



# Value-Based Compliance: A Marketplace Lending Call to Action

*Preparing P2P for an expected  
escalation in regulation*

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# Letter to the Reader

Seldom do we find ourselves at a point in time when rapidly evolving disruptive technologies have the impact on a traditional industry that marketplace lending currently is having on financial services businesses.

Though still very small in comparison to most banks, marketplace lenders—which use proprietary, algorithm-fueled technology platforms to operate online credit marketplaces that connect borrowers, lenders, and investors—are rattling the cages.

Their competitive advantages are fundamental and significant: they are speedier than banks in connecting lenders to borrowers; they offer investors higher-than-market rates; they have none of the big bank overhead; and their technology backbone is generations ahead of their brick-and-mortar peers. As credit marketplaces, these organizations hold no deposits, and instead operate as conduits—for a fee—and facilitate activities in a two-sided transaction. At the same time, the business model in place could prove beneficial to the many people around the world who do not have access to loans, but could have access with prudent credit modeling and better means of distribution.

Additionally, they do not face the same level of regulatory scrutiny as the banks. But, as we attempt to make clear in this paper, our point of view is that more regulatory oversight of the marketplace lending industry appears to be a virtual certainty.

The question we put up for debate is: Are the industry's participants prepared for what the regulated future holds?

Our view is that unless marketplace lenders adopt a proactive, strategic posture and avoid "bolt-on" reaction, their growth spurt could be stunted. We recommend marketplace lenders learn from the recent regulatory actions against their traditional banking peers: Do not wait for the big regulatory event to change your compliance behavior.

In offering this point of view, we do not presume to have all of the answers. However, we do suggest a step-by-step plan for marketplace lenders to achieve compliance while they scale.



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“Right now ... just 20 percent (of the world’s population has) access to a loan product from a financial institution. Roughly five billion people that banks don’t serve today. More than anything, finance is poorly distributed. It’s staggering to think how one of the oldest, most powerful, farthest reaching industries still avoids four fifths of humankind. In other words, banks haven’t figured out how to make money from lending to those other five billion people.”

“Lending (Capital) in the Twenty-First Century,”  
Foundation Capital, March 13, 2015

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# Gearing Up for Governance

There seemingly is no end to the almost breathless hype:

**"Innovation of the Year: Online Marketplace Lending."**

**"A Trillion Dollar Marketplace by the People, for the People."**

**"Six Technology Companies to Hasten the Demise of Retail Bank Giants." "Why Crowd-funding Is Set to Explode in Size Over the Next Few Years."**<sup>1</sup>

These headlines are just a handful of literally hundreds of recent articles in every major newspaper and trade publication. If nothing else, the upsurge in lending, borrowing, and investing spawned by marketplace platforms has made for good copy in the media over the past couple of years. And, the hype just seems to be reaching a higher pitch with each passing week.

At the same time, marketplace lending growth has begun to negatively impact the heavily regulated traditional banking industry. More questions are being raised about when more stringent regulations will be imposed on these upstarts.

Correspondingly, more questions are being asked about how more government oversight could slow or even reverse marketplace lending's arc of growth, and whether the platforms have been proactive in their planning for what is expected to be a regulatory eventuality.

In order to gauge what may be in store for them in terms of regulation, marketplace platform businesses need look no further than the published minutes from the U.S. Federal Reserve Bank Board of Governors' Federal Advisory Council meeting on February 6, 2015.

While we witness this simultaneously fascinating and fundamental shift in the marketplace and the change in behavior by lenders and borrowers, we keep coming back to a central question: Can these Internet-powered institutions proactively and strategically prepare for the certainty of more demands for oversight and transparency by powerful regulators and still maintain what many see as competitive advantage over traditional banks?

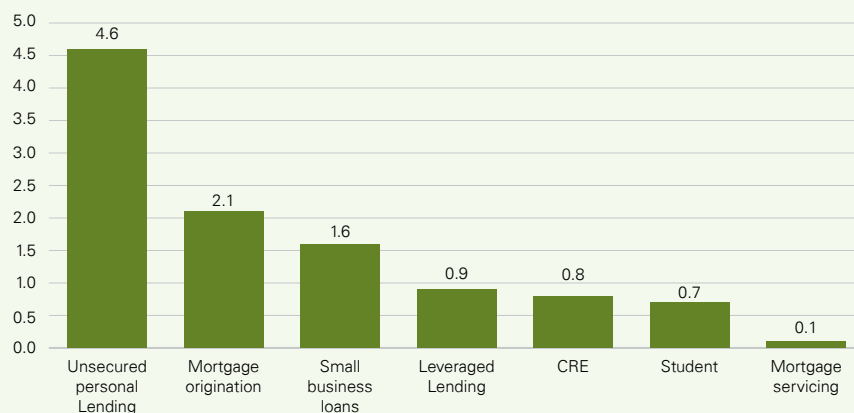
These few lines speak volumes about what seems to be in the offing:

- **"The growing popularity of peer-to-peer lending, as with the Lending Club, could change the consumer credit market and bears close watch."**
- **"Many of these lenders use models that are innovative but untested over an economic cycle."**

And, notice in the following notation that the word "how" instead of "if" appears to leave little doubt about what to expect:

- **"These alternative lenders face significantly less regulation, and it is yet to be determined how they will be regulated in the future."**

■ Billions of banking profits at risk from shadow banks



Source: Federal Reserve, Goldman Sachs Global Investment Research.

"The Future of Finance," Goldman Sachs, March, 2015

<sup>1</sup> "Innovation of the Year: Online Marketplace Lending," *American Banker*, December 17, 2014

"A Trillion Dollar Marketplace by the People, for the People," *FoundationCapital.com*, 2014

"Six Technology Companies to Hasten the Demise of Retail Bank Giants," *Computerweekly.com*, March 18, 2015

"Why Crowd-funding Is Set to Explode in Size Over the Next Few Years," *Quartz.com*, April 23, 2014



# The Challenge

Are the marketplace lending platforms ready to comply, in a cost-effective manner, with regulatory mandates? Moreover, are the platforms even aware of the scope of rules and regulations that affect them today?

The online lending start-ups would say they will not be caught off guard. They are putting chief risk officers (CROs) in place and propping up lobbyists with long résumés on Capitol Hill. However, these efforts may be paper-thin—the CROs focus

primarily on credit and the lobbyists are detached from core processes, bolted-on instead of embedded. We think there is more that the platforms can do to proactively prepare.

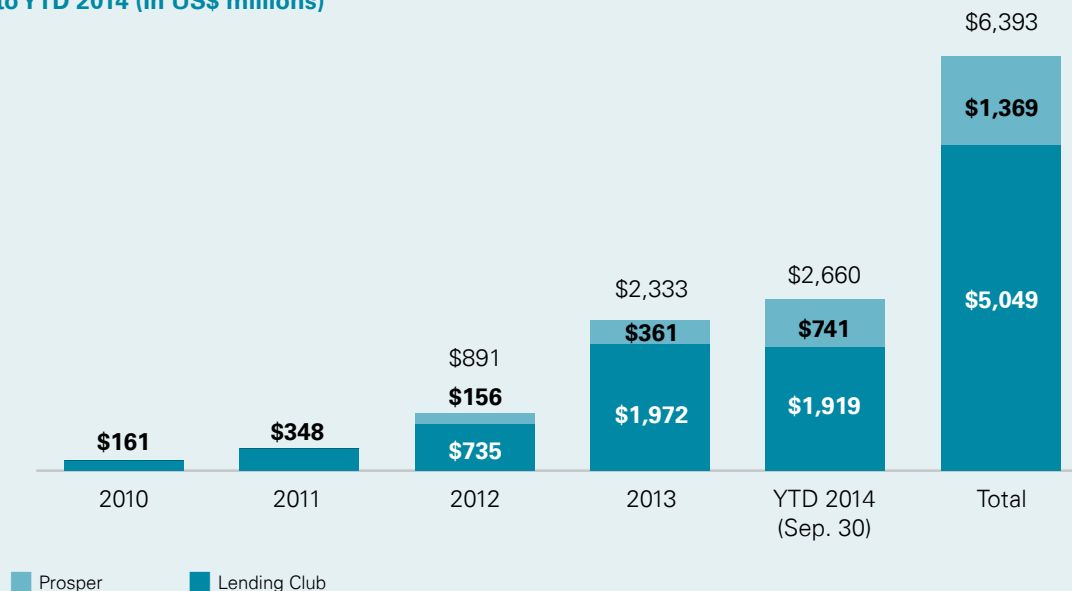
What is at risk? With more than 50 similar platforms in the market, some of which can operate globally, reputation is king. History has shown that “go-betweens” that facilitate credit between banks and other parties have been penalized in the past for lack of regulatory transparency. The stakes here are just as high; multimillion-dollar fines are not uncommon.



# The Landscape

In gauging what is over the horizon, it is often enlightening to take a look back. A lot has happened in a very short time.

**Loan Originations Growth for Largest U.S. P2P Platforms, 2010 to YTD 2014 (in US\$ millions)**



Source: Crowdnetic, Lendvius product. Figures are through September 30, 2014; as of December 31, 2014, Lending Club has surpassed US\$6 billion.

Along with the types of originators and the types of institutions getting into the game, the who's who of financial services headliners keeps growing. Among them:

- Larry Summers, former Secretary of the U.S. Treasury, former Morgan Stanley chief executive officer (CEO) John Mack, and former Morgan Stanley analyst Mary Meeker sit on the board at Lending Club.
- Vikam Pandit, former Citigroup CEO, is among the investors in Orchard Platforms.
- Legendary investor George Soros's Soros Fund Management took a position in February 2015 in Lending Club.
- Former Pimco CEO Mohamed El-Erian recently took an equity stake in online platform Payoff, a platform designed to help consumers pay off high-rate credit card and other debt.
- Banking giants, such as Wells Fargo, Royal Bank of Scotland, and Santander, invest in marketplace lending, either through a joint venture or an investor in loan securities.

- 360 U.S.-based small and business banks, through recently announced consortia, are in cobranding partnerships with multiple platforms providing discounted lending rates to the banks' customers.
- China's Alibaba Group Holding Ltd. announced in February that it was joining with Lending Club to provide sales financing to small U.S. businesses buying from Chinese suppliers. The deal allows U.S.-based businesses to apply for lines of credit of \$5,000 to \$300,000 from Lending Club to pay for goods from China-based suppliers on the trading platform Alibaba.com.<sup>2</sup>

Whether these industry heavyweights have placed smart bets is a question whose answer will only become clear in the years ahead. As noted in a recent *American Banker* news article, "These platforms will have a role to play. As to how big or small will depend on the kind of trust they develop over time, through cycles and stresses and strains, and through learning."<sup>3</sup>

<sup>2</sup> "Alibaba, Lending Club Join Forces to Finance Purchases," *The Wall Street Journal*, February 3, 2015

<sup>3</sup> "Innovation of the Year: Online Marketplace Lending," *American Banker*, December 17, 2014

At the moment, although the number is not precise because of the quick entry of players, we estimate there are in excess of 50 platform lenders globally. There may be many more in emerging economies around the world. The mature platforms are originating loans for consumers, small businesses, and real estate businesses, and they are in such diverse markets as solar, education, medical, small business, and receivables. On the institutional investor side, the loans are being purchased by hedge funds, banks, insurers, pension funds, governments, sovereign-wealth funds, as well as foundations.

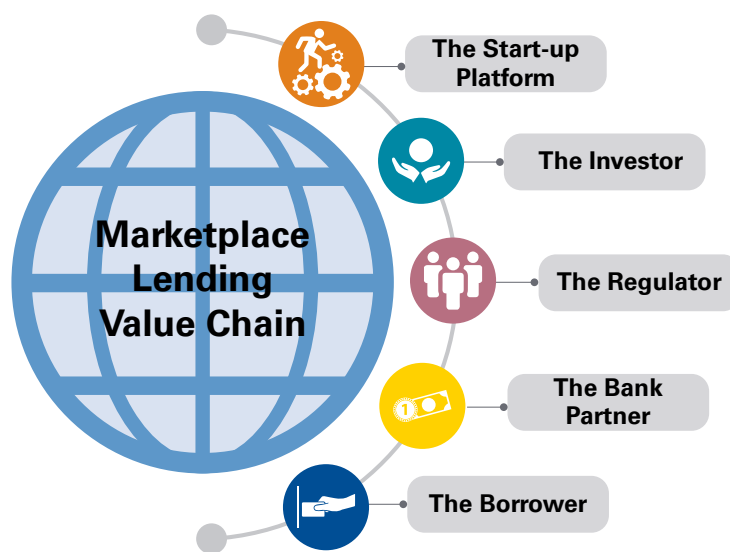




# The Marketplace Lending Value Chain

Impending costs of compliance and regulatory pressures present significantly separate implications across a spectrum of constituents—call them the marketplace lending value chain—that can be defined as the platforms, the investors, the regulators, the borrowers, and the bank partners.

Marketplace lending has separate meanings for discrete segments of its ecosystem. KPMG offers a Marketplace Lending Value Chain, which identifies the links in the chains as well as some of the key challenges and implications each face.



Source: KPMG 2015

Being ill-prepared to effectively—and swiftly—manage regulation could negatively affect the industry's three key attributes that create competitive advantage: **speed, cost, and return on investment**. Consequently, we believe it prudent to review how broader regulations could diminish these three attributes by examining the regulatory impact to each segment in the value chain in the marketplace platform industry. Without such an analysis, our view is that the chances will increase that participants in the industry could lose the market's trust or the participants' reputation could be damaged by being reactive rather than proactive.

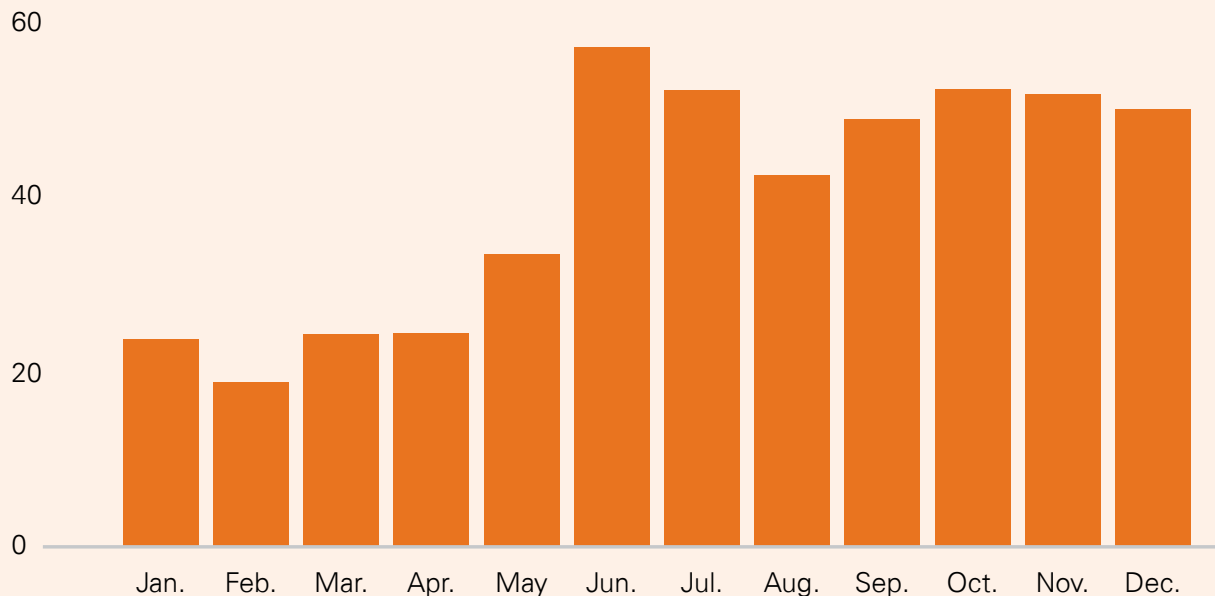
## The Start-up Platform

- Can a start-up platform gain an understanding of how existing regulations apply to marketplace lending, and actively explore how new regulation could affect through examination of state, federal, and foreign regulations? The issues will affect securities laws, lending laws and lender regulations, and consumer protection laws.
- Does the lack of a prudential supervisor for the state-licensed platforms leave them exposed if their business crosses borders?
- Can the organization identify a realistic strategy that achieves compliance while reducing a slowdown in growth due to a structure or culture that does not adequately focus on regulations, which could slow down the operation and add costs—and thus stunt growth?
- Ask this vital question: Do we understand compliance requirements in other jurisdictions as the organization considers expansion into new locations? What “blue-sky” state laws apply? If looking abroad, how will the organization smoothly enter the marketplace by avoiding regulatory snags?



<b>The Start-up Platform (continued)</b>	<ul style="list-style-type: none"> <li>• How will marketplace lenders be able to keep their advantage of lower operating costs than traditional banks if they are hit with a bevy of new (and costly) regulatory compliance and reporting demands relating to securities, lending/lender registration, and consumer-protection laws?</li> <li>• Will marketplace platforms be able to sustain the level of rapid service that is a prime attraction for mobile borrowers who seek funding in just a few clicks?</li> <li>• Can marketplace platforms withstand an inevitable reversal of the currently favorable credit environment? Will higher rates create high defaults?</li> <li>• Will platforms be tempted to lower credit standards to subprime levels to fuel the borrower supply line?</li> <li>• What steps are marketplace lending executives taking right now in anticipation of likely demands related to risk management, governance, compliance programs, and processes?</li> <li>• What understanding of the bank regulatory compliance is needed for the rented bank charter? Is there a third-party vendor risk assessment in place? Does the platform understand the aggregated reputational risk?</li> </ul>
<b>The Investor</b>	<ul style="list-style-type: none"> <li>• The investor will expect attention to the compliance issues listed above. Can your organization clearly articulate its market-penetration strategies regarding future growth?</li> <li>• Does your organization have an explicit plan that it can share when investors ask for a stated plan or pipeline for new services?</li> <li>• For institutional investors, does the platform comply with similar regulatory compliance practices? Specifically, what evidence is required for compliance with Anti-Money Laundering (AML) or Office of Foreign Assets Control (OFAC) laws?</li> <li>• As a securitized investor, what controls are in place to provide transparency as to the first entrants into the securitized pool? Is there preferential treatment?</li> <li>• Will regulation slow the speed of investment? Currently, a large portion of loans are picked up for investment within 10 seconds or less. If regulation proves to be a strong drag on production, will investors seek other platforms?</li> </ul>
<b>The Regulator</b>	<ul style="list-style-type: none"> <li>• Does the compliance staff have the requisite depth and knowledge to hold detailed conversations with regulators about the array of federal securities laws, state usury laws, truth-in-lending laws, data privacy demands, money laundering laws, federal OFAC laws, fair lending laws, and many others?</li> <li>• Are lenders thinking about overall training for the staff? The training should include compliance-awareness training for all in the operation as well as specific role-based training for particular functions—all of which will add to a general culture of compliance in the organization.</li> <li>• Do controls allow regulators an uninhibited view of where funds are at any given time?</li> <li>• Will the platforms open their doors to share the nuances of their proprietary models? If so, how do “Facebook-type” metrics such as application fonts or size of requested loans fit into fair lending laws?</li> <li>• Are controls routinely examined? Are accountability standards assigned? It is important to build in the “three lines of defense”—the first in operations, the second in compliance and risk, and the third in internal audit.</li> </ul>

## Percentage of whole loans purchased in less than 10 seconds for the year 2014



Orchard Platform Advisors, used with permission

### The Bank Partner

- Is the platform able to provide the bank partner with information about money flow or risk issues at any stage of the transaction?
- Is the platform ready to hand over clear documentation regarding all requisite compliance issues, and does it have a strategic committee in place that is preparing for pending or possible regulatory changes proactively?
- How can the bank partner help to ensure that the platform is in compliance with relevant regulations to avoid additional or new regulatory scrutiny/potential fines of their own organizations?

### The Borrower

- Is the borrower treated fairly and without discrimination regarding loan terms and rates? Can you produce documentation, stated in clear language, that articulates how borrowers are rated?
- Will the cost of noncompliance be added to the borrower fees, interest rate, or other loan terms?
- How will new compliance protocols affect the user borrowing experience? Will more information be requested, slowing down the funding or servicing processes?



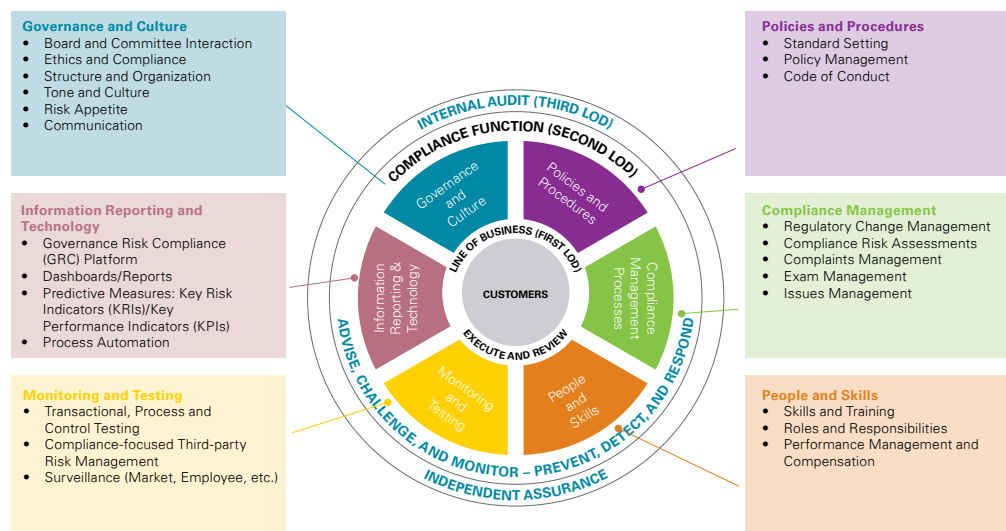


# KPMG Recommendations

While recognizing that a single action plan cannot fit all organizations—especially those such as marketplace lenders that are now in a highly dynamic state—we nevertheless offer 10 steps for consideration going forward:

1. **Align the overall business strategy** with foundational risk management practices, including regulatory compliance.
2. Institute a **tone-at-the-top** focus on compliance importance, including ongoing training and tying compliance conduct to performance measures and top-down, executive-level messaging to support a strong culture of compliance.
3. **Take inventory of stakeholders/third parties** in the lending process, including counterparties, vendors, and outside service providers. Inventory corresponding third-party expectations (audit clauses, regulatory reporting, etc.).
4. **Create an inventory of applicable or emerging regulations**, including the rationale for regulations that do not apply, with consideration to what business processes affect compliance with each (*see our chart below*).
5. Consider the benefits of creating a **master reporting calendar to proactively plan for reporting requirements** for the Federal Deposit Insurance Corporation Improvement Act or Sarbanes-Oxley Act that will be requested by regulators, external auditors, third parties, and other stakeholders at year-end.
6. **Create a communication and training plan** that includes expectations of board members and committees of the board, executive committees, and other parties. The plan should proactively manage expectations by defining the nature, timing, and extent of dashboard or status reporting.
7. **Perform a compliance risk assessment**, including potential monetary fines and reputational impact of actual and perceived noncompliance.
8. **Map the flow of money and perform a credit-specific risk assessment** among all parties and through the platform. **Create a few high-level process documents** for the key processes for control definition, execution, and monitoring that align to existing policy and board-approved governance.
9. **Perform a skills assessment** of current compliance professionals and **assign specific responsibilities** for chief risk, compliance, and credit officer roles that are linked to performance metrics.
10. Validate controls identified and consider when to **invest in a tool** that will automate regulatory compliance work flow, certifications, or notifications, and provide a compliance data repository.

The following schematic is a KPMG tool used to define and develop a Regulatory Compliance Framework.



Source: KPMG LLP (U.S.) 2015.





## Marketplace and Lender Laws

### Nonexhaustive list of federal legislation and networks

- Anti-Money Laundering (AML)
- Bank Secrecy Act (BSA)
- Blue Sky Laws
- Card Act (CARD)
- Dodd-Frank – Wall Street and Consumer Protection Act
- Electronic Funds Transfer Act (EFTA)
- Electronic Signatures in Global and National Commerce Act (ESIGN)
- Equal Credit Opportunity Act (ECOA)
- Fair and Accurate Credit Transactions Act (FACTA)
- Fair Credit Reporting Act (FCRA)
- Fair Debt Collection Practices Act (FDCPA)
- Fair Housing Act (FHA)
- Financial Crimes Enforcement Network (FinCEN)
- Gramm-Leach Bliley Act (GLBA)
- Know Your Customer (KYC)
- Service Member Civil Relief Act (SCRA)
- Truth in Lending Act (TILA)
- Unfair, Deceptive or Abusive Acts or Practices (UDAAP)
- USA Patriot Act

### Nonexhaustive list of federal regulatory bodies

- Commodity Futures Trading Commission (CFTC)
- Consumer Financial Protection Bureau (CFPB)
- Federal Deposit Insurance Commission (FDIC)
- Federal Housing Finance Agency (FHFA)
- Federal Reserve (FED)
- Federal Trade Commission (FTC)
- Financial Industry Regulatory Authority (FINRA)
- Financial Stability Oversight Council (FSOC)
- National Credit Union Administration (NCUA)
- Office of the Comptroller of the Currency (OCC)
- Securities and Exchange Commission (SEC)

**Additionally, there are state-by-state licensing requirements specific to each asset class and business model.**



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