Consumer Finance Monitor (Season 3, Episode 2): The OCC's and FDIC's Proposals to Undo the Madden Decision: What They Would and Wouldn't Fix

Speakers: Alan Kaplinsky and Jeremy Rosenblum

Alan:

Welcome to the Consumer Finance Monitor podcast, where we explore important new developments in the world of consumer finance and we tell you what they mean for your business, your customers, and the industry. I'm your host today, Alan Kaplinsky. And I'm the chair of the Consumer Financial Services Group at Ballard Spahr. And I will be moderating today's program. For those of you who want even more information than we're able to provide to you today, don't forget to go on our blog, which is also called consumerfinancemonitor.com. We've been doing our blogs since 2011, so there is a lot of content there. We also regularly host webinars on subjects of interest to those of you that are in the consumer finance industry. So to subscribe to our blog or to get on the list for our webinars, please visit us at ballardspahr.com. And if you like our podcast, please let us know about it. Leave us a review on Apple podcasts, Google Play, or wherever you get your podcasts.

Alan:

So, today I'm very pleased to have as my guest, my colleague Jeremy Rosenblum. Jeremy, he is a leader in the Consumer Financial Services Group at Ballard Spahr. And one of many areas that Jeremy focuses on is of federal usury law and how it interacts with state usury law, particularly when it involves banks. And we've got a very interesting topic to talk about today, but first Jeremy, let me welcome you to the program.

Jeremy:

Thank you, Alan.

Alan:

Okay. So, I guess it's about a year and a half ago, the second circuit came down with an opinion in a case called the Madden case. M-A-D-D-E-N. And that really shook the foundations of the consumer financial services industry. Before we get into what the reaction to that case has been, I would like you to share with our audience what that case involved and what the court held? And why it is such a problem?

Jeremy:

Okay, Alan. So, Madden involved charged-off credit card debt initiated by Bank of America National Bank. Unquestionably, when the debt was held by Bank of America, the rates charged on the debt were entirely lawful.

Alan:

Is that because they were in Delaware?

Jeremy:

It was because they were located in Delaware, which is a state that did not have limitations on interest rates. And under federal banking law, banks are allowed to charge interest at the rate allowed by the laws of the state where they're located. So, when it owned the debt, there was no question of a usury violation. But Bank of America sold the debt probably for pennies on the dollar to a company called Midland Funding, which was not a bank, but nevertheless tried to collect the debt and also to

collect interest on the debt at the same rate that Bank of America had utilized prior to the sale. The second circuit reviewed that arrangement and basically concluded that while Bank of America had the right to charge the interest rate, Midland funding did not. Therefore, there was a violation of New York usury laws.

Alan:

Why did the court reach that conclusion? What was its reasoning Jeremy?

Jeremy:

Well, the conclusion was basically, that banks have special usury powers under federal law, but non-banks do not. So, once the bank no longer held the debt, the special power available to banks was no longer applicable.

Alan:

Wow. Well, that really, why it was what happened in that particular case and that's pretty bad. But aren't the implications here much, much broader? Because banks very often don't keep receivables in their portfolio. They can't for capital reasons. They've got to offload the receivables. So what are the implications?

Jeremy:

So the fears are much broader than the facts of this case, involving charged-off debt. It's not entirely clear to me that when presented with a different set of facts that a court, even the second circuit would reach the same result. So central the second circuit's conclusion was that application of a new lower interest rate to the debt that had been assigned to a non-bank was its conclusion that applying this lower rate would not have a material adverse impact on the bank. The court would clearly, its mode of analysis suggested that it would have reached a different result if there had been a significant impairment of any bank power that it sought. When banks engaged in sales of debt prior to charge-off, when for example, they engage in a marketplace lending program where they originate the debt with the intention of selling it off shortly after origination to apply the same rule to those scenarios would have a much greater impact on the bank. And therefore it's not clear that the court would reach the same result. Additionally-

Alan:

Here, we were talking about a national bank and national banks have the express power, don't they, to originate certain assets and to sell them. Isn't that actually a side from the usury provision section 85, isn't there a further right under, I think it's section 24, paragraph seven?

Jeremy:

That's correct.

Alan:

Yeah. And you would think that that ought to have some bearing. I mean, if Congress thought that and it would be really extreme it seems to me for Congress to give the power to a national bank to originate and sell, but then say, which they didn't say in the statute, but if you sell, you're going to lose this other authority you have under section 85.

Jeremy:

That's exactly right. And that's why I'm not sure that well, Madden gives me concern as a practitioner and as somebody guiding banks and non-banks through these kinds of transactions, but I feel actually relatively confident that I can address Madden in ways that don't entirely eliminate risk, but can keep risk at a manageable level. That being said, I mean, the action that we're here to talk about, the proposal by both the FDIC and the OCC to conclude in a formal rulemaking proceeding, that the interest rates charged by a bank at loan origination, remain or permitted by the bank at loan origination, remain the

permitted interest rates even after the sale by the bank. I think that's a worthwhile thing. Madden has the markets to some extent, I think the immediate reaction has abated somewhat, but still it's a worthwhile thing to do. I consider this a little bit more than a baby step to address Madden. And there are other serious issues that can arise in debt sales that I would like to see the agencies address.

Alan:

Well, yeah. And I definitely want to get to that, but let's stay with Madden for a moment. And so, the OCC and the FDIC obviously don't like the Madden opinion or they're worried about it, right? As I recall, when Madden got to the Supreme court was served petition, got filed by the debt buyer, the defendant. And I think the solicitor-general with the support of the comptroller filed a brief in the Supreme court where while they didn't urge the court to take the case, I wished they had, seems to me that was shortsighted not urging the court to grant cert, although cert may very well not been granted in any event, but they did say very clearly the Madden opinion was wrong in their brief, right?

Jeremy:

Yes they did. And they said it recently in an Amicus curiae brief, they filed in a bankruptcy case, which was very unusual to file a brief really at that level, not in the appellate courts. And I have to say that they articulated a rationale for opposing, disagreeing with Madden that I found quite convincing.

Alan:

Yeah, well, tell me, let's tell our listeners what that rationale is? What did they say?

Jeremy:

So they argued three things. First, they argued that first and second, they argued that there were two common law principles that ought to have been applied by the court in Madden and in the bankruptcy case. They said that there's a general principle that when a contract is assigned that the asset-ne, the recipient of the contract, steps into the shoes of the asset-nor and has all the rights with respect to the contract that the asset-nor had and that this rule was disregarded by the court. They added that there's a second common law rule that basically the rule is that valid at inception that went a loan is made, you look to see whether there's a usury violation at the time it's made. And if it's valid and lawful at inception subsequent events or changes in the law or assignments to the loan, don't render the loan invalid or unlawful. And that's basically the position that they articulate very clearly in the proposed rules.

Alan:

And that's a principle that you just reiterated is a venerable principle. I mean, is that like a very basic usury law principle that I would think that if you looked at state usury laws around the country, you would find that as being pretty well-established.

Jeremy:

There is sweeping language in many cases, including U.S. Supreme court cases in the 19th century, that basically articulate this position.

Alan:

Right. So, the OCC and the FDIC now have issued a, it's not a final reg, right? So just proposed subject to a comment period. I assume that it would be a good idea for people in the industry, certainly national banks, state chartered banks, whether you're involved in selling loans, because they've been charged off, you're selling them to a debt buyer, or you've got a private label credit card program with a merchant or you've got a marketplace online lending program where you've partnered with a non-bank or you're securitizing receivables, you should be coming in there, filing a comment letter and making your views known and being supportive of what the OCC and the FDIC have proposed here.

Jeremy:

Absolutely.

Alan:

Yeah. Any idea Jeremy, how after the comments come in, how long it might take for a final rule to be issued?

Jeremy:

I'd just be guessing. I think I wouldn't expect to see a final rule in less than three months or so, but it seems to me that this is more discrete rulemaking than others we've seen. For example, the payday loan rulemaking, where-

Alan:

Although it was likely to be controversial, don't you think? There will be a lot of consumer advocates and plaintiff's attorneys that may be involved in cases where this could have an impact. I would assume they will not like what the OCC and the FDIC are proposing here.

Jeremy:

This will clearly be controversial. We have already seen blog posts from the plaintiff side or the consumer advocacy groups that really they're up in arms about the proposal.

Alan:

Professor Adam Levitin at GW or Georgetown, I can't remember which one, he's already written a pretty detailed blog post setting forth his position. And he's I know didn't like the filing of the Amicus brief and it doesn't like the proposed reg here at all. I guess, just a concern I have that the agencies is better get this thing wrapped up before the end of the year, probably before the election. But assuming hypothetically, we have a democratic president next January changes will happen at the OCC and the FDIC. And just a guess.

Jeremy:

I'm not prepared to accept that your hypothetical Alan but yes, I think, there is, you mentioned Professor Levitin and he is a very bright guy and he writes forcefully. So, it is incumbent upon the industry to have its advocates put their best foot forward in support of this role. And yes, if it doesn't happen this year before January, there is at least a possibility that it will never happen.

Alan:

Yeah. So assuming it gets finalized, Jeremy, this really happens, do all the problems in this area go away, or is there anything else left for us to worry about?

Jeremy:

So, the problems do not go away. And there are many programs are out there where a bank in a non-bank agent will partner together to offer loans and other consumer financial products. And these programs are subject to attack, not only under the Madden doctrine, but also under a rule called the true lender rule. And here, the opposition says that, "Well, the loan is formally made by the back that in substance, it's the non-bank that has the greater financial interest, the so-called predominant economic interest in the loans. And that when the non-bank does all the marketing, does all the servicing and acquires the loan or the overwhelming economic interest in the loan that it should be regarded as in substance, the true lender. And since non-banks did not have the special usury authority provided by federal law than if the lender is recharacterized as the non-banking agent, the parties to these programs are basically in a world of hurt.

Alan:

Isn't this an issue that you and I litigated many years ago when payday lenders had partnered with banks, I think at the time it was principally national banks, but there may have been some state charter banks involved, and there had been a class action litigation. And I seem to recall, you want an important case, the Hudson case. And if my recollection serves me correctly, it was in federal court in Indiana, am I right?

Jeremy:

There's no way you forgot in that case, it was-

Alan:

It was a big case.

Jeremy:

It was an important case. And yes, the decision was favorable to the industry. And the court basically said, "This is not an area where a piecemeal litigation should establish the rules that the Supreme court recognized in its leading case, the Marquette decision, that certainty was important to the banking industry." It further recognized that the protection of usury laws was a matter best left to Congress and not the courts by establishing exceptions to the principles that were outlined by Congress. So, that was basically what we argued in Hudson and the court adopted that argument that basically said that there was some superficial appeal to this idea of re-characterization, but it was something best left to Congress and perhaps the banking agencies. And I felt that way 10 years ago, or when Hudson was decided and I still feel that way. I think there really is a place for Congress or more likely the backing agencies to get involved in these issues. I think the agencies... Right now, we have a number of FDIC supervised banks that are engaging in loan programs with non-bank agents assisting in the delivery of the loan products.

Jeremy:

The FDIC is clearly aware of these programs and is letting them proceed. So it is apparent that the FDIC believes these programs are lawful. The agency however, has been somewhat reticent in communicating that view explicitly.

Alan:

Well, isn't it even beyond reticent, couldn't you argue based on some of the language, not in the reg itself, but in the commentary accompanying the reg that the FDIC seems hostile to these kinds of programs. It has some negative things to say about the program, am I'm right?

Jeremy:

Yes.

Alan:

And what did it say?

Jeremy:

So actually there were two statements in the preamble to the proposed rule. I'll just read one of them. It says, "The FDIC views unfavorably a state bank's partnership with a non-bank entity for the sole purpose of evading a lower interest rate established under the law of the entities licensing states." That is clearly a warning shot to participants in programs of this type. Now, what I would like to see, and what I think is fair for the industry to request is although this may fall in the rubric of, "Be careful what you wish for," but I would like to see the FDIC articulate the scenarios where it feels comfortable with programs

of this type and scenarios where it clearly feels that there's something going wrong. For example, when Congress enacted Dodd-Frank. It adopted skin in the game rules for asset-backed securitizations.

Jeremy:

And basically, it said that the promoters of these securitizations ought to retain at least a 5% economic interest in the underlying loans. And what Congress was effectively saying is 5% is enough to impose discipline on the market to make sure that the promoters have a meaningful economic state. Now, it seems to me that in programs where a bank retains a 5% economic interest and transfers 95% either to the non-bank agent or to a third party, a passive institutional investor, for example, that by analogy to what was approved by, in Dodd-Frank were asset-backed securitizations that the 5% ought to be enough. Now I'm not saying that that's ought to be required, but I think that for the FDIC to articulate that at least in that scenario, something is going on here beyond just a mere attempt to evade usually what state usury laws that something that the FDIC had a problem with.

Jeremy:

I think they could say clearly when the bank is retaining a meaningful economic interest, either 5% or something that is meaningful at least to the back, which might be less than 5% for a small bank, then in that scenario, what's happening is an appropriate use of federal banking powers that the bank is putting assets on its books, it's taking a risk, it is acting as a true lender, but it is using the auspices of a non-bank party to market and service the loans. And this is what banks do all the time. Banks don't go alone. They have service providers, including of course non-bank service providers. And I think the FDIC in the preamble has raised an issue. And I hope that I think it's gone a little bit down the road of raising this issue. And I think it really would behoove the FDIC to clarify its concern and at least articulate situations where it does not have a problem with-

Alan:

Did the OCC address the subject in its preamble?

Jeremy:

It did not. But the statement by the FDIC is very, very similar to a statement articulated, I think by the former acting controller of the currency.

Alan:

Keaton.

Jeremy:

I think it was Keaton who basically made comments that were very similar. And I know we were scratching our head at the time, trying to understand what he was trying to communicate. And like I said, there's a possibility of appall over these programs created by language of this type. And it would be helpful to have-

Alan:

And the same goes, "Loose lips sink ships."

Jeremy:

Well, I wouldn't put it quite that way, but that is the same.

Alan:

Right. So you sort of wonder whether the FDIC is trying to chart staying with the ship analogy, chart a middle course here, trying to give the industry Madden, but make it clear they're not dealing with true lender. And by the way, they really have

somewhat of a jaundiced view of certain kinds of partnerships that state chartered banks have entered into. One wonders what's wrong with entering into I mean, the premise of the FDIC. I guess I would challenge that head on and say, so what? I understand your argument Jeremy about skin in the game and the bank retaining at least a 5% interest, but banks have always for many, many years relocated their principal office for the specific purpose of evading the usury law of a lot of states.

Jeremy:

I would say avoiding the usury law.

Alan:

Yeah. Well, avoiding, okay? Why isn't this just another avoidance technique and what the heck is wrong with it? Is there anything wrong with it?

Jeremy:

Okay. So look, my philosophy is I like to see consumer choice, I did not adopt a paternalistic view that is reflected in many narrow usury laws. So, I'm quite comfortable with banks making loans throughout the country at effectively deregulated interest rates. And if banks can do it, then the question becomes, well, why not non-banks? Now one role that banks have in a properly structured program of this type is that they exercise supervision and control over the program. And so, when you think of a FinTech company that has a great new idea for making or delivering loans. The odds are that that company will not have the broad base of knowledge of federal banking laws, of consumer protection laws required to deliver the product effectively and fairly on its own. So there really is a valuable role played by banks that are engaging in these programs properly.

Jeremy:

And that role is a supervisory role that the bank approves the loan documents, it approves the marketing messages, it approves basically everything that the non-bank is doing. And this is a feature of well-done programs. Now, are there programs are out there where the bank itself may lack sophistication and may not be exercising the requisite level of supervision and control? I suspect that there are, or that there are banks that are seeking to do that. And perhaps, viewed charitably, that's what these comments are all about, that there ought to be some important role for the bank. And in my view that that role would be supervision and control. And frankly, the bank is on the hook for legal violations for the loans that it makes. And when it sells a participation interest, as opposed to selling the whole loan, it remains on the hook after the origination of the loan for the proper servicing of the loan.

Alan:

And the OCC, or the FTIC can examine the non-bank partner, right? They've got a right to go in and kick the tires to see are they treating consumers okay?

Jeremy:

Yes.

Alan:

Yeah.

Jeremy:

And you will find that sometimes the FinTech folks are surprised at the level of supervision that they encounter both from the bank directly and indirectly from the federal banking regulators.

Alan:

Right. Well, Jeremy, I want to thank you very much for sharing your wisdom with us today about Madden and true lender. This is a topic, certainly it's not going to go away and I'm sure, once the comment period is over and we can gauge sort of what the level of opposition to this thing, it may be worth revisiting it again sometime in the next several months. But thank you and for our listeners, thank you listening today, make sure to visit our website, www.ballardspahr.com, where you can subscribe to our show, either an Apple podcast, Google Play, Spotify, or your favorite podcast platform. And don't forget to check out our blog, consumerfinancemonitor.com for daily insights of the consumer finance industry. And if you have any questions or suggestions for our show, few feel free to email us at podcast, that's singular podcast, @ballardspahr.com and stay tuned each Thursday for a new episode, we have a new program except when a holiday falls on a Thursday, we take that week off. Thank you again.