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# Competition Policy in Consumer Financial Services: The Disparate Regulation of Online Marketplace Lenders and Banks

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## INTRODUCTION

In October 2014, Washington D.C. City Council passed legislation that effectively allowed Uber to operate in the District. David Plouffe, formerly an advisor to the President and now an executive with Uber, greeted the new legislation with the following observation:

> Obviously what we're doing doesn't necessarily in all cases fit in existing regulation. I think that's what Washington really wrestled with and decided they needed to chart a new pathway forward. So rather than say how do we fit this new technology and service into existing regulations, let's look at how do we create new regulations that give citizens of the city the right kind of confidence on things like safety, on things like insurance.[2]

Uber is just one of many startups struggling to fit their businesses into existing regulatory frameworks. As technological innovation leads to new business models, there is increasing friction between these new companies and the existing regulatory regime.

The tension between regulated entities and new entrants is particularly acute in the context of online marketplace lending.[3] While bank lenders enjoy regulatory privileges that enable them to lend immediately to consumers in all 50 states, non-bank lenders are forced to engage in resource-intensive analyses to satisfy state-specific compliance requirements. As non-bank lenders expand access to credit to those currently underserved by banks—providing new underwriting methodologies, real-time data transmission and new financing mechanisms—disparate regulation of banks and non-bank lenders appears problematic.

In the past, where new entrants have challenged existing regulatory frameworks, restructuring has occurred to ensure a functioning market. This continues to happen in a number of industries, with the Uber-led transformation of taxi regulation being the most prominent. This kind of regulatory reorganization is also needed in the lending space. The existing framework for regulating the delivery of financial services works

against the interests of consumers, competition, regulators and society as a whole. A state-by-state legal regime serves as barrier to entry protecting incumbent banks from competition and depriving consumers of alternatives. There is simply no reason why banks should enjoy access to the common market while non-bank lenders cannot.

This is not to say that banks and non-banks should be treated similarly on all counts. There are numerous situations in which it is appropriate for banks to maintain regulatory privileges inaccessible to non-banks. In fact, in the context of financial services, banks tend to bear a greater regulatory burden than non-banks (e.g., application of customer identification program requirements, required maintenance of leverage ratios, etc.). In the lending context, however, banks' unique ability to offer products on a nationwide basis remains largely unjustified.

In Part I below, we provide an overview of online marketplace lending. We suggest that marketplace lenders offer value that is not currently replicable by banks. Part II examines marketplace lending across state lines, recognizing the near impossibility of full compliance. Part III provides examples of cases in which new entrants have successfully challenged existing regulatory frameworks. In these cases, regulatory change reinvigorated competition to the benefit of consumers. Finally, in Part IV, we suggest the need for reorganization of the existing lending regulatory framework. The current bifurcated regulatory framework increases costs to consumers, limits consumer choice and insulates banks from competition.

**Online Marketplace Lending Benefits Both Underserved Borrowers and Investors**

In the past few years, marketplace lending has emerged as an alternative to traditional bank lending. In the wake of the 2008-2009 financial crisis, banks tightened credit guidelines. This left many consumers and small businesses without access to bank-issued credit. Total consumer lending fell by 6.1 percent between January 2009 and March 2010.[4] At the same time that they tightened credit standards, banks found themselves a safe haven for deposits even as yields on those deposits plummeted.

The simultaneous tightening of credit standards and drop in yields created an opportunity for new credit intermediaries to emerge. Marketplace lenders filled this gap. In their initial incarnation, firms such as Prosper and Lending Club enabled lenders to fund loans to borrowers. They and other alternative lenders simultaneously expanded the pool of available credit and enabled yield-starved investors to obtain a positive rate of return on funds that would have generated no return had they been left on deposit at banks and other depository institutions.

Marketplace lenders differ from traditional financial institutions in a number of ways. First, marketplace lenders often serve demographics that are underserved by bank lenders. Marketplace lenders have enabled "thin file" borrowers and small business borrowers to access credit that traditional financial institutions were unwilling to extend. Borrowers rendered ineligible by traditional bank underwriting models may find investors on online marketplaces willing to finance their credit needs. Alternative underwriting models may enable such lenders to extend credit to thin file borrowers who would not qualify for credit based solely on traditional underwriting criteria such as FICO score.

Second, marketplace lenders rely on technology to reduce the cost of connecting borrowers with lenders. They use algorithms, rather than lending officers, to screen borrowers, and they provide granular

information about repayment risk to investors. Further, many such platforms have eliminated unnecessary or unwanted services associated with traditional lenders, such as branches and other physical locations.[5] Through better underwriting and more efficient operations, marketplace lenders and other lending platforms have lowered the cost of obtaining loans and are able to offer borrowers credit on better terms.

Third, platform lenders offer value to investors. Marketplace lenders have enabled investors to diversify their investment portfolios by investing directly in individual loans. Even to the extent that investors choose to fund pools of loans rather than individual loans, marketplaces may be able to pass a larger portion of the interest that those loans generate to the investors that fund their loans.[6]

**Marketplace Lending Across State Lines Triggers Significant Compliance Obligations**

In lending across state lines, marketplace lenders, like other non-bank lenders and, indeed, all non-bank providers of financial services, confront a complex, unstable and fragmented regulatory regime. The regulatory thicket that surrounds the financial services industry in the United States, particularly the lending business, is Byzantine. A firm that is considering launching a product that provides liquidity to customers must grapple with a long list of Federal laws and regulations, including the Truth-in-Lending Act,[7] the Fair Credit Reporting Act,[8] the Electronic Funds Transfer Act,[9] the Equal Credit Opportunity Act,[10] Regulation Z,[11] and Regulation E[12] (to name but a few). Individual states have their own laws. California, for example, regulates non-bank lenders through the California Constitution,[13] the Finance Lenders Law[14] and, in some instances, the Consumer Legal Remedies Act.[15]

How and whether any one of these laws or regulations applies turns on a number of factors, including the following: (1) whether the service is provided for household use; (2) whether the service provider is a bank (or other federal insured deposit taking institution); (3) whether the service creates a debt enforceable against the customer; (4) whether the service involves a finance charge on a loan or a "time-price" charge associated with a sale; (5) whether the service is associated with a prepaid account but not a deposit account; and (6) whether the information on which the decision to provide liquidity is collected from the customer directly, third parties that have a direct relationship with the customer, or third parties that collect information from others about the customer.

This body of law and regulation is also unstable. Regulators, courts, and, of course, legislatures change the rules from time-to-time, and these changes can have significant repercussions for industry participants. The Second Circuit's recent decision in *Madden v. Midland Funding, LLC*,[16] provides one timely example. *Madden* arose from a dispute between a consumer and purchaser of debt owed by the consumer to the bank that had issued the consumer a credit card.[17] The consumer sued the debt collector in New York state court alleging that the fees charged by the debt collector exceeded the cap set by New York usury law.[18] The Second Circuit held that federal preemption was not available to the debt collector in collecting the debt pursuant to the terms of the loan agreement because the debt collector was acting on behalf of itself rather than the bank.[19] The court deflected criticism that its decision would undermine the sale of charged-off debt by banks by arguing that it "would not significantly interfere with any national bank's ability to exercise its powers under the [National Bank Act]."[20]

Among other things, *Madden* illustrates that the regulatory burdens and benefits are not evenly distributed in the lending space. On its face, the Second Circuit's decision creates a special privilege for banks relative to non-banks. A bank purchaser of another bank's debt can, under the Second Circuit's analysis, invoke its ability to preempt state law to block a consumer's challenge to the fees collected by the second

bank based on the loan originated by the first. Most non-banks not exercising the powers of a national bank, according to the Second Circuit, have no such right.[21] Both of the publicly traded platform lender, Lending Club and OnDeck, saw their valuations decline relative to traditional lenders in the wake of the decision, and commentators have attributed the relative severity of the decline to regulatory risk.[22]

The existing regulatory framework for regulation of non-bank lenders is a patchwork of complicated and overlapping state laws and regulations. Each state sets a different maximum interest rate that parties may contract for, and this rate may vary depending on whether the credit will be used for personal, household or family purposes (i.e., consumer credit) or for business purposes (i.e., commercial credit). In many states, consumer and/or commercial lenders may be authorized to charge interest above a state's usury cap if they obtain a state lender license—a time-consuming and expensive process. For example, a marketplace lender may contract with a Utah-based borrower for any rate of interest without a license.[23] In Virginia, a lender must obtain a lender license to offer consumer loans to Virginia residents at interest above 12 percent per annum.[24] In California, a license is required to engage in the business of a finance lender, regardless of what interest rates are offered.[25]

Lender license applications can also be quite burdensome and appear designed to deter applications. The applications often require applicants to submit background checks and fingerprints on all persons owning or controlling 10 percent or more of the lending entity, financial statements, and surety bonds. Nevada, for example, requires lenders to maintain a physical office in the state—a requirement that is particularly onerous for online lenders with no physical location.[26]

**To Avoid State Lending Laws, Marketplace Lenders Are Forced to Partner with Banks**

To avoid this morass of state lending laws, a number of marketplace lenders have chosen to partner with banks. A regulatory regime where the burden of compliance is so high that companies are forced to partner with competitor incumbents to provide cost-effective products seems unequivocally problematic.

Both Prosper and Lending Club were, in their original incarnations, fairly novel. They enabled investors to fund loans extended to individuals without a traditional financial institution, either a bank or licensed lender, serving as originator. Yet although Prosper and Lending Club were serving as intermediaries between borrowers and investors, neither used the form that has dominated the consumer lending business in the United States since the early part of the Twentieth Century—i.e., a chartered financial institution such as a bank, credit union or thrift. And it was not at all clear how either company thought that it was complying with the raft of Federal and state laws related to consumer lending.[27]

But times have changed. In the almost ten years that have passed since Prosper got its start, Prosper and Lending Club have almost completely reinvented their businesses. Today, both companies rely on banks to originate loans. Likewise, both companies have jettisoned the direct investment approach. Under the model that both companies have now adopted, investors no longer directly fund loans to borrowers. Rather, the companies interpose intermediaries that own the right to the receivables generated by borrowers, and those intermediaries then pay investors based on the repayment history of borrowers. Although the platforms offer investors far more visibility into the performance of particular loans, the structure of the relationship between investors in the loans and borrowers is similar in form to traditional securitization.[28]

Viewed through this lens, the "new" platform lending businesses look pretty similar to "old" consumer lending businesses. That is, a non-bank contracts with a bank to help the bank acquirer borrowers, underwrite

those borrowers, service those borrowers and manage the resulting portfolio for the benefit of third-party investors. Although some of the details have obviously evolved, the basic components of the "new" platform-lending model should be familiar to anyone who has followed the credit card industry since General Motors offered the GM Rewards card in the 1980s.[29] In fact, the 1996 Narratives to the Office of the Comptroller of the Currency handbook issued for the supervision of credit card lending describes the component parts of a credit card business in terms that mirror the relationship between platform lenders, their bank origination partners, consumers, and investors.[30]

Having chosen to partner with a state chartered bank for the origination of the loans, Lending Club and Prosper have subjected themselves to regulatory supervision in more or less the same way that non-bank technology providers have been subjecting themselves to regulatory supervision for decades. The loans are bank products, and the banks that originate them are answerable to their regulators for the financial performance of those loans as well as the many regulatory issues that arise in connection with the issuance of such loans. In short, Lending Club and Prosper have achieved regulatory compliance by relying on banks' preemptive privileges.

**Varied State and Federal Regulation in the Airline, Telecommunications and Taxi Industries Demonstrate the Need for Regulatory Reorganization**

The fact that Lending Club and Prosper felt compelled to partner with a bank to reduce the regulatory burden should be understood as broad indictment of that regulatory regime. In other industries where new business models have challenged existing regulatory frameworks, the government has been willing to revise the overarching regulatory framework to ensure a functioning market. In the airline, telecommunications, and taxi industries, for example, existing regulations unfairly advantaged incumbents, thus precluding competition. To ensure a functioning market, regulatory reorganization was necessary.

Prior to passage of the Airline Deregulation Act of 1978[31] ("ADA"), airlines were heavily regulated by the Civil Aeronautics Board ("CAB"). The CAB had jurisdiction to control route entry and exist of air carriers, regulate fares, award subsidies, and control mergers and inter-carrier agreements.[32] The inflexibility of this federal regulation made it increasingly difficult for carriers to comply. A number of studies determined that economic regulation resulted in excessively high fares and a net economic loss to society at large.[33]

In an effort to avoid this stringent federal regulation, some carriers began investing in intrastate travel—a market that remained outside of CAB jurisdiction. Carriers operating in the unregulated intrastate markets were able to offer lower fares to consumers and avoid CAB regulation all together.[34] As Lewis A. Engman, then chairman of the Federal Trade Commission stated,

If you have any doubt that one consequence of the CAB's control over rates and routes is higher prices, you need only look at what happened some years ago in California when Pacific Southwest Airlines, an intrastate carrier not subject to CAB regulation or entry restrictions entered the San Francisco/Los Angeles market with rates less than half those being charged by the interstate CAB certified carriers TWA, Western, and United.[35]

Fares were 30 percent less for the unregulated intrastate airlines in Florida.[36]

Eventually, economists determined that economic regulation in the airline industry was distorting the efficient performance of the marketplace. With leadership from Senator Edward Kennedy, Congress

eventually passed the ADA. The ADA rescinded CAB's authority over route entry and exist, airline fares, and mandated that the CAB be dissolved by 1984. In essence, the government acknowledged that there was a problem: consumers were poorly served by a system that incentivized airlines to provide only intrastate travel.

Similarly, the telecommunications faced significant organization where state and federal regulation were set up so as to encourage monopolistic behavior. Prior to 1969, the telecommunications industry was regulated as a lawful monopoly.[37] Local telephone service was provided by an operating company of the AT&T-owned Bell System or by one of approximately 1,600 independent telephone companies. Long distance telephone service was provided by the long Lines Department of AT&T in partnership with the Bell operating companies.[38]

In 1969, however, the Federal Communications Commission approved an application submitted by AT&T competitor MCI to construct and operate a long distance telephone system between Chicago and St. Louis.[39] Effectively, however, to provide long distance service, MCI would need to rely on AT&T-owned interconnections and local distribution facilities. Although MCI and AT&T attempted to negotiate a permanent agreement regarding access to this infrastructure, negotiations failed. Among other things, MCI claimed that AT&T was unlawfully denying it interconnections and that it was being charged excessive and discriminatory prices for local distribution facilities.[40] MCI filed suit. Shortly thereafter, the Department of Justice ("DOJ") began an investigation.

Again, consumers were unable to benefit from competition in the market. And again, the government was forced to step in. After a protracted lawsuit, AT&T settled with the DOJ. Among other things, AT&T agreed to divest itself of the operating companies that provided the local exchange service. Challenging AT&T's established monopoly, new entrant, MCI effectively transformed the existing regulatory paradigm, opening telecommunications up to multiple providers and offering consumers greater choice.

This trend—new business models threatening existing regulatory frameworks—continues today. As noted at the beginning of this article, Uber poses a tremendous threat to the incumbent taxi industry. While common carrier regulations are well intentioned, these regulations were written in a time before geolocation-enabled smartphones and ride-sharing applications. They reflect and benefit regulatory concerns associated with taxi service, not peer-to-peer ride-sharing. Yet as consumers continue to use Uber's services and demand regulatory changes to support Uber's business, state governments have begun to revise state utility laws to accommodate Uber—despite taxi industry protests.

In California, for example, Uber was successful in lobbying the California Public Utilities Commission ("CPUC") to create a new category of regulated entities ("Transportation Network Companies") to cover peer-to-peer ride-sharing services. Recognizing the value of Uber's product, the CPUC altered its regulatory framework, thus expanding the market for transportation services and consumer choice.

**Leveling The Playing Field Between Banks and Non-Banks**

In the same way that new entrants have forced re-examination of the regulatory framework for the airline, telecommunications and now, taxi industries, the effort of Prosper, Lending Club and countless others to reinvent financial services should lead regulators to re-evaluate the regulatory framework for that industry. The fact that Lending Club and Prosper have effectively joined the club by partnering with incumbents does not give regulators in this industry a pass.

Banks have a vested interest in preserving the regulatory status quo. Banks benefit from the complexity, instability and fragmentation of regulation in two ways. First, banks are incumbent providers of services that others would like to offer, and as incumbents, the complex and unstable regulatory regime serves as a barrier to entry. Second, banks have a unique ability to export the terms of the loans that they offer from the states in which are chartered to the states in which their consumers reside.[41]

There is no policy justification for giving banks and other chartered financial institutions a monopoly on the ability to export contract terms from one state to another. Although banks are subject to prudential supervision, there is no discernable connection between onsite government supervision to protect against the systemic risks that massively leveraged institutions create for the economy as a whole and banks' unique ability to exploit the efficiencies associated with the common market. Exportation of product terms is not a source or solution to the systemic risks created by the enormous leverage that lurks on bank balance sheets. In short, the risks that uniquely justify much of the supervision of banks do not also justify their sole ownership on exportation. After all, the massive risks of leveraged institutions simply are not present for online lending marketplaces or other alternative lenders. To the extent that exportation of product terms creates regulatory issues, those regulatory issues fall in the realm of consumer protection, and in the wake of the passage of Dodd-Frank, that playing field has been largely leveled with the creation of the Consumer Financial Protection Bureau.

The bank monopoly on national contracting is also a relatively recent creation. Until the mid-1960s, the prevailing rule in U.S. courts when faced with disputes about which law to apply to a lending agreement—the law of the domicile of the lender or the law of the domicile of the borrower—did not turn on whether the lender was a bank or an unchartered financial institution. Courts generally enforced the law of the lender, rather than the borrower.[42] When the prevailing judicial approach to conflict of laws changed in the 1960s, banks sought new ways to ensure that their contracts could be enforced on a nationwide basis, and courts eventually latched on to the pre-emptive force of federal banking statutes. Although non-banks cannot currently claim a similar right, they could regain the ability to export terms if courts simply reverted to the conflict rule that used to apply to lenders regardless of charter—i.e., that the law of the state of the lender, not the borrower, governs the relationship between the two.

**Conclusion**

The broader point goes well beyond giving non-banks the same ability to contract across state lines as banks. In the financial services industry today, as in the telecommunications and transportation industries a generation ago, competition has essentially been lost as a guiding regulatory principle. Regulatory compliance has become an economic moat that existing providers are using to fend off disruptive competition. Rather than looking for ways to force upstarts to join with those incumbents, regulators in this industry should look for inspiration in the examples of the past and find ways to level the regulatory playing field. Leveling the playing field will ensure greater consumer access to better financial products.

[1] Thomas P. Brown is a partner and Molly E. Swartz is an associate at Paul Hastings LLP. The views expressed are entirely their own. Their views do not represent the view of the firm or any client of the firm.

[2] Dana Rubenstein, "Uber Publicly Embraces Regulation, the 'Modern' Sort," *Politico New York*, October 29, 2014, http://www.capitalnewyork.com/article/city-hall/2014/10/8555647/uber-publicly-embraces-regulation-modern-sort.

[3] For purposes of this paper, we use the phrase "marketplace lenders" to distinguish between bank lenders and technology driven lenders. In our experience, however, this taxonomy is a bit narrow in that technology driven lenders follow two variations—(1) those that involve discrete sources of third-party capital and are generally described as "marketplace lenders" such as Prosper, Lending Club, and OnDeck; and (2) those that lend off their own balance sheet such as PayPal Credit but that use an essentially identical origination model and are generally described as "platform lenders."

[4] "Epic Consumer Credit Crunch Unfolding," *Seeking Alpha*, March 2, 2010, http://seekingalpha.com/article/191517-epic-consumer-credit-crunch-unfolding.

[5] Andrew Verstein, "The Misregulation of Person-to-Person Lending," *U.C. Davis Law Review* 45, (2011): 445, 457.

[6] *Id*.

[7] 15 U.S.C. §§ 1601 *et seq*.

[8] 15 U.S.C. §§ 1681 *et seq*.

[9] 15 U.S.C. §§ 1693 *et seq*.

[10] 15 U.S.C. §§ 1691 *et seq.*

[11] 12 C.F.R. §§ 1026 *et seq*.

[12] 12 C.F.R. §§ 205.1 *et seq.*

[13] Cal. Const. art. XV, § 1.

[14] Cal. Fin. Code §§ 22000 *et seq*.

[15] Cal. Civ. Code §§ 1750 *et seq*.

[16] *Madden v. Midland Funding, LLC*, 786 F.3d 246 (2d Cir. 2015).

[17] *Id*. at 247-49.

[18] *Id*.

[19] *Id*. at 245-53.

[20] *Id*. at 249.

[21] *Id.* at 251 (stating that "[i]n most cases in which NBA preemption has been applied to a non-national bank entity, the entity has exercised the powers of a national bank—i.e., has acted on behalf of a national bank in carrying out the national bank's business. This is not the case here."). *See also Marquette Nat. Bank of Minneapolis v. First of Omaha Service Corp.*, 439 U.S. 299, 308, 313-316 (1978) (holding that a federally chartered bank may offer loans to consumers in any of the other 49 states at any interest rate allowed by the bank's state of residence regardless of whether the consumer's home state recognizes a lower usury cap); *Smiley v. Citibank (South Dakota), N.A*., 517 U.S. 735 (1996) (holding that the NBA preempts state limits on fees as well as finance charges).

[22] Leena Rao, "Once-hot Online Lending Companies Go Cold in Face of Skepticism," *Fortune*, June 30, 2015, http://fortune.com/2015/06/30/lending-club-ondeck-shares.

[23] Utah Code Ann. § 15-1-1 (West).

[24] Va. Code §§ 6.2-1501, 6.2-303.

[25] Cal. Fin. Code § 22100(a).

[26] Nev. Rev. Stat. §§ 675.090(2)(a); 675.090(3).

[27] Eileen Ambrose, "Peer-to-Peer Lending Alternative Runs into a Regulatory Wall," *Baltimore Sun*, December 7, 2008, http://articles.baltimoresun.com/2008-12-07/business/0812060058_1_lending-sites-peer-to-peer-lending-prosper-loans (stating that "Peer-to-peer lending . . . recently has come into regulators' sights . . . [sidelining] the largest peer-to-peer lending site, Prosper.com," and also quoting Lending Club CEO's statement that he "concluded that the industry was headed toward regulation.").

[28] Jane Kim, "Peer-to-Peer Lender Relaunched," *Wall Street Journal*, April. 28, 2009, http://www.wsj.com/articles/SB124088142201761953; Prosper Funding LLC, August 2015 prospectus for up to $500,000,000 in principal amount of Borrower Payment Dependent Notes at *10, https://www.prosper.com/Downloads/Legal/Prosper_Prospectus_2015-08-13.pdf ; Lending Club, August 2014 prospectus for Member Payment Dependent Notes at *7, https://www.lendingclub.com/fileDownload.action?file=Clean_As_Filed_20140822.pdf&type=docs.

[29] David S. Evans and Richard Schmalensee, *Paying with Plastic* (Cambridge: The MIT Press, 2005), 78-79.

[30] *See* OCC Credit Card Handbook 1996 at 12 ("Although some institutions develop their own scoring models, most are built by outside vendors."); *id.* at 5 ("Issuing banks often employ outside vendors to perform solicitation, servicing, collections, or other functions ….").

[31] Airline Deregulation Act of 1978, Pub. L. No. 95-504, 92 Stat. 1705 (codified as amended in scattered sections of 49 U.S.C.).

[32] Andrew R. Goetz and Paul S. Dempsey, "Airline Deregulation Ten Years After: Something Foul in the Air," *Journal Air Law and Commerce* 54, (1986): 927, 929.

[33] *Id*. at 930.

[34] *Id*.

[35] Christine Chmura, "The Effects of Airline Regulation," *The Freeman*, *Foundation for Economic Education*, August 1, 1984, http://fee.org/freeman/the-effects-of-airline-regulation/ quoting Lewis A. Engman, "Regulating Industry," *Washington Post*, October 15, 1974.

[36] *Id.* quoting Robert Lindsey, "Airline Deregulation is Weighted," *New York Times*, February 7, 1975, p. 39.

[37] *MCI Communications Corp. v. American Tel. & Tel. Co*., 708 F.2d 1081, 1093 (7th Cir. 1983).

[38] *Id*.

[39] *Id*. at 1094.

[40] *Id*. at 1096.

[41] 12 U.S.C. § 1831d; *Greenwood Trust Co. v. Mass.*, 971 F. 2d 818, 826 (1st Cir. 1992).

[42] *Ury v. Jewelers Acceptance Corp.*, 227 Cal. App. 2d 11 (Ct. App. 1964).