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Comments by Americans for Financial Reform on "Expanding Access to Credit through Online Marketplace Lending." U.S. Department of the Treasury RFI. 4810-25-P. September 30, 2015

Americans for Financial Reform (AFR) is pleased to submit these responses to the RFI issued by the Department of the Treasury. AFR is a coalition of more than 200 national, state, and local groups who have come together to advocate for reform of the financial industry. Members of AFR include consumer, civil rights, investor, retiree, community, labor, faith based, and business groups.[1]

Several AFR member groups, including US PIRG, NCLC, and the Woodstock Institute have also submitted comments on this RFI focused on consumer issues involved with on-line lending. We support the arguments made in those comments. However, we would also like to add additional comments on the regulation of on-line lending in the context of prudential concerns and also securities regulation/investor protection. We therefore limit our comments to the responses to Questions 9 and 10 below.

9 – What role should the Federal Government play in prudential and securities regulation?

10—Should lenders have "skin-in-the-game?

Those marketplace lenders who are funded through their own balance sheets and significant amounts of their own capital do of course have 'skin-in-the-game' and have incentives to properly monitor borrower ability to pay. However, potentially serious prudential concerns exist with regard to online platforms which are funded through lender purchase of pass-through notes intermediated by the platform, lines of credit from external financial institutions, loan sales, or other arrangements in which the final investor may find it difficult to properly monitor underwriting. In addition, even those marketplace lenders with balance sheet capital do not face minimum capital requirements applied to banks.

Peer to peer online lending platforms dependent on pass-through notes may be described by some simply a servicing infrastructure that permits lenders to transfer money to borrowers, with the underwriting decision made by the lender/investor. However, lender/investors are in fact dependent on the platform for accurate information on borrower characteristics and other forms of screening. The early experience of the Prosper on-line marketplace from 2006 to 2008, where investors suffered a 36% loan default rate, shows the possibility that poor underwriting and screening may lead to extremely risky lending to

[1] A list of AFR member organizations is available at http://ourfinancialsecurity.org/about/our-coalition/.

borrowers and losses to investors.[2] After this experience, the Prosper marketplace took on a greater role in borrower screening and in setting interest rates for borrowers, in order to address high default rates.[3]

While the size of the online lending sector was not at that time significant enough to cause major economic disruption, the sector is of course growing rapidly, with loan volumes fifteen times the level they were just three years ago.[4] Federal regulators should look ahead to the need to ensure a strong regulatory framework. A failure to do so could not only risk an unstable supply of credit in important areas, but major regulatory gaps which could cause consumer lending to move from the regulated banking or securities sector to online platforms for reasons of regulatory arbitrage. The 2008 financial crisis showed us that markets involving long chains of credit intermediaries who do not bear the risk of the final loan can lead to deterioration of underwriting standards. It also demonstrated that complex intermediation structures can create agency issues that lead to situations where even economically rational loan modifications are not made. Regulators should plan ahead to ensure that this outcome is not repeated in online lending.

There are some areas in which on-line lending is reached by existing financial regulations. For example, proper oversight of bank capital can indirectly create 'skin in the game' for marketplace lenders funded through bank lines of credit. But regulators should attempt to ensure that all lending through on-line platforms is subject to similar degrees of transparency and the incentives for proper underwriting that other forms of credit are. Some ways to achieve this include:

- Subjecting pass-through notes and possibly whole loan sales to credit risk retention requirements such as those required for asset-backed securities under Section 941 of the Dodd-Frank Act. There are still questions about how this model will be applied to the on-line sector, including the issue of which entity is the 'sponsor' for purposes of risk retention. Requiring that the platform provider be the sponsor would provide the provider with significant incentives to ensure proper underwriting. However, the key agent for underwriting may differ in different business models.

- Setting standards for adequate and verifiable informational reporting to final investors concerning borrower characteristics. Currently such reporting appears to be controlled only by anti-fraud laws and by reputational concerns.

- Ensure that bank regulators provide proper oversight of the credit risk of bank lines of credit extended to peer to peer lenders.

- Continuing to monitor the marketplace for instances in which non-bank funders of on-line lending are not risking their own capital and are not providing adequate transparency regarding loan characteristics to investors and external monitors such as credit rating agencies.

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[2] Renton, Peter, "A Look Back At Prosper 1.0", Lendacademy, February 13, 2012.
[3] Manjoo, Farhad, "On This Site, a Stranger Will Spot You Some Cash", Washington Post, April 24, 2011, Page G04; Hunsberger, Brett, "Peer to Peer Lending: Know the Risks", The Oregonian, October 4, 2009.
[4] Robinson, Edward, "As Money Pours In To Peer to Peer Lending, Some See a Bubble Brewing", Bloomberg Markets, May 14, 2015.

- Regulators should be attentive to whether procedures are in place that would permit modification of loans if such modifications are economically rational for both the actual investor/lender and the borrower.

As the on-line lending sector grows, these issues will become more important. Further, if they are not addressed then financial institutions that would otherwise be regulated may seek ways to make loans in the less regulated on-line space. While the delivery method of on-line loans differs from traditional lending, the actual loan types do not. On-line platforms can potentially be used to deliver almost all types of ordinary consumer and small business credit. Permitting the sector to grow in an unregulated fashion could thus permit significant regulatory arbitrage.

The extraordinary diversity of on-line lending models and the rapid growth of the sector mean that continued monitoring will be necessary and the sector will likely fall into the purview of multiple regulators. We encourage the Treasury Department to remain active in determining the appropriate regulatory models, and we will further examine the responses to this RFI with interest to evaluate what types of regulation seem appropriate.

Thank you for the opportunity to comment on these matters. Should you have any questions, please contact Marcus Stanley, AFR's Policy Director, at marcus@ourfinancialsecurity.org or (202) 466-3672.