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Online lending platforms and securitisation: Bringing the wholesale market to the individual

by Julian Craughan, David Palmer and Emily Reid and first appeared in the June edition of Butterworths Journal of International Banking & Financial Law.

Key Points:

- Online lending platform securitisation in Europe is an exciting new development.
- For a portfolio of loans to be originated through an online platform, 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.
- Regulatory requirements for sound underwriting standards and investor due diligence (for example, under the AIFM Regulation and Article 409 CRR) may help ensure maintenance and promotion of high credit standards by the platforms.

In this article the authors consider the issues to be addressed in structuring an online lending platform securitisation in Europe.

Introduction

Online lending platforms market themselves as a portal to match borrowers, which are generally consumers borrowing for personal, family or household consumption purposes, SMEs 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; retail investors (hence the monikers "peer-to-peer" lending ("**P2P**") or "peer to business" lending) but also corporates and institutional investors investing directly or institutional investors investing indirectly through the wholesale funding market. Online 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.

Lending through online platforms has becoming increasingly attractive for retail investors given the eye-catching potential returns, additional security features (such as reserve funds)[1] which aim to protect investors in the event that a borrower defaults and, in the UK, the potential for tax relief by making P2P lending eligible through ISA allowances as confirmed in the 2015 budget.

It is not just retail investors that are getting in on the act; with relatively thinly capitalised platforms and granular portfolios of consumer and SME loans these loans are a natural candidate for funding in the wholesale markets through securitisations. Securitisation will also offer online lending platforms significant extra liquidity to help grow this developing market.

In the US, there have already been securitisations of consumer loans originated through online platforms Prosper Marketplace Inc. and Lending Club. Europe is not lagging far behind, with deals for Kreditech already completed and a number of other transactions due to complete during 2015. Recently, Bondora, an online lending platform which allows investors to invest in loans originated in Estonia, Finland, Slovakia and Spain, secured $5 million from one of the backers of LendingClub to invest in more complex infrastructure needed for pan-European leading.[2]

With the online lending platform securitisation market still in its infancy, in this article we consider a number of issues that would need to be addressed in structuring an online lending platform securitisation in Europe. For the purposes of this article we have focussed 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. We have not considered lending to online platforms via retail investors or direct lending via corporates or institutional investors.

Background

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 broker in matching lenders and borrowers. In certain jurisdictions, such as Germany and France, due to regulatory requirements it is necessary for a licensed bank to be the initial lender of record and then transfer the loan receivables to the ultimate lender. In addition, in some structures the platform will acquire receivables and then transfer or hold the benefit of part of those receivables for different investors (for example, this is common on supply chain or trade receivables finance platforms).

[1] See, for example, the Lending Works Shield.

[2] "P2P lender Bondora targets Europe", Financial Times Online, February 26 2015.

Accordingly, the platform itself will not typically hold a portfolio of loans for securitisation. It will probably be necessary therefore for an intermediate lender to lend through the platform and then sell the portfolio, once at a sufficient size, to a special purpose vehicle established for the securitisation (the "securitisation SPV").
We would expect the platform to continue to run credit and anti-money laundering checks on potential borrowers and provide a set of terms and conditions to which both borrowers and lenders adhere. The platform will co-ordinate advances and repayments on behalf of the borrowers and lenders and deduct fees for its services.

Online lending platforms have a number of key differences, some of which are summarised below:

- Some platforms focus on consumer lending whilst others focus on SME lending or trade finance.

- Some platforms allow lenders to approach the platform with the returns they are seeking and depending upon the risk appetite of the lender the platform will identify suitable borrowers. Others allow borrowers to make a proposal for lending which potential lenders can review.

- Lenders may be able to make all or part of a loan to a borrower. However, some platforms cap the maximum exposure of a lender to a borrower which can result in a loan being split into multiple smaller loans with different lenders.

- Lending is generally unsecured although some platforms do provide for secured lending.

- On some platforms the rate is fixed depending on investor's appetite for risk, but on others the borrower, through a form of reverse auction, can select the lenders which offer the lowest rates.

- Servicing is generally undertaken by the platform although some platforms will outsource servicing and collection to a third party. Enforcement of defaulted loans would usually be carried out by third parties.

- In some platforms (in the UK) repayments will ideally be made into a trust account so that lenders are insulated from an insolvency of the platform.

How could an online lending platform securitisation be structured in Europe?

Pan-European or single country?

For a pan-European securitisation to be possible there would need to be platform operators which sourced loans on a pan-European basis. At the date of this article many platforms (including all the significant UK consumer platforms)[3] operate on a single country model so at least initially it is much more likely that an online lending platform securitisation would be based on loans originated in one country. Alternatively, pan-European pools could be created if loans were aggregated from different platforms. This is likely to introduce additional complexity in describing the credit processes of each platform.

However, precisely because this is currently a relatively small (but growing) market, the pooling of loans from different jurisdictions within Europe may be necessary to achieve a sufficiently large portfolio to make a securitisation cost effective. We outline below the 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.

Lending and other permissions

One immediate legal problem with securitising loans originated through online lending platforms is that in many jurisdictions the platform provider itself will not be lending and will therefore not have needed regulatory permission to lend.

Accordingly, for a portfolio of loans to be originated through an online platform it is likely that 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, more likely, an intermediate entity will need to have permission to lend.

In the UK this permission to lend would not be required, for example, if each loan was in excess of £25,000 and was only made for the borrower's business purposes. For unsecured loans to consumers in the UK, it is unlikely that any exemptions would be applicable 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 ("**FSMA**"). 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 France and Germany, it would not be possible for the securitisation SPV or an origination company to lend directly as they do 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.

[3] Zopa, Rate Setter, Lending Works and Funding Circle all operate out of the UK

In the Netherlands, a securitisation SPV or origination company should be able to lend funds to SMEs without obtaining a banking licence provided that each loan is not provided for the purposes of consumer credit and the securitisation SPV or origination company has attracted its own funding from professional market parties. An SPV or origination company is deemed to attract repayable funding from professional market parties if the initial (minimal) amount is at least €100,000 or funding is obtained from other parties which qualify as professional market parties. Lending to consumers in the Netherlands through a platform is likely to require regulatory permissions.

The platform provider or other third party who agrees to service the loans for the SPV will also need to be appropriately regulated in the relevant jurisdictions. In the UK, this will likely include permissions for debt collection and debt administration among other matters. In addition, the platform operator will need permission to operate "a regulated platform in relation to lending" under Article 63H of the Regulated Activities Order under FSMA.

In the Netherlands, the position of platform providers is under review. The Dutch Authority for the Financial Markets (*Stichting Autoriteit Financiële Markten*) has recently published a report (https://www.afm.nl/en/professionals/nieuws/2014/dec/rapport-crowdfunding) which details the current regulatory status of the crowdfunding market in the Netherlands. Certain legislative recommendations have subsequently been suggested to the Dutch Ministry of Finance which are currently under review.

EU regulation of online lending platforms

In a recent opinion, the EBA has identified a series of risks for borrowers and lenders in respect of lending based crowdfunding through online lending platforms.[4] The EBA has recommended the convergence of practices across the EU, based on EU legislation, in order to avoid regulatory arbitrage and ensure a level playing field. This changing regulatory matrix may impact online lending platform securitisations in the coming years as the permissions that online lending platforms are required to hold develop.

The EBA has suggested a number of potential regulatory measures to address these risks, including the following:

- **Disclosure** - by ensuring that the platform discloses information in relation to the borrowers and the risks of investing, by ensuring that the platform conducts a risk analysis and by ensuring that the platform categorises lenders according to their appetite for risk;
- **Due diligence requirements** - by ensuring that the platform discloses detailed information about the extent to which a risk assessment has been performed and by requiring the platform to undertake an effective, proper and clearly defined due diligence procedure; and
- **Assessments of creditworthiness** - by requiring borrowers to make data available to platforms and by ensuring that the platform retains a certain amount of charges in a reserve fund to ensure repayment in the event of a default.

We would expect securitisation investors and rating agencies to want to see information on these areas in the prospectus or other offering materials in any event. To the extent not required by regulation, the securitisation SPV or origination company would need to agree with the platform that it would make this information available and, potentially, stand behind the accuracy of it for the purposes of the prospectus disclosure.

[4] Opinion of the European Banking Authority on lending-based crowdfunding, 26 February 2015.

Risk retention and the originator

To the extent that online lending platform securitisations are to be offered in the European wholesale markets or funded privately by European banks, alternative investment funds or insurers these will need to be structured to include qualifying risk retention. To qualify the "originator, sponsor or original lender" must retain a material net economic interest of not less than 5 per cent. in the transaction in accordance with Article 405 of Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012 (the "**CRR**") and Article 51 of Regulation (EU) No 231/2013 (the "**AIFM Regulation**"). Under the EU directive on the taking up and pursuit of the business of insurance and reinsurance (2009/138/EC) ("**Solvency II**") similar requirements will be imposed on insurers and reinsurers authorised in the EU.

As noted above, given that the platform will not generally act as the initial funder and it is not usually part of their business model to take exposure to the underlying loans, it may not be commercially possible for platform operator to hold the risk retention. Accordingly, some of the approaches seen to risk retention on CLOs may need to be adopted for this asset class. For example, a new originating company could be established, funded by a short-term loan facility and refinanced by the securitisation SPV once the portfolio is of a sufficient size. This company would act as the entity which originates the underlying loans and sells them to the securitisation SPV.[5] This entity could also hold any

[5] Given the "*Opinion of the European Banking Authority on the securitisation retention, due diligence and disclosure requirements*" published on 22 December 2014, care would need to be taken to ensure that the entity had sufficient capital at risk. https://www.eba.europa.eu/documents/10180/657547/EBA+OP+2014+14(%20Securitisation+Risk+Retention+Opinion).pdf

necessary permission to lend as well provided it had sufficient substance.

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 Alternative Investment Fund Managers Directive (2011/61/EU). There is an exemption for securitisation companies (which is usually relied upon) but this is only available where there is an originator entity and this will not be available where the loans are originated directly by the securitisation SPV itself.

In the UK, current guidance also provides more generally that a debt issuing entity will not ordinarily fall within the scope of AIFMD as implemented in the UK. This, however, 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.

Split loans

Certain platforms cap the exposure of lenders to a single borrower to ensure diversity of risk for lenders. This usually results in loans being split into smaller amounts (for example a £1,000 loan might be split between 10 lenders funding £100 each).

The cost to investors of increased diversity may be the loss of control. Depending on how the split loans are structured the securitisation SPV may not be able to direct that enforcement action be taken against borrowers if it had funded only part of a loan without involving the platform or other lenders. Furthermore, in the UK, unless there are exceptional circumstances, all lenders would need to be joined to a legal action against the borrower which would mean involving other retail lenders under the split loan. The undertaking of certain platforms to repurchase defaulted loans, which would side-step these issues, would not provide comfort to the required standard for a securitisation given the exposure to credit risk of the platform lender.

Generally, though, the split loans will be established as separate individual loans to the borrower so that each investor can take legal action against the borrower. Alternatively, with larger lenders it may be possible to agree with the platform to waive the diversification provisions given they will not require this protection.

Servicing and collections

We would expect the platform (or another third party) to 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.

To mitigate these risks:

- In the UK payments by borrowers and lenders should be made into segregated trust accounts so as to insulate these monies from the insolvency estate of the platform. Securitisation investors may want to establish a separate trust account for loans originated by (or sold to) the securitisation SPV to ensure that the trust property held for the securitisation SPV is clearly identifiable. Alternatively, and in other jurisdictions, instructions could be given to borrowers to pay directly to an account of the securitisation SPV or origination company.
- Some platforms have a back-up servicer in place which will step in should the platform default. Securitisation investors would need to be comfortable with the entity appointed as back-up servicer, the triggers for the replacement of servicing and the speed at which the back-up servicer can commence servicing the portfolio.
- Some platforms do not service delinquent receivables but sell these receivables onto specialist collection companies. This should mean that the securitisation SPV does not need the servicer to deal with more complex loan enforcement activities.

Origination Standards

Originators and sponsors in respect of online lending platform securitisations will also need to have regard to the requirements for disclosure to investors under Article 409 CRR and similar provisions in the AIFM Regulation and Solvency II 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. The Regulatory Technical Standards published by the EBA on 17 December 2013 indicate 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.

Furthermore, under Article 17 of AIFMD as expanded by Article 52 of the Level 2 Delegated Regulation, an alternative investment fund manager (AIFM) 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.
These requirements for investor due diligence including of loan underwriting standards may encourage the 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. Public disclosure of loan-level data, as required under Commission Delegated Regulation (EU) 2015/3 of 30 September 2014 regarding the regulatory technical standards on disclosure requirements for structured finance instruments, should be on an anonymised basis and therefore we would expect those disclosures to be permissible.

What additional incentives can be offered to investors in online lending platform securitisations?

Liquidity Coverage Ratio and High Quality Securitisation

Notes issued by a securitisation SPV backed by a portfolio of loans may be eligible as level 2B assets of high liquidity and credit quality for the purposes of Commission Delegation Regulation 2015/61 (the "**LCR**") and, subject to haircuts, count towards the liquidity buffer of a credit institution investor. Subject, among other matters, to the application of notes issued by the securitisation SPV being rated at least AA- (S&P / Fitch) or Aa3 (Moody's).

Article 13(2)(g)(iii) of the LCR permits the inclusion of certain securitisations of SME loans in the liquidity buffer. Article 13(2)(g)(v) of the LCR permits the inclusion of certain securitisations of loans and credit facilities to individuals resident in a Member State for personal, family or household consumption purposes in the liquidity buffer.

In order to be eligible, among other matters:

- An origination company is required - as it is unlikely that the securitisation SPV will be able to originate the loans directly since Article 13(2)(c) requires the underlying exposures to have been acquired by means of a true sale. Furthermore, Article 13(13) requires the originator, if it is not a credit institution, to have its principal activity as one of the activities listed in points 2 to 12 and point 15 of Annex I to Directive 2013/36/EU. These activities comprise matters such as deposit taking, lending and payment services.
- The pool of loans would need to be homogenous which could raise issues if there are loans from more than one jurisdiction (particularly, for example, if the nature of the loans are different) or there is a mixture of consumer loans and business loans (Article 13(2)(g)).
- Obligors would need to have made at least one payment under the credit agreement.

Eligibility for ECB liquidity scheme

Notes issued by a securitisation SPV may qualify as collateral eligible for use in liquidity schemes offered by the ECB to credit institution investors.

Notes issued by a securitisation SPV may be eligible for Eurosystem operations under Guideline ECB/2014/60 which applies from 1 May 2015 ("**Guideline**"). In order to be eligible:

- the securitisation may not contain any assets originated directly by the SPV which means an originator company will be required (Article 73(3) of the Guideline);
- the securitisation SPV and the originator company would both need to be established in the EEA (Article 74 of the Guideline);
- the securitisation should be homogenous, which could potentially raise issues if there are loans from more than one jurisdiction (particularly, for example, if the nature of the loans are different) or there is a mixture of consumer loans and business loans; and
- loan level data templates would need to be prepared, which may cause issues if insufficient performance data is available.

Conclusions

Online lending platform securitisation in Europe is an exciting new development. The way forward though is not free from obstacles especially given the absence of an obvious originator under most platforms therefore making it more difficult for the structures to comply with risk retention requirements.

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Hogan Lovells' Global Securitisation Practice

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We advise on the financing of a wide range of classic and innovative asset types, both as public and private stand-alone issues, master trusts, programs, and through conduit structures. We are regularly commended by independent market guides, particularly for our work in asset-backed financing and insurance-linked securitisations, and for our ability to advise on new and innovative transactions. In addition, we run one of the few practices able to offer dedicated and knowledgeable advice to capital markets trustees.

Our experience in structured finance and securitisations, combined with the resources dedicated to tax, regulatory, and US securities issues resident within Hogan Lovells' international offices, allows us to provide clients with a competitive, knowledge-based service for all structured finance transactions.

Our team is also involved in issues regarding the changing regulatory environment relating to structured finance, Dodd-Frank legislation in the US and the relevant EU directives, including, compliance counseling, disclosure and advocacy relating to the legislation. In addition, our team has experience advising clients on issues relating to derivatives related infrastructure, including clearing, data repositories, broker-dealer matter and exchange execution. Hogan Lovells' track record

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- Residential mortgage backed (RMBS)
- Commercial mortgage backed (CMBS)
- Trading receivables
- Insurance
- Equipment leases and operating assets
- Future flow securitisations from emerging markets
- CLOs
- Whole business