Clash of the Titans: Federal v. State Interests in Bank Partnerships

January 31, 2019 | Catherine M. Brennan

There is a slow-moving high drama happening in Colorado between the Federal Deposit Insurance Corporation ("FDIC") and the Administrator of the Colorado Uniform Consumer Credit Code ("UCCC"). This refers, of course, to the litigation filed by the Colorado UCCC Administrator against Avant and related parties and Marlette Funding and related parties[1] (hereinafter the "Partners"). This drama intensified last fall when the regulator amended its complaint, originally filed on (March 2017) to add national bank defendants. In these cases, the national bank defendants - Wilmington Trust, N.A. and Wilmington Savings Fund Society, FSB - act as the trustee for trusts established to hold bank-originated loans or receivables that are sold by the banks after origination.

At the heart of the litigation is who is the "true lender" on the loans made by banks. The Partners assert that the banks involved in the partnership are, in fact, the lender. Conversely, the Colorado Administrator asserts that the alleged partnership is a mere sham, a way for non-banks to avoid state laws by taking advantage of the powers of banks to export interest and interest fees from their home states or states where they have a branch. This power - rate exportation - is extended to banks because banks are given special treatment under federal and state law. It takes more to become a bank than to simply be a licensed lender. Banks are subject to rigorous oversight by not only their state regulator, if said bank is state-chartered, but also by a federal regulator, such as the Federal insurance Deposit Corporation ("FDIC"), which has, it turns out, spent a great deal of time thinking about how its member banks work with Partners. Additionally, state regulators, some more than others, despise that rate exportation exists, because states would prefer to exercise control over all depository entities, sometimes asserting "consumer protection" as the ostensible basis for their desire to control the banks.

Although the FDIC is not named as a defendant in the Colorado litigation, the Colorado UCCC Administrator is taking direct aim at the banking agency's guidance to its member banks who engaged in the partnership space. The FDIC has discussed third-party involvement with its member banks in numerous publications, including the Winter 2015 issue of *Supervisory Insights*.[2] This brief article, titled "Marketplace Lending," offers guidance to participants in the bank partnership space. The FDIC notes that some marketplace lending companies operate though a cooperative arrangement with a partner bank. The FDIC describes the arrangement thusly:

> In these cases, the bank-affiliated marketplace company collects borrower applications, assigns the credit grade, and solicits investor interest. However, from that point the bank-affiliated marketplace company refers the completed loan applications to the partner bank that makes the loan to the borrower. The partner bank typically holds the loan on its books for 2-3 days before

selling it to the bank-affiliated marketplace company.

In July 2016, the FDIC went beyond the discussion in the Supervisory Highlights and issued proposed guidance for its member banks that work with Partners to originate loans, including vendors involved in bank partnerships, supplementing the many financial institution letters the FDIC has issued on this topic. The FDIC requested comments on its proposed guidance[3] that outlines the risks that may be associated with third-party lending as well as the expectations for a risk-management program, supervisory considerations, and examination procedures related to third-party lending.[4] The proposed guidance, which has never been finalized, describes third-party lending as an arrangement in which a bank relies on an outside source to perform a significant aspect of the lending process, such as originating loans for third parties, originating loans through third parties or jointly with third parties, and originating loans using platforms developed by third parties. The draft guidance supplements and expands on previously issued guidance and would apply to all FDIC-supervised institutions that engage in third-party lending programs.

In its publications on this topic, the FDIC has walked through factors a bank should examine before entering into a partnership with a non-bank entity. It directs its member banks to consider the partner's compliance with applicable federal law, consumer protection requirements, anti-money laundering rules and fair credit obligations, as well as applicable state laws such as licensing or registrations necessary to engage in the partnership. The FDIC also asks its member banks to consider whether the partnership will meet the FDIC's safety and soundness requirements. Specifically, member banks should consider the following questions:

- What duties does the bank rely on the marketplace lending company to perform?
- What are the direct and indirect costs associated with the program?
- Is the bank exposed to possible loss, and are there any protections provided to the bank by the marketplace lending company?
- What are the bank's rights to deny credit or limit loan sales to the marketplace lending company?
- How long will the bank hold the loan before sale?
- Who bears primary responsibility for consumer compliance requirements and how are efforts coordinated?
- Is all appropriate and required product-related information effectively and accurately communicated to consumers?
- What procedures are in place to prevent identity theft and satisfy other customer identification requirements?
- What other risks is the bank exposed to through the marketplace arrangement?

In its complaints against Avant and Marlette Funding, the Administrator trots out several facts as allegedly indicating that the bank is not the true lender in the partnership. Some questions fintech companies and their partner banks may ask themselves because of the Colorado litigation include the following:

- Did the partner pay an implementation fee? What was the amount of the implementation fee?
- Does the partner pay the bank's legal fees and expenses related to the partnership? Does the partner pay the expenses and legal fees that the bank incurs to negotiate the partnership? Does the partner pay the bank's legal fees when the bank is sued over the partnership?
- Does the partner bear all the expenses incurred in marketing the loans?
- Does the partner pay all the costs of determining which loan applicants will obtain loans, including paying employees to evaluate loan applications, purchasing credit reports, and paying wire transfer and ACH costs for money transfers in connection with the loans?
- Does the partner decide which applicants get loans, applying lending criteria agreed to by the partner and the bank?
- Did the partner or the bank develop and implement the processes used by the partner to identify qualifying loan applicants?
- Is the partner responsible for ensuring that the partnership complies with all applicable federal and state laws?
- Who developed and implemented policies for the partnership, which were used to ensure compliance with those laws? Laws such as the Bank Secrecy Act, the Truth in Lending Act and others.
- Who is responsible for all communications with loan applicants and borrowers, including providing adverse action notices or loan agreements?
- Who is responsible for all servicing and administration of the loans, event before the bank sells the loans to the partner?
- Who has the right to consumer information? If an applicant is denied credit, can the partner solicit the consumer for other credit products? Is the bank permitted to use the information from applicants or borrowers? If so, how?
- Who bears the risk of loss of principal if a borrower defaults?
- Is there a collateral account? Does it secure the purchase of the loans by the partner? Where is the collateral account held? How much money must be in the account?
- What does the purchase price for the loans include? Does it only include the amount advanced to the borrower, or does it include other amounts?
- How are the loans sold? With or without recourse?
- Does the partner indemnify the bank from and against claims arising from the partnership?
- How are the loans funded? Does the partner fund the loans? Does it raise money from institutional investors to fund the loans?

- Who shares in the profit of a paid-off loan? What is the distribution of profit, percentage-wise?

The "rent a bank" or "true lender" theory advanced by the Colorado Administrator does not derive from a statute or regulation. Rather, it derives from case law and brute disdain that rate exportation exists. The lawsuit represents a most serious affront to the power of banks to both export interest rates and to hire partners to help them do it. There is, in fact, no statute or regulation in Colorado that prohibits a bank from engaging the services of a partner to aid them in their lending activities.

Indeed, the FDIC noted in its *Supervisory Highlights* that banks can manage the risks posed by potential partnerships through proper risk identification, appropriate risk-management practices, and effective oversight of the non-bank partner. Virtually all documents that memorialize partnerships will contemplate and address these questions; importantly, the FDIC does not dictate what the answers should be. Rather, the FDIC is concerned about the risks vendor relationships pose to its member banks that engage in third-party relationships as an exercise of their bank power.

As of this writing, there has yet to be any litigation that addresses the tension between the directives of the FDIC to its member banks and the concept of "true lender," although the Colorado litigation certainly raises questions. The FDIC and its member banks should not shy away from this discussion, which raises significant public policy issues over who gets to claim the mantle of consumer protection and what consumer protection should look like. Many consumers in Colorado no doubt WANT loans originated by banks through partnerships. They want those loans because they are often less expensive than available alternatives and because they are quicker than those alternatives. And, an argument can be made that a bank acts as a "true lender" when it exercises the authority granted to it by its primary federal regulator, the FDIC. That is, a bank exercising its power to hire a partner doesn't magically stop being a bank by exercising this power. It is likely that as pressure continues to tighten on bank partnerships though litigation such as the Colorado lawsuits and legislative efforts to curtail bank powers, banks involved in such partnerships and their partners will assert their power to engage partners consistent with the FDIC's guidance in response.

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[1] *Zavislan v. Avant of Colorado LLC, 2017cv30377 (District Court City & County of Denver*, CO, March 9, 2017); Meade v. Marlette Funding LLC d/b/a Best Egg, 2017cv30376 (District Court City & County of Denver, CO, March 3, 2017)

[2] FDIC Supervisory Insights, "Marketplace Lending," Vol. 12, Issue 2, Winter 205, at 12, available at https://www.fdic.gov/regulations/examinations/supervisory/insights/siwin15/SI_Winter2015.pdf.

[3] FDIC, "Examination Guidance for Third-Party Lending," (July 29, 2016), available at https://www.fdic.gov/news/news/financial/2016/fil16050a.pdf and FDIC, "FDIC Extends Comment Period on Third-Party Lending Guidance," (August 4, 2016), available at https://www.fdic.gov/news/news/press/2016/pr16067.pdf.

[4] Id.

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