BANK PARTNERSHIP OR GO IT ALONE?

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Bank partnerships in online marketplace lending are getting a lot of attention. There is pent up demand for these arrangements, with banks operating in this space experiencing increased inquiries from FinTech startups with lending ideas. Seeing these opportunities, other banks are considering becoming FinTech partners. All of this interest has translated into some regulators and enforcement agencies taking a critical look at how bank partnerships operate.

A few lending platforms have already been shut down and others are the target of open investigations. In June, the West Virginia Attorney General took action against a marketplace lending platform that resulted in the platform voluntarily ceasing to do business in West Virginia. The California Department of Business Oversight has been actively investigating several lending platforms since December 2015 and recently sent follow-up questions to the target platforms. Many of California's questions center on the platforms' relationships with their partner banks. The New York Department of Financial Services has undertaken a similar initiative. The unifying theme of all these investigations is that they concentrate on "true lender" considerations and compliance with state law, including licensing.

Bank partnerships in lending are nothing new. In fact, one of the first assignments this writer worked on as a new associate 17 years ago was a co-branded loan program under which loans were made by an unaffiliated bank to clients of a brokerage firm without lending capabilities. Private-label credit card and affinity joint venture lending arrangements with partner banks have been around even longer.

Of course, times are different. The financial and foreclosure crises have driven regulators and enforcement agencies to be more proactive, to cover more ground. FinTech has dramatically opened up the lending playing field, providing new space for all to explore. But, despite this increased scrutiny, there still should be a place for bank partnerships in online marketplace lending, provided they are arranged in a way that appropriately addresses regulatory, enforcement and litigation risk.

WHAT ARE THE PRIMARY ONLINE MARKETPLACE LENDING MODELS?

To level set, there are two primary online marketplace lending models: (1) direct lender and (2) bank partnership.

Direct lenders obtain their own state lender licenses and make loans in their own name, either holding the loans on their balance sheet, selling to investors or securitizing. The direct lender services the loans itself or through a sub-servicer.

In a bank partnership, a FinTech platform company, under the direction and control of a partner bank, markets,

takes and processes applications according to the bank's criteria and guidelines. The bank funds and closes the loans in its own name. After holding the loans for a period of time, the bank sells loans to the platform company. Just like a direct lender, the platform company holds, sells or securitizes the loans, continuing to service them directly or through a sub-servicer.

WHAT ARE THE PLUSES OF CHOOSING THE BANK PARTNERSHIP MODEL?

The bank partnership model has two big advantages if structured properly: (1) no lender licenses for the platform company and (2) interest may be charged uniformly nationwide at rates that may not be permitted for direct lenders.

Licensing. All states license persons that make residential mortgage loans, most license those that make unsecured consumer loans and many fewer license commercial lenders. It can take up to a year or more to obtain all licenses necessary across the country, with all-in costs as high as $500,000 or more, including application and investigation fees, surety bonds, legal fees and internal expenditures. In addition to being time consuming and costly, the licensing process can be invasive, requiring fingerprints and criminal checks, background investigations, personal history questionnaires and financial statements for officers, directors and individual 10% owners. Licensing authorities may need to approve future investment rounds or acquisitions before they are closed, if there will be new 10% owners.

Lender licensing laws contain a number of substantive limitations and requirements that apply to licensees, including disclosures and loan term restrictions. A good example is the California Finance Lenders Law referral provision which places a number of limitations and requirements on commercial loans sourced from referrals, including an APR limit and documentation, ability to repay determination, recordkeeping, reporting and disclosure requirements.[1] Some licensing laws require an in-state office and others necessitate licensing authority approval to engage in any business other than lending. States periodically examine licensees for compliance with these limitations and requirements, and take enforcement action for failing to comply.

Platform companies that partner with a bank normally do not obtain lender licenses because the bank makes and funds the loans. Obviously, the time to market saved by not going the direct lender route and getting state licenses is a significant advantage.

Servicing and broker licensing must be considered, though. About half the states license debt collectors and collection agencies and many of these licenses apply to persons that receive payments on performing loans. Additional states license mortgage servicers. Platforms that contract with licensed sub-servicers to service loans reduce their debt collector/collection agency/servicer licensing obligations.

In the West Virginia action mentioned above, the Attorney General alleged that the platform company in the bank partner model was operating as an unregistered credit services organization. In West Virginia, a "credit services organization" is "a person who, with respect to the extension of credit by others and *in return for the payment of money* or other valuable consideration, provides...any of the following services:

1. Improving a buyer's credit record, history or rating;
2. Obtaining an extension of credit *for a buyer*; or
3. Providing advice or assistance to a buyer with regard to subdivision (1) or (2)..."[2]

For purposes of the definition of "credit services organization," "buyer" means "an individual...who purchases the services of a credit services organization ..."[3]

Focus is on the second of the enumerated services and the definition of "buyer." Read together, the intent of the law seems to cover credit repair organizations and loan brokers, including advance fee loan brokers, that charge consumers a fee for their services. For a marketplace lending platform to fall within the definition of a credit services organization, a borrower would seemingly have to "buy" the services of the platform. Although, borrowers may pay the bank partner an origination fee to obtain the loan from the bank, typically borrowers do not purchase platform services, that is, they do not pay broker fees to the platform. The West Virginia Attorney General appears

to be taking an aggressive read of the credit services organization law. Recently, the Maryland Commission of Financial Regulation took a similar position on its credit services law.[4] More than three-quarters of the states have a credit services organization or repair law and a number have a loan broker licensing law.

Usury. Loans closed by bank partners may be made with interest rates and fees that direct lenders cannot charge.[5] A bank enjoys interest rate exportation. That is, on a nationwide basis, a bank may charge interest rates and fees considered components of interest (e.g., origination fees, late fees, NSF fees, annual fees) permitted in the state it is headquartered.[6] For example: a bank headquartered in New Jersey can charge its borrowers across the country interest permitted to it in New Jersey.

A direct lender generally complies with the usury limits in the various states it lends. The states are a hodge-podge on usury with varying interest rate restrictions resulting in direct lenders offering different rate structures by state, even "going dark" and not lending in some states on higher interest products.

Building on the New Jersey bank exportation example as an illustration:

- New Jersey law permits a New Jersey bank to charge up to 30% interest on consumer loans.[7]
- The civil usury limit in New York is 16%.[8]
- New York's criminal usury limit is 25%.[9]
- A direct lender that obtains a New York Licensed Lender license is authorized to make consumer loans of $25,000 or less with interest rates that exceed the civil usury limit (16%), but are under the criminal usury limit (25%).[10]
- Whereas a direct lender is limited to 25% interest in New York, a New Jersey bank may charge its New York borrowers up to 30% interest, exporting its permitted New Jersey rate to New York.

WHAT ARE MINUSES OF THE BANK PARTNERSHIP MODEL?

Naturally, the major minuses are in the risks. (A future *FinTech* Flash will cover marketplace lending-related regulatory, enforcement and litigation actions.) All of these risks are related to the bank partner being correctly viewed as the "true lender." The "true lender" must have the authority (e.g., bank charter, state license) to charge the platform loans' interest rates. Of course, the bank partner is the initial lender of record because the loans are closed in its name, and has this authority. The arrangement must be structured in a way that does not make the marketplace lending platform company susceptible to being considered the "true lender." If the platform company can be successfully challenged as the "true lender," it may be alleged that the company is operating without a state license and the platform loans are usurious. These allegations were made in the West Virginia action and the platform agreed to refund all interest, fees and charges imposed on West Virginia borrowers. (Our next *FinTech Flash* will present "true lender" guidelines to follow when structuring bank partnerships.)

WHAT ABOUT THE DIRECT LENDER MODEL?

The pluses and minuses of the bank partnership model are flipped for the direct lender model – negatives turn into positives, advantages become disadvantages.

Pluses

- *Control*. Many FinTech companies have potentially revolutionary lending ideas for which they must cede some control over to their bank partner. The linchpin of being the "true lender" is controlling the program. For example, the bank should approve all material aspects of the program from signing off on marketing materials to adopting changes in the underwriting guidelines. If the program exceeds projections, the bank partner may not be able to keep up with funding and may not be able to make loans. Banks routinely seek exclusivity in partnership arrangements, but having a back-up bank is prudent. A direct lender has more control over its business.

- *Economics*. Direct lenders keep all the economics. Certainly, the bank partner, as lender, would have a material economic interest in platform production.
- *Less Headline Risk*. "True lender" regulatory, enforcement and litigation risk is unique to the bank partnership model.

Minuses

- *State Licenses*. A direct lender must invest significant time, cost, and effort to become licensed to make loans nationally.
- *More Compliance*. State licensing laws have many substantive requirements and limitations. Implementing these requirements in a particular state can cost 10 or more times the cost of obtaining the license. A direct lender will have multiple examinations annually by licensing authorities for compliance with its laws.
- *Lights Out.* Interest and fee limitations, as well as restrictions on loan terms offered by licensees (e.g., interest rate limits tiered by loan amount), can require a direct lender to offer different rates and terms by state. Legal constraints in some states can cause a direct lender not to lend in those states.

ABOUT GOODWIN'S FINTECH PRACTICE

Goodwin's FinTech Practice is backed by a cross-disciplinary team of approximately 70 attorneys with expertise in financial services, private equity, technology, investigations, intellectual property, consumer financial services, business and securities litigation. Having represented more than a quarter of the companies on the current *Forbes FinTech 50* list and ranked as one of the top 5 most active law firms advising on FinTech industry deals according to *PitchBook* and SNL rankings, Goodwin is a recognized market leader in the FinTech sector and serves an extensive client base on corporate, regulatory, litigation and enforcement matters.

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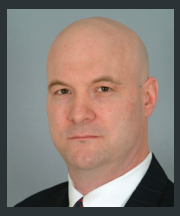

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End notes

[1] Cal. Fin. Code § 22602.
[2] W. Va. Code § 46A-6C-2(a) (emphasis added).
[3] W. Va. Code § 46A-6C-1(1).
[4] *CashCall, Inc. and J. Paul Reddam v. Maryland Commissioner of Financial Regulation*, Md. Court of Appeals, No. 80, Sept. Term 2015 (June 23, 2016), affirming Court of Special Appeals, No. 1477, Sept. Term 2013 (Oct. 27, 2015).
[5] Just as there are fewer state licensing requirements for commercial lenders, the usury limits in many states do not apply to commercial loans, either because business-purpose loans are exempt or business organizations are unable to plead usury as a defense in civil actions.
[6] Alternatively, a bank may be able to export interest from a state it has a branch if it conducts certain non-ministerial functions from that state (i.e., makes the decision to extend credit, physically disburses the proceeds of a loan, and first communicates final approval of the loan).
[7] N.J. Stat. § 17:13B-2; N.J. Stat. Ann. § 17:13-104(b); N.J. Stat. Ann. § 2C:21-19(a).
[8] N.Y. Gen. Oblig. Law § 5-501(1); N.Y. Banking Law § 14-a(1).
[9] N.Y. Pen. Law § 190.40.
[10] N.Y. Banking Law § 340.