Marketplace Lending Investments

A primer for investment managers

JOSEPH SUH AND THOMAS R. WEINBERGER, SCHULTE ROTH & ZABEL LLP

Web-based platforms offering marketplace lending, or P2P lending, are proliferating as many traditional consumer and small business lenders struggle with increasing regulatory compliance costs and operational inefficiencies. Sponsors of marketplace lending platforms, such as Lending Club, Prosper and OnDeck, use proprietary advanced technologies to bring the loan underwriting process to the digital age and expedite the loan approval process. Institutional investors in the United States, Europe and Asia appear to have substantial interest in investing in marketplace loans because of the favorable risk-return profile of such investments relative to other comparable loan products. A recent survey by the influential New York Hedge Fund Roundtable confirms the growing interest of hedge funds in acquiring loans through marketplace lending platforms. This article is highlights important considerations for investment managers who may be interested in managing a private investment fund or a securitisation issuer that invests in marketplace loans.

No water without an NDA...

Before investing the assets of a private investment fund in marketplace loans originated by any platform, the investment manager of the fund must conduct a thorough diligence review of the platform's sponsor and the platform's underwriting and servicing processes. In connection with any such diligence, the investment manager will be required to sign some form of non-disclosure agreement (NDA) restricting the use of certain confidential information that will be provided to the investment manager. Sensitivity among marketplace lending sponsors over confidentiality is high. Paraphrasing a manager that has invested in marketplace loans from multiple platforms, some marketplace loan platform sponsors believe that their platforms are such unique golden geese that during a site visit "they will make you sign an NDA just to use their water coolers." It is important for investment managers to negotiate the terms of the NDA carefully so that the NDA does not restrict the manager's ability to provide information to its investors and regulators, including pursuant to routine SEC examination, without the burden of procuring the sponsor's approval.

May I have another (loan) please?

Most marketplace loans are short term loans (12 months to 36 months), the sizes of the loans are small relative to the corporate leveraged loan market (ranging from a few thousand dollars to under a million dollars) and marketplace loans are not "portable credit" like credit cards. These factors make the volume of marketplace place loans small relative to comparable traditional consumer and business loans. Loans made to borrowers with good credit can be particularly hard for investors to source. This limitation may be severe for loans originated by marketplace lending platforms with good historical performance. Before investing substantial resources to diligence a particular marketplace lending platform, the investment manager should consider entering into an agreement with the sponsor that, among other things, requires the sponsor to give the manager's investment funds access to a specific percentage of loans originated under the platform for a specified number of months.

Loans that are non-loans

Certain loan products that are offered by some platforms are not, in fact, loans. This is particularly true for platforms that sell 'fractional loans' or slices of loans in the form of notes issued by the sponsor or one of its affiliates. Such notes are, in fact, more like credit-linked notes or notes referencing the performance of the underlying loans, and are referred to as 'borrower payment dependent notes.' The performance of such notes are not only dependent on the performance of the borrowers of the underlying loans but also the performance by the issuer of such notes. This means that the investor will be exposed to not only the credit risk of the underlying borrowers but also the credit risk of the issuer. Careful diligence of the issuer's financial situation and the terms of the notes should be conducted by the manager before investing in the notes.

Loan purchase and servicing agreements

When negotiating loan purchase and servicing agreements with a marketplace platform sponsor, the investment manager will need to consider several key issues:

- How are loan collections paid to the investor?
- Are they held by the servicer before they are wired to the investor's account?
- Are there fees to the sponsor or third-parties that will be automatically deducted from loan collections (the investor is subject to the fee payee's credit risk) or does the investor pay such fees out of the loan collections (the fee payee is subject to the investor's credit risk)?
- Are fees payable to the sponsor or third-parties significant enough to eliminate most of the excess spread upside from the loans to the investor while the investor remains exposed to all of the downside on the credit risks of the loans?
- What notice or consent rights will the investor have to potential changes to the loan underwriting and servicing criteria used by the sponsor?
- What information and reporting rights will the investor have? For instance, will the sponsor agree to provide information required by leverage providers or, in connection with any securitisation transaction, rating agencies?
- Loan eligibility criteria must be carefully constructed and negotiated by the investment manager with not only the sponsor of the platform but also any leverage provider or, in connection with any securitisation transaction, rating agencies. These criteria will need to address, among other things, restrictions on the inclusion of loans made to borrowers in certain states that might have usurious interest rates in those states in light of the decision from the 2nd Circuit Court of Appeals in Madden v. Midland Funding.

- Representations and warranties about the loan portfolio made by the seller (and the terms of any repurchase obligation and other remedies in the event of a breach of such representations and warranties) will need to be robust enough to give comfort to the investing fund about the loan portfolio because the fund, as a borrower under a loan facility or the issuer of securitisation securities, will itself need to make representations and warranties about the loan portfolio.

Leverage and first child as collateral

Use of leverage to increase the returns on a fund's investment in marketplace loans may be important to attract investors to the fund. Although the number of banks willing to provide loan facilities collateralised by marketplace loans is increasing, most of the lenders currently operating in this space will require a substantial collateral package and conservative borrowing base tests.

It is not unusual for such lenders to require the fund to pledge all of its assets to collateralise the loan and require the principals of the investment manager to provide personal indemnities with respect to certain willful breaches made by the borrower or the investment manager. More than one manager has said (in jest, we believe) that some lenders exclude the principals' first born children from the collateral package only because of potential UCC perfection issues.

It is also not unusual for such lenders to require that 100% of cash collections from the loan portfolio be used to pay down fees, interest and outstanding principal under the loan facility. This means that the fund must rely on its ability to borrow from the loan facility to meet all obligations, such as paying the fund's operating expenses and meeting investors' withdrawal requests.

In light of the lender-friendly loan terms, the investment manager may wish to hold a marketplace loan portfolio through a wholly-owned subsidiary and restrict the reach of the lender lending against that portfolio to the assets of that subsidiary.

Securitisation of marketplace lending portfolios

With several rated transactions consummated in 2015, the securitisation of marketplace lending assets is becoming a critical link in the broader funding environment for marketplace lenders. At the end of 2015, total issuances stood at nearly $45 billion, with consumer loans and student loans comprising the bulk of the securitised assets. To date, securitisation of marketplace loans has been limited to loans originated through a handful of the top platforms, but as the asset class is better understood and other originators mature and establish longer performance records, the securitisation of marketplace loans is expected to grow.

Despite the optimistic forecasts for future growth, there are issues that, if left unaddressed, may limit the demand in the securitisation market for marketplace loans. The start of 2016 saw the first downgrade of certain tranches of marketplace lending securitisations, primarily due to an uptick in defaults on unsecured consumer loans. In response, some marketplace lenders have increased rates charged to borrowers. Proper, a leading marketplace lender active in unsecured consumer loans, has increased rates to certain borrowers by as much as 140 basis points. Another challenge is the fact that some originators may not be prepared to provide the full set of representations and warranties found in asset backed securitisations (such as representations and warranties concerning credit quality, origination and servicing). While certain originators have met the demand for traditional ABS representations and warranties, others have resisted. Whether the resistance will last or whether the market will come to accept the underlying underwriting performed by the originators and the related servicing with a more modest set of representations and warranties remains to be seen.

Tax challenges

A non-US investor investing in a fund that invests in marketplace loans will typically be concerned about investments that could potentially generate effectively connected income from a US trade or business (ECI). The investment manager will need to consult with the fund's tax counsel and accountants to analyse the loan origination process of each platform and the fund's loan purchase process for each platform to determine if the fund's investment in the marketplace loans create ECI issues. Depending on the results of this analysis, careful structuring of the investment process and appropriate disclosure of ECI risks in the offering materials will be needed to minimise both ECI risks and the fund's disclosure liability.

ECI is just one of several issues that an investment manager will need to address. Depending on the fund's structure, the manager of the fund will need to address other tax issues, such as potential phantom income and related PFIC issues.

Investing in marketplace loans is not something that can be done casually. The investment manager must not only conduct substantial diligence on the platform and its sponsor but also carefully consider certain important issues, many of which are discussed above. **THFJ**

ABOUT THE AUTHORS

Joseph Suh and Thomas R. Weinberger are partners in the Structured Finance & Derivatives Group at Schulte Roth & Zabel LLP (SRZ). SRZ is a full-service law firm that represents leading investment managers in connection with investments in marketplace loan products.

Schulte Roth&Zabel
New York | Washington DC | London | www.srz.com