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Key Online Lending Takeaways As Regulators Assess Industry

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Law360, New York (August 26, 2015, 11:27 AM ET) -- Online consumer and small business lending, which has experienced considerable growth in recent years as a popular alternative to traditional sources of credit, is receiving fresh attention from regulators and industry observers. Within the past month, the U.S. Department of the Treasury issued a request for information about online consumer and business lending,[1] the Office of the Comptroller of the Currency delivered remarks on financial technology,[2] and the Responsible Business Lending Coalition released a "Small Business Borrowers Bill of Rights" that has implications for online transactions.[3]

Not surprisingly, these developments coincide with the emergence of online lending as a significant portal for consumers and small businesses to obtain credit. Indeed, in less than a decade, the online lending marketplace has grown into an estimated $12 billion origination business.[4] In many ways, this growth has revolutionized capital deployment for lenders and access to credit for borrowers. For example, online lending provides consumers and small businesses with loans more quickly, and often less expensively, than traditional lending sources. In light of this rapid growth and because the regulatory framework governing online lending is decentralized and in some respects ambiguous, government authorities and private stakeholders are considering new approaches to oversight and the establishment of best practices. This article discusses these developments and highlights key takeaways and opportunities for industry participants.

Overview of Online Lending

Online lending companies facilitate bank and nonbank loan origination outside of traditional brick-and-mortar locations by directly connecting borrowers with lenders or investors through an Internet platform. Although they may vary in their exact lending or servicing focus (i.e., consumer, small business, student loan, etc.), these companies typically operate without physical branches, limit their product offerings, and perform underwriting using innovative, automated credit risk models.

As the online lending industry continues to mature, so do its business models, funding structures and borrowers. As described by the Treasury Department, businesses that operate in the online marketplace tend to fall into three general categories:

1. Balance Sheet Lenders. These lenders retain credit risk in their own portfolios and are typically funded by venture capital and other private investment funds, or family office investments;

2. Online Platforms (aka Peer-to-Peer Lenders). Platform lenders obtain financing, generally through the sale of securities such as member-dependent notes, to enable third parties to fund borrowers; due to the contingent nature of the payment obligation on such securities, these lenders do not retain the risk that the borrowers will not pay; and

3. Bank-Affiliated Online Lenders. These bank-affiliated lenders are funded by commercial banks, often a regional or community bank, originate loans, and directly assume the credit risk.[5]

In general, online lenders facilitate the provision of credit, particularly to small businesses and consumers, through a streamlined online platform. Applications are made online, electronic data sources and technology-enabled underwriting models are automated to determine a borrower's identity and credit risk, and credit is disbursed electronically, such as via Automated Clearing House transfer.

The underwriting models may still use information commonly relied upon by traditional lenders, such as income and assets, employment status and credit history, but they may also rely on additional data collected from the applicant and other online sources, which can be combined to construct a risk profile of the applicant. Due to the cost efficiencies of this type of platform, online lenders generally originate loans more expeditiously, often in smaller dollar amounts and with shorter maturities than loans made by traditional lenders.[6]

Regulatory Framework

Currently, there is no single comprehensive regulatory framework or regulator for online lending. Rather, the regulatory framework varies depending on the particular structure and operations of each online business. At a high level, online lending is potentially subject to regulation by numerous federal and state regulators under banking, consumer finance, anti-money laundering, privacy, debt collection and securities laws.

The relevant federal-level agencies include the Board of Governors of the Federal Reserve System, the OCC, the Federal Deposit Insurance Corporation, the Consumer Financial Protection Bureau, the Federal Trade Commission, the U.S. Securities and Exchange Commission, and the U.S. Department of Justice. At the state level, lender licensing, usury, disclosure and other credit laws may be applicable, and attorneys general may seek to bring actions against online lenders.

While prudential regulation varies by jurisdiction, states increasingly are seeking to bolster their substantive laws surrounding online and small business lending.[7] Despite this substantial regulatory framework, regulatory authorities are finding the rapid technology developments in the financial services industry a challenge that merits new efforts to further refine their regulatory approaches.

Recent Public and Private Sector Developments

Recent analysis from the public and private sectors has shed light on both the opportunities and challenges associated with online lending. While the continued development of flexible, cost-effective lending models has the potential to expand consumer and small business access to credit, some observers have expressed concern that online lenders may not be subject to the same level of direct, comprehensive supervision as traditional bank ¬or even nonbank ¬lenders. Supporters and critics of online consumer and small business lending alike have cited considerations such as borrower safeguards, data security, privacy and risk retention as a few of the issues that may need to be addressed in a systematic fashion in connection with the growth of online lending platforms.

Several federal initiatives are underway that seek to examine different aspects of online lending. In the first half of 2015, the CFPB has made inquiries into short-term, alternative forms of credit and set forth detailed questions for online and small-business lenders.[8] Similarly, the Treasury RFI, issued on July 20,

2015, seeks comments from the public on the various business models of and products offered by online marketplace lenders to small businesses and consumers, the potential for online marketplace lending to expand access to credit to historically underserved market segments, and how the financial regulatory framework should evolve to support the safe growth of this industry.[9] Comments are due on or before Sept. 30, 2015.[10]

Most recently, on Aug. 7, 2015, Comptroller of the Currency Thomas Curry delivered remarks focusing on innovation by fintech companies and announcing an initiative to "develop a framework to evaluate new and innovative financial products and services."[11]

The areas of regulatory focus that are emerging include:

- The appropriate level of market fragmentation;
- The role of electronic data sources in facilitating the growth of online lending;
- The extent to which online lending is expanding credit markets to traditionally underserved markets and customers;
- How online and small-business lenders manage operational practices such as loan servicing, marketing, debt collection and credit reporting;
- The extent to which consumers and small businesses may be exposed to potential harms, ranging from inconspicuous and unfair loan terms to data security-related vulnerability;
- The factors considered by investors when financing the activities of online and small-business lenders; and
- The existence of, or prospects for, a viable secondary market for loans originated through online models.[12]

The challenge faced by regulators as they examine — and ultimately craft solutions to — these issues is striking the right balance between protecting market participants and ensuring stable economic growth for small businesses while not impairing the dynamic evolution of the efficiency and other benefits of online lending platforms.

The private sector has also called for a common approach to ensuring that small business, including online, lending is conducted in a responsible manner. Perhaps most notable is the advocacy being done by the Responsible Business Lending Coalition, a group comprised of nonprofit and for-profit lenders, credit marketplaces, brokers, and small businesses. The coalition's "Small Business Borrowers' Bill of Rights," which was issued on Aug. 6, 2015, enumerates six principles the coalition recommends online and small-business lenders recognize in dealing with borrowers :

1. The Right to Transparent Pricing and Terms. Cost and terms should be disclosed in a clear, complete and easy-to-compare written format such that the rate is transparent (e.g., via an annualized percentage rate disclosure), there are no hidden fees, terms are in plain English, and terms allow for comparison shopping;

2. The Right to Nonabusive Products. Products should not trap borrowers in expensive cycles of reborrowing, such as through limiting the provision of new credit or the addition of new fees or charges on existing unpaid principal balance;

3. The Right to Responsible Underwriting. Lenders should analyze borrower ability to repay, conduct thorough due diligence, ensure loan product suitability and make accurate reports to credit bureaus;

4. The Right to Fair Treatment from Brokers. Brokers should clearly disclose loan options, broker compensation, conflicts of interest and their respective track records; educate borrowers on loan products; and not charge fees when loans are obtained;

5. The Right to Inclusive Credit Access. Lenders and brokers should conduct their affairs in a nondiscriminatory manner affording borrowers equal access to credit; and

6. The Right to Fair Collection Practices. Debt collection should be done fairly and respectfully and pursuant to the spirit of the Fair Debt Collection Practices Act.[13]

Key Takeaways and Opportunities

For those involved in or considering online lending, the regulatory and industry initiatives underway suggest some key takeaways:

- Regulatory and Stakeholder Engagement. The regulators are interested in receiving feedback from the industry as to how online and small business lending is evolving and how regulation of the industry should evolve in response. Participants in the marketplace may wish to engage with the regulators and provide feedback, such as through a comment letter in response to the Treasury RFI by Sept. 30, 2015, or through other meetings with OCC, Treasury or CFPB staff. Similarly, whether it is by adopting the Small Business Borrowers' Bill of Rights or by adopting a proprietary commitment to lending standards that recognize the unique needs of small business and consumer borrowers, lenders and brokers can potentially deflect unwanted scrutiny by taking proactive measures of their own.

- Online Lending Platform M&A. The combination of increased compliance costs borne by innovative online lending platforms, on the one hand, and a well-regulated and mature but less dynamic incumbent banking and nonbanking lenders on the other hand, makes for an attractive environment for online lending platform mergers and acquisitions. Traditional lenders may wish to gain market share and diversified revenue through acquisition of a propriety online lending platform and online lenders may find it more suitable to piggyback off of the robust compliance function of traditional lenders as they face greater regulatory requirements.

Conclusion

Regulators are assessing what a well-calibrated online lending regulatory framework may look like — one that balances greater access to credit with appropriate risk management and borrower protections. This assessment may impact investments relating to online lending, the compliance burdens for online lenders, and the M&A opportunities available to strategically acquisitive bank and nonbank lenders. Although it is still too early to tell what changes may ultimately be made in the regulatory landscape, industry participants would be well-advised to stay abreast of the increased attention online lending is receiving from the public and private sectors. They also should consider engaging proactively with regulators and private industry stakeholders to educate their counterparties and advocate for their positions.

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[1] Public Input on Expanding Access to Credit Through Online Marketplace Lending, 80 Fed. Reg. 42,866 (Jul. 20, 2015) (hereinafter Treasury RFI).

[2] Comptroller of the Currency Thomas J. Curry, Remarks before the Federal Home Loan Bank of Chicago (Aug. 7, 2015).

[3] Small Business Borrowers' Bill of Rights, available at http://www.responsiblebusinesslending.org/.

[4] Treasury RFI at 42,867.

[5] See id. at 42,866.

[6] See id. at 42,867.

[7] See Brayden McCarthy, Regulation Could Be a Blessing in Disguise for Online Lenders, Am. Banker, Aug. 4, 2015, available at http://www.americanbanker.com/bankthink/regulation-could-be-a-blessing-in-disguise-for-online-lenders-1075841-1.html.

[8] See, e.g., CFPB, Small Business Advisory Review Panel for Potential Rulemakings for Payday, Vehicle, Title, and Similar Loans (Mar. 26, 2015), available at http://files.consumerfinance.gov/f/201503_cfpb_outline-of-the-proposals-from-small-business-review-panel.pdf; Press Release, CFPB, Spring 2015 Rulemaking Agenda (May 22, 2015) (discussing pending or current rulemaking initiatives governing payday loans and deposit advance products, prepaid credit products, and overdraft practices, among others), available at http://www.consumerfinance.gov/blog/spring-2015-rulemaking-agenda/.

[9] Treasury RFI, supra note 1, at 42,866.

[10] On Aug. 18, 2015, the Treasury Department published in the Federal Register a notice extending the comment period from Aug. 31, 2015, to Sept. 30, 2015. See Public Input on Expanding Access to Credit Through Online Marketplace Lending, 80 Fed. Reg. 50,071 (Aug. 18, 2015).

[11] Comptroller of the Currency Thomas J. Curry, Remarks before the Federal Home Loan Bank of Chicago (Aug. 7, 2015).

[12] See generally Treasury RFI, supra note 1, at 42,867-68.

[13] Responsible Business Lending Coalition, Small Business Borrowers' Bill of Rights (Aug. 6, 2015), http://www.responsiblebusinesslending.org/. Endorsers include The Aspen Institute, Community Investment Management, Small Business Finance Institute, Small Business Majority, Alliance Partners, and Corporation for Enterprise Development. Various lenders and brokers have become signatories. See

also Brayden McCarthy, Regulation Could Be a Blessing in Disguise for Online Lenders, Am. Banker, Aug. 4, 2015, http://www.americanbanker.com/bankthink/regulation-could-be-a-blessing-in-disguise-for-online-lenders-1075841-1.html (calling for regulation in which: (i) loan terms are clear, concise and comparable, (ii) lenders ensure borrowers genuinely understand loan terms, (iii) lenders verify borrowers' ability to repay, (iv) lenders handle big data with care, and (v) brokers are governed by fiduciary duties.