NATIONAL CONSUMER LAW CENTER®

1001 Connecticut Ave., NW, Suite 510
Washington, DC 20036
202-452-6252
www.consumerlaw.org

PREEMPTION AND REGULATORY REFORM:

RESTORE THE STATES' TRADITIONAL ROLE AS "FIRST RESPONDER"

A National Consumer Law Center White Paper

September 2009

Contact:

Lauren K. Saunders
Managing Attorney

LSaunders@nclcdc.org
(202) 452-6252 x 105

TABLE OF CONTENTS

EXECUTIVE SUMMARY

Consumer protection in the financial world has been dramatically weakened in the last several years by preemption of state consumer protection laws. Broad preemption of state law is a recent phenomenon; for most of the 150 years since national banks were created, they have complied with state law. Preemption has harmed states' ability to respond to financial abuses in both the banking and the nonbank world. Restoring the states' role as "first responders" is an essential element of regulatory reform.

For most of this nation's history, consumers have depended on states, not the federal government, to protect them**.** Even in the banking world, national banks were expected to comply with state law. Only in the last decade or so have federally-chartered depositories been able to ignore state laws with impunity.

- From 1864 to 1978, state laws were preempted *only* if they prevented or significantly interfered with national banks' exercise of their powers, or the law favored state banks over national banks.

- From 1978 to 1995, preemption of state laws governing interest rates began and laws covering certain mortgage terms were preempted for any lender, including nonbanks.

- From 1996 to the present, national banks have been able to ignore wide swaths of consumer protection laws.

The preemption of state consumer protection laws has harmed consumers. In area after area, abuses have followed preemption.

- *Mortgages.* The preemption of state laws in the mortgage area is a significant cause of the current crisis. In 2006, the peak year of irresponsible lending, national banks, federal thrifts, and their subsidiaries made 32% of subprime loans, 40% of Alt A loans, and 51% of interest-only and option ARM loans. A total of over $700 billion in risky loans were made by entities that states could not touch. States were also preempted from regulating *any* mortgage lender on the very terms that made many mortgages dangerous: balloon payments, negative amortization, variable rates, and other nontraditional terms.

- *Credit cards.* The abuses that eventually led to a federal crackdown – bait and switch rate increases, abusive fees, payment manipulations – were allowed to take off and grow due to preemption.

- *Overdraft fees.* Federal regulators preempted state laws while watching programs designed to induce overdraft fees grow into a $27 billion tax on the very consumers who need those funds the most.

- *Exploding debt, a climate of deception and high rate predatory lending.* The explosion of unaffordable debt that has destroyed many families and the growth of destructive forms of predatory lending have their seeds in preemption and the race to the bottom that preemption triggered.

States are our nation's first responders when new threats target consumers. Restoring their vital role in protecting consumers is a critical piece of regulatory reform.

- Only states provide comprehensive consumer protection. Flexible state laws are critical when gaps in protection or new abuses emerge.

- States see abuses sooner, react more quickly, and can address local problems before they become national ones. States have the tools and the incentives to enforce their laws and can augment federal resources.

- State laws provide the models for federal law. They are an essential element of our constitutional system of federalism.

- Exempting some entities from state laws leads to an uneven playing field and inconsistencies that are easily exploited.

- Preemption allows banks to cherry-pick those parts of state laws they need and ignore consumer protections in other parts of those same laws.

- Preemption undermines our dual banking system.

Contrary to the claims of bank lobbyists, restoring the role of states to protect individuals from banking and mortgage abuses will not impede nationwide commerce.

- When new problems arise, states approaches tend to converge. The uniform law movement and other national organizations promote uniform and model state laws. The uniform mortgage broker licensing laws that 49 states adopted in the past year are a case in point.

- Other nationwide corporations comply with state laws, and banks do in many areas. Banks tailor their products to many niche markets and can adapt to state variations. Minor differences do not prevent banks from marketing a standard product.

- Congress can adopt uniform national rules in particular areas, but state consumer protections should not be cleaved off with a meat-ax wholesale.

The uniformity achieved by preemption comes at a heavy price. States act when there is a problem. We have a choice: we can have uniformly weak protection, or vibrant consumer protection that uses the strengths of our system of federalism.

I. NATIONAL BANKS HAVE HISTORICALLY BEEN SUBJECT TO STATE CONSUMER PROTECTION LAWS[1]

For most of their 150 year history, national banks have been expected to comply with state consumer protection laws. Only in the last decade or so have national banks, as well as federal thrifts and federal credit unions, been able to ignore state law.

A. The Banking System

Federal law creates three different types of federally chartered depository institutions. National banks are chartered under the National Bank Act (NBA) and are supervised by the Office of the Comptroller of the Currency (OCC). Federal savings associations, or "thrifts," are chartered under the Home Owners Loan Act (HOLA) and are supervised by the Office of Thrift Supervision (OTS). Federal credit unions are chartered under the Federal Credit Union Act (FCUA) and are supervised by the National Credit Union Administration (NCUA).

Preemption of state laws applicable to national banks and federal thrifts and credit unions stems from these three federal banking statutes–the NBA, HOLA, and FCUA–and the regulations under them promulgated by the OCC, OTS, and NCUA, respectively. In addition, other federal statutes preempt state laws on some specific issues and give state chartered institutions parity with nationally chartered depositories in some areas.

B. Preemption, States and the Constitution

The preemption doctrine arises from the Supremacy Clause of the United States Constitution. If the provisions of a state law are "inconsistent with an act of Congress, they are void, as far as that inconsistency extends."[2] Federal regulations have the same preemptive force as federal statutes,[3] as long as the regulation is within the scope of the agency's authority to promulgate.

There are three general categories of preemption: (1) *express preemption* (a federal statute explicitly overrides state law); (2) *conflict preemption* (the state legislation is inconsistent or conflicts with federal law); and (3) *field preemption* (a federal law "occupies the field" and ousts all state laws in that area, even those that are consistent with federal law).[4] Express preemption occurs when Congress states directly that state law is preempted. Conflict preemption is implicit and arises from court interpretations of federal law. Field preemption is usually implicit but can be express.

---

[1] The term "banks" in this paper will at times be used to refer to banks, thrifts, and credit unions. For a comprehensive discussion of the preemption of state consumer protection laws, see National Consumer Law Center, The Cost of Credit: Regulation, Preemption, and Industry Abuses Ch. 3 (4th ed. 2009).
[2] Gibbons v. Ogden, 22 U.S. (9 Wheat.) 1, 31 (1824).
[3] Capital Cities Cable v. Crisp, 467 U.S. 691, 699 (1984); Fidelity Fed. Sav. & Loan Ass'n v. De la Cuesta, 458 U.S. 141, 153–154 (1982).
[4] *See* Lorillard Tobacco Company v. Reilly, 533 U.S. 525, 541 (2001).

Under the Constitution, the federal government is a government of limited powers, restricted to those set out in the Constitution. The states, however, are governments of general powers and the Constitution carefully preserves to the states all powers that have not been specifically taken away.[5]

The system of federalism created by our Constitution has led the Supreme Court to employ a presumption against preemption of state laws:

> [B]ecause the States are independent sovereigns in our federal system, we have long presumed that Congress does not cavalierly pre-empt state-law causes of action. In all pre-emption cases, and particularly in those in which Congress has "legislated ... in a field which the States have traditionally occupied," we "start with the assumption that the historic police powers of the States were not to be superseded by the Federal Act unless that was the clear and manifest purpose of Congress."[6]

As discussed below, consumer protection is an aspect of the states' police power–the power to protect individuals—a traditional area of state activity.

C. 1864 to 1978: Limited Preemption of Laws That Significantly Interfere with National Banks

The National Bank Act (NBA) was passed in 1864 to create a system of national banks, in large part to fund the Civil War. At a time when state and federal authorities were engaged in bloody combat, the NBA protected national banks from state efforts to destroy them or to give state banks a competitive advantage. Consequently, the NBA gave national banks the right to charge interest at the higher of two rates: the rate charged by state banks or an alternative federal rate.[7]

In 1864, all states had usury laws and there was no interstate banking. The alternative usury caps in the NBA—the state cap or the federal one–provide alternative *limits* on national banks, not a means to preempt state usury laws. The NBA prohibits usurious interest and imposes double damages on banks that charge more than the higher of the two permitted rates.[8]

For over 100 years, until the recent wave of preemptive activity in the latter part of the twentieth century, state laws governing contracts, property rights and transfers, consumer protection, and other laws applied to the activities of national banks.[9] The

---

[5] U.S. Const. amend. X.
[6] Medtronic, Inc. v. Lohr, 518 U.S. 470, 485 (1996) (citations omitted); *accord* Reid v. Colorado, 187 U. S. 137 (1902).
[7] 12 U.S.C. § 85.
[8] 12 U.S.C. § 86. As of August 2009, the alternative federal rate is less than 2%.
[9] *See generally* Arthur E. Wilmarth, Jr., *The OCC's Preemption Rules Exceed the Agency's Authority and Present a Serious Threat to the Dual Banking System*, 23 ANN. REV. BANKING & FIN. L. 225 (2004) ("OCC Threat").

NBA has no preemption provision other than the alternative usury cap. Like every federal law, the NBA implicitly preempts state laws that conflict with it. But any such conflict preemption is a narrow exception to the general rule that national banks were expected to follow state laws. As one of the earliest Supreme Court decisions explained:

> [National banks] are subject to the laws of the State, and are governed in their daily course of business far more by the laws of the State than of the nation. All their contracts are governed and construed by State laws. Their acquisition and transfer of property, their right to collect their debts, and their liability to be sued for debts, are all based on State law. *It is only when the State law incapacitates the banks from discharging their duties to the government that it becomes unconstitutional*.[10]

For most of our nation's history, national banks have rarely been permitted to ignore state law. State laws were preempted only if they prevented or significantly interfered with national banks' exercise of their powers, or the law favored state banks over national banks. For example, in 1954 the Supreme Court held that national banks did not have to comply with a New York law that prohibited any banks other than New York's own chartered savings banks and savings and loan associations from using the word "savings" in their name.[11] In other cases, the Supreme Court repeatedly affirmed that "national banks are subject to state laws, unless those laws infringe the national banking laws or impose an undue burden on the performance of the banks' functions."[12]

The Home Owners Loan Act of 1933 and the Federal Credit Union Act of 1934 were interpreted similarly to the NBA in the early decades, preempting only state laws that conflicted with a specific federal law or significantly interfered with federal thrift or credit union operations.[13]

---

[10] National Bank v. Commonwealth, 76 U.S. (9 Wall.) 353, 362 (1869) (holding that state taxes on bank stock are not preempted) (emphasis added).
[11] Franklin Nat'l Bank of Franklin Square v. People, 347 U.S. 373 (1954).
[12] Anderson Nat'l Bank v. Luckett, 321 U.S. 233, 248 (1944); *accord* Lewis v. Fid. & Deposit Co., 292 U.S. 559, 564–66 (1934); First Nat'l Bank in St. Louis v. Missouri, 263 U.S. 640, 656–59 (1924); McClellan v. Chipman, 164 U.S. 347, 356–59 (1896); Davis v. Elmira Sav. Bank, 161 U.S. 275, 287 (1896) (affirming that "so far as not repugnant to acts of Congress, the contracts and dealings of national banks are left subject to the state law"); First Nat'l Bank of San Jose v. California, 262 U.S. 366, 368–69 (1923) (recognizing that "[the] contracts and dealings [of national banks] are subject to the operation of general and undiscriminating state laws which do not conflict with the letter or the general object and purposes of congressional legislation"); *see generally*. Wilmarth, OCC Threat, Jr., *supra*, 23 ANN. REV. BANKING & FIN. L. 225 (2004).
[13] *See generally* National Consumer Law Center, The Cost of Credit: Regulation, Preemption, and Industry Abuses §§ 3.5, 3.6 (4th ed. 2009).

D. 1978 to 1996: Preemption of State Laws on Interest Rates and Certain Mortgage Terms

Preemption of state consumer protection laws began with interest rate preemption in 1978 in the context of credit cards. In *Marquette National Bank v. First of Omaha Service Corp.*,[14] the Supreme Court interpreted the National Bank Act to hold that the applicable state interest rate cap governing lending by national banks was the interest rate law of the bank's home state, even for loans made to consumers in other states. This decision meant that a national bank could "export" its own home state laws governing interest rates, even when the state where the consumer lived and the loan was made was different.

The decision had the effect of wiping out the usury laws applicable to credit cards[15] that protected consumers of the other forty nine states. Not surprisingly, the decision provided national banks a powerful tool to convince states to either mimic the unlimited interest rates allowed by their sister states or risk losing the jobs and revenue sustained by a bank's headquarters. Banks had the upper hand: if they convinced the legislators of just one state to allow sky high interest rates on credit cards, they now had the power—by threatening to move their operations out of state—to force most other states to similarly deregulate. That is in fact what happened: national banks with credit card operations either moved to states with no interest rate caps, or convinced their home state to deregulate.

Meanwhile, the double-digit inflation of the late 1970s was making it difficult for mortgage lenders to make loans while complying with state caps on mortgage interest. In 1980 Congress attempted to calm the inflation fires in the mortgage market by passing the Depository Institution Deregulation and Monetary Control Act (DIDA).[16] DIDA completely removed state interest rate caps for most lenders, not just national banks, issuing loans secured by first mortgages on homes.[17] DIDA also preempted state limitations on a lender's ability to assess "points," finance charges, or "other charges."[18]

DIDA also gave all federally chartered or federally insured depository lenders—not just national banks—the right to export their home-state interest rates when lending to consumers in other states.

Congress went even further in 1982, in a law that opened up mortgage lending to abuses beyond high interest rates. The Alternative Mortgage Transaction Parity Act

[14] 439 U.S. 299 (1978).
[15] Though the immediate impact of the *Marquette* decision was in the credit card world, as national banks began offering other products across state lines, it eventually had the impact of eliminating state interest rate caps in those areas.
[16] Pub. L. No. 96-221, 94 Stat. 161 (1980), codified throughout Title 12 of the U.S. Code.
[17] States were allowed to opt out for a limited time but only 15 states did so and some only opted out of some aspects of DIDA's preemption.
[18] States had the ability to "opt out" of the preemption so long as it was accomplished within three years of enactment. Only 13 states acted in time.

(AMTPA)[19] removed states' abilities to limit terms on "alternative" mortgages. Specifically, AMPTA preempted state laws governing:

- Variable rate loans (even those that only go up, and never go down and exploding adjustable rates);[20]
- Balloon payments;[21]
- Negative amortization and other types of "rate, method of determining return, term, repayment, or other variation not common to traditional fixed-rate, fixed-term transactions."[22]

In 1996, the OTS issued a regulation interpreting AMPTA to preempt prepayment penalties, but when the resulting abuses became clear, it rescinded the regulation effective in 2003.[23]

AMPTA also included a section that preempted state restrictions on due-on-sale clauses in mortgages.[24]

Aside from the specific issues of interest rate preemption and certain mortgage terms, the general rule in effect from 1978 to 1996 continued to be that national banks were covered by state laws except in those rare instances of conflict with federal law. For example, in 1996, the Supreme Court held in *Barnett Bank v. Nelson* that a state law prohibiting national banks from acting as insurance agents conflicted with a federal law specifically granting them that power.[25]

However, the Court made clear that state laws generally apply to national banks unless they significantly interfere with the bank's powers:

> In defining the pre-emptive scope of statutes and regulations granting a power to national banks, these cases take the view that normally Congress would not want States to forbid, or to impair significantly, the exercise of a power that Congress explicitly granted. *To say this is not to deprive States of the power to regulate national banks, where (unlike here) doing so does not prevent or significantly interfere with the national bank's exercise of its powers*.[26]

---

[19] 12 U.S.C. § 3801.
[20] 12 U.S.C. § 3802(1)(a).
[21] 12 U.S.C. § 3802(1)(b).
[22] 12 U.S.C. § 3802(1)(c).
[23] 12 C.F.R. § 560.34, *rescinded by* 67 Fed. Reg. 60,542 (Sept. 26, 2002). *See also* National Home Equity Mortgage Association v. Office of Thrift Supervision, 271 F. Supp. 2d 264 (D.D.C. 2003).
[24] 12 U.S.C. § 1701j-3. That section of AMTPA is known as the Garn-St. Germain Depository Institutions Act.
[25] 517 U.S. 25 (1996).
[26] *Id.* at 31 (emphasis added).

Congress expressly approved the *Barnett* standard in 1999 when it enacted the Gramm-Leach-Bliley Act.[27]

Similarly, in 1994, when Congress authorized interstate banking in the Riegle-Neal Act, it added this provision to the National Bank Act:

> *The laws of the host State regarding community reinvestment, consumer protection, fair lending, and establishment of intrastate branches shall apply to any branch in the host State of an out-of-State national bank to the same extent as such State laws apply to a branch of a bank chartered by that State*, except—
>
> (i) when Federal law preempts the application of such State laws to a national bank; or
>
> (ii) when the Comptroller of the Currency determines that the application of such State laws would have a discriminatory effect on the branch in comparison with the effect the application of such State laws would have with respect to branches of a bank chartered by the host State.[28]

Thus, the status of preemption for national banks (as well as federal thrifts and credit unions) in early 1996 was:

- Interest rate caps for credit cards and first mortgages were preempted, and the combination of exportation and deregulation was eroding rate caps in other areas;
- States were preempted from regulating certain mortgage terms regardless who the lender was;
- Otherwise, state laws were not preempted unless they significantly interfered with the bank's exercise of its powers.

E. 1996 to Present: National Banks and Thrifts Enjoy Increasing Preemption of Consumer Protection Laws

In 1996, the OCC issued a regulation expanding interest-rate exportation to include preemption of state laws covering a long list of fees.[29] The regulation was passed in response to a suit by a California consumer challenging the credit card late fees charged by Citibank (a South Dakota bank). OTS took the same position.[30]

In 1996, in *Smiley v. Citibank (South Dakota)*, the Supreme Court upheld the OCC regulation. Without deciding whether the fees violated California law, the Court

[27] 15 U.S.C. § 6701(d)(2)(A).
[28] 12 U.S.C. § 36(f) (emphasis added).
[29] 12 C.F.R. § 7.4001.
[30] 12 C.F.R. § 560.110(a).

held that state law challenges to the fees of national banks are preempted as long as the fees are legal in the bank's home state.[31] Not surprisingly, states like South Dakota and Delaware, where many national banks are located, allow any fees specified in the agreement with the consumer, regardless whether they are unconscionable or unfair.

In the fall of 1996, after the *Smiley* decision came out, the OTS finalized a sweeping preemption regulation. The rule asserts that "with certain narrow exceptions, *any* state laws that purport to affect the lending operations of federal savings associations are preempted."[32]

To avoid losing their regulated banks to other, more permissive oversight, the other banking agencies embarked on similar efforts. From 2000 to 2004, the OCC worked with increasing aggressiveness to prevent the states from enforcing state consumer protection standards against national banks. For example, the OCC openly instructed banks that they "should contact the OCC in situations where a State official seeks to assert supervisory authority or enforcement jurisdiction over the bank,"[33] and warned states that national banks need not comply with state laws.[34]

The OCC's efforts culminated in 2004, when the agency adopted a regulation preempting all state laws unless their effect on national bank powers was "only incidental."[35] The regulation allows national banks to ignore state laws regarding licensing, terms of credit, disclosure and advertising, solicitations, billing, and other topics.

Both the OCC and OTS also asserted that the subsidiaries of national banks and federal thrifts—though they are creatures of state law, are not banks, and do not have a federal charter—can ignore state law to the same extent that their parents can.[36]

Though somewhat less aggressive than the OTS and OCC, the National Credit Union Administration has also enacted regulations preempting state laws as applied to federal credit unions.[37] However, the NCUA regulation does not extend preemption to subsidiaries.

---

[31] Smiley v. Citibank (South Dakota), 517 U.S. 735 (1996), and state-chartered credit unions, 46 Fed. Reg. 24,153 (Apr. 30, 1981). Federal credit unions have a federal usury cap of 18%, but state laws regulating interest rates and fees are otherwise preempted. *See* 12 U.S.C. § 1785(g).

[32] 61 Fed. Reg. 50,951 (Sept. 30, 1996) (enacting 12 C.F.R. § 560.2(a)); *see also* 12 C.F.R. § 557.11 (preempting state laws regulating deposits).

[33.] Office of the Comptroller of the Currency, Interpretive Letter No. 957 n.2 (Jan. 27, 2003) (citing OCC Advisory Letter 2002-9 (Nov. 25, 2002)) (viewed June 19, 2009, at http://www.occ.treas.gov/interp/mar03/int957.doc , and available at 2003 OCC Ltr. LEXIS 11).

[34] *See, e.g.*, Office of the Comptroller of the Currency, Preemption Determination and Order, 68 Fed. Reg. 46,264, 46,264 (Aug. 5, 2003).

[35] 12 C.F.R. §§ 7.4007(c), 7.4008(e), 7.4009(c)(2).

[36] 12 C.F.R. § 7.4006 (OCC); *id.* § 559.3(h), (n) (OTS).

[37] The Federal Credit Union Act (FCUA) and NCUA regulations and opinion letters preempt state consumer protections in a wide number of areas, including state anti-predatory lending laws, and laws related to closing costs, balloon payments, prepayment limits, conditions on the type or amount of security for a loan, changes of terms in open-end credit, grace periods, and minimum payment disclosure

In 2007, the Supreme Court upheld the OCC regulation, including the rule preventing the states from imposing their inspection and registration requirements on non-bank subsidiaries doing business in their states.[38]

The effect of these regulations is that federal banks, thrifts, and credit unions can simply ignore wide swaths of state law—even much of the state law of their home state.

F. State-Chartered Banks Receive Less Preemption

The preemption rights of state-chartered institutions are more complex. Like their federal cousins, they enjoy preemption of state laws governing interest rates, fees, and certain mortgage terms. But beyond those specific terms, the scope of preemption is not as broad, though it varies state to state and issue to issue, and is more a creature of state parity laws than federal preemption.[39]

Another aspect of preemption that exacerbates the discrepancy between the playing fields for federally and state chartered institutions is that of enforcement. The ability of the states to enforce *any* laws—including non-preempted state laws and federal laws—against national banks, thrifts, or credit unions, or their subsidiaries, is severely restricted. States can file judicial actions to enforce non-preempted state laws, but they cannot seek information from the bank to investigate the issue first.[40] Though federal agencies in theory can enforce state law, they virtually never do. In contrast, state enforcement of state laws is generally vigorous against state-chartered institutions—which might be one reason these state institutions do not cause as much trouble.

II. THE PREEMPTION OF STATE CONSUMER PROTECTION LAWS HAS HARMED CONSUMERS

For consumers, the upshot of all these efforts to preempt state law has been the predictable failure of consumer protection. Consumer protections eliminated on the state level were never replaced with federal protections.[41] Though stronger consumer protection laws are definitely needed at the federal level, restoring states' ability to protect consumers is a critical part of regulatory reform. Preemption has played a role in every major consumer protection failure in recent years.

---

requirements relating to credit card plans. *See generally* National Consumer Law Center, The Cost of Credit: Regulation, Preemption, and Industry Abuses § 3.6 (4th ed. 2009).

[38] Watters v. Wachovia Bank, N.A., 127 S. Ct. 1559 (2007).

[39] *See generally* National Consumer Law Center, The Cost of Credit: Regulation, Preemption, and Industry Abuses §§ 3.7.3, 3.7.4 (4th ed. 2009).

[40] *See* Cuomo v. Clearing House Association, 129 S. Ct. 2710 (2009).

[41] *See, e.g.,* Adam J. Levitin, *Hydraulic Regulation: Regulating Credit Markets Upstream*, 26 YALE J. ON REG. 143 (2009).

Mortgages. The preemption of state laws in the mortgage area is a significant cause of the current crisis. Many of the irresponsible loans that led to the foreclosure crisis were made by entities that could ignore state law.

Mortgage lending by national banks, federal thrifts, and their operating subsidiaries made up 31.5% – nearly a third – of the most dangerous, subprime loans during the peak year of 2006. Subprime loans typically were made with no documentation of income, without regard to ability to repay, and with a host of other problems such as exploding rates, failure to include escrow in affordability analysis, and inflated appraisals. Not surprisingly, they have failed in large numbers.

Table 1: Subprime Loans By National Banks and Federal Thrifts 2006
(includes operating subsidiaries)

LENDER	**RANK**	**$ (BILLIONS)**	*MARKET SHARE*
CitiMortgage, NY*	4	$38	6.3%
WMC Mortgage (GE), CA	5	33	5.5%
Wells Fargo Home Mort., IA	9	28	4.6%
First Franklin (National City Bank), CA	10	28	4.6%
Washington Mutual, WA	11	27	4.4%
BNC Mortgage, CA (Lehman Bros. Bank)	16	15	2.4%
Chase Home Finance, NJ	17	12	1.9%
Equifirst, NC (Regions Bank)	18	11	1.8%
TOTAL		$190	31.5%

Source: Inside Mortgage Finance
*CitiMortgage became an operating subsidiary of CitiBank in October 2006. Its volume of subprime originations rose in the 4th quarter, and its market share increased to 10%.

In the Alt A market, the percentage of loans made by banks or their operating subsidiaries was higher: 40.1% in 2006, as reflected in Chart 2. Alt A loans were made to borrowers who did not qualify for a prime loan though they may have had very good credit. Like subprime loans, Alt A loans were often obtained with little documentation, weak underwriting and risky features and have turned out to have high foreclosure rates.

Table 2: Alt A Loans By National Banks and Federal Thrifts 2006

(includes operating subsidiaries)

LENDER	RANK	$ (BILLIONS)	*MARKET SHARE*
IndyMac, CA	1	$70	17.5%
Washington Mutual, WA	5	25	6.1%
WMC Mortgage Corp. (GE), CA	8	18	4.4%
SunTrust Mortgage, VA	11	10	2.5%
Chase Home Finance, NJ	12	9	2.4%
National City Mortgage Co., OH	13	9	2.2%
CitiMortgage, MO*	14	8	2.1%
ABN AMRO Mortgage Group, MI (LaSalle Bank)	22	4	1.1%
Wells Fargo Home Mortgage, IA	24	4	1.0%
Flagstar Bank, MI	25	3	0.8%
TOTAL		$161	40.1%

Source: Inside Mortgage Finance

*CitiMortgage became an operating subsidiary of CitiBank in October 2006. Its volume of Alt A originations doubled in 2007 and its market share increased to 6%.

Bank domination was heaviest in the nontraditional interest-only and payment-option adjustable rate mortgage (ARM) markets: they held 51% of the total market in 2006, as shown in Chart 3. Typically made to prime borrowers, these loans also had features that put homeownership at risk. Interest-only loans had initial payments that did not include principal, making them appear affordable. Payments later increased once principal repayment began. Payment option ARMs had a fixed initial minimum payment but not a fixed rate. As rates rose, lenders who made the minimum payment experienced negative amortization and quickly owed more than their house was worth. Though the borrowers were prime, the loans were toxic.[42]

[42] *See, e.g.*, Allen J. Fishbein & Patrick Woodall, Consumer Federation of America, Exotic or Toxic? An Examination of the Non-Traditional Mortgage Market for Consumers and Lenders (May 2006), *available at* http://www.consumerfed.org/pdfs/Exotic_Toxic_Mortgage_Report0506.pdf; Testimony of Margot Saunders, Counsel, National Consumer Law Center, on Mortgage Lending Reform: A Comprehensive Review of the Current Mortgage System, Subcommittee on Financial Institutions and Consumer Credit, House Financial Services Committee, at 7-10 (Mar. 11, 2009), *available at* http://www.consumerlaw.org/issues/predatory_mortgage/content/MortgageLendingReform0309.pdf (describing dangers of payment-option adjustable rate mortgages).

Table 3: National Bank and Federal Thrift Payment Option & Option ARM Lenders 2006
(includes operating subsidiaries)

LENDER	RANK	$ (BILLIONS)	*MARKET SHARE*
Wells Fargo Home Mortgage, IA	2	$94	17.7%
Washington Mutual, WA	3	68	8.8%
IndyMac, CA	4	54	7.0%
Golden West Financial, CA (World Savings/Wachovia)	7	31	4.0%
CitiMortgage, MO*	10	28	3.6%
Bank of America Mtg. & Aff., NC	11	24	3.1%
SunTrust Mortgage, VA	12	21	2.7%
Chase Home Finance, NJ	14	14	1.7%
National City Mortgage, OH	16	11	1.4%
First Franklin Financial, CA (National City Bank)	20	8	1.0%
TOTAL		$352	51.0%

Source: Inside Mortgage Finance
*CitiMortgage became an operating subsidiary of CitiBank in Oct. 2006. Its volume of PO/option ARM lending increased 20% in 2007 and its market share increased to 5.4%.

Overall, in 2006, national banks, federal thrifts, and their operating subsidiaries were responsible for over $700 billion of the riskiest loans. States could do little to touch these loans because of federal preemption.

Even for mortgage lenders who were technically still within the states' regulatory purview, states' ability to regulate many terms was also limited by preemption. Thus the stage was set for the wild, wild west of mortgages. Each element of a mortgage transaction that has been immune from state law has led directly to abuses:

- *Interest rates.* Preemption of interest rate caps led to a fringe market of high-cost predatory mortgages.

- *Point and fees.* The ability of lenders to charge high up-front fees and recoup them immediately by simply adding to the homeowner's loan fed the flames of equity stripping abuses.[43]

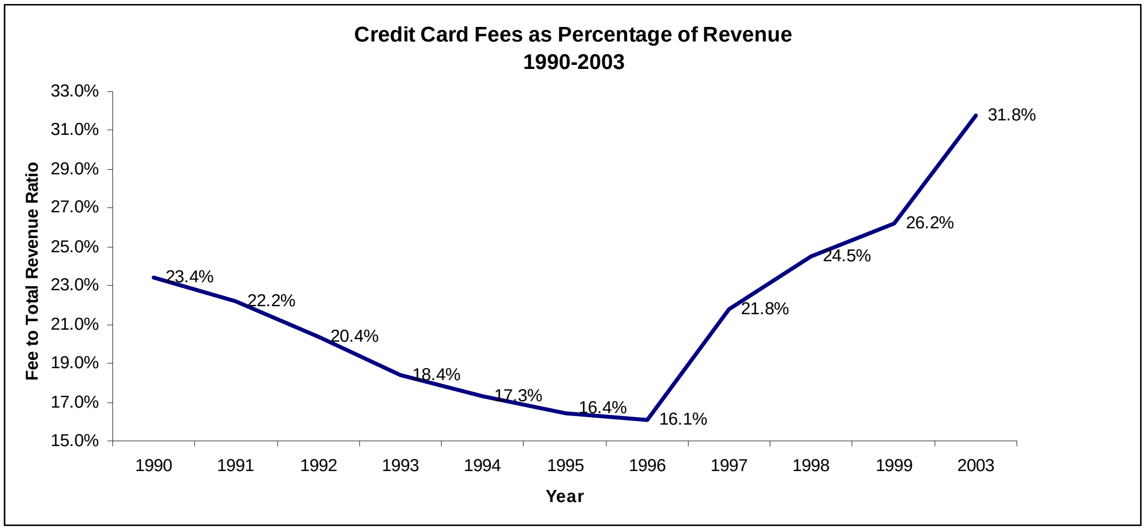
- *Balloon payments.* The use of balloon payments also forced homeowners into repeated home-equity stripping refinancings, as a new loan is generally the only way to pay off a large balloon payment due at the end of the loan term.

---

[43] *See* National Consumer Law Center *et al.*, Comments Regarding the Advance Notice of Proposed Rulemaking, OTS Docket Number RIN 2550-AB37, 12 C.F.R. Part 560, No. 2000-34 (July 5, 2000), *available at* http://www.consumerlaw.org/issues/predatory_mortgage/NCLC_CFA_comments.shtml.

- *Negative amortization and variable rates.* Equity that shrinks rather than grows, and low teaser rates that explode to unaffordable levels, are prime elements of the toxic mortgages that took down the financial system.

Credit cards. The preemption of state laws governing bank fees in 1996 also had pernicious effects. Credit card companies immediately began using tactics to increase their fee revenue:[44]



The broader preemption of state consumer protection laws allowed a variety of other unfair and deceptive credit card practices to take off unchecked. States had no power to address bait-and-switch rate increases, tricks to induce late payments and over-limit purchases, or payment allocation manipulations.[45] These abuses went on for years until the Federal Reserve, under the gun of losing its regulatory authority, and Congress, under a storm of public outrage, finally reined them in.

Overdraft fees. Overdraft fee abuses began shortly after the OCC and the OTS began expanding preemption. In the late 1990s, bank consultants started promoting services to banks and credit unions that would *encourage* consumers to overdraw their accounts. For example, one website promised that banks could increase non-sufficient

---

[44] Source: Mark Furletti, Payment Cards Center, The Federal Reserve Bank of Philadelphia, Credit Card Pricing Developments and Their Disclosure, at 32 (Jan. 2003) (citing October 1999 and July 2000 issues of CardTrack, CardWeb.com as the source), *available at* http://www.philadelphiafed.org/payment-cards-center/publications/discussion-papers/2003/CreditCardPricing_012003.pdf. Mr. Furletti updated the information through 2003 at the request of the Center for Responsible Lending. (E-mail from Mark Furletti, March 5, 2003, on file with CRL.)

[45] *See* Plunkett Reg. Restructuring Testimony, *supra*, at 11-12; Testimony of Arthur E. Wilmarth, Jr., Professor of Law, George Washington University Law School, *Before The Subcommittee on Financial Institutions and Consumer Credit of the Committee on Financial Services, U.S. House of Representatives Hearing on "Credit Card Practices: Current Consumer And Regulatory Issues*, at 7-13 (Apr. 26, 2007) ("Wilmarth Credit Card Testimony"), *available at* http://financialservices.house.gov/hearing110/htwilmarth042607.pdf.

funds fee income by "100%, 200%, 300% or more!"[46] Federal bank regulators did little to stop abuses[47] – even intervening in consumer protection lawsuits to argue, successfully, that state laws protecting consumers against overdraft abuses were preempted.[48]

The deep recession caused by the foreclosure crisis has helped banks in one respect. Consumers now lose $27 billion to overdraft fees annually.[49] These fees come from consumers who most need every penny. Indeed, much overdraft income comes from Social Security and other exempt income needed for basic sustenance.[50]

Exploding debt and increasing high rate predatory lending. The preemption of state usury laws through exportation led to a deregulatory race to the bottom as banks competed to retain their banking industries. The result was an explosion of credit card debt,[51] the consequences of which are now apparent.

A culture of deception. The limited ability of states to address rate and fee abuses also fed the ever-present culture of deception in the credit marketplace. Substantive state consumer protections have been eliminated in favor of weak federal disclosures, and the true cost of various forms of credit—credit cards,[52] overdraft loans,[53] mortgages[54]—is frequently obscured, made up of hidden fees and interest rate hikes.[55]

---

[46] *See* NCLC & CFA, Bounce Protection: How Banks Turn Rubber Into Gold By Enticing Consumers To Write Bad Checks: An Examination of Bounce Protection Plans at 6 n. 33(January 2003), available at http://www.nclc.org/issues/bounce_loans/appendix.shtml.

[47] *See* Testimony of Lauren Saunders, National Consumer Law Center, Before the Subcommittee on Monetary Policy, Committee on Financial Services, U.S. House of Representatives, Hearing on Regulatory Restructuring: Safeguarding Consumer Protection and the Role of the Federal Reserve at 16-19 (July 16, 2009) ("Saunders Reg. Restructuring Testimony"), available at http://www.nclc.org/issues/legislative/content/Testimony7-16-09.pdf; Testimony of Travis Plunkett, Consumer Federation of America, and Edmund Mierzwinski, U.S. PIRG, Before the Committee on Financial Services, U.S. House of Representatives, Hearing on Regulatory Restructuring: Enhancing Consumer Financial Products Regulation at 12-14 (June 24, 2009) ("Plunkett Reg. Restructuring Testimony"), available at http://www.house.gov/apps/list/hearing/financialsvcs_dem/mierzwinski_-_submitted_with_plunkett.pdf.

[48] *See Lopez v. Washington Mut. Bank, FA*, 302 F.3d 900 (9th Cir. 2002) (finding California's laws imposing restrictions on overdraft fees to protect Social Security and Supplemental Security Income benefits preempted).

[49] Ron Lieber And Andrew Martin, "Overspending on Debit Cards Is a Boon for Banks," New York Times (Sept. 8, 2009).

[50] Center for Responsible Lending, Quick Facts on Overdraft Loans, *available at* http://www.responsiblelending.org/overdraft-loans/research-analysis/quick-facts-on-overdraft-loans.html.

[51] *See* Mercatante, *The Deregulation of Usury Ceilings, Rise of Easy Credit, and Increasing Consumer Debt*, 53 S.D. L. Rev. 37 (2008). The amount of revolving debt, most of which is credit card debt, is approaching $1 trillion. *See* Federal Reserve, Statistical Release G-19, Consumer Credit, *available at* http://www.federalreserve.gov/releases/g19.

[52] Comments of the National Consumer Law Center et al. Regarding Advance Notice of Proposed Rulemaking Review of the Open-End (Revolving) Credit Rules of Regulation Z (Oct. 12, 2007), *available at* http://www.consumerlaw.org/issues/credit_cards/content/open_end_final.pdf (describing in detail the way fees have been used to undermine the usefulness of the APR disclosure).

[53] *See, e.g.*, Testimony of Eric Halperin, Center for Responsible Lending, *Before the U.S. House Committee on Financial Services, Subcommittee on Financial Institutions and Consumer Credit on Overdraft Protection: Fair Practices for Consumers* (July 11, 2007) *available at*

III. STATES ARE OUR NATION'S FIRST RESPONDERS AND PLAY A VITAL ROLE IN A FULL CONSUMER PROTECTION REGIME

A. Only States Provide Flexible, Comprehensive Consumer Protection That Can Attack New Abuses

States, not the federal government, have historically been the source of consumer protection. Consumer protection is an aspect of the states' broad "police power"—the power of the states, preserved under the Constitution, to regulate behaviors and enforce order in order to protect public welfare, security, health, and safety.[56] The federal government, by contrast, is a government of limited, enumerated powers under the Constitution. Though the power of the federal government has grown in the last century, the protection of individuals remains, in the first instance, a state responsibility.

States have a comprehensive network of laws to protect their citizens. This web of protection in the states is comprised of several levels: first, the traditional Anglo-Saxon common law, including the rules governing contracts, property rights, and commercial transactions, and those prohibiting fraud and unconscionability; second, universally applicable statutory laws such as those against unfair and deceptive acts and practices; and third, specific laws enacted in response to particular problems, such as those governing mortgage lending.

On occasion, Congress has passed limited and specific protections. However, there is no comprehensive network of federal law that protects consumers. There is no federal common law providing a broad set of rules governing contracts, property transfers, or commercial transactions.[57]

Also, federal law provides consumers with neither the broad nor the specific protections in state law governing contractual relations, requiring good faith and fair dealing, or prohibiting unjust enrichment, fraud and deceit, negligent misrepresentation, or unfair or deceptive acts and practices. Though the federal banking agencies have authority to stop banks from engaging in unfair or deceptive conduct, they have rarely done so,[58] and individuals have no direct recourse under federal law against unfair or deceptive practices.[59]

---

http://www.responsiblelending.org/overdraft-loans/policy-legislation/congress/testimony-of-eric-halperin-7-11-07.pdf.

[54] HUD Final RESPA Rule, National Consumer Law Center's Summary Analysis (Dec. 5, 2008), *available at* http://www.consumerlaw.org/issues/predatory_mortgage/content/RESPAruleanalysis120508.pdf.

[55] *See* Elizabeth Renuart and Diane E. Thompson, *The Truth, The Whole Truth, and Nothing but the Truth: Fulfilling the Promise of Truth in Lending*, 25 Yale J. on Reg. 181 (Summer 2008).

[56] *See* "Police Power," Wikipedia, http://en.wikipedia.org/wiki/Police_power; Encyclopedia Britannica, http://www.britannica.com/eb/article-9060615/police-power.

[57] Erie Railroad Co. v. Tompkins, 304 U.S. 64 (1938).

[58] *See* Julie L. Williams & Michael L. Bylsma, *On the Same Page: Federal Banking Agency Enforcement of the FTC Act to Address Unfair and Deceptive Practices by Banks*, 58 Bus. Law. 1243, 1244, 1246, n.25,

Federal law has always been an overlay rather than a replacement for state law. The federal government has never set out to enact a comprehensive scheme to take over from the states the frontline role in protecting consumers. The federal Truth in Lending Act (TILA), while providing important standardized disclosures about the cost of credit, was not intended to replace the substantive protections provided by state law. The Supreme Court "has long recognized that federal law has a 'generally interstitial character,' in the sense that Congress generally enacts legislation against the background of existing state law."[60]

President Obama recognized the importance of state law in our federal system in one of his first executive orders:

> From our Nation's founding, the American constitutional order has been a Federal system, ensuring a strong role for both the national Government and the States. The Federal Government's role in promoting the general welfare and guarding individual liberties is critical, but State law and national law often operate concurrently to provide independent safeguards for the public. Throughout our history, State and local governments have frequently protected health, safety, and the environment more aggressively than has the national Government.[61]

After the recent mortgage debacle, it should be clear that the state laws protecting consumers are the last bastion of redress when federal protections fail. State laws on fraud, unfair trade practices, unconscionability, foreclosure defenses, good faith and fair dealing, conspiracy, joint venture, as well as other torts and contract defenses, have been the primary way many individual homes have been saved from foreclosure.[62] The rich and textured common law in the states has been particularly useful to the courts as they

---

1253 (2003); Julie L. Williams & Michael L. Bylsma, *On the Same Page: Federal Banking Agency Enforcement of the FTC Act to Address Unfair and Deceptive Practices by Banks*, 58 Bus. Law. 1243, 1244, 1246, n.25, 1253 (May 2003) ("An obvious question is why it took the federal banking agencies more than twenty-five years to reach consensus on their authority to enforce the [ban on unfair and deceptive practices under the] FTC Act").

[59] The Federal Trade Commission Act bans unfair and deceptive practices, but it is not enforceable by individuals. 15 U..S.C. § 45.

[60] Watters v. Wachovia Bank, N.A., 550 U.S. 1, 23–24 (2007) (Stevens, J., dissenting); Three Affiliated Tribes of Fort Berthold Reservation v. Wold Engineering, 476 U.S. 877, 895 (1986) (The Supreme Court "has long recognized that federal law has a 'generally interstitial character,' in the sense that Congress generally enacts legislation against the background of existing state law." (quoting *Richards v. United States*, 369 U.S. 1, 7 (1962)); Shell Oil Co. v. Iowa Dep't of Revenue, 488 U.S. 19, 27 (1988) ("Congress recognized, however, that because of its interstitial nature, federal law would not provide a sufficiently detailed legal framework to govern life on [oil drilling platforms].").

[61] Memorandum for the Heads of Executive Departments and Agencies; Subject: Preemption (May 20, 2009).

[62] *See* Testimony of Margot Saunders, Counsel, National Consumer Law Center, *"HR 1728: Mortgage Reform and Anti-Predatory Lending Act," Before House Financial Services Committee* (Apr. 23, 2009), *available at* http://www.consumerlaw.org/issues/predatory_mortgage/content/Testimony-HR-1728-042309.pdf.

craft appropriate responses to the new and complex set of problems that have arisen in recent years.

B. States See Abuses Sooner, React More Quickly, and Provide the Experiments for Federal Law

States governments, with fewer residents commanding their attention, are closer to consumers. Individuals are much more likely to complain to state and local government agencies than they are to federal ones. States see credit market abuses when they first arise, before they become an essential part of an industry's profit model.

When specific problems have arisen that are not adequately addressed by more general laws, whether in the consumer area or any other area, states have traditionally been the ones to respond. States generally act much more quickly than do federal lawmakers. Understandably, Congress and federal agencies are more deliberate before adopting rules that will apply to the entire nation. But even when national attention is clearly needed, Washington is often slow to act.

Several years into the subprime mortgage crisis, Congress has yet to adopt laws to address toxic mortgages. The rules adopted belatedly in 2008 by the Federal Reserve—years after given the authority in 1994—were too little and too late. Neither Congress nor the banking agencies have adopted any rules addressing abuses in the prime market. In the meantime, though states have been severely hampered by preemption in their ability to adopt mortgage protections, they have made efforts to use what authority they have. Several states, including Illinois, New Jersey, New Mexico, New York, North Carolina, and Ohio, have passed predatory mortgage lending laws.

Similarly, California was the first state to address foreclosure rescue scams in 1979 as a result of a unique problem facing that state with its exceptionally robust and rising real estate prices. Other states found no need to respond until 2004 when the scams began spreading.[63] From 2004 to 2009, over half of the states adopted laws to address foreclosure rescue scams. In 2009, Congress gave the Federal Trade Commission authority to address the scams. The FTC is now considering such a rule, following the models and experience under the state laws. But in the meantime, it is the states that are providing protection to consumers.

States also act more quickly to enforce laws when a financial institution violates them. In the past decade there have been major multistate enforcement actions taken against Household, Ameriquest, and Countrywide. State regulators took more than 7,000 mortgage enforcement actions in 2008 alone.[64] Federal bank regulators, by contrast, have

---

[63] While the housing market was still strong, many of the scams were aimed at equity stripping. After the foreclosure crisis hit, foreclosure consultant scams (extracting a fee in exchange for a false promise of help) came to predominate.

[64] *See* Mark Pearce, *Viewpoint: Far From Blame, States Deserve Vital Reg Role*, American Banker (Aug. 26, 2009). (The author, Mark Pearce, is North Carolina's deputy commissioner of banks and the president of the American Association of Residential Mortgage Regulators.)

been more reluctant to take aggressive action against predatory mortgage lending abuses.[65]

Thus, preserving the role of states is essential to protecting consumers from local abuses that have not commanded national attention and may not receive a federal response. Allowing states to act as new problems first develop also has the potential to stop them before they become a widespread, national problem.

On many other occasions, states have been prescient in addressing problems first, developing models eventually copied in federal legislation.[66] Even in the financial area, in which states' efforts have been heavily preempted, states have led the way on multiple issues:

- Congress adopted protections against identity theft only after several states did so. Congress omitted the right to a security freeze but most states gave consumers that right, and eventually the credit bureaus adopted the freeze nationwide.

- The "Schumer" box now required for all credit card applications followed California's rule that consumers be provided a chart showing the interest rate, grace period, and annual fee.

- States led the way in stopping long holds on deposited checks, which Congress followed with the Expedited Funds Availability Act.[67]

In these and many other areas, Congress benefitted from having solutions tried out on the state level first.

C. Exempting Some Entities Results in Unequal Treatment, Gaps in Protections and Manipulations to Exploit Those Gaps

A clear lesson of the financial crisis is that protections should apply consistently across the board, based on the product or service that is being offered, not on who is offering it. Disparities in the treatment of different institutions lead to a race to the bottom and anomalies that get exploited.

Preemption of laws for one segment of the market creates a disincentive for states to regulate other actors. One reason states were reluctant to use their limited authority to regulate nonbank lenders was the sense that it would be fruitless. As state law could not affect a significant segment of creditors, states may have perceived that the effect of

---

[65] *See* Brief of *Amici Curiae* Center for Responsible Lending *et al.*, Clearing House Association, L.L.C. v. OCC, No. 08-453 (Mar. 4, 2009); Saunders Reg. Restructuring Testimony, *supra*, at 5–12.

[66] *See* Plunkett Reg. Restructuring Testimony, *supra*, at 36–39 (discussing Clean Air Act, national organic labeling laws, national "motor voter" laws, and Do-Not-Call Registry), *available at* http://www.house.gov/apps/list/hearing/financialsvcs_dem/mierzwinski_-_submitted_with_plunkett.pdf.

[67] *See id.*

partial regulation would be to place state lenders at a disadvantage without clear benefits for consumers.

Preemption allows different rules to be applied to the same product. This in turn leads to creditor gyrations just to avoid consumer protections. One example of disparate treatment is in the payday loan area. Payday loans are very high-rate (typically 300% to 400% APR) short term (2- to 4- week) loans that lead to a cycle of exploding debt. In the 1990s, as states started recognizing the evils of payday loans and began re-imposing their usury rates, payday lenders attempted to gain preemption rights by partnering with state and national banks.[68] The rent-a-bank partnerships were not completely shut down by the federal banking regulators until 2006.

Preemption leads to unequal levels of consumer protection that can undermine protections that do exist. For example, banks are now starting to get directly involved with payday lending. Bank payday loans take the form of direct deposit "account advance" loans on bank accounts and prepaid cards, with the same short-term repayment and similar triple-digit interest rates as traditional payday loans.[69] Though the destructive effect on consumers is the same, the bank products can ignore state laws. For example, payday lenders in Ohio must comply with Ohio's 28% payday loan cap but Fifth Third Bank's account advance product does not. Bank payday loans may be the new wave of abuse, as banks begin marketing them aggressively and see them as a substitute for the overdraft loans that are receiving increasing scrutiny.[70] Payday lenders hope that the banks' entry into the payday market will legitimize their own predatory product and weaken protections for everyone.[71]

D. Banks Often Take Advantage of State Laws and Should Not Be Able to Cherry Pick What to Use and What to Ignore

To transact commercial business it is necessary for banks to operate under the laws of the states in which they do business. The basic rules governing offer and acceptance of a contract, recordation of security interests, and foreclosure are routinely used and followed by banks in all of their commercial transactions with consumers. However, while the banks use one part of these laws to exercise their own rights, they have too often claimed preemption as to those parts of these same rules and laws that protect consumers.

---

[68] *See* Plunkett Reg. Restructuring Testimony, *supra,* Appendix 3; Saunders Reg. Restructuring Hearing, *supra*, at 21–23.

[69] *See* NCLC, Bank Payday Loan …… They're Baaaaaaaack (June 2009), *available at* http://www.consumerlaw.org/issues/payday_loans/content/Bank_Prepaid_Payday_Loans.pdf. There are two main differences between a traditional payday loan and a direct deposit account advance. First, the advances are made by the same institution that receives the direct deposit of the paycheck or public benefit check. Second, the term may be much shorter for an account advance, because the loan is repaid as soon as the direct deposit comes in, which is likely sooner than the full two weeks of a traditional payday loan.

[70] *See* Heather Landy, *Turning Fee Revenue into Customer Opportunities*, American Banker (June 24, 2009); Chris Serres, *Biggest Banks Stepping into Payday Arena*, Minneapolis Star Tribune (Sept. 9, 2009).

[71] Serres, *Biggest Banks Stepping into Payday Arena*, *supra*.

For example, banks use state foreclosure laws to collect on mortgages. Yet the OCC, the OTS and NCUA have all permitted their regulated institutions to ignore consumer protections in some state foreclosure laws.[72]

This cherry-picking approach is similar to the OCC's approach to preemption: it preempts state laws that protect consumers from banks, but leaves untouched state laws that are helpful to banks.[73]

E. Preemption Undermines the Dual Banking System

Preemption disrupts the balance between state and federal banks by favoring federal charters over state charters. State-chartered institutions do not enjoy the same broad preemption rights as federally chartered ones do, and can even led to a charter change to avoid state laws.[74] "The resulting imbalance threatened to harm a system that has been a proven laboratory of innovation."[75] As former FDIC Chairman Don Powell described in 2005:

> The facts of life today with regard to preemption are fairly simple. A state-chartered bank that wants to do business across state lines is at a substantial competitive disadvantage relative to a national bank or federal thrift. . . . In my view, there is little doubt what the current competitive imbalance, if not addressed, means for the future. . . . In the end, Congress may choose to level the playing field and preserve the dual banking system or it may, through inaction or otherwise, choose not to, and let the dual banking system fade into history. In my opinion, that would be a mistake.[76]

Current FDIC Chairman Sheila Bair agrees that applying the same rules to everyone will "eliminate the potential for regulatory arbitrage that exists because of federal preemption of certain State laws."[77]

---

[72] *See, e.g.* 68 Fed. Reg. 8,959 (Feb. 26, 2003) (OCC preemption determination of the Georgia Fair Lending Act); National Consumer Law Center, The Cost of Credit: Regulation, Preemption, and Industry Abuses § 3.4.6.3 (4th ed. 2009).

[73] *See* Wilmarth Credit Card Testimony, *supra*, at 9–10.

[74] *See* Paul Wiseman, *Industry Lines Up to Fight Consumer Protection Agency*, USA Today (Sept. 9, 2009) (describing Capital One's charter change following West Virginia enforcement efforts). Charter changes to avoid regulation can happen in both directions, and both from state to federal and within different types of federal charters. *See* Plunkett Reg. Reform Testimony, *supra*, at 7–9.

[75] Stefan L. Jouret, Jouret & Samito, *Ruling in Cuomo Can Be Pro-Industry,* American Banker (July 10, 2009).

[76] Arthur E. Wilmarth, Jr., Fed. Res. Bank of Chi., "The OCC's Preemption Rules Threaten to Undermine the Dual Banking System, Consumer Protection, and the Federal Reserve Board's role in Bank Supervision," *Proceedings of the 42nd Annual Conference on Bank Structure and Competition*, at 106 (2006) (quoting Sept. 26, 2005 speech by Mr. Powell to the American Bankers Ass'n).

[77] Statement Of Sheila C. Bair, Chairman, Federal Deposit Insurance Corporation, *On Regulatory Perspectives On Financial Regulatory Reform Proposals Before The Financial Services Committee, U.S. House Of Representatives*, (July 24, 2009), *available at* http://www.house.gov/apps/list/hearing/financialsvcs_dem/sheila_bair.pdf.

The OCC's preemption rules have had a very significant impact in encouraging large, multistate banks to convert from state to federal charters. Between 2004 and 2005 alone JP Morgan Chase, HSBC, and Bank of Montreal (Harris Trust) converted from state to national charters, moving over $1 trillion of banking assets from the state banking system. The share of all banking assets held by national banks and thrifts rose from 56% to 67%, while the share held by state banks declined from 44% to 33%.[78]

These trends have continued. State banks now make up only 29% of banking assets.[79] At this pace, state banks are a dying breed.

IV. RESTORING THE ROLE OF STATES WILL NOT IMPEDE NATIONAL COMMERCE

The banking system did quite well before state laws were widely preempted in the last decade or so. Of course, both national uniformity and state flexibility have their costs and benefits. But overall, the burdens of permitting different state standards are minimal and are far outweighed by the dangers of eliminating state protections in favor of a uniformly weak consumer protection.

A. States Laws Tend to Converge; Minimal Differences in Detail Do Not Impede National Products

Allowing states to act does not lead typically lead to widely divergent schemes. States generally look at other state models. After the first states experiment with a couple of approaches, the states that follow tend to converge on one approach.

For example, California passed the first specific foreclosure rescue scam law in 1979. In 2004, as the scams spread, Minnesota copied the California law with some improvements. Two dozen other states copied the Minnesota law from 2005 to 2009. These laws generally only have minor variations.[80]

In the privacy area, the 2003 Fair and Accurate Credit Transactions Act allowed states to take additional actions to prevent identity theft. Since its passage, fully 47 states and the District of Columbia have granted consumers the right to prevent access to their credit reports by identity thieves through a security freeze, and the credit bureaus then adopted the freeze nationwide.[81]

The Uniform Laws movement, spearheaded by the National Conference of Commissioners on Uniform State Laws, has created many uniform or model state laws—most notably the Uniform Commercial Code—that have been widely adopted by the

[78] Wilmarth Credit Card Testimony, *supra*, at 11–12.
[79] Data from Conference of State Bank Supervisors (using FDIC data).
[80] *See* National Consumer Law Center, Foreclosures § 15.4.5 (2d ed. 2007 and Supp. 2009).
[81] *See* Plunkett Reg. Reform Testimony, *supra*, at 37.

states. Often these uniform laws carve out specific areas for individual state variations, always with a mind to minimizing compliance burdens.

Other national organizations also work to encourage uniform laws. For example, the Conference of State Bank Supervisors drafted a model mortgage broker licensing law, which many states have adopted:

> The Secure and Fair Enforcement for Mortgage Licensing Act of 2008 (S.A.F.E. Act) is one very recent example of a how this "floor not ceiling" approach has led to strong and *uniform* standards. The S.A.F.E. Act, passed on July 31, 2008, gave the states one year—until July 31, 2009—to pass legislation to meet minimum licensing and registration requirements for loan originators. The states have risen to the challenge and have unified under a Model State Law. I am pleased to inform the Committee that, as of today, 49 states and the District of Columbia have enacted or introduced legislation implementing the S.A.F.E. Act.[82]

The National Conference of State Legislatures, the American Legislative Exchange Council, and other organizations also promote model state laws. Federal agencies can also work with the states to promote uniform standards.

Differences in state laws tend to be minor ones in areas such as disclosures, coverage, and remedies that do not prevent the same product from being offered in multiple states. The minor inconvenience of adding a few words to the fine print in a contract to comply with individual state disclosures laws is not a significant hindrance to national commerce.

In areas where Congress has acted, states do not deviate significantly even when given the chance. Virtually none of the federal consumer protection laws in the financial area preempt stronger state laws, yet there are few significant state variances. The Truth in Lending Act, the Electronic Funds Transfer Act, the Fair Credit Reporting Act, the Fair Debt Collection Practices Act, the Equal Credit Opportunity Act, the Truth in Savings Act, and a number of others all preempt only state laws that conflict with federal law and otherwise allow states to go farther. The few state laws in those areas that have added additional consumer protections have not proven problematic.

[82] Testimony of Joseph A. Smith, Jr. North Carolina Commissioner of Banks on behalf of the Conference of State Bank Supervisors on *"Financial Regulation And Restructuring" Before The Financial Services Committee United States House of Representatives*, at 6 (July 24, 2009), *available at* https://www.csbs.org/AM/Template.cfm?Section=Search&section=Regulatory_Restructuring&template=/CM/ContentDisplay.cfm&ContentFileID=7171.

B. Other Nationwide Corporations Comply with State Laws; Banks Do in Many Areas and Often Tailor Their Products to Niche Markets

National employers, department stores, auto makers, national credit reporting agencies, nationwide debt collection agencies, and makers of other goods and services can and do follow local laws. Those industries have not needed preemption and the banking industry does not either.

Banks with multi-state operations have to comply with state laws in some areas, and routinely adapt to local rules without problems. For example, banks must comply with state laws regarding contracts, torts, criminal law, the right to collect debts, acquisition and transfer of property, taxation, and zoning as long as they only incidentally affect the exercise of national banks' powers.[83] Banks must still be cognizant of the specific—and different—state requirements for a host of state specific issues, such as:

- Contract law rules (parole evidence rules, what is considered an acceptance of an offer, what actions are considered anticipatory breach) vary considerably from state to state.
- Rules relating to preserving priority to title of secured property vary widely.
- Some states have judicial foreclosures, some have non-judicial foreclosures. Many states have rights to cure defaults, some do not. The terms of these rights to cure vary between states. Some states have rights of redemption after the sale, others do not.
- Rules relating to establishing a presence and running a business—the taxing authorities, the zoning rules, the employment compensation requirements—are all different from state to state.

Banks operating in multiple states are sophisticated entities with state-by-state legal compliance operations and are fully able to deal with regional differences where they exist. Indeed, many national banks have international operations that require them to comply with the laws of different countries—many of which are smaller than some American states. State-chartered banks also operate across state lines even though they do not enjoy the same full preemption rights that national banks do.

If banks wish to offer a uniform product, they can choose to apply a more protective law nationwide. Or, if it is more advantageous for the bank to apply that law only for consumers in a particular state, it can do so.

Banks have shown no difficulty offering a wide array of mortgages, credit cards, and other products aimed at different sets of consumers based on their income, credit, and other features. They also differentiate their treatment of different groups of consumers.

[83] 12 C.F.R. §§ 7.4007(c), 7.4008(e), 7.4009(c)(2), 34.4.

A consumer who calls to complain about a credit card fee will get a different response depending on the volume of spending on the card.

Banks can tailor their products to state markets as well. Sophisticated computers and automated systems make it easier than ever to adapt products to particular markets. Those same tools can be used to accommodate differences in state markets.

C. Congress Can Act to Impose Uniformity in Particular Areas, As It Already Has Done

Congress can always preempt state law and impose a uniform standard, as it often has done in the past. For example, Congress passed the Electronic Signature Act in 2001 to standardize the rules for electronic authorizations, preempting state laws in that area.[84]

A state law that conflicts with a specific federal law will always be preempted even if banks no longer enjoy the automatic preemption of most consumer protection laws. For example, state restrictions on due-on-sale clauses are preempted if they conflict with the Garn-St. Germain Depository Institutions Act, which permits such clauses.

But preemption should happen issue by issue, after a debate in Congress. State consumer protections should not have been eliminated across the board through regulations by the banking agencies.

Even if the National Bank Act, Home Owners Loan Act, and Federal Credit Union Act are amended to roll back the broad preemption of the last several years, state laws that significantly interfere with the operation of national depositories will always be preempted, just as they were in the early days of those statutes. But laws that do not significantly burden those institutions will not be automatically wiped out.

D. The Costs of Uniformly Weak Consumer Protection Outweigh the Minimal Costs of Complying with State Laws

States have no need or desire to legislate if a problem has been fixed. A flurry of state activity only occurs when states are hearing an outcry of complaints on the ground and no response is coming from Washington.

The specter of "51 state laws" has been used for years to fight against consumer protection, but most recognize today that the financial industry would be better off if it had been subjected to more serious consumer protection laws. For example, in 2005, mortgage lenders pushed for preemption of the "uneven patchwork" of state laws that "drives up costs," and yet the estimated cost of complying with state predatory lending laws in states that had them was only $1 per mortgage.[85]

[84] 15 U.S.C. § 7001 *et seq.*

[85] *See* Center for Responsible Lending, Complying with Laws against Predatory Lending Costs Lenders About One Dollar per Mortgage (July 26, 2005), *available at* http://www.responsiblelending.org/media-

The widespread preemption of state laws in the financial area has eliminated protection for consumers, wreaked havoc on communities, allowed abuses to take hold and spread into national problems, deprived Congress of the benefit of the experience of state approaches, and undermined our constitutional system of federalism. Our national banking system did quite well before state consumer protection laws were wiped out, and the minor inconveniences of some state variations are well worth the added safety value of allowing states to protect their citizens. As Nobel Laureate Joseph Stiglitz has pointed out, the cost of regulatory duplication is miniscule compared to the cost of the regulatory failure.[86]

V. CONCLUSION

The federal government cannot do everything. That much has become quite apparent with the spectacular failure of consumer protection in the financial world. There is plenty of fault to go around, and states could have done better too. But they were operating with two hands tied behind their backs, able only to bite and kick to stop abusive practices aimed at consumers.

The current crisis should be a wake-up call that everyone—consumers, the financial industry, and the economy as a whole—is better off with serious consumer protection. Effective regulatory reform demands a comprehensive system that does not leave significant gaps in protection, allow new destructive practices to spring up unhindered by reforms aimed at yesterday's problems, or ignore local problems until they reach the point where they command national attention.

Restoring the role of the states as first responders is vital to protecting consumers. States, with their ears closer to the ground, the ability to react more quickly, flexible laws that can adapt to new situations, and a set of resources to supplement federal enforcement efforts, are essential parts of a truly revitalized system of consumer protection.

center/press-releases/archives/complying-with-predatory-lending-laws-costs-about-one-dollar-per-mortgage.html.

[86] "Some worry about the cost of duplication. But when we compare the cost of duplication to the cost of damage from inadequate regulation—not just the cost to the taxpayer of the bail-outs but also the costs to the economy from the fact that we will be performing well below our potential—it is clear that there is not comparison," Testimony of Dr. Joseph E. Stiglitz, Professor, Columbia University, *Before the House Financial Services Committee,* at 16 (Oct. 21, 2008).