LOS ANGELES & SAN FRANCISCO
Daily Journal
www.dailyjournal.com

MONDAY, OCTOBER 12, 2020

PERSPECTIVE

The ‘true lender’ rule and the battle over the bank partnership model

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On July 22, the Office of the Comptroller of the Currency issued a proposed rule clarifying when a national bank is the ”true lender” of a loan, and which provides much-needed guidance for banks and fintech lenders that offer loans through partnership models. Along with its recent “valid-when-made” rule, the “true lender” rule is another step streamlining regulations for national banks and loans originated by them, while simultaneously expanding the OCC’s supervisory authority. While some states, including California and New York, have challenged this expansion head-on, other states are creating alternative approaches to regulate bank partnerships.

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The Bank Partnership Model and the “True Lender” Rule

For years, banks partnered with third parties to facilitate consumer loans, where a third party may market the loan and process the loan application. The partner bank makes and funds the loan, pursuant to its underwriting criteria, and sometimes sells all or part of the loan back to the third party. Critically, the purchaser relies on the loan originator’s ability to preempt under federal law state usury laws.

Naturally, state regulators and the plaintiff’s bar forcefully challenge these models, arguing that the partner, not the bank, is the lender, and therefore, no preemption rights apply. Still, proponents of these partnerships praise the heightened uniformity in banking operations and the broadened access to credit to a wide array of borrowers.

The OCC attempts to resolve this conflict with a bright-line standard to determine when a national bank is the true lender of a loan, thus applying preemption to loans potentially usurious under state law. Under the proposed rule, a bank is the true lender if, as of the date of origination, the bank “is named as the lender in the loan agreement,” or it “funds the loan.” The rule also considers the bank as having a “predominant economic interest in the loan,” as the funder, even when it is not “the named lender in the loan agreement[.]” If implemented, the rule expands the OCC’s regulatory reach to loans issued by entities not normally under the OCC’s purview. The FDIC is expected to propose a similar rule for state-chartered banks.

The proposed rule operates in conjunction with the “valid-when-made” rule, which was adopted to address the uncertainty created by the 2nd U.S. Circuit Court of Appeals’ decision in *Madden v. Midland Funding*, 786 F.3d 286 (2nd Cir. 2015). In *Madden*, the court held that a loan originated by a national bank could become usurious under state law if sold or assigned to a non-bank. Under this rule, the OCC clarified that the terms of a loan, including its interest rate, “made” by a national bank, remain valid after the loan is sold and transferred to any other entity. The rule captures a long-standing practice allowing national banks to sell loans they make on the secondary market, without risk that the purchaser is unable to collect interest at the same rate as the national bank.

Like the “valid-when-made” rule, the “true lender” rule responds directly to the divergent standards determining the lender, and therefore, the governing regulatory framework. For instance, in 2016, the Consumer Financial Protection Bureau filed suit against California lender CashCall, arguing it was the true lender of certain loans, and not its bank partner, Western Sky Financial, a South Dakota tribal lender. The CFPB argued that CashCall skirted California’s usury caps through a bank partnership model where Western Sky originated and assigned loans to CashCall. After performing a fact-intensive balancing test, the Central District of California held that CashCall had the predominant economic interest in the loan and was the true lender. The court considered several factors, including that CashCall funded every loan, purchased each loan within three days of origination, and indemnified and guaranteed a minimum payment to Western Sky. In a similar case, the Supreme Court of Appeals of West Virginia determined that CashCall, and not its bank partner, was the true lender because CashCall funded each loan before it was assigned by the bank partner. Likewise, other courts in Utah and California have developed different standards for determining the true lender.

A State of Uncertainty for the Bank Partnership Model and the “True Lender” Rule

This regulatory uncertainty can significantly impact consumer lending. According to a study performed by Colleen Honigsberg of loans following the *Madden* decision, lenders made marked changes, as investors discounted notes in secondary markets and lenders declined credit for higher-risk borrowers. The study found that borrowers in the states affected by *Madden* had less access to credit for already underserved consumers. Without guidance resolving true lender issues, uncertainty may inhibit companies from entering partnerships with banks and may reduce the marketability of such loans to investors, both of which could cause similar impacts.

Both the OCC's recent rules have faced immediate legal challenges. On July 29, the attorneys general for New York, California and Illinois filed suit in the Northern District of California to block the "valid when made" rule. Likewise, the "true lender" rule has been met with criticism from states and consumer groups. California joined 24 state attorneys general denouncing the rule as an attempt to strip states of their regulatory sovereignty. The states contend these partnerships are "rent-a-bank" schemes, which allow non-banks to evade state usury laws.

If adopted, the OCC can expect to face similar legal challenges to the "true lender" rule, potentially culminating in appeals to the U.S. Supreme Court given that the rule implicates federal regulatory authority and a state's power over its banks and non-bank lenders.

Alternate State Regulatory Models

Yet, some states are developing frameworks to facilitate lending partnerships. Recently, the Colorado attorney general settled with two lenders who partnered with state-chartered banks to make loans in excess of Colorado's usury law. The settlement provides a safe harbor if the partnership meets comprehensive oversight, disclosure, and interest rate requirements, and a requirement that the bank funds the loan. Colorado's settlement serves as a promising regulatory model for other states seeking to encourage lending partnerships.

With years of legal uncertainty over the "true lender" rule, the uncertainty surrounding bank partnerships will continue, potentially leading to decreases in access to credit and a declines in innovative partnerships and credit solutions. In the meantime, perhaps Colorado has paved the way for states to create a regulatory framework to encourage bank partnerships while safeguarding their residents against predatory lenders. ■

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