

# Client Alert

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## Treasury Issues White Paper on Online Marketplace Lending

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On May 10, 2016, the U.S. Department of the Treasury (“Treasury”) issued a white paper, entitled “Opportunities and Challenges in Online Marketplace Lending” (“White Paper”). The White Paper describes Treasury’s review of online marketplace lending and provides Treasury’s recommendations to the private sector and the federal government on how to encourage “safe growth” in the industry. The White Paper also summarizes the approximately 100 responses to Treasury’s July 20, 2015 request for information (“RFI”) on the marketplace lending industry.

According to Treasury, the White Paper is the next step in a “multi-stage process led by Treasury, in consultation with regulatory partners, to understand this market . . . and to inform appropriate policy responses.”<sup>1</sup> For purposes of the White Paper, Treasury’s “regulatory partners” include 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”), the Small Business Administration (“SBA”), and the Securities and Exchange Commission (“SEC”).

### PRIOR PUBLIC OUTREACH

In advance of issuing the White Paper, Treasury sought input from various stakeholders, both through the RFI and at an Online Marketplace Lending Forum hosted by Treasury on August 5, 2015. The RFI was wide-ranging, requesting information from the public on many topics, including the following:

- Policy considerations related to market segmentation (e.g., platform lenders, balance sheet lenders, and bank-affiliated lenders);
- The role of electronic data sources and data-based processes in marketplace lending;
- Business models and product offerings across borrower segments;
- Access to credit for underserved markets;
- Customer acquisition processes;
- Accuracy of credit risk and underwriting models;
- Marketplace lender relationships with traditional lending institutions;
- Marketplace lenders’ back-end operations and the use of third-party service providers;
- The role of government in encouraging growth of the market;

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<sup>1</sup> U.S. DEP’T OF THE TREASURY, OPPORTUNITIES AND CHALLENGES IN ONLINE MARKETPLACE LENDING 3 (2016), available at [https://www.treasury.gov/connect/blog/Documents/Opportunities\\_and\\_Challenges\\_in\\_Online\\_Marketplace\\_Lending\\_white\\_paper.pdf](https://www.treasury.gov/connect/blog/Documents/Opportunities_and_Challenges_in_Online_Marketplace_Lending_white_paper.pdf).

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- Marketplace lenders' risk-retention and alignment with investor interests;
- Potential risks of harms posed to consumers and small businesses;
- Considerations that are relevant to investors; and
- Development and growth of a secondary market for loans originated through marketplace lending.

The Online Marketplace Lending Forum convened by Treasury included representatives from industry, consumer groups, academia, and government. These representatives provided views on various issues, including those related to consumer protection, capital markets, and investors.

As reported in the White Paper, in addition to the approximately 100 comments submitted in response to the RFI, Treasury also considered various market reports and news media articles on marketplace lending.

## TREASURY'S FINDINGS FROM RFI RESPONSES

The White Paper identifies broad themes in the responses to the RFI:

- The use of data and data modeling represents both potential benefits and potential risks, including fair lending risks and gaps in consumer protection.
- Marketplace lending has the potential to expand access to credit, although Treasury notes that the majority of consumer loans are being originated for debt consolidation purposes.
- Marketplace lending has experienced significant growth during a strong part of the credit cycle, but the industry has not yet experienced a full credit cycle.
- Various stakeholders sought enhanced protections for small business borrowers.
- Commenters suggested that there is a need for greater transparency for market participants, including with respect to pricing terms for borrowers and standardized loan-level data for investors.
- The secondary market is still developing and will require transparency and significant repeat issuances of securities to thrive.
- Some commenters asserted that regulators could provide additional clarity around the roles and requirements for the various participants in the market, including with respect to consumer and small business protection, cybersecurity and fraud, bank partnerships and the true lender doctrine, Bank Secrecy Act and anti-money laundering ("BSA/AML") requirements, and risk retention.

## TREASURY RECOMMENDATIONS IN THE WHITE PAPER

Based on Treasury's research and the comments received in response to the RFI, the White Paper outlines Treasury's recommendations to the industry and regulators to facilitate safe growth of online marketplace lending.

- **More Robust Small Business Borrower Protections and Effective Oversight.** Treasury indicated that small business loans under \$100,000 share common characteristics with consumer loans, but observed that small business loans do not have the same consumer protections as consumer credit transactions. Treasury suggested that additional protections be developed for small business borrowers, consistent with efforts such

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as the Small Business Borrowers' Bill of Rights proposed by industry. Treasury also offered to "work with members of Congress to consider legislation that addresses both oversight and borrower protections."<sup>2</sup> With respect to effective oversight, Treasury noted that while depository institutions and marketplace lenders are generally subject to the same regulatory requirements with respect to small business loans, depository institutions generally have higher borrower satisfaction. Treasury seemed to attribute this difference to additional oversight that depository institutions receive from prudential regulators.

- **Ensure Sound Borrower Experience and Back-End Operations.** Treasury recommended that marketplace lenders have comprehensive back-up servicing and collection options in place in the event that delinquencies increase. Additionally, Treasury suggested that the industry adopt standards to improve each borrower's experience throughout the entire loan process, even in the event of delinquency or default.
- **Greater Transparency for Investors and Borrowers.** In order to improve transparency for investors and borrowers, Treasury recommended that the industry create a publicly available registry for tracking data on transactions that includes data on the issuance of notes and securitizations and data on loan-level performance. Treasury suggested that improved transparency would help to develop a wider investor base and a more active secondary market. To improve investor transparency, Treasury suggested the adoption of:
  - Standardized representations, warranties, and enforcement mechanisms;
  - Consistent loan data reporting standards;
  - Performance transparency for securitized loans; and
  - Consistent market-driven pricing methodology standards.
- **Greater Access to Credit Through Partnerships.** Treasury recognized the potential for online marketplace lending to expand access to credit in underserved markets. According to Treasury, however, marketplace lenders currently serve primarily prime or near-prime borrowers. Treasury noted that as the marketplace lending industry and the current credit models mature, credit is also likely to be expanded to near-prime and subprime borrowers. Nevertheless, Treasury recommended that marketplace lenders better serve underserved markets through referral, co-branded, or white label partnerships with Community Development Financial Institutions ("CDFI"). While recommending partnerships between financial institutions and marketplace lenders, Treasury encouraged prudential regulators to evaluate these partnerships and their associated risks carefully.
- **Improved Access to Government-Held Data.** Treasury encouraged wider use of smart disclosures (i.e., release of information in standard machine-readable formats). Treasury recommended that the CFPB and the FTC include the use of smart disclosures in their guidance and standards on consumer disclosures. Treasury envisioned that the use of smart disclosures will allow third-party companies to create comparison shopping sites for loans to allow consumers to easily compare loan terms. Additionally, Treasury encouraged federal agencies, including the Internal Revenue Service, to make more government-held data accessible and machine-readable so that marketplace lenders can access this data and conduct verifications of borrower data in real time.

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<sup>2</sup> *Id.* at 28.

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- **Creation of Standing Working Group.** Treasury recommended the creation of a standing working group on marketplace lending that includes Treasury, the CFPB, FDIC, FRB, FTC, OCC, SBA, SEC, and a representative of a state bank supervisor. Treasury proposes that the focus of the working group include:
  - Identifying and promoting awareness of existing regulations applicable to marketplace lenders;
  - Supporting responsible innovation;
  - Examining the impact of non-traditional data on credit scoring models; and
  - Monitoring risk throughout the credit cycle.

The White Paper also included a discussion of trends and developments that should be monitored. Namely, Treasury identified the evolution of credit scoring models and potential fair lending implications, interest rate increases and a constricting credit cycle, as well as cybersecurity and BSA/AML requirements and challenges that marketplace lenders may face. Even though Treasury stated that these developments should be monitored, Treasury appeared to recognize the potential for marketplace lending to expand access to credit and improve efficiencies in credit markets. The Treasury cautioned, however, that efficiencies in underwriting, including decision making by algorithm, do not eliminate a lender's fair lending obligations.

## TAKE HOME LESSONS?

The White Paper can be characterized both as a federal regulator's "wish list" for future regulation and as Treasury's acknowledgment that online marketplace lending is a beneficial innovation that should be facilitated. As such, the White Paper may foreshadow future federal government regulation of both unsecured consumer and small business lending. At the same time, Treasury in part collected and synthesized information to arrive at findings that have been part of the regulatory discussion for some time, such as additional regulation of small business loans.

Going forward, industry observers may take particular interest in the following aspects of the White Paper:

- Treasury's findings about small business lending echo others' calls to enact legislation or promulgate rules providing special protections for small business borrowers. For example, on November 3, 2015 Senators Sherrod Brown, Jeff Merkley, and Jeanne Shaheen sent a letter to the Secretary of the Treasury and the Administrator of the SBA requesting information from the agencies on online lending to small businesses and how online lenders are regulated.<sup>3</sup> It is also expected that the CFPB will soon turn its attention to small business lending.<sup>4</sup>
- Treasury noted the need for additional clarity from government agencies on compliance and appropriate market conduct, but did not suggest that non-bank players are "unregulated." For example, Appendix A to the White Paper provides a list of federal laws that apply to the market.

<sup>3</sup> Letter from Sherrod Brown, Jeff Merkley, & Jeanne Shaheen, Senators, U.S. Senate, to Jack Lew, Sec'y, U.S. Dep't of the Treasury, & Maria Contreras-Sweet, Adm'r, U.S. Small Bus. Admin. (Nov. 3, 2015), available at <https://www.merkley.senate.gov/news/press-releases/merkley-brown-shaheen-press-for-information-on-financial-technology-markets-impact-on-small-businesses-and-consumers>.

<sup>4</sup> See, e.g., CFPB Press Release, "CFPB Announces New Additions to Leadership" (Apr. 12, 2016) (announcing hiring of Assistant Director for Small Business Lending), available at <http://www.consumerfinance.gov/about-us/newsroom/cfpb-announces-new-additions-to-senior-leadership-20160412/>; CFPB Fact Sheet, "Policy priorities over next two years" (Feb. 25, 2016) (includes agency's statement of intent to regulate small business lending), available at [http://files.consumerfinance.gov/f/201602\\_cfpb\\_policy-priorities-over-the-next-two-years.pdf](http://files.consumerfinance.gov/f/201602_cfpb_policy-priorities-over-the-next-two-years.pdf).

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- Treasury recognized that “traditional” depository institutions have partnered with online marketplace lenders to integrate technology services and broaden product offerings. Treasury noted the potential for “white label” products to be marketed through CDFIs, in order to supply affordable credit to underserved populations of borrowers. Treasury’s statements could be interpreted as suggesting an avenue for marketplace lenders to expand their market share with additional bank and community-based partnerships.
- Treasury noted that secondary market offering of marketplace loans and similar credit products by marketplace lenders can be subject to liquidity constraints. The White Paper indicates that ongoing research will be necessary to monitor the liquidity of online marketplace lending and the impact of the credit markets.
- Inasmuch as the White Paper is the result of Treasury’s cooperation with a wide array of other federal regulators, Treasury’s observations about creation of an interagency standing working group for online marketplace lending bears watching. At this point, it is not known when such a group actually will be formed, and, if so, how the group will be composed and governed. The formation of this working group, however, is highly unlikely to slow down the separate initiatives of other federal regulators, particularly the CFPB, to regulate in this space.
- Treasury noted that online marketplace lenders are expanding product offerings into the auto loan and mortgage loan markets. Treasury stated that these markets are “still in early stages of development for online marketplace lenders,” and that it will “continue to monitor origination volumes and loan performance as the sector matures.”<sup>5</sup> While it is unclear the extent to which Treasury would assert jurisdiction over these particular consumer lending markets, the contemplated “interagency working group” will likely pay close attention to these markets.

Morrison & Foerster will continue to follow and engage in legal, regulatory, and policy developments affecting online marketplace lending. Stay tuned.

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<sup>5</sup> U.S. DEP’T OF THE TREASURY, OPPORTUNITIES AND CHALLENGES IN ONLINE MARKETPLACE LENDING 37.

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