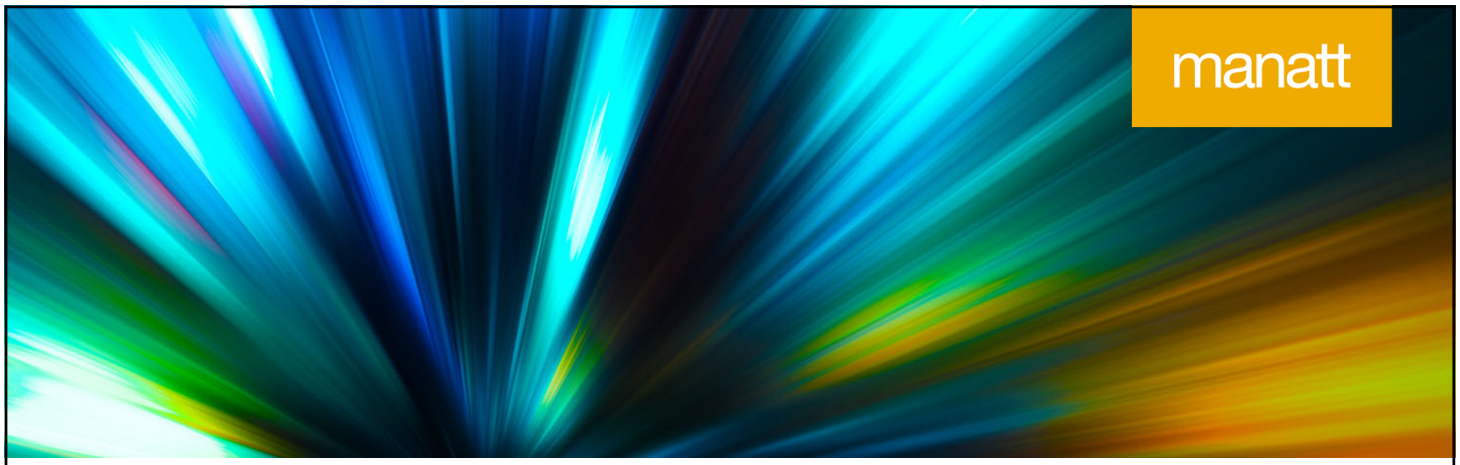

Bank Partnerships Update

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February 13, 2024

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Agenda

- **Overview**
- **Attacks on Rate Exportation Authority (DIDMCA Opt-Outs)**
- **"Reverse Preemption" Bills**
- **True Lender Investigations and Class Actions**
- **Prudential Regulation of Participating Banks**
- **Best Practices for Partnership Agreements**
- **Q&A**

Overview

- Limitations of non-bank lending
  - State licensing requirements
  - Varying state limits on interest rates and other finance charges
- Federal Law permits banks to lend at rates allowed by their home states
  - National Bank Act (federally chartered banks)
  - DIDMCA (state-chartered banks)
- Challenges to the Bank Model
  - *Madden* and "True Lender"
  - State "Reverse Preemption" Laws
  - DIDMCA Opt-Outs
  - Prudential regulation of participating banks

Depository Institutions Deregulation and Monetary Control Act (DIDMCA)

- In 1980, at a time of historically high interest rates, Congress acted to even the playing field between nationally and state-chartered financial institutions.
  - While nationally chartered banks were permitted to export interest rates across state lines, state-chartered banks were subject to the constitutional and statutory usury rates operative in their chartering state.
  - Section 521 of DIDMCA provides that state-chartered, federally-insured banks may lend in any state at the rate of interest allowed in the state where the bank is located.
    - Contrary state laws are preempted.
    - Rate-exportation authority applies to all credit products.

DIDMCA Opt Outs

- In response to concerns about potential federal overreach, Section 525 of DIDMCA authorized states to opt out of the rate exportation authorized by Section 521:
  - Section 521 shall not apply to loans made after the date "on which [a] State adopts a law or certifies that the voters of such State have voted in favor of any provision, constitutional or otherwise, which states explicitly and by its terms that such State does not want [Section 521] to apply with respect to ***loans made in such State****…." (emphasis supplied)*
  - A total of 7 states and Puerto Rico quickly opted out under Section 525
  - 6 states have since have repealed their opt-outs, leaving only Iowa and Puerto Rico
  - Colorado House Bill 23-1229, enacted June 5, 2023, purports to again opt Colorado out of DIDMCA rate exportation effective July 1, 2024
    - Colorado was one of the original opting out states but subsequently opted back in

Can States Still Opt Out?

- Section 525 imposes no deadline on when states may opt out.
- Section 525 was never codified, but instead appeared as a statutory note to each of the sections granting rate-exportation authority to various types of federally insured depository institutions – banks, credit unions, and savings and loan associations.
  - The Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) repealed the provision granting rate exportation to savings and loan associations and with it the reference to opting out.
  - However, Section 525 opt-out is still noted in the codification of the rate-exportation provision applicable to banks.
  - 2020 FDIC Final Rule regarding state bank interest rate authority says that states "may opt out," indicating that the agency interprets the opt out to be effective.

Colorado Court Holds That Ability to Opt Out Has Been Repealed

In a case involving a Delaware-chartered ***bank***, the Colorado Court of Appeals held that FIRREA repealed Section 525 opt-out authority and, therefore, that Colorado's initial opt out was no longer effective. *Stoorman v. Greenwood Tr. Co*., 888 P.2d 289 (Colo. App. 1994), *aff'd*, 908 P.2d 133 (Colo. 1995).

- Implies that Section 525 opt-out authority no longer exists and that the 2023 opt-out may be infirm.
- Perhaps wrongly decided because of FIRREA's limited applicability to federally-insured savings and loan associations.

Where is a Loan Made—State Law Considerations

- In the state in which the borrower resides?
  - The Attorney General of Iowa, the only originally opting-out state that did not rescind its opt-out, endorsed this position in a recent Assurance of Discontinuance involving a non-Iowa state-chartered bank
  - Some state laws attempt to codify this borrower-residency rule
    - *E.g.,* Colorado Uniform Commercial Credit Code provides that a loan is made in Colorado if "a consumer ***who is a resident of this state*** enters into the transaction with a creditor who has solicited or advertised in this state by any means, including but not limited to mail, brochure, telephone, print, radio, television, internet, or any other electronic means." (emphasis supplied)

Where is a Loan Made—Federal Law Considerations

- Federal law interpreting Section 521 finds that where a loan is made is not bright-line
  - 1988 FDIC Interpretive Letter: where a loan is made "is not necessarily the State in which the bank is located; nor is it necessarily the State in which the borrower is located."
- Multiple factors impact decision of where a loan is made according to a 1998 FDIC General Counsel Opinion
  - Parties' choice of law
  - Where credit decision is made
  - From where decision to grant credit is communicated
  - From where funds are disbursed

What is Next for DIDMCA?

- The Colorado 2023, and any subsequent opt outs, are likely to be litigated:
  - Does a state have the right to opt out?
  - What law applies to determine where a loan is made?
    - Federal vs. state conflict
    - Do FDIC interpretations of Section 521 apply to Section 525?
    - Will earlier FDIC interpretations survive in the current administration?
      - Will current FDIC permit Section 525 to be interpreted such that the only effect of an opt-out is to deny rate exportation to banks chartered by the opting-out state?
- Other legislation
  - Proposed DC ordinance
  - Nevada ballot initiative

"Reverse Preemption" Bills

- Certain states have passed laws codifying concepts from "true lender" cases.
- While the exact terms of the laws vary, they generally attempt to undermine bank partnerships by providing that a person is a "lender" subject to state regulation if:
  - The person holds the "predominant economic interest" in a loan;
  - The person is involved in the marketing, brokering, arranging, or servicing of a loan; or
  - The totality of the circumstances indicate that the transaction is structured to evade state law.
- These laws also commonly cap the interest rates that may be charged "by" such "lenders."
- Fundamentally, these laws are an improper attempt by states to override the rate exportation authority provided to banks under federal law by making the nonbank partner, rather than the bank, the lender.

Who Has Passed a "Reverse Preemption" Law?

- "Older" Laws:
  - California, Illinois, Maine, and New Mexico.
- Recently Enacted Laws:
  - Connecticut, Minnesota, and Nebraska.
- Proposed Laws:
  - Alaska, Florida, Indiana, Maryland, Missouri, Washington, and Washington, DC.

Recent State Enforcement Developments

- Colorado
  - Widely publicized AOD with Avant, Marlette, and their bank partners in August 2020 after years of intense litigation
  - AOD was proclaimed to be a model resolution for bank partnerships
    - Several structures permitted
    - All include a 36% rate cap
  - However, Colorado continues to pursue bank model programs
    - AOD applies only to partners of the two banks who are parties to it
    - AOD does not apply to open-end programs
    - Many programs have exited Colorado and more likely will follow

Recent State Enforcement Developments

- OppFi/CA DFPI
  - In 2021, California DFPI commenced nonpublic investigations of several subprime bank programs, focusing only on the partners (not the banks)
  - In March 2022, OppFi preemptively sued DFPI, seeking to validate its program. DFPI counterclaimed.
  - In October 2023, the court denied DFPI's motion for preliminary injunction
  - Court found that DFPI simply failed to prove the truth of its allegations; litigation continues
- Washington DFI
  - In early 2023, DFI sent information requests to 10 program sponsors seeking detailed information on their bank programs
  - In September 2023, DFI issued a report; no enforcement activity has taken place to date

Recent State Enforcement Developments

Several other states have demonstrated significant hostility towards bank-model programs, through prior enforcement activity, guidance or otherwise, particularly if rates exceed 36%

- Connecticut
- District of Columbia
- Iowa
- Illinois
- Maryland
- Massachusetts
- Minnesota
- Montana
- New York
- Oregon
- Pennsylvania
- West Virginia

Enforcement Activity - Federal

- Press reports and commentators have claimed that several recent consent orders with banks engaged in lending partnerships reflect weakness in the bank model
- In fact, these orders did not involve the true lender theory or otherwise constitute a rejection of the bank model
  - The orders do, however, indicate that banks must adequately supervise the activities of their partners, and that they otherwise won't be permitted to take on new partners
  - The banks are ultimately responsible for their partners' compliance with applicable consumer protection laws, BSA/AML requirements, etc.
  - Companies wishing to participate in bank model programs should:
    - Understand that substantial bank oversight is beneficial to the partner; and
    - Think twice about pushing back when a bank partner recommends costly compliance activities such as fair lending reviews

Enforcement Activity - Federal

- What's coming next?
- Although they haven't yet been as aggressive as their state counterparts in pursuing public enforcement actions, today's federal regulators clearly do not like the bank model
- Companies can expect greater scrutiny of vendor management under the current regime, perhaps as a proxy for direct attacks on the bank model
  - More on this later in our presentation . . .

Class Actions

- Resurgence of activity
  - New York cases against credit card securitization vehicles (unsuccessful)
  - Relatively new cases pending in California, Georgia, Texas, Virginia, and Washington
- Key Issues
  - Arbitration (Plaintiffs who opted out, California's *McGill* decision)
  - Settlements of class actions may not prevent follow-on regulatory enforcement cases
  - Proper structuring and operation of bank model programs should, at least in theory, allow these claims to be defeated

Prudential Considerations– Federal Regulatory Guidance on Bank Partnerships

- Interagency Guidance on Third Party Relationships (June 2023)
  - Consolidates and replaces prior guidance issued by the Federal Reserve Board, OCC, and FDIC on "sound risk management principles" for banking organizations in connection with third-party relationships.
  - Highlights include:
    - Banking organizations are ultimately responsible for conducting activities in a safe and sound manner.
    - Risk management practices should be commensurate with risks posed by third-party relationships
      - NO ONE SIZE FITS ALL
    - Emphasizes the necessity of sound risk management throughout all five stages of the "third-party relationship life cycle" – (1) planning, (2) due diligence and third-party selection, (3) contract negotiation, (4) ongoing monitoring, and (5) termination.

Federal Regulatory Guidance on Bank Partnerships-Planning

- Higher-risk activities warrant a greater degree of planning
  - For critical activities, plans may (read should?) be presented to the bank's board of directors or designated board committee
  - Factors to consider
    - Alignment with strategic goals
    - Volume of business
    - Use of subcontractors
    - IT and physical security
    - How will bank monitor vendor's compliance with applicable laws
    - Contingency plans in the event another third-party needs to transition or responsibilities must be taken in house

Federal Regulatory Guidance on Bank Partnerships-Due Diligence

- Scope and degree of diligence commensurate with level of risk and complexity
- If diligence is limited – short operating history, inability to share information – bank may consider alternative data:
  - Industry consortiums
  - Joint efforts (consistent with antitrust laws)
- Legal and Regulatory Compliance
  - Does third-party have legal authority (including licenses) to operate
  - Company or owners subject to OFAC sanctions
  - Responsiveness to federal and state regulators and self-regulatory agencies
  - Identification and articulation of a process to mitigate areas of potential consumer harm

Federal Regulatory Guidance on Bank Partnerships-Due Diligence

- Financial Condition
- Experience
  - History of handling customer complaints
- Qualification of Personnel
- Financial Condition
- Risk Management
  - Governance
  - Effective audit assessment
- Use of Subcontractors
  - Effective downstream controls

Federal Regulatory Guidance on Bank Partnerships-Contract Negotiations

- Board of directors should be aware of and approval (or delegate approval) of contracts involving higher-risk activities
- Periodic ongoing review
- Performance Measures and Benchmarks
- Audit Rights
- Handling of customer complaints
- Subcontracting
- Termination
  - Without penalty and notice if directed by the bank's regulator
- Stipulation that services subject to regulatory supervision

Federal Regulatory Guidance on Bank Partnerships-Ongoing Monitoring and Termination

- Board of directors should be aware of and approve (or delegate approval) contracts involving higher-risk activities
- Periodic ongoing review
- Performance Measures and Benchmarks
- Audit Rights
- Handling of customer complaints
- Subcontracting
- Termination
  - Without penalty and notice if directed by the bank's regulator
- Stipulation that services subject to regulatory supervision

Implications of Federal Prudential Oversight

- "True lender" and related issues are not addressed
  - Continues pattern of federal prudential regulators not taking an explicit position on such issues
  - Suggests that federal regulators are not opposed to bank partner agreements in principle
- Bank partners need to be aware of federal regulators' emphasis on risk management
- Heightened scrutiny of bank partnership agreements should be expected
  - Federal regulators willing to direct termination of arrangements if proper controls not established
  - Risk of inconsistent application
  - Potential significant challenges for smaller community banks

Drafting Best Practices: Program Control

- Bank partnership agreements and all customer-facing documents should make clear that the bank is the lender and that the partner is marketing and servicing loans on behalf of the bank.
- The bank should conduct comprehensive oversight of the partner throughout the life of program loans (including after sale of loans or participation interests), including:
  - Conducting extensive due diligence prior to program launch, requiring changes to customer-facing documents, policies and procedures, and other matters where necessary.
  - Controlling all aspects of the program, including the credit policy and anything affecting regulatory compliance.
  - Conducting periodic compliance audits of the partner.
  - Terminating or suspending the partnership if the partner fails to comply with applicable law.

Drafting Best Practices: Allocation of Risk

- "True lender" recharacterization less likely if the partner purchases participation interests in the loans, rather than the whole loans.
- The program should be structured such that the bank bears economic risk.
  - The longer the bank holds the loans, the more economic risk it bears.
  - The higher the participation percentage that the bank retains, the more economic risk it bears.
  - Excessive collateral reduces the bank's economic risk.

Questions?

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