Consumer Finance Monitor (Season 4, Episode 36): Congress Overrides the OCC's True Lender Rule: What Are the Risks for Banks and Their Loan Program Nonbank Partners?

Speakers: Alan Kaplinsky, Jeremy Rosenblum, Ron Vaske and Mindy Harris

Alan Kaplinsky:

Welcome to Consumer Finance Monitor Podcast, where we explore important new developments in the Consumer Financial Services industry. Very recently, we did a webinar on a very important and timely topic that remains very timely. And I felt we owed it to our podcast listeners who presented to you today in its entirety. The title of the webinar was Congress overrides the OCC's true lender rule. What are the risks for banks and their loan program non partners? I'm Alan Kaplinsky, Senior Counsel at Ballard Spahr and former chair of our Consumer Financial Services group. So let me just give you a little bit of background about our podcast today. The Comptroller of the currency's true lender rule was intended to create a bright line test for when a national bank or a Federal Savings Association should be considered the true lender in the context of a third party partnership.

Alan Kaplinsky:

Now that Congress through a Congressional Review Act resolution that was signed by President Biden has overturned the OCCs rule. Banks and their non bank partners must continue to navigate diverging court decisions and can expect their lending programs to face increased scrutiny from state regulators. In addition, changes in leadership at the OCC and other federal agencies under the Biden administration could result in a much more challenging regulatory environment. So in today's program, we are going to analyze and discuss the risks to banks and their loan program non partners in the wake of the true lender rules congressional demise. We will discuss the implications of the Congressional Review Act override for future true lender rulemaking, and the impact of the override on existing law.

Alan Kaplinsky:

We will also discuss key true lender decisions and current true lender challenges. The status of the OCC and the FDICs related Madden-fix rule, potential loading programs structures and risk mitigants for loan programs. I'm joined today by three of my colleagues who have a wealth of experience in navigating through these complicated rules, the true lender rule and the Madden-fix rule. And they've done it in the context of a bank model lending partnerships, which is about as complex a type of joint venture as you can identify. So my colleagues who will be discussing this today are Mindy Harris, and Jeremy Rosenblum and Ron Vaske. So without further ado, I'm going to turn this program over to Mindy.

Alan Kaplinsky:

Before I turn the program over to our first speaker, Mindy Harris, who also has been working very much with Jeremy on putting together this new memo dealing with bank model lending. But let me introduce to you our speakers today. Mindy Harris, has been with us for well over a year now. And she has a wealth of experience in the Consumer Financial Services industry. At one time was the General Counsel of Nordstrom credit card Bank, and anyway, we're absolutely delighted down to have Mindy, part of our team. Jeremy is a partner in our Consumer Financial Services group works out of our Philadelphia Office. And it's been a while since he's been there, but should be back there soon. And his practice also focuses on a wide range of issues and topics, dealing with consumer finance and has a particular focus on the topic that we're going to talk about today.

Alan Kaplinsky:

And the reason we're saving him for last is because while you might find the early part of the webinar, upsetting and troubling, and it is, because there's unfortunately, developments that have occurred that have not been good for that industry. Jeremy at the end will tell you, give you, share with you some ideas for mitigating risks. So I very much encourage you stay on right through Jeremy's presentation. Ron Vaske will also be on our program today. Ron works out of our Minneapolis office. And Ron also, like Jeremy and Mindy is very heavily involved in bank model lending, both representing banks and non banks. So without further ado, let me now turn the program over to Mindy.

Mindy Harris:

Thanks, Alan and good afternoon, or good morning, everyone. Thanks for joining us today. As Alan said, a lot has happened in the last six months on the true lender front. And before we jump into current events, just in case anyone needs a refresher, I want to quickly go over the background and the basics of the true lender issue. And its companion topic valid-when-made and what set the stage for the rules issued last year by the OCC and the FDIC. And here we are on slide eight. The National Bank Act which is Civil War era, federal law establishes preemption of state law to protect national banks from state laws that significantly interfere with the national banks exercise of powers. And a very important element of the National Bank Act is interest rate exportation.

Mindy Harris:

Under the NBA a National Bank has the power to charge interest on loans at the rate permitted by the state where the bank is located, regardless of any conflicting law of the state where the borrower resides. Obviously, this power is critically important in multi state lending programs and bank model programs. Over 100 years later in the 1980s, state banks and federal and state savings associations were given basically, equivalent interest rate exportation rights under federal law. And case law and regulatory interpretations over the last 30 plus years, solidified bank rate exportation powers. And then things started to change. In 2010, the Dodd-Frank Act narrowed the OCC's authority to adopt overarching preemption interpretations.

Mindy Harris:

But Dodd Frank also included a section that clearly preserves a national bank's right to export interest rates. On slide nine please slide nine, illustrates the concepts we're discussing and the arguments used by rate exportation opponents and I thought I'd give you a little graphic to look at rather than words, but we're going to go right back to lots of words. Beginning before Dodd-Frank, definitely before, but steadily increasing after 2010 numerous cases have been brought by state AGs putative class plaintiffs and others attacking interest rate exportation claiming. And you can see the attacks illustrated here that an entity other than the bank was the true lender, or even if a loan was valid when made by a bank, the bank's rate exportation powers would not survive sale or assignment of the loan.

Mindy Harris:

Slide 10 please. In these cases, it was argued that marketing structure servicing agreements, back end financing arrangements or early financing arrangements in place with respect to the loans in question caused the loans to be made or owned by a non bank third party, not the originating bank and therefore it was the ledge the interest rate charged by virtue of the originating lenders exportation rights now violated state usury limits. The remedy sought in these cases are extremely punitive. Including restitution of all interest paid, damages, fines, penalties, permanent injunctions and orders declaring that the subject loans were unenforceable and void.

Mindy Harris:

So if we could go to slide 11 please, one The cases that garnered a lot of attention in this area was Madden versus Midland funding, a class action that attacked valid-when-made. And you can see the details of the Madden case on slide 11 and read it at your leisure when you receive the deck in the future. In a nutshell, in this case, the Second Circuit Court of Appeals overturned a federal district court decision and held that when a national bank sold a loan to a non bank, the originally valid

interest rate became subject to the usury laws of the borrower's home state. Even though the national bank had the power to export the interest rate permitted under the law of its own state when making the loan.

Mindy Harris:

The United States Supreme Court declined to review this case. And it's important to note that the OCC and the Solicitor General, filed an Amicus brief advising the Supreme Court not to review it but, acknowledging the outcome in the Second Circuit was wrong. And even though courts have distinguished the Madden and decision when people try to use it, many courts have followed it and Madden really sent shockwaves through the industry. Giving rise to fears that would result in constraints on credit, due to bank concerns that they would not be able to securitize debt or enter into other financing arrangements for their loan portfolios, which apparently did happen in Second Circuit states. And then let's go to slide 12, please, and talk about true lender.

Mindy Harris:

So, as I mentioned earlier, the true lender argument attempts to defeat bank rate exploitation by claiming that someone other than the bank really made the loan. Not the bank itself, and therefore the interest rate cannot be exported. For example, in bank FinTech or bank model arrangements, where a FinTech provides operational and marketing support to a bank to help with loan origination and the FinTech buys all a significant portion of the receivables generated, the plaintiffs will claim that the FinTech, not the bank is the true lender. And there are catchphrases used in these claims. They're based on allegations that the FinTech has the predominant economic interest. You'll see that in a lot of these cases where overriding control over key elements such as underwriting and pricing. And some courts have agreed in these cases that the FinTech, not the bank is the true lender, while other courts in what we think are better reasoned decisions, view the bank as the true lender because the bank originated the loan, is the party to the contract with the borrower is named in the contract as the lender, is responsible for compliance and advance the money in the first place.

Mindy Harris:

So, that's background, and let's go to slide 14 and talk about against this backdrop and in light, one more slide 14. In the light of this growing patchwork across the United States, have diverse case law and actions by state authorities, the federal prudential banking regulators decided to step in. The OCC's final valid-when-made rule, also known as the Madden fixed rule was issued at the end of May 2020. And as you can see, the rule says, "Interest on a loan made by a national bank or a federal thrift that is permissible when the loan is made, shall not be affected by the sale assignment or transfer of the loan." In the supplementary material with issued with this rule, the OCC made it clear that the valid-when-made rule was not intended to address true lender one way or the other. The FDIC then followed suit with a final valid-when-made rule issued just about a month later, basically mirroring for state banks the effect the OCC rule had for national banks.

Mindy Harris:

Three states promptly filed a lawsuit in federal court challenging the OCC valid-when-made rule and then a bunch of states also filed suit in the same court trying to enjoin the FDIC valid-when-made rule, and both of those cases are pending in front of the state judge. So let's go to slide 15. And now we come to the OCC true lender rule. In later July of 2020, the OCC issued its proposed true lender rule, and the OCC wanted to state a very clear, bright line true lender test. Basically, if a national bank or federal thrift is named as the lender in the loan agreement, or funds the loan, then that lender, that bank is the true lender, according to this rule. The rule sparked an incredible amount of controversy and dialogue. The OCC when it issued the final rule set about 4000 comments were submitted on this rule. I personally saw over 700 comments posted on the regulations.gov website where comments are posted, and the agency doesn't have to post all the rules. Interesting, this is in contrast to 60 or so comments that were posted on the OCC valid valid-when-made.

Mindy Harris:

So when the OCC issued its final true lender rule at the end of October 2020, it adopted the same test as the proposed rule, the bright line, and then a new subsection that said if two banks are involved, when named as the lender in the documents,

and the other that funds the loan, then the bank named in the loan documents is the true lender. The FDIC did not issue a true lender rule, some people were disappointed about that, and there were reasons why the FDIC felt it did not have the statutory authority to do that. And then not surprisingly, many of the same states that filed lawsuits against the valid-when-made rules, filed lawsuit in federal court in New York, seeking declaratory judgment and to enjoin the OCC true lender rule. So, after the 2020 election brought democratic control of the Senate, along with the house and the administration, the opponents of the true lender rule wasted no time in pursuing invalidation of the true lender rule using the Congressional Review Act.

Mindy Harris:

I'm going to refer to that as the CRA and of course, it's not to be confused with the Community Reinvestment Act. To be eligible for the special procedure that allows Congressional Review Act resolution to be passed with only a simple majority, the Senate had to act within a certain time after the rule was published in the federal register. These CRA deadlines had passed for the FDIC and OCC valid-when-made rules, but the Senate was able to act on the true lender rule to vote to invalidate it within the required timeframe. And so a CRA invalidation resolution was introduced in the Senate in March 2021. Running up to that vote in April 2021, the Senate Banking Committee held a hearing on some, entitled The Reemergence of Rent-a-Bank. The title was a giveaway. The primary focus of the hearing was the true lender rule. And predictably at the hearing, true lender rule, detractors, which were the democratic committee members and their witnesses, called on Congress to overturn the true lender rule. Claiming that the true lender rule would enable unfair rich bank schemes, predatory lending, payday lending, usury and debt traps.

Mindy Harris:

The true lender rule proponents and the republican committee members and their witnesses, including Brian Brooks, the former acting comptroller, said the true lender rule would benefit consumers, the banking system and the economy as a whole and would result in the availability of lower costs credit to a wider range of people. And Brooks also said that he felt the true lender role would empower the OCC to go after unfair rent-a-bank schemes and make sure that national banks involved in marketplace lending were held accountable. However, this information did not avail the proponents of the true lender rule. So on May 11th, the Senate voted to invalidate the true lender rule. The Senate vote was 52 to 47, generally along party lines. But three Republican Senators, Senator Lummis of Wyoming, Senator Rubio of Florida and Senator Collins of Maine, voted with the democrats to invalidate the true lender rule.

Mindy Harris:

The testimony in the hearing revealed why Senator Lummis, who had been very actively supportive of financial innovation, said she voted against the true lender rule. She made a statement on the Senate floor explaining that she supported the principles behind the true lender rule, but she voted to invalidate it because she worried that it would result in a competitive disadvantage for state charter banks as against national banks. And she said she planned to introduce true lender legislation that would apply to all banks, state and national but so far, I haven't been able to find anything introduced along those lines. The rest of the statements in the senate were predictable and along party lines. And then the house also voted to disapprove the true lender rule on June 24th, and as you can see on the slide on July 1st, President Biden signed the disapproval resolution meaning the resolution wiped out the true lender rule and the true lender litigation was dismissed.

Mindy Harris:

And now I'd like to turn it over to Ron Vaske to discuss the effects of the CRA disapproval of the true lender rule and the OCCs reactions and the potential effects of the administration change. Go back to slide 15 for a while, and then Ron will change to 16. Thank you.

Ron Vaske:

Thank you, Mindy and hello everyone. So that really is the question at this point. What is the effect of the Congressional override of the OCC's true lender rule. Technically, it puts us back to where we were a year ago at this time. The only thing

that the Congressional Review Act specifically does, is it prohibits the agency, the OCC from adopting a rule that is substantially the same as the one that Congress overrode. So we know that that's not going to happen, but I don't think anyone thought that would happen anyhow. That if the OCC did pursue new true lender rule making at this point, it probably wouldn't have nearly the same political objectives as the former OCC did. I think what we can certainly expect at this point well, acting comptroller Hsu, last month testified before Congress, said that the agency is going to take another look, and it's going to ask the staff to review data and take a look at the ability of people to obtain credit and the effect of the bank model lending and how that impacts the market.

Ron Vaske:

So we know that the OCC is taking another look at it. Insofar as what is the actual impact of the act itself in litigation, one could argue that the OCCs analysis, although Congress overrode the rule, that the analysis still applies, and that courts should defer to the OCCs analysis that it published when they adopted the rule. That's probably not an argument that's going to get very far. Among other things, I think we can probably expect that the OCC is not going to be supportive and amicus briefs like it was in under the former comptroller. Interestingly, and importantly, the Madden inside the Madden-fix rules were not overwritten by Congress. It could not have been, they had passed the time deadline as Mindy indicated. And so far, Comptroller and the FDIC have continued to support their Madden-fix rules in litigation.

Ron Vaske:

Along with that, keep in mind that we did have an election last November and Democrats took control both of Congress and of the end of the presidency. And along with that, gives the president the ability to make some changes in the agencies. The comptroller, we haven't seen an actual nominee yet, but we do have an acting comptroller that the President Biden appointed. FDIC, Chairman McWilliams term expires in 2023. But the FDIC, unlike the OCC is governed by a board of five directors, one of which is now vacant, and the others, one being the CFPB director, and one being the OCC comptroller would be filled by President Biden. So President Biden could have four of the directors appointed, which would most certainly outweigh the views of Chairman McWilliams in any rulemaking that the FDIC would propose.

Ron Vaske:

So reconstituted OCC and FDIC could reverse the Madden-fix rules or valid-when-made rules. And the OCC could in theory, adapt a new true lender rule. We don't really expect either of those things to happen, among other things, as I mentioned, but the true lender rule, the CRA specifically says that the comptroller could not adopt a rule that's substantially the same. It's kind of up in the air of what substantially the same means. Whether it's the entire topic or whether it is the final policy outcome, which certainly would be up to interpretation. But also, if the agencies were to take any action to repeal the Madden-fix rules, or to adopt a new true lender rule, we'd start the regulatory process all over again. They'd have to publish a proposed rule, see comments of at least 30 days and then of course, any rule that they did adopt would just like the others have been, be subject to judicial challenge, and of course subject to review Congress under this CRA.

Ron Vaske:

I think now we'll transition into what's going on post override. Things have been going on in the courts for some time. But we also have some developments of state statutes and state regulatory action. So I'll turn it back to Mindy. Mindy.

Mindy Harris:

Thank you, Ron. So as Ron said, with the OCC true lender rule off the table and questions as to whether the new OCC will issue a different rule, it's more important than ever for the industry to be on top of what has been going on in the courts and on other fronts. So on slide 18, you can see a discussion of some litigation that happened in Colorado, beginning in 2017, against two Fintechs, Marlette and Avant. So in 2017, the Colorado AG sued Marlette and Avant respectively, claiming that they, not their partner banks, were the true lenders in arrangements involving marketing and sales of loans to Colorado borrowers, even though the loans were clearly originated by the partner banks. The Colorado AG raised true lender and Madden arguments as well.

Mindy Harris:

And Colorado's usury limit applicable to these loans was basically capped at 21%, or for very small dollar amounts sort of a sliding scale. And these loans had rates up to 36%. It was unusual for that reason, because most of the AG litigation before this case, was brought against programs where the interest rates were much higher. So people were sort of surprised that the AG was going after these loans, but they were up to 36%, and so they were in excess of Colorado's usury limits. And then a really scary thing happened in 2018. An amended complaint was filed adding as defendants the securitization trusts and trustees involved in the financing arrangements. Claiming that when you securitize these loans, the securitization trusts and trustees now own the loans and questions, and they were then the true lenders and they should be subject to fines, penalties and disgorgement of excess interest.

Mindy Harris:

You can see that this was really alarming because if upheld in court, and adopted in other jurisdictions, it could have significantly affected a broad swath of financing arrangements by lenders, even beyond the bank FinTech partnership realm. In early June 2020, the Colorado Trial Court ruled in one of these cases, the Marlette case that a non bank purchaser of a loan originated by state bank could not continue to charge the interest rate established at the outset. Shortly after that, negotiations were in progress and the Colorado AGs lawsuit against the Avant, Marlette, their partner banks and the securitization defendants were settled and dismissed with prejudice. And the settlement as documented in a very detailed assurance of discontinuance that establishes the safe harbor, permitting these banks and their partner Fintechs to offer closed in consumer loans in Colorado, in excess of Colorado's usury limits at rates up to 36%.

Mindy Harris:

And you can see the outline of the elements of the safe harbor at the bottom of the slide, there's oversight, the bank has to oversee the FinTech partners, the bank has to be identified as the lender in all the program materials and must fund the loans. Well, I think that was in place anyway. But it's in the assurance of discontinuance licensing criteria. So the Fintechs have to be supervised lenders, terms criteria. The loan agreements had to be no higher than 36% APR, and structural criteria, having to do with the types of commitments made to buy loans and skin in the game for the banks. And then there were some payments funding, some, I guess, fines or penalties or agreement to make payments to fund consumer education and other programs.

Mindy Harris:

So that was a major event and people are still pondering over these assurance of discontinuances and trying to figure out the implications. But, now what I'd like to do is turn it back to Ron for more concerns About litigation that's going on and activities by state authorities. Ron.

Ron Vaske:

Thanks Mindy. We'll stick with Colorado and in this case, Rent-Rite Super Kegs. It wasn't actually a state court development, it was in Colorado bankruptcy court, so federal court. In this matter the bankruptcy, the claim was that the loans were usurious and therefore invalid, and that the trustee did not have the ability to collect on them. The Bankruptcy Court upheld, the case was basically argued on a Madden basis. And the bankruptcy court found that Madden did not adopt the Madden principle and found that the originating bank, which was a Wisconsin bank, the rate that was allowable to be charged by the bank, was also allowable by the S&E and therefore upheld the contracts.

Ron Vaske:

Both the OCC and the FDIC had filed amicus briefs in support of that decision. Of course, the decision was appealed to the district court. And the district court upheld the analysis on the Madden basis and upheld the claim or the holding, but it did remand back to the bankruptcy court for a finding on whether or not the bank was in fact, the true lender, which obviously is not a good development in that situation, so waiting to find additional developments there. Pulling back a little bit further, think finance litigation. Here, this is litigation, a number of actions that were filed by the Pennsylvania Attorney General, as

well as the CFPB and private litigants that, among other things were concerning because, like the Colorado settlement or the Colorado litigation that Mindy talked about, they did not just attack the non bank partner in the litigation, but also attacked the passive investors, the funders of these loans as part of this scheme, and had a significant settlement in that case.

Ron Vaske:

Also more recent last year, June 2020, Attorney General for the District of Columbia filed a true lender complaint against Elevate. That one was argued on the basis of true lender, whether or not the bank or Elevate the non bank partner, has the predominant economic interest in the loans. Elevate and the bank sought removal of the case to federal court, it has been remanded on to state court waiting for further developments on that. Still others older yet, I guess, but notable decisions. In West Virginia the CashCall case is really one of the landmark early cases in this was a bank model lending case. It was one of the first to adopt the predominant economic interest test, which finds that the holder of the predominant economic interest is the actual true lender of the loan on that one West Virginia in 2014. Similar copycat litigation really in Minnesota by the Attorney General, the same result there.

Ron Vaske:

And then CFPB also suing CashCall in 2016, not on the basis that the loans were usurious, but instead on the basis of unfair and deceptive and abusive acts and practices. With the argument being that loans were unenforceable under state law yet, the lender still attempted to collect on the loans, which was in fact a deceptive practice.

Mindy Harris:

Well, I'm happy to have the opportunity to say something cheerful finally. After all these gloom and doom kinds of cases, I do want to point out that there were two recent helpful federal court decisions on the true lender and valid-when-made issues that occurred this year. So the first one noted on the slide is Sims versus Opportunity Financial. This involved a Utah State Chartered Bank, making consumer loans in partnership with a FinTech. The plaintiff who lives in California, filed a suit on behalf of the general public. So private AG suit under California law, claiming the arrangement was around a bank scheme, and that the FinTech was the true lender and made the loans that rates over those permitted under California law. And based on the loan documents and other facts, the California federal district court held the bank was the true lender, and was exempt from the California usury laws, so a nice outcome.

Mindy Harris:

The other one is a case called Robinson and Spears versus National Collegiate Trust that involves student loans made by a national bank, and then sold to its non bank partner that had designed and facilitated the program or to certain designated trusts involved in the program. And these plaintiffs claim that based on the program structure, the National Bank was not the true lender and therefore, the loans were made by the non bank trust and violated Pennsylvania usury laws. In this case, the Massachusetts federal district court held the loans were valid-when-made and remain valid after their transfer, signing lots of case law, so it's a good read, and the OCC valid-when-made rule, and also held that the bank was the true lender, again, based on cited case law and the loan documents, but did not cite the OCC true lender rule.

Mindy Harris:

And as I noted on the slide, this case was brought to the attention of the court in California, by the OCC in the litigation challenging the OCC valid-when-made rule, which is a positive development, because it suggests that the OCC wants to defend that rule, at least it did in April, when they filed it. And both of these cases are on appeal. And now I would like to turn it back to Ron to focus on state legislation and administrative activity on this topic.

Ron Vaske:

Thanks, Mindy. So yeah, there has been a lot of activity in the States, beginning with administrative action in Maryland, which is a little bit different. It's not exactly a true lender action, but instead, there's statutory provisions in Maryland that the

commissioner, the banking commissioner argues, requires any party that is servicing or supporting a lender that's making loans in the state is required to be licensed as a service provider, and therefore brought action against Fortiva Financial earlier this year, for its failure to be licensed to support that. What's also interesting about that, though, is that the commissioner didn't just bring the claim against the non bank partner, but also brought a similar claim against the bank itself.

Ron Vaske:

And in that the bank, which is a state bank, also needed to be licensed in order to make loans to Maryland residents. Of course, that case is brand new, no developments there at this point. But, as I mentioned, it's not exactly a true lender case, but if the parties are subject to the licensing obligation, and they're also subject to the Maryland usury limitations, which would prohibit loans that Fortiva Financial was servicing and purchasing in Maryland. Also in state legislatures, Georgia and Nevada have had statutes that have been troubling from a true lender perspective for some time. But recently in Illinois, just this year, and Maine basically adopted very similar statutes on that, specifically target the bank model lending program, and adopt the predominant economic interest theory as a determinant of who the true lender is.

Ron Vaske:

Also legislation proposed in New Mexico, understand that that's on hold at this time where is defeated on procedural grounds, but very likely or could very likely come back so need to watch what's going on there. Talking about Illinois, the Illinois Predatory Loan Prevention Act, what it does is, as I mentioned, it adopts this predominant economic interest theory that the person who is the true lender is the person who holds, acquires, maintains directly or indirectly the predominant economic interest in the loan or person or entity that markets, brokers, arranges, facilitates the loan and holds the right requirement or right of first refusal to purchase loans or receivables are interested in the loans. Or based on the totality of circumstances, then and specifically if the totality of circumstances would indicate that the program is structured to evade the Illinois loan, Predatory Loan Prevention Act, then, the true lender would be the non bank partner.

Ron Vaske:

On circumstances that weigh in favor of a person or entity being the lender include, whether the non bank indemnifies, ensures or protects the bank, the exempt person for any costs or risks related to the loan, if the non bank predominantly designs, controls or operates the loan program, or purports to act as the bank's agent, service provider, or in another exempt, or another capacity, while acting directly as a lender in other states. So you can see, the Illinois Act, much like the Act recently adopted in Maine, specifically targets these bank model lending programs. And I will transition to risk mitigations and I'll turn it over to Jeremy Rosenblum. Jeremy.

Jeremy Rosenblum:

Thank you, Ron. So before I go forward with my presentation, I want to add a few points and correct a few points. The first correction is Alan indicated that we had sold our 2017 survey for $2500. And I wish we could have done that, but the price was actually $5,000 for that survey. And I don't want any of the purchasers in this audience to think that they got hosed and pay double the amount that others were paying. And secondly, Alan, I am back in the office as those who can see the background might see. My apartments only half a block from the office so I don't have much of a community problem to come here and walk around the empty halls that we currently have.

Jeremy Rosenblum:

Wanted to say something about state actions. And that is, in addition to the lawsuits that have been brought by state enforcement authorities, we are aware of a number of investigations that are ongoing right now. And I think it's relevant for folks to understand that, just among the investigations we're aware of, there are ongoing investigations of programs that APRs in excess of 36% in Colorado. There are ongoing investigations in Connecticut, Massachusetts, and Washington. And from my perspective, there's been a definite uptick in the amount of regulatory interest in that model lending programs. And then I want to say something about the Illinois statute. One thing that was extraordinary about the statute was its mode of adoption. It was basically presented in the middle of the night, one day and adapted in less than 24 hours after presentation.

Jeremy Rosenblum:

So it was a stealth attack on pet model programs. And that's a strategy that may be utilized by hostile parties in other states in the future. And one thing that I want to emphasize is that these statutes, the Maine statute, the Illinois statute, which would clearly mark most programs as the facilitator, being the true lender, and therefore unlawful. Just want to emphasize the preemption principles that apply to common law recharacterization of who the true lender is, apply equally to statutes that would accomplish the same result. So even though under state law, the answer may be clear that the true lender is not the bank, but it's the facilitator, the real question is, what does federal law say on that subject? And that's where the litigation will focus in the future.

Jeremy Rosenblum:

So, my discussion I primarily want to talk about what participants in bank model programs can do in order to mitigate the risk posed by a state usury statutes and state licensing statutes. And the recommendations that we've been making for years as ways of mitigating risk are set forth on this slide, that's showing. The first thing that can be done to reduce risk is to avoid states where you know that there's going to be an active enforcement authority out to enforce the that states usury laws. New York and West Virginia probably stand alone as high risk states where there is case law that is adverse to programs where the regulators are very aggressive. Colorado and Pennsylvania, Massachusetts, there have been public enforcement actions or lawsuits brought against these programs. So there's a history of regulatory attack on these programs without necessarily the same adverse results that have been obtained in New York and West Virginia, although I'm sorry, Maryland, the decision was adverse to the participant in the program CashCall.

Jeremy Rosenblum:

But that case was not well argued and I wouldn't regard that decision is necessarily binding in future litigation in that state. Another thing, that key risk factor is the rate on the loans. So Colorado, and Maryland, have brought actions against programs in the sub 36% space. Other states have threatened actions against participants in that space. But nobody else has really brought enforcement proceedings of sub 36% lenders. And the companies that really have the most exposure are the ones that are charging interest rates far in excess of 36% and certainly ones that are charging interest in triple digit or near triple digit areas. Arbitration, I'm amazed that Alan got through his introduction without saying something positive about arbitration.

Jeremy Rosenblum:

But this is why you're not likely to see too many individual class action attacks against these programs. And that is that, any lender with the slightest bit of sense will have a well crafted arbitration provision in the loan documents, compelling any disputes to be resolved through individual in that class action arbitration. That strategy has been validated by the Supreme Court in the Concepcion case. It's perhaps a little bit under stress in California, where the California Supreme Court decided a case that basically concluded that an arbitration agreement cannot dispose of a claim for a public injunction. That's a kind of right that maybe somewhat particular to California. But you have to know that California has some enhanced risk because of that.

Jeremy Rosenblum:

One additional strategy is to have the bank lender retain privity of contract with the borrower that addresses the Madden issue somewhat. So too does having some of the compensation to the back, not be paid by the purchaser upfront, but be paid on the basis of loan performance that would also serve to distinguish the Madden case. Personally, I'm much less concerned about Madden than I am about true lender recharacterization. And the item in red here is a key factor that can help reduce risk in a bank model program. And that is, if the bank maintains a meaningful economic interest in the loans and by meaningful, I mean at least 5% and could be higher. That creates an additional argument in defense of these programs. So, in prior litigation that we were involved in prior to the adoption of the Dodd-Frank Act, the programs we were defending, it would have been easy for the plaintiff to say that the bank maintained virtually no economic interest or an insignificant economic interest.

Jeremy Rosenblum:

But Congress in adopting Dodd-Frank, included so called skin in the game rules with respect to asset backed securitizations. And to my mind, what these rules demonstrate, is that the Congress that adopted Dodd-Frank viewed a 5% economic interest by the promoter of an asset backed securitization, and by analogy by the bank and one of these programs, to have a real significant economic impact, to impose underwriting discipline, and the originating back, and therefore to have legal significance. And so in defending one of these cases, I were perfectly willing to argue that the whole concept of lender recharacterization is inappropriate under the federal banking laws. But it's nice if you can also say that even granting the possibility that in some cases, recharacterization is appropriate, is not appropriate, where the bank retains a legally meaningful economic interest.

Jeremy Rosenblum:

So you have to take issue with the predominant economic interest test, I think that, that test has arisen in cases where virtually the entire economic interest was maintained, was acquired by the facilitator. So you can distinguish those cases, attack the role, or the loose language of the case and suggest an alternative role. But you're only going to be able to do that if the bank is maintaining a 5% or greater economic interest. The second red bullet or the first one on this slide, but the second on my slides, is another way that the risks of this litigation can be very, very materially reduce. And that is, if the company that is facilitating the loans that's doing the marketing and origination, perhaps the servicing, post sale of the loans is not the company that acquires the loan, but rather the acquirer is a third party investor, then again, you have a very good, strong defense, that the whole idea of pointing to the facilitator, as the true lender is totally inappropriate.

Jeremy Rosenblum:

The facilitator in this kind of structure is only acting as the loan broker, and a passive investor is acting as the loan purchaser. And if those two functions are not combined, the whole idea that there's any party that is really in substance the true lender, is in my view, fatally weakened. Having the bank actively involved in marketing or servicing the loans is another way of managing program risk. And just a warning, that when the company facilitating the loans is posting cash collateral, in amounts in excess of the sale price of the loans, then it becomes very easy for somebody to argue that the bank is not actually funding the loans, but that core loan function is being performed by the facilitator. So I like to recommend in my programs, that the facilitator, if there's going to be collateral, that time of that type, it should be posted in another bank, or be in the form of a letter of credit rather than cash collateral.

Jeremy Rosenblum:

Now, remember, I said that one mechanism for limiting risk is to have the purchaser of the loans or the participation interest in the loans, be an independent third party. And that suggests a way that current programs could and perhaps should be restructured to reduce risk. And in the current programs, when a facilitator acquires loans or economic interests in loans, those acquisitions are typically financed in substantial part through warehouse lines of credit. And it's my observation that when that happens, the loan funds, the warehouse funds become the facilitators funds, and then the combination of whatever equity contribution is being made by the facilitator and the warehouse funds to purchase the allowance or economic interest, those funds can readily be characterized as funds of the facilitator.

Jeremy Rosenblum:

That's not good. Or it's not nearly as good as a situation where the party that is providing most of the funding, the warehouse lender in current programs, that party could actually acquire or fund some third party, not the facilitator to acquire the economic interest. And then the facilitator's role becomes more limited to brokering the loans and perhaps guaranteeing the purchaser return on the loans. And the facilitator can obtain its compensation as servicing and guarantee compensation, rather than as funding compensation. And in that situation, the facilitator can argue that it is not providing the funds needed to purchase or hold the loans to fund a lot of that, then, because it's not playing that key role in the long process, that it is not in substance the true lender. There are all sorts of variants on this idea, you can readily structure the program so that the investor

is getting the same economics or similar economics as it would to in connection with a more traditional program that's in the market these days.

Jeremy Rosenblum:

Or, if the investor is sufficiently comfortable with the underwriting of the loans and the long term performance, it can dispense with any guarantee from the facilitator. And that dispensing with that kind of guarantee would go a long way towards reducing the risk of recharacterization in a program of this type. And basically, the basic idea is that, by separating the acquisition function or the funding function from the services provided, you reach a position where it's difficult or much more difficult for a hostile party to point to any other party, any participant in the program has been the so called true lender. It's not the SPV, one can argue or the ambassador because it's not actively involved in the program, it's just performing a normal investment function.

Jeremy Rosenblum:

It's arguably not the facilitator, because it's not funding the loans and hope, perhaps not even guaranteeing loan performance. And so in the absence of anybody that in substance looks like a true lender, the form of the transaction should not be recharacterized, the argument goes. And the point that I'd like to emphasize is that, all these risk mitigants can be combined, and so the bank can retain a 5% interest and yet sell the remaining 95% economic interest to some party unaffiliated with the facilitator. And with that, I'm going to conclude my remarks.

Alan Kaplinsky:

Well, my thanks, of course, to Mindy, Jeremy and Ron, for doing a terrific job in explaining the significance of the Congressional Review Act override of the OCC true lender rule, and the status of the Madden-fix rule. And I also want to thank all of our listeners today, who downloaded our podcasts. And also I want to remind our listeners that don't forget to check out our blog, which also goes by the same name as our podcast, Consumer Finance Monitor. We've been doing our blog now for more than 10 years. And the subject that we covered today, we fully explore it on our blog, so if you go on consumerfinancemonitor.com and you search true lender or Madden fix, you'll certainly find a wealth of articles that provide a great deal of insightful analysis into the subject that we talked about today. So once again, I want to thank everybody for listening.