasury, 1500 Pennsylvania Avenue NW, Room 1325, Washington, DC 20220. *Responses to the RFI will be made public.*

⁴ “Securitization of Online Loans Already \$1B This Year,” Asset Securitization Report (April 15, 2015)



Please feel free to contact any of the authors of this Client Alert, any of the members of our Structured Finance, Banking and Finance, Supreme Court and Appellate Litigation, Public Policy or White Collar groups or other Orrick attorneys with whom you work to discuss any questions you may have with regard to the foregoing.

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