

# BankThink Don't let court squander online lenders' chance

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Most of the country has never heard of *Madden v. Midland Funding* and the common law doctrine of "valid-when-made," but the impact of the misguided decision by the 2<sup>nd</sup> U.S. Circuit Court of Appeals on consumers is far-reaching.

Officials from the Obama administration — including the former U.S. solicitor general and senior attorneys at the Office of the Comptroller of the Currency — stated that the case **was wrongly decided**, echoing the views of banking industry representatives. But it is the consumers and small business owners in the three 2<sup>nd</sup> Circuit states (New York, Connecticut and Vermont) who are paying the price for the ruling.

Under current law, banks can export loans bearing home-state interest rates to borrowers in other states where the bank does business, or alternatively, the bank can choose to operate under the "host" state's rate cap. After rate exportation was challenged, a **Supreme Court ruling** in 1978 affirmed it. The court rejected the argument that extending credit into a state effectively located the bank there. Rate exportation has been key to the rise of standardized nationwide financial products, like credit cards, allowing banks to lend to borrowers across state lines without necessarily establishing a physical presence in every state, giving

consumers' better choices.



Congress can ensure that the Madden decision does not inadvertently force borrowers into abusive loans when a more responsible, lower-cost product is potentially available online.

Bloomberg News

But what happens if those loans are slated to be sold, and the originating bank is only retaining a small portion of the risk? Following the Madden decision, it is unclear in the 2<sup>nd</sup> Circuit whether certain bank loans transferred to a marketplace lending platform would be ruled valid or not. Are loans bound by the bank's "home" state rate cap, or the borrower's "host" state rate cap? No one knows for sure. This legal uncertainty has caused nonbank investors in these loans to pull back, which, in turn, has led to a reduction in responsible and affordable online lending. Borrowers who are still trying to build credit have lost better options. According to an August [study](#) by professors at the Columbia, Stanford and Fordham law schools, "the decision reduced credit availability for higher-risk borrowers in affected states."

Thankfully, members of Congress are working on this issue. Reps. Patrick McHenry, R-N.C., and Gregory Meeks, D-N.Y., have authored a [bipartisan bill](#), the Protecting Consumers' Access to Credit Act, which will help resolve uncertainty in our credit system. A bipartisan bill is also pending in the U.S. Senate, led by Sens. Mark Warner, D-Va. and Pat Toomey, R-Pa. Their legislation would clarify that legitimate bank loans can indeed be sold to a nonbank without the risk of invalidation. This matters to real people who need access to credit.

To illustrate how the Madden decision is having an adverse impact, let's look at a common real-world example: a New York resident with a 625 FICO score seeking to refinance credit card debt at a lower interest rate.

The credit card issuer is an out-of-state bank that charged the borrower 30% APR. Even though that rate is above the New York "host" state interest rate limit, the bank can legally apply its "home" state rate because it will keep the loan on its balance sheet.

The borrower seeks an online installment loan to pay off the credit card, and would qualify for one at a rate of 26% APR. The installment loan too would be originated by a bank from out of state. Not only is the installment loan less expensive, but it is arguably more transparent too; the borrower's payments are the same every month and are due the same day every month, and the borrower knows when the debt is fully paid down. The catch is that the cheaper installment loan lacks legal certainty under the Madden decision about applying a "home" state rate, simply because the loan is slated to be sold to a non-bank. As a result, the borrower gets stuck with the more expensive 30% credit card.

Another example is an online "point-of-sale" loan compared to the alternatives. If an expensive critical home appliance like an oven or a refrigerator suddenly fails, a low-credit score borrower in New York might well need to resort to getting a loan from a pawn shop in the 48-60% APR range, or a [rent-to-own product](#) with an APR that can legally reach 125% APR or even higher. Pawn shops and rent-to-own companies simply ignore New York's rate

law and can charge sky high rates because, amazingly, these types of companies are not considered "lenders." Similar to the previous example, a point-of-sale installment loan from an out-of-state bank, partnering with a more reputable nonbank marketplace lender, with a 26% APR might not be available as a result of the uncertainty stemming from the Madden decision. The borrower misses out on hundreds, or even thousands of dollars in savings from the lower interest rate.

[New research](#) from the Federal Reserve Bank of Philadelphia has shown that online marketplace loans have been priced fairly, and are filling gaps in underserved locations where the number of physical bank branches has declined. With these new lending models, it may be possible to improve borrowers' financial health by providing simple and transparent credit products at a cost that is well below what the Consumer Financial Protection Bureau deems unaffordable in [proposed rules designed to police risky products](#). The average APR on consumer installment loans from members of the Marketplace Lending Association is 17%, while the CFPB's rate threshold for "high-cost" installment lending is 36%.

Regulatory endorsement of the online lending model was illustrated just recently when the CFPB granted its [first ever "no-action" letter](#) to an MLA member to further the use of alternative credit data, which eventually may help reduce borrowing costs for millions of Americans who have little traditional credit history.

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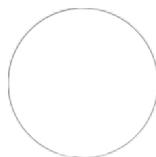


August 23

Some have claimed that legislative fixes to address concerns about the Madden decision [could aid unscrupulous lenders](#) that simply seek to avoid usury limits. It is important to remember, however, that to export interest rates, all loans must be valid bank loans to begin with. That means they must be blessed by both state and federal regulators, including the CFPB. The [Federal Deposit Insurance Corp.](#) has proposed clear guidance on proper procedures for bank lending partnerships, and ignoring such guidance can have serious repercussions. And since the passage of the Dodd-Frank Act, regulators have much more authority to go after unfair and deceptive practices and bring enforcement actions against bad actors, should the need arise.

The Protecting Consumers' Access to Credit Act is gathering bipartisan momentum on Capitol Hill for good reason — the clock is ticking. As more physical bank branches close, there are billions or even trillions of dollars at nonbanks that could be unlocked to support lending to lower FICO borrowers that many traditional banks ignore. More investment liquidity means narrower risk premiums. That can drive better prices for these borrowers at origination. Do we really want such a deep pool of potential liquidity that can support responsible lending to remain on the sidelines due to legal and regulatory uncertainty?

At every point on the credit spectrum, simple, transparent products and lower interest rates save people money and can help set them on a better economic path. Congress and the states must make sure that the Madden decision does not inadvertently force borrowers into abusive loans when a more responsible, lower-cost product is potentially just a click away.



## Nathaniel Hoopes

Nathaniel Hoopes is the executive director of the Marketplace Lending Association.

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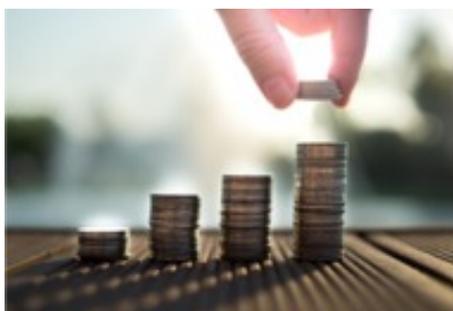
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