House Committee on Financial Services Hearing: *Oversight of Prudential Regulators: Ensuring the Safety, Soundness, Diversity, and Accountability of Depository Institutions?*

December 4, 2019

Valid-When-Made Doctrine and the Madden Decision

Perhaps the most contentious topic in the hearing was on the FDIC's recent proposed regulation in response to the Madden case. FDIC Chairman Jelena McWilliams pointed out numerous times that the valid-when-made doctrine is a long-standing ("nearly 200 years") doctrine stating that a loan made by a bank with an interest rate that is valid when made under applicable federal law (that allows for charging the maximum rate permissible in the state in which it originates) remains valid even if the loan is subsequently sold or assigned to a third party. According to Chair McWilliams, the recent *Madden v. Midland* decision questioned this doctrine, with the OCC and FDIC both making statements that the decision undermines the safety and soundness of the financial system, with the FDIC having recently issued a proposed rulemaking that reiterated their position on the validity of the doctrine. This proved to be a contentious issue, with many members from both sides of the aisle bringing it up in their questions. Reps. William Lacy Clay (D-MO, 1), Rashida Tlaib (D-MI, 13), and Katie Porter (D-CA, 45) all brought up this new rulemaking, with Reps. Tlaib and Porter specifically asking about it in relation to "rent-a-bank schemes" in which banks seek to evade usury laws at the state level. At every turn, Chair McWilliams stressed that this rulemaking is meant to clarify FDIC's position, reassert the existing common law doctrine that Madden ignored, and that the "rent-a-bank schemes" member brought up were subject to a second doctrine (the "true lender" doctrine) that their rulemaking did not address. She went on to further stress multiple times that this doctrine ensures there is a healthy secondary market for these loans and that states have an opportunity to opt out of the ability for out-of-state entities to provide interest rates that are prohibited in that state, a power granted to them by Congress. When asked about this issue by Rep. Barry Loudermilk (R-GA, 11), who had concerns about the fragmented and unclear interpretation since the ruling, she reiterated this yet again. *See below for exchanges.*

Repo Markets

Republican members expressed concerns about the recent volatility in the repo market and the Fed's intervention. Ranking Member Patrick McHenry (R-NC, 10) suggested that regulatory and supervisory issues may have contributed to the shortage of cash in the repo markets. Vice Chair Quarles noted that there were a complex set of factors that contributed to the problem. However, he noted that internal liquidity stress tests may have inadvertently created a preference for central bank reserves over other liquid assets. Rep. French Hill (R-AR, 2) also asked about the economic incentive to have a rising repo rate and Rep. Warren Davidson (R-OH, 8) was concerned that the Fed's actions could introduce moral hazard.

LIBOR Transition

Vice Chair Quarles' testimony stated, "we also understand the need to ensure a smooth transition away from LIBOR, and other legacy benchmark rates, so institutions can manage risks comprehensively and effectively." Ranking Member McHenry referenced LIBOR in his opening statement and was especially concerned about the volatility in the repo markets and the consequences if SOFR is adopted as the new reference rate. Following up on his comments regarding the repo market, Rep. McHenry expressed concerns that deficiencies in the repo market could be exacerbated with the new SOFR standard. Rep. Anthony Gonzalez (R-OH, 16) also discussed SOFR, specifically asking whether the Fed would support extending LIBOR beyond 2021. Vice Chair Quarles said that the issue in extending Fed support of LIBOR beyond 2020 for existing contracts isn't regulator prohibition, but the possibility that the rate may no longer be calculated at all, as many of the banks involved in doing so have signaled they will be exiting the regime. Regarding the procyclical nature of SOFR, Rep. Gonzalez asked if the Fed was exploring the creation of credit sensitive overlays to SOFR. Quarles responded that it is something the Fed should be examining. *See below for exchanges.*

Corporate Debt

Rep. Bill Foster (D-IL, 11) asked about the unprecedented level of corporate debt, noting an IMF study that it was the weakest firms that accounted for most of the corporate debt growth and are using debt for financial risk taking. He also noted the problems with the issuer pay model for bond ratings. Vice Chair Quarles noted that corporate debt has been growing, but the debt service burden has not been growing and the structures in which riskier debts are held in CLOs and leveraged lending that have longer terms of maturity than those held within the institution. Therefore, he sees less of a financial stability risk, but there could be loss of value in the assets which could be exacerbated in the long-term. Vice Chair Quarles also clarified that the Fed does not solely rely on bond ratings to evaluate expected losses. Chair McWilliams noted that part of the problem with looking at corporate debt and leveraged lending is that there is no clear definition of leveraged loans.

Valid-When-Made Doctrine Exchanges

Chairman Lacy Clay (D-MO, 1)

- Rep. Clay: In 2015 the second circuit held in *Madden v. Midland* that non-bank debt collectors that had purchased debt originated by a national bank could not benefit from the bank's exportation power. The OCC stated that the proposal was intended to address confusion resulting from the Madden decision. Consumer groups and legal experts have raised serious concerns that the proposal will encourage predatory rent a bank schemes that are designed to evade state usury caps. Chair McWilliams what are the FDICs intentions with this proposed regulation? Is it intended in any way to override the Second Circuit decision in the Madden case?

- Chair McWilliams: In fact, it is meant to clarify the confusion that has been caused by the Madden decision. Since 1828 there has been Supreme Court precedent that if a loan is not usurious at the time when the loan is made nothing subsequently makes that loan usurious. Long standing court precedent and in 1865 Congress, this body, gave national banks the ability to adopt those principles. In 1980 Congress gave the FDIC the ability to approve the same principles for state chartered banks and everything was going fine we have had an existing guidance in place for over twenty years on this issue until the second circuit court of appeals in Madden decided to ignore the long standing procedural and case precedent and regulatory precedent in this area. And we would not have had to act at all frankly if it were not for the decision in Madden. Once the decision in Madden was what it is, we felt there was a necessity to re-uphold the long-standing principles we have had and to reissue our statement that has been in existence for over twenty years.

- Rep. Clay: Ok, so would your proposed regulation it effectively rent out these banks chartered to third parties hoping to evade state usury limits?

- Chair McWilliams: No, in fact the FDIC, and we have stated this explicitly as well as implicitly, we look unfavorably upon such arrangements and in the cases where there are such arrangements we will take supervisory action that is appropriate if any state or federal laws are being violated.

- Rep. Clay: So, you will supervise the third party then and make sure there is not an overcharging?

- Chair McWilliams: We have a couple of different statutory authorities that allow us to supervise third parties that do business with banks or end up affiliating with banks in any form.

Rep. Bill Huizenga (R-MI, 2)

- Rep. Huizenga: And how does the Madden decision factor into small dollar loans (referencing low income borrower's access to credit)?

- Chair McWilliams: The Madden decision frankly disrupts over a century long precedent that we have had that allows; Congress made it legal to allow banks to originate loans. Basically, what the Madden decision disrupted was the ability of a bank to sell the loan and the ability of the purchaser to assume the interest rate under which that loan was sold. And frankly the disruption in the secondary market which affects safety and soundness.

Rep. Barry Loudermilk (R-GA, 11)

- Rep. Loudermilk: Since the Madden court decision in 2015, it's really created a fragmented interpretation of banking laws and regulations. Valid-When-Made has been in place for a century and brought stability. Ranking Member McHenry and I sent a letter to you that was signed by all the Republicans on this committee, to you and Comptroller Otting in September asking for you to provide clarity on the issue that will help keep credit access available and affordable. Some have made the argument that this rulemaking will allow non-bank lenders to evade state laws. Can you explain how that is not the case?

- Chair McWilliams: It is not the case and I have to correct you; it was an 1820's court case so it's more than a century, almost two. The only thing we did in our rulemaking frankly is take the guidance we have had based on the laws Congress gave us in the 1980 to ensure there clarity especially in the secondary market which we view as important for banks to maintain safe and sound standards as they look to sell the loans. That's all we did.

- Rep. Loudermilk: What your saying is that this rulemaking does not allow for non-bank lenders to evade existing state laws?

- Chair McWilliams: That is correct. The issue the Congresswoman from Michigan (Rep. Talib) mentioned is something we did not touch (true lender). The only thing we said is that we will look unfavorably and consider it unfavorably in our supervisory approach if banks engage in the practices that basically are deemed as predatory.

- Rep. Loudermilk: I appreciate that. It's something that needs to be done.

LIBOR Transition Exchanges

Ranking Member Patrick McHenry (R-NC, 10)

- Ranking Member McHenry: I expressed my concerns in May about the transition from LIBOR to SOFR, six months later I'm still concerned consumers will be impacted by this transition. The repo market intervention is just one example of why that is of concern and should be of concern to average, every day, investors. As you know, LIBOR is the underlying bank reference rate for approximately 200 trillion in financial contracts worldwide and is set to be phased out as a bank reference rate at the end of 2021, or by 2021, and replaced with SOFR. Given the volatility in the repo markets, I am concerned about the consequences that volatility will have on mortgages, auto loans, business loans and other consumer loans as a new reference rate if that's driving overnight financing. Transferring LIBOR-based legacy contracts to SOFR will also require financial institutions to renegotiate with consumers, customers and expose banks to litigation risk.

- Ranking Member McHenry followed-up on LIBOR in his questioning.

- Ranking Member McHenry: Want to pivot to the conversion from LIBOR to SOFR and this change, the repo market issues in September highlight the deficiencies of this new SOFR standard. You commented publicly Mr. Quarles on some challenges related to that and I think it would be important for Congress to hear back on the financial stability challenges and the intention of the Federal Reserve to ensure that this new rate does not cause greater stress on the financial system or unnecessarily create financial instability. And so, I would encourage that undertaking by the Fed but also, I know it affects the FDIC and NCUA as well.

Rep. Anthony Gonzalez (R-OH, 16)

- Rep. Gonzalez: With the SOFR transition that is coming, does the Fed support extension of LIBOR beyond 2021 for existing contracts?

- Vice Chairman Quarles: The issue is, and there has been some confusion about it, it's not a question of the regulators prohibiting LIBOR beyond 2021 for existing contracts, but the risk that it simply won't be available because they banks that participate in the production of LIBOR have indicated they will be unwilling to participate.

- Rep. Gonzalez: If it's available would you support it?

- Vice Chairman Quarles: We'd have to consider what that meant. How many banks had dropped out how arbitrary was it given the remaining production process? In connection with your connection, the issue of how we handle the legacy contracts is a big one and we are wrestling with an efficient way to do that, that would ideally not require the renegotiating of millions of products.

- Rep. Gonzalez: Also hear that SOFR could be procyclical given the nature of SOFR itself. Do you believe in the creation of credit sensitive overlays to SOFR or to an alternative rate with credit spreads?

- Vice Chairman Quarles: I think that's a question we ought to examine more than we have. I don't have a view of whether that's something that ought to be there. I do think it requires more examination.

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