Our Perspectives:
Commentary on the economy & regulatory policies affecting financial companies

Barnett Sivon & Natter, P.C.
ATTORNEYS at LAW
WASHINGTON, DC

Online Marketplace Lending Moves on Stage[*]

Bob Barnett

September, 2015

With the Request for Information filed by the Treasury Department in July,[1] online marketplace lending has come over the footlights and onto the stage where it will now be reviewed more closely and perhaps be assigned a more regular role in financial services.

Treasury's Request for Information

The RFI seeks comment on (1) the various business models of and products offered by online marketplace lenders to small businesses and consumers; (2) the potential for marketplace lending to expand access to credit to historically underserved markets; and (3) how the regulatory framework should evolve to support the safe growth of the industry. In brief, Treasury is saying that it doesn't know too much about this industry, that it tends to like what it does know and would like to support its growth, and is enough of a regulator to say that a consideration of how to regulate it is important as time moves forward.

The RFI defines online marketplace lending as the segment of financial services that uses investment capital and data-driven platforms to lend to small businesses and consumers. Treasury carefully avoids stepping on the regulatory toes of CFPB by excluding from comments any directed at the rulemakings proposed by CFPB on payday loans, vehicle title loans, deposit advance products and certain high-cost installment loans and open-end loans. It also caveats that activities on the lenders' platforms also may raise questions surrounding the securities laws.

While Treasury asks for any comments the writers care to make, they have listed 14 key questions to which they would like responses. They include these general inquiries:

- In what ways should policymakers be thinking about market segmentation?
- What role are electronic data sources playing in enabling marketplace lending?
- How are lenders designing their business models for different borrower segments?

[*] 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***. Comments were due by the end of August.

- Is it making credit more accessible for underserved market segments?
- How are lenders acquiring new customers?
- How well do lenders assess creditworthiness and ability to repay?
- How well is the industry and its servicers complying with current regulations?
- How are lenders handling operational practices such as loan servicing, fraud detection, credit reporting and collections?
- In what way can the Federal Government help to promote innovation in this market segment, both for non-banks and banks?
- Should lenders be required to have risk retention responsibilities, and, if so, how does that apply in a non-securitization context?
- Does online marketplace lending present risks to consumers and small businesses, as well as benefits and value?
- What is the investor perspective of risks and rewards in this segment and how do they address them?
- Is there a secondary market for loan assets originated in this segment; should there be; and should it include derivatives?
- What should policymakers be watching as this segment develops?

The online marketplace industry

The industry has targeted small businesses and consumers. It utilizes technology and caters to those consumers that are adept with such tools. While these innovations are appealing to the government as a way to channel the power of technology, it is yet to be determined what kinds of customers will gravitate and be served by this market. That will be an important part of the Treasury review.

Treasury is interested in expanding services to the underserved segments of the population both in small lending and in consumer lending and in making financial services generally more efficient for the benefit of the country's economy. Yet, there is not a definitive picture of those that are customers for the online marketplace lenders. Generally, they are loans that are too small for the banks to make profitably or ones for whom the MPL have used new credit scoring systems to determine creditworthiness, making a new class of good credits where banks have seen less than good ones.

MPLs have found these kinds of loans profitable because they have created systems not hampered by clunky legacy systems and, therefore, have avoided some embedded costs. In addition, they have been innovative in utilizing additional data points not used by banks for determining aspects of the relationship such as whether the borrower has the ability to repay the loan. Mainly, however, they have greater capital freedom than existing competitors.

The market for this segment in the U.S. has grown dramatically from just about nothing in 2010 to about $12 billion in 2014. Morgan Stanley projects that it will reach well over $100 billion by 2020.[2] There is some evidence that most of the lending has been debt consolidation, but there is no reason to expect that it will not expand into student loans and perhaps, ultimately, into mortgages.

[2] ***"Global Marketplace Lending: Disruptive Innovation in Financials,"***, Morgan Stanley Research May 2015

MPL is no longer a P2P business, having expanded rapidly beyond that into a business that is funded by institutional investors who find the participations or securities created by the products sold (even on a no risk retention basis in the MPLs) worthy of investment. While the homespun story of P2P was accurate in the beginning phases, once performance had been established and risk profiles had been tested, wholesale investors began funding the segment and now are the dominant supplier of funds (and take most of the risk also).[3]

Exactly what customers find appealing about MPL is unclear, but it probably is found, at least in part, in the fact that service by MPL is quick and understandable when compared with traditional lenders. Millennials, that group that is most attracted to this segment, has grown accustomed to immediate response in their communications, and prefer something similar in financial transactions.[4] At the present time, it is the MPLs that can provide that speed. Others find speed important but conclude that millennials rank interest paid and fees much higher than speed, and, in fact, seem to have a bias to traditional lenders.[5] Perhaps the future will be found in a combination of the two.

Is growth inevitable?

Governments have an irresistible temptation to regulate the unregulated. Whether it is a belief that they can do better than the market or whether faults in the market drive them to it, it is a political reality. MPLs are not completely unregulated now. But the combination of technology use and incursion into consumer fields will most likely produce some new regulations. At the same time, they are not operating with consumer deposits, the direct risk they are retaining is modest, and they are making efforts to utilize innovative tools to determine if the customer has the ability to repay — all central to regulators' concerns. Still with regulation comes slower growth.

Capital requirements, of course, provide the leverage that exists in favor of the MPL. Exactly how the regulators get a handle on the capital requirements of the MPL is not yet clear, and as long as that advantage persists, they should be able to continue growing.

Put another way, the service MPLs are providing seems wanted, it is compatible with the habits of those aged 18 to 34 who want quick easily accessible solutions through technology, and, at this point, they have a running start to grow for a few more years before they really cause a pinch in the business of the traditional marketplace lenders.

Bob Barnett is a partner with the law firm of ***Barnett Sivon & Natter, P.C.***

[3] There will be bumps along the way. See the 2d Circuit Court of Appeals decision in Madden v. Midland 786 F. 3d 2456 (May 22, 2015) . The 2d Circuit held that national bank preemption could not be used to avoid usury ceilings for the benefit of investors who bought the loans from a national bank in an adjoining state.

[4] Viacom sponsored a study that resulted in 2014 with a report called ***"Sorry Banks, Millennials Hate You."*** That study created a Millennial Disruption Index which concludes that millennials see tech companies as the future for their financial transactions. Four of the 10 brands millennials hate most are bank brands, and 7 of 10 say they would rather talk to their dentist than their banker.

[5] See AlphaWise research results in Morgan Stanley research.