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Subcommittee on Financial Institutions and Consumer Credit
Committee on Financial Services
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Hearing on "Examining Opportunities and Challenges in the Financial Technology ('Fintech') Marketplace"

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Chairman Luetkemeyer, Ranking Member Clay, and members of the Subcommittee, thank you for the opportunity to appear before you to testify about opportunities and challenges in the fintech marketplace.

My name is Andrew Smith, and I am a partner at the law firm of Covington & Burling LLP, where I co-chair the Financial Institutions Practice Group. I also serve as the Chair of the Consumer Financial Services Committee of the American Bar Association, and I am a Fellow of the American College of Consumer Financial Services Lawyers. Earlier in my career, I worked at the Federal Trade Commission ("FTC") on financial services issues.

I am appearing today on my own behalf, but we represent many companies and trade associations in the fintech space and have many years of experience with these issues. You have asked me to discuss "the opportunities and challenges posed by fintech in the financial services marketplace, the current regulatory landscape, the need to amend the regulatory landscape or the necessity to amend existing financial laws or develop new legislative proposals that would allow financial services entities to use fintech to deliver new products and services to consumers." In response to your request, I want to focus on three key points:

(1) *Bank partnerships with fintech providers are good for consumers.* The ultimate promise of fintech – delivering safer, more transparent, lower cost and more convenient financial

products and services to consumers over the Internet and mobile devices – depends on the ability of banks, particularly community banks, to cooperate with third-party fintech providers to offer financial products and services to consumers.

(2) *Bank partnerships are rigorously supervised.* Banks of all sizes routinely rely on third parties to provide critical services and also to purchase loans originated by the bank. A robust regime of third-party supervision has been established at the federal banking agencies to ensure that activities that occur outside of the bank are examined and supervised to the same extent as if they were being conducted by the bank itself, thereby protecting consumers and the financial system. Bank-sponsored lending programs with fintech firms are no exception, and the FDIC has published detailed guidance as to how these relationship should be managed and supervised.

(3) *New and inconsistent court decisions threaten to undermine bank partnerships with fintech providers.* A relatively recent litigation trend threatens the ability of community banks to expand access to credit through partnerships with third-party fintech providers. Some courts have taken it upon themselves to look beyond the actual, legal rights and responsibilities with respect to a particular loan transaction, and have instead examined the facts and circumstances of each individual loan transaction to consider who is the "true" lender – the bank or the fintech provider. That is, even though the bank is the legal lender to whom the borrower is obligated to repay the loan, the court is willing to ignore the loan agreement and instead examine the differing interests and motives of the various participants in the transaction. These decisions upend the reasonable commercial expectations of all of the participants in the loan transaction and threaten to discourage banks and fintech providers from entering into partnerships with one another. Legislation has been introduced which would ameliorate the situation by clarifying

what we knew all along: if a bank loans money to a borrower, and the borrower promises to repay the bank, the bank – not the bank's vendor or service provider – is the lender.

Bank Partnerships with Fintech Providers Are Good for Consumers (and for Banks)

Banks routinely rely on relationships with vendors to deliver financial services more broadly, more efficiently, and with less risk to consumers, the economic system, and the banks themselves. While individual banks may not have all of the technical know-how to market, underwrite, originate, service and collect personal loans over the Internet, they have access to a wide variety of vendors who have the requisite technical expertise, as well as sources of funding which can share the risk of the loans with the bank. These vendors may have made significant investments in new technology and analytics, with many years spent developing and refining their expertise. To enter these new markets, banks could create their own systems from scratch at great expense and delay or partner with those who already have proven expertise. These partnerships allow the bank to deploy its own capital to make new loans, thereby providing broader access to credit for consumers.

Banks, particularly smaller or community banks, can extend their reach and diversify their risk profile by partnering with nonbanks to offer credit to consumers. Nonbank fintech providers can bring expertise to the table that the bank would not otherwise have – for example, expertise in electronic and Internet marketing of loans, innovative underwriting and credit risk assessment techniques, or online statementing and servicing of loans. Access to this new technology might enable a smaller bank to originate loans through new channels, such as the Internet; to new markets, such as small businesses; to borrowers outside of the bank's traditional

footprint; or to borrowers of lesser credit quality, such as thin-file or no-file consumers. New technology also might allow a bank to more narrowly target its offers or more accurately customize its product offerings, thereby offering its products more efficiently. All of this means more competition among providers of credit, lower costs of credit, and more options and access to credit for consumers.

The Center for Financial Services Innovation, in a recent comment letter to the FDIC, characterized this as a "win-win-win" for all involved, including consumers. Banks win because they can serve a broader and deeper segment of the consumer market than they otherwise could. Third-party fintech providers win by creating an opportunity to offer products and services to consumers that they would not otherwise reach. Consumers win because they "get access to high-quality credit that they otherwise would not." And, these partnerships can allow "smaller and more rural banks to broaden the set of products and services they can offer to consumers and small businesses in their communities."[1]

The FDIC, in proposed examination guidance for third-party lending programs, echoes these sentiments: "Third-party lending arrangements may provide institutions with the ability to supplement, enhance, or expedite lending services for their customers. Engaging in third-party

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[1] CFSI Comment Letter on Proposed Guidance for Third-Party Lending (Oct. 27, 2016), https://cfsinnovation.org/research/cfsi-comment-letter-on-proposed-guidance-for-third-party-lending/.

lending arrangements may also enable institutions to lower costs of delivering credit products and to achieve strategic or profitability goals."[2]

Indeed, smaller banks might need the ability to partner with fintech providers to offer credit to consumers just to survive. According to an American Bankers Association "Fintech Playbook," by 2020, community banks could lose as much as $15 billion in revenue to fintech firms and other banks going digital, if they failed to keep up.[3] But, if these community banks are able to adopt financial technologies, they could stand to *gain* as much as $20 billion in revenue by 2020. The ABA projects roughly $100 billion in revenues for the community bank segment in total, so the $35 billion revenue swing resulting from failure to adopt financial technology is an enormous need.

Bank Partnerships Are Rigorously Supervised

Any loans issued by a bank – including those that benefit from the technology of a fintech partner – are subject to the same high-level of scrutiny and regulation that any other loan issued by the bank would be. This ensures borrowers are protected and supervision is appropriate, and enables consumers to choose to work with a federally-licensed lender, giving them greater confidence and security.

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[2] FDIC, Proposed Guidance: Examination Guidance for Third-Party Lending (July 29, 2016), https://www.fdic.gov/news/news/financial/2016/fil16050a.pdf.

[3] American Bankers Association (ABA), Fintech Playbook (Oct. 17, 2016), https://www.aba.com/Press/Documents/2016_FintechPlaybook_ES.pdf.

Although banks are not typically subject to state licensing, consumer protection, and rate-and-term requirements,[4] they are instead subject to a pervasive federal supervisory program, as well as the full battery of federal consumer protection regulations. The regulators have issued extensive guidance that impose substantial obligations on banks when they engage third parties. When a bank has not fully complied with the standards, the regulators have brought enforcement actions. Moreover, the regulators also may directly examine a third-party fintech firm with respect to its relationship with a bank.

In this context, recent FDIC supervisory guidance lays out an aggressive and robust regime for supervision of third-party lending arrangements with fintech providers, including 12-month examination cycles for institutions with significant third-party lending program relationships along with concurrent risk management and consumer protection examinations. In addition, the FDIC specifies that it will conduct targeted examinations of specific and significant third-party lending arrangements, including direct examination of a third party's corporate governance, financial strength, compliance management systems, credit underwriting administration, model risk management, vendor management, audit, information safeguarding, consumer complaints and litigation – not to mention transaction testing of individual loans to assess compliance with consumer protection regulations.

In this guidance, the FDIC repeatedly stated its expectation that an individual bank engaged in third-party lending activities is responsible for ensuring that its fintech partner is in compliance with all consumer protection and fair lending requirements "to the same extent as if

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[4] *See, e.g.*, 12 U.S.C. § 85; Beneficial Nat. Bank v. Anderson, 539 U.S. 1 (2003).

the activities were handled within the [bank] itself." The agency made clear that the bank must establish the credit underwriting and administration standards; that all loans, not just those held in portfolio, must be included in performance monitoring and sensitivity analyses; and that banks conducting significant third-party lending activities would be expected to maintain capital well above any regulatory minimums.

In addition to outsourcing marketing, origination or servicing functions to third-party fintech firms, banks may also rely on third parties for liquidity. More specifically, banks that grant credit in connection with partnerships with fintech providers will frequently hold the loan for only short periods of time before selling the whole loan or a participation to the fintech partner or another third party. The sale of all or part of a loan, however, is routine in all lending markets – auto, student, mortgage, credit card, etc. – and is a critical means of freeing up bank capital, providing banks the liquidity necessary to get back to the business of lending. Greater liquidity enhances the safety and soundness of banks and leads to broader availability of credit, which in turn drives economic growth.

Moreover, the sale of a loan does not relieve a bank of the risks and obligations associated with any lending program. As lender and regardless of any later transactions, the bank must comply with several consumer protection laws, including Truth in Lending, fair lending, credit reporting, unfair and deceptive practices, and privacy. In addition, the bank must have in place rigorous risk management policies and procedures that keep pace with the growth of a lending program and that protect the bank should a third party responsible for purchasing the loan production be unable to perform as agreed. Further, a bank continues to bear credit risk for loans sold if the bank is subject to repurchase requirements or otherwise guarantees the purchaser

against any risk of loss. The FDIC guidance explains these risks and the appropriate bank response in greater detail.

So, permitting banks to partner with fintech companies to offer credit products to consumers does not let the bank, or the fintech provider, off the hook. The federal banking agencies aggressively police and supervise these programs, and the banks themselves remain at risk in these transactions, even where the loan is sold.

Proposed Legislation Would Fix Uncertainty over Inconsistent "True Lender" Decisions

Despite the demonstrated consumer benefits and consumer protections associated with banks' third-party lending arrangements with fintech providers, a handful of courts have called these arrangements into question, holding that – even though the bank signed the loan agreement, the bank funded the loan, and the borrower promised to repay the bank – the bank may not be the "true lender," rather, the service provider could be the "true lender." These courts look past the explicit terms of the loan agreements, preferring instead to rely upon other facts and circumstances, such as who marketed the loan, who hosted the website, who designed the product, who developed the underwriting algorithm, who serviced the loan, who collected the loan, who bore the costs of the loan program, how long the bank held the loan, whether the bank sold the loan and on what terms, how profitable the program was for each party, and who has the subjectively determined "predominant economic interest" in the loan.

These cases are significant because, if the bank is the true lender, then it is subject to the federal bank regulatory framework. If the fintech firm is the true lender, however, then the fintech firm may be subject to different State licensing requirements and the loan itself may be

subject to State rate and term regulation, including limits on the interest rate that can be charged. In some states, this might even void the loan or make it uncollectible, meaning that the lender may not even be able to recover its principal, much less its costs and profit.[5]

In many of these "true lender" challenges, the loan in question was originated by a federally supervised bank, consistently with well-settled principles of federal law, and months or years after the fact, the justified expectations of the bank, the fintech firm, the loan purchasers and investors, and all of the other participants in the loan transaction are upset by a court that looks beyond the terms of the loan agreement and invalidates not only that single transaction, but potentially entire portfolios of loans. This after-the-fact overturning of parties' expectations introduces significant uncertainty and unpredictability into the lending market, which in turn can diminish market liquidity. Liquidity requires clear, predictable, and uniform rules for banks to follow in the origination and sale of loans, and liquidity is critical to a stable and robust lending market.

A handful of these "true lender" challenges have been brought in the last several years. Some courts have relied upon the loan agreement to hold that the bank is the true lender,[6] and

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[5] We note that the "true lender" argument is different than the "valid when made" issue raised by the *Madden v. Midland* case. *See Madden v. Midland Funding, LLC*, 786 F.3d 246 (2d Cir. 2015). In *Madden*, a loan originated by a bank was charged off and sold by the bank to a debt buyer. The debt buyer argued that because the loan was valid when it was made by the bank, any fees that could be charged by the bank also can be charged by the debt buyer. In a true lender challenge, however, it is the validity of the underlying loan that is under attack, the allegation being that the loan was originated by a nonbank in violation of State law. In other words, a defendant never gets to a "valid when made" challenge, unless it first survives the "true lender" challenge.

some have been willing to look beyond the loan agreement to entertain claims that the non-bank vendor has the "predominant economic interest" in the transaction and is the true lender.[7]

It is hard to determine what explains these varying outcomes, and that is of course the challenge for banks, fintech firms and investors. Without certainty, these market participants will no longer be willing to enter into these types of transactions, thereby depriving consumers, banks and the economy of the many benefits of bank partnerships with fintech providers while also hampering the liquidity necessary to support a robust lending market.

Legislation has been introduced that would reconfirm and reinforce existing federal law with respect to a bank's identity as the true lender of a loan originated by a bank with the assistance of a third-party service provider. Specifically, H.R. 4439 would resolve any uncertainty about a bank's ability to use third-party service providers by confirming the principle that when a bank enters into a loan agreement, it is the bank that has made the loan. A bank thus may export its location-state's interest rate on any loan to which the bank is a party. The

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[6] *See* Beechum v. Navient Solutions, Inc., 2016 WL 5340454 (C.D. Cal. Sept. 20, 2016); Sawyer v. Bill Me Later, Inc., 23 F. Supp. 3d 1359 (D. Utah 2014); Discover Bank v. Vaden, 489 F.3d 594 (4th Cir. 2007) *rev'd and remanded (on other grounds)*, 556 U.S. 49 (2009); Hudson v. ACE Cash Express, Inc., 2002 WL 1205060 (S.D. Ind. May 30, 2002); Krispin v. May Dept. Stores Co., 218 F.3d 919 (8th Cir. 2000); *cf.* SPGGC, LLC v. Ayotte, 488 F.3d 525, 534 (1st Cir. 2007).

[7] *See* Consumer Fin. Protection Bureau v. CashCall, Inc., 2016 WL 4820635 (C.D. Cal. Aug. 31, 2016); CashCall, Inc. v. Morrisey, No. 12-1274, 2014 WL 2404300 (W. Va. May 30, 2014) *cert. denied sub nom.* CashCall, Inc. v. Morrissey, 135 S. Ct. 2050 (2015); Bankwest, Inc. v. Baker, 324 F. Supp. 2d 1333 (N.D. Ga. 2004), *aff'd*, 411 F.3d 1289 (11th Cir. 2005), *en banc review granted*, 433 F.3d 1344 (11th Cir. 2005), *vacated for mootness*, 446 F.3d 1358 (11th Cir. 2008); People ex rel. Spitzer v. County Bank of Rehoboth Beach, 846 N.Y.S.2d 436 (2007); *cf.* Commonwealth of Pa. v. Think Finance, Inc., 2016 WL 183289 (E.D. Pa. Jan. 14, 2016); Ubaldi v. SLM Corp., 852 F. Supp. 2d 1190 (N.D. Cal. 2012).

proposed legislation also would effectively confirm that the full relationship between the bank and the online lender comes under the close scrutiny of the bank's federal regulator, including the extensive supervisory regime outlined above. We believe that by reinforcing existing federal banking laws, the proposed legislation would provide much-needed guidance to courts and help preserve the benefits of bank-fintech partnerships for consumers and the economy in general.

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Thank you again for the opportunity to testify before you today. I am happy to answer any questions.