PEERIQ

September 30, 2015

DELIVERED VIA ELECTRONIC SUBMISSION

Laura Temel
ATTN: Marketplace Lending RFI
U.S. Department of the Treasury
1500 Pennsylvania Ave. NW.
Room 1325
Washington, DC 20220

Re: Docket ID: TREAS-DO-2015-0007
Public Input on Expanding Access to Credit through Online Marketplace Lending

Dear Ms. Temel:

On behalf of PeerIQ, we are pleased to contribute to the Department of Treasury's inquiry into the potential for online marketplace lending to expand access to credit. Moreover, we greatly appreciate the chance to attend your Marketplace Lending Forum on August 5, 2015, which we found enlightening and engaging. Much of our views expressed in this comment reflect considered discussion stemming from the Forum.

PeerIQ is a financial information services company that provides tools to allow institutional participants to analyze, access, and manage risk in the marketplace lending sector. We work alongside both platforms and institutional investors, providing market surveillance, portfolio management, reporting, benchmarking, and advanced credit analytics (including credit modeling and cashflow analytics). Founded in 2014—and backed by venture capital firms Uprising, Victory Park Capital, and Fenway Summer Ventures, as well as capital markets leaders such as John Mack, Arthur Levitt, Vikram Pandit, Eric Schwartz, among others—PeerIQ aims to strengthen marketplace lending by enhancing transparency, creating standards and accountability, and enabling efficient risk management.

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Today, banks face a variety of regulatory and balance sheet constraints which can serve as impediments to efficient lending. This is especially felt in consumer and small business lending—two segments that have historically lagged economic recoveries. Small business loans as a percentage of total bank loans continues to decline, despite the fact that small business creates a majority of net new jobs.[1] Similarly, segments of creditworthy consumer borrowers are

[1] *See* Ann Marie Wiersch and Scott Shane, Why Small Business Lending Isn't What it Used to Be, FEDERAL RESERVE BANK OF CLEVELAND, August 14, 2013, *available at:* https://www.clevelandfed.org (last visited September 27, 2015). *Also see* Maria Contreras-Sweet, Small Businesses Create 2 Million Jobs, The SBA Administrator, January 15, 2015, *available at:* https://www.sba.gov/blogs/small-businesses-create-2-million-jobs (last visited September 30, 2015).

arguably unable to access credit because their risk profile does not fit into underwriting models and/or parameters used by traditional banks.

Innovation in marketplace lending has been a tremendous success story to date, leading to much needed expansion of credit access to consumers and small businesses across the country. Leading platforms have created new technologies and online tools to better access and identify creditworthy borrowers that traditional banks cannot efficiently underwrite. They have built new borrowing experiences, with underwriting, risk-based pricing, and funding at a fraction of the time of traditional banks. Moreover, their investigation and collection of new data sources is leading to improved underwriting and risk-based pricing. As such, marketplace platforms are often in a privileged position to better match credit risks to institutional investors ideally situated to absorb and price the risk.

This is consistent with the dominant trend in the industry: as marketplace lending continues to mature, institutional investors are playing an increasingly important role in funding loans originated by marketplace lenders. This "institutionalization" of the sector brings with it great promise of efficient, long-term, low-cost, diverse funding sources absolutely necessary to fuel its next phase; it additionally creates the need for investment infrastructure, transparency, and standards to ensure efficient, responsible growth.

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Questions raised by U.S. Department of Treasury's Request for Information ("RFI") are addressed as follows:

1. **There are many different models for online marketplace lending including platform lenders (also referred to as "peer-to-peer"), balance sheet lenders, and bank-affiliated lenders. In what ways should policymakers be thinking about market segmentation; and in what ways do different models raise different policy or regulatory concerns?**

As suggested, there are multiple models for marketplace lending. Models are differentiated primarily by:

- Market segments (*i.e*) consumer, small business, commercial loans;
- Products (*e.g.*) installment loans, lines of credit, factoring, merchant cash advances;
- Origination channels (*e.g.*) direct mail, online, partner affiliate, branch, and paid search;
- Credit risk (*i.e*) prime, near-prime, sub-prime, thin-file;
- Funding mechanisms (*i.e*) balance sheet, marketplace, hybrid, bank-affiliated

While recognizing that certain business models have inherent advantages or disadvantages, we believe that to the extent further regulation is deemed warranted, policymakers should strive towards a transparent, principles-based approach and avoid the pitfalls of potentially mandating uneven regulatory treatment.

It would be prudent to consider the implications of loan origination moving from the banking system to potentially less transparent non-bank lenders. A reduction in transparency on metrics including origination growth, credit quality, and interest rates can inhibit the collection of data necessary to measure credit conditions and generate sound economic policy. We applaud the major marketplace lenders for leading by example and premising their business models on the principle of transparency.

The number of new platforms is increasing dramatically and business models are still evolving. A potential point of concern is that rapid platform proliferation leads to a deterioration in underwriting standards as platforms compete for new origination. But in fact, we are observing quite the opposite. The mix of high-grade loans on leading platforms is actually increasing.[2] Mature platforms are developing industry trade associations; self-policing abounds, promoting best practices that are based upon lessons from the pre-financial-crisis mortgage market. Nevertheless, as competition intensifies, regulators should encourage data collection to monitor credit trends. PeerIQ provides tools enabling investors to surveil these credit trends in real time.

2. According to a survey by the National Small Business Association, 85 percent of small businesses purchase supplies online, 83 percent manage bank accounts online, 82 percent maintain their own website, 72 percent pay bills online, and 41 percent use tablets for their businesses. Small businesses are also increasingly using online bookkeeping and operations management tools. As such, there is now an unprecedented amount of online data available on the activities of these small businesses. What role are electronic data sources playing in enabling marketplace lending? For instance, how do they affect traditionally manual processes or evaluation of identity, fraud, and credit risk for lenders? Are there new opportunities or risks arising from these data-based processes relative to those used in traditional lending?

The availability of electronic data plays a significant role in marketplace lending. As small businesses continue to use online tools and generate corresponding data, "tech firms are stepping up efforts to mine that data to get into the lending business."[3]

Small business lending is substantially more difficult to underwrite than consumer loans due to the lack of standardized credit bureau data among other factors. New electronic data sources are creating opportunities for loan originators to understand the small business credit. Data sources may include: financial statements from online bookkeeping applications, data from merchant acceptance or bill-pay services, and real-time insights on a firms inventory or receivables. The mining of such data provides insight improving loan originators' ability to calculate probability of default and expected loan performance. Furthermore, non-traditional data sets allow for more precise calculations of risk and broaden access to credit to thin-file or hard to price borrower segments.[4]

On the other hand, traditional lending institutions, particularly large banks, also have access to payment and performance data on a wide variety of datasets. Banks can monitor the overall relationship with the customer – from cash management activity, to mortgage products, and

[2] *See* PeerIQ research, Comparing Lending Club and Prosper Across Grades attached hereto as Exhibit A
[3] Tech Firms Venture into New Territory: Lending, *available at* http://www.wsj.com/articles/tech-firms-venture-into-new-territory-lending-1442438820.
[4] *Id.*

wealth management – to underwrite from a more holistic perspective. Traditional lenders also have substantial resources and long track-records of underwriting through lengthy credit cycles.

3. How are online marketplace lenders designing their business models and products for different borrower segments, such as:
- **Small business and consumer borrowers;**
- **Subprime borrowers;**
- **Borrowers who are "unscoreable" or have no or thin files;**

Depending on borrower needs (e.g., new small businesses, mature small businesses, consumers seeking to consolidate existing debt, consumers seeking to take out new credit) and other segmentations?

Within each borrower segment, there is a diversity of value propositions and business models. For example, Lending Club has established partnerships with data companies to improve customer acquisition and underwriting. Prosper has recently acquired a spending-and-tracking app company, to improve customer engagement. Lenddo is using social media criteria to assess credit worthiness.[5] Upstart factors in education and experience in determining creditworthiness for thin-file borrowers.[6] Affirm is creating speedy point-of-sale algorithms as an alternative to credit cards.[7] As for small business lending, PayPal is relying on its merchant data payment to extend credit to small business[8]; Amazon offers lending services to "help sellers grow"[9]; and Dealstruck provides lending tools for the mid-prime market, which includes SMBs who are not eligible for traditional bank financing.

4. Is marketplace lending expanding access to credit to historically underserved market segments?

Yes.

Post-crisis, banks started accounting for a variety of risks: put-back risk, litigation and settlement risks, costs of servicing distressed borrowers, borrower income verification and appraisal costs, and increased capital costs to name a few. Banks are re-evaluating the economics of consumer, small business, mortgage and student lending, and in several cases have downsized or shuttered lending operations. The personal installment loan business after 2008 provides a good example. Former Capital One bank executive Frank Rotman states that "with the exception of Discover, practically overnight the personal loans business units at major banks were shuttered."[10]

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[5] *See* https://www.lenddo.com/ (last visited July 28, 2015).
[6] *See* https://www.upstart.com (last visited September 17, 2015).
[7] Lending Start-Up Affirm Raises $275 Million, Steve Lohr, NEW YORK TIMES, May 6, 2015, *available at* http://bits.blogs.nytimes.com/2015/05/06/lending-start-up-affirm-raises-275-million/?_r=0 (last visited July 28, 2015).
[8] *See* http://venturebeat.com/2015/05/11/paypal-says-its-loaned-500m-to-small-businesses-in-the-past-18-months/ ((last visited July 28, 2015).
[9] *See* http://www.channeladvisor.com/blog/?pn=marketplaces/amazon-lending-amazon-starts-loaning-capital-to-sellers-to-help-them-scale (last visited July 28, 2015).
[10] Frank Rotman, The Hourglass Effect: A Decade of Displacement, *available at*: http://qedinvestors.com/wp-content/uploads/2015/04/the-hourglass-effect.pdf (last visited September 28, 2015)

Meanwhile, marketplace lending platforms such as Lending Club continued to increase lending growth at a robust pace filling the gaps.

A recent study from the American Enterprise Institute shows that there is a "seismic shift [in lending] away from large banks to non-banks."[11] The study shows that since November 2012, large bank share of agency mortgages has dropped from 61% to 33%, "a dramatic decline that has been met point-for-point by 27 point increase in the non-bank share from 24% to 51%".[12]

Non-bank lenders are taking an increased share of mortgage lending to lower-income segments as well. FHA-backed home loans funded by non-banks has increased to 62% as compared to 30% for non-banks. The share for banks and non-banks were nearly reversed as recently as 2012.[13]

Moreover, banks have increased credit standards, often tighter than regulatory guidelines. Average FICO scores for mortgages are 50 points above their pre-financial-crisis levels.[14] Moreover, banks prefer to underwrite qualifying mortgages and avoid non-QM loans which marketplace lenders such as Social Finance are offering. In short, non-bank and marketplace lenders are expanding credit to both under-served and lower income customer segments.

5. Describe the customer acquisition process for online marketplace lenders. What kinds of marketing channels are used to reach new customers? What kinds of partnerships do online marketplace lenders have with traditional financial institutions, community development financial institutions (CDFIs), or other types of businesses to reach new customers?

Customer acquisition for online marketplace lenders is achieved through a variety of channels: direct mail, online affiliate networks, joint marketing with partner banks, 'turndown' channels, paid search, sponsored content, social media partnerships and community organizations, and lead generation platforms such as Credit Karma or Lending Tree.

Lending Club, the largest US marketplace lender has joined forces with Google to extend credit to small businesses, as well as with Alibaba Group to attract a broader borrower demographic.[15] In addition, leading marketplace lending platforms have established partnerships with large financial institutions such as Citibank as well as a national consortium of 200 community

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[11] Trey Garrison, Mortgage Lending Continues Seismic Shift from Large banks to Nonbanks, *available at*: http://www.housingwire.com/articles/33428-mortgage-lending-continues-seismic-shift-from-large-banks-to-nonbanks (last visited September 28, 2015).
[12] *Id.*
[13] Kate Berry, Non-Bank Mortgage Lenders Bite Back, *available at*: http://www.nationalmortgagenews.com/news/origination/nonbank-mortgage-lenders-bite-back-1048217-1.html (last visited September 27, 2015).
[14] *See* Nick Timiraos, How Tighter Mortgage Standards are Holding Back the Recovery *available at:* http://blogs.wsj.com/economics/2013/09/29/how-tighter-mortgage-standards-are-holding-back-the-recovery/ (last visited September 28, 2015).
[15] *See* http://www.bloomberg.com/news/articles/2015-04-23/lending-club-expands-into-business-loans-with-google-alibaba-help (last visited July 28, 2015).

banks.[16] Prosper, another major marketplace loan originator, possesses a partnership program with Western Independent Bankers, which includes more than 160 independent and community banks located in 13 western states.[17]

There are multiple types of partnerships between traditional financial institutions and marketplace lenders. As it relates to customer acquisition there are two types of partnerships:

- Some banks seek partnership opportunities with marketplace lenders to round out their product suite. Underwriting installments loans requires deep underwriting and servicing expertise that many community banks may not have the resources to invest in. Banks can partner with marketplace lenders to extend credit to their customer base.

- Banks may send 'turndown' applications to a marketplace lending platform for funding. Consider a bank that offers a co-brand credit card program with a major co- airline or hotel. The co-brand partner earns economics by jointly marketing the bank product offering to their customer base. The co-brand partners seeks to maximize the number of certain loan applications that are approved by the issuing bank. However, the issuing bank has a pre-defined credit scorecard. Loan applicants that do not fit the credit scorecard ('turndowns') can be listed on a marketplace lending platform for funding, and the credit risk can be matched to an institutional investor that is able to price the risk. In this way, the credit buy-box can be expanded to include a broader set of creditworthy borrowers by including institutional investors with greater risk appetites.

6. How are borrowers assessed for their creditworthiness and repayment ability? How accurate are these models in predicting credit risk? How does the assessment of small business borrowers differ from consumer borrowers? Does the borrower's stated use of proceeds affect underwriting for the loan?

Consumer loan underwriting incorporates several disparate data sources.

These data sources may include:
- Credit bureau attributes specific to the borrower's credit history such as the borrower's FICO score, credit utilization, recent credit inquiries, delinquency behavior, whether the borrower owns a home, and hundreds of other bureau attributes.
- Channels, which drive expected loan performance. Channel(s) may include direct mail, affiliate, online, repeat customer marketing, reverse inquiry to the website, lead from a marketing partner.
- Borrower application data such as the amount of funds requested relative to the maximum allowed, loan purpose, whether an ACH is provided to sweep periodic payments, and metadata regarding how the user fills the application.
- Relationship data that includes other variables regarding the borrower's relationship with the underwriter (repeat borrower, breadth and depth of relationship, etc.).

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[16] *See* https://www.lendingclub.com/public/lending-club-press-2014-05-05.action (last visited September 8, 2015). *See* https://www.alliancepartners.com/apsite/docs/LC%20%20AP%20-%20Press%20Release%202-9-15.pdf
[17] See http://www.lendacademy.com/prosper-announces-partnership-consortium-160-community-banks/ (last visited September 8, 2015).

Statistical techniques or credit scorecards are applied to the data to generate expectations of customer value, probability of default, or loss-adjusted return. Statistical techniques may range from logistic regression to more advanced non-parametric machine learning techniques.

The borrowers stated use of proceeds may impact the perceived risk of a loan. Certain loan purposes (weddings, small business, etc.) have higher rates of default than other loan purposes (such as debt consolidation) and marketplace lending platforms may incorporate such data to the extent the differing credit risk is not already captured by other variables in the underwriting process.

7. Describe whether and how marketplace lending relies on services or relationships provided by traditional lending institutions or insured depository institutions. What steps have been taken toward regulatory compliance with the new lending model by the various industry participants throughout the lending process? What issues are raised with online marketplace lending across state lines?

Generally, marketplace lending platforms such as Lending Club or Prosper maintain a segregated deposit account on behalf of lenders with a traditional bank ("Deposit Bank").[18] The principal amount of each funded loan is also advanced to the borrower by a traditional bank (a "Funding Bank"), which may be different from the Deposit Bank.[19] At or shortly after funding of a loan by the Funding bank, the marketplace lending platform will (i) purchase the loan from the Funding Bank and (ii) issue a note to the applicable platform investor representing the right to receive a portion of the loan proceeds.[20] Each of the Funding Bank, the Deposit Bank and marketplace lending platform possess distinct state and federal regulatory compliance obligations.

In the recent judicial opinion, *Madden v. Midland Funding, LLC,*[21] the U.S. Court of Appeals for the Second Circuit held that a non-bank debt collector that purchased loans from a national bank was not entitled to rely on the bank's federal preemption of New York State's usury law. The opinion has been described as "controversial" and "inconsistent with long-standing circuit court precedent if allowed to stand".[22] Uncertainty created by this ruling may impact the growth of marketplace lending.

8. Describe how marketplace lenders manage operational practices such as loan servicing, fraud detection, credit reporting, and collections. How are these practices handled differently than by traditional lending institutions? What, if anything, do

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[18] For a more detailed explanation *see* Peter Manbeck and Marc Franson, The Regulation of Marketplace Lending: A Summary of the Principal Issues (2015 Update), , *available at* http://www.chapman.com/media/publication/146_Chapman_Regulation_of_Marketplace_Lending_White_Paper_040815.pdf (last visited July 28, 2015).
[19] *Id.*
[20] *Supra* nt. 18.
[21] *Madden v. Midland Funding, LLC,* No. 14-2131-cv, 2015 WL 2435657 (2d Cir. May 22, 2015).
[22] *See* http://www.pepperlaw.com/publications/valid-at-inception-rule-shot-down-by-the-second-circuit-2015-06-24/ (last visited July 28, 2015).

marketplace lenders outsource to third party service providers? Are there provisions for back-up services?

Leading marketplace lenders have made substantial investments in loan servicing, fraud detection, credit reporting, collections, and third party verification services. Often the full set of operational practices are sourced by a mix of internal systems and outsourced partners.

9. What roles, if any, can the federal government play to facilitate positive innovation in lending, such as making it easier for borrowers to share their own government-held data with lenders? What are the competitive advantages and, if any, disadvantages for nonbanks and banks to participate in and grow in this market segment? How can policymakers address any disadvantages for each? How might changes in the credit environment affect online marketplace lenders?

Banks have certain advantages such as access to cheap stable deposit financing and a low cost of capital. The low cost of capital enables a bank to enjoy a higher net interest margin on loans issued. As a result, banks can profitably fund loans to high credit quality borrowers (such as investment grade corporates and sovereigns) that have plenty of access to credit at relatively low rates. At the same time, banks have certain disadvantages which may include legacy systems, excess branch overhead, impersonal servicing platforms, and less-focused product offerings.

Banks also face regulatory capital requirements that shape their lending behavior. Under the Basel III framework, banks are tested for liquidity, asset quality, and funding stability. Consumer and small business loans have a risk weight of 100% under the standards approach as compared to a substantially lower risk-weight for investment-grade corporates or sovereign loans. Banks can improve their liquidity, improve asset quality, and reduce their regulatory capital requirements by shifting the marginal dollar from consumer and small business lending towards corporates or sovereigns.

Additionally, banks are re-assessing the true cost of lending to riskier credit segments as they account for post-crisis credit losses, put-back risks, litigation risks, the increased cost of servicing distressed borrowers, and reputational risks.[23]

Simply put, certain consumer and small business lending activities have higher opportunity costs for banks after factoring in capital requirements and strict underwriting rules.

Non-banks have a higher cost of capital and therefore focus on originating higher-rate loans to borrowers that have a correspondingly higher credit risk. A major disadvantage of non-banks is that they do not have access to stable, cheap deposit financing. Non-banks rely on multiple strategies to finance their origination including the securitization market, corporate debt, forward flow agreements, and marketplace technology.

[23] *See* Mark Zandi and Jim Parrott, Opening the Credit Box. MOODY'S ANALYTICS AND URBAN INSTITUTE, *available at:* https://www.economy.com/mark-zandi/documents/2013-09-29-Opening-the-Credit-Box.pdf (last visited September 27, 2015).

A turn in the credit cycle would test the stability of funding to non-banks and marketplace lenders that do not have access to diverse and patient sources of capital.

10. **Under the different models of marketplace lending, to what extent, if any, should platform or "peer-to-peer" lenders be required to have "skin in the game" for the loans they originate or underwrite in order to align interests with investors who have acquired debt of the marketplace lenders through the platforms? Under the different models, is there pooling of loans that raise issues of alignment with investors in the lenders' debt obligations? How would the concept of risk retention apply in a non-securitization context for the different entities in the distribution chain, including those in which there is no pooling of loans? Should this concept of "risk retention" be the same for other types of syndicated or participated loans?**

Risk retention has been proposed as a potential method for aligning interests between platforms and investors.

Marketplace lenders are subject to market discipline by sophisticated institutional investors that do not have the obligation to fund loans originated by marketplace loans each day. If marketplace lenders produce loans that do not satisfy the risk-adjusted return expectations of institutional investors, such institutional investors can walk away. As a result, marketplace lenders offer investors significant transparency and are building brands associated with responsible credit extension.

Transparency is a mechanism for driving accountability. Publishing loan origination and loan performance invites a high degree of public scrutiny. Institutional investors can compare and benchmark marketplace lenders to other sources of credit risk.

Institutional investors perform collateral analysis at a loan-level and stress cash flows using PeerIQ's analytical tools at a level of granularity that did not take place in the residential mortgage crisis. Institutional investors use PeerIQ's tools to create benchmarks that enable a clinical comparison of risk across multiple loan originators.

Additionally, institutional investors have other mechanisms to drive accountability. For example, investors or ABS sponsors negotiate forward flow agreements as well as representations and warranties. This is a market-driven mechanism for binding marketplace lenders to specific obligations that is flexible to the needs of both parties and market conditions.

Most marketplace lenders are thinly capitalized, as compared to bank counterparts, as they are not in the business of absorbing credit risk. By contrast, sophisticated, well-capitalized institutional investors with decades of experience in analyzing and managing credit risk are able to retain and manage that risk on their balance sheet. Further, technology companies are not investment firms and marketplace lenders simply do not have the loss absorption capacity, risk-transfer, trading or hedging capabilities that institutional investors may utilize in this new asset class.

Importantly, requiring marketplace lenders to retain credit risk would force a significant business model shift, and prematurely select winners and losers not via their origination/underwriting core competencies, but rather by their ability to attract lower cost capital on balance sheet.

Marketplace lenders use technology to connect pools of capital to borrowers seeking credit. Applying risk retention requirements risks transforming marketplace lenders into non-banks would curtail the pace of innovation and investment in the category by raising the regulatory and capital costs of doing business.

11. Marketplace lending potentially offers significant benefits and value to borrowers, but what harms might online marketplace lending also present to consumers and small businesses? What privacy considerations, cybersecurity threats, consumer protection concerns, and other related risks might arise out of online marketplace lending? Do existing statutory and regulatory regimes adequately address these issues in the context of online marketplace lending?

E-commerce laws and regulatory rules translate well into marketplace lending. Marketplace lending platforms are subject to myriad federal consumer protection, privacy, anti-money laundering and export laws, as well as state laws and regulations. Moreover, given the integral role of federally regulated banks in marketplace lending, existing statutory and legal regimes adequately address privacy, cybersecurity and consumer protection concerns.

12. What factors do investors consider when: (i) investing in notes funding loans being made through online marketplace lenders, (ii) doing business with particular entities, or (iii) determining the characteristics of the notes investors are willing to purchase? What are the operational arrangements? What are the various methods through which investors may finance online platform assets, including purchase of securities, and what are the advantages and disadvantages of using them? Who are the end investors? How prevalent is the use of financial leverage for investors? How is leverage typically obtained and deployed?

Investors consider a range of factors when funding loans through marketplace lenders. A sample of factors include:

- Stated coupon and projected yield,
- Credit risk,
- Transparency into underlying loan credit attributes,
- Historical loan performance,
- Primary and back-up servicing capabilities,
- Underwriting capabilities including tools for fraud detection and verification,
- Quality of the management team,
- Business fundamentals,
- Regulatory risk, and
- Ability to place loans in an SPV and secure a credit facility or potentially securitize.

Leverage is typically provided by a credit facility extended by a bank that has recourse to the assets.

Investors in loans include hedge funds, large banks, community banks, insurance companies, family offices, and retail investors. End-investors in asset backed securitizations ("ABS") include hedge funds, banks, and insurance companies.

13. What is the current availability of secondary liquidity for loan assets originated in this manner? What are the advantages and disadvantages of an active secondary market? Describe the efforts to develop such a market, including any hurdles (regulatory or otherwise). Is this market likely to grow and what advantages and disadvantages might a larger securitization market, including derivatives and benchmarks, present?

Secondary Market

Today, there is virtually no secondary market liquidity. Retail investors have access to limited liquidity (to limited volumes), via FolioInvesting.

A secondary market can create liquidity and price discovery for investors. There is no standardized valuation methodology for loans and a secondary market would enable Net Asset Value pricing.

One challenge for a secondary market is that the loan size is relatively small. Institutional investors are accustomed to exchanging larger-sized pools of risk via secondary market transactions in the ABS market rather than one-off loans.[24]

Another challenge to a secondary market is that no two loans represent the same credit risk or will generate the same path of cash flows. Therefore loans are not fungible within grade and each loan must be priced separately. There are possible solutions to creating a secondary market, however, the idiosyncratic nature of the risk increases the complexity of creating a liquid secondary whole loan market.

A secondary market would likely lead to loans trading higher than par value. Marketplace lending loans have their coupon set via the originator rather than via an auction process. There is excess demand for such as loans partly owing to the excess spread and lack of an auction in the process in the primary market. Consequently, market participants that have access to primary issuance would be able to capture the excess spread by immediately selling the loan in the secondary market. This high-frequency flipping behavior would be minimized as the excess spread available to investors in the primary market diminishes or as sound market microstructure rules are established to govern trading.

Key building blocks toward a robust secondary market include execution, settlement and clearing infrastructure, downstream trade management infrastructure, establishment of standardized trade protocols, independent third party credit risk assessment of loans, and resolution of certain regulatory issues.

[24] *Supra* nt. 1

Securitization

The risk-transfer market, namely securitization and derivatives may potentially encourage bank lending and reduce funding risks to non-bank and marketplace lenders in the event of a credit cycle downturn.

Securitization is a mechanism for banks and non-banks to convert pools of disparate loans into securities which have increased liquidity, transparency, and reduced administrative and regulatory capital costs as compared to the underlying loans. The securitization process also dramatically expands the base of eligible investors to institutions such as insurers and pensions that have investments horizons beyond the next credit cycle.

It is no surprise that an often cited risk factor in the 10-Ks of publicly traded non-banks is the concept that non-banks rely on the securitization market for financing. If the securitization market freezes, non-banks would be forced to curtail credit extension. Non-banks would also be forced to raise rates to successfully attract institutional capital in a frozen ABS environment – a perverse outcome from a policy perspective as these credit conditions would likely be paired with a recessionary environment. It would be prudent to promote transparency, liquidity, and price discovery in the ABS market to avoid this pro-cyclical phenomenon.

Securitization is an essential link in the funding chain connecting originators to institutional investors in the capital markets. A transparent, simple, high quality securitization market with active repeat issuance would reduce the funding risk of marketplace lenders in a recessionary environment.

We believe the marketplace lending securitization market will grow substantially in the years ahead. PeerIQ offers institutional investors sophisticated credit risk analytics to prospective ABS issuers, end-investors, and marketplace lending platforms with the aim of improving transparency, liquidity, and efficient pricing for ABS market participants. With respect to securitizations, PeerIQ facilitates the calculation of credit risk under various economic scenarios, enables more robust diligence practices, and more accurate assessment(s) of risk exposure.

Challenges for securitization models include potentially complex, obtuse structuring, and lack of visibility into the underlying collateral that make modelling the risks of the underlying collateral virtually impossible. To date, the structure of marketplace securitizations are straightforward, and PeerIQ is monitoring the structure of such securitizations in our research.

Policymakers can promote the smooth functioning of the securitization market by improving transparency, simplicity, and standardization. Transparency for existing and future securitizations can be improved by requiring loan-level visibility into the collateral pools of securitized products, or by consolidation and dissemination of trade prices for such securities.

PeerIQ sees instructive analogues in other markets which should be considered as the marketplace lending securitization scales. For example, the European DataWarehouse, a centralized platform for collecting, storing, and distributing European ABS loan-level data provides infrastructure improving the transparency and liquidity of ABS products.[25] PeerIQ sees

[25] *See* https://eurodw.eu/ (last visited September 27, 2015).

the common securitization platform under the direction of the FHFA as an important analogy to infrastructure improving the liquidity, fungibility, and standardization of securitizations.

Derivatives
As noted above, there is no obligation for institutional investors to purchase marketplace loans each day. The stability of institutional funding will arguably be tested in the next credit cycle.

Institutional investors must be comfortable holding marketplace loans for several years, without liquidity, and inevitably through a credit cycle. Institutional investors and banks are better able to manage their risk and commit to longer-term funding agreements when they know they can reliably hedge and manage their credit risks much like they do today with other credit asset classes.

There are risks that ill-designed or opaque credit derivatives could play a role in price distortions or speculation, especially when the underlying cash market is not transparent.[26] Regulations and standards introduced post 2008 address many of these deficiencies. Designed properly, credit derivatives also can lead to accurate pricing of credit risk, facilitate risk shifting to centrally cleared environments, and ultimately reduce costs of borrowing.[27] Credit derivatives promote market liquidity, enable risk transfer, and price discovery.[28]

While certain derivatives are also bespoke (those traded "over the counter"), we believe that non-bespoke, listed, responsibly-designed derivatives based on an index will ultimately be made available to trade on U.S. Commodity Futures Trading Commission ("CFTC") registered Swap Execution Facilities and/or Designated Contract Markets and cleared by CFTC registered Derivatives Clearing Organizations.

A transparent credit derivatives market would enable banks to manage their concentration and balance sheet risk, lower the overall cost of capital, and put banks in a better position to extend consumer and small business credit.[29]

Analysts at the FDIC performed an empirical analysis on the use of credit derivatives on the corporate loan market. They conclude:

- Banks use of credit derivatives lowered corporate loan spreads;
- The above results are consistent with banks passing on risk management benefits from derivatives use to borrowers;
- Risk management benefits persisted during the crisis;
- Banks using credit derivatives have generally lower charge-offs and faced smaller contractions in lending volumes during the crisis.[30]

[26] Prof. Ronald W Anderson, Credit Default Swaps: What are the Social Benefits and Costs, Banque De France, Financial Stability Review, No. 14, Derivatives-Financial Innovation and Stability, July 2010 *available at:* https://www.banquefrance.fr/fileadmin/user_upload/banque_de_france/publications/Revue_de_la_stabilite_financiere/etude01_rsf_1007pdf (last visited July 28, 2015).
[27] *Id.*
[28] *Supra* nt. 26.
[29] *Supra* nt. 26.

Derivatives present an opportunity for investors and banks to access and hedge marketplace loan risk responsibly and realize the benefits of corresponding risk transfer markets while abiding by the principles set forth under the Dodd Frank Act. PeerIQ's credit risk analytics tools enable the valuation of loan portfolios, standardization, and benchmarks – all of which are required to enable a successful risk-transfer market.

14. What are other key trends and issues that policymakers should be monitoring as this market continues to develop?

There are several trends and issues policymakers should monitor as the marketplace lending market matures.

- Regulators should monitor and encourage ***loan-level transparency*** in marketplace lending securitizations to promote secondary ABS liquidity and price discovery. PeerIQ is working with ABS sponsors to develop credit risk analytics to price securitizations, project future cash flows under various scenarios, and promote simple, comparable, and high quality securitizations.

- As institutional capital flows into the category, policymakers should encourage ***benchmarks, standardization, and normalization*** to promote consistent representation of risk.

- Risk management tools including ***hedging and analytical tools*** that can forecast and stress cashflows under adverse conditions can promote efficient risk mitigation for investors in marketplace lending loans.

- ***Institutional infrastructure*** has not kept pace with the growth of marketplace lending. Infrastructure such as: trade recording, portfolio management, settlement and clearing, is especially important in a credit downturn or in the event of a failure of a large institutional investor or platform.

- As marketplace lenders proliferate and competition intensifies across, there is a need for ***market surveillance*** to monitor origination volumes, credit quality, and pricing trends.

- The lack of a ***standardized valuation and pricing methodology*** creates an investor fairness consideration. The issue is especially pronounced in hedge funds that offer periodic liquidity based on net asset value to limited partners. Either NAV is too high or to low, consequently either current or future investors are advantaged or disadvantaged accordingly.

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[30] *See* Lars Norden, Consuelo Silva Busoton, Wolf Wagner, Banks' Use of Credit Derivatives and the Pricing of Loans: What is the Channel and Does it Persist Under Adverse Economic Conditions, *available at* https://www.fdic.gov/bank/analytical/cfr/2011/sept/buston_presentation.pdf (last visited September 28, 2015).

- Institutional investors that fund illiquid marketplace lending loans and offer periodic liquidity to limited partners have an ***asset / liability mismatch***. The mismatch is typically exacerbated during periods of losses when limited partners may redeem simultaneously.

* * *

PeerIQ firmly believes in the promise of marketplace lending to redefine borrowing—particularly in underserved consumer and small business segments. And as the asset class scales, it can do so safely with onset of innovative tools and approaches to enhance transparency, coalesce standards, and foster accountability across the credit value chain. We believe these components are instrumental in establishing the foundation for a resilient and responsible marketplace lending industry.

We thank you for initiating this public dialogue and welcome the opportunity to engage and further support the Department of Treasury inquiry into marketplace lending.

Respectfully submitted,

/RA/
Ram Ahluwalia
CEO
PeerIQ

/MB/
Manavinder S. Bains

Attachments: Appendix A

Appendix A

Comparing Lending Club and Prosper Across Grades

2 September 2015

PEERIQ

Peer-to-Peer Loan Data Update:
Comparing Lending Club and Prosper Across Grades

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With the recent release of second quarter loan data by both Lending Club and Prosper, we thought it apt to revisit with the consumer P2P leaders, dive into the data via our platform, and identify any new trends.

With a focus on comparing corresponding loan grades across platforms, we observed several notable shifts:

- **Average grades for issuance are rising.** Specifically, Lending Club 5-year notes and Prosper 3-year notes have increased their mix of higher grade issuance since 2011.
- **High-grade loans are similar across originators, with more divergence in lower grades**. Prosper and Lending Club coupons and debt-to-income ratios are similar for higher grade loan segments and disperse for lower graded ones.
- **Prosper and Lending Club loan performance metrics are converging.** Prosper cumulative charge-off and prepayment rates decreased relative to Lending Club's for loans issued after 2011—and now are nearly comparable.
- **Overall, a greater amount of higher grade issuance by major platforms belies the notion that as the industry matures, credit quality standards will decline.** This may, in part, be explained by the ability of large platforms to better identify higher grade borrowers via evolving marketing and risk modeling capabilities.

Introduction

Given the relative youth of the consumer peer-to-peer loans, a robust, common metric of credit risk across originators does not yet exist as each has its own grading system utilizing different underwriting models. This makes comparisons a fruitful lens for analysis. Working from the latest data, we provide a comparison of corresponding loan grades for the two largest consumer loan originators: Lending Club and Prosper. First, we identify originator issuance trends by grade. Then, we compare relative charge-off and prepayment performance at specific junctures in a loan's term.

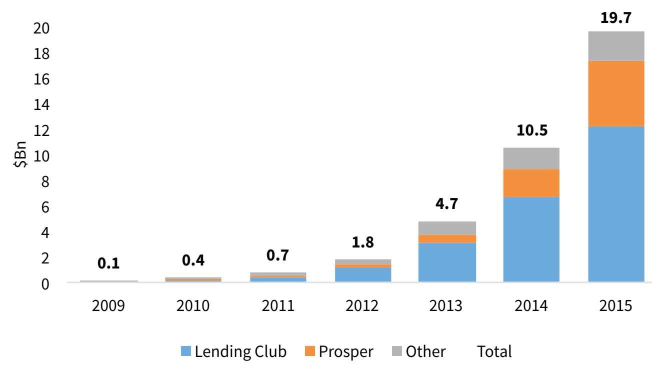
Our review shows that although marketplace consumer lending is still in its early stages, important trends associated with a maturing market are emerging. Issuance characteristics and performance by grade are converging. Large platforms are shifting towards higher grades, which also tend to have more similarities across originators than lower grades. Overall, we think these trends are positive developments for the market as credit quality of loan originated by the largest platforms is improving as the industry matures.

Comparing Issuance Trends

It is no secret that total origination across lending platforms continues to rise steadily, due both to platform growth and a proliferation of new platforms entering the space. We focus on Lending Club and Prosper in this piece because we estimate they have originated over 80% of the outstanding balance for US marketplace consumer loans to date and thus their issuance growth still drives the market. Specifically, Lending Club issuance climbed from $261MM to $3.5Bn annually from 2011 to 2014, while Prosper's climbed from $75MM to $1.6Bn (according to public data).

Exhibit 1

US Marketplace Cumulative Loan Origination



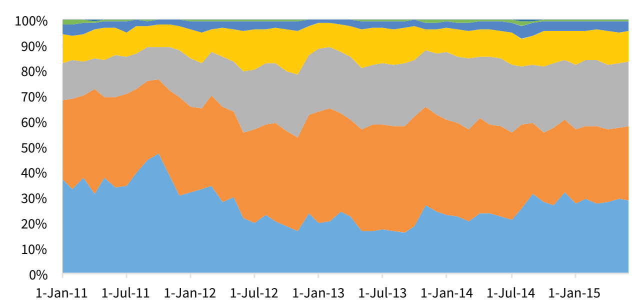
Notes: Other is estimated from summing contribution of several smaller platforms and scaling up using market growth rate of 150%. 2015 numbers are estimated by doubling half-year issuance of Prosper and LC. Source: Prosper, Lending Club, PeerIQ Research

Underneath this macro trend, segment specific issuance trends emerge when we filter by term and grade. Overall these large platforms have originated a greater amount and percentage of higher grade loans. For Lending Club 3-year notes, the issuance composition by grade has been remarkably stable, with grades A thru C making up approximately 80% of monthly issuance since 2011 (as referenced in the exhibit below).

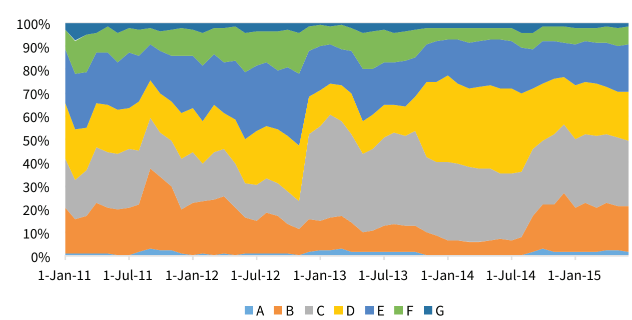
Exhibit 2

Lending Club Percentage Issuance by Grade

3y Loans



5y Loans



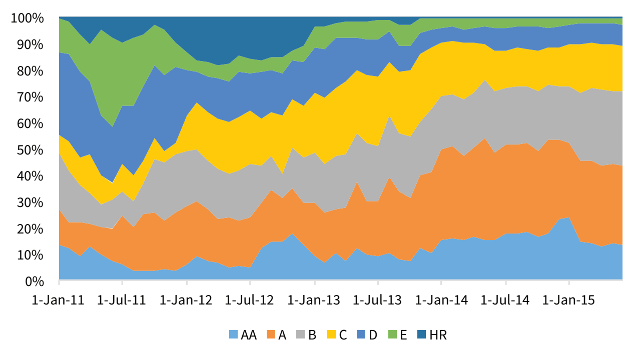
Notes: Data is from Jan 2011 thru Jul 2015. Source: Lending Club, PeerIQ Research.

On the other hand, Lending Club 5-year note (exhibit above) and Prosper 3-year note (exhibit below) issuances have skewed towards higher grades on a percentage basis since 2011. For example, in 2012, 36% of Lending Club 5-year notes were rated A thru C and 45% of Prosper 3-year notes were rated AA thru B, whereas in 2014, those percentages increased to 42% and 73%, respectively. For Lending Club's 5-year notes, the rise in average grade started at the end of 2012 with an increase in C grade note issuance. The pickup in Prosper higher grade 3-year notes accelerated after 2012, which was approximately two years after Prosper's relaunch in April 2009. Prosper's 5-year notes have actually shown a drop in average grade (exhibit below), but they are a smaller component of issuance at 65% of the 3-year note issuance since 2011.

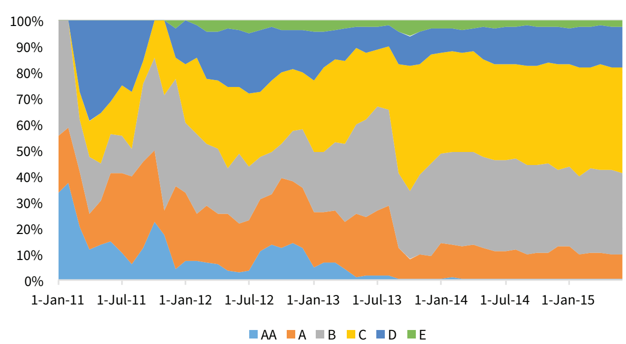
Exhibit 3

Prosper Percentage Issuance by Grade

3y Loans



5y Loans



Notes: Data is from Jan 2011 thru Jul 2015. Source: Prosper, PeerIQ Research.

Comparing Key Loan Metrics

In this section, we compare like grades across the two originators (with the caveat that the grade systems are not equivalent):

First, we see greater similarity across higher graded corresponding segments. Prosper and Lending Club weighted average coupons are very close for the four highest quality grades (Prosper AA thru C and LC A thru D) across terms for loans initiated since 2009. Coupons for lower graded loans disperse somewhat, with Prosper's being higher on average for both. For example, the weighted average coupon spread between 3-year Prosper AA and Lending Club As is near 0%, but that difference grows to 4% for Prosper Es versus Lending Club Fs.

Typical loan sizes for higher corresponding grades are similar as well. Moving down the grade spectrum, Prosper loans have lower loan sizes by design. For instance, 3-year Prosper AAs and Lending Club As have average loan sizes of $12.7K and 13.6K, while Prosper Es and Lending Club Fs are $5.1K and $10.1K respectively. Some of this difference is due to the fact that the maximum loan size for Prosper E and HRs are $15,000 (up from $10,000 in June 2015) and $7,500, while Lending Club does not have a specific cap for lower graded borrowers. Similar to coupons, higher graded corresponding segments have closer debt-to-income ratios than lower graded ones. The debt-to-income difference between 5-year Prosper As and Lending Club Bs versus Prosper Ds and Lending Club Es grows from 3% to 7% on average.

Exhibit 4

Prosper - Lending Club Key Metrics by Grade Since 2009

Prosper – Lending Club, 3-year Notes

Grades	WAvg Coupon	WAvg FICO	Wavg DTI	Avg Loan Size Ratio	CPR @ 18m	CDR @ 18m
Pr AA - LC A	0%	17	4%	94%	3%	0%
Pr A - LC B	-1%	13	6%	104%	2%	-1%
Pr B - LC C	-1%	9	6%	105%	2%	-1%
Pr C - LC D	0%	4	6%	94%	3%	2%
Pr D - LC E	2%	-4	3%	73%	3%	3%
Pr E - LC F	4%	-13	12%	51%	3%	3%
Pr HR - LC G	7%	-14	9%	25%	7%	6%

Prosper – Lending Club, 5-year Notes

Grades	WAvg Coupon	WAvg FICO	WAvg DTI	Avg Loan Size Ratio	CPR @ 18m	CDR @ 18m
Pr AA - LC A	1%	36	2%	88%	1%	1.3%
Pr A - LC B	0%	18	3%	82%	0%	1.5%
Pr B - LC C	-1%	13	7%	91%	1%	1.5%
Pr C - LC D	0%	3	7%	78%	2%	0.5%
Pr D - LC E	1%	-4	7%	64%	0%	7.0%
Pr E - LC F	3%	-7	4%	33%	-1%	1.3%

Notes: Above table contains differences between key metrics at issuance for coupon, FICO, and DTI, which are weighted by original loan size. Average loan size ratio is calculated as the ratio of Prosper to LC average loan size for a particular grade. CPR and CDR @ 18m are calculated as the quarterly vintage average of the ratio of the sum of unscheduled prepayments and charge-offs from 1 to 18 months of age divided by initial loan amount. Tables are based on public data available for loans originated from Nov2005-Jun2015 for Prosper and Jun2007 –Jun2015 for LC. Source: Lending Club, Prosper, PeerIQ Research.

For some characteristics, the above trend does not always hold. Prosper loan borrower FICO scores start off higher than Lending Club's for higher grade segments and then tend to decline on a relative basis for lower graded ones. But the largest FICO differences on an absolute basis are between corresponding higher graded segments (e.g. Prosper AA vs Lending Club A), although the absolute average FICO scores for them are both well above 700.

Comparing Performance Trends

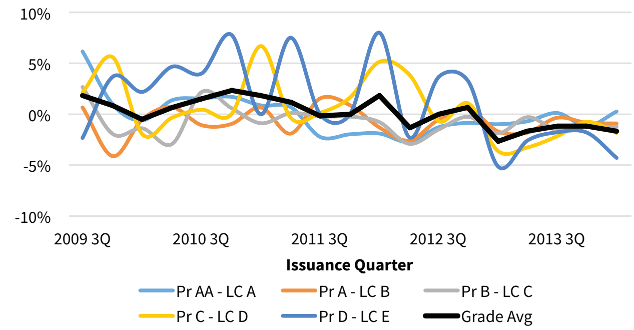
Here we explore Lending Club and Prosper loan segment charge-offs and prepayment rates at specific junctures of a loan's term to enhance our understanding of relative performance. We use *differences* in cumulative charge-offs at 18 months of age as our point of reference because they tend to accelerate between 1 to 1.5 years after issuance. Conversely, we focus on prepayment rates at 9 months of age because most unscheduled principal is paid relatively early in a loan's life. We control for seasoning by dividing our population of loans by issuance quarter or vintage, as defined by the originator.

The evidence suggests that Lending Club and Prosper charge-off and prepayment rates converged for recent vintages. Prosper cumulative charge-off rates have fallen relative to Lending Club's for vintages starting in Q1 2012 and, in some grade segments, have outperformed. Similarly Prosper prepayment rates have fallen relative to Lending Club's after being consistently higher.

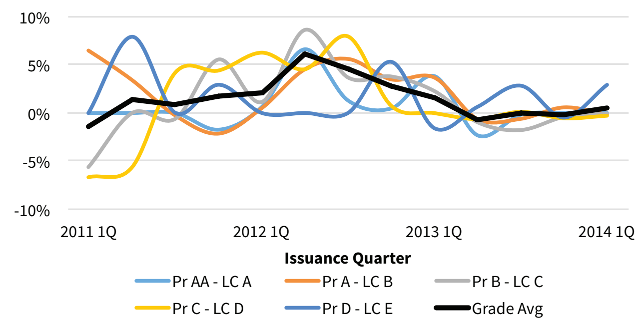
Exhibit 5

Prosper - Lending Club Cumulative Charge-Off Rates

3y Notes at 18 Months of Age



5y Notes at 18 Months of Age



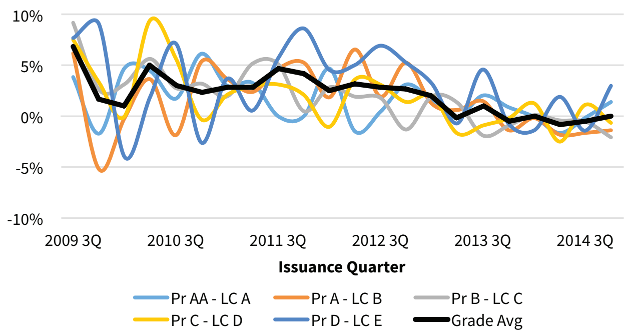
Notes: To get chart above, first we calculate the 18 months of age cumulative default rate (sum of defaults between months 1 and 18 divided by loan amount) for loans issued in particular calendar quarter or vintage. Next we take the difference between the Prosper and LC calculated rates. Grade averages excludes differences between the bottom 2 grades (LC: F, G and Prosper: E, HR). PeerIQ performs basic data ETL to ensure the original data has integrity. Data includes vintages from 2009 3Q thru 2014 1Q for 3y notes and 2010 4Q thru 2014 1Q for 5y notes. Source: Lending Club, Prosper, PeerIQ Research.

Prosper cumulative charge-off rates are nearly even with Lending Club's for 2013 vintages. Pre-2013 vintages, Prosper segments had higher charge-offs than Lending Club's. For example, the average quarterly charge off rate differences for the highest graded Lending Club and Prosper pairs (for 3-year loans) fell from approximately +2% in 2012 1Q to approximately -1% in 2013 4Q. Overall, lower graded segments show a larger 'beta' in that the differences tended to be more positive before 2013 and more negative afterwards.

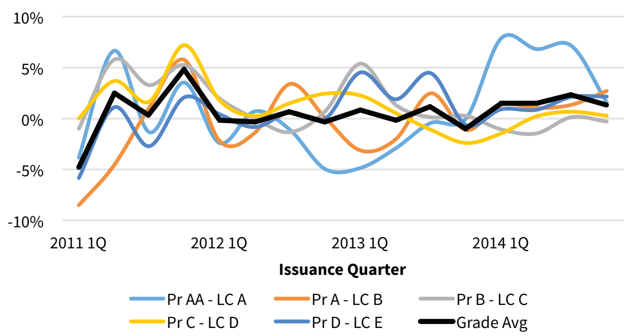
Exhibit 6

Prosper - Lending Club Prepayment Rates

3y Notes at 9 Months of Age



5y Notes at 9 Months of Age



Notes: To get chart above, first we calculate the 9 months of age cumulative prepayment rate (sum of unscheduled principal paid between months 1 and 9 divided by loan amount) for loans issued in particular calendar quarter or vintage. Next we take the difference between the Prosper and LC calculated rates. Grade averages excludes differences between the bottom 2 grades (LC: F, G and Prosper: E, HR). PeerIQ performs basic data ETL to ensure the original data has integrity. Data includes vintages from 2009 3Q thru 2014 1Q for 3y notes and 2010 4Q thru 2014 1Q for 5y notes. Source: Lending Club, Prosper, PeerIQ Research.

For prepayments, the story is similar. Older Prosper vintages have higher prepayment rates than corresponding Lending Club vintages, but for recent vintages the rates converged. For example, the average quarterly rate difference for the highest graded pairs of 3-year loans was approximately +3% in 2012 1Q and then approximately even in 2013 4Q. The same trend appears for 5-year loans, but is less pronounced.

Conclusion

Overall, a greater amount of higher grade issuance by major platforms belies the notion that as the industry matures, credit quality standards will decline. Smaller platforms are pursuing mid-prime and subprime borrowers. But the two major ones set the pace for the broader market and they have remained focused on higher quality borrowers. This could be, in part, attributable to the notion that large platforms may better identify higher grade borrowers due to their evolving risk modeling. A deeper performance history and a larger set of independent variables allow large platforms to more accurately target attractive borrowers and score credit risk. For example, in July 2015, Prosper rolled out their PMI 6 underwriting model, which shows significant changes to PMI 5. For example, approximately 60% of loans in a sample set that would have had PMI 5 grades of A-HR ended with a higher grade using the newer model. Therefore, the industry may be better able to attract and satisfy customers seeking to responsibly manage their finances.

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