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FDIC Puts Up More Road Blocks for Marketplace Lenders

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THE FDIC CONTINUES TO BE THE ONE REGULATOR WITH THE MOST CAUTIOUS OUTLOOK REGARDING MARKETPLACE LENDING.

The Federal Deposit Insurance Corporation's (FDIC's) February 1 issue of *Supervisory Insights* (available at https://www.fdic.gov/regulations/examinations/supervisory/insights/siwin15/SI_Winter2015.pdf) continues the agency's negative view on the risks associated with marketplace lending. The publication focuses on the importance of effective risk identification for banks that conduct business with marketplace lenders. To do so, the FDIC is urging banks to perform "the same due diligence they practice whenever they extend credit to a borrower" and a "thorough pre-analysis and risk assessment on each marketplace lending company with which it transacts business."

The FDIC previously raised this issue in its November 6, 2015 Financial Institution Letter FIL-49-2015, which addressed the underwriting and credit risks associated with purchased loans and loan participations from third parties. FDIC-supervised institutions were reminded of the importance of underwriting and administering purchased loans as if they were originated by the bank. For a more in-depth analysis on FIL-49-2015, see our client alert (available at http://www.pepperlaw.com/publications/fdic-throws-water-on-the-marketplace-lending-phenomenon-2015-11-16/).

The new *Supervisory Insights* publication takes the FDIC's concerns one step further by discussing the specific risks that banks need to consider when dealing with marketplace lending companies, including third-party risk, compliance risk, transaction risk, servicing risk and liquidity risk, as well as specific due diligence recommendations. According to the FDIC, banks should ensure effective risk identification practices are in place as part of the risk identification process.

Third-Party Risk

The FDIC stresses the importance of considering whether any proposed activities the financial institution is engaging in with a marketplace lender are consistent with the institution's overall risk tolerances and business strategy. In doing so, bank management is instructed to develop a thorough understanding of the marketplace lending company's business model and establish written agreements to protect bank partners from risk. As part of the bank's ongoing due diligence, it is encouraged to regularly monitor the marketplace lender and require those companies to take corrective action in the event of any deficiencies.

Compliance Risk

Banks are warned of "inherent" compliance risk in any marketplace lending activity. To ensure that marketplace lender partners are complying with applicable lending, consumer protection, anti-money laundering and fair credit regulations responsibly, banks are urged by the FDIC to conduct appropriate due diligence and ongoing monitoring of the marketplace lender.

Transaction Risk

Supervisory Insights suggests that marketplace lending has the potential for transaction risk given the "large volume of loans, handling of documents, and movement of loans funds between institutions or third-party originators." As such, the FDIC suggests that banks should anticipate specific risks associated with "customer service, product delivery, technology failures, inadequate business continuity, and data security breaches."

Servicing Risk

The FDIC believes servicing risks exist based on the possibility that a marketplace lending company could become insolvent and the loan servicing process disrupted. Therefore, at a minimum, banks that invest in marketplace loans should identify whether back-up servicing agreements are in place with an unaffiliated company before investing.

Liquidity Risk

The FDIC is concerned about liquidity risks with the limited secondary market for selling marketplace loans. Therefore, banks need to consider liquidity risks as they form an overall picture of risk as part of their due diligence.

Pepper Points

- The FDIC continues to be the one regulator with the most cautious outlook regarding marketplace lending. To date, neither the Federal Reserve nor the Comptroller of the Currency has followed the FDIC's cautionary lead in this area. As we have noted before, this is in contrast to the recent Treasury request for information, which seemed to support marketplace lending and focused in part on how the federal government could be supportive of the innovations taking place in the marketplace lending space.

- Additional road blocks put in place by the FDIC will only add to the cost for banks to purchase marketplace loans or partner with marketplace lending companies in an attempt to participate in this vibrant and rapidly growing space. For marketplace lenders, the increased costs and regulatory hurdles will serve to slow innovation and provide barriers to entry for new participants.

- The FDIC's outlook regarding the risks it views as inherent in marketplace lending could push more marketplace lenders away from the bank partnership model and towards a direct funding model.