



# **Marketplace Lending: Opportunities and Challenges for Private Investment Funds**

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# The Financial Revolution

**Banking is critical.  
Banks are not.**

# What is P2P Lending?

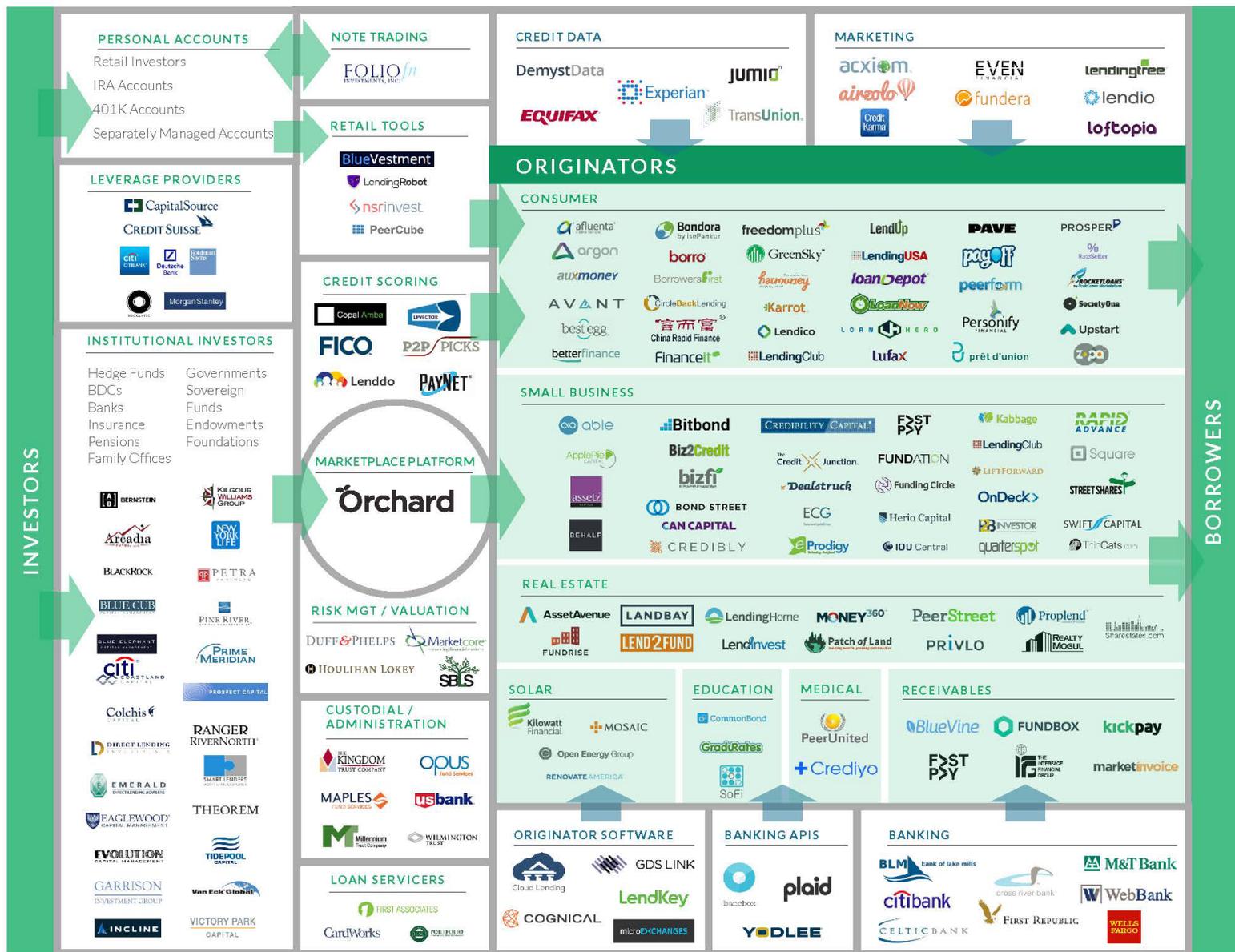
- **Individuals lending money to other individuals without a banking intermediary.**
- **It is a type of crowdfunding that facilitates loan originations outside of the traditional banking system by connecting lenders and borrowers through an Internet platform.**
  - Generally, the platforms do not make loans; instead, they serve as matchmakers, pairing borrowers and lenders.
- **P2P lending platforms have distinguished themselves from traditional lending by employing innovative credit modeling and underwriting processes.**
  - The platforms incorporate a wide range of data elements to move beyond traditional credit scores.

# The Platforms — Marketplace Lenders

Consumer	
Pay Day	
Purchase Finance	
Education Financing	
Real Estate	
Merchant Cash Advance	
SMB Credit	

Source: "A Million Dollar Market by the People, for the People," Foundation Capital

# Online Lending Ecosystem



As of late 2014, the U.S. Peer-to-Peer lending space has a range of players and is expanding. While not comprehensive, the above is intended to serve as a simplified illustration of what Orchard believes are typical interactions between some of the categories of industry parties. The illustration should not be interpreted to imply a relationship (or lack thereof) between Orchard and any named company and is not an endorsement by Orchard of any named company.

# Players in P2P Lending

- **P2P platforms**
- **Banks**
  - Many P2P platforms partner with banks to fund loans and these loans are sold or assigned to the platforms.
- **Individual investors**
- **Institutional investors**
  - For U.S. P2P platforms, approximately 80% of funding comes from institutional investors.

# The P2P Lending Process

- **Before a loan is posted on a platform's website, a prospective borrower submits an application to the platform for consideration.**
- **The platform obtains a credit report on the applicant and uses this information, along with other data, in proprietary models to assign a risk grade to the proposed loan and sets an interest rate corresponding to the assigned risk grade.**
- **If accepted, a loan request is posted on the platform's website, where investors can review all loans or search for specific loans that meet their desired risk/return characteristics.**

# The P2P Lending Process (Cont'd)

- If there are enough investors to fund the loan (a single loan is typically divided into many pieces to allow investors to diversify their portfolio and distribute the default risk among multiple investors), the loan is then originated by a bank.
- The originating bank then sells the notes associated with the specific loan to the platform, which, at the same time, sells the notes to each lender that has agreed to fund the loan. The notes issued by the platform are specific to each borrower, and some notes may be registered with the SEC.
- The notes issued by the platform (also referred to as “borrower payment dependent notes”) are guaranteed by the underlying loan. Investors are only due payment by the platform if the underlying borrower repays the loan.

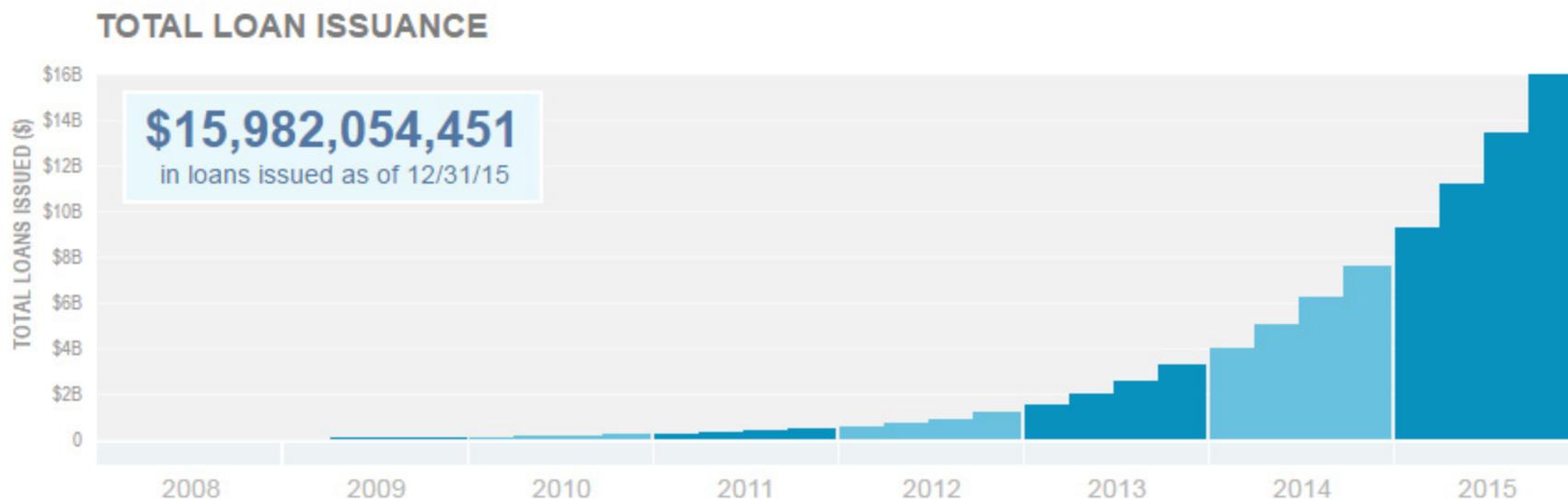
# Marketplace Lending

- **“Marketplace lending” is a better name to describe this new system, which is fundamentally about creating platforms to connect borrowers with lenders.**
  - Charles Moldow, General Partner, Foundation Capital
- **Four maxims — the keys to marketplace lending**
  - Data, data, data
  - Connections and liquidity
    - It’s not just about matchmaking but also about market-making
  - Formidable barriers
  - Built to last
    - Displace, not just disrupt

# **Marketplace Lending – The Size of the Market**

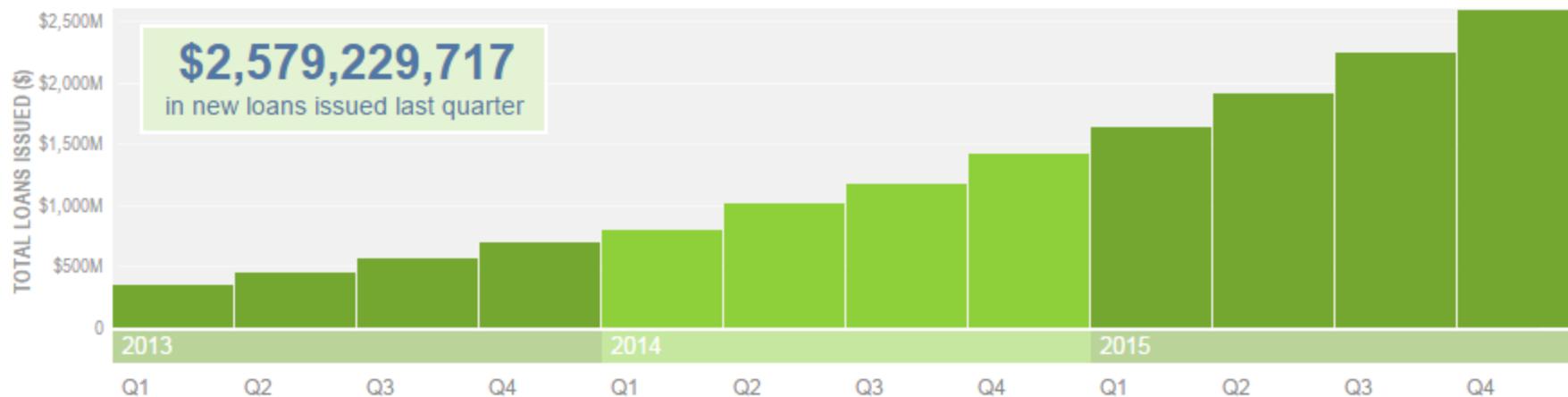
- The five largest platforms (Lending Club, Prosper, Sofi, Zopa and Ratesetter) have issued over 1,000,000 loans and are generating more at the rate of \$10 billion a year.**
- Charles Moldow predicts that by 2025, \$1 trillion in loans will be generated by marketplace lenders.**

# The Stats from Lending Club



# The Stats from Lending Club

## QUARTERLY LOAN ISSUANCE



# Hedge Funds and Marketplace Lending

- **NY Hedge Fund Roundtable survey**
  - P2P lending platforms will increasingly rely on larger hedge funds to fund their expansion.
  - Given the rapid growth in the sector, alternative investors will need to participate in P2P platforms to diversify investments.
  - If securitizations backed by P2P loans offer attractive returns, investors will buy.
- **There are concerns about potential imbalances between supply and demand.**

# Regulatory Focus

- **To date, regulatory efforts concerning marketplace lending have focused on narrow issues of licensing and securities laws.**
  - Lending laws
    - Lender or loan servicer
    - Applicability of consumer credit laws
    - Statutes relating to financial institutions
  - Securities laws
    - Securities Act compliance
      - Registration/Exemption

# Systematic Risk

- **The debate between Todd Baker, Managing Principal at Broadmoor Consulting, and Mike Cagney, CEO and Co-Founder of SOFI:**
  - Baker: “While MPLs have introduced valuable innovation into financial services, they carry a fundamental flaw that threatens to undermine their business, destabilize financial markets and cause real economic hardship.”
    - What is this fundamental flaw? Access to funding.
  - Cagney: “MPLS operate marketplaces. The beauty of marketplaces is real-time information feedback.”
  - “MPLS can’t expand their balance sheets and leverage like banks do.”
    - They use very little of their balance sheets for lending and have no real leverage.

# More Thoughts on Systematic Risk

**“Platform lending doesn’t have the central connection to leverage that traditional banking does. There is no entity that carries a balance sheet with leverage. There’s nothing there that is too big to fail. There is nothing there that requires deposit insurance. There is nothing there that is implicitly subsidized, and there is, therefore, a greater contribution to stability, to the kind of stability that we seek to achieve.”**

- Larry Summers, former economic advisor to Obama, head of Treasury and president of Harvard

# Growing Involvement of Leveraged Entities

- **With the transition from P2P to MPL, hedge funds, banks and asset management firms have taken over the investor side. These institutions are highly leveraged.**
  - Lending Club announced a partnership with Citibank to provide loans to underserved communities. Citi is providing a \$150-million credit line to Varadero Capital to purchase these loans from LC.
  - J.P. Morgan Chase is using On Deck Capital's platform to help make loans to some of the bank's roughly four million small-business customers. On Deck Capital will help the bank process applications more inexpensively and quickly, in hours instead of weeks.

# Securitizations of MPL Loan Pools

- **Pools of loans originated through marketplace lenders are being securitized.**
- **In fact, securitization is becoming a critical aspect in the funding cycle for MPLs.**
- **In Q4, 2015, 9 MPL-backed securitizations deals were consummated with a total par amount of \$2.7 billion.**
  - 9 tranches were rated by at least one rating agency
- **At the end of 2015, total securitizations of marketplace loans stands at \$8.4 billion (25 consumer loan transactions, 9 student loan transactions and 7 SME loan transactions.)**

# Securitization: Bumps in the Road

- **Moody's announced a potential downgrade of certain Citi Chai Bonds backed by Prosper loans. At the same time, Moody's upgraded certain of BlackRock's CCOL bond, which are also backed by Prosper loans.**
  - The CHAI bonds were hit by increased delinquencies.
- **Losses on a \$126-million bond backed by CircleBack consumer loans have overwhelmed the collateral loss trigger.**
- **In response, Prosper has increased rates by as much as 140 basis points.**
- **Despite this, capital is still pouring into the space.**

# Legal Decisions of Note

- **As discussed, marketplace lenders generally make loans through a partner bank. There are a number of significant cases that may call this platform-bank partnership into question.**
  - *Madden v. Midland Funding*
  - *Kane v. Think Finance*
  - *Maryland Commissioner of Financial Regulation v. CashCall*

# ***Madden v. Midland Funding***

- **The Second Circuit Court of Appeals' May 22, 2015, decision in *Madden v. Midland Funding, LLC* held that a nonbank entity taking assignment of debts originated by a national bank is not entitled to protection under the National Bank Act from state law usury claims.**
- **The Second Circuit and the Southern District of New York both appear to have not considered the “Valid-When-Made Doctrine” — a longstanding principle of usury law that states if a loan is not usurious when made, then it does not become usurious when assigned to another party.**
- **This decision is being appealed to the U.S. Supreme Court.**

# Reactions to *Madden v. Midland*

- **While the decision has raised concerns for all marketplace lenders, the case does not squarely address marketplace lenders.**
  - *Madden* involved charged-off credit card debt purchased by a debt collection company, which is distinguishable from marketplace lending operations.
- **Lending Club has revised its program structure to ensure that the WebBank has ongoing economic interest in all loans made after they are sold. WebBank's revenues will be tied to borrower repayments.**

# ***Kane v. Think Finance***

- **Pennsylvania Office of the Attorney General filed actions against a payday lender, Think Finance, alleging that Think Finance was the de facto lender under loans made by a Delaware bank.**
- **The arrangements with the bank were described as a “scheme to avoid state usury laws” and a fraudulent “rent-a-charter” arrangement.**
- **The case survived a motion to dismiss.**

# ***Maryland Commissioner of Financial Regulation v. CashCall, Inc.***

- **This case arises out of a business in which CashCall advertised its website to consumers so they could apply for loans online. The loans were made by out-of-state banks at annual rates between 59% and 96%, significantly in excess of the rate permitted by Maryland law, and the banks also charged loan origination fees. Shortly after origination, the banks sold the loans to CashCall, which collected all payments on the loans.**
- **The Commissioner argued that CashCall met the statutory definition of a “credit services business,” and required a license.**
- **CashCall was ordered to cease doing business and to pay \$5.6 million in fines.**

# Problems with the *CashCall* Decision

- **CashCall claimed that it could not be considered a credit service business because it did not receive a direct payment from the consumer.**
  - The court ruled that: (1) no direct payment is required where a company is exclusively engaged in assisting Maryland consumers to obtain loans at rates that would be usurious under Maryland law (if it applied); and (2) in any event, CashCall did receive direct payment in return for services to consumers when it acquired the loans and collected the entire principal on the loans, including the loan origination fee.

# **Additional Defenses to the *CashCall* Decision**

- **Any loan origination services CashCall provided were on behalf of the bank lenders and not the borrowers.**
- **Loan payments received by CashCall were in return for its purchase of the loans and corresponding payment of the purchase price, and not for loan origination services.**
- **The Maryland law purports to prohibit a credit services business from assisting a bank in the origination of loans at rates expressly authorized by federal law. Accordingly, the Maryland law conflicts with and is preempted by federal law with respect to the origination of the loans under the CashCall program.**

# Regulation of MPLs: The Lending Side

- **A web of federal and state regulations govern the entire credit cycle.**
  - Key federal statutes
    - Truth in Lending Act
    - Equal Credit Opportunity Act
    - Fair Credit Reporting Act
    - Gramm-Leach-Bliley
    - Electronic Funds Transfer Act
    - Bank Secrecy Act
    - Fair Debt Collections Practices Act
  - MPLs generally partner with banks who have the infrastructure to ensure compliance, but these arrangements are drawing scrutiny from regulators.

# Regulation of MPLs: The Funding Side

- **In November 2008, the SEC issued a cease and desist order to Prosper because it determined that its borrower payment dependent notes were securities.**
  - Applied the *Reves v. Ernst & Young* test
    - Rebuttable presumption that all notes are securities
    - Four-part balancing test
      - The motivation of the buyer and seller
      - The plan of distribution
      - The expectations of the investing public
      - Whether some factor, such as the existence of another regulatory scheme, significantly reduces the risk of the investment

# The GAO Proposal

- **In a 2011 report on P2P lending, the GAO acknowledged problems with the overlapping jurisdictions of multiple regulatory agencies. The GAO outlined two possible approaches to the future of P2P regulation:**
  - SEC-centered approach
    - Federal regulation covering investors/lenders
    - State regulation to protect borrowers
  - CFPB-centered approach
    - Treat P2P loans as consumer financial products and let the CFPB regulate and monitor the lending and borrowing sides of P2P platforms

# Regulations on the Rise for MPLs

- **The Treasury Department solicited feedback on marketplace lending. Key issues considered:**
  - Consumer protection
  - Additional protections for small business owners
  - Applicability of risk retention rules
    - MPLs are not currently a priority for the Financial Stability Oversight Council
- **The CFPB is now accepting complaints from consumers using on-line lenders.**
- **Also, the CFPB is looking to extend consumer protection to small business owners.**
- **The FDIC is also watching MPLs, as banks complain that MPLS are lightly regulated threats to their core business.**

# Speaker Biography



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Thomas R. Weinberger is a partner in the New York office. Tom focuses his practice on asset-backed securities and corporate finance, with an emphasis on marketplace lending, insurance and risk-linked securities and specialty finance companies. He has expertise in esoteric asset classes, including marketplace lending and other non-bank finance products, life settlements, reserve funding transactions, premium finance, longevity and pension risk transfer and alternative risk transfer.

Tom lectures on matters relating to specialty finance, the mortality and longevity markets, and he writes on topics involving marketplace lending, life settlements and securities. He earned his J.D. from Columbia Law School, where he was a Harlan Fiske Stone Scholar and Note Editor of the *Columbia Journal of Environmental Law*. He earned his B.S., *magna cum laude*, from Yeshiva University.