Portfolio Media. Inc. | 111 West 19th Street, 5th Floor | New York, NY 10011 | www.law360.com
Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

A State Win In Bank Loan Suit Would Hurt Access To Credit

By **William MacLeod** (March 17, 2021, 6:19 PM EDT)

William MacLeod

On May 7, the U.S. District Court for the Northern District of California will hear arguments over access to billions of dollars of credit for millions of Americans. The case is California v. Office of the Comptroller of the Currency.[1]

On one side, regulators in California, Illinois and New York are seeking the power to prohibit financial institutions inside their states from acquiring loans that banks make in other states if the interest rates on those loans exceed local caps.

On the other side, the OCC argues that if a bank loan is legal when extended, it remains legal whether the bank keeps it on its books or sells it to someone else, even when the buyer resides in a state that frowns on the rate.

In the middle are consumers, who could suffer the heaviest casualties in this turf war.

The legal issue boils down to the applicability of the National Banking Act to loans that banks extend and then sell. When a bank makes a loan, the law of the bank's state governs the interest rate, no matter where the customer resides.

A unanimous 1978 U.S. Supreme Court decision that confirmed this principle, Marquette National Bank of Minneapolis v. First of Omaha Service Corp.,[2] is widely credited with reducing barriers to interstate financial competition and expanding consumer access to credit.

A 2015 U.S. Court of Appeals for the Second Circuit decision, Madden v. Midland Funding LLC,[3] cast doubt on the applicability of Marquette to loans that are sold after they are made. To resolve any doubt, the OCC adopted a rule[4] confirming that Marquette applied. California, Illinois and New York sued to invalidate the rule.

Banks will continue to lend, regardless of the outcome. To be sure, if the states prevail, competition for the resale of loans will diminish, banks will lose sources of funds, costs of credit will rise, and lending will shrink. But when costs go up, banks can raise interest rates on the loans they do make.

They will still find borrowers, although not as many, who can afford to pay more. When costs go down, even better — banks can lower rates and reap profits on higher volumes.

Regulators will still protect consumers, regardless of result. The outcome of the case will not change the basic laws of deception, unfairness, discrimination, abuse and the like. Illegal lending, servicing and collecting will remain illegal. Numerous federal and state authorities are on guard and ready to prosecute violations.

The parties who stand to win or lose the most in California v. OCC are consumers. A state victory means that borrowers will pay more for credit, and those will be the lucky ones. The biggest losers will be people whose loan applications are denied because the secondary market shies away from the debt. Loans that are harder for originators to sell are less likely to get extended in the first place.

For a preview of the damage this case could do, consider the experience of borrowers in Connecticut and New York after the Second Circuit ruled in Madden that a loan sold to institutions in those states must comply with local usury laws, regardless of the originators' domicile.

In other words, loans legally made by South Dakota banks could become illegal if sold to financial institutions in New York. The ruling immediately cast doubt on the validity of loans extended across state lines and then sold, a common practice in finance.

The holder of an invalid loan has little recourse when a borrower walks away from it, and rights that cannot be enforced will not attract top dollar in secondary markets. If loans bundled for sale as a single security include any that may be unenforceable when the security is sold, the entire bundle can lose value.

Buyers will prefer securities limited to loans that pass muster in even the toughest jurisdictions. Lawyers will need to vet loans in the bundle against all the laws that could apply, which will raise the cost of the security. Added risks and legal costs mean fewer buyers. Banks will keep more loans on their balance sheets instead of replenishing funds that could be lent to new borrowers.

The hazards for consumers are far from hypothetical. Experts have already documented what happens to borrowers when secondary credit markets recede.

According to a 2017 study published in The Journal of Law and Economics,[5] in the five years since Madden, both the number of loans and volume of credit extended in Connecticut and New York fell well behind loans elsewhere in the U.S. Higher-risk borrowers were disproportionately disadvantaged. Loans declined by half among borrowers with FICO scores below 625 in Connecticut and New York, and neither economic trends nor attitudes of lenders explained the drop. Loans for similar borrowers in other states more than doubled.

In short, national markets expand access for credit. Barriers at borders curtail access.

The hearing in May could reveal whether the rest of the country will follow the path of New York and Connecticut. Briefing is done. Oral arguments could be the last round in the dispute over whose regulations should apply to these loans, as both sides moved for summary judgment.

The court will most likely hear about principles of statutory construction and rulemaking practices at the OCC. Perhaps the states will mention that consumer advocates are on their side, since amici representing consumer groups uniformly backed local regulators. Amici from the financial sector supported the OCC. It will be up to the OCC to represent the marginal consumers who could search in vain for lenders in balkanized credit markets.

Cases like this explain why the Taskforce on Federal Consumer Financial Law at the Consumer Financial Protection Bureau recommended that Congress authorize federal charters for more financial institutions and that the bureau advocate more often for competitive markets.

Preserving competition is an express objective of the Dodd-Frank Act, but seldom does the bureau intervene in cases that imperil that objective.

The Federal Trade Commission has long explained to courts how competition can advance consumer protection. For the sake of consumers, the bureau should join the cause.

William MacLeod is a partner at Kelley Drye & Warren LLP. He was previously a member of the Taskforce on National Consumer Financial Law at the Consumer Financial Protection Bureau.

[1] People of the State of California v. The Office of the Comptroller of the Currency et al, No. N.D.Cal. 4:20-cv-05200.

[2] 439 U.S. 299 (1978).

[3] Available at, https://www.scotusblog.com/wp-content/uploads/2016/03/14-2131-2015-05-22.pdf.

[4] OCC, Permissible Interest on Loans That Are Sold, Assigned, or Otherwise Transferred, 85 Federal Register, No. 106, 3350, June 2, 2020, available at https://www.occ.gov/news-issuances/federal-register/2020/85fr33530.pdf

[5] Honigsberg, Colleen and Jackson, Jr., Robert J. and Squire, Richard C., How Does Legal Enforceability Affect Consumer Lending? Evidence from a Natural Experiment, 26-27 (August 2, 2017). The Journal of Law and Economics, Forthcoming, Available at
SSRN: https://ssrn.com/abstract=2780215 or http://dx.doi.org/10.2139/ssrn.2780215.