P2P and Online Marketplace Lending – Some Important Considerations for Bankers

By George Meinz

Online marketplace lending is a broad category of loan transactions where consumers, and increasingly small businesses, obtain loans originated by means of an online platform. As discussed below, these loans are funded by a variety of means, including crowdfunding. Although peer-to-peer (P2P) lending should be considered a subset of online marketplace lending that involves funding provided by individual investors, for purposes of this article we will refer to all types of online marketplace lending as "P2P." P2P lending has experienced what could be considered to be explosive growth. In 2014 the Federal Reserve Bank of Cleveland estimated that P2P was growing at a rate of 84% per quarter. It has clearly expanded beyond its crowdfunding origins. The market is continuing to see greater sophistication in the funding sources for loans and expansion into new loan markets. It is important for bankers to better understand what P2P is and the risks involved in participating in that market.

What Is P2P Lending and How Does It Work?

P2P lending had its genesis in the idea that crowdfunding (i.e., many interested persons making small investments with correspondingly small risks) could serve as a funding source for loans. By pooling these small investments, loans could be made to consumers for a variety of purposes, including debt consolidation, household expenses and other personal loans (e.g., Lending Club, Prosper) or student loans (e.g., SoFi). The loan originations are facilitated outside the normal banking system by an online platform that "connects" borrowers with these investors. The business model allows the lending platform to offer loans at what are perceived to be lower rates due to lower overhead and systemic efficiencies in underwriting and origination (but see Communities & Banking, Federal Reserve Bank of Boston (Fall 2014 edition)).

A typical P2P loan starts with a loan application being submitted to the lending platform (e.g., Prosper, SoFi). The platform performs a credit check on the applicant and applies an algorithm using the platform's proprietary lending model to assess the loan risk. If the risk is acceptable, the platform will post information about the loan on its website for potential investors to review. If an investor is interested in making funds available for the loan, and there are enough other investors to fund the amount requested by the borrower, the loan will then be originated by a bank or other licensed lender. That lender receives an origination fee for its services in originating the loan. After origination and funding, the lender will sell the loan the platform on a non-recourse basis. Simultaneously the platform issues a note to each investor that has agreed to fund the loan commitment in the amount of that investor's commitment. The investor notes are non-recourse and are payable solely from payments made by the borrower. In addition to origination fees received by the bank, the platform receives ongoing loan servicing fees and may also receive an origination fee.

The P2P model is attractive to investors because it offers higher yield investments in modest increments and provides a high level of transparency into the investment both at origination and throughout the life of the loan. Further, it is attractive to borrowers because of the ease of use and the availability of perceived lower interest rates.

What roles do banks perform in P2P lending?

Within this structure there are three primary opportunities for banks. First, as noted above, a bank may develop a relationship with the platform in order to serve as the lender of record for the loan before sale to the platform. The bank's revenue stream in this role is from the loan origination fees earned as the lender. In this role a bank typically does not have an ongoing customer relationship with the borrower or an opportunity to cross-sell other financial products. It is worth noting that because of the 24/7 nature of P2P lending, a bank would need to have infrastructure and staffing to support its role as the lender of record.

A second role might be that of an investor purchasing loans from the platform (typically pursuant to pre-established criteria set by the investor). This role suffers some of the same limitations as the lender of record role – especially the lack of an ongoing relationship with the borrower. For some platforms a third opportunity might be the formation of an alliance with the platform for purposes of referring potential borrowers or partnering on the creation of credit products. Although this option helps mitigate some of the cross-selling and relationship issues, the bank also gives up considerable control and may have additional risk management and third party relationship management issues to address.

What are the risks for the originating bank?

Because the platforms typically lack sufficient expertise and sophistication regarding regulatory compliance, they often look to banks or other lenders to fill that gap. Within the P2P lending structure, much of the borrower risk, interest rate risk, liquidity risk and regulatory risk is shifted to the platform and the investors. For example, the platform and the investors may be subject to regulatory risk regarding advertising, fair lending, interest rate and debt collection rules.

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However, the originating bank will also be exposed to regulatory risk. The role of banks in originating loans for non-bank lenders (so called "rent-a-charter") has been the subject of significant regulatory scrutiny. Additionally, the risks for the originating bank are substantially the same as those involved in originating a consumer loan for its own portfolio or for sale. Although the platform may have some responsibilities under the following laws, as the lender of record, the bank would not be able to avoid responsibility for its violations of the Truth in Lending Act, Equal Credit Opportunity Act, Fair Credit Reporting Act, Bank Secrecy Act, Gramm-Leach-Bliley Act, similar consumer protection acts and usury laws.

Additionally, a bank's supervisory agency may consider the platform to be a third party relationship with respect to which the bank is obligated to exercise all of the due diligence and ongoing oversight obligations it has with respect to any other third party relationship. The ongoing obligations to monitor and audit the third party relationship with the platform could well prove to be burdensome to smaller banks.

Moreover, in addition to the laws mentioned above, the banking supervisory agencies will have authority in connection with alleged unfair, deceptive or abusive acts or practices (UDAAP) of the bank and the platform (as a service provider to the bank). The Federal Trade Commission may have independent jurisdiction over the platform under the unfair and deceptive acts and practices restrictions of the Federal Trade Commission Act.

Other Issues

There are a number of other issues that need to be assessed that are beyond the scope of this article. For example, there are potential securities law issues to be considered in the sale of loans or interests in loans. Additionally, the SEC has adopted crowdfunding rules that go into effect on January 29, 2016, that, among other things, place limits on the funds that can be raised by crowdfunding.

In conclusion, prior to jumping into the P2P lending pool, it is important for banks to carefully consider the regulatory issues, the bank's obligations under both Federal and State laws, and the obligations and risks it is undertaking in its contracts with the lending platform. Front-end due diligence regarding these requirements will play a significant role in assisting a bank to understand and mitigate potential risks. ■

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