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Title: The Current Landscape of Bank-Fintech Partnerships
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Guest: Jeremy Rosenblum

[CHRIS WILLIS]

Welcome to the Consumer Finance Podcast. I'm your host Chris Willis, the co-practice leader of Troutman Pepper's Consumer Financial Services regulatory practice and we have a great episode for you today about bank-fintech partnerships. But before we jump into the substance of today's podcast, let me remind you to visit and subscribe to our blog – ConsumerFinancialServicesLawMonitor.com where we put up tons of relevant industry content all the time. And don't forget about our other podcast – Troutman Pepper's *FCRA Focus* which, as the name suggests, is devoted to developments under the Fair Credit Reporting Act and it's released monthly on all popular podcast platforms. And if you like our podcast, leave us a review on whatever podcast platform you use to download us, send us a review and tell us what you think. Now as I said today we're going to be talking about bank-fintech partnerships and to do that I'm joined by my partner, Jeremy Rosenblum, who has been working on bank-fintech partnerships for many, many years and who I consider to be one of the country's leading experts on this topic. So, Jeremy, thanks a lot for being on the podcast today.

[JEREMY ROSENBLUM]

Thanks for having me, Chris.

[CHRIS WILLIS]

Bank-fintech partnerships have been incredibly popular over the last few years as a way to deliver consumer financial products and services to consumers, especially loans, and your practice revolves a lot around structuring those partnerships. But they've also been subject to some controversy, especially at the hands of certain state regulators. So just to introduce the audience to this topic, can you just tell us how bank-fintech partnerships work?

[JEREMY ROSENBLUM]

Typically, these partnerships have involved smaller banks that have limited tech resources partnering with non-bank fintech companies and the fintechs have the capacity to promote and deliver products through on-line and local apps, a capacity that these smaller banks don't have in-house. Some of these products are only possible because the fintech is able to deliver messages or require disclosures pretty much on a real time basis. One use of the fintech-bank partnership is frequently to deliver loans nation-wide on a uniform basis. That depends upon the power of banks under federal law to charge interest based on the rates permitted by the law of the state where the bank is headquartered. But that's a power that's spawned into the National Bank Act, it's spawned in the Federal Deposit Insurance Act and the Supreme Court on more than two occasions, has concluded that this power applies nation-wide, and it applies notwithstanding usury laws that may impose restrictions in the laws where borrowers may be located. And that power is recognized by the Supreme Court in the *Marquette* decision back in '78, really has been very important in the development of the credit card industry and consumer lending generally and it has become increasingly important and central to these bank-fintech partnerships. There's always been a bit of controversy over this power created by Congress and recognized by the Supreme Court. Advocates of strict usury laws are offended by this power because it basically eviscerates state usury laws in favor of a more credit-friendly policy that Congress has adopted.

[CHRIS WILLIS]

Thanks Jeremy. And so, as I mentioned at the beginning of the podcast and as you just mentioned, there's controversy especially relating to the impact on compliance with state usury laws. So given those challenges, what are the principal legal issues that face these partnerships and that the parties to them have to structure to try to avoid?

[JEREMY ROSENBLUM]

Well, the point of many of these partnerships is to deliver loans on a uniform basis nationwide without regard to state usury laws. In these programs, the fintech will characteristically provide all of the marketing and servicing of the loans under the control and direction of the bank. The bank needs to exercise control because as the lender it's on the hook for any regulatory violations that may exist under the program. In the FDIC or OCC as the federal supervisory authority for these banks will insist that the bank really has control over the program and it's not just allowing its fintech partner to run amuck without supervision. In these programs it is probably most common that the bank will sell either the loan or a very substantial likely the predominate economic interest in the loan shortly after origination. And in some of those programs, the sale may be to an institutional investor. For example, Prosper.com and Lending Club set up marketplaces that were designed to facilitate the sale of loans to institutional investors or retail investors. In many of these programs the sale of the loan or the economic interest in the loan or the predominate economic interest in the loan will be to the fintech partner. When the fintech combines the marketing and servicing functions with the function of basically funding the loan over its duration, not at origination but shortly after origination, the party hostile to the bank's exercise of its federally-created usury authority can assert that it's not the bank that in substance is making the loan, but what's going on in reality is that the bank is the pejorative term that's used it's renting its charter to the fintech company and it's trying to pass on the power that only the bank is supposed to exercise under federal law. It's passing this on to the fintech and that the whole arrangement is a sham and subterfuge to avoid state usury laws and effectively while the form of the transaction is a loan by the bank, the substance is more consistent with a loan by the fintech partner. And since the fintech partner has no special power under federal law to disregard state usury laws, the opponents of these programs will argue that they are in violation of state usury laws and/or state licensing laws. And of course, poorly constructed programs – there are all sorts of federal and state laws that could be violated. Just like any other financial product, there is a huge body of law – the Truth in Lending Act, the Electronic Funds Transfer Act, etc., etc. that could be violated. But the common feature and the common source of attack, the true worry with respect to these programs, is that a court can be convinced to recharacterize the loan nominally in the bank's name as being in reality a loan by the fintech partner. And when that happens, there are very serious consequences to the fintech and potentially to the bank participating in the program.

[CHRIS WILLIS]

So, Jeremy that's a pretty dire risk that participants in these programs, particularly the non-bank participants, are taking, right? Because if it's recharacterized, it's the non-bank that's on the hook for it, right?

[JEREMY ROSENBLUM]

It's principally going to be the non-bank. When a state enforcement authority or private litigant wishes to attack these programs, the goal is to argue that the program is really the fintech's program. They are always suing these programs and it's a rare circumstance where the bank is also sued. It does happen. There were cases many years ago – *Spitzer v. County Bank* where the bank was charged with aiding and abetting a violation by its fintech partners in a payday lending program. The banks should not disregard the risk entirely but it falls much more heavily on the fintech partner. And the remedies for usury vary from state to state but they can be quite severe. At a minimum charging more interest than is authorized by applicable law will give rise to an obligation to make restitution of the overcharge. But that's the mildest usury remedy available. There are many, many states where some form of treble damages will be available. Where a loss of all of the interest is available. And there are even many states where the principal of the loan is at risk and there is a danger of the loan being voided entirely by virtue of the usury or licensing violation. And then of course there's the prospect of criminal liability. We've seen a limited amount of that in partnerships of this type. More frequently tribal partnerships between banks and Native American tribes. But there is certainly that risk for a program of this type. These are not programs for the fearful. It requires some courage to engage in these programs especially for those programs with high rates of interest. For some period of time the rates of interest on these programs were effectively capped at the 36% annual rate by attitudes of the federal banking regulators, but over the past few years programs are no longer limited at 36% and it's the higher rate programs that are especially attracting opposition and hostility from consumer advocates and some enforcement authorities.

[CHRIS WILLIS]

So, Jeremy, as you mentioned, this idea of bank/non-bank partnerships honestly pre-dates fintech but certainly have been going on for a couple of decades now. Now the fintech side of it has become very popular as we talked about before. But what are the developments that you're seeing currently with respect to these kinds of partnerships. In other words, what's going on right now?

[JEREMY ROSENBLUM]

The controversy increases and as the political environment changes, we are seeing a number of developments. First, we're seeing state legislation that directly attacks programs of this type, especially for high-rate programs. Illinois, for example, adopted a bill called the Predatory Loan Prevention Act and basically that statute says that any loan made at an annual rate in excess of 36% where the bank sells the predominate economic interest in the loan to its fintech partner or where there are other indicia that arguably suggest that the fintech partner is the true lender, that these loans are unlawful and subject to especially expansive remedies for violation. So, you see that there are very few programs of this type that are operating in Illinois and those programs that do exist in Illinois these days are structured with this statute very much in mind. For example, where the bank will make the loan and instead of selling the predominate economic interest in the loan, will retain the majority economic interest in the loan. Even that may not satisfy the Illinois statute but, in my view, is enough to pass muster under the governing federal law even in front of a court hostile or inclined to be hostile to these programs. So, we're seeing state legislation. We're certainly seeing a substantial increase in enforcement activity at the state level as well. We're seeing informal inquiries. We're seeing civil investigative demands and we're seeing actual lawsuits and enforcement proceedings brought by the states. Several years ago there was very closely followed litigation where the Colorado Attorney General took issue with a couple of bad model programs. Those cases were quite shocking because the initial target of the Colorado AG were participants in programs that in fact were involved modest rates of interest at rates below the 36% rule of thumb for programs of these types. So, while the Colorado AG had plenty of targets available who offered higher rate programs, for some reason or another it chose to go after some large programs that had more modest rates of interest. Colorado led the way there. We've had lawsuits by the state of New York, by the state of West Virginia, generally against high-rate programs. Maryland's been in the fray obtaining judgment in connection with a high-rate program and also is currently involved in a dispute for a lower rate program. DC has also entered into settlements with two participants in higher rate programs. And then there are a number of other states that are also attacking or investigating programs of this type. We are seeing more coordinated efforts by consumer advocates that are hostile to these programs. So, we are seeing lots of publicity. We've seen consumer advocates attacking programs for their rates, for the goods and services that they might finance. It is clear to me that the Illinois legislation was not authored by some random legislator in Illinois. I'm sure that legislation was put together by a consumer advocacy organization and brought to the Illinois legislature where it passed basically proposed and it was quite an extraordinary procedure for adoption of that legislation. But it all involved very close contacts between consumer advocates and in that case state legislators. In other cases it's clear that the consumer advocates are in very close contact with the CFPB, the FTC, federal and state banking agencies. There are many venues where the consumer advocates definitely have an ear and they are taking advantage of the hearing that they can get to lobby against programs of this type. The industry side – it's all defense. The industry has of course noted the developments adverse to the legislation, the enforcement proceedings. And so we're seeing some modifications to programs. Instead of having the banks sell whole loans to a fintech partner shortly after origination you see more and more programs where the bank will retain a significant economic interest in the loans so that if the bank sells the entire loan the defense has to be that it's just inappropriate under federal law to ever recharacterize the lender from being the bank to the fintech partner. But if the bank retains an economic interest in the loan, then a second defense becomes available. And that is that first defense is never appropriate to recharacterize. Second defense is if in some circumstances it's appropriate, it's not appropriate in this case. It's not appropriate because the bank is retaining a meaningful economic interest in the loan. Congress, when it adopted the Dodd-Frank Act, concluded that part of the cause of the economic meltdown that we experienced in advance of that act was that banks were originating loans and not retaining any economic interest in them and just off-loading them in the form of asset-backed securities, etc. And Congress said we can't permit that to happen anymore, and it imposed requirements that banks retain or the sponsors of asset-backed securitizations retain a 5% economic interest, at least, in those programs. We see a lot of banks in the current environment retaining at least a 5% economic interest in the loans and that creates a very powerful argument that they're doing exactly what Congress instructed them to do in Dodd-Frank and they are putting their money where their mouth is –

they're putting their skin in the game and hence their program should not be subject to attack on the basis that they're a sham or a subterfuge or the like. That's a very common program structure now with the retained economic interest of the bank, at least at the 5% level. And then there are programs that are even more conservatively structured where the bank may retain a 10% or even higher economic interest for all loans or at least loans in the service state. And then finally I've been advocating to my clients for several years now what I regard as a better mouse trap – a better way of doing these programs. And my proposal is that if the bank needs to sell economic interest in the loans as it may need to do to satisfy capital requirements or other interests that it has, if the bank were to sell the loans to an institutional investor or the economic interests in the loans to an institutional investor, that would create yet another argument for defending against these true lender attacks. The reason for that is the attack starts with the proposition that the fintech partner is in substance acting as the true lender for the transaction. That argument becomes much weaker when the fintech is not providing any of the funds used securing the loan prior to maturity. If those funds are coming from outside sources, institutional investors, etc., then it's hard to point to the fintech and say that its functions are anything more than normal marketing and servicing functions that third-parties perform all the time throughout the economy. And by the same token, it's not really possible to point to the unaffiliated institutional investor as being the true lender because it's playing basically a passive role in the program. It's not doing the marketing; it's not doing the servicing. And its role is just like purchasers of loans throughout the economy, it's doing what Fannie Mae or Ginny Mae or other entities throughout the economy are doing all the time. That's a new structure that some of my clients are actively pursuing and a better approach to fend off attacks of this type against programs involving bank-fintech partnerships.

[CHRIS WILLIS]

That's a great set of observations Jeremy I mean you've really done a great job of laying out what the legal considerations and challenges are here as well as the new developments in terms of the structure of these programs. So, I want to thank you for being on the podcast today and sharing your knowledge and immense expertise and experience on this issue with our audience. And of course, I'd also like to thank our audience for tuning in. Be sure to visit us at our blog ConsumerFinancialServicesLawMonitor.com for all the important updates about the industry and be sure to go either to the blog or to troutman.com to add yourself to our Consumer Financial Services email list so you can get our alerts and webinar invitations. And keep listening to this podcast. We're going to be releasing a new episode every Thursday and you can subscribe to it on all the popular podcast platforms. So, until next time, thank you all for listening.