

MODERNIZING REGULATION TO ENCOURAGE FINTECH INNOVATION

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Examining Opportunities and Challenges in the Financial Technology (“Fintech”) Marketplace

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Good morning, Chairman Luetkemeyer, Ranking Member Clay, and members of the subcommittee. Thank you for inviting me to testify.

My name is Brian Knight, and I am the director of the Program on Financial Regulation and a senior research fellow at the Mercatus Center at George Mason University. My research primarily focuses on the role of technological innovation in financial services. Any opinions I express today are my own and do not necessarily reflect the views of my employer.

First, let me thank Chairman Luetkemeyer and Ranking Member Clay for your leadership in holding a hearing on the promise and challenges of financial technology, or “fintech,” and how the legal and regulatory environment should adapt in response. I also appreciate your efforts to have representatives from a broad array of positions and viewpoints engage in a collegial and respectful discussion. It is an honor to be asked to testify.

Defined most broadly, fintech is simply the application of technology to the provision of financial services, and it is therefore ubiquitous and constant. However, we are seeing a unique period of innovation in financial services marked by the use of the internet (as a borderless delivery mechanism), lower barriers to entry, new competitors from outside the traditional financial services industry, and increasingly rapid innovation by firms and adoption of innovative technologies by customers.¹ These characteristics are placing pressure on the existing regulatory environment.

Given the potential breadth of the topic and the limited time available, I would like to focus my testimony on some of the issues facing nonbank financial firms and the role that Congress should play in supporting innovation, though I am happy to try to answer any questions you may have to the best of my ability.²

¹ For a thorough analysis of these and other characteristics of the current fintech movement, see *generally* CHRISTOPHER BRUMMER & DANIEL GORFINE, FINTECH: BUILDING A 21ST-CENTURY REGULATOR’S TOOLKIT (2014), <http://www.milkeninstitute.org/publications/view/665>.

² The breadth of the topic has also given rise to inconsistent use of terminology. For the purposes of this testimony, a firm identified as a “fintech” will be a nonbank; “virtual currency” will include cryptocurrencies like Bitcoin. I apologize in advance for any unintentional inconsistencies.

Specifically, there are three ways Congress could help:

1. Clarifying existing regulation, including but not limited to issues around the validity of a loan made by a depository institution in conjunction with a fintech lender partner so that consumers can benefit from more efficient and competitive credit markets.
2. Modernizing regulation to eliminate unnecessary or unjustified barriers to competition from new firms, including but not limited to fintech lenders and money transmitters being subject to state-by-state licensing and limitations while their bank competitors enjoy broad uniformity granted by federal law.
3. Enabling regulators to provide the necessary and appropriate regulatory environment where companies can experiment with innovative services while ensuring appropriate consumer protection.

THE POTENTIAL PROMISE OF FINTECH

Innovations in financial technology have the potential to significantly improve the quality of financial services available to Americans. For example, there is evidence that nonbank fintech lenders are able to fill in holes left by banks that have left communities and to offer some consumers credit at lower rates than would otherwise be available using traditional funding and credit scoring metrics or to consumers who otherwise would have trouble accessing credit.³ This would explain why a significant portion of loans offered by fintech lenders are used by borrowers to consolidate existing debt.⁴ There is also evidence that the use of algorithmic scoring may result in *less* discrimination than traditional underwriting. For example, researchers at the University of California, Berkeley, have found mortgage data indicating that fintech lenders who use algorithmic underwriting were significantly less likely to discriminate against African American and Hispanic borrowers than were traditional lenders.⁵

Likewise, in money transmission, nonbank technology-enabled firms are providing alternatives to traditional checks and wires, offering real-time and peer-to-peer payments.⁶ This competition has prodded banks to improve their products, including the introduction of same-day ACH payments and the introduction of bank-sponsored peer-to-peer payments apps.⁷ Fintech firms are also helping facilitate payments by employers, allowing employees to be paid on a daily basis rather than being paid every week or every two weeks.⁸

³ See Usman Ahmed et al., *Filling the Gap: How Technology Enables Access to Finance for Small- and Medium-Sized Enterprises*, 10 INNOVATIONS 35, 35–36 (2015) (finding PayPal Working Capital loans disproportionately disbursed to areas with relatively high declines in the number of banks and to traditionally underserved populations); JULAPA JAGTIANI & CATHARINE LEMIEUX, FINTECH LENDING: FINANCIAL INCLUSION, RISK PRICING, AND ALTERNATIVE INFORMATION, 19–22, 26 (Working Paper No. 17-17, Fed. Res. Bank of Phila., 2017), <https://www.philadelphiafed.org/-/media/research-and-data/publications/working-papers/2017/wp17-17.pdf>. See also YULIA DEMYANYK & DANIEL KOLLINER, PEER-TO-PEER LENDING IS POISED TO GROW (Fed. Res. Bank of Cleveland, Aug. 14, 2014), <https://www.clevelandfed.org/newsroom-and-events/publications/economic-trends/2014-economic-trends/et-20140814-peer-to-peer-lending-is-poised-to-grow.aspx>; U.S. DEP'T OF THE TREASURY, OPPORTUNITIES AND CHALLENGES IN ONLINE MARKETPLACE LENDING, 21 (2016) [hereinafter TREASURY REPORT], https://www.treasury.gov/connect/blog/Documents/Oportunities_and_Challenges_in_Online_Marketplace_Lending_white_paper.pdf.

⁴ TREASURY REPORT, 11.

⁵ ROBERT P. BARTLETT, ADAIR MORSE, RICHARD STANTON & NANCY WALLACE, CONSUMER LENDING DISCRIMINATION IN THE FINTECH ERA, 18–22 (UC Berkeley Public Law Research Paper, Dec. 7, 2017), <https://ssrn.com/abstract=3063448>.

⁶ See, e.g., Venmo (<https://venmo.com/>); Square (<https://squareup.com/>).

⁷ Zelle is a real-time payments app (<https://www.zellepay.com/>) established by Early Warning Services, LLC, a company owned by Bank of America, BB&T, Capital One, JPMorgan Chase, PNC Bank, U.S. Bank, and Wells Fargo (<https://www.earlywarning.com/pdf/early-warning-corporate-overview.pdf>). The Zelle app facilitates transfers between bank accounts of partnering banks.

⁸ Michael Corkery, *Walmart Will Let Its 1.4 Million Workers Take Their Pay Before Payday*, N.Y. TIMES, Dec. 13, 2017, <https://www.nytimes.com/2017/12/13/business/walmart-workers-pay-advances.html> (discussing Walmart's partnership with Even [<https://even.com/>] to facilitate same-day wage payments to Walmart employees).

Virtual currencies, the largest and most famous being Bitcoin, are also providing consumers with new means to conduct financial transactions. Virtual currencies are means to an end, rather than an end in themselves. For example, Bitcoin was designed to compete with government-backed currencies. However, the underlying technology of a distributed, modification-resistant ledger has been considered for a wide range of transactions outside of currency where the ability to maintain a common record of transactions is important.⁹ Other virtual currencies have also developed seeking to more effectively facilitate actions ranging from international money transfer to corporate capital formation.

THE CHALLENGES POSED

While fintech presents significant promise, it also presents certain challenges. For example, while Initial Coin Offerings (ICOs) may enable firms to access capital more effectively than traditional methods, there are significant concerns that they are being used by both outright frauds and well-meaning but ignorant firms to obtain capital in contravention of existing laws governing the sales of securities, commodities futures contracts, and products and services.

The considerable increase in value for numerous virtual currencies in the past year has given rise to fears that the prices reflect an asset bubble rather than the assets' true value and that the eye-popping prices attract scammers preying on the vulnerable.¹⁰ Virtual currencies may also potentially present risks to both law enforcement and national security by allowing bad actors to move money illegally or avoid sanctions.¹¹ This risk, however, is not unique to virtual currencies—it exists with every means of value transmission, including cash.

In the lending context, there is a concern that fraudulent and unlicensed lenders, brokers, or lead generators will defraud borrowers. This concern is particularly acute in the online payday loan space and in small-business lending, where concerns about broker business practices have led to industry initiatives like the Small Business Borrowers' Bill of Rights.¹²

The firms providing fintech services also face challenges. For example, online lenders face a significant risk of being defrauded by borrowers because of the arms-length nature of and limits in knowledge inherent in the online model. Borrowers may use false identities to obtain credit they have no intent to repay, or they may apply for multiple loans from different lenders over a short period of time. This “stacking” prevents the lender from knowing about the borrower's other lines of credit until it is too late. While not every “loan staker” intends to defraud lenders, the practice can prevent lenders from making fully informed lending decisions and increase the risk of default, leading to increased prices for other borrowers.¹³

⁹ While the Bitcoin ledger is often called immutable, there is a dispute as to whether this is true. See, e.g., Angela Walch, *The Path of the Blockchain Lexicon (and the Law)*, 36 REVIEW OF BANKING AND FINANCIAL LAW 713, 735–745 (2017) (discussing whether Bitcoin's ledger is truly “immutable”); in the context of Bitcoin, this ledger is called the “blockchain.” Other virtual currencies may use different means of maintaining a ledger with different characteristics in terms of distribution, mutability, and control mechanisms.

¹⁰ See, e.g., Gabriel Rubin, *CFTC Alleges Fraud in Three Virtual-Currency Cases*, WALL STREET JOURNAL, Jan. 19, 2018, https://www.wsj.com/amp/articles/cftc-alleges-fraud-in-three-virtual-currency-cases-1516338060?__twitter_impression=true; Sarah Buhr, *SEC's New Cyber Unit Takes Its First Action to Halt an Initial Coin Offering “Scam,”* TECHCRUNCH, Dec. 4, 2017, <https://techcrunch.com/2017/12/04/secs-new-cyber-unit-takes-its-first-action-to-halt-an-initial-coin-offering-scam/>.

¹¹ See, e.g., Max Seddon & Martin Arnold, *Putin Considers “Virtualruble” as Moscow Seeks to Evade Sanctions*, FINANCIAL TIMES, Jan. 1, 2018, <https://www.ft.com/content/54d026d8-e4cc-11e7-97e2-916d4fbac0da>.

¹² Available at <http://www.borrowersbillofrights.org/>. This is not intended as an endorsement of the Small Business Borrowers' Bill of Rights or any other industry initiative.

¹³ See, e.g., Penny Crosman, *How Fraudsters Are Gaming Online Lenders*, AMERICAN BANKER, Mar. 28, 2017, <https://www.americanbanker.com/news/how-fraudsters-are-gaming-online-lenders>.

THE CHALLENGES POSED BY THE CURRENT REGULATORY ENVIRONMENT

Every example of fintech is highly regulated from the moment it is conceived of. In some cases, the existing regulatory environment harms innovation by forcing firms to comply with multiple, often inconsistent sets of rules, pay the costs of having to constantly monitor numerous state and federal regulators, and face the uncertainty of not knowing whether an activity is subject to regulation.

The ability of new fintech competitors who are able, from the very beginning, to serve customers nationwide, is hampered by state-by-state regulation that their bank competitors do not face.¹⁴ If this discrepancy were justified, there would be no concern, but all too often it isn't. One clear example is the difference in treatment around lending licenses and the laws governing interest.

Under federal law, nationally chartered banks and federally insured state-chartered banks are able to lend nationwide on the basis of their charter and under their home state's laws governing interest.¹⁵ This uniformity allows for legal certainty and product uniformity nationwide, as banks are able to lend to similarly situated borrowers at the same terms. Conversely, fintech lenders are primarily regulated at the state level and are required to obtain licenses from each state they wish to lend in, and they are subject to the laws governing interest of the borrower's home state.¹⁶

This difference in regulatory treatment makes it very hard for fintech lenders to compete directly with banks, since banks are simply able to operate in a more consistent and streamlined manner. This has encouraged fintech lenders to partner with banks. Partnering with a bank allows fintech lenders to offer a consistent product nationwide. It also allows the banks to access additional borrowers and make more loans than they would otherwise be able to. While the bank often sells off at least a significant portion of the loan to either an institutional buyer or the fintech lender, the bank frequently receives a fee tied to the performance of the loans and ultimately retains regulatory responsibility for the loans.¹⁷ The fintech lender is also regulated under the Bank Service Company Act and is subject to examination by the bank's federal regulator for the lender's actions conducted pursuant to the partnership.¹⁸ While partnerships driven by regulation can benefit fintech lenders, their bank partners, and the public, they are also a second-best solution.

Yet even this second-best solution of bank partnerships is under threat from recent litigation and regulatory actions. The most notable of these actions are the decision in *Madden v. Midland Funding* in the United States Court of Appeals for Second Circuit and Colorado's lawsuits against two marketplace lenders.¹⁹ The result in *Madden* has called into question whether a bank could sell a loan that was valid when made by the bank to a nonbank, and have the loan remain valid if it was usurious under the borrower's state's law. While this case does not directly implicate fintech lenders, its seeming refutation of the principle that a loan valid when made remains valid even if sold implicates the bank partnership model.

¹⁴ For a more thorough discussion of this topic, please see Brian Knight, *Federalism and Federalization on the Fintech Frontier*, 20 VAND. J. ENT. & TECH. L. 129 (2017), available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2928985.

¹⁵ US DEP'T OF THE TREASURY, OPPORTUNITIES AND CHALLENGES IN ONLINE MARKETPLACE LENDING, 6 (May 10, 2016); John L. Douglas, *New Wine into Old Bottles: Fintech Meets the Bank Regulatory World*, 20 N.C. BANKING INSTITUTE JOURNAL 1, 17, 34 (2016). See 12 U.S.C. § 85 (national banks); 12 U.S.C. § 1831d(a) (federally insured state-chartered banks); see also *Marquette Nat. Bank v. First of Omaha Corp.*, 439 U.S. 299 (1978). Other financial institutions, including federal credit unions and savings associations, enjoy similar provisions. See, e.g., 12 U.S.C. § 1785(g)(1) (federal credit unions); 12 U.S.C. § 1463(g)(1) (savings associations).

¹⁶ US DEP'T OF THE TREASURY, OPPORTUNITIES AND CHALLENGES, 5; Douglas, *New Wine into Old Bottles*, 31-32.

¹⁷ E.g., Guidance for Managing Third-Party Risk, FIL-08-044 (Jun. 6, 2008) ("[T]he FDIC evaluates activities conducted through third-party relationships as though the activities were performed by the institution itself. In that regard, it must be noted that while an institution may properly seek to mitigate the risks of third-party relationships through the use of indemnity agreements with third parties, such agreements do not insulate the institution from its ultimate responsibility to conduct banking and related activities in a safe and sound manner and in compliance with law.").

¹⁸ 12 U.S.C. § 1867(c).

¹⁹ *Midland Funding, LLC v. Madden*, 786 F.3d 246 (2d Cir. 2015).

More directly relevant are the recent enforcement actions by Colorado against two marketplace lenders who made loans in Colorado in conjunction with bank partners. Colorado is seeking to hold that the marketplace lenders are the “true lender,” and that therefore the loans are governed by Colorado state law, despite the loans actually being made by two FDIC-insured state-chartered banks. Colorado does not dispute that if the loans are made by the banks, they are valid—rather, they argue that the banks lack a sufficient economic interest in the loans to qualify as the true lender. The banks have in turn sued Colorado, arguing that the state’s efforts impede their ability under federal law to make and sell loans.

The uncertainty surrounding the bank partnership model has reduced credit availability. For example, recent research has found that credit availability for borrowers with FICO scores below 700 from three large fintech lenders decreased significantly in New York and Connecticut compared to states outside the Second Circuit after the *Madden* decision.²⁰ Further, the uncertainty risks creating an absurd situation where the legality of a loan is not determined by the loan’s characteristics but by who ends up owning the loan, even though the borrower’s obligations do not change. It also privileges banks over competitors because banks are allowed to make and hold loans that nonbanks may not be allowed to.

Another area where state-by-state regulation risks impeding innovation is money transmission, both for firms that operate in dollars and those that use virtual currencies. While, generally speaking, banks are not required to obtain state money transmitter licenses,²¹ nonbanks—including innovative fintech firms—are required to obtain a license in every state where they offer services.²² While almost all states require licenses, the criteria of who is covered by the licensing regime and what is required for compliance vary among states, and obtaining licenses can be an expensive and time-consuming activity.

This problem is even more acute with firms that provide payments services via virtual currencies. Some states have held that virtual currency exchanges are covered under their existing money transmission laws; others have modified their laws or remained silent about the extent to which their existing rules govern virtual currency transactions.²³ New York is unique in creating a virtual-currency-specific regulatory regime with its BitLicense.²⁴ While the Uniform Law Commission has proposed a uniform law to regulate virtual currency transmitter businesses at the state level, this law has not yet been adopted by any state.²⁵

Beyond questions of federalism, there are broader problems with the fragmentation of the current regulatory system. While this problem is not new,²⁶ the pace of innovation and adoption and the cross-cutting nature of fintech offerings exacerbate the problems created.

For example, outside of the money-transmission context there is confusion as to which regulators have authority over transactions involving virtual currencies. The use of digital tokens by firms to raise money may be considered a sale of securities, commodities, or the presale of a product, or some combination thereof. This confusion is the result of the law privileging substance over form in that the economic reality of the transaction, rather than the method, governs. While this approach is understandable, it can also create gray areas that Congress could clarify.

²⁰ Colleen Honigsberg, Robert J. Jackson & Richard Squire, *How Does Legal Enforceability Affect Consumer Lending? Evidence from a Natural Experiment*, JOURNAL OF LAW AND ECONOMICS (Aug. 2, 2017), available at <https://ssrn.com/abstract=2780215>.

²¹ Kevin V. Tu, *Regulating the New Cashless World*, 1 ALABAMA LAW REVIEW 65, 77, 89 (2013).

²² Tu, *Regulating the New Cashless World*, 86–89.

²³ See Coin Center State Regulation Tracker (<https://coincenter.org/page/state-digital-currency-regulatory-tracker>).

²⁴ N.Y. COMP. CODES R. & REGS. TIT. 23, §§ 200.1–200.22 (2017).

²⁵ NATIONAL CONFERENCE OF COMMISSIONERS ON UNIFORM STATE LAWS, UNIFORM REGULATION OF VIRTUAL-CURRENCY BUSINESS ACT (2017), <http://www.uniformlaws.org/Act.aspx?title=Regulation%20of%20Virtual-Currency%20Businesses%20Act>.

²⁶ See GOVERNMENT ACCOUNTABILITY OFFICE, COMPLEX AND FRAGMENTED STRUCTURE COULD BE STREAMLINED TO IMPROVE EFFECTIVENESS (GAO-16-175, Mar. 28, 2016), available at <https://www.gao.gov/products/GAO-16-175>.

Overlapping regulatory jurisdictions may hamper any efforts by regulators to provide regulatory relief via a “regulatory sandbox” or other means.²⁷ Even if one regulator enters into an agreement with a company to allow the company to experiment in exchange for limited liability, this would not be binding on other regulators (potentially including state regulators), severely limiting the usefulness of the regulatory relief program. This problem would also apply in cases where a state wished to offer a regulatory sandbox because the company would still face potential federal enforcement and private liability.²⁸

POSSIBLE IMPROVEMENTS

The current regulatory environment is not ideal, and Congress could improve it in several ways. First, while the power of a bank to make a loan and have it remain valid after it is sold exists under current law, clarification would be helpful to provide certainty. Congress could amend the relevant statutes to make explicit the right of a bank to make and sell a loan, and have the loan remain valid on its original terms.

Second, fintech firms should be able to operate on a nationwide basis without unduly burdensome state-by-state regulation. One option currently being considered by the Office of the Comptroller of the Currency (OCC) is to offer national-bank charters to nondepository lenders and money transmitters. This would allow those firms to tap into the existing powers of national banks. While this is a worthy idea, it is not and should not be the only solution. Instead, in addition to the OCC’s efforts, the states should be allowed to play a more active role in forwarding innovation.²⁹

States are currently at a disadvantage in that, while it is arguably possible for national banks to be nondepositories and still be able to export their home state’s law governing interest, under federal law that power is limited to FDIC-insured state banks. Congress could change this requirement to allow states to offer new nondepository bank charters comparable to those considered by the OCC.

Congress could also allow nonbank, state-licensed lenders and money transmitters to operate on the basis of their home state license and law in a way comparable to the privileges banks enjoy under federal law. This would allow innovative nondepository firms to be able to compete on a national basis without forcing them into the banking system, and it would allow for state experimentation and competition.

Third, Congress should explore allowing state and federal regulators to establish regulatory sandboxes or other comparable regulatory relief programs for limited trials of innovative products. Congress could allow a firm that participates in such a program and complies with the program’s requirements to avoid liability beyond that established by the program, subject to minimum requirements including the firm making its customers whole if the firm causes harm owing to a violation of the law.

²⁷ While definitions of “regulatory sandbox” differ, they can generally be thought of as a program where a company or group of companies enters into an agreement with regulators that allows the company to try a new product or service on a limited set of customers under the observation of the regulator. This program could involve allowing firms to offer a service they would otherwise need a license for or providing some limitation to potential liability faced by the firm if the experimental product or service ends up violating the law, though a requirement that the firm make the customers whole is standard. The United Kingdom Financial Conduct Authority is credited with launching the first regulatory sandbox for fintech in 2015.

²⁸ For example, Arizona Attorney General Mark Brnovich and Arizona State Representative Jeff Weninger have introduced legislation (HB 2434) to create a regulatory sandbox for financial firms operating in Arizona (<https://www.azag.gov/press-release/ag-brnovich-works-rep-weninger-introduce-groundbreaking-regulatory-sandbox>).

²⁹ For a more thorough discussion of what this might look like, see *generally* J.W. VERRET, A DUAL NON-BANKING SYSTEM? OR A NON-DUAL NON-BANKING SYSTEM? CONSIDERING THE OCC’S PROPOSAL FOR A NON-BANK SPECIAL PURPOSE NATIONAL CHARTER FOR FINTECH COMPANIES, AGAINST AN ALTERNATIVE COMPETITIVE FEDERALISM SYSTEM, FOR AN ERA OF FINTECH BANKING (Geo. Mason Law & Econ. Research Paper No. 17-05, Jan. 26, 2017), <https://ssrn.com/abstract=2906329>; Knight, *Federalism and Federalization on the Fintech Frontier*, 20 VAND. J. ENT. & TECH. L. 129, 200–204 (2017).

Fintech presents significant potential to improve the quality and inclusiveness of financial services. The current regulatory environment risks hampering this development, but intelligent changes can be made to make regulation friendlier to innovation and competition while still protecting consumers.

Thank you again for the opportunity to testify. I look forward to your questions.

ATTACHMENTS (4)

Modernizing Financial Technology Regulations to Facilitate a National Market (Mercatus on Policy)

Risks to Innovative Credit Posed by Emerging Regulatory and Litigation Trends (Mercatus on Policy)

Brian Knight, "Innovation Will Stall without a Regulatory Fintech Sandbox," *American Banker*,

November 15, 2016.

Brian Knight, "Credit Markets Need Legislative Guidance after Madden Decision," *American Banker*,

September 14, 2017.

MERCATUS ON POLICY

Modernizing Financial Technology Regulations to Facilitate a National Market

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CURRENT TECHNOLOGY ALLOWS NONBANK

financial service providers to compete on a national scale with banks more effectively in areas including lending and money transmission.¹ While these firms may be able to offer services at lower cost² and lower risk³ while improving access to underserved customers,⁴ they also face challenges from the existing regulatory structure. If these challenges are not successfully addressed, they risk denying consumers the benefits of innovation and competition that financial technology (fintech) can provide.

The inadequacy of the existing regulatory structure is particularly evident in the allocation of regulatory responsibility between the states and the federal government. Banks frequently are subject, via federal law and state comity, to relatively uniform legal rules in important areas like licensing⁵ and the laws governing interest on a loan.⁶ Conversely, nonbank fintech firms providing lending or money transmission services are generally subject to inconsistent state-by-state regulation.⁷ Nonbank fintech providers thus operate at a disadvantage compared with banks, and the unequal treatment of banks and nonbank firms causes both inefficiency and inequity in the financial marketplace. Table 1 illustrates the differences in regulatory treatment for certain issues between national banks, state banks, and nonbank financial institutions.

PROBLEMS POSED BY INCONSISTENT STATE-BY-STATE REGULATION

The choice between federalization and state regulation is a continuum, not a binary decision. Banks, despite the uniformity owing to federal preemption that they enjoy in many areas, are still subject to significant state regulation in certain cases. The current regime of burdensome state regulation for nonbank

Table 1. Select Regulatory Differences between Banks and Nonbanks

REGULATORY BARRIER	NATIONAL BANK	INSURED STATE BANK	NONBANK FINANCIAL INSTITUTION
Laws governing interest on loans	exportation of home state law ^a	exportation of home state law ^b	law of borrower’s state applies ^c
State lender licensing	exempt ^d	generally exempt ^e	state license required ^f
Money transmission licensing	exempt ^g	generally exempt ^h	state license required ⁱ

Notes: ^aNational Bank Act, 12 U.S.C. § 85 (2015); see also *Marquette Nat. Bank v. First of Omaha Corp.*, 439 U.S. 299 (1978); 12 C.F.R. § 7.4001(a)(1997) (allowing banks to use their home state’s definition of what constitutes interest nationwide); *Smiley v. Citibank (S.D.), N.A.*, 517 U.S. 735 (1996) (upholding same).

^bThe Depository Institutions Deregulation Act of 1980 (12 U.S.C. § 1831d(a) (2015)) (granting the same power to state-chartered, federally insured banks); FDIC, General Counsel’s Opinion No. 10; Interest Charges under Section 27 of the Federal Deposit Insurance Act, 63 Fed. Reg. 74 (1998) citing 12 C.F.R. § 7.4001(a) (1997) and 12 C.F.R. § 560.110(a)(1997) (allowing banks to use their home state’s definition of what constitutes interest nationwide); *Greenwood Trust Co. v. Massachusetts*, 971 F.2d 818, 827 (1st Cir. 1992) (“The historical record clearly requires a court to read the parallel provisions of DIDA and the Bank Act in pari materia. It is, after all, a general rule that when Congress borrows language from one statute and incorporates it into a second statute, the language of the two acts should be interpreted the same way.”).

^cJohn L. Douglas, “New Wine into Old Bottles: Fintech Meets the Bank Regulatory World,” North Carolina Banking Institute Journal 20, no. 1 (2016): 17, 31–32; letter from Manuel P. Alvarez, chief compliance officer for Affirm, Inc., to US Treasury, September 30, 2015, 7; letter from Sam Hodges, managing director for Funding Circle, and Conor French, general counsel, to US Treasury, September 30, 2015, 27; letter from Mitria Wilson for Oportun to US Treasury, September 30, 2015, 11–14; letter from Robert Lavet, chief legal officer for Social Finance, Inc., to US Treasury, September 30, 2015, 3–5.

^dUS Department of the Treasury, Opportunities and Challenges in Online Marketplace Lending, May 10, 2016, 6; Douglas, “New Wine into Old Bottles,” 34.

^eDepartment of the Treasury, Opportunities and Challenges, 6; Douglas, “New Wine into Old Bottles,” 34.

^fDepartment of the Treasury, Opportunities and Challenges, 5; Douglas, “New Wine into Old Bottles,” 32.

^gKevin V. Tu, “Regulating the New Cashless World,” Alabama Law Review 65, no. 1 (2013): 77, 89. See also Bryan Cave LLP, “The Latest in Money Transmitter Licensing,” February, 19, 2015, slide 20.

^hTu, “Regulating the New Cashless World,” 89; Bryan Cave LLP, “The Latest in Money Transmitter Licensing.”

ⁱTu, “Regulating the New Cashless World,” 86–89.

fintech firms creates three separate but interrelated problems: (1) it harms consumers by forcing fintech firms into an inefficient regulatory environment; (2) it damages competitive equity by differently regulating firms that offer similar services; and (3) it risks violating political equity among citizens of different states because some states de facto regulate the national market. Fortunately, there are ways to address these problems, which will be discussed below.

Inefficiency

Being forced to obtain licenses from each state in which a nonbank firm wishes to do business can be costly and time consuming.⁸ In addition to the cost and delay of obtaining licenses, different states impose different substantive requirements regarding licensing⁹ and what products or services licensed firms can provide.¹⁰ This inconsistency can also impose significant ongoing “search costs” on firms as they need to constantly monitor each state for

changes in the law.¹¹ This inefficiency can make it hard for firms to offer products, which has led many firms, especially in the lending space, to partner with banks to take advantage of the banks’ federally granted preemption.¹²

The bank-partnership model addresses the inefficiencies of state-by-state regulation, but it does so at a cost. The direct costs include the banks’ compensation for their participation and the added complexity required to structure the transaction. But there are also indirect costs, including uncertainty about enforceability, which has been exacerbated by recent litigation and state regulatory action.

These actions include the recent *Madden v. Midland Funding, LLC* decision,¹³ in which the United States Court of Appeals for the Second Circuit held that a loan originally valid when made by a bank could subsequently become usurious and invalid once sold to a nonbank. While this decision does not directly involve innovative nonbank lenders, it does strike at

While the problems posed by inapt state regulation of nonbank fintech firms are real, there are solutions. Federal regulators, the states themselves, and Congress all have options that can help.

the heart of the bank-partnership model, which relies on banks selling loans to nonbanks for servicing.

The *Madden* court's reasoning has affected the nonbank lending market. Loan volume for borrowers with relatively low credit scores seeking to use innovative lenders has declined significantly in 2016 relative to 2015 in the areas covered by the Second Circuit, while it has increased outside the Second Circuit.¹⁴ Additionally, other parties have adopted the reasoning of *Madden* to directly attack the bank-partnership model, arguing that even if a loan is valid when made by a bank, it can become invalid when sold to a nonbank firm. For example, Colorado's Uniform Consumer Credit Code administrator has sued two marketplace lenders alleging that the loans made by their bank partners were invalid, in part based on the claim that once the loans were sold to the nonbank lender, the loans lost the benefit of exporting the bank's home state law.¹⁵

In addition to the issue of loans that were valid when made, the issue of who is the true lender in a bank partnership—and whether it should matter—also calls the validity of the bank-partnership model into question. Some courts have held that the contractual relationship between the borrower and the bank controls¹⁶ because looking beyond the contract would intrude on the powers provided to banks by federal law.¹⁷ Other courts have held that the party with the “predominant economic interest” in the loan (i.e., the most to gain or lose based on the loan's performance) is the true lender and that the laws that apply to that entity govern the loan.¹⁸ Concerns about true lender issues have caused firms and their bank partners to distort their contractual relationships in ways that seek to avoid invalidation of the loan but do not provide greater efficiency or benefit to customers.¹⁹

Competitive Equity

Nonbank fintech firms turn to banks to avoid the inefficiencies of state-by-state regulation, indicating that banks enjoy a competitive advantage, despite the similarity of the products and services being offered. For example, the loans that Colorado is attacking would be unquestionably legal if made by a bank. The disparate treatment makes even less sense when one considers that nonbank lenders are governed by the same federal consumer protection laws as banks.²⁰ Likewise, nonbank money transmitters are subject to federal consumer protection and anti-money-laundering law²¹ similarly to banks.

This disparate treatment of similar products runs contrary to “the principle that institutions offering similar products should be subject to similar rules.”²² Senator Dale Bumpers made this statement in the context of the debate about whether competitive fairness demanded that interest rate exportation be provided to state banks on the same terms as it was provided to federal banks.²³ A similar dynamic exists today between banks and nonbank fintech firms, where the differences in regulation are not driven by differences in risks generated by the firms' activity but by the charter or license status of the firms.

Political Equity

Competitive equity isn't the only type of fairness imperiled by state-by-state regulation of fintech firms. There is also the risk that a state, especially a state that represents a large share of the market, will end up de facto regulating the national market. The New York Department of Financial Services (NYDFS) acknowledged as much in its complaint

against the Office of the Comptroller of the Currency (OCC) when NYDFS sought to stop the OCC's fintech bank charter (discussed below).²⁴ NYDFS's statement that "New York is a global financial center and, as a result, [NY]DFS is effectively a global financial regulator"²⁵ is not inaccurate, but it highlights the problem. While NYDFS may have global reach, it does not have global political accountability. The citizens of other states have no means of democratic redress against the NYDFS (or the regulators of other large and systemically important states).

This dynamic presents a problem for fintech firms because they will face significant economic and regulatory pressure to limit their national product offering to conform to state specific rules. For example, New York's licensing regime for virtual currencies—the "BitLicense"—claims a sweeping jurisdiction, including any virtual currency transaction (as defined by the rule) that involves New York or a New York resident.²⁶ Given New York's importance to the financial system, it is questionable whether a firm seeking to establish a viable business could elect to avoid New York. Given the breadth of New York's rules, firms would rightly be concerned that even if they intended to avoid New York, the NYDFS would consider them covered by New York law. Even if a firm were to successfully defend an enforcement action on the grounds that the NYDFS lacked jurisdiction, the diversion of resources away from competition to litigation could fatally cripple a company.

If firms must change their national products to comply with a specific state's rules, then the residents of other states must also bear with their choices being limited by rules they have no control over. State regulators and legislators have an incentive to act in the best interests of their state (or the most powerful political factions therein), even if this means imposing costs on other states.²⁷ Conversely, federal law and regulation is driven ultimately by the laws Congress passes, and Congress is accountable to the country as a whole.

WAYS TO ADDRESS THE PROBLEMS POSED BY INCONSISTENT STATE-BY-STATE REGULATION

While the problems posed by inapt state regulation of nonbank fintech firms are real, there are solutions. Federal regulators, the states themselves, and Congress all have options that can help modernize and streamline fintech regulation and make it more efficient and equitable.

Federal Regulators

Federal regulators—in particular the OCC, the Federal Deposit Insurance Corporation (FDIC), and the Federal Reserve (Fed)—can address at least some of the problems facing fintech lenders and money transmitters.

- *Address "valid when made" and "true lender" issues via regulation.* The United States solicitor general and the OCC have correctly taken the position that the Second Circuit's Madden decision is incorrect as a matter of existing law and that a national bank's power to lend includes the power to sell the loan and have it remain valid.²⁸ The Federal Deposit Insurance Act²⁹ should be interpreted in parallel³⁰ to convey the same power to state banks. Therefore, regulators could clarify via rulemaking that a bank may sell a loan without undermining the loan's validity. Additionally, bank regulators should clarify that the power of a bank to make a loan it plans to sell does not hinge on which party maintains the "predominant economic interest" in the loan.
- *Provide a viable bank charter option for non-depository firms.* The OCC has announced its intention to offer a special-purpose national bank charter for nondepository fintech firms.³¹ The OCC should continue to move this project forward and should structure the charter so that it is a viable option for smaller entities, omitting needlessly onerous

or restrictive requirements. The OCC should also vigorously defend its effort against the lawsuits brought by the NYDFS³² and the Conference of State Bank Supervisors.³³ The Fed should support the inclusion of special-purpose national banks into the Federal Reserve system as needed.

Additionally, the FDIC should clarify that the definition of “deposit” for the purpose of federal law does not include money provided to fintech banks for the purposes of money transmission.³⁴ The FDIC and the Fed should also support efforts by state banking regulators to pursue innovative charter structures comparable to the OCC’s effort, including supporting any necessary changes to federal law.

The States

The States could still play a major and productive role in improving fintech regulation. While they are making some efforts already,³⁵ those efforts revolve around making it easier for firms to apply for multiple licenses and deal with multistate supervision.³⁶ They do not address the core problems posed by the requirement for multiple licenses and the inconsistency of state law. Truly effective reform likely will require collaboration with the federal government.

- *Harmonization and reciprocity.* The states do not need the federal government’s help to make their laws more uniform and grant reciprocity for licensed entities. However, the history of state regulation in this space is not heartening. For example, Congress called on the states to harmonize their money transmission laws in 1994,³⁷ but to date only seven states have adopted the Uniform Money Services Act established by the Uniform Law Commission for that purpose.³⁸ The states could work with Congress to pass legislation that would allow for reciprocity for state-regulated nonbank financial services companies or for the exporting of certain legal provisions (for example, provisions governing interest),

akin to the powers granted to state-chartered banks. States would remain the primary regulator, but it would be easier for state-licensed entities to compete on a national scale.

- *Innovative chartering and licensure.* Rather than opposing the OCC’s efforts at innovation, the states should emulate (and possibly surpass) those efforts by creating new chartering options for nondepository institutions. To the extent such efforts are inhibited by existing federal law,³⁹ the states should work with Congress to remove those impediments to facilitate salutary competition between national banks and state-chartered or state-licensed financial institutions.

Congress

Given the interstate nature of the commerce in question, Congress has the broadest authority to address the issues posed by inapt state regulation of fintech.⁴⁰ As discussed above, there are several areas where Congress may be needed to help state-licensed entities compete at the national level. Additionally, there are other areas of federal law that can be clarified or improved to help rationalize the regulation of fintech firms.

- *Codify “valid when made” and clarify “true lender.”* Congress could provide regulatory certainty by explicitly codifying the long-standing common-law rule of “valid when made”⁴¹ and making clear that a firm does not need to maintain a “predominant economic interest” in a loan to be considered the true lender. This clarification would assist in protecting existing powers held by national and state banks.
- *Change the law to help state-based innovation.* Congress could change federal law to allow state-licensed or -chartered entities to export key provisions of their home state’s law (for example, provisions governing interest) and

mandate reciprocity for certain licensed activities (for example, money transmission licensing). Congress also could amend the Federal Deposit Insurance Act and other laws to allow state-chartered nondepository banks to enjoy the relevant powers of a bank granted to insured depositories.

- *Modernize tools to resolve uninsured nondepository banks.* As Acting Comptroller Keith Noreika recently testified, the power of the OCC to place a noninsured bank in receivership relies on law going back to the passage of the National Bank Act and needs to be modernized.⁴²

Additionally, Congress could amend the bankruptcy code to expand its application beyond non-insured state banks that are members of the Federal Reserve system to include, at a minimum, nondepository national banks.⁴³ In cases where receivership is unlikely to be necessary to protect customers, failing firms should go through bankruptcy.

CONCLUSION

There are many virtues to the United States' federal system, but as the Founders understood when they granted Congress the power to regulate interstate commerce,⁴⁴ there are times when the patchwork of inconsistent state regulations is counterproductive or even pernicious. The regulation of nonbank fintech lenders and money transmitters presents one such case, with inconsistent state regulation harming efficiency, competitive equity, and political equity. Both the federal government and the states themselves have options available to help address these problems and their underlying causes. They should consider exercising those options.

NOTES

1. Brian R. Knight, "Federalism and Federalization on the Fintech Frontier" (Mercatus Working Paper, Mercatus Center at George Mason University, Arlington, VA, 2017). An updated version is forthcoming at Brian R. Knight, "Federalism and Federalization on the

Fintech Frontier," *Vanderbilt Journal of Entertainment & Technology Law* (forthcoming).

2. Yuliya Demyanyk and Daniel Kolliner, "Peer-to-Peer Lending Is Poised to Grow," Federal Reserve Bank of Cleveland, August 14, 2014.
3. "Ripple eliminates the risk that payments will not reach the targeted payee once the payer initiates the transaction. . . . Either the entire transaction happens or none of the steps happen at all." Marcel T. Rosner and Andrew Kang, "Understanding and Regulating Twenty-First Century Payment Systems: The Ripple Case Study," *Michigan Law Review* 114 (2016): 661.
4. Usman Ahmed et al., "Filling the Gap: How Technology Enables Access to Finance for Small- and Medium-Sized Enterprises," *Innovations: Technology, Governance & Globalization* 10, no. 3-4 (2015).
5. Kevin V. Tu, "Regulating the New Cashless World," *Alabama Law Review* 65, no. 1 (2013): 77, 89. Note, however, that not all states exempt other state banks from licensing. Bryan Cave LLP, "The Latest in Money Transmitter Licensing," February, 19, 2015, slide 20.
6. The National Bank Act, 12 U.S.C. § 85 (2015), allows national banks to charge the amount of interest under their home state's laws nationwide. The Depository Institutions Deregulation Act of 1980, 12 U.S.C. § 1831d(a) (2015), grants the same power to state-chartered, federally insured banks. See also *Marquette Nat. Bank v. First of Omaha Corp.*, 439 U.S. 299 (1978); 12 C.F.R. § 7.4001(a) (1996); 12 C.F.R. § 560.110(a) (1997) (allowing banks and federal savings associations to use their home state's definition of what constitutes interest nationwide); *Smiley v. Citibank (South Dakota), N.A.*, 517 U.S. 735 (1996) (upholding same); FDIC, General Counsel's Opinion No. 10; Interest Charges under Section 27 of the Federal Deposit Insurance Act 63 Fed. Reg. 74 (1998) (citing 12 C.F.R. § 7.4001(a)(1997) and 12 C.F.R. § 560.110(a)(1997)).
7. John L. Douglas, "New Wine into Old Bottles: Fintech Meets the Bank Regulatory World," *North Carolina Banking Institute Journal* 20, no. 1 (2016): 17, 32; letter from Manuel P. Alvarez, chief compliance officer for Affirm, Inc., to US Treasury, September 30, 2015, 7; letter from Sam Hodges, managing director for Funding Circle, and Conor French, general counsel, to US Treasury, September 30, 2015, 27; letter from Mitria Wilson for Oportun to US Treasury, September 30, 2015, 11-14; letter from Robert Lavet, chief legal officer for Social Finance, Inc., to US Treasury, September 30, 2015, 3-5; Tu, "Regulating the New Cashless World," 87-88.
8. Obtaining licenses and maintaining compliance can cost over \$1 million and take more than two years. Douglas, "New Wine into Old Bottles," 46.
9. Douglas, "New Wine into Old Bottles," 32-34; Tu, "Regulating the New Cashless World," 91.
10. Thomas W. Miller Jr. and Harold A. Black, "Examining Arguments Made by Interest Rate Cap Advocates," in *Reframing Financial Regulation: Enhancing Stability and Protecting Consumers*, ed. Hester Peirce and Benjamin Klutsey (Arlington, VA: Mercatus Center at George Mason University, 2016), 346-50 (listing different state law requirements governing interest charged on loans).
11. Tu, "Regulating the New Cashless World," 112.
12. For example, Lending Club, Prosper, and PayPal all originate loans through WebBank, a state-chartered Utah industrial bank. Square partners with Celtic Bank, also a state-chartered Utah industrial bank,

- and Intuit partners with Cross River Bank, a state-chartered New Jersey bank.
13. Madden v. Midland Funding, LLC, 786 F.3d 246 (2d Cir. 2015).
 14. Colleen Honigsberg, Robert J. Jackson Jr., and Richard Squire, "What Happens When Loans Become Legally Void? Evidence from a Natural Experiment" (Columbia Business School Research Paper No. 16-38, Columbia University, New York, December 2, 2016), 28–29.
 15. Amended Complaint, Julie Ann Meade, Administrator, Uniform Consumer Credit Code v. Avant of Colorado LLC d/b/a Avant, and Avant Inc., No. 17CV30377 (D. Colo. Mar. 9, 2017); Amended Complaint, Julie Ann Meade, Administrator, Uniform Consumer Credit Code v. Marlette Funding LLC d/b/a Best Egg, No. 17CV30376 (D. Colo. Feb. 15, 2017).
 16. See, for example, Krispin v. May Dept. Stores Co., 218 F.3d 919 (8th Cir. 2000); Sawyer v. Bill Me Later, Inc., No. 2:11-cv-00988, 2014 U.S. Dist. LEXIS 71261 (D. Utah May 23, 2014); Hudson v. ACE Cash Express, Inc., No. 01-1336-C, 2002 U.S. Dist. LEXIS 11226, at *4, *16 (S.D. Ind. May 30, 2002); Beechum v. Navient Solutions, Inc., No. 2:15-cv-08239-JGB-KK (C.D. Cal. Sept. 20, 2016).
 17. See, for example, Hudson at *16 ("[the plaintiff] invites the courts to draw boundaries between federal and state bank regulation depending on the subjective purpose of those engaged in the transaction and/or the precise extent of financial risk accepted by the national bank. The court sees no basis for drawing jurisdictional boundaries in such an uncertain and unpredictable way.>").
 18. See, for example, CashCall, Inc., v. Morrissey, No. 12-1274, 2013 W. Va. LEXIS 587, at *18 (W. Va. May 30, 2014); Spitzer v. County Bank of Rehoboth Beach, 846 N.Y.S.2d 436 (N.Y. App. Div. 2007); Kane v. Think Finance, Inc., No. 14-cv-7139, 2016 WL 183289 (E.D. Pa. 2016) (refusing to grant a motion to dismiss a complaint of conspiracy to avoid Pennsylvania usury law. The defendant was a nonbank lender who partnered with a bank and a Native American tribe.); Consumer Financial Protection Bureau v. CashCall, Inc., CV 15-7522-JFW (RAOx) (C.D. Cal. 2016) (summary judgment was granted to CFPB on August 31, 2016).
 19. Kevin Wack, "Lending Club Tweaks Business Model in Effort to Thwart Legal Challenges," *American Banker*, February 26, 2016.
 20. US Department of the Treasury, *Opportunities and Challenges in Online Marketplace Lending*, May 10, 2016, 10.
 21. Knight, "Federalism and Federalization," 32–33.
 22. 126 Cong. Rec. 6,907 (1980) (statement of Sen. Dale Bumpers).
 23. Knight, "Federalism and Federalization," 13–14.
 24. Complaint for Declaratory and Injunctive Relief, Maria T. Vullo v. Office of the Comptroller of the Currency, 1:17-cv-03574-NRB (S.D.N.Y. May 12, 2017).
 25. *Ibid.*, ¶10.
 26. Knight, "Federalism and Federalization," 39–40.
 27. Samuel Issacharoff and Catherine Sharkey, "Backdoor Federalization," *UCLA Law Review* 53, no. 6 (2006): 1353, 1387–88; Paul Nolette, *Federalism on Trial: State Attorneys General and National Policymaking in Contemporary America* (Lawrence, KS: University Press of Kansas, 2015); Knight, "Federalism and Federalization," 72, 82–83.
 28. Brief for the United States as Amicus Curiae Supporting Petitioners, Midland Funding, LLC v. Madden, No. 15-610 (U.S. May 24, 2016).
 29. Codified at 12 U.S.C. § 1831d(a) (2014).
 30. "The historical record clearly requires a court to read the parallel provisions of DIDA and the Bank Act *in pari materia*. It is, after all, a general rule that when Congress borrows language from one statute and incorporates it into a second statute, the language of the two acts should be interpreted the same way." *Greenwood Trust Co. v. Massachusetts*, 971 F.2d 818, 827 (1st Cir. 1992). See also FDIC, General Counsel's Opinion No. 10; Interest Charges under Section 27 of the Federal Deposit Insurance Act, 63 Fed. Reg. 74 (1998).
 31. Office of the Comptroller of the Currency, *Exploring Special Purpose National Bank Charters for Fintech Companies*, December 2016.
 32. Complaint for Declaratory and Injunctive Relief, Maria T. Vullo v. Office of the Comptroller of the Currency, 1:17-cv-03574-NRB (S.D.N.Y. May 12, 2017).
 33. Complaint for Declaratory and Injunctive Relief, Conference of State Bank Supervisors v. Office of the Comptroller of the Currency, 1:17-cv-00763-JEB (D.D.C. Apr. 26, 2017).
 34. Lawrence D. Kaplan et al., "The OCC's Proposed Fintech Charter: If It Walks Like a Bank and Quacks Like a Bank, It's a Bank," Paul Hastings LLP, December 13, 2016 (acknowledging that funds provided to a bank for money transmission purposes may potentially constitute deposits under the Federal Deposit Insurance Act (12 U.S.C. § 1813(l))).
 35. Conference of State Bank Supervisors, "CSBS Announces Vision 2020 for Fintech and Non-Bank Regulation," news release, May 10, 2017.
 36. *Ibid.*
 37. Riegle Community Development and Regulatory Improvement Act of 1994, Pub. L. No. 103-325, § 407(b)(1-5) (1994).
 38. Uniform Law Commission, "Money Services Act," Enactment Status Map, accessed June 30, 2017.
 39. For example, the Federal Deposit Insurance Act defines "State Bank" as a bank "engaged in the business of receiving deposits" (12 U.S.C. § 1813(a)(2)(A)) and limits the ability to export home-state interest rates to "State-chartered depository institutions" (12 U.S.C. § 1831d(a) (2015)).
 40. Knight, "Federalism and Federalization," 60–61.
 41. Section 581 of the Financial CHOICE Act, H.R. 10, 115th Cong. (2017), Section 925 of the House Financial Services Appropriations Bill for FY 2018, H.R. 3280, 115th Cong. (2017), and the Protecting Consumers' Access to Credit Act of 2017, H.R. 3299, 115th Cong. (2017) seek to address this issue; see also Protecting Consumers' Access to Credit Act of 2017, 115th Cong. (2017).
 42. Testimony of Keith A. Noreika, Acting Comptroller of the Currency, before the US Senate Committee on Banking, Housing, and Urban Affairs, June 22, 2017, 35–36.
 43. 11 U.S.C. §§ 109(b)(2) and (d) (2006) preclude almost all banks from utilizing bankruptcy. See also Richard M. Hynes and Steven D. Walt, "Why Banks are Not Allowed in Bankruptcy," *Washington and Lee Law Review* 67, no. 3 (2010): 985, 986–87.
 44. 44 U.S. Const. art. I, § 8, cl. 3.

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MERCATUS ON POLICY

Risks to Innovative Credit Posed by Emerging Regulatory and Litigation Trends

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Nonbank online “fintech” lenders (sometimes known as *marketplace* or *peer-to-peer* lenders¹) have emerged as an important source of credit for individuals and small businesses. In 2015, these fintech lenders issued approximately \$36.5 billion in loans in the United States.² Although fintech lenders were initially discussed as a possible existential threat to banks, many such lenders rely on banks to facilitate credit.³ These innovative firms could expand access to credit for millions of American consumers and small businesses that are credit constrained. Unfortunately, recent regulatory and litigation developments that call into question the right of banks to issue and sell loans threaten to impede access to this new credit source. This policy brief outlines the threats to the bank-partnership model used by some fintech lenders, explains why the survival of the model matters, and offers suggestions for action.

THE ROLE OF BANKS IN FINTECH LENDING

Banks play an important role for many fintech lenders, including Lending Club, Prosper, PayPal Working Capital, Square, and Intuit.⁴ Those lenders work with a bank to originate a loan that the bank sells to the lender after a short period of time. The lender—which may sell, securitize, or retain the loan on its balance sheet—services the loan and collects payment.⁵

Lenders partner with banks in part because of regulation. Fintech lenders, being creatures of the Internet, are capable of extending credit from coast to coast, but they are subject to onerous state-by-state regulation. Under federal law, banks are able to “export” the

interest rate requirements of their home state for loans they make nationwide.⁶ This exportation includes not only the maximum allowable interest rate, but also the law governing what constitutes interest.⁷ By partnering with a bank, nonbank lenders can provide a consistent product, which is governed by the law of the bank's home state, and they can avoid having to be licensed by every state in which they extend credit.⁸

Lenders and borrowers benefit. The US Department of the Treasury found that these arrangements have helped fintech lenders improve the credit market.⁹ For some borrowers, fintech lenders provide cheaper credit.¹⁰ For others, fintech lenders provide greater access. For example, PayPal Working Capital, which partners with a bank to issue loans to small businesses, has been able to extend credit disproportionately to underserved populations and to areas that have seen a significant decline in the number of banks serving them.¹¹

EMERGING THREATS TO THE BANK-PARTNERSHIP MODEL

Despite its benefits, this model might not survive. Recent litigation has undercut the assumption that a nonbank entity can buy a loan from a bank and benefit from the bank's ability to export rates and terms. This ability is key to the bank-partnership model. Although the recent cases generally do not involve fintech lenders, those cases implicate such lenders and have already had a negative effect on consumers' access to credit.

The Threat to "Valid when Made"

The ruling of the US Court of Appeals for the Second Circuit in *Madden v. Midland Funding LLC*¹² calls into question the venerable common-law principle that a loan that is valid and nonusurious at its inception cannot subsequently become usurious (the "valid-when-made" doctrine).¹³ In the *Madden* case, a New York borrower opened a credit card account with a national bank that charged an interest rate that was permitted by the bank's home state laws but that exceeded New York's usury cap. When the borrower defaulted, the bank sold the debt, which eventually was purchased by Midland Funding, a nonbank debt purchaser. Midland Funding sought to collect the outstanding debt,

including interest that accrued after the debt had been sold. The borrower sued, and the Second Circuit held that the National Bank Act's interest rate export did not cover the nonbank debt buyer. The court reasoned that its decision did not significantly infringe on the powers of the national bank because the bank could still sell the debt, albeit either to a more limited pool of buyers or at a discount.

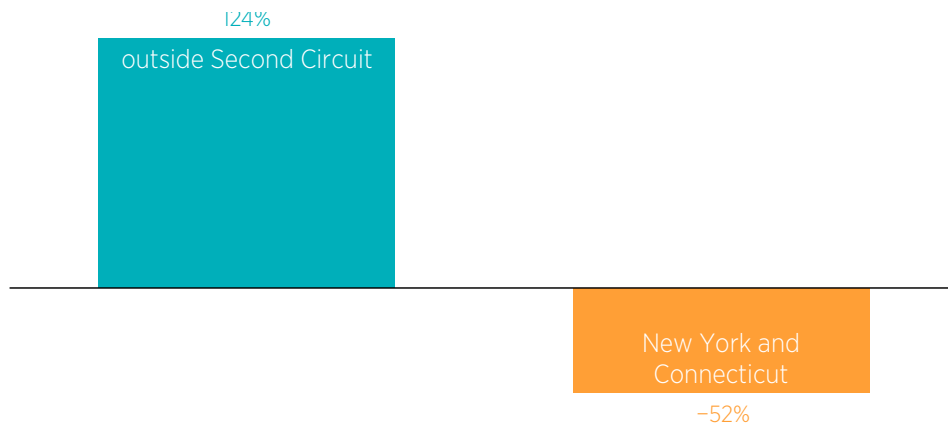
Midland Funding appealed the decision to the Supreme Court. The Supreme Court requested the solicitor general's view, and the solicitor general, along with the Office of the Comptroller of the Currency (OCC), opined that the Second Circuit got the law wrong and that the power to make loans included the power to sell loans to nonbank entities and have the loans retain their validity.¹⁴ Notwithstanding their disagreement with the appellate court on the law, the solicitor general and the OCC argued on procedural grounds that the Supreme Court should not take the case, and the Supreme Court declined to do so.¹⁵

Although the *Madden* case did not involve fintech lenders, the risk that a bank loan purchased by a nonbank could become invalid has direct implications for the bank-partnership model. The case has produced considerable fallout in the Second Circuit, including a significant reduction in credit for borrowers with lower credit scores (who would be charged a higher rate). Professors Colleen Honigsberg, Robert J. Jackson, and Richard Squire have documented this decline.¹⁶ As shown in figure 1, they find that in 2015 in New York and Connecticut (states in the Second Circuit¹⁷) the number of loans made by leading marketplace lending platforms to borrowers with FICO credit scores below 625 *decreased* by 52 percent relative to 2014, while in other circuits the number of loans for comparable borrowers *increased* by 124 percent.¹⁸ Conversely, loan growth for borrowers with FICO scores above 700 (who would be less likely to be charged interest in excess of New York's or Connecticut's usury limits) were comparable between New York and Connecticut and other circuits.¹⁹

Who Is the True Lender—and Should It Matter?

In *Madden*, there was no dispute about who the lender was. The bank issued the borrower a credit card with the expectation that the borrower would remain a bank customer and sold the debt only when it became

FIGURE 1. GROWTH IN LOAN VOLUME FOR BORROWERS WITH A FICO CREDIT SCORE UNDER 625 AFTER THE *MADDEN* DECISION



Source: Colleen Honigsberg, Robert J. Jackson, Jr., and Richard Squire, “What Happens when Loans Become Legally Void? Evidence from a Natural Experiment” (Columbia Business School Research Paper No. 16-38, December 2, 2016), 28–29. (Finding a decline in loan volume from studied lenders in 2015 for borrowers with FICO scores below 625 in New York and Connecticut, while finding an increase in states not covered by the *Madden* decision).

nonperforming. Conversely, in the bank-partnership model, the expectation has been that the bank would promptly sell the loan to the fintech lender, which would then own and maintain the customer relationship. This situation raises the specter of the “true lender” doctrine, which has significant implications for what law applies to a loan. If the nonbank entity is deemed to be the true lender, then it does not enjoy broad federal preemption but is instead bound by state usury laws.

Courts take different approaches to the true lender question. Some courts have looked only to the loan contract.²⁰ For those courts, looking beyond the contract to factors such as the parties’ subjective intent or the risk borne by the bank would add uncertainty and be inconsistent with the exemption from state usury laws that banks enjoy under federal law.²¹ However, other courts have looked beyond the contract to the underlying economic reality of the loan at its inception.²² Those courts consider the role the bank (or tribe) and nonbank perform in the loan process, including advertising, setting underwriting criteria, making loan decisions, and underwriting specific borrowers. The courts also look at the amount of risk borne by each party. If a bank sells a loan quickly or has a standing agreement or prepaid account with the nonbank entity, courts may consider this evidence that the nonbank entity is the actual lender.

Consumer Financial Protection Bureau (CFPB) v. CashCall provides a recent example of the difficulties

posed by looking beyond the contract. The CFPB sued a nonbank lender (CashCall) that partnered with Western Sky Financial (WSF), a corporation operating under the law of the Cheyenne River Sioux Tribe (CRST) to issue loans. The contract listed WSF as the lender, and a choice-of-law provision stipulated that the contract was governed by CRST law. Moreover, WSF employees performed underwriting and made lending decisions. Nevertheless, the court found CashCall to be the true lender. The court based its decision on the conclusion that CashCall bore the entire economic risk of the transaction because WSF was contractually insulated from default risk and CashCall funded a reserve to pay for two days’ worth of loans in advance.²³ The court also invalidated the contract’s choice-of-law provision because it found that the CRST did not have sufficient ties to the transaction (even though lending decisions were made in the CRST’s jurisdiction).²⁴ The court then found that the law of the borrowers’ home state, instead of CashCall’s home state, should apply because the borrowers applied for, paid for, and received funds in their home state.²⁵

The court’s analysis in that case highlights the danger of looking beyond the contract. Although it is plausible to view the transaction as occurring in the borrowers’ state, it is equally or even more plausible to view the borrowers as coming to the lender’s state to avail themselves of the lender’s state’s law. The Supreme Court in *Marquette National Bank of Minneapolis v. First of Omaha Service Corp.* noted that a borrower was always able to go to the lender’s state to avail herself of the

lender's state laws and that applying for a credit card via the mail was similar.²⁶ Applying for a loan online is a natural continuation that does not justify a departure from this reasoning. The *CashCall* court's analysis is also inconsistent with the Supreme Court's determination in *Marquette* that the lender's home state bore the closest nexus to the loan transaction and that defining "location" by where the credit was received would introduce significant confusion.²⁷

Fintech lenders are experiencing the fallout from *Madden* and the true lender cases. A New York borrower sued Lending Club for allegedly making a usurious and invalid loan with WebBank's "sham" participation.²⁸ Regulators are also starting to consider whether loans made by fintech lenders with bank partnerships are governed by state law. For example, Colorado has notified fintech lenders that the state considers the loans to be governed by its law.²⁹ Lenders, for their part, have changed their contracts with their bank partners to tie the bank's compensation more closely to the long-term performance of the loan.³⁰

When lenders change their relationships with banks solely to mitigate regulatory risk, the process is likely to introduce more complexity and cost to the borrower. Why should it matter who the true lender is from a regulatory perspective? If a loan is acceptable for a bank to make, why should a nonbank entity be prohibited from making the same loan? Raising questions about the validity of marketplace loans blocks innovative fintech lenders' efforts to improve access to credit for marginal borrowers.

WHAT CAN BE DONE

To encourage innovation and access in lending, a clear, consistent regulatory approach is needed. Several potential and nonexclusive paths can be pursued to establish such an approach.

State Coordination

States could change their lending regulations to make it easy for lenders licensed in one state to lend in other states without having to comply with the laws of both states. Although state regulators have discussed such an approach,³¹ those discussions may not result in any meaningful change. First, states could have changed their laws to permit greater uniformity for banks in the

past, but federal law intervention was necessary to provide reliable exportation. There is little reason to think that this time will be different. Second, even if states were able to establish a uniform standard, state laws could change, so nonbank lenders—unlike their bank competitors—would have to engage in costly, constant monitoring.

Federal Regulatory Relief

The Federal Deposit Insurance Corporation (FDIC) and OCC could issue a regulation clarifying that a bank can sell a loan without compromising exportation. Such a regulation could be modeled on a similar clarifying regulation by the FDIC and OCC about what constitutes interest.³² Such a federal regulation would preempt state law,³³ and it would provide certainty to lenders and their bank partners.

Expanded Bank Chartering

Fintech lenders could become banks themselves, an approach that would obviate the need for a bank partnership and reduce the complexity and uncertainty of loan transactions. The OCC has proposed creating a bank charter for fintech firms, including lenders.³⁴ Such a charter would give fintech firms the powers granted to national banks by the National Bank Act. Although this change could be an important step in equalizing the regulatory landscape, fintech firms would not avail themselves of such a charter if obtaining and maintaining the charter were unduly difficult or expensive. Additionally, while a charter might benefit fintech firms, banks seeking to sell loans to nonbank lenders would still run into problems because of the legal uncertainty. The result would be higher costs for borrowers.

Legislation

Congress also could act to create a clear and effective regulatory environment for banks and fintech lenders. For example, codifying the principle of "valid-when-made" would address the concerns raised by the *Madden* decision.³⁵ Likewise, legislation could clarify whether a loan should be considered a bank loan if it was sold by a bank soon after it was made and without the bank's retaining ongoing default risk.

CONCLUSION

Fintech lenders present an opportunity to expand credit access and quality. Although such lenders should be subject to appropriate regulation, the regulation must work with the fundamental economic reality of the market. Ensuring that regulations do not burden fintech lenders more heavily than their bank competitors are burdened and that the validity of their loans is not in doubt are important steps toward helping realize the promises of innovation.

NOTES

1. Defined narrowly, *marketplace lending* would involve a two-sided market in which the lender sells the loans it generates, and *peer-to-peer* lending would involve individuals funding loans for other individuals. Many leading companies, including Lending Club and Prosper, use both these models for at least some of their loans. However, the two terms are often used more broadly to encompass a wider range of innovative nonbank lenders. See, for example, California Department of Business Oversight, “California DBO Announces Inquiry into ‘Marketplace’ Lending Industry,” December 11, 2015. The broader definition is used in this paper.
2. Tim Sablik, “Tomorrow’s Lenders?,” *Econ Focus*, Richmond Federal Reserve Bank, Second Quarter 2016.
3. US Department of the Treasury, *Opportunities and Challenges in Online Marketplace Lending*, May 10, 2016, 5–8.
4. Lending Club, Prosper, and PayPal all originate loans through WebBank, a state-chartered Utah industrial bank. Square partners with Celtic Bank, also a state-chartered Utah industrial bank, and Intuit partners with Cross River Bank, a New Jersey state-chartered bank.
5. US Department of the Treasury, *Opportunities and Challenges in Online Marketplace Lending*, 5–8.
6. The National Bank Act grants this power to nationally chartered banks (12 U.S.C. § 85 (2015)). The Depository Institutions Deregulation Act of 1980 grants this power to state-chartered banks (12 U.S.C. § 1831d(a) (2015)); see also *Marquette Nat. Bank v. First of Omaha Corp.*, 439 US 299 (1978).
7. See 12 C.F.R. § 7.4001(a). See also 12 C.F.R. § 560.110(a); *Smiley v. Citibank (South Dakota), N.A.* 517 U.S. 735 (1996).
8. US Department of the Treasury, *Opportunities and Challenges in Online Marketplace Lending*, 6.
9. *Ibid.*, 21.
10. Yuliya Demyanyk and Daniel Kolliner, *Peer-to-Peer Lending Is Poised to Grow*, Federal Reserve Bank of Cleveland, August 14, 2014.
11. Usman Ahmed et al., “Filling the Gap: How Technology Enables Access to Finance for Small- and Medium-Sized Enterprises,” *Innovations: Technology, Governance & Globalization* 10, no. 3–4 (2015).
12. *Midland Funding, LLC, et al., v. Saliha Madden*, 786 F. 3d 246 (2d Cir. 2015).
13. The Supreme Court has embraced this doctrine at least since 1833. See *Nichols v. Fearson*, 32 US 103, 109 (1833) (holding that “a contract, which, in its inception, is unaffected by usury, can never be invalidated by any subsequent usurious transaction”). However, the doctrine predates that case.
14. Brief for the United States as amicus curiae supporting petitioners, *Midland v. Madden*, No. 15-610 (May 24, 2016), 6.
15. *Midland Funding v. Madden*, No. 15-610, 136 S. Ct. 2505 LEXIS 4211 (June 27, 2016), *cert. denied*.

16. Colleen Honigsberg, Robert J. Jackson, Jr., and Richard Squire, "What Happens when Loans Become Legally Void? Evidence from a Natural Experiment" (Columbia Business School Research Paper No. 16-38, Columbia University, New York, December 2, 2016).
17. While New York and Connecticut usury law can void usurious loans, in Vermont (which is also in the Second Circuit), the loan is modified to become nonusurious. Hence, Honigsberg, Jackson, and Squire focus on the loan environment in New York and Connecticut. *Ibid.*, 16 (also noting that the inclusion of Vermont made little difference in the results).
18. *Ibid.*, 28–29.
19. *Ibid.*
20. See, for example, *Krispin v. the May Department Stores Co*, 218 F.3d 919 (8th Cir. 2000); *Sawyer v. Bill Me Later, Inc.*, No. 2:11-cv-00988, 2014 U.S. Dist. LEXIS 71261 (D. Utah May 23, 2014); *Hudson v. ACE Cash Express, Inc.*, No. 01-1336-C, 2002 US Dist. LEXIS 11226, at *4, *16 (S.D. Ind. May 30, 2002); *Beechum v. Navient Solutions, Inc.*, No. 2:15-cv-08239-JGB-KK (C.D. Cal. Sept. 20, 2016).
21. For example, *Hudson* at 16 states that the plaintiff "invites the courts to draw boundaries between federal and state bank regulation depending on the subjective purpose of those engaged in the transaction and/or the precise extent of financial risk accepted by the national bank. The court sees no basis for drawing jurisdictional boundaries in such an uncertain and unpredictable way."
22. See, for example, *CashCall, Inc., v. Morrisey*, No. 12-1274, 2013 W. Va. LEXIS 587 at 18 (W. Va. May 30, 2014); *Spitzer v. County Bank of Rehoboth Beach*, 846 N.Y.S.2d 436 (N.Y. App. Div. 2007); *Kane v. Think Finance, Inc.*, Civ. No. 14-cv-7139, 2016 WL 183289 (E.D. Pa. 2016)(refusing to grant a motion to dismiss a charge of conspiracy to avoid Pennsylvania usury law by a nonbank lender who partnered with a bank and a Native American tribe); *Consumer Financial Protection Bureau v. CashCall, Inc.*, CV 15-7522-JFW (RAOx) C. D. Cal. (summary judgment granted August 31, 2016).
23. *CashCall* at 8.
24. *Ibid.* at 9.
25. *Ibid.* at 11.
26. *Marquette* at 310–12.
27. *Ibid.* The court in *Marquette* based the decision of where a bank was located for purposes of the law on the bank's organization certificate, not on the strength of ties to a particular state. The court's strength of ties analysis was used to rebut Minnesota's argument that the borrower's state was the relevant location.
28. *Ronald Bethune v. Lending Club Corporation*, S.D.N.Y. 1:16-cv-02578, filed April 6, 2016.
29. Telis Demos and Peter Rudegeair, "Greater Scrutiny Looms for 'Rent-a-Charter' Deals," *Wall Street Journal*, August 21, 2016.
30. See, for example, Kevin Wack, "Lending Club Tweaks Business Model in Effort to Thwart Legal Challenges," *American Banker*, February 26, 2016; Kirby Smith, "Banking on Preemption: Allowing National Bank Act Preemption for Third-Party Sales," *University of Chicago Law Review* 83 (2016): 1631–82.
31. Lalita Clozel, "States Hurry to Boost Their Fintech Appeal in Wake of OCC Plan," *American Banker*, December 9, 2016.
32. See 12 C.F.R. § 7.4001(a); see also 12 C.F.R. § 560.110(a).
33. *Smiley v. Citibank (South Dakota)*, N.A. 517 U.S. 735 (1996).
34. Office of Comptroller of the Currency, *Exploring Special Purpose National Bank Charters for Fintech Companies*, December 2016.
35. Rep. Patrick McHenry (R-NC) introduced the Protecting Consumers' Access to Credit Act of 2016 (H.R. 5724) on July 11, 2016. For the bill to become law, it would have to be reintroduced in the new Congress.

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BankThink Innovation Will Stall Without a Regulatory Fintech 'Sandbox'

By **Brian Knight**

Published November 15 2016, 11:00am EST

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All policymakers and regulators claim to love innovation, especially if it might help the underserved. Unfortunately, regulators' thinking often fails to keep up with their rhetoric.

A particularly frustrating example is the emerging opposition from some in the government, including Sen. Mark Warner, D-Va., and [Comptroller of the Currency Thomas Curry](#), to a regulatory sandbox for financial services. Sandboxes provide a space where companies can try new ideas, under the watchful eye of regulators, but with some degree of regulatory forbearance, including the waiver of certain rules or limits to enforcement actions.

Opponents fret that a sandbox would provide companies with a way to avoid consumer protection laws. However, sandboxes need not be a Hobbesian "[war of all against all](#)," where the powerful prey on the weak. Instead — provided they are done right — sandboxes can offer an environment where companies can innovate while ensuring consumers are protected.

Fear and uncertainty about regulatory risk are major impediments to companies pursuing innovative financial products. Concern is especially high for innovators trying to serve populations who need help the most. The fear of facing the regulator's wrath chills innovation, deprives consumers and encourages firms — especially small innovators — to stay under the radar. In addition to harming companies, innovation and consumers, this state of play isn't good for regulators. Refusing to let innovators experiment in a permissive environment keeps regulators in the dark. For regulators, who all too often have to play catch up, this reality ought to be reason enough for them to accommodate innovators.

Regulatory sandboxes are a potential solution to innovators' and regulators' problems. In the U.K., [the Financial Conduct Authority](#) runs a sandbox program focused on financial technology companies. This sandbox allows firms to test new products that regulators deem are truly innovative and potentially beneficial to consumers. (Of course, one wonders whether regulators can judge whether a product meets these criteria. Regulators, like the rest of us, can't see the future until it's here.) The FCA also requires firms to have appropriate consumer safeguards, such as the wherewithal to compensate consumers who are harmed if the test goes awry.

Likewise, a U.S. sandbox could help encourage innovation without jeopardizing consumers. In exchange for greater transparency from the company, regulators could agree to limit the company's potential liability for future consumer protection violations. In this model, companies would not be able to escape the responsibility for compensating inadvertently harmed consumers, but would have the assurance that the government would not assess fines and penalties. Of the three justifications for sanctioning a company — compensation, punishment and deterrence — only the first is appropriate for companies operating with transparency and in good faith.

Taking fines, penalties and the reputational harm that comes from an enforcement action off the table would remove a major source of risk and uncertainty for innovators. But consumers would remain protected. Not only would consumers be able to enjoy the fruits of

innovation, but entrepreneurs would compensate consumers for any inadvertent harm suffered in the process. Given the nature of the product and anticipated number of customers, a firm can estimate in advance the potential for consumer harm. By contrast, fines, which are driven by the whims of the regulator, can often dwarf the compensatory damages, and may bear little or no relationship to actual customer harm. For example, in the Wells Fargo scandal dealing with unauthorized accounts, the bank may end up paying only \$5 million in compensation to consumers while it must pay \$185 million in fines.

While fines in addition to customer restitution are appropriate for intentional bad acts, a firm that wants to try a new product to better meet the needs of consumers and acts in good faith doesn't deserve regulators penalizing it or dragging its name through the mud. Without having to worry about outsized and arbitrary risk, firms could pursue innovation with confidence while still being responsible for making customers whole if they are harmed.

Needlessly spurning useful tools based on a misunderstanding of how they would work in practice prevents progress and doesn't protect the public. While consumer protection is vital, it is not incompatible with innovation or providing certainty to companies trying to improve options for the public. Policymakers and regulators should match their rhetoric with action and provide regulators and companies the space they need to build a better future.

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BankThink Credit markets need legislative guidance after Madden decision

By Brian Knight

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Editor's note: This post originally appeared in slightly altered form on the [FinRegRag](#) blog.

In a recent [op-ed](#) in American Banker (derived from a longer [blog post](#)), professor Adam Levitin argues that the recent legislative proposals to “fix” the repercussions of the United States Court of Appeals for the Second Circuit’s [Madden v. Midland Funding](#) decision are “overly broad and unnecessary and will facilitate predatory lending.” The legislation Levitin opposes would restore the ability of banks to sell loans to nonbanks and have the loans remain valid on their original terms, the type of transaction on which the Madden decision has cast doubt. [I disagree](#), at least with regard to marketplace lending. There are compelling legal and policy arguments to undo the Madden decision that Congress should consider. (To be clear, this is not an endorsement of any particular legislation.)

Applying valid-when-made is appropriate

The [text of](#) the Protecting Consumers Access to Credit Act of 2017 states that the principle

that a loan is “valid at inception cannot become usurious upon the subsequent sale or transfer of the loan to another person” has been a cornerstone of banking law, “as provided in the case of [Nichols v. Fearson](#)”. Levitin argues that supporters of the legislation rely on an incorrect interpretation of “valid-when-made.” Levitin [points](#) out that the Nichols case, as well as a number of other 19th-century cases dealing with whether “in a string of transactions from X to Y to Z, if X to Y is nonusurious, but Y to Z is usurious, can X shelter in Y’s usury defense[?]” The answer those cases gave was “no.” Levitin considers this a just result because the originator of the note should not get off the hook simply because a subsequent unrelated transaction was usurious.

Levitin argues that the Madden case is different. In Madden, the ultimate purchaser of the loan (Midland Funding) wanted to take advantage of the state usury law preemption enjoyed by the originator of the loan (the bank). Levitin argues that valid-when-made has nothing to do with the issue in Madden and similar arrangements where banks sell loans to nonbanks.

Levitin is certainly right that the Nichols case and the similar 19th-century cases reflect a different fact pattern than was presented in Madden. It does not necessarily follow, however, that the principle of valid-when-made should not also apply under the Madden facts. The drafters of the Madden fix bills might have set themselves up for trouble by saying that valid-when-made “as **provided** by Nichols v. Fearson” (emphasis added), since that implies that the court created the doctrine, or set out its boundaries in the Nichols case. But this isn’t what happened. Instead, the Nichols court cited a preexisting maxim and applied it to a certain set of facts. Proponents of the Madden fix can’t cite Nichols as controlling legal precedent (or else we wouldn’t be having this debate), but that doesn’t mean that the maxim of valid-when-made is limited to the Nichols facts or shouldn’t apply in the present case.



Congress should correct the Second Circuit's mistake in *Madden v. Midland Funding* and restore clarity to credit markets and access to borrowers who need it.

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In fact, courts have cited *Nichols* and the principle of valid-when-made in other contexts. Perhaps the most direct example is the case of [FDIC v. Lattimore Land Corp.](#) In that case, the U.S. Court of Appeals for the Fifth Circuit held that a nonusurious loan made by a nonbank under Georgia law and subsequently transferred to a Tennessee-based national bank did not become usurious, even though it exceeded Tennessee's usury cap, because "[t]he nonusurious character of a note should not change when the note changes hands." The *Lattimore* court cited to *Nichols* for the proposition that:

"If, in its inception, the contract which that instrument purported to evidence was unaffected by usury, it was not invalidated by a subsequent transaction."

This proposition was articulated by the Supreme Court as one of the “cardinal rules in the doctrine of usury.”

In Lattimore, as well as in Madden, the original borrower is trying to assert a usury defense because the loan changed hands. This case is not identical to the issue in Madden, because the loan in Lattimore went from a nonbank to a bank. As the United States Solicitor General and Office of the Comptroller of the Currency [point out](#), however, there is an “appealing symmetry” to the idea that if valid-when-made applies in the context of a nonbank assigning a loan to a bank, the reverse should also be true.

Applying valid-when-made is just

There is also a strong argument that applying valid-when-made to cases like Lattimore and Madden is just. Recall Levitin’s argument that X, the original borrower, should not get out of her original and valid contract simply because a usurious transaction happened downstream. In the present case, we have a borrower who took out a legal loan, something happened to the loan downstream (a sale) that did not change the original borrowers’ obligations, and now the original borrower wants to use that downstream event to get out of their obligation to repay. Why should the borrower get a windfall because a loan is sold?

Levitin [argues](#) that the loan is only valid when *held* by a bank; the loan was actually usurious from the start and the law only stayed the application of the usury laws so long as the loan was held by a bank. This interpretation of the law is not shared by, among others, the solicitor general and the OCC, who argue that the ability of a bank to sell a loan contains the ability to have the loan remain valid on its original terms.

And why should the validity of the loan hinge on who holds it anyway? Levitin argues that banks are subject to an “alternative federal regulatory regime” that does not apply to nonbanks, and therefore nonbanks should not be entitled to the benefits of federal regulation.

However, it is unclear what relevant regulation banks are subject to that nonbanks aren't. The issue at question in Madden, the interest charged on the loan, was set by *the bank* at the loan's inception. The borrower got the benefit of the federal regulatory regime, which includes the incorporation of the bank's home state usury law, when the loan was created, and the relevant characteristics did not change. So why is there suddenly a problem?

Further, Levitin seems to accept that a bank should be allowed to shift the credit risks of the loan off of its portfolio. Why should a bank be allowed to shed risk via securitization (which he acknowledges may be implicated by Madden) or financial engineering but not a direct sale of the loan? Such efforts to shift credit risk would also seem to undo another supposed benefit of Madden, that it forces banks to take greater care underwriting. Banks shifting credit risk off their books, regardless of method, could lower their underwriting standards, but they still face the reality that selling interests in loans that fail to perform will be punished by the market.

Regardless of whether the bank sells the loan, securitizes it, or offers some sort of participation interest, the loan can only ever be what the bank is allowed to offer under its federal regulatory regime (or else it isn't valid). If the loan remains what the borrower, the lender, and the law thought was acceptable when the loan was made, why should a change in ownership of the loan destroy the contract? Contrary to Levitin's assertion, fixing Madden is not about repealing usury laws, it is about making clear that the usury laws applicable to a loan do not change suddenly and arbitrarily.

It is also unclear just how different the relevant law between banks and nonbanks actually is. As the Treasury Department [noted](#), federal consumer protection laws apply equally to marketplace lenders and banks. Both are subject to Dodd-Frank's prohibition against unfair, deceptive, or abusive acts or practices, and the Consumer Financial Protection Bureau has jurisdiction over both. For example, any qualifying loans, whether made in conjunction with a marketplace lender or not, will be subject to the CFPB's anticipated small-dollar rule. Likewise, marketplace lenders who partner with banks are generally subject to examination

and regulation by federal banking regulators under the Bank Service Company Act. There may be differences in how the law treats banks and nonbanks, but that doesn't mean the differences are material. There is a robust federal and state consumer protection regime governing marketplace loans, not a "regulatory vacuum."

Levitin calls for various new requirements for loans, including an ability to repay component, dictating certain loan characteristics other than the interest rate, and a prohibition on forced arbitration. All these requirements are beyond the scope of the laws implicated by Madden. While they may have merit as a matter of policy, that is a separate debate from the question posed by the Madden decision — whether a borrower should be held to the terms of her original contract if her loan is sold.

The impact of Madden on innovative credit is harmful to borrowers

Levitin argues that there is no policy justification for applying valid-when-made in the aftermath of Madden. However, this isn't true. Besides the question of justice discussed above, Madden also appears, as would be expected, to be [reducing access](#) from marketplace lenders to credit for borrowers with lower credit scores. Contrary to Levitin's argument, a recent [study](#) shows a reduction in credit availability not just for borrowers with FICO scores under 625 (though that is where the reduction is most pronounced). The study indicates that borrowers in New York and Connecticut with FICO scores under 700 saw a reduction in availability relative to comparable borrowers outside the Second Circuit.

Even if the Madden decision does reduce credit availability, Levitin finds the reduction acceptable; after all, we don't let people "[pledge their children and organs as collateral](#)," right? While it might be true that certain access-to-credit-enhancing policies might impose unacceptable costs, fixing Madden does not. The loans in question were societally acceptable to begin with. All fixing Madden does is ensure that the expectation of the borrower, seller, and the law at the time the contract was created are validated. Making people abide by the contracts they legally entered into is hardly the same as pledging a kid

or kidney as collateral.

This hyperbole also ignores the reality that access to credit is often consumer protective. For example, it is important to keep in mind that the majority of marketplace loans are used to [pay off](#) bank-issued credit cards (which are not subject to borrower state usury laws) or consolidate existing debt. Denying borrowers access to these loans does not leave the borrowers unencumbered by debt; it leaves them in the situation they view as worse than taking out this new loan. We should not be dismissive of this risk, or throw roadblocks up that prevent borrowers from improving their situation. This is especially true given that there [is evidence](#) that marketplace lenders can help provide expanded access and competition, services in areas that have few banks, and better pricing for some borrowers than they would receive from banks. Cutting off access isn't protecting borrowers, it is leaving them with fewer, perhaps inferior, tools to protect themselves.

As Levitin acknowledges, usury caps are crude tools. Interest rate caps impact only part of what determines the cost of a loan. Usury caps can lead to loan arrangements being distorted in ways that make the loans legal but worse for the borrower. We see examples of this in the shift from payday to "payday [installment](#)" and subprime [auto loans](#), where lenders bound by interest rate caps change the loan principal amount or repayment schedule to make the loans viable. These loans can actually be more expensive in total because the lower interest rate is applied to a higher principal over a longer time period. Larger loans also can be more expensive for borrowers if they pay them off early or go into default. Borrowers also could be forced into using suboptimal options like pawn shops or illegal loans, or find themselves without credit altogether.

Levitin is right that we don't know if the borrowers being cut off from marketplace loans are finding credit elsewhere. Even if borrowers are finding credit elsewhere, however, we should be concerned that the replacement credit is inferior to the marketplace loans they are being denied. The burden is on those who advocate denying borrowers their first choice to show that the borrower isn't being harmed.

Madden should not be the end of the discussion

With the expansion of nonbank credit providers, the role of technology, and evolving regulation and [consumer preferences](#), Levitin is absolutely right that the rules of the credit market should be rethought. After all, why should banks have a unique advantage to provide credit nationwide? Rather, lenders offering similar products, posing similar risks, should be held to [similar standards](#). While that discussion absolutely should happen, in the meantime, Congress should correct the Second Circuit's mistake and restore clarity to credit markets and access to borrowers who need it.



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