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Too Big to Disintermediate?
Peer-to-Peer Lending Takes on Traditional Consumer Lending

By Jon Kibbe

Borrowers always grumble about their banks' high interest rates on consumer loans. And depositors habitually complain about their banks' low interest rates on deposit accounts. What if one could remove the banks and let an electronic version of Adam Smith's invisible hand sort the supply and demand of capital between borrowers and depositors?

With the help of peer-to-peer (P2P) networking technology and some creative financial lawyering, something similar has already been done, and the early results are promising. Electronic marketplaces for consumer loans—including Lending Club and Prosper in the United States; Zopa, Funding Circle and Rate Setter in the UK; Auxmoney in Germany; Pret d'Union in France; Smartika in Italy; and SocietyOne in Australia—are off to a running start in this growing global phenomenon.

There are great economic prospects in this new lending space, but the legal and regulatory framework needs to be fully functional to protect both lenders and borrowers in the P2P environment. This white paper examines the current state of P2P lending in the US, the challenges and opportunities within the industry and the outlook for future growth.

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AN OVERVIEW OF P2P LENDING

P2P lending is part of a broad trend of P2P financial innovation, which includes parallel developments in global microfinance, affinity lending, social lending and crowd funding. These activities share a desire to harness the power of the internet to connect individuals and mediate financial supply and demand efficiently and transparently.

The mission statement of P2P lending is simple: facilitate a flow of funds from knowledgeable lenders to qualified borrowers by creating a user-friendly, online community. P2P lending could not have existed until recently as its success depends upon a robust global internet, huge databases of consumer credit histories, sophisticated financial algorithms, tremendous computing power and, perhaps most importantly, our growing acceptance of the internet as a trusted medium for secure and complex financial transactions. The entrepreneurs behind P2P lending platforms recognize that individuals today are more familiar with computers and cloud storage than with loan officers and savings passbooks—and that those same individuals are ready, willing and able to borrow and lend online.

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The value proposition for P2P lending is correspondingly straightforward: create lower interest rates for borrowers, attractive rates of return for individual investors and clean and simple electronic interfaces designed to make sophisticated consumer transactions between individuals efficient, convenient and painless—and to create this value with lower operating costs and more scalability than a consumer loan department within a traditional bank.

P2P platforms offer simple $1,000 - $35,000 amortizing loans with fixed interest rates and 3-5 year maturities. The loans appeal to individuals seeking to consolidate credit card debt, repay high interest rate loans, or borrow funds for other general purposes.

Recent data suggests the trend toward P2P is growing fast: Lending Club has facilitated loans totaling $2.5 billion; Prosper has facilitated loans totaling $630 million; and Zopa has facilitated loans totaling £380 million in the UK. This is still a very small percentage of total consumer lending, but monthly increases in the number of P2P loans show traction in the US and abroad. Perhaps more importantly, the P2P model is still evolving in a networked economy and future lines of business combining consumer finance and internet technology are on the horizon. Future strategies include expanding the types of loans made by P2P lending platforms, making loans to small businesses and loans secured by specific collateral, tailoring lending platforms to the needs of certain categories of borrowers (including high risk borrowers originating sub-prime loans), making P2P consumer loans across national borders, offering credit enhancement or default insurance as an add-on option for lenders on P2P platforms, as well as expanding platforms to serve neighboring financial spaces, perhaps including a P2P insurance market for individuals.

BORROWING ON A P2P PLATFORM IN THE US

To join a platform, a borrower must be 18 years old, a US citizen or legally in the US on a long-term visa, have a social security number and have a bank account at a US financial institution. Borrowers can apply online 24 hours a day from any location. Their identities are verified by the platform using identity verification and anti-fraud databases and their credit histories are reviewed based on consumer credit reporting agency data.

Each platform uses proprietary computer software and credit algorithms, designed to evaluate a borrower's income, credit history, repayment performance, credit score, debt-to-income ratio, the number of recent "inquiries" about the borrower received by consumer credit reporting agencies (often a signal of other loan applications) and other relevant data to review loan applications. Employment is verified for some, but not for all, borrowers and the algorithms determine when employment should be verified. Lending Club reports that it verifies employment 68% of the time, while Prosper selects only a subset of funded listings to verify employment and income. Borrowers are also asked to describe and self-report the purpose of the loan in a brief sentence.

The borrower evaluation process varies by platform and have varying degrees of selectivity. For example, Lending Club says only 11% of individuals applying for loans have met the platform's criteria to post a loan request. Alternatively, Prosper has a lower minimum FICO credit score requirement, so it may be easier to get a loan approved on the Prosper platform.

Once a borrower's application has been accepted and a risk category and corresponding interest rate have been assigned, the loan request is posted on the platform's website with details of the intended use of loan proceeds. Potential lenders can review the loan request (stripped of borrower-specific identity information) and can generally dig deeper to review certain credit history details, including a borrower's current revolving credit balances and utilization factors, as well as dates of past inquiries and delinquencies.

LENDING ON A P2P PLATFORM

Lenders can join a P2P platform 24 hours a day, from any location, and the process can take less than 5 minutes. Potential lenders must represent that they satisfy certain minimum financial suitability standards and that they will not invest more than a maximum investment amount through the platform. Lenders pre-arrange to fund loans by authorizing the P2P lending platform to withdraw funds from a specified account at an existing financial institution.

Once they join a platform, potential lenders can see pending loan applications and the available information posted about each loan. Lenders are free to pick and choose the loans they want to fund and can commit to fund all or part of a loan. Lenders can also see how many days the loan has been available on the platform, the percentage of the loan that has been funded by other members, and the brief description of the purpose of the loan provided by the potential borrower. Diversification is encouraged and both Lending Club and Prosper have very low minimum lending commitments ($25 per loan). P2P lending platforms offer portfolio generation tools that allow lenders to assemble diverse portfolios consisting of fractions of posted loans. Portfolio creation and historical return sorting tools have also been developed by third party programmers to help prospective lenders screen large amounts of data and construct more finely tailored portfolios of loans.

After committing to fund a loan or portfolio of loans identified on the platform, lenders transfer funds to a deposit account controlled by the P2P lending platform. The funds transferred by a lender to the platform are ultimately used to originate and fund all or a specified portion of the borrower loans identified and selected by the lender.

THE ROLE OF THE P2P PLATFORM

P2P lending platforms are user-friendly and their web interfaces create the impression that matching lenders and borrowers is effortless and straightforward. But behind the exceedingly simple look and feel of an attractive P2P interface lies a complex series of financial and computational tasks that must be performed quickly, accurately, reliably and continuously throughout the life of the loan in order for any P2P lending platform to operate successfully. Despite abundant personal information shared on the platform, borrowers and lenders never meet or directly communicate and the platform itself remains a vital, active and functioning intermediary that is the legal and operational counterparty to both the lender and the borrower.[1]

The P2P lending platforms manage all of the details of the electronic transfer process, from collection and disbursement of funds to servicing the loan by coordinating principal and interest payments. The P2P lending platforms also track historical borrower payment performance on individual loans and provide that information to lenders through the platform. When a borrower defaults, the P2P lending platform is contractually required to take reasonable steps to collect on the defaulted loan.

Revenue for P2P lending platforms is derived from origination fees that are deducted from loan proceeds disbursed to the borrower and servicing fees that are deducted from principal and interest payments paid to the lender.

THE KEY LEGAL ISSUE

A central hurdle to P2P innovation in the lending market is reconciling the different ways P2P entrepreneurs and lending lawyers think about borrowing and lending. P2P entrepreneurs focus on creating interconnected networks of borrowers and lenders, while lending lawyers focus on banking regulations, privacy protections for consumers, counterparty risk and bank loan liquidity.

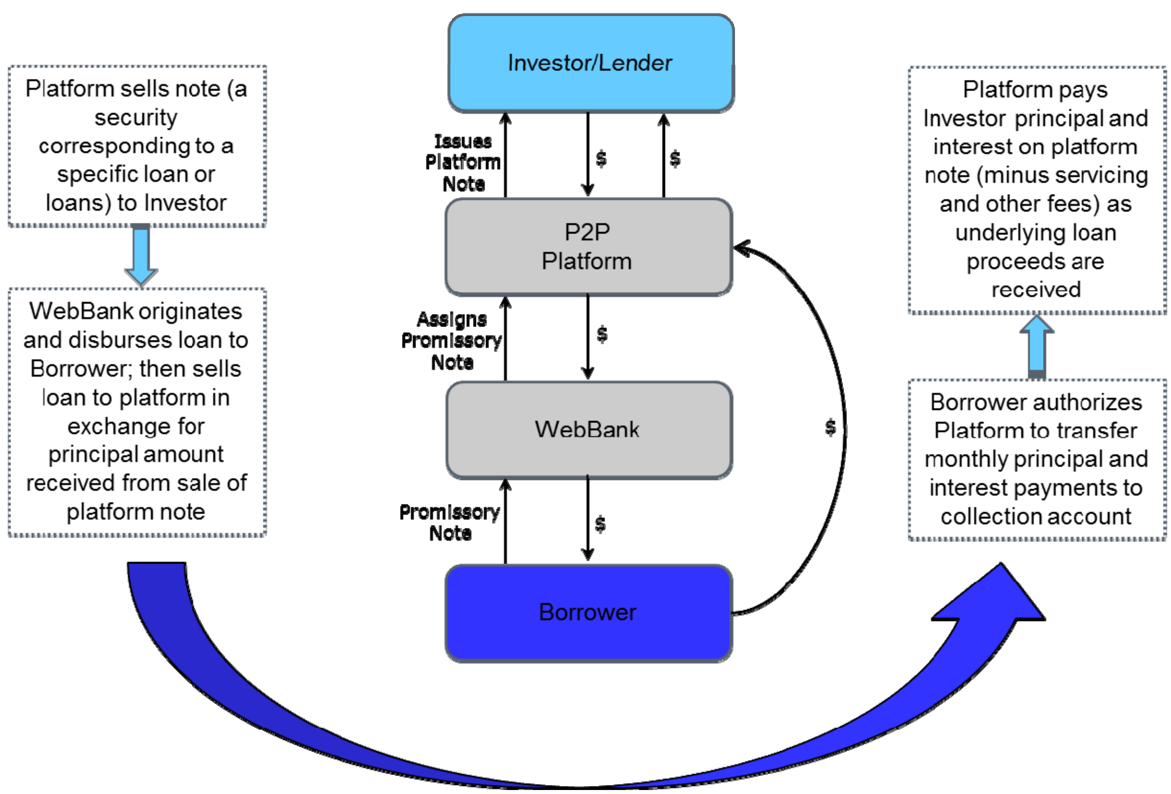
Lending lawyers understand that loans are made by banks and are not designed to be fractionalized or held by individuals. They worry greatly about any risk that could cause a loan to be re-characterized as a security.

Notes evidencing loans (especially notes delivered in consumer financing transactions) are generally not considered securities.

In the US there is a world of difference between loan markets and securities markets.[2] Unlike traditional lenders making loans to borrowers, investors purchasing securities vary dramatically in their motivation, experience, sophistication and investment goals. Investors in the securities markets also rely on issuers to disclose information about the securities under strict rules, which are designed to ensure equal access by investors to current material information about the issuer and the security.

P2P lending platforms may appear to blur the hard and fast distinctions between loans and securities and between loan markets and securities markets. However, **the key legal innovation of the P2P lending platforms is that lenders on the platform are not lending money to borrowers.** In essence, lenders are "investors" in securities issued by the platform that are linked directly to specific loans originated by an underlying bank.[3] The limited recourse notes correspond to specific loans that will be advanced to specific borrowers.

The proceeds from the sale of the note are used by the platform to fund the purchase of a corresponding loan made by an underlying bank, as the bank originates and disburses the loan to the borrower. When the loan is funded, the bank assigns the loan to the P2P lending platform in exchange for the note sale proceeds. Title to the loan is held by the platform for the relevant noteholder. The loan is serviced by the platform and payments derived from a borrower's repayment of principal and interest on the loan originated by the bank and assigned to the platform are passed through the platform to noteholders.



THE KEY REGULATORY ISSUE

The biggest regulatory issue facing P2P lending is predicting future regulatory responses to fast evolving P2P business models. On the one hand, traditional banking regulators will have a continuing interest in protecting borrowers on P2P lending platforms. Borrower protections include the truthful and fulsome disclosure of terms and conditions of a loan, protection from discriminatory lending practices, privacy protections and guidelines for the conduct of debt collectors in connection with consumer debt. On the other hand, the Securities and Exchange Commission and state securities regulators will have a continuing interest in protecting lenders on the P2P lending platform as they purchase platform notes. Those investor protections include the panoply of disclosures required in any sale of securities, as well as the extensive remedies available to purchasers of securities that have been harmed as a result of a failure of an issuer or transactional counterparty to abide by the securities laws.

Because this new way of doing systematically important financial business raises complex regulatory issues, P2P lending platforms have attracted the attention of regulators. The Dodd-Frank Wall Street Reform and Consumer Protection Act required the U.S. Government Accountability Office ("GAO") to report to Congress on the federal regulatory structure for P2P lending. In July of 2011, after extensive discussion with industry leaders and regulators, the GAO issued a report ("The GAO Report") summarizing the state of P2P lending and concluding that the activity was subject to regulation by a number of existing and overlapping regulatory agencies, including the Securities and Exchange Commission, state securities regulators, the Federal Deposit Insurance Corporation, state banking regulators and the newly formed Consumer Financial Protection Bureau.

The GAO identified two options for regulating P2P lending in the future: (1) maintaining the status quo of interlocking and overlapping regulatory oversight, or (2) consolidating borrower and lender protections under a single federal regulator. The GAO found that both options offered advantages and disadvantages:

> "The current system offers protections that are consistent with those for traditional borrowers and investors. Some industry observers suggested that protecting lenders through securities regulation under this system lacked flexibility and imposed inefficient burdens on firms. Under a consolidated regulatory approach, current protections for borrowers would likely continue and, depending on how implemented, lender protections could be expanded. But uncertainty exists about shifting to a new regulatory regime and about the potential benefits. Finally, regardless of the option selected, new regulatory challenges could emerge as the industry continues to evolve or if it were to grow dramatically, particularly if that growth was primarily due to the increased participation of institutional versus individual investors."

For now, P2P lending platforms enjoy some freedom from comprehensive regulation. Using a brute force approach, the platforms have managed to comply with lending laws and regulations for the underlying loans (which have not been deemed securities), and securities laws and regulations for the limited recourse notes issued by the platforms notes (which are linked to the loans but are considered securities.) The brute force approach has been successful to date, but P2P lending platform compliance and legal costs are high and remain a significant barrier to entry to the industry.

On the bank regulatory front, thousands of federal and state laws and regulations have evolved in the US to keep peace between borrowers and lenders and to reduce inherent imbalance of power towards lenders. The thicket of laws and regulations applying to institutions that lend to individual borrowers of consumer loans is particularly dense. P2P lending platforms have designed and embedded processes to ensure that platform operating procedures and the legal agreements governing the loans, notes and the servicing of the loans comply with federal and state laws.

Despite this progress, P2P lending platforms have not yet been approved in all 50 states, and borrowers and lenders residing in certain states may not yet participate in P2P lending platforms.

On the securities regulation front, the longstanding question of whether certain loans should be considered securities remains open for now. The growing participation by individuals in P2P loan platforms may provide an opportunity for re-visiting the currently accepted view that loan transactions generally do not involve "securities." Despite the clear demarcation between loans and securities embedded in the legal structure of P2P lending platforms, the GAO Report provides evidence that the question of whether certain types of loans are securities (or should, for the sake of uniformity, be regulated as if they were securities) is not safe from legislative or regulatory reconsideration.

Obviously, both banking and securities regulation are appropriate for P2P lending platforms. The exact nature of an integrated regulatory response is under active consideration and can be expected to evolve alongside of the business model for P2P lending. Formulating a response will not be easy—there are few business models that so completely integrate a range of discrete transactions capable of raising non-trivial banking and securities regulatory issues. To make matters even more interesting, individuals, and not sophisticated institutions, actively participate in the transactions that are essential to a P2P lending platform. This fact alone will add a dimension of complexity to any governmental response.

POTENTIAL ISSUES WITH THE P2P LENDING MODEL

P2P lending platforms face a number of intertwined structural, financial and competitive risks as their businesses continue to expand. At a high level, those risks involve (i) borrower defaults, (ii) potentially disappointed noteholders, (iii) style drift to I2P lending, and (iv) the risk of failed platforms.

(i) Borrower defaults

Payments made to holders of platform notes (securities) purchased on a P2P lending platform depend entirely on the platform's receipt of payments under a corresponding borrower loan. If a borrower fails to pay on a loan, payments under the platform note will be reduced. In a perfect world, purchasers of platform notes would perform careful diligence on the loans linked to their notes. However, on a P2P lending platform, certain information supplied by borrowers is not independently verified, and borrowers may submit inaccurate, incomplete or false information without being detected. Loan applications published on a P2P lending platform do not disclose the identity of the borrower, and purchasers of platform notes have no independent ability to obtain or verify borrower information before or after purchasing a platform note. Some borrowers may intentionally use the platform to defraud lenders, despite platform-level borrower identity and fraud checks. The credit information of an applicant published on the website may not accurately reflect an applicant's creditworthiness.

After obtaining a loan, borrowers are free to incur additional debt, and this may impair their ability to repay a loan originated on the platform. Cross-default provisions are not embedded in the underlying consumer loan agreement, and a borrower's loan is not accelerated if the borrower defaults on a debt obligation unrelated to the loan. Some borrowers may have subprime credit ratings and may have difficulty obtaining credit from traditional sources. Such borrowers have a high risk of loan delinquency of default and may be disproportionally attracted to P2P lending platforms. Loss rates on the underlying loans may also increase as a result of deteriorating macro-economic conditions. And because the platforms are new, their long-term loan loss experience may differ from traditional banks. Borrowers may not view their repayment obligations to an electronic platform as having the same significance as their repayment obligations to a bricks-and-mortar bank.

Lastly, since borrower loans are unsecured, repayment is neither guaranteed nor insured by the platform, and the holder of a platform note has no right to directly pursue any collection efforts against a defaulting borrower. While the platform is obligated to perform "reasonable" collection efforts if a borrower defaults on a loan, this standard is defined to include prompt referral of a delinquent loan to a collection agency. Fees paid to the collection agency will range from 20-40% of any recovered amount (plus legal fees incurred by the collection agency), and will reduce any recovery on the platform note corresponding to the loan.

(ii) Disappointed noteholders (including noteholders who want to sell their notes)

Platform notes are special, limited obligations issued by the P2P lending platform. The notes depend entirely on the repayment of the corresponding underlying loan and are not enhanced by the platform or any third party. Unlike a bank deposit, notes issued by a P2P lending platform are not insured by the Federal Deposit Insurance Corporation ("FDIC") or any other governmental agency.

A platform's proprietary algorithms may have hidden biases or defects and may set incorrect interest rates on the loans based on historical data. If the rates are too low, noteholders will not be adequately compensated for risk. If they are too high, borrowers may disproportionately default and the risk adjusted returns for noteholders will be too low. Noteholders can invest small amounts in many loans, but the risk of a programming error or systematic bias at the platform algorithm level would not be mitigated by such diversification.

Perhaps the biggest possible disappointment is lack of liquidity. As of today there are no robust and active re-sale markets for the notes. The notes are not listed on any securities exchange and must be held by lender members. They are non-transferable, except in some cases through the P2P lending platform itself. The early results of secondary trading through the platform have been disappointing, and the mere technical ability to sell a note does not guarantee that a seller will find a buyer or receive a fair sale price. If an active market in the platform notes fails to develop, noteholders will need to hold the note until the maturity of the underlying 3-5 year term loan.

(iii) P2P lending becomes I2P lending

Currently there are more "peers" seeking to lend than there are "peers" seeking to borrow, and the shortage of available loans has sparked competition to find borrowers and fund loans with desirable risk categories. Not all lenders on a platform are individuals: institutional investors searching for yield have discovered P2P lending. The institutional investors (including hedge funds and traditional banks) currently participate in P2P lending on a large scale, either by buying notes referencing loans with specific characteristics through the platform, providing liquidity to the platforms by buying loans initially funded in part by the platform, or by buying whole loans directly from the platform.[4] There is no assurance that all loans requested by borrowers attracted to the platform are first offered to individual lenders, and this is a risk worth watching as "institution-to-peer" or "I2P" lending conducted through P2P lending platforms becomes more active.

(iv) Platform risk

The P2P platform is a corporate entity and as such it is subject to a variety of legal and operational risks. Based upon the bankruptcy experience of other failed financial institutions and pass-through entities, it is likely that borrowers will initially delay or suspend loan payments to the platform in light of the uncertainty created by a bankruptcy proceeding. After a bankruptcy filing, a platform may be prevented from making regular payments to holders of platform notes as a matter of law.[5] Post-petition interest accruing upon a platform note may not be paid when due or at all, and there is an operational risk that any comingled funds held by the platform may be claimed by competing creditors.

Unfortunately, the credit and operational risks faced by a P2P platform are not merely theoretical. Most P2P lending platforms are in start-up mode or experiencing rapid growth and likely have incurred operating losses since inception. A P2P lending platform may find itself lacking sufficient operating capital to meet ongoing obligations under adverse circumstances. P2P platforms have devised a number of legal and operational measures to mitigate these risks, but they have not been eliminated entirely.[6]

Finally, economic success is not assured for any P2P platform. Platforms compete against each other for both borrowers and lenders, and it is expected that competition will intensify in the future. Competition will also arise if borrower default rates vary materially from platform to platform, or if one platform is more successful than others in attracting borrowers perceived as creditworthy or otherwise desirable by lenders from a risk reward basis. Fierce competition may cause a platform to experience reduced lending volumes, receive reduced revenue from origination and servicing fees, and fail to achieve market penetration and/or brand recognition as a trusted financial intermediary. As start-ups, the platforms must spend aggressively to increase facilities, personnel and technological infrastructure to grow and expand their business and market share. As a result, P2P lending platforms are likely targets for acquisition by established internet companies with existing customer bases and established distribution channels,[7] or by traditional financial institutions desiring to enter the P2P lending business through the acquisition of an existing operating platform.

CONCLUSION

P2P lending is evolving quickly and all signs point to the fact that it is here to stay. Indeed, it is hard to imagine a future where P2P lending and P2P finance does not play a significant role in reducing the cost of many consumer financial transactions. However, the exact form and extent of economic penetration by P2P lending platforms is difficult to gauge at present. No one questions the ability of technology or financial innovation to keep pace with the expansion of P2P lending. The significant impediments to growth, or to predicting the course of future expansion, involve determining whether legal and regulatory frameworks will be successfully and timely adjusted. Once there is consensus on the best way to provide transparency and protection to both lenders and borrowers without creating an inefficient regulatory and compliance burden, the evolution of P2P growth and expansion will become clear.

The future of P2P lending goes beyond law and finance. To explore it fully may require re-consideration of our fundamental notions about information, knowledge and culture, and the interaction between capitalism and democracy in a networked world. The gradual evolution of the answer to this question will be well worth observing.

QUESTIONS

If you have questions regarding the matters discussed in this white paper, please call your usual contact at Richards Kibbe & Orbe LLP or the person listed below.

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ENDNOTES

1 Some P2P lending platforms allow lenders to pose limited questions to borrowers, who remain anonymous. Borrowers are not required to respond to the queries and any response is shared with all potential lenders.

2 A unique set of historical circumstances has helped to shape the established view that a loan is not a security under the federal securities laws. Those circumstances include conflicting banking and securities regulatory policy, as well as a "result-oriented" interpretation of the statutory definition of a "security" offered in a line of court cases. The current view is based on the U.S. Supreme Court's decision in *Reves v. Ernst & Young*, 494 U.S. 56 (1990), which advanced a "context-based" approach to determining applicability of the securities laws to commercial lending. A context-based approach to interpretation affords flexibility to deal with evolving markets, while introducing a level of ambiguity and imprecision into any attempt to predict resolution of a close question.

3 P2P lending platforms must register platform notes as securities with the Securities and Exchange Commission (the "SEC"). The comprehensive filings necessary to complete the registration process describe the P2P lending platform, certain operational matters and financial results, the platform notes, and the material risks that are faced by owners of the notes. P2P lending platforms can use Rule 415 of the Securities Act of 1933 to file a shelf registration statement to register platform notes to be issued to investors in the future. P2P lending platforms file a prospectus supplement specifying the amount of platform notes sold and the applicable term (referencing the underlying loan). P2P lending platforms file hundreds of prospectus supplements daily, and the process of preparing and filing the supplements is automated, to a large extent.

4 For example, in September 2013, Englewood Capital Management sold a portfolio of its Lending Club loans in a securitization. (*The New York Times* Deal Book, October 1, 2013)

5 The platform notes are pass-through obligations of a P2P lending platform and cash from borrowers is held under an indenture for the benefit of platform note holders. A security interest in loans held by the platform is granted to the indenture trustee.

6 For example, P2P lending platforms retain an independent "back-up servicer" to service the loans if the platform is unable provide customary servicing due to an operational or financial default. However, the platform will experience an operational lag as the back-up servicer assumes responsibility for servicing, and this lag could affect collections and result in losses to platform noteholders.

7 In May 2013, Google led a $125 million investment in Lending Club. (New York Times Deal Book, May 2, 2013). In September 2013, Sequoia Capital and BlackRock invested $25 million in Prosper. BlackRock announced that it is likely to lend money to Prosper borrowers as well. (*The New York Times* Deal Book, September 9, 2013)

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