CLIENT ALERT

Department of the Treasury Whitepaper - Opportunities and Challenges in Online Marketplace Lending

On May 10, 2016, the U.S. Department of the Treasury released a whitepaper regarding online marketplace lending and made several recommendations to the industry and regulatory agencies. The release follows enhanced interest in online marketplace lending from Federal financial regulators and signals increased regulatory attention for the online marketplace lending sector.

In summary: On May 10, 2016, the U.S. Department of the Treasury (Treasury Department) released a whitepaper titled, "Opportunities and Challenges in Online Marketplace Lending" (whitepaper or report). The report, which was the product of interagency collaboration, comes closely on the heels of increased regulatory interest in online lending by the Federal Deposit Insurance Corporation (FDIC), the Office of the Comptroller of the Currency (OCC), and the Consumer Financial Protection Bureau (CFPB), among others.[1] It summarizes responses to the Treasury Department's July 2015 Request for Information (RFI), presents research on the industry, and issues a set of recommendations.

The report raises a number of important operational and credit risk issues highlighted by the more than 100 organizations responding to the RFI. It represents the Treasury Department's views, though the Treasury Department acknowledges that it consulted with other agencies, and, as such, serves as an indicator of policy trajectories from the Federal government regarding supervisory expectations for this emerging market. Much of the report offers conceptual support for the market given its potential to expand access to credit to previously under-served consumers and small businesses. It also highlights the growing ties between online marketplace lenders and more traditional financial institutions.

The Treasury Department paper makes the following recommendations to government agencies and market participants "to facilitate the safe growth of online marketplace lending while fostering safe and affordable access to credit for consumers and businesses:"

1. Support more robust small business borrower protections and effective oversight;
2. Ensure sound borrower experience and back-end operations;
3. Promote a transparent marketplace for borrowers and investors;
4. Expand access to credit through partnerships that ensure safe and affordable credit;
5. Support the expansion of safe and affordable credit through access to government-held data; and
6. Facilitate interagency coordination through the creation of a standing working group for online marketplace lending.

The report highlights some specific regulatory issues related to compliance with fair lending laws and risks associated with disparate impact under the Equal Credit Opportunity Act (ECOA). The report states that "while data-driven algorithms may expedite credit assessments and reduce costs, they also carry the risk of disparate impact in credit outcomes and the potential for fair lending violations." This kind of strong statement, when paired with the creation of an inter-agency working group, suggests that fair lending and the risk of disparate impact will continue to be regulatory focal areas with respect to proprietary models, underwriting algorithms, and related procedures. The report also highlights that

[1] See FDIC Supervisory Insights Journal (Winter 2015), Supporting Responsible Innovation in the Federal Banking System: An OCC Perspective (March 2016), and CFPB Now Accepting Complaints on Consumer Loans from Online Marketplace Lender (March 2016).

small business loans are covered by ECOA and the prohibitions on unfair or deceptive acts or practices (UDAP) under the Federal Trade Commission Act but are generally not covered by the Federal consumer protection laws. The Treasury Department indicates a willingness to work with Congress to expand regulatory oversight and consumer protections for small business loans.

Implications: The Treasury Department indicates that the largest online marketplace lenders have doubled originations from $5.0 billion in unsecured consumer credit in 2014 to over $10 billion in 2015. They also indicate that the number of online marketplace lenders continues to grow, potentially reaching an estimated market size of nearly $1.0 trillion (excluding mortgages) by 2020. [2]

This rate of expansion seems to be generating growing pains and market pressures. News reports suggest that capital markets participants have expressed concerns regarding business practices at online lenders[3] and uncertainty about interest rate exportation rules.[4] In recent months, online lenders have seen management changes, the suspension of relationships with securitizers, and a pullback in loan originations. Scale of this size necessarily generates increased attention from the regulatory policy community as well, as indicated by the Treasury Department whitepaper.

KPMG anticipates that, given the focus of multiple regulators, both supervisory expectations and enforcement activity related to online marketplace lenders will increase. For example, concerns regarding potential disparate impact combined with a recommendation that credit be granted using government data suggests new processes for granting credit may raise potential enforcement concerns associated with allegations of unfair or deceptive practices (covered by the FTC's UDAP provisions as well as the unfair, deceptive or abusive acts or practices (UDAAP) provisions of the Consumer Financial Protection Act enforced by the CFPB), lack of access to credit (covered by the ECOA), and lack of access to housing finance (covered by the Fair Housing Act). In addition, Treasury Department concerns regarding robustness of back office processes suggests Federal regulators may begin taking more assertive action to assess the adequacy of operations and controls implemented by online marketplace lenders to protect data security and potential misuse of their platforms by cyber criminals and others seeking to commit financial crimes. The CFPB in particular has broad consumer-related supervision and enforcement powers while the Treasury Department's Financial Crimes Enforcement Network (FinCEN) can pursue anti-money laundering and counter-terrorism finance enforcement actions without additional rulemaking.

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The deep knowledge gained from working with leaders in the FinTech Industry enables our professionals to provide keen insight and perspective on economic, market, and regulatory conditions affecting businesses. Our industry experience allows us to identify and respond to key business and performance issues as they arise, and provide a broad scope of services to help address those issues.

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[2] See U.S. Department of Treasury, Opportunities and Challenges in Online Marketplace Lending (May 2016).

[3] "Prosper Said to Cut 28% of Staff As Growth at Online Lender Slows," Bloomberg (May 3, 2016); "Prosper Marketplace to Cut Jobs and Shuffle Executives," Wall Street Journal (May 3, 2016); "Lending Club, Leading Online Lender, Says Its Chief Has Resigned," New York Times (May 9, 2016); "The Quickening: Why is the Justice Department Suing One of the Nation's Most Careful FHA Lenders?", Wall Street Journal (May 3, 2016).

[4] *Madden v. Midland Funding LLC*, 786 F.3d 246 (2nd Cir. 2015). The decision limits the ability of non-bank financial market participants to purchase debt originated by depository institutions, at least in the Second Circuit where New York's financial markets are located.

Our service offerings include, among others, assisting clients in the areas of:

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- Compliance policies, procedures, and testing
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- Fair lending pricing, underwriting, and loss mitigation analysis
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- Governance, risk, and compliance, and related tools
- IT strategy and planning
- Information assurance and privacy, identity and access management
- Market, credit, and operational risk management
- Regulatory change management

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The Americas Financial Services Regulatory CoE is based in Washington, DC and comprised of key industry practitioners and regulatory advisers from across KPMG's global network.