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2024

Rethinking Regulations for P2P Lending

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ABSTRACT

The peer-to-peer ("P2P") lending industry has undergone a remarkable transformation since its nascent beginnings in the early 2000s. Evolving from a time characterized by lenient regulations aimed to foster industry growth, the P2P lending sector has matured and now faces a complex regulatory landscape that reflects its importance in the broader financial ecosystem. Following the global financial crisis, the P2P lending sector experienced robust growth. The industry's promise of democratizing finance struck a chord with investors and borrowers alike.

However, recent developments have cast a shadow over the P2P lending landscape. The P2P lending industry, which was once a beacon of financial innovation and inclusivity, now finds itself grappling with regulatory uncertainties. These uncertainties have imposed substantial challenges on the core business model of P2P lending, raising concerns about its future sustainability and growth prospects.

This paper aims to explore a pressing question: Is there a need for updated regulatory changes to safeguard the future of P2P lending? As the industry contends with maturing changes, increased regulatory scrutiny, and the persistent uncertainty in legal interpretation, it is crucial to assess the merits and shortcomings of the existing regulatory framework. In doing so, this paper aims to shed light on whether updated regulations are necessary to ensure the continued viability of P2P lenders in a regulatory environment that is increasingly challenging and sometimes adversarial. This investigation delves into the evolving P2P lending industry, its characteristics, and the challenges it faces. By examining the impact of regulatory changes on the industry's development and competitiveness, this discussion looks to contribute to the ongoing discourse on the future of P2P lending and its critical need for regulatory clarity.

I. BACKGROUND

a. What is P2P lending?

Peer-to-Peer ("P2P") lending and borrowing is a subset of fintech[1] firms that have revolutionized traditional lending and financial services. These platforms facilitate direct transactions between individuals or small businesses, cutting out traditional financial intermediaries, such as banks.[2] P2P lending companies provide a digital marketplace where borrowers can access loans, often at competitive rates, while lenders[3] can fund these loans and earn interest, creating a win-win scenario for both parties.[4] P2P lending aimed to democratize access to credit and investment opportunities, offering a more inclusive and efficient financial ecosystem. The market size is currently USD $5.91 billion and expects to reach USD $21.41 billion by 2030, growing at a compounded annual growth rate (CAGR)[5] of 20.2% from 2023 to 2030.[6] Changing consumer preferences and attitudes toward borrowing and investing have propelled the growth of the P2P lending market in the last decade, with a growing number of individuals preferring to borrow directly from peers or investing directly in loans that align with their goals.[7] The COVID-19 pandemic accelerated the growth and wider acceptance of the fintech lending

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[1] Fintech is used here to describe technology companies that leverage technology and digital platforms to facilitate various aspects of P2P lending. This paper will focus only on the P2P aspect of fintech lending. For an overview of other fintech lending, *see* Danielle Antosz, *What is fintech lending? Benefits, examples, and impact* (Oct. 3, 2022), available at https://plaid.com/resources/fintech/what-is-fintech-lending/.

[2] Marketplace Lending, *FDIC Supervisory Insights* (2016), available at https://www.fdic.gov/regulations/examinations/supervisory/insights/siwin15/siwinter15-article2.pdf. [hereinafter FDIC Insights].

[3] Lenders can be individuals or institutions. For the purpose of this paper, the difference is immaterial, and we refer to them collectively as lenders.

[4] FDIC Insights, s*upra* note 2. (note that the insight refers to P2P lending as "marketplace lending," the two terms are often used interchangeably).

[5] CAGR is a financial metric used to measure the annual growth rate of an investment, asset, or business over multiple periods.

[6] *See Peer-to-Peer Lending Market to Hit $21.42 Billion by 2030: Grand View Research, Inc.*, Bloomberg (Aug. 28, 2023, 6:30 AM EDT), available at: https://www.bloomberg.com/press-releases/2023-08-28/peer-to-peer-lending-market-to-hit-21-42-billion-by-2030-grand-view-research-inc.

[7] *Id.*

market.[8] With reduced access to physical bank services, borrowers and investors found P2P lending to be a highly convenient and efficient alternative.

b. Historical Development of P2P lending

The concept of P2P lending originated in the UK in 2005 when Zopa, the world's first P2P lending platform, was founded.[9] In 2006, the P2P lending model made its way to the United States with the establishment of Prosper and Lending Club.[10] These platforms looked to be an alternate source of funding for borrowers and offered a novel investment opportunity for lenders. However, it was in the aftermath of the 2008 financial crisis that P2P lending truly gained traction.[11] As trust in traditional financial institutions waned, people turned to P2P platforms seeking more accessible and flexible credit options.[12]

Since emerging more than a decade ago, P2P lending has experienced dramatic growth. The acceptance of P2P lending became more widespread as these platforms proved their reliability and efficiency, helping to reshape the lending landscape. But this growth also uncovered many of the underlying risks and vulnerabilities of the P2P lending model. In addition to the usual risks inherent in loans (whether originated by P2P platforms or traditional banks), such as credit risk,

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[8] *See* Guilio Cornelli et al., *The impact of fintech lending on credit access for U.S. small businesses* (Monetary and Economic Department, September 2022), available at: https://www.bis.org/publ/work1041.pdf (finding that fintech lenders filled a credit gap during a time of dried-up funding supply during the COVID-19 pandemic and facilitated PPP loans for small businesses that did not have established banking relationship).

[9] *See* Ulrich Atz & David Bholat, *Peer-to-peer lending and financial innovation in the United Kingdom*, Bank of England (Staff Working Paper No. 598, April 2016), at 6.

[10] *See* Jack R. Magee, *Peer-to-Peer Lending in the United States: Surviving after Dodd-Frank*, 15 N.C. Banking Inst. 139 (2011).

[11] Following the 2008 financial crisis, banks introduced stricter lending criteria, resulting in increased complexity and longer approval processes for loans. This shift prompted borrowers to explore alternative lending avenues outside of conventional banking institutions, with P2P lending emerging as an attractive option due to its reputation for efficiency and simplicity.

[12] *See* Alan B. Krueger, *In Credit Crisis*, *Some Turn to Online Peers for Cash*, N.Y. TIMES BLOG (Oct. 14, 2008, 9:17 AM), https://archive.nytimes.com/economix.blogs.nytimes.com/2008/10/14/in-credit-crisis-some-turn-to-online-peers-for-cash/ (noting a 41% increase in volume of loans financed at Prosper [one of the two largest P2P platform at the time] from April 2008 to September 2009 compared to the preceding six months and suggesting that the crisis led some of the traditional banks' customers to seek nontraditional lending sources).

operational risk, interest rate risk, P2P lenders faced risks unique to their model. For one, loans issued by P2P platforms are mostly unsecured loans.[13]

Lenders on these platforms could experience complete loss on the loan if borrowers were to default on their loans.[14] Naturally, the business model of these platforms attracted borrowers with varied creditworthiness—and some exploited the platform's less stringent (compared to traditional banks)[15] approval process. Regulatory uncertainty was also a major issue at this time, as the sector was new and lighter regulation was imposed so as not to unduly burden the sprout of this sector.[16] It is essential to note that the P2P lending industry has evolved, and some of these vulnerabilities have been addressed and many of the risks inherent in the initial stage have improved.[17] In recent years, P2P lending has faced new challenges. Growth has slowed with the market maturing and increased competition in the P2P sector.[18] Moreover, the uptick in institutionalization within the P2P sector has markedly changed its landscape, reducing the prominence of the "peer" aspect

[13] P2P lending offers both secured and unsecured loans. However, most of the loans in P2P lending are unsecured personal loans.
[14] The way these business models are structured, the lender would not know the identity of the borrower and the platform maintains the anonymity of both parties. Lenders rely on the platform to collect repayments of loans and interest, as well as delinquencies. However, platforms tend to refer delinquent loans to collection agencies for payment and selling defaulted loans to debt purchasers. As a result, lenders may face complete loss. See Prosper Marketplace, Inc., Cease-and-Desist Order, Securities Act of 1933 Release No. 8984, at 4, 94 SEC Docket 1913 (Nov. 24, 2008) [hereinafter Prosper Cease-and-Desist Order] ("[s]ince the lender does not know the borrower's identity, the lender would be unable in any event to pursue his or her rights as a noteholder in the event of default[]").
[15] Krueger, *supra* note 13 ("[t]he sites [popular P2P lending sites] tend to attract high-risk borrowers who are unable to obtain credit at lower rates from traditional sources like a bank[]").
[16] See Jeffrey Luther, Note, *Twenty-First Century Financial Regulation: P2P Lending, Fintech, and the Argument for a Special Purpose Fintech Charter Approach*, 168 U. PA. L. REV. 1013, 1028 (2020).
[17] *See* Tetyana Balyuk, *Financial Innovation and Borrowers: Evidence from Peer-to-Peer Lending* (May 6, 2019), https://www.fdic.gov/bank/analytical/fintech/papers/balyuk-paper.pdf (noting the attraction of sophisticated investors and the use of proprietary algorithms have positioned them to evaluate borrowers with more information that is not available to banks).
[18] *See* Tobias Berg et al., *FinTech Lending*, 14 Annu. Rev. Financ. Econ. (2022), 187–207, at 191 (noting that P2P lending is increasingly competing with other fintech sectors like business lending and Buy-Now-Pay-Later, all vying for similar borrower demographics within the fintech lending landscape).

altogether.[19] As the sector evolves, P2P platforms are under pressure to expand their offerings to maintain their relevance in the evolving fintech landscape.

c. Business Model and Platform Characteristics

P2P lending platforms operate as platforms that allow borrowers to solicit funds directly from investors. This novel business model departs from the traditional banking paradigm, where financial institutions often take a more prominent role as intermediaries between depositors and borrowers, resulting in higher intermediary fees. In contrast, P2P lending enables both individual and institutional participants to engage directly in the lending process, often offering lower fees than traditional banks. These cost savings are made possible due to the streamlined operations and lowered overhead expenses due to the digital native nature of P2P platforms, rendering this lending approach more appealing for those interested in reducing intermediary costs.[20] The reduced overhead expenses, alongside the digital convenience of P2P lending increased the accessibility of this service to practically anyone with a digital device. Consequently, P2P lending played a pivotal role in enhancing financial inclusion by making it possible for individuals and small businesses that were often neglected by traditional banks to access much-needed financial resources.[21] This financial democratization was notably progressive, bridging the funding gaps to those unbanked and underserved.

Generally, P2P platforms act as a broker between borrowers and lenders.[22] The platforms typically make their profits by charging an origination fee. The success of these platforms hinged

[19] *See id.* at 191.
[20] *See* Havrylchyk et al., *The Expansion of the Peer-to-Peer Lending* (September 2016), available at https://ssrn.com/abstract=2841316.
[21] Julapa A. Jagtiani & Catharine Lemieux, *Fintech Lending: Financial Inclusion, Risk Pricing, and Alternative Information* (Fed. Reserve Bank Phila., Working Paper No. 17-17) (2017), available at https://www.fdic.gov/analysis/cfr/bank-research-conference/annual-17th/papers/14-jagtiani.pdf.
[22] *Id.*

on their ability to leverage their proprietary technology for credit assessment, allowing them to efficiently match suitable borrowers and lenders. Borrowers can submit their loan applications, typically specifying their desired loan amount, repayment timing and intended use as well as various characteristics informing credit risk.[23] Upon receiving these loan requests, the platform undertakes a comprehensive credit assessment to gauge the creditworthiness of prospective borrowers.[24] Based on the outcomes of this risk assessment, borrowers are assigned an appropriate term.[25] The investors on these platforms, ranging from retail individuals to institutional entities, can then browse loan listings and select the loans in which they wish to invest.[26]

Through online platforms, borrowers can easily access information on terms, rates, and fees, all of which enables them to make informed choices. Similarly, investors can scrutinize individual borrower profiles, enabling them to select investments aligned with their risk preferences. This cultivates more autonomy between borrowers and investors, bolstering the credibility and expansion of the P2P lending sector. In contrast to traditional banks, which often have stringent eligibility requirements and restrict lending to subprime borrowers, P2P lenders consider a broader range of factors in assessing credit risk, providing a more inclusive approach to lending.[27] This inclusivity attracts borrowers who may have been underserved by traditional banks. Moreover, P2P lenders tend to offer a quicker approval and disbursement process, a notable

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[23] *See* Michael Siering, *Peer-to-Peer (P2P) Lending Risk Management: Assessing Credit Risk on Social Lending Platforms Using Textual Factors* (June 2023). *https*://dl.acm.org/doi/pdf/10.1145%2F3589003.

[24] *See id.* at 7 (detailing borrower evaluations based on income, employment duration, debt-to-income ratio, recent credit inquiries, utilization of revolving credit lines, lifetime of the loan, home ownership, and number of open accounts); *see also* Jagtiani, *supra* note 21, at 24 (highlighting additional factors like payment history, medical/insurance claims, and social network data, all of which are not typically considered in traditional credit scores).

[25] *Id.*

[26] *Id.*

[27] *See* Jagtiani, *supra* note 21, 24 (factors such as bill payments, medical and insurance claims, as well as social network).

contrast to the lengthier procedures found at traditional banks. These advantages have been pivotal in driving the explosive growth of the P2P lending sector.

d. Increasing Institutionalization and the Evolving Model

While P2P lending has achieved success in recent years, its initial model has significantly transformed from its “peer-to-peer" approach. The expansion of the model necessitated a shift away from the original model.[28] Consequently, the lender base has shifted from predominantly individual investors engaging in modest investments to large institutional investors.[29] The remaining individual investors are increasingly dependent on automated tools to assess credit risk, rendering them to become more like "passive investors,” a departure from the personalized approach typical of early P2P lending.[30] Concurrently, P2P lending platforms have become more selective in approving borrowers, these platforms began utilizing metrics similar to those traditionally employed by banks and financial institutions. This evolution reflects a convergence of P2P lending practices with conventional banking practices.[31]

e. Coming of Age for Updated Regulations

As with many startups, regulations are often lenient in the infancy stage to avoid stifling early-stage growth. The P2P lending industry is no exception. In its infancy stage, the P2P lending industry operated with limited regulatory oversight. The fact that P2P lenders were subject to less regulation than banks played an important catalyst in their growth. However, as the industry matured, regulatory authorities became more involved. In the United States, P2P lending platforms

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[28] Tetyana Balyuk & Sergei Davydenko, *Reintermediation in Fintech: Evidence from Online Lending* (2023), available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3189236.
[29] *Id.*
[30] *Id.* at 1-2.
[31] *Id.*

are subject to extensive regulations at both the federal and state level. P2P firms are bound by the federal regulations that apply to all financial service providers. Some of these regulations include the Truth in Lending Act, the Equal Credit Opportunity Act, the Fair Credit Reporting Act, the Gramm-Leach-Bliley Act, the Electronic Fund Transfer Act, and Fair Debt Collection Practices Act.[32] On the state level, state laws exist to safeguard customers of these companies against predatory interest rates, unfair collection, deceptive advertising, and discriminatory behavior.[33] This paper does not intend to examine every regulation applicable to the industry; instead, it aims to focus on a key regulatory issue in the industry—the "True Lender" doctrine. Section II will closely examine the existing regulatory framework governing P2P lending, with a particular emphasis on how the "True Lender" doctrine and recent regulatory shifts have impacted the industry and its compliance landscape.

II. The P2P Lending-Bank Partnership: Examining the Contentious Parts

Traditional banks and P2P lending platforms differ significantly in their operational frameworks and regulatory environments. Traditional banks operate under a well-established and regulated framework and strict banking laws.[34] As such, banks must evaluate borrowers by stringent eligibility criteria.[35] In contrast, P2P lenders do not. These platforms adopt a broader range of criteria for evaluating borrowers, which include non-traditional credit factors such as one's social network and one's history of payment to retail merchants.[36] This approach allows for

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[32] *See generally* Marc Franson, Chapman & Cutler LLP, The Regulation of Marketplace Lending: A Summary of Principal Issues (2020), https://www.chapman.com/media/publication/15044_Regulation-of-Marketplace-Lending-2022.pdf (describing the results of an annual survey conducted by the law firm on marketplace lending and associated regulatory and securities issues).

[33] *Id.*

[34] Banking and finance are two distinct areas within the broader financial services industry. For background on the distinction, *see "What is the difference between banking and finance?"* First Utah Bank Blog, accessed December 13, 2023, https://firstutahbank.com/what-is-the-difference-between-banking-and-finance/.

[35] *Id.*

[36] *See* Jagtiani, *supra* note at 27.

a more comprehensive assessment of one's ability to repay, appealing particularly to those who may not quality under traditional banking norms.[37] Not confined to the same stringent standards as banks, P2P lending operates with comparatively reduced regulatory oversight; this allows them to have more flexibility in their approval selection.

Notwithstanding this difference, P2P lenders and banks often enter into partnerships that present to be mutually beneficial. In these partnerships, P2P platforms leverage the banks' established infrastructure and regulatory frameworks, while banks can access the holistic lending metrics used by P2P platforms.[38] Crucially, such partnerships allow P2P platforms to circumvent certain state-level regulatory constraints, particularly in terms of complying with state usury limits, licensing requirements and other registration needs. By partnering with chartered banks that do not have to abide by individual states' regulated interest rates, P2P platforms can offer loans at rates that would otherwise be prohibited under some state laws.[39] This symbiotic relationship, while not prohibited, raises significant regulatory and legal concerns, particularly regarding consumer protection and fair lending practices.

a. The Current Partnership Structure

Partnerships between banks and P2P lenders are typically structured to leverage the strengths of both entities. Usually, the P2P platforms handle the front-end processes, including marketing to customers and handling applications.[40] Banks, in this partnership, are responsible for originating the loans, which they usually hold before selling them to the P2P platforms.[41] This

[37] *See* Jagtiani, *supra* note at 21.
[38] *See* Balyuk, *supra* note 17, at 33-34.
[39] "National banks are afforded preemption under 12 U.S.C. § 85 and state banks under 12 U.S.C. § 1831d. Thus, a Funding Bank may rely on federal preemption to extend loans at a higher interest rate than applicable state law might otherwise allow. As a result, Funding Banks tend to be located in states with no interest rate limitations, such as Utah or Delaware." *See* Franson, *supra* note 32, at 5, fn. 12.
[40] *See* Balyuk, *supra* 28, at 1.
[41] *Id.*

structuring allows the banks to earn a portion of the origination fees while avoiding the long-term loan holding risks; as for the P2P platforms, since banks are the entity originating these loans, the process adheres to federal regulations and enables the platform to contend that their operations should fall under federal oversight as opposed to the states'.[42] After the partner banks sell the loans back to the P2P platforms, they typically undertake the back-end processes as well, such as loan servicing and customer support.[43] While this model is common, it's important to recognize that this is not the only structure. Some partnerships may involve different revenue-sharing models, variations in loan servicing responsibilities, or other collaborative efforts that differ from the typical framework.[44] For one, the P2P platforms may originate the loan and handle all aspects of the loan process, but this is the more uncommon case.[45]

b. Regulatory Implications for Non-Bank Partnerships

i. Usury Limits

In the absence of partnerships with banks, P2P lending platforms are subject to a complex set of state-specific regulations, particularly regarding licensing and registration. Each state has its own rules for financial service providers operating within its borders; this often required the P2P platforms to obtain state-specific licenses and adhere to state-specific practices. This kind of regulatory environment can pose significant operational challenges, as platforms must navigate a patchwork of legal requirements, from interest rate limits to consumer protection standards. While the National Bank Act allows federally chartered banks to preempt these state laws, P2P platforms operating independently do not benefit from this preemption. This meant that without a bank partnership, P2P platforms must comply with each state's unique regulatory

[42] *See* Franson, *supra* note 39.
[43] *See* Balyuk, *supra* 28, at 7.
[44] *See* FDIC Insights, *supra* note 2, at 14.
[45] *Id.*

framework to stay in operation. This situation underscores the critical role of bank partnerships in shaping the operational landscape for P2P lenders.

Usury is a complex topic influenced by factors such as the lending entity, the characteristics of the loan or borrower, and the loan amount. Usury laws may limit loan terms and set maximum interest rates that can be charged on loans within a particular state.[46][47]When operating across different states, an independent P2P lender would face the necessity of complying with individual state usury laws.[48]This compliance is mandated even though it may not be ideal for the lender, both in terms of monitoring adherence to the various limits and the significant costs such compliance may incur.[49]comparatively low, the P2P lenders might earn less than they would if they were preempted. This necessitates the reliance of P2P platforms on the partnership with banks to leverage § 85 of ,[50]which asserts that state usury laws do not apply to national banks—and by extension, P2P platforms—to the extent they conflict with the interest rate authority granted by the National Bank Act.[51] Specifically, these lenders partner with a bank to utilize the "rate exportation rule" to bypass a state's usury law and apply the interest rate regulations of the bank's home state, which may permit higher interest rates than in borrowers' states or allow for other departures from the borrower's home state [52]

ii. State Licensing and its Regulatory Frameworks

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[46] *See* Franson, *supra* note 31 at 67-69.
[47] *Id.*
[48] *Id.*
[49] *Id.*
[50] 12 U.S.C. § 85.
[51] *See* 12 U.S.C. § 85. The relevant part of 12 U.S.C. § 85 states that, "[a]ny association may ... charge on any loan . . . interest at the rate allowed by the laws of the State, Territory, or District where the bank is located ...." The phrase "allowed b the laws of the State" implies that the national bank is subject to the interest rate regulations of the state where is it location and effectively preempts state usury laws that might otherwise limit the interest rates a national ban can charge.
[52] *See* Franson, *supra* note 31 at 5, fn. 12.

Federal laws allowing banks to "export" interest rates apply only to the rates charged by the lender and do not preempt state licensing and consumer credit regulations. As such, States retain the authority to regulate marketplace lenders and impose individual state licensing requirements, which vary in nature and in processing time.[53] Compliance obligations can also include recordkeeping, financial reporting, and observing state limits on rates and fees, with examination by state regulators.[54] Accordingly, state licensing requirements may create significant compliance burdens. This multistate compliance challenge often leads to P2P lenders partnering with banks. These collaborations often rely on § 24 of the National Bank Act[55] to create the impression that the partner bank is the "true lender," and thereby enabling these P2P platforms to avoid certain state licensing requirements.[56] However, even when working with a funding bank, P2P lenders may need additional state licenses for certain services and loan management.[57] The use of bank partnerships to circumvent state licensing requirements has been the subject of legal and regulatory scrutiny. Regulatory authorities have sought to clarify and enforce the "true lender" doctrine, and the implication of this will be explored in Part III.

III. The "True Lender" Doctrine and Its Implications on P2P Lending

In the ever-changing landscape of P2P lending, regulatory compliance, particularly those concerning state licensing and usury laws, has become a focal point in discussions. Central to these discussions is the "true lender" doctrine, a topic that has captured the attention of policymakers,

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[53] *See* Franson, *supra* note 31 at 97-98.
[54] *Id.*
[55] *See* 12 U.S.C. § 24; https://columbialawreview.org/content/interest-exportation-and-preemption-maddens-impact-on-national-banks-the-secondary-credit-market-and-p2p-lending/.https://columbialawreview.org/content/interest-exportation-and-preemption-maddens-impact-on-national-banks-the-secondary-credit-market-and-p2p-lending/.

[56] *See generally* Franson, *supra* note 31, at 4-14.
[57] *Id.*

legal scholars, and those involved in the industry.[58] This doctrine, pivotal in defining the regulatory responsibilities amongst bank-P2P platform partnerships, plays a critical role in guiding lending practices and determining the interaction between P2P platforms and their partnered banks[59] Yet, the difficulty of defining who is a "True Lender" continues to highlight the complexities and ongoing uncertainties faced by the industry.

a. What is the "True Lender" Doctrine

The "true lender" doctrine is an influential legal principle in the lending industry, particularly in scenarios involving partnerships between banks and non-bank financial entities. This doctrine seeks to determine the entity that is the actual lender when a bank collaborates with a non-bank platform, like a P2P lending company, to facilitate loans.[60] In these partnerships, though the bank is the entity originating the loans, the non-bank entity may be so heavily involved in the other aspects of the loan process (e.g., marketing, underwriting, and servicing of the loans) that they could be seen as the "true lender."[61] In these situations, the "true lender" doctrine is used to determine whether the bank, the non-bank platform, or both should be considered the actual lender in the eyes of the law. Identifying the true lender determines which entity is subject to the proper regulations. If the P2P platform is recognized as the true lender, it might need to adhere to the specific licensing requirements and consumer protection laws of all the states where it operates.[62] This could lead to a costly process to obtain these licenses and implement compliance

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[58] For background information on the True Lender Rule, *see* David Polk Client Update, *The OCC Finaalizes a Rule to Answer The True Lender Question* (Oct. 9, 2020), https://www.davispolk.com/insights/client-update/occ-finalizes-rule-answer-true-lender-question; David Polk White Paper, *Federal Banking Regulators Can and Should Resolve Madden and True Lender Developments* (Aug. 2018), https://www.davispolk.com/sites/default/files/madden-true-lender-federal-regulatory-fix-whitepaper_final.pdf.
[59] *Id.*
[60] *Id.*
[61] *See* Balyuk, *supra* note 28 at 1.
[62] *See* Franson, *supra* note 31, at 4-6.

strategies; further, it raises questions about the validity of some existing loans.[63] Conversely, if the bank is acknowledged as the true lender, the existing advantageous relationship between the bank and the P2P platform could proceed without significant changes.[64]

There is no universal standard to determining the "true lender," but several key factors commonly considered in the analysis include: the source of loan origination, the predominant economic interest[65] (which examines which party has control and oversight over compliance and interest in the loan), and risk and reward distribution.[66] The source of funding factor focuses on the entity providing the funding for the loans and mainly considers the entity named in the loan agreement and the one disbursing the proceeds.[67] This often led to the conclusion that the bank is the true lender, thereby applying federal preemption, but this approach has not been interpreted uniformly.[68] Additionally, the entity that is more involved in the origination process is often scrutinized. The more involved the bank is in these processes, the more likely it is to be seen as the true lender; the same can be said for the P2P platform.[69] The scrutiny also looks to which party

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[63] *Id.*
[64] *Id.*
[65] *See* John Hannon, *The True Lender Doctrine: Function over Form as a Reasonable Constraint on the Exportation of Interest Rates*, 67 Duke L.J. 1261, 1280 (2018) (citing a 2004 Georgia bill to explain that "[a] purported agent shall be considered a *de facto lender* if the entire circumstances of the transaction show that the purported agent holds, acquires, or maintains a predominant economic interest in the revenues generated by the loan.")
[66] *Compare CFPB v. CashCall, Inc.*, No. CV157522JFW, 2016 WL 4820635, at *6 (C.D. Cal. Aug. 31, 2016) (holding that in identifying the true or de facto lender, courts generally consider the totality of the circumstances and apply a "predominant economic interest," which examines which party or entity has the predominant economic interest in the transaction), with *Beechum v. Navient Sols., Inc.*, No. EDCV 158239JGBKKx, 2016 WL 5340454, at *8 (C.D. Cal. Sept. 20, 2016) (holding that the court will look "only to the face of the transactions at issue").
[67] *See generally id.*
[68] *Compare NRO Boston, LLC & Indelicato v. Kabbage, Inc. & Celtic Bank Corp.*, No. 1:17-cv-11976 (D. Mass. Oct. 12, 2017) (alleging that the non-bank lender was the true lender due to its involvement in loan origination, underwriting, and risk assumption), with *Beechum v. Navient Solutions, Inc.*, No. 8:15-cv-01167 (C.D. Cal. Sept. 30, 2016) (opining that the bank's involvement in the loan origination process and the funding of the loans sufficient to exempt the loans from state usury cap under preemption clause; implying that the bank is the true lender).
[69] See *Fulford et al. vs. Marlette Funding, LLC et al.*, No. 2017-cv-30376 (Dist. Denver Cty.), and *Fulford et al. vs. Avant of Colorado, LLC* et al., No. 2017-cv-30377 (Dist. Denver Cty.).

has the predominant economic interest in the loan.[70] What consists of predominant economic interest has not been well-defined, but courts have looked to who burdens the financial risk, who was more involved in the overall process, and who stands to gain the most from the interest and fees charged on the loan.[71] Finally, how the risk and rewards from the lending activity are distributed between the bank and the non-bank entity can also signal the true lender. If the bank retains a significant portion of the risks and rewards, it is more likely to be considered the true lender.[72]

b. P2P Platforms and the "True Lender" Designation

P2P platforms have consistently positioned themselves to be loan facilitators instead of the "true lenders." While these platforms managed most front-end operations, including marketing and preliminary credit assessments, they play no role in the origination. P2P lenders often leveraged this fact to posit that since the banks are responsible for loan origination, they should be considered the true lenders.[73] This argument reinforces the notion that such loans should be exempt from state law compliance because they are issued by a federal bank, which aligns with these P2P platforms' goal to identify as a loan facilitator. However, the relationship between P2P platforms and banks typically involved the banks holding the loans for only a brief period—often just a few days—before selling them to the P2P platforms.[74] This quick turnaround minimizes the banks' risk and involvement in the loan; after the loan, the P2P platform usually has all the subsequent responsibilities, which include loan servicing, customer support, and when necessary, debt

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[70] *See id.* (ruling two online lending platforms that had partnered with banks to be the "true lenders" because they had played a significant role in marketing, underwriting, and servicing the loans and deeming such actions to qualify as having "predominant economic interest").
[71] *Id.*
[72] *Id.*
[73] *See* Franson, *supra* note 31, at 78-92.
[74] *See* FDIC Insights, *supra* note 2.

collection.[75] These ongoing responsibilites suggested that P2P platforms might actually hold the "predominant economic interest" in the loans, despite the banks' initial involvement in the origination process. Nevertheless, P2P platforms continue to defend their position as loan facilitators and service providers, rather than direct lenders. Over the years, it remains unclear what is the true definition and responsibilities of a "true lender" in such arrangements.

c. *Madden v. Midland*: Analyzing its Impact on defining "True Lender"

In 2015, the Second Circuit Court of Appeals case, *Madden v. Midland* generated significant interest due to its potential impact on the "true lender" doctrine.[76] Despite not addressing the "true lender" issue directly, the *Madden* court determined that Midland Funding, a non-bank debt buyer, was not permitted to charge interest rates exceeding state usury limits on debts they acquired from a national bank.[77] This ruling suggested that the usual exemptions granted to loans issued by national banks might not extend to non-bank entities, such as debt buyers or fintech companies, upon acquiring loans from these banks.[78] The wider implication here, is that the interest rate cannot be exported from a national bank to a non-bank entity because the bank is *not* the "true lender." Consequently, this decision added more complexity to the "true lender" doctrine's existing framework, raising questions about the ability of non-bank entities to enjoy the same preemption from state usury laws as banks as things stand.[79] The *Madden* decision introduced great uncertainty for P2P platforms that rely on partnerships with banks to avoid individual state regulations. The decision suggests that these partnerships might not fully shield them from state lending laws; potentially affecting their existing business models if they need to

[75] *Id.*
[76] *Midland Funding, LLC v. Madden*, 136 S. Ct. 2505, 195 L. Ed. 2d 839 (2016) (cert. denied).
[77] *See* Franson, *supra* note 31 at 1-4.
[78] *Id.*
[79] *Id.*

gain compliance across all states, as this can be a timely and costly process. While the holding primarily affects state usury laws, it also opens the door for potential challenges to the preemption of other state law restrictions, to areas such as licensing requirements, consumer protection laws, and other state-level financial regulations.[80]

Post-*Madden* and Revised Partnership Models

d.

In response to *Madden*, P2P platforms significantly revised their partnership structures with banks. Initially, the banks' involvement was limited to collecting a one-time fee at the loan's origination and avoid partaking in any aspects of the ongoing loan process. However, post-*Madden*, there has been a strategic shift towards a more integrated and continuous relationship between the banks and P2P platforms.[81]

Under the altered arrangements, banks no longer withdraw completely from the process post-origination; instead, they engage in an ongoing fee structure that correlates with the loan's performance.[82] This altercation serves to weaken previous arguments with respect to the P2P platforms' economic interest in the loans, which pointed to P2P platforms as the "true lender" because they bore the[83] economic stakes in the loans.[84] With this change, both P2P platforms and

[80] *Id.*
[81] One notable instance was from LendingClub, one of the most prominent players in the industry, who restructured its relationship with WebBank by increasing the fees paid to the bank to ensure an ongoing economic interest in all loans after they're sold back to LendingClub; but requiring WebBank to have a continued interest in these loans. *See* Kevin Wack, *Lending Club Tweaks Business Model in Effort to Thwart Legal Challanges*, Am. Banker (Feb. 26, 2016), available at https://www.americanbanker.com/news/lending-club-tweaks-business-model-in-effort-to-thwart-legal-challenges.
[82] *Id.*

[84] *Id.*

banks now share in the risks and rewards associated with the loans. By moving away from a model of one-time origination fees, banks have adopted a sustained interest in the loans, which align their incentives more closely with those of the P2P platforms. This alignment reflects a deeper commitment to the loan's life cycle, marking a significant shift in the dynamics of bank-P2P lender partnerships.

e. End of an Era for P2P Lending

In reaction to an increasingly adversarial environment following the *Madden* decision, several prominent P2P lending platforms have opted to rebrand and shift their focus to different financial services sectors and withdraw from the P2P model. A notable instance of this is LendingClub's departure from P2P lending in 2020.[85] As an early advocate and a prominent player in the P2P market, LendingClub has dominated the industry for some time.[86] However, facing an increasingly uncertain regulatory landscape, the company determined that continuing its P2P operations was no longer economically feasible.

In a strategic pivot, LendingClub acquired a bank and transitioned into the traditional banking sector—ironically, the same industry it aimed to revolutionize.[87] This shift does not imply LendingClub is exiting the lending business altogether.[88] The company has committed to honoring and servicing existing P2P loans, but has decided to cease accepting new retail investors, who were

[85] "LendingClub Corporation Form 8-K 2020." Securities and Exchange Commission EDGAR Online. Securities and Exchange Commission, Oct. 7, 2020, www.sec.gov/edgar.shtml.
[86] *See* Boris Vallee & Yao Zeng, *Marketplace Lending: A New Banking Paradigm?* (May, 2018), at 8, fn.9, available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3102984 (stating that the two largest P2P platforms in the US, Prosper and LendingClub, jointly captured around half of the lending activities by fintech firm in 2016).
[87] LendingClub is now a bank holding company (LendingClub Bank, N.A.) after acquiring Radius Bancorp and its subsidiary bank on Feb. 1, 2021. LendingClub will not longer accept new retail accounts but will continue to service its existing P2P obligation. *See* Matthew Frankel, *LendingClub Is Ending Its P2P Lending Platform – Now What?* (Oct. 8, 2020), available at https://www.nasdaq.com/articles/lendingclub-is-ending-its-p2p-lending-platform-now-what-2020-10-08.
[88] *Id.*

the backbone of the original P2P investment model.[89] Moving forward, LendingClub's lending services will resemble more like those offered by traditional banks, indicating a significant evolution from its founding ethos.[90] Other P2P platforms are also shifting towards banking, likely influenced by LendingClub's move and the more structured regulatory environment of the banking sector.[91]

Despite the trend of P2P lending platforms evolving into banks or exiting altogether, there remains a significant opportunity for the P2P lending sector to operate independently, without necessitating a transition into traditional banking. The growing dominance of institutional investors in this space, while overshadowing retail participation, brings its own set of advantages.[92] The increase in institutional involvement saw an improved credit assessment process and a reduced rate of loan defaults.[93] These improvements align with the original goal of P2P platforms to promote financial inclusion by ensuring a more stable and reliable lending environment. While this shift to conform with institutional standards may disqualify some borrowers under stricter lending criteria, it also serves to filter out higher-risk loans, thereby improving the overall P2P lending ecosystem. P2P lending, at its core, was about disrupting traditional financial models and offering alternative, accessible lending methods and investment opportunities. A move towards banking could dilute this innovative spirit; thus, to preserve the unique value proposition of P2P lending, updates to the existing regulatory framework is necessary.

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[89] *Id.*
[90] *Id.*
[91] LendingClub's exit is not abnormal. UK P2P lender, Zopa, has taken a similar route and obtained a banking license, with aims to expand into a banking model. Another lender, SoFi Technologies, acquired Golden Pacific Bancorp in 2021 and received the OCC's approval to become a national bank (SoFi Bank, N.A.). Though there seems to be an emerging pattern of fintechs (including P2P lenders) seeking to become a bank, it's important to note that very few can obtain a banking charter. *See* Paige Smith & Yuegi Yang, *Becoming a Bank Proves Challenging for Fintechs Seeking Survival*, Bloomberg News (Aug. 22, 2023, 5:30 EDT).
[92] *See* Balyuk, *supra* note 28.
[93] *Id.*

IV. Proposals for Clearer P2P Lending Regulations

P2P lending, which emerged as an innovative financial alternative to traditional banks, was praised for promoting inclusivity and choice in financing. The industry's progression shouldn't necessitate P2P platforms to adopt the traditional banking status for regulatory simplicity. As such, addressing the "true lender" issue is critical for clearly defining the respective roles in P2P transactions. As P2P platforms increasingly aim to broaden their services, potentially evolving into banks, it's essential to also consider regulatory frameworks specifically designed for such an entity, so not to confine it to strict banking standards. Tailored solutions like the Special purpose bank charters and Industrial Loan Company (ILC) charter might be more suitable for P2P platforms, for they can be effective regulations that offer clarity but support the unique dynamics and continued growth of the P2P lending sector.

a. Clarification around the "true lender" definition

Since the *Madden* decision in 2015, interpretations of the "true lender" doctrine continues to lack consensus. Though the *Madden* decision has not been universally adopted, it maintains as a significant precedent. Under the current regime, P2P lenders partnering with banks can continue to rely on Sections 85 and 24 of the National Bank Act to bypass compliance with individual state laws. However, the *Madden* ruling, seemingly minor and currently binding only to the Second Circuit, harbors the potential to be persuasive beyond the Second Circuit's jurisdiction. Thus, clarification on factors to classify a "true lender" is crucial.

b. The Special Purpose Bank Charter

In December 2016, the OCC announced that it was considering issuing special purpose bank charters to qualified fintech companies.[94] The OCC took the position that expanding a tailored bank regulatory framework to fintech companies will (i) benefit customers, businesses, and communities and will help ensure that these companies operate in a safe and sound manner; (ii) bringing the regulation of fintech companies within the singular purview of the OCC; promoting consistency in application of laws; and (iii) make the financial system stronger by including these companies within the regulatory ambit.[95] This charter offers an alternative pathway for fintech firms to operate as national banks, subject to federal banking regulations.[96] Under this charter, fintech companies can access the benefits of becoming a national bank, such as preemption of state-by-state licensing requirements, while being subject to a consistent set of federal rules.[97]

In the fintech charter proposal, the OCC has stipulated that applicants must create and adhere to a financial inclusion plan, which seems to be more stringent than the analogous requirements under the Community Reinvestment Act[98] for banks.[99] It is not known how the OCC might impose financial inclusion requirements on P2P lenders seeking a charter, whether retention of some portion of loans will be required, or how off-balance sheet items such as loan sales will be treated for capital purposes. Federal law also limits transactions with affiliated companies and absent a change in law, and depending on how the interplay of regulators comes out, a parent

[94] Office of the Comptroller of the Currency, *Exploring Special Purpose National Bank Charters for Fintech Companies* (Dec. 2016).
[95] *Id.*
[96] *Id.*
[97] *Id.*
[98] 12 U.S.C. 2901. The Community Reinvestment Act (”CRA”) is a law that encourages banks to help meet the credit needs of the communities where they operate, including low- and moderate-income neighborhoods. [Simply put, it's a rule that tells banks to not just lend money or provide banking services to wealthy areas, but also to make sure they are helping people and businesses in less wealthy areas. This way, everyone, no matter where they live, can have a better chance of getting loans and other banking services.]
[99] Lalita Clozel, *Financial inclusion rules tougher than CRA in OCC fintech charter* (Apr. 3, 2017), https://www.americanbanker.com/news/financial-inclusion-rules-tougher-than-cra-in-occ-fintech-charter.

company might become a bank holding company, subject to not only additional regulation but also a restriction on being engaged in activities constituting banking or being closely related to banking.[100]

The special purpose fintech charter is intended to allow fintech firms to operate on a national scale, similar to traditional national banks. The preemption that comes with the federal charter would allow them to avoid obtaining individual licenses in all 50 states and navigating each state's unique regulatory framework.[101] By obtaining the proposed charter from the OCC, P2P lenders could reduce the compliance costs of conforming to each jurisdiction where they intermediate lending activities. This development would support the ongoing trend of P2P lenders transitioning into banks to expand their product offerings, permitting them to adopt the necessary requirements typical of banks but allowing them to retain their unique features that set them apart from conventional banks, such as maintaining capital and liquidity requirements.[102] This charter would be a positive step towards integrating P2P lenders more fully into the financial system, providing them with a framework that supports their innovative business models while ensuring regulatory compliance and stability.

c. The Industrial Bank Charter

The Industrial Bank Charter presents an alternative regulatory pathway for the P2P lending sector. One notable advantage is that the charter allows fintech firms to offer traditional banking

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[100] This ventures into the area governed by the Bank Holding Company Act, which provides guidelines and regulations for companies that own or control banks. *See* 12 U.S.C. § 1841 et seq.

[101] *See* Gideon Blatt, *What New Bank Charters Mean For Fintech* (Oct. 12, 2018), https://www.ropesgray.com/en/insights/alerts/2018/10/what-new-bank-charters-mean-for-fintech.

[102] P2P lenders are not deposit takers; therefore, pose less of a risk to the financial system. Imposing the stringent regulatory standards of traditional banks on P2P lenders would therefore constitute an excessive regulatory burden on them. Therefore, under this charter, they need not maintain capital nor liquidity requirements because they will not be accepting deposits. *See* Andrew E. Bigart, *OCC Moving Forward with Special Purpose Bank Charters or Fintech Companies* (Dec. 6, 2016), available at https://www.venable.com/insights/publications/2016/12/occ-moving-forward-with-special-purpose-bank-chart.

services. By holding this charter, fintech firms can broaden their financial product offerings to include deposit-taking, potentially diversifying their revenue streams. The allure of an ILC charter lies in its ability to offer a wide range of financial products and services, with the notable exception of demand deposit accounts.[103] As an FDIC-insured institution, ILCs benefit from federal preemption over state usury laws. Additionally, ILCs can be owned by non-bank entities.[104] Despite being insured by the FDIC, ILCs are not classified as "banks" under the federal Bank Holding Company Act. Consequently, a commercial company can own an ILC without being subjected to the extensive regulations and Federal Reserve supervision that apply to bank holding companies.[105] However, maintaining an ILC charter still requires the fintech companies to comply with a range of regulatory obligations, which include: the Volcker Rule, fulfilling various reporting and auditing requirements, and maintaining adequate capital and liquidity levels. In comparison to the Special Purpose Charter, this framework resembles more alike to traditional banks but subject to a less comprehensive set of regulations (e.g., no stress test).[106]

Furthermore, the charter can bring regulatory clarity on the state level.[107] State-chartered industrial banks are subject to state regulations, offering a more straightforward compliance landscape compared to the complex patchwork of state laws that P2P lending platforms often encounter. This can pave the way for platforms to operate in a stable and regulated environment. However, one key constraint is their restricted expansion options.[108] Industrial banks typically

[103] *See* Franson, *supra* note 31 at 38.
[104] *Id.*
[105] *Id.*
[106] Federal Deposit Insurance Corporation, *Industrial Loan Companies: Growing Industry Sparks Regulatory Discussion*, *Supervisory Insights*, Summer 2004, available at https://www.fdic.gov/regulations/examinations/supervisory/insights/sisum04/sisummer04-article1.pdf.
[107] Utah, California, and Nevada are the only states that currently have industrial banks. Other states have a statutory framework that allows for industrial bank charters, but they are not currently active. *See* National Association of Industrial Bankers, *https://www.industrialbankers.org/resources.*
[108] *Id.*

have limits on branching and geographical reach, which may hinder the nationwide growth ambitions of some P2P lending platforms.[109] Additionally, obtaining an ILC charter is notably challenging. Since 2009, no company has been successful in securing an ILC charter, partly due to a federal moratorium on issuing deposit insurance.[110] Even though the FDIC has shown openness to reviewing new applications, these attempts have largely been unsuccessful.[111] Therefore, while the ILC charter could potentially provide regulatory clarity, the process of acquiring it remains a formidable challenge.

d. Choosing a Path Forward

In light of the current regulatory landscape for P2P lending, the industry faces a complex choice regarding its regulatory path forward. Whether P2P lenders opt to pursue charters like the Industrial Bank Charter or the Special Purpose Bank Charter to operate within a more regulated framework, or advocate for greater regulatory clarification surrounding the "true lender" doctrine, one clear challenge is the prevailing uncertainty. To ensure the industry's continued growth and health, it is vital that regulatory guidelines are made clearer, providing much-needed certainty for everyone involved in the rapidly changing world of P2P lending.

V. Conclusion

The P2P lending sector, once a dynamic component of the fintech lending landscape, now finds itself grappling with regulatory ambiguity, posing a significant challenge to its existence and

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[109] For example, since ILCs are chartered by individual states, their operations are subject to the regulations of that particular state. Some states may have more restrictive rules than others. *See* Federal Deposit Insurance Corporation, *Industrial Loan Companies: Growing Industry Sparks Regulatory Discussion*, *Supervisory Insights*, Table 2 at 7, Summer 2004, available at https://www.fdic.gov/regulations/examinations/supervisory/insights/sisum04/sisummer04-article1.pdf.

[110] 86 Fed. Reg. 10703 (Feb. 23, 2021).

[111] *See* Franson, *supra* note 31 at 38 (noting that the openness to approving applications has shifted following a change in the federal administrations after the 2020 elections and a change in leadership at the federal banking agencies; pending applications have either been stalled or withdrawn).

hindering its growth. This stems primarily from the unclear interpretation of the “True Lender” doctrine, which has a significant impact on P2P lending’s business model. Current strategies to address this uncertainty are either fraught with regulatory complexities or difficult to implement. For the P2P lending sector to remain significant and evolve within the fintech landscape, resolving these issues is crucial.