Financial Services Management

Nationwide Interest Rates

Cite

OCC, Notice of Proposed Rulemaking, Permissible Interest on Loans That are Sold, Assigned, or Otherwise Transferred; FDIC, NPR, Federal Interest Rate Authority

Recommended Distribution:

Corporate Planning, Policy, Legal, Government Relations

Websites:

https://www.occ.gov/news-issuances/federal-register/2019/nr-occ-2019-132-federal-register.pdf

https://www.fdic.gov/news/board/2019/2019-11-19-notice-dis-c-fr.pdf

Impact Assessment

- Regulatory codification of interest-rate preemption reinforces charter value vis-à-vis nonbank lenders, giving banks a unique near-term efficiency and net-interest-margin advantage for higher-cost retail finance products and protection in rising-rate environments.
- Higher-cost consumer and small-business credit availability would increase, albeit at possible cost or risk to vulnerable consumers.
- "Rent-a-bank" arrangements would be unimpaired, increasing fintech and nonbank-lender opportunities to operate nationwide through accommodation arrangements. If these become a major market force, then banks could lose franchise value as they transform from intermediaries into conduits.

Overview

As recommended by the Treasury Department,[1] the OCC and FDIC have proposed rules to overturn a controversial court decision limiting the extent to which national banks can export home-state interest rates and state banks may similarly take advantage of national markets. If finalized, the rules would clarify the ability of covered banks to securitize and otherwise sell loans as has long been the practice and reduce one obstacle to business alliances with nonbanks in the "rent-a-bank" arrangements that have more recently become a vehicle for fintech, short-term installment lenders, and other nonbanks seeking to operate under uniform and/or preferable interest rates regardless of otherwise-applicable state usury ceilings. In

1 See Client Report **FINTECH21**, August 7, 2018.

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light of changing business practices, the proposals are controversial, but will give banks legal protections in "valid-when-made" disputes from which to assert preemption in markets affected by the current court decision and to protect themselves from similar challenges in other regions unless or until a Supreme Court decision or statutory change decides the issue.

Impact

In 2015, the U.S. Court of Appeals for the Second Circuit decided in *Madden v. Midland Funding* that a national bank or federal thrift's loans sold to a third party or otherwise assigned do not enjoy nationwide interest rates as would have unquestionably been the case if the loan had been retained by the federally-chartered entity. This ruling posed significant challenges to longstanding loan-transfer activities in secondary markets as well as to more recent arrangements in which banks serve as conduits for nonbanks that quickly acquire a bank-originated loan and assume all of the risks associated with it while enjoying interest rates preferential to those to which it is entitled on its own under applicable state law. The scope of this ruling is potentially so sweeping that the U.S. Treasury, federal banking agencies, and many banks sought quickly to overturn it on appeal. Although appeal was denied, Congress has proved unable to enact statutory change to reverse the *Madden* decision and protect banks fearful of like-kind litigation in other parts of the country.

As a result, the FDIC and OCC have proposed a rule to codify what they believe to be the correct interpretation of law and thus to give regulated banking organizations protection against litigation. The extent to which these rules withstand challenge remains to be seen, but the legal dispute would, if these rules are finalized, likely shift to the questions under the "*Chevron* Doctrine" about the extent to which courts must defer to federal-agency rulings. At the least, this would give banks stronger grounds on which to protest any additional litigation and possibly discourage it altogether.

The agencies' rules are thus intended to preserve the "valid-when-made" doctrine – i.e., that a loan that is non-usurious upon origination remains non-usurious even if assigned, sold, or otherwise transferred. Maintaining the valid-when-made principle is essential to preserving the franchise value of a national charter – indeed, federal preemption not only of interest rates, but also of many other provisions of state law permits uniform, efficient nationwide operation in ways that make the federal charter the preferred option for most large banking organizations. The FDIC's proposal emphasizes the importance of maintaining as much parity as possible to this power in order to preserve the value of state-bank charters. The banking agencies cite this efficiency rationale in the NPRs even though the FDIC proposal does not permit preemption but instead allows application of host state rates regardless of a state non-member bank's home-state usury ceiling. The agencies also cite the significant risk-management benefits of loan transfers.

The implications of the *Madden* decision are evident in the markets covered by the Second Circuit decision. Higher-cost lending usually originated by banks for sale to investors in Vermont, Connecticut, and New York has reportedly plummeted. The fear is that the loan, once sold, would be considered usurious by virtue of assignment to a third party, saddling the assignee with a lower-return asset in concert with costly legal risk. This risk is less likely in lower-cost areas such as mortgage origination for the GSEs or government agencies, but is problematic in credit-card lending and the increasingly significant market for online consumer and small-business finance. Some of these loans are originated by banks through their

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own fast-growing digital portals, but most are originated by nonbanks through partnership arrangements with insured depositories.

These rent-a-bank arrangements would be protected by codification of the valid-when-made doctrine, but not necessarily fully insulated from all legal risk. Despite attempting to settle the valid-when-made question, these NPRs do not also address pending litigation over the parallel "true lender" question. These cases directly concern "rent-a-bank" arrangements, going beyond the preemption question also to assert that bank loans do not enjoy preemption or other assignment protections when the bank is not the "true lender." Banks must have the predominant economic interest in a loan to be "true lenders" when this doctrine applies, challenging relationships in which banks are essentially agents of the nonbanks that acquire their loans.

Regulators and policy-makers also have concerns about rent-a-bank arrangements, which consumer advocates also argue permit predatory loans to skirt usury ceilings and consumer-protection standards. Risks include reputational hazard as well as "pipeline" risk that could lead a small bank charter to be saddled with many loans intended for a fintech or other partner that the assignee is suddenly unable or unwilling to absorb. Global regulators are also concerned that banks will increasingly be disintermediated by nonbank lenders outside the reach of prudential regulation if they allow themselves to become service companies for other lenders.[2,3]

What's Next

The OCC issued this NPR on November 21; comment is due January 21. The FDIC issued its companion proposal on November 19 at a contentious board meeting by a 3-1 vote.4 Comment is due sixty days after publication in the Federal Register.

Analysis

A. Legal Rationale

The NPRs assert that it has long been established that national banks and federal savings associations may charge the maximum rate allowed state-chartered institutions in their home state and export that to host states. It is similarly well established that national banks and federal thrifts may make contracts and therefore to sell, assign, and otherwise transfer loans charging interest rates allowed the originating bank. The entity to which the bank transfers the loan is the assignee of the bank and therefore enjoys the benefits and is responsible for the duties accorded the bank under the applicable contract. The FDIC's rationale is similar except that it does not posit preemption of host-state law and instead allows an FDIC-regulated entity to charge the interest rates allowed in both its home and host states.

[2] See Client Report **FINTECH25**, June 27, 2019.

[3] See Client Report **FINTECH24**, June 17, 2019.

[4] See **PREEMPT30**, *Financial Services Management*, November 19, 2019.

Federal Financial Analytics, Inc.
1255 23rd Street, N.W., Suite 500, Washington, D.C. 20037
Phone: (202) 589-0880
E-mail: info@fedfin.com Website: www.fedfin.com

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To counter *Madden*, the NPRs lay out principles based on the agencies' read of current law to reinforce this view.

B. Proposal

The NPRs codify the valid-when-made doctrine without also addressing the true-lender issue. This question is also pending in the courts. No specific questions are posed on this formulation.

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