STRUCTURED FINANCE ASSOCIATION

Valid-When-Made Doctrine

Overview

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Regulatory assistance from the OCC and FDIC is needed to ensure that loans originated by national banks can be sold or securitized without concerns about enforceability. Without this assistance credit markets will further unsettle, competition will decrease, the cost of consumer credit will increase and access to credit will decline.

“Valid-When-Made” Contractual Doctrine is a Bedrock Common Law Principle and Cornerstone of U.S. Banking Law for over 100 years

- Provides that a loan that is valid at inception cannot become invalid or unenforceable according to its original terms upon its subsequent transfer to another person, when applied to a lending arrangement
- Provides critical legal certainty, and is central in permitting healthy financial markets that are able to supply credit to individuals and small businesses

Second Circuit decision indirectly and dangerously undermined the “Valid-When-Made” legal doctrine

- Did not specifically analyze this deep-rooted legal principle in the case of *Madden v Midland Funding*
- However, the Court did indirectly and dangerously undermine the legal conclusion that a loan with an interest rate that complies with applicable state law at the time of its origination remains valid when it is sold, transferred, or assigned to a third party.

The Obama Administration’s Solicitor General and the Office of the Comptroller of the Currency (OCC) called the decision “incorrect” with analysis reflect[ing] a misunderstanding

- The Solicitor General’s brief further noted the Second Circuit’s failure to properly consider the “Valid-When-Made” doctrine and stated that “a loan that was valid when made will not be rendered usurious by the transfer.”
- The case is unusual in the breadth of legal experts (regulatory and industry) challenging the decision. Amicus briefs opposing the Madden decision were filed by SFA and SIFMA as well as the ICBA, ABA, CBA, and BPI.

If regulatory or legislative action does not clearly codify the “Valid-When-Made” doctrine, then the Second Circuit’s decision will continue to unsettle credit markets, increase costs, decrease competition, chill efforts to expand access, and impact products and lending models

- Could significantly disrupt secondary markets for consumer and commercial credit, impacting all stripes of financial services providers and other businesses that rely on the availability and post-sale validity of loans originated by national- or state-chartered depository institutions.

Indeed, the decision has had an immediate impact on credit markets, demonstrably impacting borrowers in the Second Circuit

- A Columbia-Stanford study shows that Second Circuit borrowers with credit scores under 625 have seen a 52% reduction in credit availability post-Madden. One of the researchers for the study, Robert Jackson, is now an SEC Commissioner.
- The decision has the potential to affect all types of securitized debt or whole loan sales and to impact access to credit and risk mitigation.
- Even though the FDIC and OCC have issued guidance recognizing third party lending arrangements (FIL-50), there is a lack of uniform interpretation of banking law across the country. And, while this decision only directly impacts the three states in the Second Circuit (NY, VT, CT), the lack of legal certainty has brought forward similar cases in other jurisdictions.

It also impacts the liquidity and valuation of bank assets

- Creates uncertainty for buyers of bank loans as to the value of these loans, thus impairing the ability of banks to sell, assign, or otherwise transfer their loans and manage their balance sheets. This is inconsistent with the safe and sound operation of these banks and may impair market liquidity.
- May affect a bank's ability to securitize loans and, as a result, banks may be forced to hold more loans in their portfolio. This restricts their ability to diversify certain risks, such as geographical and market sector concentrations.
- Calls into question the permissible interest rate on previously sold or securitized loans, transactions that historically relied on the valid-when-made doctrine

Madden decision has sparked follow-on lawsuits which broaden potential fallout to securitization

- In June 2019 two lawsuits were filed in New York against affiliated entities for two banks' credit card securitization programs alleging that the bank affiliates and securitization trusts purchasing the receivables from the national banks cannot collect interest at the rate permitted by the cardholder agreement.
- In 2017 the Administrator of the Colorado Uniform Consumer Credit Code (UCCC) sued Avant and Marlette, alleging that the loans originated by their respective partner banks, WebBank and Cross River Bank, to Colorado consumers carried interest rates above the maximum rate allowed by the UCCC. The Administrator later amended the complaints to name the securitization trusts and the two trustees, Wilmington Trust, N.A. and Wilmington Savings Fund Society, FSB, as co-defendants.

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