FINANCING MARKETPLACE LOANS: TEN KEY THINGS TO KNOW BEFORE CATCHING THE SECURITIZATION WAVE

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Securitization and Structured Finance Alert

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Marketplace loans are the most exciting securitization asset class to emerge since credit cards and student loans. Securitization provides marketplace loan investors with liquidity, diversified funding and interest rate arbitrage opportunities. Securitization also involves complex legal requirements and specialized expertise that investors need to be familiar with if they want to grow with this new market.

This article provides a basic overview of important issues that must be considered in a securitization, including structural issues, ratings, securities law reporting, and liability and credit risk retention requirements. It also addresses how the JOBS Act, the Volcker rule, Regulation AB and other regulations might affect marketplace loan securitizations.[1]

1. THIS IS HOW SECURITIZATION DIFFERS FROM OTHER TECHNIQUES FOR FINANCING PORTFOLIOS OF MARKETPLACE LOANS.

Sometimes we see confusion about the meaning of the term "securitization" and how it differs from other types of secured finance, such as asset-based financing and warehouse lines. Securitization differs from those other types of financing because it represents disintermediated financing that is delinked from the creditworthiness of the sponsor.

Securitization classically involves the issuance to capital markets investors of securities that are backed by and paid from a distinct pool of financial assets. The asset-backed securities are issued by a special purpose vehicle (an "SPV") that has purchased the financial assets from the sponsor or originator and that pledges them as security for its obligations under the asset-backed securities. The asset-backed securities consist of two or more tranches, each of which assumes a distinct credit or other risk of the securitized assets. If the SPV is established in a bankruptcy-remote manner, and if the transfer satisfies the requirements for a "true sale", then the securitized assets can be presumptively removed from the bankruptcy estate of the originator of the assets.[2]

A key objective in tranching of asset-backed securities is to create as large a senior class as possible that has a better credit profile than the securitized assets generally, thus permitting the sponsor to issue asset-backed securities with a lower net funding cost than the interest and fees received on the securitized assets. Tranching is accomplished through the use of credit enhancements, such as prioritization of payments to the more senior tranches. Initial losses are absorbed by the first-loss tranche, followed by a mezzanine tranche, which absorbs additional losses until reduced to zero, with further losses being absorbed by senior tranches in reverse order of seniority until each is reduced to zero. Tranching insulates the most senior investors from the default risk of the underlying asset pool to the extent that the more junior tranches absorb credit losses.

Marketplace loan securitizations involve the issuance of "asset-backed securities" ("Exchange Act ABS"), as defined in section 3(a)(77) of the Securities Exchange Act ("the Exchange Act"). An Exchange Act ABS is "a fixed-income or other security collateralized by any type of self-liquidating financial asset (including a loan, a lease, a mortgage, or a secured or unsecured receivable) that allows the holder of the security to receive payments that depend primarily on cash flow from the asset." The definition of Exchange Act ABS is generally understood to apply to tranched exposures. Exchange Act ABS may be issued as notes or as pass-through certificates and may be publicly registered, privately placed or sold in Rule 144A offerings. A servicer (and possibly one or more back-up servicers) is appointed to manage the securitized assets and payments made thereunder.

Representations and warranties and repurchase obligations are standard features of securitizations. In the underlying transaction agreements for an asset securitization, the sponsor and the originators typically make representations and warranties relating to the pool assets and their origination, including about the quality of the pool assets. Upon discovery that a pool asset does not comply with the representation or warranty, under transaction covenants, an obligated party, typically the sponsor, must repurchase the asset or substitute a different asset that complies with the representations and warranties for the non-compliant asset. The practical impact of repurchase obligations in a marketplace loan securitization may be different than it is in securitizations of many other asset classes because the online lending platform often retains recourse only in very limited circumstances. This means that the sponsor may not be able to look to the marketplace lending platform or the originator to satisfy repurchase demands.[3]

The appeal of securitized marketplace loans is that they have the attributes of a fixed-income security with a relatively low default risk. Marketplace loans are both suitable and desirable for securitization for a number of reasons. They are a highly homogenous asset class with low borrower concentration and a steady flow of new originations. They have relatively high risk-adjusted interest rates and have thus far enjoyed relatively low default rates. They pay a predictable stream of principal and interest payments over a relatively short three- or five-year time horizon. A marketplace loan securitization does not raise particularly complex tax issues (unless it is backed by mortgage loans).

However, the asset class is not without challenges. These include consumer protection laws, potential applicability of state usury laws, and potential assignee liability. They also include particular risks associated with the originators of the loans and the lending platforms that sell and service the loans, including risks that may arise from their bankruptcy, violations of lending laws and the potential unavailability of federal preemption of state usury and consumer protection laws.

In addition, a securitization is vulnerable to performance and bankruptcy risks of the online lending marketplace that acts as the servicer, because any disruption to the ability of the platform to service the loans can impact the SPV's ability to timely receive payments on the securitized loans and meet payment deadlines on the asset-backed securities. Another risk is that in the case of fractional marketplace loans (as opposed to whole loans), the SPV does not own actual loans, but instead holds borrower payment-dependent notes issued by a separate trust vehicle, giving the SPV a participation right that is subject to additional risks created by having an intermediate trust vehicle in the chain of ownership. These risks may be mitigated by back-up servicing arrangements, perfection of ownership interests in the assets under the applicable uniform commercial code and other devices.

To read the full alert, click here.

Notes:
[1] For a discussion of certain securities law, investment advisory and investment company regulatory issues applicable to this industry, please see our alert entitled *Securities Law Considerations in Marketplace Lending*.

[2] See section 3 below for a discussion of bankruptcy remote structuring considerations.

[3] For a discussion of these issues and of differences in the approaches that some marketplace lending platforms take with respect to recourse on assets sold to securitizers, see *Why Lending Club has shunned securitisations*, Financial Times (Jan. 11, 2016).

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