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Davis Polk

January 21, 2020

By electronic submission to regs.comments@occ.treas.gov; comments@fdic.gov

Chief Counsel's Office
Attention: Comment Processing
Office of the Comptroller of the Currency
400 7th Street SW, Suite 3E–218
Washington, DC 20219

Robert E. Feldman, Executive Secretary
Attention: Comments
Federal Deposit Insurance Corporation
550 17th Street NW
Washington, DC 20429

Re: Comment Letter on the Notices of Proposed Rulemaking Regarding Permissible Interest on Loans That Are Sold, Assigned, or Otherwise Transferred (Docket ID OCC–2019–0027 and RIN 1557–AE73) and Federal Interest Rate Authority (RIN 3064–AF21)

Ladies and Gentlemen:

Davis Polk & Wardwell LLP (**Davis Polk**) welcomes the opportunity to comment on the notices of proposed rulemaking issued by the Office of the Comptroller of the Currency (**OCC**) and the Federal Deposit Insurance Corporation (**FDIC**) that would clarify the treatment of bank loans upon their transfer, sale or assignment (**Proposals**).[1]

We believe the Proposals would provide welcome certainty for banks and other loan market participants regarding the ongoing validity of interest rate terms of bank loans. This certainty is an essential building block for the legal foundation of a nationwide lending market, which in turn is necessary to ensure that credit is available for American consumers and for bank safety and soundness, particularly given the rapid technological transformation in financial services and the associated changes in how consumers and businesses expect to receive those services. In our view, the Proposals represent an appropriate balance of the

[1] OCC, *Permissible Interest on Loans That Are Sold, Assigned, or Otherwise Transferred*, 84 Fed. Reg. 64,229 (Nov. 21, 2019) [*hereinafter*, OCC Proposal]; FDIC, *Federal Interest Rate Authority*, 84 Fed. Reg. 66,845 (Dec. 6, 2019) [*hereinafter*, FDIC Proposal].

important goals of consumer protection, availability of credit through a national lending market, and safe and sound bank lending.

I. The Rulemaking Is Appropriate Given the Legal Uncertainty in a National Lending Market Caused by the *Madden* Decision

As we discussed in our 2018 white paper,[2] we agree with the OCC and the FDIC that the decision of the U.S. Court of Appeals for the Second Circuit in *Madden v. Midland Funding, LLC* (***Madden* Decision**)[3] has created undue legal uncertainty for banks' authority to sell, assign or otherwise transfer loans, which is a core banking power. The *Madden* Decision failed to acknowledge or address a long-settled legal principle known as the "valid-when-made" doctrine that has served for almost two centuries as the bedrock for bank lending.[4] Recent developments originating from the *Madden* Decision, despite often being intended to address important consumer protection concerns, deviate from the well-established doctrine and practice.

We are concerned that the legal uncertainty and risk caused by such deviation would interfere with the core powers afforded to banks under federal law and undermine the smooth functioning of the U.S. financial system.[5] The court-by-court and state-by-state nature of these developments further complicates the ability of banks to engage in lending activities as part of a nationwide lending market in a consistent manner. We believe that the Proposals would end this uncertainty and confusion by clearly codifying what the banking regulators and "the banking industry have always believed,"[6] which is that a loan that is valid at its inception cannot become usurious upon subsequent sale or transfer to another person.[7]

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[2] Davis Polk & Wardwell LLP, White Paper, *Federal Banking Regulators Can and Should Resolve Madden and True Lender Developments* (Aug. 14, 2018), *available at* https://www.davispolk.com/files/madden-true-lender-federal-regulatory-fix-whitepaper_final.pdf.

[3] *Madden v. Midland Funding, LLC*, 786 F.3d 246 (2d Cir. 2015), *cert. denied*, 136 S. Ct. 2505 (2016).

[4] *Id.*

[5] Such uncertainty is widespread across banks of different charter types. While the *Madden* Decision concerned the assignment of a loan by a national bank, the uncertainty that it created also challenges the enforceability of loans originated and sold by federal savings associations or state-chartered banks because the federal statutory provisions governing federal saving associations' and state banks' authority with respect to interest rates are patterned after and interpreted in the same manner as section 85 of the National Bank Act. *See* 12 U.S.C. § 85; 12 U.S.C. § 1463(g); 12 U.S.C. § 1831d.

[6] OCC Proposal at 64,232.

[7] *Id.* at 64,231 (citing *Nichols v. Fearson*, 32 U.S. (7. Pet.) 103, 109 (1833); *Gaither v. Farmers & Mechs. Bank of Georgetown*, 26 U.S. (1 Pet.) 37, 43 (1828)); FDIC Proposal at 66,848 (citing *Nichols*, 32 U.S. at 109; *Gaither*, 26 U.S. at 43; *FDIC v. Lattimore Land Corp.*, 656 F.2d 139 (5th Cir. 1981); *FDIC v. Tito Castro Constr. Co.*, 548 F. Supp. 1224, 1226 (D. P.R. 1982)).

We appreciate that the Proposals recognize the importance of a national lending market and support the initiative to restore its important legal foundations. If a bank cannot be certain about the continued permissibility of an interest rate after potential assignment or transfer of a loan, and therefore is unable to reliably and readily resell loans, or if the value of those loans is significantly reduced as a result of legal uncertainty, the bank's ability to make loans and manage risk by moving loans off of its balance sheet would be severely impaired. Such impairment would threaten a bank's ability to operate in a safe and sound manner.

The uncertainty would also increase legal and business risks to potential purchasers of bank loans, which in turn may reduce overall liquidity in loan markets, further limiting the ability of banks to sell loans to manage balance sheet risk.[8] As a result, banks may be forced to compensate loan market participants for these increased risks by requiring all borrowers to pay higher interest rates or by simply cutting off already underserved borrowers' access to responsible credit, which would impair credit availability for customers.

The *Madden* Decision and relevant developments threaten the mechanisms that many banks rely on to partner with third-party service providers, especially those which employ technology to aid the credit underwriting decision or transfer loans. This would interfere with efficient functioning of the U.S. financial system, particularly given the rapid technological transformation in financial services and the associated changes in how consumers and businesses expect to receive those services.

We believe that the Proposals would promote safe and sound banking practice by facilitating banks' ability to manage their balance sheets, efficiently and effectively controlling credit risk and partnering with nonbank service providers in a responsible manner. Ultimately, this would support the availability of credit for consumers, especially the underserved ones, and protect loan market participants' expectations in lending transactions. As the Proposals seek a return to the pre-*Madden* Decision status quo, we agree that the rulemaking would not cause any significant net new economic impact on supervised banking entities, including small institutions.[9]

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[8] While the *Madden* Decision may not have yet caused widespread or significant negative effects on credit availability or securitization markets as stated in the preamble to the FDIC Proposal, at least one academic study has found evidence of a decline in consumer lending in jurisdictions directly impacted by the *Madden* Decision. FDIC Proposal at 66,952; Colleen Honigsberg, Robert J. Jackson, Jr., and Richard Squire, *How Does Legal Enforceability Affect Consumer Lending? Evidence from a Natural Experiment*, 60 J. L. & ECON. 673 (Nov. 2017). Thus, we support that this timely rulemaking could minimize the extent of negative effects.

[9] We do not have any particular reason to believe that the rulemaking proposed by the FDIC would have any significant effects on small entities that the FDIC has not identified.

II. The Rulemaking Is an Appropriate Application of Federal Banking Law

We agree that the proposed rulemaking is an appropriate application of federal banking law. The federal statutes grant banks the authority to make contracts, including loan contracts.[10] While not expressly stated in those statutes, the authority to subsequently assign or transfer some or all of the benefits of a contract to a third party is one of the essential rights of banks associated with the power to contract under the fundamental principles of contract law.[11] Since at least 1848, the Supreme Court has also recognized that banks' authority to assign a loan is a power incident to the authority to make one.[12] As part of banks' authority to make loans, banks may charge interest rates as permitted by federal banking law.[13]

The proposed rulemaking is within the appropriate exercise of the statutory authority vested in the OCC and the FDIC under section 39 of the Federal Deposit Insurance Act. Section 39 gives federal banking regulators broad authority to address unsafe or unsound practices, violations of law, unsafe or unsound conditions or other practices.[14] Setting conditions for the ongoing validity of interest rate terms for bank loans after their sale, assignment or transfer would contribute to the establishment of safety and soundness standards by which the OCC and the FDIC would regulate the conduct of banks to assure their safety and soundness, compliance with laws and regulations, fair access to financial services and fair treatment of customers.[15]

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[10] The federal statutes grant national banks and federal savings associations the authority to make contracts (12 U.S.C. §§ 24(Third) and 1464) and the power to lend money (12 U.S.C. §§ 24(Seventh) and 1464). Section 27 of the Federal Deposit Insurance Act grants state-chartered banks the authority to make loans, and state banking laws typically provide state-chartered banks the authority to sell or transfer loans, and to engage in banking activities similar to those enumerated in the National Bank Act and activities that are incidental to banking. 12 U.S.C. § 1831d.

[11] Restatement (Second) of Contracts § 317 (1981).

[12] *See Planters' Bank of Miss. v. Sharp*, 47 U.S. 301, 322–23 (1848).

[13] Section 85 of the National Bank Act permits a national bank to charge interest on any loan at the rate permissible by the laws of the state where the bank is located, or at a rate one percent above the Federal Reserve discount rate, whichever is higher. 12 U.S.C. § 85. Section 27 of the FDI Act provides state banks with the authority to charge interest at the rate allowed by the law of the state where the bank is located, or one percent more than the rate on 90-day commercial paper, whichever is greater. 12 U.S.C. § 1831d.

[14] 12 U.S.C. § 1831p-1.

[15] 12 U.S.C. § 93a; 12 U.S.C. § 1819(a)(Tenth); 12 U.S.C. § 1820(g).

III. The Rulemaking Is a Good Model of Legal and Regulatory Clarity, which Paves the Way to Tackle the Outstanding True Lender Question

In our view, the Proposals are a good model of rulemaking that encourages a clear, easy-to-apply rule. We commend the OCC Proposal in particular for its remarkable brevity of the rule text that still provides clear legal and regulatory certainty. We also appreciate the FDIC's effort to provide "a logical and fair rule that is easy to apply."[16]

With these Proposals as a model, we recommend that the OCC and the FDIC consider addressing the challenges and uncertainty caused by a similar issue associated with bank lending. Some state legislatures and state courts have recently considered the question of which entity is the true lender when a bank makes a loan and assigns it to a third party in the context of payday lending. As with the *Madden* Decision, the recent developments around the true lender question have created additional uncertainty in the ability of banks to sell loans they have originated. In our view, this should be addressed in the same way that the OCC and the FDIC seek to address the challenges associated with the *Madden* Decision—that is, by issuing clarifying regulations, which look to existing guidance issued by federal banking regulators and are informed by long-standing principles.

The FDIC expressed its position in the preamble to the FDIC Proposal that it will "view unfavorably entities that partner with a state bank with the sole goal of evading a lower interest rate established under the law of the entity's licensing state(s)."[17] We believe that additional clarifications should be provided to the standard that the FDIC would apply to its making such unfavorable determination in order to avoid any legal and regulatory uncertainty or confusion.

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[16] FDIC Proposal at 66,848.

[17] *Id.* at 66,846.

Davis Polk thanks the OCC and the FDIC for their consideration of our comments. If you have any questions, please do not hesitate to contact Margaret E. Tahyar at (212) 450-4379 or Randall D. Guynn at (212) 450-4239.

Yours sincerely,

DAVIS POLK & WARDWELL LLP

By: [redacted]
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