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Treasury Issues White Paper on Fintech and Marketplace Lending

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Related Author

- Edward V. Murphy

Edward V. Murphy, Specialist in Financial Economics (tmurphy@crs.loc.gov, 7-6201)

Marketplace lenders exemplify some of the ways that shadow banks have sought to access securities markets to fund commercial loans for consumers and businesses. Although there are several marketplace lending arrangements, it is typical for these firms to use data and modeling techniques to evaluate risks and finance loans, which are then typically destined for securities markets instead of depository banks' portfolios. In some cases, online platforms partner with depository banks to originate the initial platform notes to fund the loans even though the loans are then sold. On May 10, 2016, the U.S. Department of the Treasury issued a white paper analyzing regulatory issues for the marketplace lending industry and offering several recommendations for industry and government responses.

Background

Fintech is a broad term relating computer technology to financial services. The recent white paper is primarily focused on the part of the Fintech industry that uses online websites and platforms to originate and market loans. Although the term peer-to-peer is sometimes used, marketplace lenders have partnered with a variety of funding sources, including banks, institutional investors, hedge funds, and invited investor pools. As a result, who regulates participants in marketplace lending, and how, can vary from marketplace lending model to marketplace lending model. For example, investor protections for general securities offerings may differ to some degree from investor protections entirely funded by sophisticated investors. Similarly, borrower protections may differ if a marketplace lender focuses on consumer loans compared to if a marketplace lender focuses on business loans. In general, activity-based regulation, such as the Truth in Lending Act, applies no matter how a marketplace lending platform is organized, but some institution-based regulations apply only to banking organizations (e.g., Volcker Rule, Community Reinvestment Act).

The May 2016 Treasury white paper followed a formal Request for Information (RFI) issued by Treasury on July 17, 2015. The white paper includes analysis of both risks and benefits of the marketplace lending industry. Among the potential benefits, Treasury asserts that marketplace lending can increase the speed of credit assessments, reduce the costs of loan application processes, and expand access to credit to currently underserved markets.

The white paper also identifies a number of potential risks. For example, data-driven algorithms could result in disparate impact lending outcomes or potential fair lending violations. Loans to small businesses will not be subject to bank-like prudential regulation nor to consumer protections (this is true with or without Fintech). Treasury also noted that marketplace lending models have not been tested through a full business cycle, so their likely performance in challenging economic environments may be a concern for economic and financial stability. Some current models of marketplace lending may not provide sufficient transparency, such as consumer pricing information to facilitate competition, or loan standard transparency to facilitate greater investor protection. Although many aspects of marketplace lending are subject to long-standing securities and lending laws, some other areas may lack regulatory clarity.

Treasury Recommendations

Treasury included a number of recommendations. Treasury recommended

- regulatory changes to protect business borrowers because neither Consumer Financial Protection Bureau (CFPB) jurisdiction nor banking regulator jurisdiction currently applies;
- regulatory adjustments for "back-end operations," by which is meant the servicing and collection activities for loan payments and delinquent accounts;
- transparency-related issues, including standardized representations and warranties, consistent reporting standards for origination data and loan performance, and consistent market-driven pricing methodologies;
- encouragement of partnerships with Community Development Financial Institutions (CDFIs) to expand credit opportunities and address underserved communities, including programs similar to the 2015 CDFI Fund innovation challenge;
- additional uses of government data as part of its 2009 Transparent and Open Government initiative, specifically (1) smart disclosure techniques for data standardization, and (2) data verification. Treasury uses the term *data verification* to mean borrower capacity to repay the loan (a provision added to the Truth in Lending Act for mortgage lending by the Dodd-Frank Act). Treasury argued that, currently, online lenders do not have the ability to verify borrower's ability to repay in real time. One possible solution, according to Treasury, would be automating IRS income verification;
- the cybersecurity sector join the Financial Services and Information Sharing and Analysis Center; and
- regulatory agencies form a Standing Working Group for online lending topics.

Treasury also noted several issues that warranted monitoring. Treasury noted that the current form of marketplace lending evolved during a period of low interest rates, and although the economy has been weak, it has generally been improving annually since 2010. Treasury identified a number of factors to watch as conditions change. For example, the short history of the industry means that Fintech firms do not know how borrowers will prioritize payments in a deteriorating economic environment. Treasury expressed concern about liquidity of Fintech firms because as a form of securitization, many current marketplace lending approaches depend upon access to securities markets to continue to provide funding. Treasury expressed concern that more complex credit scoring models, while more efficient, might not satisfy other values such as fairness and consumer protection. Treasury noted that seemingly accurate models of risk may instead "reflect underlying bias and discrimination." Treasury also intends to monitor cybersecurity issues and Bank Secrecy Act compliance for covered firms. Although initial marketplace lending has focused on unsecured forms of consumer and business credit in general, Treasury intends to monitor growth of secured debt, such as mortgages and auto loans.

Recent Industry Performance

The Treasury white paper was issued on the heels of a series of bad events for the industry. Several measures of industry health have recently deteriorated, including issuance volumes and earnings. In addition, the CEO of a large marketplace lender (Lending Club) recently resigned under fire. The firm revealed that it had violated its own business practices by arranging its loan packaging for the benefit of one business partner.