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Regulatory Reform

Richard H. Neiman, New York's Superintendent of Banks, counsels federal lawmakers and regulators now working on the most extensive overhaul of financial regulatory structures in many decades to take care not to undercut the key role states play in the highly innovative and dynamic U.S. banking system.

The important goals of regulatory streamlining and efficiency should not obscure the contributions of state regulators in the areas of consumer protection and bank supervision, Neiman says. Thus, federal preemption should establish a floor, not a ceiling, on consumer standards, allowing states to respond to local realities. He applauds the Hutchison-Klobuchar amendment recently agreed to by the Senate for maintaining Fed supervision of all state member banks, thus eliminating the incentive to convert to a federal charter to avoid supervision by a third regulator.

Financial regulatory reformers should coordinate and focus the resources of each level of government to reinvigorate our dual banking system.

Managing Preemption and Oversight in A Modernized Dual Banking System

BY RICHARD H. NEIMAN

As Congress debates regulatory reforms for the 21st century, we should move boldly to fix weaknesses in supervisory structures and standards that contributed to the financial crisis. The reform agenda is also an important opportunity to streamline our regulatory architecture and ensure that U.S. financial firms remain competitive in an increasingly global marketplace. At the same time, however, we should be vigilant to retain what is best in our current system- especially, the meaningful role of the states in financial services oversight.

The dual banking system in its simplest form means that banking institutions may be chartered and regulated either by a national regulator or by the states. The reason we have this system has been described as an

Mr. Neiman is Superintendent of Banks for the State of New York, and a member of the Congressional Oversight Panel for the U.S. Troubled Asset Relief Program. This paper was originally presented at ''Seminars in Federalism and Plural Governance: Financial Regulation and Reform,'' Emory University School of Law April 30 – May 1, 2010.

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historical accident, and has also been criticized recently as creating duplication and regulatory gaps. However, the dual banking system has worked to create one of the most vibrant and innovative banking systems in the world.

History of Banking Regulation

The first banks in this country were chartered by the states, originally by legislative act, and eventually by state banking agencies. For example, the New York State Banking Department was created in 1851. At the time, banks issued a form of currency called bank notes, which often traded at a discount to their face value, depending on the perceived strength of the bank.

In the early 1860s, calls for a uniform and stable national currency resulted in the passage of the law that created the Office of the Comptroller of the Currency, which not only had responsibility for controlling the new national currency, but also for chartering, supervising and examining national banks.

To give banks more incentive to join the national bank system and to foster the development of a national currency, in 1865, Congress imposed a prohibitive 10 percent tax on state bank notes, and the assumption was that state banks would all fold or would become national banks.

Instead, state banks innovated and developed competitive advantages that did not involve the issuance of bank notes. And what they did was to create checking accounts—probably the first great innovation of the dual banking system.

But the fifty states and the Comptroller are not the only bank regulators. In the early 1900s, Congress realized that, in order to prevent runs on banks, it would be useful to have a central bank that could rediscount, or lend against, eligible collateral of member banks. So in 1913, they created the Federal Reserve System, which has the right to regulate member banks. National banks must be members, and membership is optional for state banks.

As a result of the great Depression in the 1930's, Congress passed the Banking Acts of 1933 and 1935, which included creation of the Federal Deposit Insurance Corporation to provide insurance coverage on bank deposits. The FDIC also has the right to regulate banks they insure.

Finally, in 1956, Congress recognized the fact that many banks wanted to be owned by holding companies that engaged in activities other than banking. This led to passage of the Bank Holding Company Act, which authorized the Federal Reserve to regulate holding companies.

Chartering Choices

A bank can therefore choose to be chartered as a national bank by the Comptroller of the Currency, and have one primary federal regulatory, the OCC or the Office of Thrift Supervision (OTS) for thrifts.

A bank can also choose to be chartered as a state bank, in which case it will be dual-regulated by the chartering state and a federal counterpart, which is either the Federal Reserve or the FDIC. If the business of the bank makes access to the payments system important, or the bank wants the ability to borrow from the Fed, it will become a member of the Federal Reserve System. Non-member banks will be examined by the FDIC.

A thrift may also choose a state charter, in which case it will be insured by the FDIC and may also be subject to examination by the OTS. Similarly, state Credit Unions, are chartered by the state, but insured and examined by the National Credit Union Association.

In order to reduce the burden on banks, state regulators have cooperative agreements with the Fed and the FDIC, so that they will either perform joint examinations, or, in the case of smaller banks, alternate year exams. And they review each other's exam reports and often take joint enforcement actions.

Benefits of State Charters

Of the over 8,000 domestic banks and thrifts, 73 percent of them are state chartered. But 70 percent of the bank and thrift assets in this country are in federally chartered institutions. What that is telling us is that state chartered banks are overwhelmingly the smaller community banks.

Community banks are closely tied to local credit needs, and appreciate the proximity of a state regulator who understands their business model and is familiar with local economic conditions. Another advantage of the state charter is more immediate connection with decision-makers, without the delay of having to check with Washington.

Distinctions in Powers Between State and Federal Charters

Traditionally, bank charters competed on powers. Between the 1860's and 1990, one of the hallmarks of the dual banking system was healthy competition between state and federal banks, which resulted in many innovative products that benefitted both consumers and businesses.

In the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA), however, Congress prohibited state banks from engaging as principal in any type of activity that is not permissible for a national bank—at least without receiving a determination from the FDIC that the activity would not pose a significant risk to the Deposit Insurance Fund. So state banks are limited in the new powers they can create. At the same time, state legislatures began to adopt so-called wild card statutes, to allow states to grant any power to a state-chartered bank that a national bank has. Ultimately, the powers of state and national banks today are quite similar.

In 1994, Congress first allowed interstate branching, and if a bank is going to have branches in multiple states, it generally prefers the ability of the national bank regulators to pre-empt consumer protection law for nationally chartered banks. The OCC was particularly aggressive in pre-empting state consumer protection laws, even where there were no contradictory federal laws or regulations. A key example of the impact of preemption on consumer protection relates to state usury laws.

Preemption of State Usury Laws

From the founding of the Republic through the late 1970s, interest rates were a matter for states to deter-

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mine. All states had usury limits on the amount of interest that could be charged on consumer loans, to protect their residents from predatory lending.

Then, in 1978, in the case of *Marquette National Bank v. First of Omaha Service Corporation*[1], the U.S. Supreme Court changed all that with a new interpretation of the McFadden Act. They ruled that when a Nebraska bank issued a credit card to someone in Michigan, the usury rate that applied was the Nebraska rate, not the Michigan rate. In other words, the Nebraska bank could export its higher interest rate cap to other states. When *Marquette* was decided, the interest ceiling in South Dakota was 24 percent. The rate on most loans in New York was capped at 12 percent. South Dakota and Delaware immediately eliminated their interest rate ceilings. Citibank then moved its operations to South Dakota, when the New York legislature did not immediately raise their usury rates.

In 1980, Congress preempted state mortgage rates, when it passed the Depository Institutions Deregulation and Monetary Control Act, or Diddy Mac. That law preempted state usury laws and restrictions on discount points, finance charges and other charges with respect to residential first lien mortgage loans. And it gave the benefits of preemption to insured state banks and credit unions as well as national banks. Two years later, in the Alternative Mortgage Transaction Parity Act of 1982, Congress preempted state laws prohibiting adjustable rate mortgages, non-amortizing mortgages, and other non fixed-rate fixed term mortgages including shared appreciation mortgages.

Preemption and Interstate Branching

Another law that is important to the preemption discussion is the Riegle-Neal interstate branching law, which was passed in 1994 and amended in 1997 and 2006. Before Riegle-Neal, banks were not permitted to branch across state lines. A holding company could own separate banks in different states, but it could not have the convenience of providing banking services out of a single bank with multi-state branches. Riegle-Neal allowed a bank to branch nationwide, unless states opted out of interstate branching. And Congress gave a lot of thought to which laws should apply to a multistate bank.

In order to reduce the compliance burden on multistate banks, Congress determined that a national or state-chartered bank with multi-state branches would generally be subject to the laws of its *home* state with respect to safety and soundness, examination and enforcement, as well as collection of supervisory fees. But there were four major exceptions. Banks that branched inter-state were made subject to the *host* state's laws as to consumer protection, fair lending, community reinvestment, and interstate branching, as long as those laws were not otherwise preempted by federal law and did not discriminate against national banks or out-of-state state banks on the basis of their charter. The conference report justified giving the consumer protection responsibility to *host* states by noting that states have a legitimate interest in protecting the rights of their consumers.

State regulators consider Riegle-Neal as preserving these important consumer protection laws, except for those areas already preempted by Federal law, like exportation of usury rates under FDICIA, and preemption of usury laws and restrictions on charges with respect to residential first lien mortgage loans under Diddy Mac.

Preemption Since 2004

But the OCC disagreed. In 2004, the Comptroller issued a sweeping preemption rule, based on his own interpretation of the National Bank Act, which cast aside any state law that obstructs, impairs or conditions, a national bank's exercise of any power granted to it under federal law. This went well beyond existing U.S. Supreme Court precedent, which as reflected in its decision in *Barnett Bank of Marion County, N.A. v. Nelson*, had historically held that the state law must ''prevent or significantly interfere'' with federal law in order to be preempted[2]. The OCC's 2004 ruling arose from its preemption of the Georgia Fair Lending Act in 2003, and was an attempt to override whole classes of laws. States' considered this ruling to be inconsistent with Riegle-Neal, which contained an exemption which clarified that state fair lending and other consumer protection laws remain applicable to national banks.

And the Comptroller later went even farther, to apply preemption to products offered by non-banks, where a bank was providing services to the non-bank—for example, banks providing processing services for gift cards offered by a mall, or banks providing usurious refund anticipation loans or check cashing services made available by a tax preparer. State regulators were shocked, since this sweeping ruling included virtually all state consumer protection laws.

Recent Supreme Court Decisions

The Comptroller's expansive interpretation of preemption received some support in the U.S. Supreme Court decision of *Watters v. Wachovia* in 2007. This case involved the status of operating subsidiaries of national banks, in this instance a mortgage banker that claimed it was exempt from state registration due to preemption. A divided court, in a 5-3 ruling with a strong dissent, found in favor of the bank, reasoning that national banks have the ''incidental'' authority to conduct their activities through operating subsidiaries and therefore such operating subsidiaries enjoy the same preemption privileges as the bank itself. The requirement to register with the state was considered to be an exercise of state visitorial power. Since visitorial authority over national banks is the exclusive jurisdiction of the OCC, the state registration requirement was preempted. This decision was a setback for state oversight of the mortgage market, especially as nonbank lenders were key sources of subprime and exotic lending.

The U.S. Supreme Court's decision in 2009 in the case of *Cuomo v. Clearinghouse*, however, took a more expansive view of state authority over national banks. The decision rested on distinguishing visitation from enforcement. While visitorial authority is exclusive to the OCC, the states retain the ability to enforce non-preempted laws. The *Cuomo* decision did limit states'

[1] 439 U.S. 299 (1978)

[2] 517 U.S. 25,6 (1996)

use of investigative subpoenas, deeming that a form of visitation or oversight, but retained the states' right to bring suit against national banks. This decision was an important step in restoring the proper balance between state and federal authority in a federalist system.

Current Proposals for Regulatory Reform

Preemption issues continue to figure prominently in the current proposals for regulatory reform, both in terms of rulemaking and in supervision.

Consumer Protection. The next phase of the preemption debate centers on Congressional proposals to create an independent consumer financial protection agency or CFPA. The CFPA would be tasked with rulemaking on a wide range of consumer protection subjects. Stronger national minimum standards are clearly needed, which would apply to all lenders, whether banks or nonbanks. A critical distinction is that these national rules would serve as a floor, and not ceiling, which individual states could choose to exceed. This would preserve the ability of states to respond rapidly to local needs, as well as to develop innovative laws that could then serve as the basis for new national standards.

Additionally, the same Congressional reform proposals would also address the ability of the Comptroller to preempt state laws that went beyond the floor set by the CFPA. Both the House and Senate proposals would amend the National Bank Act to clarify that a state consumer protection law of general application, including any consumer fraud law and any law relating to unfair or deceptive acts or practices, and repossession, foreclosure and collection law, will apply to national banks and their subsidiaries and affiliates, unless: 1. it discriminates against national banks; or 2. it prevents, significantly interferes with, or materially impairs the ability of a national bank to engage in the business of banking; or 3. is preempted by another provision of federal law. Additionally, a state consumer law would not be deemed inconsistent just because it affords a higher level of protection, and there must be a federal law that addresses the same issue on the substance.

It is also important to note that the standard for judicial review of OCC rulings would change. Rather than the high degree of deference granted under *Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc.*, the standard from *Skidmore v. Swift & Co.* would apply and courts would assess the validity of the OCC's determination.

Further, the proposed reform package would also overturn the decision in *Watters v. Wachovia*, and would roll back preemption with respect to state-licensed operating subsidiaries of national banks.

Supervision. Beyond issues of preemption, current regulatory reform proposals also address regulatory architecture, to eliminate arbitrage, while retaining the federalist approach of the dual banking system. The partnership between states and federal regulators in supervising banks has contributed to the necessary checks and balances in supervision, and benefits both consumers and local economies. The original Obama plan and the House bill recognized this balance and therefore retained the supervisory role for the Federal Reserve and the FDIC, the two agencies that share oversight of state banks with state supervisors.

However, some have called for the creation of a single, monolithic federal regulator. This idea may have appeal on the surface, but there are pitfalls and serious disadvantages to total consolidation. Most notably, a monolith would increase the risk of regulatory capture by the largest banks, and would lose the benefits of diverse regulatory viewpoints that have improved our system.

The Dodd bill is an alternative to the monolith concept, and is intended as an endorsement of dual banking. The Hutchison-Klobuchar amendment recently agreed to by the Senate ensures that the bill's provisions are consistent with this purpose to support state banking.

Until the amendment, the original bill had contained provisions that could have undermined the state role in financial services supervision. The Fed would have lost supervision of state-member banks in the original bill, leaving the Fed only with oversight of bank holding companies over $50 billion in size.

This change would have created competitive disadvantages, by triple-regulating large state-member banks—with the Fed regulating the holding company and the FDIC and the state regulating the bank. In this circumstance, such banks would have been incentivized to convert to a national charter in order to replace this triple oversight with dual oversight by the OCC and the Fed.

With the Hutchison-Klobuchar amendment, however, the Fed will retain supervision of all state member banks and the incentive to convert charter to avoid supervision by a third regulator is eliminated.

Conclusion

We need the benefits of multiple regulators, both to increase the quality of supervision and to provide diverse views of complex financial subjects. While the dual banking system may seem cumbersome in comparison to more centralized approaches, no country was spared from the current financial crisis. The solution for the U.S. is to reinvigorate our federalist model, to adopt a ''New Federalism'' that coordinates and focuses the resources of each level of government to its best use.

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