Structuring a marketplace lending platform securitisation in Europe

Hogan Lovells

June 2017

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With the UK alternative finance market growing to £3.2 billion at the end of 2015[1], online lending platforms have captured the attention of investors, regulators and the media. Commenting in April 2016, Christine Farnish, chair of the Peer-to-Peer Finance Association, noted that peer-to-peer (P2P) lending "is now a mainstream and established part of the UK's financial landscape"[2].

Online lending platforms market themselves as a portal to match lenders to borrowers, which are generally consumers borrowing for personal, family or household consumption purposes, small and medium-sized enterprises borrowing for working capital or asset finance purposes or entities involved in trade finance. The lenders through the platforms fall into a number of segments – namely, retail investors (hence the moniker 'P2P' lending) and corporates and institutional investors investing directly or indirectly through the wholesale funding market. While P2P traditionally referred to lending between individuals, it is also seen to include marketplace lending given the growth in corporate and institutional investment through online lending platforms. Marketplace lending platforms therefore act as an alternative to, and compete with, traditional bank lending with the advantages of a lower cost base and no regulatory capital requirements.

In the United States, there have already been securitisations of consumer loans originated through online platforms Prosper Marketplace Inc and Lending Club. In Europe, Kreditech has completed a deal, a number of other private financings have closed and a Sterling deal involving Funding Circle UK loans in 2016[3].

With the marketplace lending platform securitisation market still in its infancy, this update considers a number of issues that must be addressed in structuring a marketplace lending platform securitisation in Europe. It focuses on indirectly funding the origination of loans from online platforms via the wholesale funding market, where the ultimate investors could include bank treasuries, insurers and investment funds. It does not consider lending to online platforms via retail investors or direct lending via corporates or institutional investors.

Role of platform

The role of the platform is to facilitate lending between the lender and the borrower. Generally, the platform does not lend to borrowers directly, but instead acts as a broker in matching lenders and borrowers. Accordingly, the platform itself will not typically hold a portfolio of loans for securitisation. Therefore, it will probably be necessary for an intermediate lender to lend through the platform and then sell the portfolio, once at a sufficient size, to a special purpose vehicle (SPV) established for the securitisation.

The platform generally performs credit and anti-money laundering checks on potential borrowers, provides a set of terms and conditions to which both borrowers and lenders adhere and often provides ongoing servicing for the loans. The platform will coordinate advances and repayments on behalf of the borrowers and lenders and deduct fees for its services.

Structuring marketplace lending platform for securitisation

Pan-European or single country?

A pan-European securitisation must involve a platform operator which sources loans on a pan-European basis, or alternatively pan-European pools containing loans which have been aggregated from different platforms. This latter approach may be necessary to achieve a sufficiently large portfolio in order to make a securitisation cost effective, but is likely to introduce additional complexity in describing the credit and servicing procedures of each platform.

The underlying originator of the loans must also comply with differing regulatory requirements across Europe which drive some of the

differences in origination structures and some of the requirements under securitisation regulations which may make this more challenging. Some of these issues are examined below.

Lending and other permissions

One immediate legal problem with securitising loans originated through marketplace lending platforms is that in many jurisdictions, the lender must have regulatory permission to lend. The platform itself may have required other permissions, including to operate a marketplace lending platform or to service the loans after origination. In the United Kingdom, although a platform provider could have permission to lend as well as to operate the platform, any loans advanced by the platform itself through the platform would not be "Article 36H" loans[4], and (unless they are exempt agreements) would generally have to be treated as fully regulated under the Consumer Credit Act 1974 instead. Article 36H of the Financial Services and Markets Act 2000 (Regulated Activities) Order (SI 2001/544) allows regulated market place platforms to introduce borrowers and lenders but the loan must be concluded between the borrower and lender through the platform, not by the platform as principal. If the platform were to act as a lender, this would have an impact both on documentation and conduct of business requirements and on potential remedies for borrowers (unenforceability as a result of certain regulatory breaches being the most obvious risk).

Accordingly, for a portfolio of loans to be originated through a marketplace lending platform the loans would need to be originated by the securitisation SPV or, more likely, an intermediate origination company to the extent permitted in the relevant jurisdiction. In this case the lending would almost certainly be treated as entered into by way of business by the origination company. This means that, unless an exemption is available under the local regulatory rules, the securitisation SPV or an intermediate entity will need to have permission to lend.

In the United Kingdom, this permission to lend would not be required if, for example, each loan was in excess of £25,000 and was made only for the borrower's business purposes. For unsecured loans to consumers in the United Kingdom, however, it is unlikely that any exemptions would apply and permission to enter into regulated consumer credit agreements is therefore likely to be required under Section 22(1) of the Financial Services and Markets Act 2000. Given the more stringent requirements (eg, relating to systems and controls) imposed on firms authorised and regulated by the Financial Conduct Authority, it may be necessary for a third party of substance to make the initial lending and then subsequently on-sell the receivables under the loans to the securitisation SPV.

In certain jurisdictions, such as Germany, it would not be possible for the securitisation SPV or an origination company to lend directly as it would not have the necessary banking permissions. Instead, the platform acts as a tool for matching credit offers and credit applications, the credit applications are then sent to a fully licensed bank that grants the loan and the bank transfers only the loan receivables to the SPV or origination company. Consequently, the SPV or origination company will not be the initial lender under the loans itself, but will acquire loan receivables originated by a fully licensed bank.

The platform provider or other third party which agrees to service the loans for the SPV will also need to be appropriately regulated in the relevant jurisdictions.

Risk retention and originator

If marketplace lending platform securitisations are to be offered in the European wholesale markets or funded privately by European banks, alternative investment funds or insurers they will need to be structured to include qualifying

risk retention. To qualify, the existing rules provide that "originator, sponsor or original lender" must retain a material net economic interest of not less than 5% in the transaction in accordance with Article 405 of the EU Capital Requirements Regulation (575/2013) or under equivalent regulations which apply to authorised fund managers, insurers and reinsurers authorised in the European Union.

For legal and commercial reasons it is unlikely to be possible for platform operator to hold the risk retention. Another entity with capacity to act as originator would therefore need to be identified.

Care must be taken in identifying an entity of sufficient substance to hold the assets for a minimum period of time before they are securitised[5]. This entity would need to provide representations in relation to the loans sold to the securitisation SPV and buy back any loans which have breached such representations.

A further reason for adopting this structure is a concern that if the securitisation SPV funded the loans directly it may itself be an alternative investment fund under the EU Alternative Investment Fund Managers Directive (2011/61/EU). In the United Kingdom, existing guidance provides that a debt issuing entity will not ordinarily fall within the scope of the EU Alternative Investment Fund Managers Directive as implemented in the United Kingdom. However, this is expressed to be subject to clarification at EU level. Some European jurisdictions have already adopted a much narrower interpretation of this debt-issuing exemption, which excludes any debt instruments having a profit participating element.

Servicing and collections

The platform (or another third party) should act as servicer of the loans for the securitisation SPV. Accordingly, general servicer risk will apply to loans sourced through platforms, as with any other securitisation. Investors may be further concerned with the lack of an established servicing track record in some cases.

Features such as account trusts or pledges, regular cash sweeps and back-up servicers can be used to mitigate these risks.

Origination standards

Originators and sponsors in respect of any securitisations must have regard to the requirements for disclosure to investors under Article 409 of the Capital Requirements Regulation (and similar equivalent provisions) to the extent that such securitisations are to be offered in the European wholesale markets or funded privately by European banks, alternative investment funds or insurers.

These disclosure requirements comprise an obligation to ensure that investors have readily available access to all materially relevant data on the credit quality and performance of the loans, the cash flows and any collateral supporting the loans as well as such information as is necessary to enable investors to conduct comprehensive and well-informed stress tests on the cash flows and collateral values supporting the underlying exposures. Commission Delegated Regulation 625/2014 confirms that this data should be determined and disclosed at the date of the securitisation and at least on an annual basis thereafter and should generally be provided on a loan-by-loan basis. Once implemented, the European Commission's Proposal for a Regulation of the European Parliament and of the Council Laying Down Common Rules on Securitisation and Creating a European Framework for Simple, Transparent and Standardised Securitisation (the 'STS securitisation proposal') requires this information on at least a quarterly basis for all securitisations[6].

Further, under Article 17 of the EU Alternative Investment Fund Managers Directive, as expanded by Article 52 of the Level 2 Delegated Regulation, an alternative investment fund manager investing in a securitisation position

should also ensure that the sponsor and originator:

- grant credits based on sound and well-defined criteria with a clearly established process for approving, amending and refinancing loans;
- operate an effective system to manage the ongoing administration and monitoring of their loans (including identifying problem loans);
- have an adequately diversified credit portfolio; and
- have a written policy on credit risk.

This requirement has been replicated in the STS securitisation proposal for originators and original lenders which are not credit institutions or investment firms[7].

These requirements for investor due diligence, including of loan underwriting standards, may encourage marketplace lending platforms to promote and maintain high underwriting standards.

Loan agreements

If the loans are to be sold by an origination company to the securitisation SPV, the loan agreements should expressly permit assignment (or, in some European jurisdictions, at least be silent on the point).

The loan agreements would also need to permit the disclosure of data to the platform, the origination company and the securitisation SPV. Further, anonymised loan level data is required to be made publicly available via a website to be established by the Europe Markets and Securities Authority (ESMA) from January 1 2017 for all securitisations, although before that date ESMA announced that the website will be available until later.

Comment

Marketplace lending platform securitisations in Europe are an exciting new development. However, the way forward is not free from obstacles, particularly in relation to regulatory compliance both in origination and ownership of the loans and in relation to risk retention and disclosure requirements.

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[1] "Pushing Boundaries – The 2015 UK Alternative Finance Industry Report", Nesta and University of Cambridge, February 2016.

[2] "Peer-to-Peer Lending Goes Mainstream", Peer 2 Peer Finance Association, April 19 2016.

[3] "Funding Circle to tap securitisation market", Financial Times, April 14 2016.

[4] See Article 36H(4A) Financial Services and Markets Act 2000 (Regulated Activities) Order 2001/544, introduced by the Financial Services and Markets Act 2000 (Regulated Activities) (Amendment) Order 2016/392 Pt 2 Article 2(5)(d) with effect from March 17 2016.

[5] The European Banking Association has been critical of attempts to structure securitisation transactions which meet the legal requirements without following the "spirit" of the Capital Requirements Regulation. The European Commission, in the STS securitisation proposal, proposes to introduce a requirement that an originator may not be an entity solely established or operating for the sole purpose of securitising exposures.

[6] STS securitisation proposal, Article 5(1).

[7] STS securitisation proposal, Article 3(1)(a).

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