Why Recent Federal Court Decisions in California Help to Preserve Consumer Access to Credit

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The secondary loan market is critical to ensuring a healthy and competitive lending market in the U.S.; recent court decisions will help preserve that market, with the net benefits flowing to every consumer and business looking for a loan.

Banks, like any other lender, make loans that carry fixed or floating interest rates and other terms of repayment. In setting rates, the bank considers factors such as its funding costs, competitors' rates, expectations for inflation and Federal Reserve policy and risks inherent in lending such as credit and liquidity risks. But a loan's journey often doesn't end at origination. Sometimes banks later sell loans to other entities, such as other banks, nonbank financial firms, investors or government-sponsored enterprises. These purchasers rely on their ability to collect on the loans on the same terms as the originating bank. With that working assumption, there is a deep and active market for purchasing outstanding loans, often referred to as a "secondary loan market," which increases liquidity by enabling originating banks to move loans off of their balance sheet and make more new loans available for consumers. Without the efficiencies and scale of the secondary loan market, banks would be deprived of a reliable source of liquidity. This would leave less room to make more new loans, thereby reducing financing options and increasing interest rates for consumers and businesses seeking to borrow money.

This note explores recent legal challenges that called into question whether nonbank purchasers of bank loans could enforce legally permissible contractual obligations agreed to by borrowers at origination.

Background: How the Valid-When-Made Doctrine Supports Fairness & the Secondary Loan Market

Generally speaking, federal law doesn't prescribe maximum rates of interest that banks may charge on loans when the state law where the bank is located does. These are called state usury limits. Federal law is not entirely silent on rates though as key statutory provisions allow banks to apply the interest-rate limit of their "home" state to the loans that they originate anywhere in the U.S., effectively allowing them to "export" that home-state interest rate limit to where borrowers live (i.e., whether in that particular "home" state or in any one of the other 49 states). For instance, a bank in its home state of Delaware can charge loan rates permitted under Delaware law to borrowers located in New York, even if New York's law would forbid it, or vice versa. For all of recorded banking history, the interest rate charged on a loan that was valid when the loan was made remained valid even if the loan was sold to a third party. Again, simply put, this "valid-when-made doctrine" meant that the New York borrower who agreed to the terms of the loan at origination could not claim his interest rate illegal, or usurious, under New York law just because the Delaware bank that made the loan sold it to a non-bank investor. If the loan's interest rate was valid and legal when made, it could not become invalid or illegal later just because it was sold. Under this doctrine, the purchaser of the loan steps into the shoes of the bank that originated it.

A Court Decision Threatened the Secondary Market for Loans

A 2015 court decision in *Madden v. Midlands Funding* (2d Cir. 2015) broke longstanding precedent by holding that usury laws of the state of the borrower (in our example, the New York borrower) could apply to loans originated by banks after those loans are transferred to a nonbank third party (i.e., even if the rate was permissible under the law of the bank's home state, in our example: Delaware).

State usury laws vary from one state to the next. Determining the maximum rate allowable under the laws may involve an individualized analysis of the particular facts and circumstances of the loan and borrower in question. Such scrutiny is not compatible with efficient closings of loan sales in many secondary loan markets. The *Madden* decision threw the secondary market for bank loans into legal uncertainty that threatened to raise borrowing costs on consumers and businesses and reduce liquidity in the financial system.

How the OCC and FDIC Reacted

Based on its supervisory experience, the OCC believed that the unresolved legal uncertainty created by *Madden* "may disrupt [national] banks' ability to serve consumers, businesses, and the broader economy efficiently and effectively", particularly in times of economic stress.[[1]] The OCC also believed that "enhanced legal certainty may facilitate responsible lending by banks, including in circumstances when access to credit is especially critical".[[2]] The FDIC had similar concerns and beliefs relating to state-chartered banks. For these reasons, both agencies issued Rules in 2020 to clarify their interpretations of federal law. In particular, each of the Rules clarified that to the extent interest rates on loans from a national bank (covered by the OCC's Rule) and state-chartered banks (covered by the FDIC's Rule) are "valid when made" under their home state's interest rate cap, they remain permissible upon transfer to a third party, notwithstanding the *Madden* decision and its potential precedential effects in the Second Circuit (i.e., Connecticut, New York, Vermont).

What Happened Following the Issuance of the OCC and FDIC Rules

Certain state officials, including the California AG, brought a lawsuit challenging the OCC and FDIC Rules on the ground that they violated the federal Administrative Procedure Act (APA) which governs the process by which federal agencies develop and issue rules. In two separate decisions issued earlier this year, the U.S. District Court for the Northern District of California denied those legal challenges.[[3]]

What is Notable about the Federal District Court of Northern California's Decisions Upholding the Validity of the Rules under the APA

The Court found that the OCC's Rule met all applicable procedural and substantive standards under the APA. While the FDIC order addresses a different statutory authority (i.e., the Federal Deposit Insurance Act[4] rather than the National Bank Act[5]), the Court's rationale for upholding the FDIC Rule closely paralleled that set out in its OCC order. Key aspects of the Court's decisions were:

- The Court recognized the common law principle that an assignee of a contract "steps into the shoes of the assignor" – i.e., contractual rights (e.g., a rate of interest on a loan) may generally be assigned to a third person.

[1] See "Permissible Interest on Loans That Are Sold, Assigned or Otherwise Transferred", 85 Fed. Reg. 33,530 (June 2, 2020) (OCC rule).

[2] See id.

[3] See California v. OCC, No. 20-cv-05200-JSW (N.D. Cal. Feb. 8, 2022): California v. OCC, No. 20-cv-05860-JSW (N.D. Cal. Feb. 8, 2022))

[4] 12 U.S.C. § 1831d

[5] 12 U.S.C. § 85

- Applying legal doctrines from U.S. Supreme Court decisions in "Chevron" and "Brand X", the court held that the OCC was not foreclosed from issuing its Rule by reason of the *Madden* decision.

- Moreover, according to the Court, the Rules were not preemption determinations of particular state usury laws, but rather reasonable interpretations of Federal choice of law provisions in the National Bank Act and the Federal Deposit Insurance Act.

- The Court held that the Rules were within the agencies' mandates to assure the safety and soundness of banks in view of the uncertainty created by *Madden* and the need to resolve potential long-term effects of *Madden*.

- The Court noted that the OCC and FDIC each considered whether the Rules would enable "rent-a-bank" schemes (i.e., lending schemes involving nonbanks for the purpose of evading state usury laws).

What These Judicial Decisions Mean for Secondary Markets for Bank Credit and Why it Matters

The Rules resolved the disruptions to the multitrillion–dollar U.S. credit markets caused by *Madden*.[6] The state AG lawsuit sought to overturn the Rules, which could have restored the uncertainty caused by the *Madden* decision. Instead, the decisions should provide a measure of legal certainty for participants in secondary markets for bank credit.

A bank's ability to efficiently sell, and an investor's ability to buy, loans in the secondary market without having to individually assess the continued validity of key loan terms such as the interest rate following the transfer enable banks to lend to more consumers and businesses, including those with less-than-pristine credit profiles, such as low-income borrowers or higher-risk small local businesses. The ability to sell loans in the secondary market also allows banks to reduce their risk as and when deemed necessary while continuing to fund new loans. The Court's decisions unquestionably help to preserve that ability.

Other Benefits of This Judicial Decision for Bank Safety & Soundness and Risk Management

Enhanced legal certainty serves to assure bank flexibility to hedge risk and manage loan books efficiently.

Because a bank's ability to sell its loans to third parties is a crucial liquidity and credit risk management tool, disruptions in the ability to originate and later sell a loan (whether as a whole loan or bundling the loan with similar loans in one "securitization" package) threaten the safety and resilience of the banking system. This problem would be exacerbated when there are general market disruptions, such as in financial crises, where market liquidity is critical and in environments of raising interest rates. In the extreme case of a bank failure, the job of federal regulators to dispose of the failed bank's assets could be severely circumscribed by the regulators' inability to assign the failed bank's loans to nonbank third parties.

[6] While the common law principle that an assignee of a contract "steps into the shoes of the assignor" should apply to <u>non-bank originated</u> credit, the Rules and the judicial decision do not apply directly to such loans.

What are the Implications for Bank Borrowers?

Acting Comptroller of the Currency Michael Hsu issued a statement that the legal certainty from the Court's OCC ruling should be "used to the benefit of consumers."[7] We hope and expect that this will be the case in terms of borrower access to bank credit on fair terms.

The concerns about less access to bank credit following the *Madden* decision were not hypothetical. Following the *Madden* decision, some lenders decided to exclude the Second Circuit states from their marketing and lending programs. Such balkanization impacted the securitization market as well, with firms removing loans made to borrowers in the Second Circuit from asset-backed securitizations due to interest rate cap concerns. Moreover, the impacts of *Madden* disproportionately harmed lower income borrowers by "reduc[ing] the flow of credit . . . to higher-risk borrowers.[8]

Lending schemes involving a bank and a nonbank partner with the sole purpose of evading usury laws have no place in a safe credit marketplace. The federal banking agencies also recognize any such schemes as a problem. Contrary to what some have implied, any such schemes remain subject to both legal and supervisory challenge and enforcement (e.g., in some cases, the scheme could be challenged by asserting that the purported lender was not the "true lender" and that entity does not have the authority to charge the same interest rate as a regulated bank).

What is the Current Status of the Legal Proceedings?

The time has expired for an appeal of the Court's decision to the U.S. Court of Appeals for the Ninth Circuit. Accordingly, the Court's decisions stand and will provide greater certainty to banks and secondary loan markets. They will serve as authority for the proposition that the Rules are consistent with contractual, banking and administrative law and also help to accomplish the important public policy objectives of enhancing bank safety & soundness and credit access.

American banks and borrowers are better off as a result of the well-grounded decisions.

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[7] "Acting Comptroller Issues Statement on Court Decision Regarding 'Madden' Rule", OCC News Release 2022-13 (February 9, 2022).
[8] Colleen Honigsberg et al., How Does Legal Enforceability Affect Consumer Lending? Evidence from a Natural Experiment, 60 J.L. & ECON. 673 (2017); *See also* McShannock v. JP Morgan Chase Bank NA, 976 F.3d 881, 892 (9th Cir. 2020) (citing scholarly research observing that lenders made fewer and smaller loans to higher-risk borrowers in Connecticut and New York after Madden was decided).