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TESTIMONY OF
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Before the
SUBCOMMITTEE ON OVERSIGHT AND INVESTIGATIONS
of the
COMMITTEE ON FINANCIAL SERVICES
of the
U.S. HOUSE OF REPRESENTATIVES
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Statement required by 12 U.S.C. 250:

The views expressed herein are those of the Office of the Comptroller of the Currency and do not necessarily represent the views of the President.

I. Introduction

Madam Chairwoman, Ranking Member Gutierrez, and members of the Subcommittee, I appreciate the opportunity to discuss the OCC's recent rulemakings pertaining to the applicability of State laws to national banks. I will begin by describing briefly what our new rules do, and, in order to address some confusion that exists, what they do *not* do. Then, I will explain why we took the actions we did and why we acted *when* we did. Finally, my testimony will address the principal arguments that have been advanced by those who question these regulations.

Madam Chairwoman, the hearings you have convened touch on fundamental characteristics of the national bank charter, fundamental responsibilities of the OCC, and the essential attributes of this country's dual banking system. I welcome the opportunity to explain how our rules further the longstanding purposes of the national banking laws, reinforce and reaffirm the high standards of integrity and fair treatment of customers that we expect of national banks, and preserve the distinct roles of Federal and State regulators that define our dual banking system.

II. The OCC's Regulations

Earlier this month, the OCC issued two final rules that address the applicability of State law to national banks. The first regulation, which follows the same approach taken by the OTS in its preemption regulations applicable to Federal savings associations, clarifies the extent to which the operations of national banks are subject to state laws (the preemption rule). The second regulation concerns one aspect of the OCC's exclusive "visitorial powers" with respect to national banks (the visitorial powers rule).

Increasingly in recent years, States – and even cities and counties – have enacted laws that attempt to constrain powers national banks are authorized to exercise under Federal law. In addition to conflicting with Federal authorities, these efforts have resulted in greater uncertainty about the standards applicable to national banks' operations and in costly litigation to resolve that uncertainty. One important purpose of our regulations is to provide the clear guidance needed to ensure that national banks operate under uniform, predictable Federal standards. I next describe each rule in turn.

The Preemption Rule

The preemption rule adds provisions to our regulations expressly addressing the applicability of certain types of state laws to national banks' lending, deposit-taking, and other Federally authorized activities. With regard to all three categories, the preemption rule states that, except where made applicable by Federal law, state laws do not apply to national banks if they "obstruct, impair, or condition" the bank's exercise of powers granted under Federal law. In the lending and deposit-taking areas, the preemption rule then lists certain types of state laws that are preempted by Federal law and therefore are not applicable to national banks.

For lending, examples of preempted laws include laws that restrict or prescribe the terms of credit, amortization schedules, permissible security property, permissible rates of interest, escrow

accounts, disclosure and advertising, and laws that require a state license as a condition of national banks' ability to make loans. For deposit-taking (in addition to laws dealing with disclosure requirements and licensing and registration requirements), the laws listed include laws that address abandoned and dormant accounts, checking accounts, and funds availability. These lists are not exclusive, and the courts, or the OCC, may subsequently conclude that other types of laws also are preempted under our rule and the applicable principles of Constitutional law. The regulation addressing other authorized national bank activities does not list particular types of State laws that are preempted, but it spells out the same basic preemption standard applicable to any national bank power. This standard is distilled from decisions of the U.S. Supreme Court and is not intended to establish any new standard distinct from the standards that the Supreme Court has expressed in its decisions under the National Bank Act dating back over 130 years.

We have taken the extra step of including in our preemption rule two new provisions to ensure that the federal standards under which national banks operate directly address abusive or predatory lending practices. First, the preemption rule prohibits national banks from making any consumer loan based predominantly on the foreclosure or liquidation value of a borrower's collateral, rather than on the borrower's ability to repay the loan according to its terms. This anti-predatory lending standard applies uniformly to all consumer lending activities of national banks, regardless of the location from which the bank conducts those activities or where their customers live. It is comprehensive, it is nationwide, and it strikes at the heart of predatory lending, namely lending practices that effectively swindle a homeowner out of his or her home.

Second, the preemption rule provides that national banks shall not engage in unfair and deceptive practices within the meaning of Section 5 of the Federal Trade Commission Act in connection with any type of lending. Section 5 prohibits "unfair or deceptive acts or practices" in interstate commerce. We added an express reference to Section 5 to our rule in response to commenters who urged us to affirm that this Federal standard applies to national banks. We viewed this addition as particularly appropriate in light of the fact that the OCC pioneered the use of Section 5 as a basis for enforcement actions against banks that have engaged in such conduct.

It is important to clarify several things that the preemption rule does *not* do. The final rule *does not* immunize national banks from all state laws, and it does *not preempt* indiscriminating laws of general applicability that form the legal infrastructure for conducting a banking or other business. Examples of laws that are not preempted are also identified in the preemption rule and include state laws on contracts, rights to collect debts, acquisition and transfer of property, taxation, zoning, crimes, and torts. In addition, any other law that only incidentally affects national banks' exercise of their Federally-authorized powers to lend, take deposits, and engage in other federally-authorized activities would not be preempted under the final rule. This distinction is solidly founded in decisions of the U.S. Supreme Court.

Although some aspects of state anti-predatory lending laws – such as state restrictions on particular loan terms and state prohibitions on particular loan products – are preempted by the rule, the rule *does not preempt anti-discrimination and fair lending laws*. There appears to have been some misunderstanding on this point, perhaps because some state predatory lending laws

have “fair lending” in their titles but do not actually address unlawful discrimination in lending.¹ The preemption rule, consistent with Federal judicial precedents,² the extensive body of Federal anti-discrimination laws, and the OCC’s unyielding commitment to national banks’ fair treatment of their customers, does not preempt any law prohibiting discrimination in lending.

In addition to *not* preempting a wide variety of state laws, the preemption rule does not authorize any new national bank activities or powers, such as real estate brokerage. Moreover, while we believe the text and the history of the statute authorizing national banks’ real estate lending activities (12 U.S.C. § 371) supports a conclusion that Congress authorized the OCC to occupy the field of national bank real estate lending through regulation, we declined to do so in the preemption rule and took a more targeted approach.

Finally, the preemption rule makes no changes to the OCC’s rules governing the activities of operating subsidiaries. The OCC already has rules on the books imposing the same terms and conditions on national banks’ activities whether they are conducted directly or through an operating subsidiary. These rules provide that State laws apply to national bank operating subsidiaries only to the extent that those laws apply to the parent bank. By virtue of these pre-existing regulations,³ the preemption rule has the same effect on national bank operating subsidiaries as it has on national banks.

The Visitorial Powers Rule

“Visitorial powers” refer to the authority to examine, supervise, and regulate the affairs of a corporate entity. Under the National Bank Act, the OCC has exclusive visitorial powers over national banks. This provision dates from the earliest days of the national banking system. It is integral to the overall scheme of the national banking system and to the ability of national banks to operate efficiently today, because it helps to assure that the business of banking conducted by national banks is subject to uniform, consistent standards and supervision, wherever national banks operate.

Our existing regulations implemented the visitorial powers statute by providing that state officials are not authorized to inspect, examine, or regulate national banks, except where another Federal law authorizes them to do so.⁴ The amendment to the visitorial powers rule that we have just issued clarifies that the scope of the OCC’s exclusive visitorial authority applies to the content and conduct of national bank activities authorized under Federal law. In other words, the OCC is exclusive supervisor of a national bank’s banking activities. The rule *does not prevent*

¹ See, e.g., the Georgia Fair Lending Act, GA Code. Ann. §§ 7-6A-1 *et seq.*, which does not address lending discrimination.

² See, e.g., *National State Bank v. Long*, 630 F.2d 981 (3d Cir. 1980) (New Jersey anti-redlining statute applicable to national banks); see also *Peatros v. Bank of America NT&SA et al.*, 22 Cal 4th 147 (2000) (where Federal law otherwise provides in employment discrimination context, state anti-discrimination statute not necessarily preempted).

³ See 12 C.F.R. §§ 5.34 (operating subsidiaries subject to same "terms and conditions" as apply to the parent bank) and 7.4006 (applicability of State law to national banks). See also *id.* at § 34.1(b) (real estate lending rule applies to national bank operating subsidiaries).

⁴ 12 C.F.R. § 7.4000.

state officials from enforcing state laws that do not pertain to a national bank's banking activities, such as health and safety standards or criminal laws of general applicability.

The new visitorial powers rule also clarifies that the National Bank Act does not give state officials authority, in addition to whatever they may otherwise have, to use the court system to exercise visitorial powers over national banks. Thus, state officials may not use the courts to accomplish indirectly what the Federal statute prohibits them from accomplishing directly through administrative action. The visitorial powers rule *does not* preclude states from seeking a declaratory judgment from a court as to whether a particular state law applies to the Federally-authorized business of a national bank.

Finally, like the preemption rule, the visitorial powers rule makes no change to the treatment of operating subsidiaries. Thus, in accordance with previously adopted OCC regulations, States generally can exercise visitorial powers over operating subsidiaries only to the extent that they could exercise visitorial powers over a national bank.

Some of the comments we received during the rulemaking process and some reactions to the final rules characterize them as "radical" or "dramatic" departures from the *status quo*. That characterization is simply incorrect.

The standard used in the preemption rule encapsulates the standards that the United States Supreme Court has applied in national bank preemption cases for well over 130 years. It is phrased in words – "obstruct, impair, or condition" – that are taken directly from those cases. The types of State laws identified as preempted in the rule include types of laws that a Federal court has previously held, or that the OCC has previously opined, are preempted. The types of laws listed as preempted are virtually the same as those listed in OTS regulations that have been on the books since 1996. The clarifications we have added to our existing visitorial powers rule reinforce the point that the statutory prohibition on the exercise of visitorial powers by authorities other than the OCC means what the text clearly says. No one other than the OCC is empowered to regulate or supervise the banking business of national banks unless Federal law provides that authority, and the statutory prohibition cannot be defeated by resort to the courts to impose indirectly standards or sanctions that the statute forbids them to impose directly.

What, then, has changed? What is different is that the legal standards that we have applied, and the legal conclusions that we have reached, for the most part, only on a case-by-case basis – for example, in legal opinions, orders, and sometimes briefs in litigation – are now collected together in one place and codified in our rules. Now, all national banks can rely on specified and predictable standards to define their compliance responsibilities. As I next explain, this is critically important if national banks are to be able to exercise fully the powers that Federal law gives them in order to operate efficiently and compete successfully in today's financial services markets.

III. The OCC's Reasons for Adopting the Regulations

As we explained in the preamble to the preemption rule, markets for credit, deposits, and many other financial products and services are now national, if not international, in scope, as a result of significant changes in the financial services marketplace, particularly in the last 20 years. Now, more than ever before, the imposition of an overlay of 50 State and an indeterminate number of local standards and requirements on top of the Federal requirements and OCC supervisory standards to which national banks already are subject has costly consequences that materially affect a national bank's ability to serve its customers. Moreover, this regulatory burden is unnecessary – in the most literal sense of the word – because it is inconsistent as a matter of law with the Federal character of the national bank charter. Finally, the Federal preemption standards that form the basis of our regulations are so well developed, and have been so consistently applied by the Federal courts over time in an extensive body of judicial precedent, that exclusive reliance on a case-by-case approach is no longer warranted.

The changing financial services marketplace

The changes we see in the market for financial services are the result of a combination of factors, including technological innovations, the erosion of legal barriers, and an increasingly mobile society.

Technology has expanded the potential availability of credit and made possible virtually instantaneous credit decisions. Mortgage financing that once took weeks, for example, now can take only hours, with decisions based on sophisticated credit-scoring derived from centralized credit underwriting facilities. Consumer credit can be obtained at the point of sale at retailers and even when buying a major item such as a car. Consumers can shop for investment products and deposits on-line, from providers whose location may well be irrelevant. With respect to deposits, consumers can compare rates and duration of a variety of deposit products offered by financial institutions located far from where the consumer resides.

Changes in applicable law also have contributed to the expansion of markets for national banks and their operating subsidiaries. These changes have affected both the type of products that may be offered and the geographic region in which banks – large and small – may conduct business. As a result of these changes, banks may branch across State lines and offer a broader array of products than ever before. An even wider range of customers can be reached through the use of technology, including the Internet. Community national banks, as well as the largest national banks, reach customers across State lines and use new technologies to expand their reach and service to customers.

Our modern society is also highly mobile. Forty million Americans move annually, according to a recent Congressional report issued in connection with enactment of the Fair and Accurate Credit Transactions Act of 2003.⁵ And when they move, they often have the desire, if not the expectation, that the financial relationships and status they have established will be portable and will remain consistent.

⁵ See S. Rep. No. 108-166, at 10 (2003) (quoting the hearing testimony of Secretary of the Treasury Snow).

These developments highlight the significance of being able to conduct a banking business pursuant to consistent, national standards, regardless of the location of a customer when he or she first becomes a bank customer or the location to which the customer may move *after* becoming a bank customer. They also accentuate the costs and interference that diverse and potentially conflicting State and local laws have on the ability of national banks to operate under the powers granted by their Federal charter.

When national banks are unable to operate under uniform, consistent, and predictable standards, their business suffers, and their customers may face higher costs or more limited product offerings – or both – as a result. The application of multiple, often unpredictable, different State or local restrictions and requirements prevents them from operating in the manner authorized under Federal law, is costly and burdensome, interferes with their ability to plan their business and manage their risks, and subjects them to uncertain liabilities and potential financial exposure. In some cases, this deters them from making certain products available in certain jurisdictions. As was recently observed by Federal Reserve Board Chairman Alan Greenspan, “increased costs resulting from restrictions that differ based on geography, may lead to an increase in the price or a reduction in the availability of credit, as well as a reduction in the optimal sharing of risk and reward.”⁶

It has been suggested that the ability to do business in multiple States under uniform, consistent and predictable standards, primarily benefits the largest banks. In fact, for community and intermediate-sized banks with customers in multiple jurisdictions, this attribute of the national bank charter may have even more practical significance than for a “megabank.” Take, for example, a community bank with customers in a multi-state metropolitan area like New York or Philadelphia; or a community bank with customers in a compact multi-state region, such as New England; or any State-based bank in a State in which cities or municipalities enact unique local requirements for bank operations. Community and intermediate-sized regional banks have a smaller base of operations, *e.g.*, a smaller number of loans, over which they are able to spread the overhead costs of legal staff, compliance staff, technology, and printing costs necessary to keep abreast of multiple State (and potentially local) requirements. This drives up their costs, and detracts from their ability to compete effectively with larger banks that have a bigger base of operations over which to apply overhead costs. This, in turn, serves as a disincentive for that bank to incur still more costs by expanding service to customers in a new State. Ultimately, the inability to compete on a cost-effective basis can be a factor that contributes to management decisions to merge or be acquired by a larger institution.

At the OCC, we supervise thousands of community and mid-size national banks, and we are as concerned about the consequences of the inability of those institutions to operate efficiently under uniform, consistent, and predictable standards, consistent with the character of their national bank charter, as we are about the ability of our national “megabanks” to operate under such standards.

⁶ Letter of February 28, 2003, from Alan Greenspan, Chairman, Board of Governors of the Federal Reserve System, to The Honorable Ruben Hinojosa (cited by Congressman Hinojosa on November 21, 2003, during House debate on the Conference Report to accompany H.R. 2622 (Conference Report 108-396)).

The Federal character of the national bank charter

Federal law is the exclusive source of all of national banks' powers and authorities. Key to these powers is the clause set forth at 12 U.S.C. § 24(Seventh) that permits national banks to engage in the “business of banking “and to exercise “all such incidental powers as shall be necessary to carry on the business of banking.” This flexible grant of authority furthers Congress's long-range goals in establishing the national banking system, including financing commerce, establishing private depositories, and generally supporting economic growth and development nationwide.⁷ The achievement of these goals requires national banks that are safe and sound and whose powers are dynamic and capable of evolving so that they can perform their intended roles. The broad grant of authority provided by 12 U.S.C. § 24(Seventh), as well as the more targeted grants of authority provided by other statutes, enable national banks to evolve their operations in order to meet the changing needs of our economy and commercial and consumers.

Moreover, the ability to operate under uniform standards is fundamental to the character of the national bank charter. As we explained in 2002 when we added to our rules new provisions concerning national banks’ electronic activities, “freedom from State control over a national bank’s powers protects national banks from conflicting local laws unrelated to the purpose of providing the uniform, nationwide banking system that Congress intended.”⁸

As we have learned from our experience supervising national banks, from the inquiries we have received, by the extent of litigation in recent years over these state efforts, and by the comments we received during our rulemakings, national banks’ ability to conduct operations to the full extent authorized by Federal law has been impaired as a result of increasing efforts by States and localities to apply State and local laws to national banks.

For example, commenters on our proposal to adopt the preemption rule noted that the variety of state and local laws that have been enacted in recent years – including laws regulating fees, disclosures, conditions on lending, and licensing – have created higher costs, increased risks, and operational impediments.⁹ Other commenters noted the proliferation of state and local predatory lending laws and the impact that those laws are having on lending in the affected jurisdictions. As a result, national banks must absorb the costs, pass the costs on to consumers, or eliminate various products from jurisdictions where the costs are prohibitive or risks are imprudent.

⁷ For a more detailed discussion of Congress's purposes in establishing a national banking system that would operate to achieve these goals distinctly and separately from the existing system of state banks, see 68 Fed. Reg. 46119, 46120 (August 5, 2003) (preamble to the proposed preemption rule). See also Office of the Comptroller of the Currency, *National Banks and the Dual Banking System* (publication dated September 2003).

⁸ 67 Fed. Reg. 34992, 34997 (May 17, 2002).

⁹ Illustrative of comments along these lines were those of banks who noted that various state laws would result in the following costs: (a) approximately \$44 million in start-up costs incurred by 6 banks as a result of a recently-enacted California law mandating a minimum payment warning; (b) 250 programming days required to change one of several computer systems that needed to be changed to comply with anti-predatory lending laws enacted in three states and the District of Columbia; and (c) \$7.1 million in costs a bank would incur as a result of complying with mandated annual statements to credit card customers.

Commenters noted that this result occurs even in situations where a bank concludes that a law is preempted, simply so that the bank may avoid litigation costs or anticipated reputational injury.

Even the efforts of a single state to regulate the operations of a national bank operating only within that state can have a detrimental effect on that bank's operations and consumers. As we explained in our recent preemption Determination and Order regarding the Georgia Fair Lending Act (GFLA),¹⁰ the GFLA caused secondary market participants to cease purchasing certain Georgia mortgages and some mortgage lenders to curtail their mortgage lending activities in Georgia. National banks have also been forced to withdraw from some products and markets in other states as a result of the impact of state and local restrictions on their activities. The impact of particular state laws on the mortgage market and credit availability is discussed in detail in part IV, below.

Federal preemption precedent

The Constitutional principles supporting the preemption of State laws that limit the powers and activities of Federally-chartered banks have been recognized from the earliest decades of our Nation. The principle of the primacy of Federal law under the Supremacy Clause was first articulated in the Supreme Court's *McCulloch v. Maryland* decision in 1819, a case involving the Federally-chartered Second Bank of the United States. Precedents of the Supreme Court dating back to 1869 have addressed preemption in the context of national banks and have consistently and repeatedly recognized that national banks were designed by Congress to operate, throughout the nation, under uniform, Federally-set standards of banking operations.

As a result, there is an extensive body of Federal court precedents that reiterate and apply preemption principles to a variety of different types of State laws.¹¹ To date, the OCC has relied on these precedents to issue many legal opinions of its own that address the applicability of State law. As national banks operate in an increasingly complex and multi-state environment, however, the shortcomings of this case-by-case approach have become increasingly apparent. Legal opinions and judicial decisions may be construed to be confined to their facts. In addition, the financial and opportunity costs to banks of a case-by-case approach may be significant – especially where litigation becomes necessary to establish clear standards upon which a business may prudently rely.

We concluded that continued, exclusive use of a case-by-case approach had become unnecessary and inefficient in light of the substantial and consistent body of Federal judicial precedent. Rather than continuing to address preemption issues on a piecemeal basis, therefore, the

¹⁰ See 68 Fed. Reg. 46264 (August 5, 2003).

¹¹ See, e.g., *Bank of America v. City & County of San Francisco*, 309 F.3d 551 (9th Cir. 2002), cert. denied, 123 S.Ct. 2220, 2003 U.S. LEXIS 4253 (May 27, 2003) (the National Bank Act and OCC regulations together preempt conflicting state limitations on the authority of national banks to collect fees for the provision of electronic services through ATMs; municipal ordinances prohibiting such fees are invalid under the Supremacy Clause); *Wells Fargo Bank, Texas, N.A. v. James*, 321 F.3d 488 (5th Cir. 2003) (Texas statute prohibiting certain check cashing fees is preempted by the National Bank Act); *Metrobank v. Foster*, 193 F. Supp. 2d 1156 (S.D. Iowa 2002) (national bank authority to charge fees for ATM use preempted Iowa prohibition on such fees). See also *Bank One, Utah v. Guttau*, 190 F.3d 844 (8th Cir. 1999), cert. denied sub nom *Foster v. Bank One, Utah*, 529 U.S. 1087 (2000) (holding that Federal law preempted Iowa restrictions on ATM operation, location, and advertising).

preemption rules address them comprehensively – by clarifying and codifying prior judicial and OCC interpretations based on long-established Constitutional principles – to provide much-needed clarity to national banks.

IV. The Timing of the Final Rules

Madam Chairwoman, you, as well as some other members of the Committee and some of the commenters on our proposals, have suggested that the OCC should have waited longer before finalizing our rules. Please be assured that we considered timing concerns very carefully, but we ultimately concluded that taking action, following an open and inclusive comment process, which included Members of Congress and their staffs, was both respectful of the role of Congress and the course most consistent with our responsibilities as supervisors of the national banking system.

We reached this conclusion for several related reasons. First, as described earlier in my testimony, the laws under which we acted exist today, and the principles incorporated in our preemption regulation and in the clarification of our visitorial powers rule are not new. The new rules are entirely consistent with *existing* law, namely, the powers Congress has granted national banks – within the past decade and dating back to the original provisions of the National Bank Act. To characterize these regulations as dramatic changes from the status quo is simply incorrect.

Second, the continuing uncertainty about the applicability of State laws has already affected national banks' ability to lend in certain markets and to access the secondary market, a curtailment of their business that is not only inconsistent with their Federally authorized powers but also one that has the potential to adversely affect credit availability as well as detract from the banks' financial strength. Moreover, we believe that the addition of predatory lending standards to our lending rules materially *reinforces* national banks' obligation to treat their customers fairly and operate pursuant to the highest standards of integrity. Delaying the implementation of those standards is, accordingly, inconsistent with our responsibility to ensure that national banks satisfy those obligations.

The trend at the State and local levels toward enacting legislation that seeks to impose costly and inconsistent compliance burdens on national banks has accelerated. These laws are well-intentioned but nonetheless curtail national banks' ability to conduct operations to the full extent authorized by Federal law and disrupt crucial credit delivery systems.

For example, in recent years, various States and localities have enacted predatory lending laws, each employing a combination of standards that differs in some respects from the others, but each typically singling out loan product features and either barring loans with those features or imposing requirements that make it impractically costly for lenders to offer them. The goals of these laws – to eliminate predatory and abusive mortgage lending practices – are laudable and we strongly support their objectives. As Comptroller Hawke has said repeatedly, predatory and abusive practices have no place in the national banking system, and we fully agree that such practices should be promptly addressed where they arise.

However, these State and local law approaches effectively ban loans based on certain loan terms. They generally prohibit certain mortgage loan terms and impose extra compliance obligations when certain other loan terms or conditions are present. They introduce new standards for subprime lending that are untested, sometimes vague, often complex, and, in many cases, different from established and well-understood Federal requirements. They also create new potential liabilities and penalties for any lender who missteps in its efforts to comply with those new standards and restrictions. These laws materially increase a bank's costs and compliance and reputation risks, especially in connection with risk-based pricing to the subprime market.

It is important to understand that this approach, while intended to stop abusive practices, also can work to constrain legitimate risk-priced lending to credit-worthy subprime borrowers.¹² The OCC is as dedicated as any State regulator to ensuring that the institutions we supervise are not engaged in abusive or predatory lending practices. However, our approach is to focus on preventing those *practices*, not on banning or restricting specified loan products or terms in the absence of evidence of abusive, predatory, unfair or deceptive practices.

Generally, State and local predatory lending laws that have such a *product-* rather than *practice-* focus have created uncertainties that adversely affect banks' ability to access the secondary market for legitimate, risk-priced mortgage loans. Let me briefly explain the material, practical significance of this issue.

When a bank is able to sell a loan on a cost-effective basis to Fannie Mae or Freddie Mac, or obtains a rating for a pool of loans that it "securitizes" and sells to investors, the bank is able to liquify its loans and redeploy capital to make additional loans available. If Fannie or Freddie are unwilling to purchase loans made in jurisdictions with specialized predatory lending restrictions and potential liabilities, or if they impose additional costs in return for their willingness to buy such loans, the funds banks have available to make additional credit available are diminished. Similarly, if a bank is unable to obtain a rating from Standard and Poors', Moody's Investors Services, or Fitch Ratings, it will not be able to securitize its loans on a cost effective basis and reallocate capital to make additional credit available. In other words, localized and State-based restrictions on loan terms substantially affect the marketability of such loans, and that, in turn, affects overall credit availability to credit-worthy consumers.

Fannie Mae and Freddie Mac have both issued policies concerning their willingness to purchase residential mortgage loans subject to various state predatory lending laws. Fannie Mae and Freddie Mac will not purchase high cost home loans from **Arkansas, Georgia, Kentucky, Illinois, Maine, Nevada, New Jersey, New Mexico, New York, and Oklahoma.**

¹² It is important to note that many legitimate, risk-priced mortgage loans would be considered "high cost home loans" under some state anti-predatory lending laws. For example, a "high cost" home loan under Georgia's anti-predatory lending law includes mortgages that have total points and fees exceeding 5% of the loan amount if the mortgage is \$20,000 or more. On a \$30,000 mortgage, this would mean any loan with origination fees of more than \$1,500 would be considered "high cost." According to the Mortgage Bankers Association's 2002 Cost Study, the average cost to originate a mortgage in 2001 was \$1,744.

S&P, Moody's, and Fitch have also issued policies concerning the inclusion of such loans in structured finance transactions.¹³ Under these policies, the rating agencies generally exclude from their rated structured finance transactions loans that carry unquantifiable assignee liability, as do some loans under certain State and predatory lending laws.¹⁴

As a result, lenders doing business in the States discussed below face the following additional secondary market constraints:

- **Arkansas, Georgia, Illinois, Maine, Nevada, New York, and Oklahoma.** In these states, S&P generally requires that sellers provide representations and warranties that the loans were originated in compliance with all applicable laws and that their compliance procedures effectively identify high cost home loans and determine that the loans do not violate predatory lending laws. Further, S&P requires that the provider of these representations and warranties is sufficiently credit worthy to purchase any loans that are in violation and cover any contingent liability associated with securitizing high cost home loans.¹⁵ Fitch will generally rate securitizations with loans from these jurisdictions subject to additional credit enhancements.¹⁶
- **Kentucky.** S&P requires sellers to conduct a loan-by-loan review of all high-cost home loans, and provide the representations and warranties noted above before it will allow high cost home loans from Kentucky in rated transactions.¹⁷ Fitch will not allow any high cost loans from Kentucky in rated transactions. In order to rate a transaction including *any* loans from Kentucky, Fitch requires receipt of a certification from a third party unaffiliated with the originators of the relevant loans that such third party conducted due diligence on a random sample of the greater of 5 loans or 10% of the loans from Kentucky and that no high cost home loans were uncovered in the sample. If the review of the sample of loans uncovers any high-cost home loans, Fitch requires a review of every loan in the pool originated in Kentucky.¹⁸

¹³ See Standard & Poor's: Evaluating Predatory Lending Laws: Standard & Poors Explains its Approach (April 15, 2003); Moody's Investor Services: Impact of Predatory Lending Laws on RMBS Securitizations (May 6, 2003); and Fitch Press Release: Fitch Revises its Rating Criteria in the Wake of Predatory Lending Legislation (May 1, 2003).

¹⁴ See, e.g., § 6(b) of the New Jersey Homeownership Security Act; and § 11 of the New Mexico Home Loan Protection Act.

¹⁵ See S&P Addresses Arkansas Home Loan Protection Law (July 11, 2003); Standard & Poor's: Evaluating Predatory Lending Laws: Standard & Poors Explains its Approach (April 15, 2003) (Georgia and New York); S&P Addresses Illinois High Risk Home Loans Act (Nov. 17, 2003); S&P Addresses Amendment to Maine Truth in Lending Act (Sept. 12, 2003); S&P Addresses Nevada Anti-Predatory Lending Law; and S&P Addresses Oklahoma Anti-Predatory Lending Law (Nov. 18, 2003).

¹⁶ See Fitch Ratings Responds to Arkansas Predatory Lending Legislation (June 20, 2003); Mortgage Bankers Association Industry News: "Fitch to Rate RMBS After Amendment to Georgia Predatory Lending Statute, GFLA" (Mar. 14, 2003); Mortgage Bankers Association Industry News: "Fitch Ratings Addresses Illinois Predatory Lending Legislation" (Dec. 15, 2003); Fitch Ratings Responds to Maine Predatory Lending Legislation (Sept. 29, 2003); Fitch Ratings Responds to Nevada Predatory Lending Legislation (Oct. 3, 2003); Mortgage Bankers Association Industry News: "Fitch: New York State Anti-Predatory Lending Legislation" (Mar. 26, 2003); and Fitch Ratings Addresses Predatory Lending Legislation of Oklahoma (Oct. 30, 2003).

¹⁷ See S&P Addresses Kentucky High-Cost Law (Jun. 20, 2003).

¹⁸ See Mortgage Bankers Association Industry News: "Fitch Ratings Responds to Kentucky Predatory Lending Legislation" (Jun. 30, 2003); and Mortgage Bankers Association Industry News: "Fitch Ratings Updates Criteria Regarding Predatory Loans" (Jan. 15, 2004).

- **New Jersey.** S&P and Fitch will not rate securitizations with certain high cost home loans from New Jersey.¹⁹ In order to rate a transaction including *any* loans from New Jersey, Fitch requires, as it does in Kentucky, receipt of a certification from a third party unaffiliated with the originators of the relevant loans that such third party conducted due diligence on a random sample of the greater of 5 loans or 10% of the loans from New Jersey and that no high cost home loans were uncovered in the sample. If the review of the sample of loans uncovers any high-cost home loans, Fitch requires a review of every loan in the pool originated in New Jersey.²⁰
- **New Mexico.** S&P will rate securitizations containing high cost home loans subject to the additional credit enhancements it requires in Arkansas, Georgia, Illinois, Maine, Nevada, New York, and Oklahoma.²¹ Fitch, however, will not rate any transaction containing high cost home loans subject to New Mexico’s anti-predatory lending law. Fitch notes that assignee liability may be unlimited in the case of punitive damages, which may be imposed for acts found to be reckless or malicious. Fitch further requires that the seller of any New Mexico loan provide adequate evidence that the transaction will enjoy the benefits of the new law’s safe harbor from the law’s unlimited liability for assignees and purchasers. In order to be protected by this safe harbor, a purchaser/securitizer must conduct due diligence and provide certain representations and warranties. Because it is unclear what constitutes sufficient “due diligence” under the New Mexico statute, Fitch requires the third party certificate and random sampling it requires in Kentucky and New Jersey.²²

These constraints translate into cost burdens at each stage of the lending process. For example, a rating agency that is willing to rate a "high-cost" loan securitization at all may, as we have seen, require representations, warranties, sampling, and certifications that go beyond the industry standard for prime loans. Satisfying these extra conditions may require a bank to increase its compliance staff, provide additional training to both existing and new staff, and pay fees to obtain third-party sampling and certification. If the rating agency requires additional credit enhancement, providing that – in the form of a guarantee, for example – will add to the financial cost of the transaction to the bank. Finally, if the bank cannot securitize the loans and must therefore retain them on book, the bank does not realize funds that it could use to make additional loans, the bank will incur carrying costs, and the bank's servicing fee income will be diminished. These costs either will be passed back to the bank's customers or, if the bank concludes they are unacceptably high, will compel the bank to stop making loans covered by state anti-predatory lending laws.

The rating agencies have, however, responded favorably to preemption decisions by the Federal banking agencies. Shortly after Fitch announced that it would not rate residential mortgage backed securitizations containing high cost home loans originated in New Mexico, Fitch also announced that, beginning the day the OCC’s preemption rule becomes effective (February 12,

¹⁹ See S&P Permits Additional New Jersey Mortgage Loans Into Related SF Transactions (November 25, 2003).

²⁰ See Fitch Ratings Responds to New Jersey Predatory Lending Legislation (Jun 5, 2003); and Mortgage Bankers Association Industry News: “Fitch Ratings Updates Criteria Regarding Predatory Loans” (Jan. 15, 2004).

²¹ See S&P Addresses New Mexico’s Home Loan Protection Act (Nov. 25, 2003).

²² See Mortgage Bankers Association Industry News: “Fitch Ratings Addresses New Mexico Predatory Lending Legislation” (Jan. 15, 2004).

2004), it *will* rate residential mortgage backed securitizations containing loans subject to any state or local anti-predatory lending laws that were originated by OCC-regulated national banks or their operating subsidiaries without additional credit enhancements.²³ This follows Fitch's August 22, 2003, decisions to rate securitizations without additional credit enhancement by OCC-regulated lenders in Georgia in light of the OCC's Preemption Order and Determination concerning the GFLA,²⁴ and by OTS-regulated lenders in all jurisdictions in light of the OTS's preemption regulations and various preemption opinions.²⁵ On October 3, 2003, S&P made the same decision concerning the GFLA Determination and Order,²⁶ and, on November 25, 2003, having reviewed the OTS's preemption opinions concerning the anti-predatory lending laws in Georgia, New Jersey, New Mexico, and New York, S&P announced that it would no longer apply its published criteria to Federal thrifts and their operating subsidiaries operating in those states.²⁷

These decisions are critical because, as we noted in our Preemption Determination and Order concerning the Georgia Fair Lending Act, without a certain secondary market for these loans, banks making risk-priced loans covered by this type of State law will be required to hold more of these loans to maturity. This, in turn, ties up more of a bank's capital as it carries the mortgage assets on its books, and thus adversely affects the ability of the bank to originate or acquire other real estate loans.

As a result of these higher costs and operational challenges, lenders must absorb the costs, pass the costs on to consumers, or discontinue offering various products in jurisdictions where the costs or exposure to uncertain liabilities are prohibitive. Notably, Option One Mortgage Corporation, a subsidiary of Wells Fargo, reportedly ceased funding for loans subject to New Mexico's anti-predatory lending law, which took effect January 1, and GMAC Residential Funding Corporation has significantly curtailed its operations in that state. Similarly, three lenders have announced they will no longer do business in New Jersey because of the State's predatory lending law, and at least 18 have significantly limited their lending activities there.²⁸ As lenders react like this, consumers will have fewer options for their home loans.

Finally, I must emphasize that our exercise of rulemaking authority was an open, broadly inclusive, and deliberative process in which we informally sought views from a number of perspectives even before proceeding with our preemption proposal. Recognizing that, in today's environment, the ability of national banks to operate under consistent, uniform national standards will be a crucial factor in their business future, the OCC began in 2002 discussing with consumer groups, members of Congress and their staffs, and industry groups the need for regulations to codify well-established preemption precedents and clarify the statute governing the OCC's exclusive visitorial powers. We have been completely open about the issues that concerned us, and the potential actions that we might take. The actions that we ultimately determined to take were not dramatic departures from existing precedent; moreover they were the product of an

²³ See Fitch Ratings Addresses Preemption Statement from the OCC (Jan. 16, 2004).

²⁴ See 68 Fed. Reg. 46264 (Aug. 5, 2003).

²⁵ See Fitch Ratings Addresses Preemption Statements from the OTS and OCC (Aug. 22, 2003).

²⁶ See S&P Announces Position on OCC's Preemption Order for the GFLA (Oct. 3, 2003).

²⁷ See S&P Announces Position on OTS Preemption Pronouncements (Nov. 25, 2003).

²⁸ See Paul Muolo and Brad Finkelstein, *Lenders Leaving New Jersey*, Dec. 2003, *American Banker-Bond Buyer*, Vol 13, No. 3 at 41.

extended and highly inclusive process that was fully cognizant of the interest and role of Congress.

V. Correcting Misconceptions about the Preemption and Visitorial Powers Rules

Some of the comments and reaction we have received in response to our rules seem to reflect fundamental misconceptions about the law on which the rules are based, or the effect of the regulations. I welcome the opportunity to correct these misconceptions.

1. *The preemption and visitorial powers rules will not demolish the dual banking system.*

Some critics have suggested that by codifying in regulations the exclusivity of the OCC's supervision of national banks and the types of State laws that are, or are not, preempted as applied to national banks, the OCC "will demolish" the dual banking system, or "deprive bankers of a choice of charters." We even heard recently that a State legislator was told that our regulation would lead to dismantling of his State's banking department because it would prevent that department from regulating *State banks*.

Some of this rhetoric is, obviously, fanciful. Other comments in the same vein profoundly short-change the qualities of the State banking systems. More fundamentally, the argument being advanced is simply backwards. Distinctions between State and Federal bank charters, powers, supervision, and regulation are not contrary to the dual banking system; they are the essence of it. Clarification of how the Federal powers of national banks preempt inconsistent State laws is entirely consistent with the distinctions that make the dual banking system dual.

The national and State charters each have their own distinct advantages. But many national banks engage in multi-state businesses that particularly benefit from the efficiency of a uniform, nationwide system of laws and regulations. Customers of national banks enjoy protections that are as strong as -- and in some cases stronger than -- those available to customers of State banks. But they also benefit from the efficiencies of the national banking system, and predictable, uniform, consistent regulation. It is important to remember that the dual banking system offers American consumers a choice -- those who believe the State system offers greater protections, or desirable variety, are free to make that choice.

2. *The OCC is using the correct preemption standards in our preemption rule.*

Some critics of the regulation have claimed that we are using incorrect preemption standards in our preemption rule. They argue that that preemption should only occur when State law significantly impairs a national bank's *express* rights under Federal law. These critics also argue that the OCC contends that national banks are immune from State law. These assertions misstate both OCC's positions and the relevant judicial standards for preemption.

The OCC is *not* arguing that national banks are immune from State law. As I have mentioned previously, the preemption standards in our new regulation are firmly grounded on standards announced by the U.S. Supreme Court in cases that trace back over 130 years, and our authority to adopt the regulation is solidly based on our statutes. The final regulation specifically -- and

meticulously – explains the sources of our authority to issue the regulation and the standards we use. In a nutshell, the preemption standards the OCC applies derive from Supreme Court and lower Federal court precedents that provide that Federal law can preempt state laws that obstruct (stand as an obstacle), *Hines v. Davidowitz* (1941); impair the efficiency of, *National Bank v. Commonwealth* (1869), *Davis v. Elmira Savings Bank* (1896), *McClellan v. Chipman* (1896); or condition the ability of national banks to exercise powers granted under Federal law, *Barnett Bank of Marion County v. Nelson* (1996); *Franklin* (1954); and that state “legal infrastructure” laws – such as contract, torts, and real property laws -- that do not restrict the content or extent of powers granted under Federal law are **not** preempted. *National Bank v. Commonwealth* (1869); *McClellan v. Chipman* (1896); *B of A v. City and County of S.F.* (9th Cir. 2002).

It is relevant to note in that regard that the laws listed as preempted in our new regulation are virtually identical to those listed as preempted with respect to Federal thrifts in existing regulations of the OTS.

3. *There is no presumption against preemption in the case of the national banking laws, as confirmed by Federal case law and the Riegle-Neal Act.*

Critics of both the preemption and visitorial powers rules contend that the rules are inconsistent with the presumptive application of state law to national banks, allegedly embodied in the Riegle-Neal Act. This is simply incorrect.

As an initial matter, case law, whether decided before or after Riegle-Neal was enacted, is consistent in holding that there is no presumption against preemption in the national bank context. The Supreme Court has said that a presumption against preemption "is not triggered when the State regulates in an area where there has been a history of significant federal presence."²⁹ Courts have consistently held that the regulation of national banks is an area where there has been an extensive history of significant Federal presence. As recently observed by the U.S. Court of Appeals for the Ninth Circuit, "since the passage of the National Bank Act in 1864, the federal presence in banking has been significant." The court thus specifically concluded that "the presumption against the preemption of state law is inapplicable."³⁰ Indeed, when analyzing national bank powers, the Supreme Court has interpreted "grants of both enumerated and incidental 'powers' to national banks as grants of authority not normally limited by, but rather ordinarily pre-empting, contrary state law."³¹

²⁹ *U.S. v. Locke*, 529 U.S. 89, 108 (2000) (explaining *Rice v. Santa Fe Elevator Corp.*, 331 U.S. 218 (1947)).

³⁰ *Bank of America*, 309 F.3d at 558-59 (citations omitted).

³¹ *Barnett*, 517 U.S. at 32. The *Barnett* Court went on to elaborate:

[W]here Congress has not expressly conditioned the grant of “power” upon a grant of state permission, the Court has ordinarily found that no such condition applies. In *Franklin Nat. Bank*, the Court made this point explicit. It held that Congress did not intend to subject national banks' power to local restrictions, because the federal power-granting statute there in question contained “no indication that Congress [so] intended . . . as it has done by express language in several other instances.”

Id. at 34 (emphasis in original) (citations omitted).

The relevant text of the Riegle-Neal Act is fully consistent with these conclusions. As explained in the preamble to the visitorial powers rule, the Riegle-Neal Act sorted out *which* state’s laws -- host state or home state – regarding community reinvestment, consumer protection, fair lending, and establishment of intrastate branches, would apply to interstate branches of national banks, and provided that the host state’s laws in those areas would apply to national banks “***except when Federal law preempts the application of such State laws to a national bank.***” The potential preemption of state laws thus was expressly recognized as possible in the Riegle-Neal legislation itself.

Moreover, the legislative history of the Riegle-Neal Act indicates that Congress expected the OCC to apply traditional, recognized preemption standards in deciding preemption issues, which, as I have already explained, is exactly what the OCC is doing.

Finally, the Riegle-Neal Act also specifically provided that the provisions of any State law to which a branch of a national bank is subject under the Act “*shall be enforced, with respect to such branch, by the Comptroller of the Currency.*” Thus, the Riegle-Neal Act is entirely consistent with the visitorial powers rule in providing that even when State law may be applicable to interstate branches of national banks, the OCC is to enforce such laws (in other words, the OCC retains exclusive visitorial authority).

4. *The OCC has ample authority to adopt the preemption rule.*

As mentioned previously, the OCC’s authority to issue the preemption regulation comes from both 12 U.S.C. § 371 (regarding real estate lending) and § 93a (for all other activities). This statutory authority was recognized by the D.C. Circuit two decades ago in *CSBS v. Conover*.³² In that case, the court expressly held that the Comptroller has the power under § 371 to issue a regulation that preempts aspects of state laws regarding real estate lending and has authority under § 93a more generally to issue regulations preempting State laws that are inconsistent with the activities permissible under Federal law for national banks. In the words of the court:

It bears repeating that the entire legislative scheme is one that contemplates the operation of state law only in the absence of federal law and where such state law does not conflict with the policies of the National Banking Act. *So long as he does not authorize activities that run afoul of federal laws governing the activities of the national banks, therefore, the Comptroller has the power to preempt inconsistent state laws.*³³

The authority under sections 93a and 371 described by the court in *CSBS v. Conover* thus amply supports the adoption of regulations providing that specified types of state laws purporting to govern as applied to national banks’ activities and operations are preempted.

5. *State law applies to national bank operating subsidiaries to the same extent as their parent banks; therefore, the preemption and visitorial powers rules apply to national banks and their operating subsidiaries equally.*

³² 710 F.2d 878 (D.C. Cir 1983).

³³ *Id.* at 878 (emphasis added).

As explained previously, the preemption and visitorial powers rules make no changes to the OCC's rules governing the activities of operating subsidiaries. As already set out in 12 C.F.R. §§ 5.34, 7.4006, and 34.1(b), national bank operating subsidiaries conduct their activities subject to the same terms and conditions as apply to the parent banks. Therefore, *by virtue of regulations already in place*, the rules apply equally to national banks and their operating subsidiaries.

It is important to note that the OCC's position does not implicate the corporate existence or governance rules of State corporations; it concerns the ability of those entities to conduct certain activities subject to *Federal* supervision and regulation. National bank operating subsidiaries conduct their activities pursuant to a *Federal license* under OCC regulations and Federal law, and do not need a State license to conduct activities they are authorized to conduct under a *Federal permit*. Operating subsidiaries are thus a Federally-authorized means by which national banks may conduct activities authorized under Federal law; as reflected in the OCC's rules, State laws in conflict with that authority must give way.

6. *States' ability to protect consumers will not be undermined by the OCC's positions on preemption of State laws and visitorial powers.*

It is simply not the case that consumers will be hurt by our rules. National banks and national bank operating subsidiaries are subject to extensive Federal consumer protection laws and regulations, administered and enforced by the OCC.³⁴ OCC examinations of national banks and national bank operating subsidiaries are conducted to ensure and enforce compliance with these laws and regulations and supplemental OCC supervisory standards.

As the OCC has made clear on a number of occasions, predatory and abusive lending practices have no place in the national banking system, and we have no evidence that national banks (or their subsidiaries) are engaged in such practices to any significant degree. Virtually all State Attorneys General have more than once expressed the view that information available to them does not show that banks and their subsidiaries are engaged in abusive or predatory lending practices. Indeed, in briefs filed in litigation involving the OTS, the State Attorneys General have acknowledged that predatory lending problems are centered in State-licensed non-depository institution lenders.

³⁴ Federal consumer protection laws and regulations that apply to national banks and to national bank operating subsidiaries include: the Federal Trade Commission Act; Truth in Lending Act; Home Ownership and Equity Protection Act; Fair Housing Act; Equal Credit Opportunity Act; Real Estate Settlement Procedures Act; Community Reinvestment Act; Truth in Savings Act; Electronic Fund Transfer Act; Expedited Funds Availability Act; Flood Disaster Protection Act; Home Mortgage Disclosure Act; Fair Housing Home Loan Data System; Credit Practices Rule; Fair Credit Reporting Act; Federal Privacy Laws; Fair Debt Collection Practices Act; the new OCC anti-predatory lending rules in 12 C.F.R. Parts 7 and 34; OCC rules imposing consumer protections in connection with the sales of debt cancellation and suspension agreements; OCC standards on unfair and deceptive practices (<http://www.occ.treas.gov/ftp/advisory/2002-3.doc>); and OCC standards on preventing predatory and abusive practices in direct lending and brokered and purchased loan transactions (<http://www.occ.treas.gov/ftp/advisory/2003-2.doc> and <http://www.occ.treas.gov/ftp/advisory/2003-3.doc>).

On those limited occasions where we have found national banks to be engaged in unacceptable practices, we have taken vigorous enforcement action.³⁵ We are firmly committed to using our many supervisory measures and enforcement tools available to keep such practices out of the national banking system.

Of course, nothing in the OCC's preemption or visitorial powers rules prevents the States from applying State standards and taking actions against the entities they supervise and regulate. Indeed, *resources* would be deployed more efficiently to protect *more consumers* if States applied their resources to the conduct of *State supervised entities*, the OCC applied its resources to national banks, and State officials referred problems involving national banks that come to their attention to the OCC.

We very much regret that these legal issues are assuming the complexion of a turf battle between Federal and State authorities. I firmly believe that we have common goals, and we have tried to avoid this result by offering a cooperative, information sharing agreement regarding consumer complaints to State officials. The response to date has been disappointing, but we will continue to pursue cooperative arrangements with the States wherever possible.

V. Conclusion

In conclusion, Madam Chairwoman, we believe our new regulations provide benefits for national bank customers, are good for national banks, are good for our economy, and are entirely consistent with the fundamentals of the dual banking system. Perhaps most importantly, our actions also are entirely consistent with Congress's design of the national banking system, the powers and authority Congress has vested in national banks, and with legal precedent dating from the earliest years of the national banking system up to current times.

I am pleased to have had this opportunity to provide our views and respond to your concerns. Once again, thank you, Madam Chairwoman, for inviting the OCC's participation in this hearing.

³⁵ For example, see *In the Matter of First Consumers National Bank, Beaverton, Oregon*, Enforcement Action 2003-100 (required restitution of annual fees and overlimit fees for credit cards); *In the Matter of Household Bank (SB), N.A., Las Vegas, Nevada*, Enforcement Action 2003-17 (required restitution regarding private label credit cards); *In the Matter of First National Bank in Brookings, Brookings, South Dakota*, Enforcement Action 2003-1 (required restitution regarding credit cards); *In the Matter of First National Bank of Marin, Las Vegas, Nevada*, Enforcement Action 2001-97 (restitution regarding credit cards); and *In the Matter of Direct Merchants Credit Card Bank, N.A., Scottsdale, Arizona*, Enforcement Action 2001-24 (restitution regarding credit cards). These orders can be found on the OCC's website within the "Popular FOIA Requests" section at <http://www.occ.treas.gov/foia/foiadocs.htm>.