Report

# Can fintech increase lending? How courts are undermining financial inclusion

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**Editor's Note:**

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How much should a thing cost? This simple question is a politically vexing one, whether the cost is for housing, energy, or health care. It is also at the center of one of the most difficult and intriguing questions in finance: how much should lenders charge borrowers for credit, especially if those borrowers are economically disadvantaged? Economists have their view, activists have theirs. But at the heart of these debates about justice and economics is the law. This essay focuses on that intractable reality: what does the law require of those who try to price credit, especially when the targeted customers are society's least well off?

## How much should credit cost?

To understand how law structures this important question, we need to understand first the stakes of the debate about the pricing of credit. To answer the normative question—how much should credit cost?—most economists would demur: so long as there is robust competition in markets with low barriers to entry, individuals and institutions will set prices through the marketplace as sellers seek to recover costs and earn profits and buyers decide whether those prices are worth it to them. If some borrowers pay more, it is because their risk profile has changed the likelihood of repayment such that the price must be higher to compensate the risks taken by the lender. The prices aren't exploitative; they will simply cover the costs of the business in question (plus some unstable premium that reflects the ongoing tumult of the market process).

Others see the question differently, especially when we pivot from the concept of pricing credit generally to pricing credit for those who are at the greatest socioeconomic disadvantage. Some argue that the differential pricing for small-dollar loans are necessarily exploitative, push people toward a permanent financial underclass, and spread political and social ills throughout the communities where high-price credit is the norm. Especially when compared to the identical product available to the wealthy—money is fungible, after all—the differentiated pricing for rich and poor in the credit markets such that the poor pay exorbitant rates while the rich pay next to nothing—or sometimes are paid for the privilege of  borrowing—undermines the basic fabric of society.

We won't resolve this debate any time soon, but it is an essential one to have. The pricing of credit to those at the bottom of the socioeconomic distribution has deep roots in a poisonous part of American history, where private institutions and the government itself used credit (mis)allocation as an active tool for racial discrimination. It is therefore vital to continue the debate about whether credit is priced fairly and whether the economic realities the poor face require some policy intervention other than what has already been done.

Here is where law enters the picture. Part of this debate about credit allocation and pricing must be to understand how law is already structured to create or prevent innovation, fraud, inclusion, socioeconomic stratification, and a host of other features and bugs of our current financial system. This kind of analysis isn't as viscerally interesting as making policy recommendations, but we must understand how courts, legislatures, and administrative agencies interact with each other to see where these policy proposals will be of most lasting impact.

## Enter the Second Circuit: *Madden v. Midland Funding*

In 2015, the U.S. Court of Appeals for the Second Circuit issued a blockbuster—and incorrect—ruling, *Madden v. Midland Funding LLC*, that gets to the heart of these credit questions. Secular and religious thinkers have debated this basic question for millennia. In the 21st century, federal and state law still answer the question differently. Banks created under federal law can "export" the price of credit from their "home" state wherever they do business, even if the state where the borrower receives the money requires a different price for the same loan. This ability for national banks is one they treasure and states resent, but it's settled legally. (The original Supreme Court opinion that reached this conclusion for national banks sponsoring credit cards was written by William Brennan, the liberal lion of the Warren Court, for a unanimous Supreme Court; the whole journey of national banks using state law to accomplish their goals has a fascinating history, as told by historian Sean Vanatta.)

The question that the *Madden* court confronted was what happens when a national bank with the ability to charge a single uniform price for its loan sells that debt to another institution that doesn't have a national banking charter? Do the price controls imposed by other states then apply?

The Second Court concluded that it did. And this answer may at first seem obviously correct. National banks have special protections under law, but the defendants in *Madden* were not national banks. Why, then, would the law give these protections to institutions that did not do the heavy lifting required of a national charter?

This understanding of banking law is facile and is exactly what the court got wrong.

The *Madden* court reached the conclusion but without much relevant explanation: so long as the defendants weren't agents of national banks (or national banks themselves), then the national law does not apply. Or, as the Court concluded with its awkward syntax, those institutions "acted solely on their own behalves, as owners of the debt."

But the statutory framework Congress created for our dual-banking system—or, the system of both national and state charters—involves more than this simple understanding. This is true for one primary reason (engaged by the Court) and one secondary reason (ignored by the Court but at the center of subsequent debates).

First, and most significantly, the Court correctly concluded that state laws do not have force against national banks when those laws "significantly interfere with a national bank's ability to exercise its power" under federal law. This doctrine of law is called "preemption." It's controversial in its policy implications, but it's not a controversial statement of the law.

Selling loans has been part of the “business of banking”—the business protected by federal law—since before the passage of the National Banking Act. The *Madden* decision changes this business substantially. Now, the business of selling loans is impaired because of the uncertainty and variability that had not existed prior to the Court’s decision.

That question—whether upending the secondary market for loans is a “substantial impairment” of a national bank’s business—is the relevant question for the *Madden* court. And it is the question that the Court ignored.

There’s a second, less important reason, that has more to do with legal history than economic ramifications. And that is the idea, as the Supreme Court put it in 1833, that “a contract, which, in its inception, is unaffected by usury, can never be invalidated by any subsequent usurious transaction.” This is the so-called “valid-when-made” doctrine that the parties in subsequent litigation focus on as the defining question.

The national banks are probably correct that assumptions about usury and the validity of contracts points in their favor, but both sides in this debate exaggerate the clarity of the legal question. The reality is that the 19th century doesn’t offer a lot that is relevant to the way the 20th and 21st century courts and Congress have defined preemption.

Instead, *Madden* is wrong for a much simpler reason: making loans is not the only “business of banking” that national banks can do with protection against contrary state law. Selling loans counts too. And while national banks can still sell their loans to other national banks, and can sell them for very different prices to other entities, they can no longer sell them at face value to the market. That inability represents a “substantial impairment” to the business of banking, the contrary conclusion in *Madden* notwithstanding.

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## The legal errors of the *Madden* Court lead to real economic consequences.

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## The Potential for Fintech and Credit Pricing

The legal errors of the *Madden* Court lead to real economic consequences. The economic consequences of Madden, for those who live in the jurisdiction of the Second Circuit (New York, Vermont and Connecticut) and are already under its effect and for the broader economy, are not good for the cause of financial inclusion. Some of the most important innovations in finance are aimed at making credit intermediation fairer and more efficient. *Madden* stands in the way.

This is true for two reasons. First is in the process of securitization, or the pooling of loans into a bucket and then selling claims to other investors on the payments borrowers make to that bucket. Securitization is far from a panacea to any financial problem that society faces at large, but the basic technology of securitization has substantially lowered costs for borrowers for decades. This may or may not be good for global financial stability, but it is very good for the individual borrower who no longer has to pay quite as dearly for the privilege of borrowing.

The *Madden* rule stands in the way of taking loans made by national banks and upends the business model of selling claims to those loans to other parties through securitization. If adopted nationally, the *Madden* rule would essentially mean that only national banks could participate and expect the same kind of price certainty that securitizers have long experienced in a national market. The average citizen may not feel that much sympathy for investors in those loan pools, but the average citizen is the one who will have to pay more when those investors leave the field.

Second, fintech is also helpful in permitting new specializations to grow within the financial system such that not everyone must go to the banking juggernauts—national banks like Wells Fargo or JP Morgan Chase—for every financial service. And incumbents are not always the best—or even usually—at the cutting edge of innovation.

*Madden* cuts that specialization process off at the knees by reducing firms' abilities to originate and distribute loans without the balance sheet of a large financial institution, including the ability to accept the regulatory and supervisory burdens of national banks. The business model pursued by many smaller banks in this space build out a lending base so that others institutions—think the Lending Clubs of the world—can provide the capital needed to make those loans so that they can be sold to others. With the interest rate uncertainty that *Madden* creates, these smaller institutions with smaller balance sheets will not be able to stay in that market. Individuals with capital needs will have to look for the largest financial institutions to meet them, something that these largest banks have not shown much historical appetite to do.

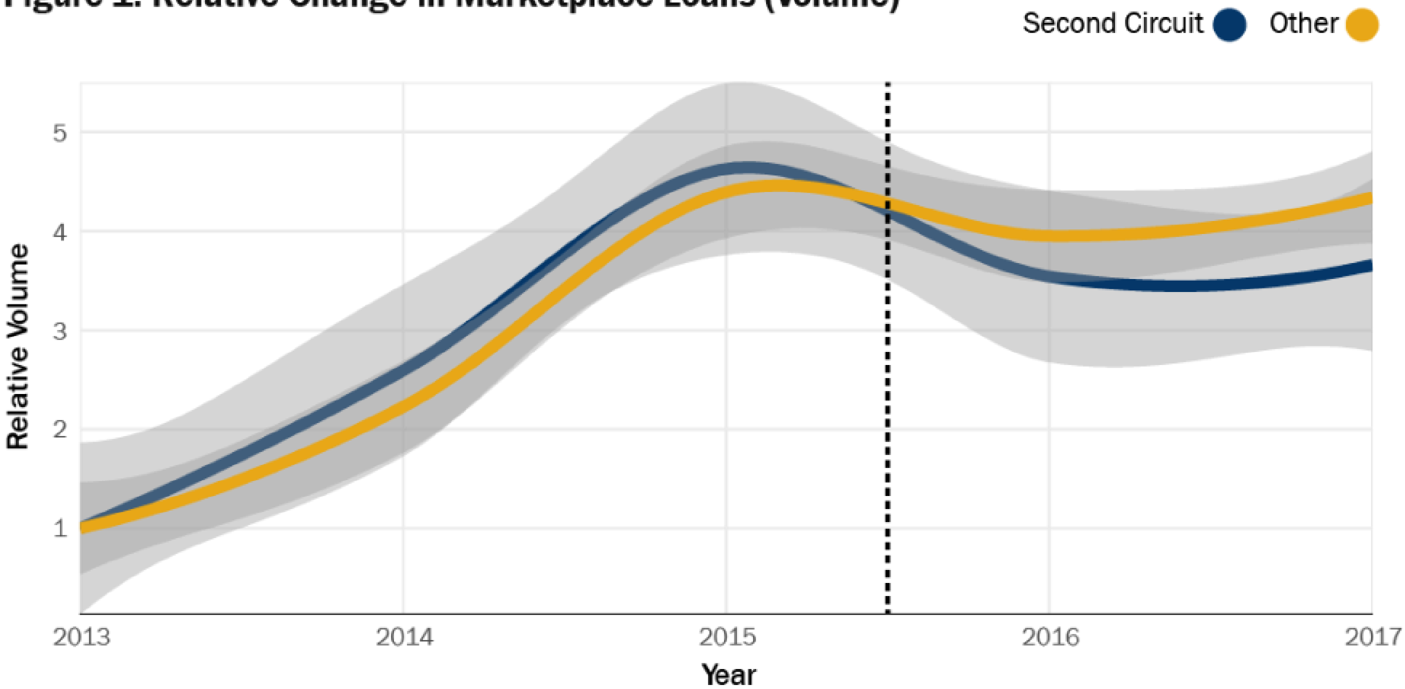
To put the point bluntly: those who want to see more diversity in business models to support the least well off in our financial system should wince at the way that *Madden* puts megabanks at the center of borrowing and lending.

## The Practical Consequences of Madden

The discussion above is not hypothetical. The economic consequences of *Madden* suggest we should take these concerns about credit availability very seriously. In a 2017 paper, legal scholars Colleen Honigsberg, Robert Jackson (now a commissioner at the SEC), and Richard Squire analyzed the consequences of the decision and concluded that the "decision reduced credit availability for higher-risk borrowers" in the states affected by the Court's decision.

These findings are consistent with a more recent paper by economists Piotr Danisewicz and Ilaf Elard reached similar conclusions in other areas, including on the availability of loans by volume and number. Danisewicz and Elard also analyze the consequences for personal bankruptcy for those borrowers who can no longer get access to this credit. With help from Andrew Baker, a PhD student at Stanford, I recreate Danisewicz and Elard's data below as Figures 1 and 2:

**Figure 1: Relative Change in Marketplace Loans (Volume)**




**Note:** I thank Danisewicz and Elard for sharing their raw data, which I display differently to (1) mark the date of the Madden decision with the vertical black line and (2) to display the relative rather than absolute changes in the number and volume of loans.

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As we see in Figure 1, the states not affected by *Madden* have had a different experience in terms of credit availability, by loans and volume. The results shouldn't be exaggerated, but there is little doubt that *Madden* has made finding credit much, much harder for some people who are least able to access credit.

## Conclusion

My colleague at the University of Pennsylvania, Lisa Servon, has written a fascinating and important book on the experience of financial exclusion in the United States, *The Unbanking of America: How the New Middle Class Survives*. In it, Servon describes a sabbatical year spent working in payday lending and check cashing businesses and interviewing people in the industry and its critics. In one illuminating conversation, an activist describes what he regards as the problem with financial products for the poor. "Imagine that you've been thrown out of a boat and you can't swim well", he said:

There's a float very near you and another one, farther away, that's tied to the boat. The easiest thing would be to grab on to the closest float, but that might take you farther and farther away from the boat, where you need to be. The smarter thing to do would be to get yourself over to that float that's attached to the boat.

Servon pushed back on the analogy (the more expensive loans are those not tethered to the boat). "I get that," Servon replied. "But what is the attached float in this story? What is the better choice for the payday borrower?"

"They need to save up," the activist said. "Or borrow from friends and family."

In other words, they need to not be poor.

The reality of poverty and banking in America is enduring, more deeply rooted than Professor Servon's interlocutor seems to understand. We can and should have a debate about the best way to provide credit intermediation to those for whom that necessary prospect is necessarily a risky one. Maybe the answer is more government subsidies for credit, or even government banking institutions writ large. But we should not hope for courts to cut off access to that credit by misinterpreting the law that Congress has written. Wherever this generation's solution lies to these perennial problems, we can do better than that.

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