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# THE "MOST FAVORED LENDER" DOCTRINE FOR FEDERALLY INSURED FINANCIAL INSTITUTIONS— WHAT ARE ITS BOUNDARIES?

*Coreen S. Arnold\* and Ralph J. Rohner\*\**

## I. INTRODUCTION

The great volatility of interest rates over the past several years led Congress to enact legislation to increase the flow of credit and to enhance competition among lending institutions. One of these enactments, the Depository Institutions Deregulation and Monetary Control Act of 1980<sup>1</sup> (DIDMCA or the Act), includes measures such as federal preemption of state usury ceilings for business and agricultural credit,<sup>2</sup> and for residential first mortgages.<sup>3</sup> Another portion of the Act<sup>4</sup> seeks to create a more "level playing field"<sup>5</sup> among financial institutions by according to all federally insured lenders—banks, savings and loan associations, and credit unions—a preferential rate policy comparable to that enjoyed for over a century by national (*i.e.*, federally chartered) banks.

The heart of this longstanding advantage for national banks is the so-

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1. Depository Institutions Deregulation and Monetary Control Act of 1980, Pub. L. No. 96-221, 94 Stat. 161 (codified in scattered sections of 12, 15 U.S.C.) [hereinafter cited as DIDMCA].

2. DIDMCA, *supra* note 1, §§ 511-512 (codified at 12 U.S.C. § 86a (Supp. IV 1980)).

3. *Id.* § 501 (codified at 12 U.S.C. § 1735f-7 (Supp. IV 1980)).

4. *Id.* §§ 521-523, 525 (codified at 12 U.S.C. §§ 1831d, 1730g (Supp. IV 1980)).

5. This language appears frequently to describe the intended purpose of this portion of DIDMCA. *See, e.g.*, 126 CONG. REC. S3164 (daily ed. Mar. 27, 1980).

called "most favored lender" doctrine. Derived from case law and federal agency interpretations of language in the National Bank Act of 1864,<sup>6</sup> the doctrine holds that a national bank may charge the highest rate that *any other lender* in a state may charge for the same type of transaction, regardless of state usury limits which otherwise would be applicable to national banks. DIDMCA extended language parallel to provisions in the National Bank Act to federally insured state banks and other federally insured depository institutions, and has been construed to accord most favored lender status to those institutions.

The legislative history for the DIDMCA amendments is sparse, and agency interpretations have barely begun to explore the possible nuances of a rule that allows one lender to borrow the rate structure authorized for other lenders. Opinions on these issues under the older National Bank Act are limited, and there is little definitive judicial construction of the DIDMCA amendments. Meanwhile, several bills are pending which would completely preempt state usury laws for all consumer credit transactions, thus rendering moot many questions about the scope of the most favored lender doctrine. But the enactment of such preemptive legislation is speculative, and until it becomes law, the boundaries of most favored lender status for federally chartered and insured institutions will command the careful attention of creditors and debtors, courts, and federal and state supervisory agencies. This article offers some background and preliminary analysis of these issues.

## II. THE STATUTORY LANGUAGE

On March 31, 1980, President Carter signed into law the Depository Institutions Deregulation and Monetary Control Act of 1980. Title V of the Act contains three parts which override state usury laws.<sup>7</sup> Part C, sections 521-523, contains language which amends various federal statutes, grant-

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6. Ch. 106, § 30, 13 Stat. 108 (current version at 12 U.S.C. § 85 (Supp. IV 1980)).

7. Section 501 of DIDMCA (codified at § 1735f-7 (Supp. IV 1980)) provides a plenary preemption of state usury laws applicable to first-lien residential mortgages, subject to a state's positive action to reimpose state ceilings before April 1, 1983. Part B, §§ 511-512, is actually an extension of prior legislation which authorizes any lender, in a business or agricultural loan transaction, to charge up to 5% over the Federal Reserve Discount rate on 90-day commercial paper. This preemption, too, is subject to state override anytime after April 1, 1980. Part C, §§ 521-523, discussed throughout this article, applies to all credit extensions by federally insured depository institutions. It authorizes two rate ceiling options for such lenders, beyond the rate limit otherwise applicable to such institutions under state law.

DIDMCA, in its entirety, was an omnibus (or "Christmas tree") banking bill which, *inter alia*, expanded requirements for maintaining bank reserves in the Federal Reserve System, provided for the phased abolition of controls on rates paid to savers (the "Regulation Q phase-out"), authorized a wide array of customer services by banks and other financial insti-

ing special interest rate privileges to federally insured depository institutions.<sup>8</sup> Each of these provisions states that, instead of the rate ceiling normally applicable, the institution may charge interest either at a rate of 1% over the Federal Reserve discount rate, or "*at the rate allowed by the laws of the State . . . where the [institution] is located, whichever may be greater.*" (emphasis added).

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tutions, and simplified the Truth in Lending Act, 15 U.S.C. §§ 1601 to 1681 (1976 & Supp. IV 1980).

8. Section 521 amends the Federal Deposit Insurance Act by adding a new § 27 (codified at 12 U.S.C. § 1831d (Supp. IV 1980)), which reads in pertinent part as follows:

(a) In order to prevent discrimination against State-chartered insured banks including insured savings banks, and insured mutual savings banks, or insured branches of foreign banks with respect to interest rates, if the applicable rate prescribed in this subsection exceeds the rate such State bank or insured branch of a foreign bank would be permitted to charge in the absence of this subsection, such State bank or such insured branch of a foreign bank may, notwithstanding any State constitution or statute which is hereby preempted for the purposes of this section, take, receive, reserve, and charge on any loan or discount made, or upon any note, bill of exchange, or other evidence of debt, interest at a rate of not more than 1 per centum in excess of the discount rate on ninety-day commercial paper in effect at the Federal Reserve bank in the Federal Reserve district where such State bank or such insured branch of a foreign bank is located or at the rate allowed by the laws of the State, territory, or district where the bank is located, whichever may be greater.

12 U.S.C. § 1831d(a) (Supp. IV 1980).

Section 522 amends Title IV of the National Housing Act by adding a new § 414 (codified at 12 U.S.C. § 1730g), which reads in pertinent part as follows:

(a) If the applicable rate prescribed in this section exceeds the rate an insured institution would be *permitted* to charge in the absence of this section, such institution may, notwithstanding any State constitution or statute which is hereby preempted for the purposes of this section, take, receive, reserve, and charge on any loan or discount made, or upon any note, bill of exchange, or other evidence of debt, interest at a rate of not more than 1 per centum in excess of the discount rate on ninety-day commercial paper in effect at the Federal Reserve bank in the Federal Reserve district where such institution is located or at the rate allowed by the laws of the State, territory, or district where such institution is located, whichever may be greater.

12 U.S.C. § 1730g(a) (Supp. IV 1980) (emphasis added).

Section 523 amends the Federal Credit Union Act by adding a new § 205g (codified at 12 U.S.C. § 1785 (Supp. IV 1980)), which reads in pertinent part as follows:

(1) If the applicable rate prescribed in this subsection exceeds the rate an insured credit union would be permitted to charge in the absence of this subsection, such credit union may, notwithstanding any State constitution or statute which is hereby preempted for the purposes of this subsection, take, receive, reserve, and charge on any loan, interest at a rate of not more 1 per centum in excess of the discount rate on ninety-day commercial paper in effect at the Federal Reserve bank in the Federal Reserve district where such insured credit union is located or at the rate allowed by the laws of the State, territory, or district where such credit union is located, whichever may be greater.

12 U.S.C. § 1785g (Supp. IV 1980).

Since the clear congressional purpose was to provide other lenders with the same interest rate advantage as national banks,<sup>9</sup> the implications of this legislation can be analyzed by comparison with similar statutory language in the National Bank Act and its interpretation by the courts. The legislative history of DIDMCA and interpretations by those agencies charged with its enforcement also provide some guidance, although virtually all of the congressional debate has centered on the "1% in excess of the discount rate" option and not on the "rate allowed by the laws of the State" language.<sup>10</sup> The DIDMCA legislative debate offers no explicit mention of the "most favored lender" doctrine as that phrase has been used in case law under the National Bank Act.<sup>11</sup>

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9. During Senate consideration of the conference report on H.R. 4986 (the bill that became DIDMCA), the chairman of the Senate Banking Committee, Senator Proxmire, described DIDMCA, Title V, as containing "a provision which provides parity, or competitive equality, between national banks and state chartered depository institutions on lending limits." 126 CONG. REC. S3170 (daily ed. Mar. 27, 1980).

The implications of this legislation in terms of market shares are significant. Of the \$318 billion in nonmortgage consumer installment and revolving credit outstanding in June 1981, commercial banks held \$143 billion, or about 45% (more than half of this held by national banks), savings and loan associations held \$11 billion (3 1/2%), and credit unions \$46 billion (14%). 67 Fed. Res. Bull. A40 (Aug. 1981). Not all of these financial institutions are federally insured, but the number relying on state deposit insurance is small.

10. See §§ 521-523, *supra* note 8. Congress focused exclusively on the first option, and seemed utterly unaware of, or unconcerned with, the case law discussed throughout this article. Since the "most favored lender" doctrine for national banks is almost wholly a creature of case law, the extension of that doctrine to lenders other than national banks really has no legislative history, and hangs on the slender thread of language in §§ 521-523 which is parallel to the language of § 85 of Title 12 of the United States Code.

The origin of DIDMCA §§ 521-523 is instructive of the perceived purpose of those sections. These provisions appeared nowhere in the original bills that were growing into the omnibus bill that became DIDMCA. In late 1979, during Senate consideration of the House-passed bill, H.R. 4986, the two senators from Arkansas voiced special concern for the plight of Arkansas state banks which, like all lenders in that state, were restricted by the state constitution to a 10% simple-interest rate ceiling on all credit extensions. 125 CONG. REC. S15,684 (daily ed. Nov. 1, 1979) (remarks of Senators Bumpers and Pryor). Those senators subsequently introduced a bill, S. 1988, on which the Senate Banking Committee held hearings in December 1979. *Hearings on S. 1988 Before the Senate Comm. on Banking, Housing and Urban Affairs*, 96th Cong., 1st Sess. (1979). A companion bill was introduced in the House, also sponsored by an Arkansas representative. H.R. 6503, 96th Cong., 1st Sess. (1979). These bills were essentially the same as the present language of §§ 521-523, but neither bill was ever reported out of committee. Yet during the course of the subsequent conference consideration of H.R. 4986, 96th Cong., 1st Sess. (1979), the provisions of the "Arkansas bill" were negotiated into the finished package.

The lack of any congressional discussion of the most favored lender case law is therefore somewhat understandable. In Arkansas, no lender could charge more than 10% simple interest, and so the legislative push was toward authorizing state banks to charge 1% over the Federal Reserve discount rate. This was the only option that would provide any real rate relief to Arkansas lenders.

11. There are at most some fleeting references to the most favored lender doctrine in

Section 85 of Title 12 of the United States Code [hereinafter section 85],<sup>12</sup> provides the same options as sections 521-523 of DIDMCA, *i.e.*, national banks may charge either 1% over the Federal Reserve discount rate, or "at the rate allowed by the laws of the state." In addition, an "except" clause adds a third alternative for national banks (an alternative not replicated in DIDMCA) providing that national banks may in any case charge the rate "limited" for state banks.

The language of section 85 is unclear, and therefore susceptible of several constructions. One reasonable interpretation of this section could be

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written statements submitted during the hearings on S. 1988. *See, e.g., Hearings on S. 1988 Before the Senate Comm. on Banking, Housing & Urban Affairs, 96th Cong., 1st Sess. 64-65 (1979) (statement of Joseph N. Cugini (Credit Union National Association)).* What is surprising is that the Comptroller of the Currency, who certainly knew of the most favored lender case law affecting national banks, submitted an extensive statement for the hearing record, but did not even hint at the existence of the doctrine. *Id.* at 19-22.

In fact, through the entire debate over the preemption provisions in Title V of DIDMCA, Congress evidenced considerable ignorance about the exact scope of the favoritism for national banks under § 85. When Senator Cochran proposed an amendment to H.R. 4986 to preempt state usury laws for business and agricultural loans, the following exchange occurred:

Mr. COCHRAN. . . . There are about 18 States, I am advised, who do have restrictions under statutory law which have the effect of prohibiting State banks from making loans at the going rate of interest or at the rate at which national banks in those States can make such loans.

Mr. MORGAN. Is it the Senator's understanding that the national banks ought not to be bound by the state usury laws?

Mr. COCHRAN. My understanding is that the Federal laws governing the operation of national banks do have precedence. Someone who is more familiar with the legal effect of the Federal law in that regard may be better qualified to answer that question. I am advised that because of the disparity in the law national banks do in fact have a different set of rules under which to operate.

Mr. MORGAN. The Senator may be quite correct. During the last few years we must have preempted or changed State laws a thousand times. It is my understanding, however, that national banks are bound by State usury laws. . . .

125 CONG. REC. S15,260 (daily ed. Oct. 29, 1979). Apparently no one ever clarified the senators' uncertainty.

12. 12 U.S.C. § 85 (Supp. IV 1980) (originally enacted as § 30 of the National Bank Act, ch. 106, § 30, 13 Stat. 108 (1864), *as amended by* ch. 89, § 25, 48 Stat. 191 (1933)). It now provides in pertinent part:

*Any association may take, receive, reserve, and charge on any loan or discount made, or upon any notes, bills of exchange, or other evidences of debt, interest at the rate allowed by the laws of the State, Territory, or District where the bank is located, or at a rate of 1 per centum in excess of the discount rate on ninety-day commercial paper in effect at the Federal Reserve Bank in the Federal Reserve district where the bank is located, whichever may be the greater, and no more, except that where by the laws of any State a different rate is limited for banks organized under State laws, the rate so limited shall be allowed for associations organized or existing in any such State under this chapter.*

*Id.* (emphasis added).

that national banks are not limited to charging the interest rate generally permitted under the laws of the state where they are located, but instead may charge the rates that are allowed for state banks, if those rates are more favorable. However, the courts and the agency charged with enforcement of the National Bank Act, the Comptroller of the Currency (OCC), have long inferred a different, and broader, meaning from the words of section 85.

The Supreme Court has consistently held that section 85 is an enabling statute which empowers national banks to charge interest at the highest rates permitted other lenders by the laws of the state in which the bank is located. As early as 1874, in *Tiffany v. National Bank of Missouri*,<sup>13</sup> the Court declared that the original statute gave advantages to national banks over their state competitors by allowing national banks to charge interest in excess of what state banks could charge, if the state law permitted some lenders to charge more. National banks could charge the rates available to the "most favored lender"<sup>14</sup> in the state in order to assure that state legislatures would be unable to bind national banks to lower rates applicable to state chartered institutions. The basic holding in *Tiffany*, which has never been modified,<sup>15</sup> underlies an OCC interpretation of section 85,<sup>16</sup> originally issued as an opinion letter in 1936 and later adopted as a formal ruling, which confirms that national banks may charge the highest rate

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13. 85 U.S. (18 Wall.) 409 (1874). The Court held that a national bank could lawfully charge 9% on a loan since Missouri law allowed a rate of 10% to lenders generally, even though that state's law limited state banks to a rate of 8%.

14. This phrase, now universally used to describe the effect of § 85, grew from language in *Tiffany*: "National banks have been national favorites." *Id.* at 413. This favoritism flowed from the purposes for creating a system of nationally chartered banks: to provide a stable currency base by driving state bank notes out of circulation, and to create a structure of financial institutions suitable for financing government expenditures in the Civil War. For the setting and history of the creation of the national banking system, see generally R. TIMBERLAKE, JR., *THE ORIGINS OF CENTRAL BANKING IN THE UNITED STATES* (1978); Davis, *The National Banking System*, V PUBLICATIONS OF THE NAT'L MONETARY COMM'N (1911).

15. The Supreme Court signaled its continuing approval of *Tiffany* as recently as 1978 in *Marquette Nat'l Bank v. First of Omaha Serv. Corp.*, 439 U.S. 299 (1978). See notes 122-41 and accompanying text *infra*.

16. 12 C.F.R. § 7.7310 (1980). The interpretive ruling provides in pertinent part: A national bank may charge interest at the maximum rate permitted by State law to any competing State-chartered or licensed lending institution. If State law permits a higher interest rate on a specified class of loans, a national bank making such loans at such higher rate is subject only to the provisions of State law relating to such class of loans that are material to the determination of the interest rate. For example, a national bank may lawfully charge the highest rate permitted to be charged by a State-licensed small loan company or morris plan bank, without being so licensed.

permitted any other lender on specific types of loans. It was not until 1933 that the National Bank Act was amended to allow national banks the additional option of charging 1% above the federal discount rate for ninety-day commercial paper.<sup>17</sup>

As a practical matter, national banks have not had to rely on the authority of the OCC interpretive ruling often. Reasonably generous state usury laws, competitive pressures, and the inability of corporate borrowers to assert usury defenses, as well as the traditional reluctance of banks to engage in high-risk (high rate) consumer lending have rendered most favored lender rights claims largely unnecessary. There was little use of the 1% above discount option until the mortgage crunch of 1979.<sup>18</sup> But where states permitted high rates (even above the discount rate) to certain creditors, such as small loan companies and retail stores, national banks have used their protected status as favored lenders to charge rates "borrowed" from those state laws.<sup>19</sup>

As a third possible interpretation of section 85, where state banks are limited to an interest rate different than the rate allowed to lenders generally, national banks are also limited to the rate for state banks. In a recent state probate court case,<sup>20</sup> the estate administrator argued for such an interpretation, but the court rejected that argument, attributing the following meaning to the "except" clause of section 85:

the words 'a different rate' means 'a higher rate,' and was inserted by the Congress to take care of the situation wherein state banks might have been allowed, through special statutory exceptions, to charge a higher rate, and thus ensure that national banks might also charge the higher rate . . . . 12 U.S.C. § 85 has been consistently interpreted as permitting national banks to charge as much as state chartered banks or any other state licensed lenders;

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17. Act of June 16, 1933, ch. 89, § 25, 48 Stat. 191 (1933).

18. *See, e.g.*, *Kimball v. National Bank of North America*, 468 F. Supp. 1069 (E.D. N.Y.), *aff'd without opinion*, 614 F.2d 1288 (2d Cir. 1979).

19. Recent court decisions have cited the OCC interpretive ruling, *see* note 16, *supra*, with approval in permitting national banks to charge small loan company rates for open-end credit card accounts above the rates specified under state law for that type of account. *Fisher v. First Nat'l Bank of Chicago*, 538 F.2d 1284 (7th Cir. 1976); *United Missouri Bank of Kansas City v. Danforth*, 394 F. Supp. 774 (W.D. Mo. 1975). In *Northway Lanes v. Hackley Union Nat'l Bank & Trust Co.*, 464 F.2d 855 (6th Cir. 1972), the court deferred to the OCC interpretive ruling and found support in the *Tiffany* decision and the legislative history of the National Bank Act, to hold that national banks could charge closing costs not allowed to banks but permitted to savings and loan associations under state law.

20. *First Nat'l Bank of Kansas City v. Estate of Ward*, (Est. No. 121,864, P. Ct. of Jackson County, Mo., Jan. 20, 1976), *reprinted in* 93 *BANKING L.J.* 593 (1976). *See also* *State Nat'l Bank of Conn. v. Cohen*, 32 Conn. Supp. 245, 349 A.2d 729 (1975).



. . . national banks were placed on a parity with 'the most favored lender.'<sup>21</sup>

Despite its convoluted language, section 85 continues to be interpreted by the courts as it was in *Tiffany*—that national banks are on a par with the most favored lender in the state. And, upon comparison, the language in DIDMCA closely tracks that in section 85.

Each of the agencies charged with enforcing DIDMCA has interpreted the provisions of that Act to extend the most favored lender doctrine to federally insured depository institutions that are not national banks. The General Counsel of the Federal Deposit Insurance Corporation (FDIC) has unofficially construed section 521 of DIDMCA to grant most favored lender status to federally insured state banks, based on the literal construction and congressional purpose of the amendment to the Federal Deposit Insurance Act.<sup>22</sup> In the language of section 521, Congress made explicit its intent "to prevent discrimination against [insured state banks] with respect to interest rates."<sup>23</sup> The Chairman of the Senate Banking Committee, a sponsor of DIDMCA, expressed a similar intent: "Title V . . . contains a provision which provides parity, or competitive equality, between national banks and State chartered depository institutions on lending limits . . . . State chartered depository institutions are given the benefits of 12 U.S.C. § 85."<sup>24</sup> The FDIC staff letter concluded that, by using the same language as that used in section 85, Congress intended DIDMCA to have the same meaning. Since the Supreme Court has interpreted the section 85 phrase "the rate allowed by the laws of the state" to mean "the rate of interest fixed by state laws for lenders generally,"<sup>25</sup> and the phrase was later interpreted to mean the rate allowed to any lender in the state,<sup>26</sup> the FDIC assumed an equally broad construction for state banks.

The Federal Home Loan Bank Board (FHLBB) has also issued an interpretive ruling for section 522 of DIDMCA, which "formally endorses the 'most favored lender' concept as a matter of Board policy."<sup>27</sup> The

21. 93 BANKING L.J. at 596.

22. FDIC Interpretive Letter from Frank L. Skillern, General Counsel (undated). This opinion was apparently issued in early 1981. See Wash. Cred. Letter (Feb. 2, 1981).

It is important to appreciate that this letter, like many of the agency staff opinions cited and discussed *infra*, has limited authoritative value. These letters are at best informal agency staff advice and are not binding on courts. None of these opinion letters has the same binding force as, for example, Federal Reserve Board staff letters interpreting the Truth in Lending Act, under *Ford Motor Credit Co. v. Milhollin*, 444 U.S. 555 (1980).

23. See note 8 *supra*.

24. 126 CONG. REC. S3170 (daily ed. Mar. 27, 1980) (remarks of Sen. Proxmire) as quoted in FDIC Interpretive Letter, *supra* note 22.

25. *Tiffany v. National Bank of Mo.*, 85 U.S. (18 Wall.) at 411.

26. OCC Interpretive Ruling, *supra* note 16.

27. 46 Fed. Reg. 13,987 (1981) (to be codified in 12 C.F.R. § 570.11).

FHLBB, like the FDIC, focused on the similarity of language in DIDMCA and in section 85, the interpretive history of the phrase "the rate allowed by the laws of the State," and the intent of Congress as expressed in the legislative history of the Act. The FHLBB's position is that since Congress, in enacting DIDMCA, intended to give to other federally insured lenders the same advantages as national banks, the use of language identical to that found in the National Bank Act clearly extends most favored lender status to all federally insured savings and loan associations.<sup>28</sup>

The National Credit Union Administration (NCUA) has likewise issued a statement of interpretation and policy<sup>29</sup> concerning section 523 of DIDMCA. NCUA recognized that one reading of the statutory language in DIDMCA would be that the "rate allowed" was the same as the "rate [otherwise] permitted," thus limiting the credit union to the rate it could normally charge under state law.<sup>30</sup> The agency determined, however, that the words "rate allowed" contemplated higher rates available to other lenders, and therefore should be interpreted to grant most favored lender status to state chartered federally insured credit unions. This interpretation, according to NCUA, was consistent with previous interpretations of the National Bank Act as well as the intent of DIDMCA to "remove the competitive advantage National banks have."<sup>31</sup>

Despite the similarities between the language of section 85 of the National Bank Act and sections 521-523 of DIDMCA, the 1980 Act contains an important difference. The apparent expansion of the most favored lender doctrine under DIDMCA was not an absolute displacement of state

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28. *Id.* at 13,988. Interestingly, while § 521 (applicable to state chartered banks) specifically states that it is designed to "prevent discrimination" against those institutions, there is no comparable language in § 522 (for savings and loan associations) or § 523 (for credit unions).

29. 46 Fed. Reg. 24,153 (1981) (to be codified in 12 C.F.R. § 741). The NCUA interpretation applies only to state chartered (but federally insured) credit unions, apparently because federally chartered credit unions are subject to an explicit federal interest rate ceiling.

30. 45 Fed. Reg. 78,624-25 (1980). NCUA's original interpretation stated that under § 523 of DIDMCA, most favored lender status was triggered when the rate credit unions could charge was less than 1% above the discount rate, and applied only when a credit union granted loans other than first mortgages, or business or agricultural loans of \$1,000 or more. Later NCUA cancelled that interpretation (IRPS 80-11) and adopted another (IRPS 81-3) which eliminated the trigger mechanism and opined that most favored lender status applied to any loan granted by a state-chartered and federally-insured credit union. 46 Fed. Reg. 24,153 (1981).

31. 45 Fed. Reg. 78,624-25 (1980). *See also* 126 CONG. REC. S3177 (daily ed. Mar. 27, 1980) (remarks of Sen. Bumpers). Note that the NCUA interpretation applies only to *state chartered* credit unions. If correct, the interpretation creates a curious inconsistency: state chartered credit unions are placed on a competitive level with national banks, but federally chartered credit unions do not enjoy the same privilege and must operate under whatever rates Congress expressly authorizes for them.

usury laws. Section 525 provides that after April 1, 1980, a state may elect *not* to have the amendments contained in sections 521-523 apply.<sup>32</sup> State "override," either by passage of a law or by vote of the people, would restore all federally insured institutions (except national banks) to their previous position under state usury laws, that is, a position where they are allowed to charge only the rates permitted to such lenders under state law. By September 1981, three states<sup>33</sup> had acted to override the most favored lender provisions of DIDMCA, and more states may be inclined to take the same course, especially once the implications of the federal statute are understood. For example, the NCUA has cautioned state chartered federally insured credit unions to contact their state supervisory agency to determine whether their most favored lender status has been superseded before granting loans at such favorable rates.<sup>34</sup> An anomalous feature of these state override provisions, of course, is that none of them affect section 85 of the National Bank Act, which has been in force for more than a century. So while DIDMCA was intended to raise state chartered and other federally chartered institutions to a position of "competitive equality" with national banks, state legislatures are free to restore to national banks their prior competitive advantage.

No federal court has yet addressed the question whether DIDMCA actually does grant other federally insured institutions the same broad most favored lender status that national banks enjoy. In what may become a

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32. Pub. L. No. 96-221, § 525, 94 Stat. 164 (codified at 12 U.S.C. § 1730g (Supp. IV 1980)):

The amendments made by sections 521 through 523 of this title shall apply only with respect to loans made in any State during the period beginning on April 1, 1980, and ending on the date, on or after April 1, 1980, on which such State adopts a law or certifies that the voters of such State have voted in favor of any provision, constitutional or otherwise, which states explicitly and by its terms that such State does not want the amendments made by such section to apply with respect to loans made in such State, except that such amendments shall apply to a loan made on or after the date such law is adopted or such certification is made if such loan is made pursuant to a commitment to make such loan which was entered into on or after April 1, 1980, and prior to the date on which such law is adopted or such certification is made.

33. 1980 Colo. Sess. Laws, H.B. 1178; 1981 Iowa Acts, ch. 1156; 1981 Mass. Acts, ch. 231.

Some states have enacted "little most favored lender" statutes of their own, permitting state lenders to charge the same rates authorized for national banks. *See, e.g.*, N.J. STAT. ANN. § 31:1-1.1 (Supp. 1981). This obviously permits state banks to use the 1% over discount option, and it also apparently would permit a state bank to use a small loan rate if national banks could use it under § 85. Where states have such statutes, an override of the DIDMCA preemption provisions does not necessarily undo the competitive equality which is DIDMCA's goal.

34. 46 Fed. Reg. 24,153-54 (1981).

major test case, however, a state trial court in Maryland has declared that "under [DIDMCA], state banks now have most favored lender status."<sup>35</sup> In its memorandum opinion in *Equitable Trust Co. v. Sachs*, the court stated:

[DIDMCA's] language . . . is the *same* as § 85's, and absent evidence to the contrary, words taken from prior legislation must be given the same meaning particularly where the provision containing those words is part of a statute that is merely a continuation of earlier legislative schemes.<sup>36</sup>

The court went on to affirm that, under DIDMCA, state chartered banks can charge the rates authorized by the Maryland Consumer Loan Law.<sup>37</sup> Given Congress' choice of language in DIDMCA, the consistent interpretation of parallel language in section 85 of the National Bank Act, and Congress' clear desire to equalize the rate structures available to national banks and other lenders, it appears unlikely that any appellate court—state or federal—would reach a result contrary to *Equitable Trust Co.*

Thus, the interpretations of the section 85 phrase "rate allowed by the laws of the state" support the general conclusion that national banks may charge the same interest rates allowed to the most favored lender in a state. For example, a national bank may charge interest on an installment loan at the higher rates permitted under that state's law for small loan companies, even though that rate is prohibited for state banks or other lenders making similar loans. From a review of interpretations of DIDMCA by federal agencies and the limited judicial interpretation of the statutory lan-

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35. *Equitable Trust Co. v. Sachs*, A-60063/120-1/ Fol. 713 (Cir. Ct. of Baltimore City, Md., Jan. 28, 1981). The plaintiffs were six Maryland banks (state and national) who sought declaratory relief to permit them to charge annual membership fees as part of their credit card plans, as well as interest at the highest rate allowed any state lender under the Maryland Consumer Loan Law. The banks also sought a declaration allowing them to charge the most favored rate by complying only with certain provisions of the law determining interest rates (amount of the loan, collateral requirements, and method of repayment). The court held that the membership fee was a permissible charge for banks since it was not defined by state law as interest or a finance charge. Under the most favored lender doctrine of both § 85 and DIDMCA, however, banks could charge the Maryland Consumer Loan Law rates on credit card accounts only by complying with those provisions of that law *material* to a determination of the interest rate.

The court has issued two opinions: the first, dated January 28, 1981, granted partial summary judgment to the plaintiff banks, holding in part that the most favored lender doctrine under DIDMCA applies to the Maryland Consumer Loan Law; the second, dated September 16, 1981, ruled on a number of specific questions concerning the applicability of state law provisions under the most favored lender doctrine. For ease of reference, these opinions are designated "slip op. no. 1" and "slip op. no. 2," respectively.

36. *Id.* slip op. no. 1, at 36-37 (citation omitted). *Accord*, Opinion of the Michigan Attorney General, No. 5894, 5 CONS. CRED. GUIDE (CCH) ¶ 97,134 (1981).

37. *Equitable Trust Co. v. Sachs*, *supra* note 35, slip op. no. 1 at 36.

guage, it appears that the same most favored lender doctrine has been extended to all other federally insured depository institutions. Thus, a federally insured state bank, savings and loan association, or state chartered credit union may also charge the higher small loan company rate, even though state law does not permit such a favorable rate for creditors generally.

### III. THE "RATE ALLOWED BY THE LAWS OF THE STATE"

The recent congressional enactment of DIDMCA means that the tiered, or structured, rate laws within the various states—permitting higher rates for certain transactions and certain lenders, often in exchange for licensing requirements or other restrictions on those high rate loans—have been merged into the highest rate permitted any lender for a particular type of transaction. Federally insured depository institutions may now charge that highest rate, while mortgage bankers, small loan and consumer finance companies, oil companies, and all retail stores remain subject to whatever rates the state legislature has specifically authorized for them. While this general conclusion follows easily from the above discussion, it is not so clear how this most favored lender policy actually may operate in the marketplace. Do the incidental provisions of a favorable state rate law (such as loan type or duration, or additional charges) bind a federally insured institution that opts to use that law? Do state consumer protection laws dealing with disclosure, rebates, creditor remedies and the like, applicable to high rate lenders, become applicable to federally insured lenders that "borrow" that rate? Do federal or state standards on rate computation control? To what extent may a federally insured institution export a favorable home state rate to customers in other jurisdictions?

Despite the existence for over a century of most favored lender status for national banks, those questions have not all been definitively or satisfactorily answered under section 85, and there is, as yet, limited guidance under DIDMCA.

#### *A. How Much of the State Law Should Apply?*

Both section 85 and DIDMCA authorize lenders to charge "interest . . . at the rate allowed by the laws of the State."<sup>38</sup> It is not self-evident, however, whether this means merely the stated interest rate itself, or includes other state law limitations that may affect a creditor's yield.

A review of the legislative consideration of DIDMCA reveals that Con-

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38. The same language appears in § 85 and in §§ 521-523. See notes 8 & 12 *supra*.

gress intended to equalize competition among national banks and all other federally insured institutions.<sup>39</sup> An understanding of the scope of that competitive equality requires, therefore, analysis of the most favored lender status which national banks enjoy under section 85. The Supreme Court first construed that federal statute in the landmark *Tiffany* case,<sup>40</sup> declaring that national banks were given a specific competitive advantage over state banks—the right to adopt a rate available to other lenders. The Court, however, did not construe the federal law to give national banks any advantages *beyond* those given the most favored lender in the state. The Court subsequently restated the holding of *Tiffany* as follows: "The intention of the national law is to adopt the state law, and permit to national banks what the state law allows to its citizens and to the banks organized by it."<sup>41</sup> In *Union National Bank of Chicago v. Louisville, New Albany & Chicago Railway*<sup>42</sup> the Supreme Court had described the effect of the federal statute:

It may be said that the rights of a national bank to interest are given by the Federal statute; that the reference to the state law is only for the measure of those rights. . . . [T]he true construction

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39. Senator Pryor described the situation existing prior to passage of DIDMCA as follows:

[Section 85] gives national banks an unfair advantage over . . . other financial institutions.

Section 85 . . . provides that a national bank may charge 1 percent above the Federal discount rate, notwithstanding any State laws setting an interest-rate ceiling. Such an advantage obviously discriminates . . . against State banks or savings and loans in those states where the usury-rate ceiling is below the discount rate. . . .

This is . . . not a "usury" issue but a matter of "competitive equality."

126 CONG. REC. S15,684 (daily ed. Nov. 1, 1979). Senator Proxmire, explaining the Conference Report on H.R. 4986 (the DIDMCA of 1980), stated that:

Title V . . . contains a provision which provides parity, or competitive equality, between national banks and State chartered depository institutions on lending limits.

Under 12 U.S.C. 85, authorized to charge 1 percent over national banks are [sic] the Federal Reserve discount rate on loans. State chartered depository institutions are given the benefits of 12 U.S.C. 85 unless a State takes specific action to deny State chartered institutions that privilege.

126 CONG. REC. S3170 (daily ed. Mar. 27, 1980).

40. *Tiffany v. National Bank of Mo.*, 85 U.S. (18 Wall.) 409 (1874).

41. *Daggs v. Phoenix Nat'l Bank*, 177 U.S. 549, 555 (1900). The Supreme Court construed ambiguous language in the old National Bank Act that allowed a rate of 7% to national banks where no rate was "fixed by the laws of the state." The Court found that the national law was intended to adopt the state law so that the Arizona law allowing parties to agree on a rate constituted a rate "allowed" or "fixed by the laws of the state," and national banks were not limited to 7% interest.

42. 163 U.S. 325 (1896).

of state legislation is a matter of state jurisprudence, and while the rights of the national bank spring from the act of Congress, yet it is only a right to have an equal administration of the rule established by state law.<sup>43</sup>

If the purpose of section 85 was to give national banks *equal* administration of state laws, it follows that the purpose of DIDMCA was to equalize the situation for other federally insured lenders as well. Adoption of the entire state law as it pertains to determining usurious interest is the logical result, but it is not always the result that emerges from existing authorities.

### 1. *Computation of the Numerical Rate*

Suppose a state law authorizes a particular rate computed on a simple-interest, or actuarial, basis. May a national bank, or other federally insured lender, borrow that rate figure but compute the actual charge by discount or add-on methods, or by compounding interest, any of which may substantially increase the lender's yield? There is a potential conflict between an early Supreme Court decision and more current lower court decisions on this issue.

Initially, the Supreme Court construed the National Bank Act to adopt state usury laws only to the extent they set forth the rate of interest. In *National Bank of Groversville v. Johnson*,<sup>44</sup> the Court stated that "[t]he sole particular in which national banks are placed on an equality with natural persons is as to the *rate* of interest, and not as to the character of contracts they are authorized to make."<sup>45</sup> Then, in 1919, in *Evans v. National Bank of Savannah*,<sup>46</sup> the Supreme Court read the National Bank Act to mean that the method of computing and taking interest was outside the restrictions of "interest at the rate allowed" by state law. The Court therefore upheld the practice of discounting interest in advance at the maximum interest rate allowed by the law of Georgia. The Court found that the authority to discount notes was expressly given to associations organized under the National Bank Act and that this authority

implies reservation of interest in advance; and, . . . when dealing with short-time paper such a reservation at the highest interest rate allowed by law is not usurious. Recognizing prevailing practice in business . . . , we think Congress intended to endow national banks with the power . . . of discounting notes reserving

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43. *Id.* at 331.

44. 104 U.S. 271 (1881). The Court found that the privilege of charging rates fixed by state law was applicable to both loans and discounts of commercial paper by national banks.

45. *Id.* at 277.

46. 251 U.S. 108 (1919).

charges at the highest rate permitted for interest.<sup>47</sup>

A strong dissent in *Evans* considered the question settled by previous cases: "Although the consequences of acceptance of usurious interest by a national bank and the penalties to be enforced are to be determined by the provisions of the National Banking Act, *the ascertainment of the rate of interest allowable is to be according to the state law.*"<sup>48</sup> Additionally, in determining the rate allowed under state law, the dissent maintained that "all applicable provisions of the [state] statutes as interpreted and construed by the court of last resort" should be considered.<sup>49</sup>

Later cases appear to have restricted *Evans* to its narrow facts. For example, the Eighth Circuit in *First National Bank in Mena v. Nowlin*,<sup>50</sup> acknowledged that it could not overrule *Evans*, but limited the *Evans* holding to the short-term, noninstallment credit which was the subject of that case. The *Nowlin* court conceded that refusal to consider more state law than merely the numerical interest might have been appropriate for commercial transactions common in the early 1900's. The court, however, thought that even such a concession required an unnecessarily strained construction:

[D]etermination of the 'rate allowed by the laws of the State' can only be accomplished with reference to state court interpretations of the state's own constitution and statutes. . . . [T]he Federal Act adopts the entire case law of the state interpreting the state's limitations on usury; it does not merely incorporate the numerical rate adopted by the state.<sup>51</sup>

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47. *Id.* at 114. The *Evans* Court relied on an earlier Supreme Court opinion which stated: "It has always been supposed that an authority to discount, or make discounts, did, from the very force of the terms, necessarily include an authority to take the interest in advance." *Fleckner v. Bank of the United States*, 21 U.S. (8 Wheat.) 338 (1823). The *Fleckner* case involved the Bank of the United States, which was incorporated by an act of Congress in 1816 and was a predecessor to the national banking system. The Bank of the United States, through its enabling statute, was given the authority to make discounts.

48. 251 U.S. at 115 (emphasis added). See also *Haseltine v. Central Nat'l Bank*, 183 U.S. 132, 134 (1901); *Union Nat'l Bank of Chi. v. Louisville, N.A. & C. Ry. Co.*, 163 U.S. 325, 331 (1896); *Farmers & Merchants Nat'l Bank v. Dearing*, 91 U.S. (23 Wall.) 29, 32 (1875).

49. 251 U.S. at 116.

50. 509 F.2d 872, 875 (8th Cir. 1975). An Arkansas national bank sought a declaration that national banks could discount loans at the maximum state interest rate, despite state prohibitions on discounting. The result is greater yields than the maximum rate based on a simple-interest computation.

51. *Id.* at 876. A federal district court gave *Evans* a similarly limited reading in *Cohen v. District of Columbia Nat'l Bank*, 382 F. Supp. 270 (D.D.C. 1974). *Evans* has also been criticized on the grounds that, even if a federal (rather than a state) computation rule controls, there is no compelling federal policy to create a uniform national rule. Rather there is, in § 85, a policy of parity between national banks and state lenders which should dictate



In contrast, a Sixth Circuit opinion<sup>52</sup> cited *Evans* in dictum to the effect that national banks located in Michigan may compute interest in advance ("discounting" or "adding-on" interest) under section 85, and that this right "arises independent of state laws."

In recent interpretive letters,<sup>53</sup> the Office of the Comptroller of the Currency has construed this case law—principally *Evans*—as authorizing national banks to compute interest on an add-on or discount basis when using the 1% above discount option under section 85. These letters thereby extend *Evans* to a situation that did not exist in 1919 since national banks were not authorized to charge 1% over the Federal Reserve discount rate until 1933. The OCC letters, however, reflect some tentativeness toward the rule they extend. In one, for example, the Comptroller's Chief Counsel notes that "the precise question has not been litigated,"<sup>54</sup> and another letter cautions that "further judicial consideration will be required before a definitive answer can be given about the permissibility under [section 85] of discounting interest on installment loans when state chartered competitors are not allowed to do so."<sup>55</sup>

While the rationale of the Eighth Circuit in *Nowlin* seems more sound (it accords national banks parity, but not a preferred position, vis-à-vis the state's most favored lender), the Supreme Court decision in *Evans* stands as an unfortunate obstacle to the general adoption of that view.

In contrast, cases interpreting the National Bank Act on the issue of compounding have supported a more expansive view of how much of the

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adoption of the local rule against compounding. Shanks, *Special Usury Problems Applicable to National Banks*, 87 BANKING L.J. 483, 495-500 (1970).

52. *Northway Lanes v. Hackley Union Nat'l Bank & Trust Co.*, 464 F.2d 855, 860 (6th Cir. 1972). It was not necessary, however, for the court in *Northway Lanes* to rely on *Evans* to permit reserving interest in advance as Michigan law permitted add-on loans. The *Evans* rationale was also relied upon to exempt national banks from state restrictions on closing costs and loan amount. For a critique of *Northway Lanes*, see Herstein, *Michigan Usury Law*, 27 WAYNE L. REV. 435, 478-86 (1981). See also *Ray v. American Nat'l Bank & Trust Co.*, 443 F. Supp. 883 (E.D. Tenn. 1978), where the court approved the charging of interest discounted in advance by national banks under § 85, even though it held the state statute permitting the practice for state banks unconstitutional because it would exceed the conventional rate per annum in the state constitution. The district court dismissed *Nowlin*, 509 F.2d 872 (8th Cir. 1975) and held that the earlier Sixth Circuit decision in *Northway Lanes* was controlling.

53. OCC Interpretive Letter No. 101 (John E. Shockey, Chief Counsel), [1978-1979 Transfer Binder] FED. BANKING L. REP. (CCH) ¶ 85,191; OCC Interpretive Letter No. 115 (Ford Barrett, Ass't Chief Counsel), *id.* ¶ 85,190; OCC Interpretive Letter No. 71 (John G. Heimann, Comptroller of the Currency), *id.* ¶ 85,146.

54. OCC Interpretive Letter No. 101, *supra* note 53, at 77,184.

55. OCC Interpretive Letter No. 115, *supra* note 53, at 77,204. The Maryland court in *Equitable Trust Co. v. Sachs*, *supra* note 35, slip op. no. 2 at 28-31, noted the Comptroller's equivocation and opted for the *Nowlin* rationale.

state law applies when charging "interest at the rate allowed by the laws of the State." As early as 1904, the Supreme Court held<sup>56</sup> that a national bank could not compound interest more frequently than permitted under state law, even though the actual dollar interest charge was less than that computed at the maximum state rate without compounding. Similarly, in *Acker v. Provident National Bank*,<sup>57</sup> the Third Circuit found that Pennsylvania case law prohibited compounding interest on revolving credit accounts unless a state statute or a contract provision specifically authorized that method for computing interest. The *Acker* court went on to specify that, where "compound interest is not permitted under the [state law], it does not matter that the effective rate of compound interest results in interest charges within the permitted 'simple interest' rate."<sup>58</sup> On a parallel issue, at least one court has ruled that a national bank may not use a 360-day/year method to calculate interest where this would produce yields in excess of those permitted under state law.<sup>59</sup>

These cases represent the better view. Permission to charge a rate allowed to other lenders under state law should carry with it any restrictions of that law on the real dollar amounts that can be charged under that rate. Such restrictions may include not only the method of calculating interest, but also the method of determining the balance on which the interest will be computed, and related loan closing costs. Therefore, to restate the example above, if a state's small loan law permits interest at a simple annual rate of 20% on the declining balance of the loan, federally insured lenders in that state should not be permitted to charge the same rate and discount the interest in advance or charge the same rate on an add-on basis. Or, in a state whose rate laws reflect inclusion in the finance charge of charges that

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56. *Citizens' Nat'l Bank of Kansas City v. Donnell*, 195 U.S. 369, 374 (1904). In this case, Missouri law allowed a contractual interest rate of 8% and permitted compounding of interest no more than once a year (in effect this authorized the payment of interest on interest). The Court held that a rate of 1% per month on overdrafts (12%) and the compounding of interest semiannually were usurious. The Court did not accept the bank's arguments that the overdraft charge was really a penalty for failure to pay a debt, and secondly, that compounding of interest more often than permitted by state law was not usurious if it resulted in less interest than the law permitted to be charged directly without compounding. *Id.*

57. 512 F.2d 729, 739 (3d Cir. 1975).

58. *Id.* at 742. See also *Partain v. First Nat'l Bank of Montgomery*, 467 F.2d 167 (5th Cir. 1972).

59. *American Timber & Trading Co. v. First Nat'l Bank of Or.*, 511 F.2d 980 (9th Cir.), cert. denied, 421 U.S. 921 (1974). But see OCC Interpretive Letter No. 102 (John E. Shockey, Chief Counsel), [1978-1979 Transfer Binder] FED. BANKING L. REP. (CCH) ¶ 85,177, at 77,187: "[I]t is the opinion of our legal staff, . . . that a national bank could compute interest on the 360-day basis under the federal [1% over discount] option currently provided by [§ 85]."

are not pure "interest" in the conventional sense,<sup>60</sup> such as brokerage fees, charges for credit reports, or insurance premiums, federally insured lenders should not be permitted to charge "interest" at the highest rate and then charge separately for the other items. Such a result is inconsistent with the stated purpose of the most favored lender doctrine, to put national banks (and via DIDMCA, other federally insured lenders) on a par with the most favored lender in the state.

## 2. *Classes of Loans*

The Comptroller of the Currency has long interpreted section 85 to mean that a national bank making loans under the most favored lender doctrine "is subject only to provisions of state law relating to such *class of loans* that are material to the determination of the interest rate."<sup>61</sup> The phrase "class of loans" is potentially significant for purposes of determining which interest rate provisions a federally insured lender may borrow, but the phrase is not defined anywhere. Credit may be categorized in broad classes such as consumer loans, commercial loans, or agricultural loans. Other classes of loans include installment loans or short-term single payment loans. In addition, open-end plans (charge accounts with varying balances up to a specified limit) and closed-end accounts (loans for a certain amount with a stated maturity date) are also distinguishable loan types. Within the area of consumer credit, classifications include real estate mortgages, mobile home loans, automobile credit, retail charge accounts, bank credit cards, home improvement loans, and student loans. Generally, the purpose of the loan, its amount and term, and the type of account could all be considered in determining the "class" of loans.

What little reported case law there is, however, suggests that consumer credit is fungible, or classless, for purposes of section 85. A federal district court in *United Missouri Bank v. Danforth*<sup>62</sup> focused on the section 85 language "evidence of debt" and declared that consumer loans made under the state's small loan law involved evidences of debt comparable to transactions through the use of bank credit cards, as defined under the state's retail credit sales law. Both types of accounts represented loans to consumers for purchasing goods and services. Despite the fact that Missouri small loan companies did not (and probably could not) offer credit cards or sell

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60. This would be true under most state small loan laws where the permitted rate must cover all creditor costs. It would also be true in those states which have enacted the UNIFORM CONSUMER CREDIT CODE, whose rate ceilings are built on a broad definition of "finance charge." See UNIFORM CONSUMER CREDIT CODE § 1.301(20).

61. 12 C.F.R. § 7.7310 (1980) (emphasis added). See note 16 *supra*.

62. 394 F. Supp. 774, 783 (E.D. Mo. 1975).

merchandise, the *Danforth* court concluded that national banks in Missouri could charge the higher small loan rates on their bank credit cards even though state banks were limited to the lower retail sales law rates.<sup>63</sup>

Interpreting DIDMCA, a recent Maryland trial court decision<sup>64</sup> followed the holding in *Danforth*. Granting partial summary judgment to the plaintiff banks, the court held that the state small loan law could be applied to both the cash-advance and purchase features of bank open-end credit plans:

The unmistakable conclusion is that Congress intended to control loans ('interest') and purchases ('evidence of debt') and intended to control them indistinguishably. Therefore, while there may be statutory (and other) distinctions between credit card loans and credit card purchases, such distinctions do not constitute sufficient generic dissimilarity to withstand the preemptive impact of the federal legislation.<sup>65</sup>

If "class of loans" is any determinant of which transactions are entitled to interest at the most favorable interest rate, it appears that a federally insured bank under DIDMCA may consider small loan transactions to be in the same category as both cash-advance and purchase transactions on open-end plans.

More incisive, and perhaps more workable in the long run, is a recent OCC staff letter<sup>66</sup> responding to a series of inquiries about which state law provisions carried over to national banks for purposes of section 85. The letter agreed that state law characterization of a charge as a "time price differential" is immaterial: "[T]here is no difference between a statute fixing a maximum 'time price differential' and one fixing a maximum interest rate." Thus, a national bank could use rates from the state Retail Installment Sales Act (RISA) for its credit card plan. Moreover, the bank could use those rates without complying with the RISA disclosure provisions which the OCC staff thought were not material to the rate limitation.

But the Retail Installment Sales Act, by its terms, was not applicable to transactions involving money and certain other products. This, according to OCC staff, barred the national bank from using RISA rates for the cash

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63. *Id.* at 785. See also *Commissioner of Small Loans v. First Nat'l Bank of Md.*, 268 Md. 305, 300 A.2d 685 (1973); *Rockland-Atlas Nat'l Bank of Boston v. Murphy*, 329 Mass. 755, 110 N.E.2d 638 (1953).

64. *Equitable Trust Co. v. Sachs*, *supra* note 35.

65. *Id.* slip op. no. 1 at 45. This rather glib conclusion by the court overlooks the traditional distinction between "interest" (on loans) and the theory of time-price differential that permitted charges in sale transactions above prevailing usury ceilings. Arguably, this makes cash loans and credit sales different classes of credit transactions.

66. OCC Interpretive Letter No. 178, 5 CONS. CRED. GUIDE (CCH) ¶ 97,239 (1981).

advance portion of its credit card plan, and indeed barred the bank from using the RISA rate at all unless it was prepared to "establish controls to ensure that the higher rates are not charged on excluded transactions."<sup>67</sup> Banks utilizing most favored lender status, under this rationale, must be prepared to apply the borrowed rate only to appropriate transactions, and not to transactions expressly excluded from the coverage of the borrowed rate law. This analysis casts some doubt on the reliability of the *Danforth* holding, where the court did not even inquire whether the state small loan law allowed its rates to be used for open-end plans or for retail sales.

The ostensible goal of section 85, and of DIDMCA, is *lender parity*, not transactional homogenization. Thus, when a state segments its rate structure not by groups of lenders but by types of credit transactions, there is no enhancement of competitive equality in allowing federally insured institutions, but not other lenders, to transport the high rates permitted for one kind of transaction (*e.g.*, three year old motor vehicles) to a completely different setting (*e.g.*, credit card plans). The OCC staff letter properly recognized this distinction.

### 3. Provisions "Material to a Determination of the Interest Rate"

For many years, the Comptroller has maintained the view that when a national bank borrows a rate under the most favored lender principle the bank is subject to all portions of that state law that are "material to a determination of the interest rate."<sup>68</sup>

With the exception of an occasional interpretive letter<sup>69</sup> from the Comptroller, there does not appear to have been much explication of what this "materiality" test means for national banks. The Maryland court, in *Equitable Trust*,<sup>70</sup> accepted materiality as the controlling rule by approving an earlier interpretation from the Comptroller which would subject national banks to "all limitations of substance"<sup>71</sup> in the borrowed rate law. The question then arises whether "limitations of substance" is to be read narrowly to include only those provisions that affect calculation of the explicit contractual rate of charge, or broadly to include any provisions that affect or may affect the creditor's aggregate yield or the borrower's aggregate

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67. *Id.*

68. 12 C.F.R. § 7.7310 (1980). The pertinent text of the interpretation is set out in note 16 *supra*.

69. *E.g.*, OCC Interpretive Letter No. 178, *supra* note 66.

70. *Equitable Trust Co. v. Sachs*, *supra* note 35.

71. *Id.*, slip op. no. 2, at 3. This alternate phrasing traces to an earlier summary of Comptroller opinion letters. Comptroller of the Currency, Digest of Opinions ¶ 9510 (1960).

cost.<sup>72</sup>

The rate of charge permitted on a class of credit transactions may be a function of many things. The Federal Reserve Board's Regulation Z,<sup>73</sup> pursuant to the Federal Truth In Lending Act<sup>74</sup> (TIL), considers "interest" to be only one component of the "finance charge," which then must be disclosed as an "annual percentage rate."<sup>75</sup> Components of the finance charge, as defined by TIL, may or may not be defined as interest under state law for purposes of usury limitations.<sup>76</sup> Where state law is less comprehensive regarding elements of the finance charge, the stated interest ceiling may reflect the fact that other charges are allowed in addition to the application of an interest rate.<sup>77</sup> The rate permitted is also likely to be a function of the method of calculating interest.<sup>78</sup> Where a rate of interest "per annum" is specified by state law, discounted loans where the borrower pays interest in advance may be usurious if the effective rate, as contrasted with the stated rate exceeds the legal maximum.<sup>79</sup> As previously mentioned, the class of loans should be considered material to a determination of the interest rate.<sup>80</sup> The amount of the loan (which may be affected by the method of computing unpaid balances for open-end credit transactions) is also material to interest rate limits imposed by state law.<sup>81</sup>

72. In fact, the Maryland court took an all-inclusive view of what provisions of the state small loan law are material to the rate. See notes 94-102 and accompanying text *infra*.

73. 12 C.F.R. § 226 (1981).

74. 15 U.S.C. §§ 1601 to 1681 (1976 & Supp. IV 1980).

75. Regulation Z, 12 C.F.R. § 226.4, as amended by 46 Fed. Reg. 20,848, 20,894 (1981), defines "finance charge" broadly to include "any charge payable directly or indirectly by the consumer and imposed directly or indirectly by the creditor as an incident to or a condition of the extension of credit." Disclosure of the annual percentage rate is required under §§ 226.6(a)(2) and 226.7(d) for open-end transaction, and under § 226.18(e) for closed-end credit.

76. For example, loan fees or points and credit report fees may be considered interest under state law. Cf., UNIFORM CONSUMER CREDIT CODE § 1.301(20)(a)(iv).

77. For example, the court in *Equitable Trust*, *supra* note 35, held that annual membership fees for credit card accounts were not interest as defined by state law and, therefore, were not usurious.

78. Under the UNIFORM CONSUMER CREDIT CODE, for example, a seller must compute closed-end rates as simple-interest, on the declining balance. UNIFORM CONSUMER CREDIT CODE § 2.201. However, for open-end seller accounts, the UNIFORM CONSUMER CREDIT CODE authorizes several different balance assessment methods which can produce different yields. UNIFORM CONSUMER CREDIT CODE § 2.202(2).

79. See *Cohen v. District of Columbia Nat'l Bank*, 382 F. Supp. 270 (D.D.C. 1974).

80. See notes 61-67 and accompanying text *supra*.

81. In OCC Interpretive Letter No. 178, *supra* note 66, the Comptroller's Office stated that a bank borrowing a small loan rate was bound by the small loan law limitations on the total amount of the loan. Specifically, the bank could not use the small loan rate (which was authorized only for loans up to \$3,000) for the first \$3,000 of a larger credit balance. See also *Deak Nat'l Bank v. Bond*, 89 Misc. 2d 95, 390 N.Y.S.2d 771 (1976).

Beyond these obvious material factors, it is not self-evident whether factors such as type of security, length of the loan, or others, should be considered determinative of interest rates even though they clearly affect a creditor's aggregate yield. A workable test is needed to determine how much of the favorable state law applies to the federally insured lender that borrows its rate. A tempting standard—and one that would be relatively easy to apply—would be to say that a federally insured institution borrowing a most favored state rate is bound by all aspects of that law that regulate or limit components of the finance charge as computed and disclosed under the federal Truth in Lending Act. State laws limiting brokers' fees, credit reports, transaction charges, mortgage insurance premiums and other items enumerated as part of the finance charge under Regulation Z would then apply to a federally insured lender as incident to the borrowed rate. State laws on such matters as application or membership fees, late charges, rebate methods, and security would not so apply.

The problem with this standard is that it is obviously artificial. It uses criteria from a law aimed at disclosing aggregate borrower costs to measure what portions of state law affect a creditor's yield and thus its competitive position. The Truth in Lending Act indicates explicitly that, except for disclosure, it does not "otherwise annul, alter or affect in any manner the meaning, scope or applicability" of any state laws, including usury laws.<sup>82</sup> On the other hand, this standard could work smoothly in Uniform Consumer Credit Code states where the definition of finance charge for rate-setting purposes is virtually identical to the Truth in Lending definition for disclosure purposes.

An approach that may help determine which provisions are material to the interest rate is one that includes all provisions tied directly to an authorized interest rate as *preconditions* for its use.<sup>83</sup> For example, state law may specify a rate of 36% for short-term consumer loans but permit a rate of no more than 18% for longer term or refinanced transactions. In such a state, federally insured lenders could charge the favorable 36% rate only for the initial extension of credit but could not charge the same rate on an extended or refinanced transaction. Similarly, a bank could not "borrow" the rate specifically authorized for loans under \$1,000 unless it was in fact extending credit below that figure. In these examples, the amount and term of the loan, as well as extension features, would be determinative of

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82. Truth in Lending Act, § 111(b), 15 U.S.C. § 1610(b) (1976).

83. This is essentially the test applied by the Comptroller of the Currency in the staff letter cited in note 66 *supra*. See also *Rockland-Atlas Nat'l Bank of Boston v. Murphy*, 329 Mass. 755, 110 N.E.2d 638 (1953) (bank cannot collect an attorney's fee where not authorized under applicable state law).

the interest rate. On the other hand, the formula for late payment charges may be identical whether the applicable rate is 18% or 36%. In that situation, late payment fee provisions would not be determinative of the interest rate. That is, the lender would not be bound by the late payment fee provision of the small loan law, but would remain subject to any late-fee restrictions applicable generally to banks.

A more narrow approach that may be helpful to identify those provisions of state law which affect the determination of the interest rate would be to consider "material" only those provisions that affect the creditor's charges when the contract is performed according to its terms, without delinquency, default, or refinancing. For example, loan term, purpose of the loan, loan amount, and service fees or other closing costs would be included. But fees for late payments, default charges, or even prepayment penalty charges would not be material to the interest rate determination since they would only come into play if the contract were not performed in accordance with the agreement of the parties. This approach, though, could put the federally insured lender in a significantly *better* position than the most favored state lender—*i.e.*, free to contract for the highest rate, but not bound by state restrictions on default remedies.

In the two approaches just discussed, the results would be the same for provisions on loan purpose, term and amount, and those concerning late payment or default penalties. There would be a difference in result, however, for requirements on rebating unearned interest charges on prepayment or refinancing. The rebate method may be tied to a particular rate or loan term.<sup>84</sup> The method of rebating obviously affects the creditor's yield, yet the earning of any rebate assumes the original payment schedule has been truncated or otherwise modified. Under the first suggested approach, the bank would have to comply with the rebate provision of the small loan law, while under the second the bank would not be so bound.

Other aspects of state law are not so readily characterized as "material" to the rate. For example, if a state has, for example, removed rate ceilings for home mortgage transactions but retained them for other forms of credit, a bank presumably could not "borrow" that unlimited mortgage rate for automobile installment loans or credit cards.<sup>85</sup> This would not be

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84. For example, the UNIFORM CONSUMER CREDIT CODE permits use of the Rule of 78s for transactions up to 48 installments, but requires use of an actuarial rebate calculation for longer term transactions. UNIFORM CONSUMER CREDIT CODE § 2.510.

85. This would also run afoul of the "class of loans" criterion. Moreover it would create a special anomaly under DIDMCA. Section 501 of that act preempts all state law limiting rates in residential first mortgage transactions. Thus, there is *no* rate ceiling for first mortgages (except for those states that have acted to override § 501). If federally insured



a rate allowed to a class of lenders but only for a class of transactions, and the bank could use it only when making home mortgage loans. But suppose a state law authorized an attractive rate for licensed lenders provided they took no real property security. Is the proviso a limitation on the class of loans, or merely an independent restriction on the permissible security? Under the better view, the proviso would be material, and a bank could not use that rate if it engaged in mortgage lending. Under the narrower second approach suggested above, however, the bank might borrow the rate while disregarding the security limitation.

A sharp example of this kind of dilemma could arise under the Uniform Consumer Credit Code. Sellers may charge 2% per month on their open-end plans, while lenders are limited to 18% annually, or 1 1/2% per month.<sup>86</sup> But sellers are restricted to purchase money security interests,<sup>87</sup> while lenders may take any security they desire.<sup>88</sup> May a bank borrow the 2% rate without the security interest limitation? The older case law under section 85 would seem to say yes.<sup>89</sup> Further, there is nothing in the several interpretations of the Comptroller's Office<sup>90</sup> that requires a different conclusion. The security interest limitation is an independent restriction on sellers, not integrally tied to the rate ceiling, and in fact subject to a separate penalty for violation. Thus it seems arguable that under existing precedent federally insured institutions may legally attain more than simple parity with the state's most favored lender. They may combine the best of both worlds to obtain lending flexibility not enjoyed by *any* lenders under state law.

Two other examples will serve to highlight the issue and its difficulty. Suppose the general banking law in the state permits a bank issuing credit cards to charge an annual fee, but the small loan law does not. May a federally insured lender borrow the small loan rate for its card program but continue to charge the annual fee? The Maryland court in *Equitable Trust*<sup>91</sup> rejected the bankers' argument that, since the authorized fee is not part of the bank's normal interest charge, when a bank borrows the small

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lenders could, under §§ 521-523 of that Act, claim unlimited rate privileges for *non*-mortgage credit by "borrowing" the rate from § 501, DIDMCA—like the proverbial snake—would have eaten its own tail.

86. UNIFORM CONSUMER CREDIT CODE § 2.203(3), 2.401(1).

87. *Id.* § 3.301.

88. The only restriction on a lender's security rights is the limited "marshalling" provision in UNIFORM CONSUMER CREDIT CODE § 5.116, which comes into play at the foreclosure stage and is not a limitation at the contracting stage.

89. See notes 62-63 and accompanying text *supra*.

90. See notes 66-68 *supra*.

91. *Equitable Trust Co. v. Sachs*, *supra* note 35, slip op. no. 2 at 15-19.

loan rate to determine interest, it remains free to impose the annual fee. The court's conclusion seems correct under the better view suggested above, that when borrowing a rate a lender takes it subject to all preconditions for that rate. If one of those restrictions is that the lender may impose no additional charges, the bank should be so limited.

Variable or floating rates provide another example. Must federally insured lenders comply with any restrictions on rate fluctuations in the state law it borrows under the most favored lender doctrine? For the same reasons just suggested, the answer should be yes. Those restrictions are limitations on the type or class of loans, and to that extent are preconditions to its use. Persuasive of the same conclusion are a number of FHLBB staff interpretations<sup>92</sup> of DIDMCA section 501, the residential mortgage preemption provision. Those letters indicate that while mortgage lenders are free to set the initial rate as high as they wish, they remain subject to state restrictions on the amount or frequency of any step increases, or on the aggregate rate increase over the term of the loan. The same view should apply under sections 521-523.<sup>93</sup>

Against this background of possible approaches to the identification of provisions of state law which are material in determining the interest rate, the decision in *Equitable Trust*<sup>94</sup> presents a sweeping standard that amounts to a virtual "all or nothing" rule. The court held that if national banks (under section 85) or federally insured lenders (under DIDMCA) wished to use the higher rates authorized under the Maryland Consumer Loan Law, they must comply with *all* substantive provisions of that law, including those that have only the most tenuous connection to the interest rate.

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92. FHLBB Interpretive Letter No. 53, from Milan C. Miskovsky, General Counsel (Sept. 22, 1980); FHLBB Interpretive Letter No. 59, from Milan C. Miskovsky, General Counsel (Aug. 26, 1980).

93. The question gets considerably more complicated if the lender is federally chartered and federal law explicitly authorizes it to impose variable or floating rate terms. (This is currently the fact in the mortgage area for national banks, federal savings and loan associations and federal credit unions.) See 12 C.F.R. §§ 29, 545, 701.21-68 (1981). There would now be not simply a question of the preemption of *state* law, but a clash of two federal rules: one permitting banks to use adjustable rate features, the other saying that if the bank borrows a rate from another class of lender under state law, it takes that rate as it finds it (*i.e.*, with its restrictions on rate adjustments). One view might be that, since the most favored lender doctrine flows directly from a federal statute, while the adjustable rate authorization is merely an agency regulation, the agency policy that contradicts the statute must give way. Perhaps the stronger case would rely on a variation of *Evans*, 251 U.S. 108 (1919), which concluded that federally chartered institutions are empowered by federal law to charge variable rates, and, when they borrow a rate figure, it is only that figure that binds them. In essence, they retain all their federal powers. We leave this issue for others to resolve.

94. See note 35 *supra*, slip op. no. 2.

In its supplemental opinion, the court first held that the pertinent standard is indeed that suggested in the Comptroller's interpretation—*i.e.*, that national banks exercising most favored lender status are subject to state law provisions which are "material to the determination of the interest rate."<sup>95</sup> But, by reference to an earlier version of the Comptroller opinion, the court articulated a standard which is much more consistent with its eventual broad holding: national banks using favorable state rate laws are "subject to *all limitations of substance with respect to size, maturity of the loan and the like*, which are prescribed by the State statute authorizing the higher rate."<sup>96</sup> From this posture, the court reviewed the consumer loan law and found all of the following provisions material, and therefore binding on federal lenders:

— Provisions that specify a numerical rate or amount of interest, including provisions that limit interest on overdue loans and on refinancings;<sup>97</sup>

— Provisions that fix the amount of the loan, particularly the \$6,000 loan maximum but including restrictions on loans disguised as purchases, and on loan splitting;<sup>98</sup>

— Sections that prescribe methods of interest computation and of loan repayment; this includes rules requiring that interest be computed on the declining unpaid balance, and barring prepayment penalties;<sup>99</sup>

— Proscriptions on extra fees and charges, which have the effect of preventing banks from charging the annual fees that the same court would permit them to charge under the general rate law;<sup>100</sup>

— Limitations on the maximum term or maturity of loans;<sup>101</sup>

— Provisions that only indirectly affect the interest rate, such as an anti-holder in due course rule, and prohibitions on confessed judgment notes, wage assignments, blank or incomplete instruments, and real property security.<sup>102</sup>

This series of rulings amounts to a holding that any financial institution wishing to be treated as a loan company (with respect to rates) must accept this status fully: the institution acquires neither a greater nor a lesser reve-

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95. *Id.* at 2-3.

96. *Id.* at 3, quoting from Comptroller of the Currency, Digest of Opinions ¶ 9510 (1960) (emphasis added).

97. *Equitable Trust Co. v. Sachs*, *supra* note 35, slip op. no. 2 at 4-7.

98. *Id.* at 8-10.

99. *Id.* at 10-14.

100. *Id.* at 15-19.

101. *Id.* at 19-21.

102. *Id.* at 21-23.

nue opportunity than the loan companies enjoy, taking as the measuring rod the aggregate yield the lender may realize from transactions under the consumer loan act. This result is generally consistent with the theoretical underpinnings of the most favored lender doctrine—that federal lenders may achieve parity, no more, no less.

On closer scrutiny, the attractiveness of the holding is somewhat superficial. An inquiry into whether state law provisions are material to determination of an interest rate becomes, under the court's analysis, a quest for all provisions having a substantial bearing on the creditor's conduct in the transaction.<sup>103</sup> This proves both too much and too little. Too much, in that it is difficult to see what the nexus is, for example, between interest rates and a prohibition against using blank contract forms. Too little, in that the state law provisions which ultimately affect a lender's interest rate may range far beyond those contained in the particular rate law. Branching or licensing laws, capitalization requirements, fee structures for demand deposits, and taxes can have a "material" influence on the terms of a lender's loan offerings.

The holding is troublesome in another—ironic—respect. It will force open-end credit card plans to adapt to rules clearly designed for closed-end credit plans. Financial institutions opting to use the consumer loan law rate may have to pay a heavy price for the privilege. While they will gain access to a higher rate, and will not need to give their credit card customers a free-ride period,<sup>104</sup> they will be barred from charging annual membership fees, foreclosed from computing unpaid balances on an average-daily-balance or comparable formula, and required to program their systems to account for maximum maturity schedules.<sup>105</sup> These trade-offs

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103. The court relies on a Comptroller opinion that states the test not as "materiality," but in terms of "limitations of substance." See note 96 and accompanying text *supra*. The foreword to the 1960 digest of opinions merely indicates that it is a reprinting of a 1948 edition. Another source indicates that the phrasing was simply an early stage in the evolution of what is now the official OCC Interpretive Ruling. OFFICE OF THE COMPTROLLER OF THE CURRENCY, 2 COMPTROLLER'S INTERPRETIVE RULINGS: CHANGES IN TEXT, 1948-1977 ¶ 7310 (undated). Thus it seems the *Equitable Trust* court gave ¶ 9510 an undeserved stature.

104. The court "reluctantly" ruled that if a bank opted for the higher consumer loan law rate, it could charge interest from the date of a credit card transaction, without allowing the free-ride period required under the general banking law. *Equitable Trust Co. v. Sachs*, *supra* note 35, slip op. no. 2 at 27.

105. The plaintiff banks in *Equitable Trust* argued that compliance with those sections of the Maryland Consumer Loan Law governing the maximum terms of repayment (maturities) and the method of computing interest would "be impracticable, undesirable and [would] in effect, prevent their credit card operations" and would "unlawfully vitiate their most favored lender status." *Id.* at 32. That observation almost certainly overstates the actual burdens to the banks in converting their computer programs, but the net effect of

could well prompt a financial institution to conclude that the benefits are not worth the cost, that there is no real advantage in most favored lender status.

#### 4. *Consumer Protection Provisions Generally*

This discussion raises an important policy question which permeates the most favored lender debate: should federally insured lenders, while enjoying rate relief as most favored lenders, be required to comply with consumer protection provisions in borrowed rate laws, whether or not those consumer protections affect the rate of interest? Although DIDMCA allows federally insured depository institutions to charge the most favorable rate for a particular class of loans, it does not specifically preempt other provisions of those state laws which may have influenced the setting of that rate (except, apparently, requirements for state licensing or supervision of federally chartered institutions).<sup>106</sup> The FHLBB, alone among the agencies affected by DIDMCA, has interpreted most favored lender status under that act to require federally insured savings and loan associations to comply with *all* substantive requirements of the state law, including consumer protections that do not affect the rate at all, if the institutions wish to

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these changes will be to decrease somewhat the attractiveness of exercising the most favored lender option.

The operational problems created for bank credit card issuers would challenge the most sophisticated computer programmer. For banks to use the higher rate, their credit card billing systems would have to calculate interest on a daily basis (to reflect the declining balance) while simultaneously readjusting minimum monthly payment requirements to make certain that all balances are paid off within the specified maturities. The interest rates authorized under the Maryland Consumer Loan Law are also step-rates, so that the daily calculations will also have to juggle those variables.

More ominously for the banks, the Attorney General is appealing the case, contending that the "merchants discount fee" and the "interchange fee" (fees among merchants and card-processing banks, not directly assessed to the cardholder) are subject to the provisions of Maryland's Consumer Loan Law which prohibit collecting indirectly any charges not otherwise permitted by law. The court found that such fees were *not* material to the interest rate agreed to by the cardholder. *Id.* at 20. If, on appeal, the court's decision is reversed on this issue, the banks face a substantial disincentive to borrow the Consumer Loan Law rates, because the merchant discount contributes measurably to the credit card program's profitability. The unattractive alternative for the card-issuing banks would be to raise interest rates even higher to compensate for the inability to assess those extra fees.

106. The Comptroller of the Currency has ruled that national banks "may lawfully charge the highest rate permitted to be charged by a State-licensed small loan company or morris plan bank, *without being so licensed.*" 12 C.F.R. § 7.7310 (1980) (emphasis added). The FHLBB has read the same limitation into DIDMCA: "Federally-chartered insured institutions would not be required to submit to state most-favored-lender restrictions that are primarily procedural or regulatory in nature. Such restrictions would include licensing, bonding, and reporting to state authorities." 46 Fed. Reg. 13,987-88 (1981) (to be codified in 12 C.F.R. § 570.11(c)).

charge the most favored lender rate.<sup>107</sup>

The fact that Congress has allowed the states to override usury preemptions under DIDMCA recognizes that states may have public policies that are inconsistent with unlimited rate competition. Usury limits and related provisions containing consumer protections are clear expressions of those policies. There is no evidence that Congress meant to displace all the protective aspects of state rate laws when it provided for the extension of most favored lender status.<sup>108</sup> It is reasonable to conclude that Congress anticipated that state laws permitting favorable rates and also providing borrower protections would be followed in all aspects of the credit transaction. To hold otherwise gives federally insured lenders artificial advantages over all other creditors, rather than competitive equality.

It is debatable, however, which consumer protections apply when a bank borrows the most favored lender rate for a particular type of credit. Many provisions that affect a lender's earnings may also be consumer protections. Restrictions on service or transaction charges, annual fees, or rebate or balance assessment methods can have a substantial effect on the amount of revenue actually generated. A federally insured lender may wish to charge a small loan rate that is higher than otherwise permitted under state law for its installment loan program. Under DIDMCA, the bank apparently may borrow the most favorable rate for that class of loan, but do small loan act provisions apply with regard to, *e.g.*, security, disclosures, default charges and remedies, or rebate methods? Obviously, where the same protections apply to small loan companies and to banks, there is no problem.<sup>109</sup> But if the rebate method is more protective under the small

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107. "Consumer protections specifically required in such loans when made by the most favored lender would also be considered substantive and must be included in loans made by insured institutions which desire to use most-favored-lender rates." 46 Fed. Reg. 13,987-88 (1981) (to be codified in 12 C.F.R. § 570.11(b)). The explanatory material accompanying the FHLBB interpretation indicates that this includes "state law requirements as to loan term and amount, use of proceeds, identity of borrower, etc." It continues: "Substantive state law requirements would also include provisions governing *prepayment refunds, late charges, credit life insurance, permissible security interests, and similar consumer protections.*" *Id.* (emphasis added). Moreover, in doubtful cases the determination of what state law provisions are substantive is to be made by *state* officials.

The FHLBB does not explain the basis for its conclusion that most favored lender status requires compliance with all "substantive" consumer protection provisions in the borrowed rate law. The Maryland court, in *Equitable Trust*, *supra* note 35, however, finds this FHLBB interpretation "highly persuasive and . . . a harbinger of things to come." *Id.*, slip op. no. 2 at 23.

108. This deference to state consumer protections is reflected also in the FHLBB's regulations on the residential mortgage preemption section of DIDMCA. See 12 C.F.R. § 590.3(c) (1981).

109. Under the UNIFORM CONSUMER CREDIT CODE, for example, most restrictions on

loan law, while the required disclosures are less protective, there is a policy conflict. And who can say ultimately which of the many varied provisions in small loan laws, retail installment sales acts, or general banking laws, are "more protective" than counterpart provisions in other laws.

The Maryland decision in *Equitable Trust*, presents a classic example of this dilemma. Whether compelled by the most favored lender doctrine or not, it may be good public policy (and may also promote competitive parity) to require banks seeking the consumer loan law rate to comply with that law's restrictions on creditor remedies.<sup>110</sup> But, in the process of requiring this compliance, the court found that the banks were excused from their obligation under the general banking law to afford credit card customers a free-ride period before finance charges began to accrue. This frustrates a clear and focused policy of the State of Maryland to provide cardholders with this specific protection. It also points out the dangers in an "all or nothing" approach to most favored lender status, as reflected in the Maryland case.

It may be the sounder policy to require federally insured institutions to comply with the requirements in the borrowed rate law, but only to the extent the consumer protections in that law demonstrably affect the rate or amount of interest, or are preconditions to charging that higher rate. Otherwise, the protections contained in the state law that would normally govern the transaction ought to apply. In the Maryland case, under this test, federally insured banks would comply with all rate-related provisions in the consumer loan law, but provisions in the general banking law on creditor remedies, disclosure, and even possibly on free-ride periods would also remain applicable. As a practical advantage, this policy avoids artificial substitutions of consumer protections from one law for those in another. For example, disclosures called for under a small loan law (typically closed-end credit) may be ill-suited for bank credit card plans to which other more appropriately designed disclosure rules already apply. It would be foolish to force a bank borrowing the small loan law to use that law's disclosure scheme merely because in some tangential way it was thought to be material or "substantive" with respect to the small loan rate.<sup>111</sup>

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contract provisions and creditor remedies are universally applicable to all creditors. *See generally* UNIFORM CONSUMER CREDIT CODE, art. 3.

110. *See* notes 94-105 and accompanying text *supra*.

111. In an advisory letter interpreting DIDMCA, the Michigan Commissioner of Financial Institutions reached just such a pragmatic conclusion. She concluded that financial institutions making loans under the Small Loan Act would not have to give monthly receipts for payments received as required by the Small Loan Act: such a requirement "has no direct

*B. Does State or Federal Law Determine Penalties?*

Both section 86 of Title 12 of the United States Code and sections 521-523 of DIDMCA contain penalty provisions<sup>112</sup> for violations of those sec-

impact on the yield, amount or other terms of the loan." Michigan Financial Institutions Bureau Interpretive Letter, May 21, 1981.

112. 12 U.S.C. § 86 (1976) provides:

The taking, receiving, reserving, or charging a rate of interest greater than is allowed by section 85 of this title, when knowingly done, shall be deemed a forfeiture of the entire interest which the note, bill, or other evidence of debt carries with it, or which has been agreed to be paid thereon. In case the greater rate of interest has been paid, the person by whom it has been paid, or his legal representatives, may recover back, in an action in the nature of an action of debt, twice the amount of the interest thus paid from the association taking or receiving the same: *Provided*, That such action is commenced within two years from the time the usurious transaction occurred.

Section 521 (codified at 12 U.S.C. § 1831d (Supp. IV 1980)) (amending the Federal Deposit Insurance Act) reads in pertinent part:

(b) If the rate prescribed in subsection (a) exceeds the rate such State bank or such insured branch of a foreign bank would be permitted to charge in the absence of this section, and such State fixed rate is thereby preempted by the rate described in subsection (a), the taking, receiving, reserving, or charging a greater rate of interest than is allowed by subsection (a), when knowingly done, shall be deemed a forfeiture of the entire interest which the note, bill, or other evidence of debt carries with it, or which has been agreed to be paid thereon. If such greater rate of interest has been paid the person who paid it may recover in a civil action commenced in a court of appropriate jurisdiction not later than two years after the date of such payment, an amount equal to twice the amount of the interest paid from such State bank or such insured branch of a foreign bank taking, receiving, reserving, or charging such interest.

Section 522 (codified at 12 U.S.C. § 1730g (Supp. IV 1980)) (amending Title IV of the National Housing Act) reads in pertinent part:

(b) If the rate prescribed in subsection (a) exceeds the rate such institution would be permitted to charge in the absence of this section, and such State fixed rate is thereby preempted by the rate described in subsection (a) of this section, the taking, receiving, reserving, or charging a greater rate of interest than that prescribed by subsection (a) of this section, when knowingly done, shall be deemed a forfeiture of the entire interest which the note, bill, or other evidence of debt carries with it, or which has been agreed to be paid thereon. If such greater rate of interest has been paid, the person who paid it may recover, in a civil action commenced in a court of appropriate jurisdiction not later than two years after the date of such payment, an amount equal to twice the amount of the interest paid from the institution taking or receiving such interest.

Section 523 (codified at 12 U.S.C. § 1785g (Supp. IV 1980)) (amending the Credit Union Act) reads in pertinent part:

(2) If the rate prescribed in paragraph (1) exceeds the rate such credit union would be permitted to charge in the absence of this subsection, and such State fixed rate is thereby preempted by the rate described in paragraph (1), the taking, receiving, reserving, or charging a greater rate than is allowed by paragraph (1), when knowingly done, shall be deemed a forfeiture of the entire interest which the loan carries with it, or which has been agreed to be paid thereon. If such greater rate of interest has been paid, the person who paid it may recover, in a civil action com-



tions which set forth rates permitted to federally insured lenders. Therefore, penalties for excessive charges are determined as a matter of federal law. For example, where State *A* permits an annual rate of 18% for consumer installment credit and the current ninety-day federal discount rate is 17.5%, a federally insured state bank charging 19% would be subject to the penalties described in DIDMCA for exceeding both the most favored state rate and the option of 1% above the discount rate. Although the penalty provisions of DIDMCA have not yet been interpreted by the courts, section 86 has been construed to offer two remedies, depending upon the facts of the case. The Supreme Court in *Haseltine v. Central National Bank*<sup>113</sup> interpreted section 86 as follows:

Two separate and distinct classes of cases are contemplated by this section: *first*, those wherein usurious interest has been taken, received, reserved or charged, in which case there shall be 'a forfeiture of the entire interest which the note, bill or other evidence of debt carries with it,' . . . *second* in case usurious interest has been *paid*, the person paying it may recover back twice the amount of the interest 'thus paid from the association taking or receiving the same.'<sup>114</sup>

In the example cited above, the bank must forfeit all interest on the usurious debt. In effect, the borrower is obligated only to repay the principal of a usurious loan. If any interest at the usurious rate was paid, the borrower can recover from the bank, in a separate action, twice the amount of interest paid. There is, however, a two year statute of limitations on the separate right of action.<sup>115</sup>

Both section 86 and the penalty provisions of DIDMCA specify that the penalties apply when the charging of excessive interest is "knowingly done." Clearly, intentional charging of usurious interest is a knowing violation.<sup>116</sup> The requisite intent, however, is simply an intent to receive

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menced in a court of appropriate jurisdiction not later than two years after the date of such payment, an amount equal to twice the amount of the interest paid from the credit union taking or receiving such interest.

113. 183 U.S. 132 (1901).

114. *Id.* at 135 (emphasis in original).

115. The statutory text is set out in note 112 *supra*. Note that the statute of limitations in § 86 runs "two years from the time the usurious transaction occurred." The statute of limitations in the applicable sections of DIDMCA is apparently longer, "not later than two years after the date of . . . payment" of the usurious interest.

116. In *American Timber & Trading Co. v. First Nat'l Bank of Or.*, 511 F.2d 980, 983 (9th Cir. 1973), *cert. denied*, 421 U.S. 921 (1975), the circuit court held that a national bank, which knew that its computation of interest based on a 360 day year would result in interest in excess of that based on a calendar (or 365 day) year, was intentionally charging excessive interest even though the bank did not know it was illegal.

compensation at a rate in excess of the interest permitted by law.<sup>117</sup>

In view of the requirement that usurious charges be "knowingly" imposed before penalties are exacted under the federal statutes, an important question remains as to whether the federal law is exclusive in this area. Where the federal discount rate exceeds the most favored lender rate, only federal penalties are applicable because the state limits are preempted and, as such, are not violated where the federal discount rate option is in force. Where the bank elects the most favorable rate as determined by state law but charges a greater amount or additional fees not permitted by that law, is the federal penalty *all* that is permitted for violations of section 85 or DIDMCA, or may the debtor elect a state remedy, or aggregate state and federal remedies? Unlike the trend in section 85 case law that generally state rather than federal law defines usury, the courts continue to consider section 86 an exclusive federal remedy.<sup>118</sup> That is, even if state law provides a penalty for usury not "knowingly done," the existence of section 86 preempts imposition of that sanction. It appears that federally insured lenders, like national banks, therefore, are favored lenders with regard to penalties as well as permissible interest charges. Indeed, the result may be that such lenders are actually granted a status superior to the most favored state lender. In the previous example, suppose the discount rate is 16.5% and the most favored state rate is 18%. A bank charging 20% would violate state usury limitations *and* federal law by charging in excess of both the most favored lender rate (18%) and the federal option (1% above 16.5%). If state law would impose penalties regardless of intent or knowledge, or if such penalties include invalidation of any security interest as well as forfeiture of usurious interest, federally insured lenders under DIDMCA may avoid the loss of interest by showing the excessive charges

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117. *McAdoo v. Union Nat'l Bank of Little Rock*, 535 F.2d 1050, 1055 (8th Cir. 1976). The court referred to Arkansas law to determine whether the bank's required deposit balance resulted in a usurious transaction with usurious intent. The court stated in dictum that knowingly charging an amount in excess of interest permitted by law was sufficient for usurious intent even though there was no intent to violate usury laws. *Cf. Crenshaw v. First Tenn. Bank*, 5 CONS. CRED. GUIDE (CCH) ¶ 97,486 (Tenn. App. 1980) (a national bank was found to lack the necessary scienter when it charged rates authorized by a state statute later found unconstitutional).

118. "[S]ince Congress has provided a penalty for usury, that action preempts the field and leaves no room for varying state penalties." *First Nat'l Bank in Mena v. Nowlin*, 509 F.2d 872, 881 (8th Cir. 1975).

A Florida court, in *Ellis Nat'l Bank v. Davis*, 359 So. 2d 466, 467 (1st Dist. Ct. App. 1978), *cert. denied*, 440 U.S. 976 (1979), held that interest at the maximum rate under state law computed on the basis of a 360 day year rather than a calendar year was usurious, but that the state law penalty provision was inapplicable because the bank is subject to § 86, "which furnishes the exclusive remedy when a national bank is found guilty of exacting usurious interest." 359 So. 2d at 469.

were not knowingly made.<sup>119</sup> In addition, federal law has no provision for loss of any security interest on a usurious loan.

A further complication can arise if either section 85 or DIDMCA is construed to require compliance by the federally insured lender with all consumer protection provisions of the borrowed state rate law (as the FHLBB has required for savings and loan associations).<sup>120</sup> What sanction awaits a lender who fails to comply with those nonrate consumer protection provisions of the state law, for example, by taking excessive security? Under one analysis, it is possible to argue that a lack of compliance with the security limitations will disqualify the lender for most favored lender status. The rate actually imposed would then presumably be usurious (under the rate limitations otherwise applicable to banks), and federal sanctions could be imposed. Another view would stress that the federal law imposes penalties only for an excessive *rate*, and that for violations of other aspects of state law the borrower's remedy is a state law remedy. This view necessarily implies that the federal sanction for misuse of most favored lender status is not exclusive, contrary to the theme of the court holdings under sections 85 and 86 of the National Bank Act.<sup>121</sup> Nonetheless, this latter approach seems a more reasonable accommodation of federal and state interests.

### C. *Can Rates be Exported?*

The Supreme Court, in its 1978 decision in *Marquette National Bank v. First of Omaha Service Corp.*,<sup>122</sup> held that the language of section 85, identical to that of DIDMCA, allows national banks to charge the higher interest rate permitted in the state where the bank is located for unpaid balances on accounts of out-of-state credit card holders. Just prior to this decision, both the Seventh and Eighth Circuits had also held that national banks could export favorable interest rates for credit card transactions to customers in other states, even though those rates were not permitted for lenders located in those other states.<sup>123</sup> The Supreme Court of Iowa, however, had reached a different conclusion.<sup>124</sup> The Iowa court drew a distinc-

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119. *Helms v. First Ala. Bank, N.A.*, 386 So. 2d 450 (Ala. Civ. App. 1980) (bank "cured" § 85 violation, thus avoiding any separate state penalty).

120. See note 107 *supra*.

121. See notes 13-21 *supra*.

122. 439 U.S. 299 (1978).

123. *Fisher v. First Nat'l Bank of Omaha*, 548 F.2d 255 (8th Cir. 1977); *Fisher v. First Nat'l Bank of Chi.*, 538 F.2d 1284 (7th Cir. 1976). Both circuits upheld the practice of national banks located outside Iowa charging out-of-state rates on open-end credit accounts for Iowa customers.

124. *Turner v. First of Omaha Serv. Corp.*, 269 N.W.2d 409 (Iowa 1978). The Iowa

tion between intrastate and interstate transactions and found that "the effect of [applying] 12 U.S.C., section 85, to *interstate* credit transactions is an unwarranted extension of the 'most favored lender status.'"<sup>125</sup> In *Marquette*, the Minnesota Supreme Court was inclined to uphold the lower Minnesota rate laws against the incursions of the Nebraska card issuer but chose instead to follow the two federal courts of appeal.<sup>126</sup> The United States Supreme Court then confronted the question of whether section 85 "authorizes a national bank based in one State to charge its out-of-state credit-card customers an interest rate on unpaid balances allowed by its home State, when that rate is greater than that permitted by the State of the bank's nonresident customers."<sup>127</sup>

The Court focused on the first clause of section 85 and held that federal law permits a national bank, "on any loan," to charge interest at the rate allowed by the state laws where the bank is "located."<sup>128</sup> In other words, the laws of the state of location determine the interest rate for all loans by that bank. Presumably DIDMCA, by using language identical to section 85, also allows federally insured depository institutions to export most favored lender rates for out-of-state customers.

An examination of the effect of the *Marquette* holding indicates that it was an unnecessary and probably unwise extension of the most favored lender doctrine.<sup>129</sup> Permission to export higher rates from one state to another gives competitive advantages to "exporting" lenders beyond those available to the most favored lenders in other states. For example, if a national bank may export the higher rate of its home state (State *A*) to a second state (State *B*) where lenders, including other national banks, are limited to a lower most favored lender rate, the exporting bank would enjoy advantages over the most favored lender of State *B* as well as over other national banks located there.

On the other hand, if *Marquette*'s import is that a bank may charge *only* rates permitted by the state where the bank is physically located, national banks located in State *B*, with low interest rate limits, would also be at a

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Supreme Court held that a national bank located in Nebraska could not charge interest on credit card accounts held by Iowa customers in excess of the amount permitted under the Iowa Consumer Credit Code.

125. *Id.* at 415 (emphasis in original).

126. *Marquette Nat'l Bank v. First of Omaha Serv. Corp.*, 262 N.W.2d 358, 365 (Minn. 1977).

127. *Marquette Nat'l Bank v. First of Omaha Serv. Corp.*, 439 U.S. 299, 310 (1978).

128. *Id.* at 308.

129. The pro and con of *Marquette* has been argued in detail elsewhere. Compare Rohner, *Marquette: Bad Law and Worse Policy*, J. RETAIL BANKING, June 1979, at 76, with Schellie, *Marquette: A Sound Legal and Social Result*, J. RETAIL BANKING, June 1979, at 85.

disadvantage when making loans in State *A*, where rates are higher. That conclusion was reached by a federal district court in *Meadow Brook National Bank v. Recile*.<sup>130</sup> The court reasoned:

In such a situation the purpose of the statute—to put national banks on an equal par with the state banks against which they compete—is frustrated if the national banks are restricted to the interest rate in the states where they are located. On the other hand, we do not think Congress intended this provision to serve as a haven for national banks which . . . charge interest on loans made in other states in excess of that allowed by the laws of those states. This, too, would frustrate the Congressional purpose of equality between national and state banks regarding the interest rate.<sup>131</sup>

*Meadow Brook National* involved a suit by a national bank located in New York to recover from the endorsers of a note made in Louisiana. The district court held that Louisiana usury laws applied because section 85 only governs the rate of interest for loans made in the state where the bank is located: “Consequently, loans made in states other than the one where the bank is located ought to be governed by the laws of the state where the loan is made.”<sup>132</sup> Although the result reached in *Meadow Brook National* appears logical, the case has never been followed.

No court has expressly held that a national bank is *limited* to its home state rates if the states where the bank does business permit higher rates. Both the Seventh and Eighth Circuits have stated in dicta, that where there is a difference between the maximum rate allowable in its home state (State *A*) and the maximum rate allowable in another state (State *B*), national banks in State *A* may charge the higher rate permitted by either State *A* or State *B* for credit extended in State *B*.<sup>133</sup> There are in fact two separate grounds on which national banks can legitimately use the higher bank rates of the state where its customers live. The “except” clause in section 85<sup>134</sup> could be read to allow such use by its reference to the “laws

130. 302 F. Supp. 62 (E.D. La. 1969).

131. *Id.* at 74.

132. *Id.* at 75.

133. *Fisher v. First Nat'l Bank of Omaha*, 548 F.2d 255, 258 (8th Cir. 1977); *Fisher v. First Nat'l Bank of Chi.*, 538 F.2d 1284, 1291 (7th Cir. 1976). In both cases the state of the bank's location had the higher rate. See note 123 and accompanying text *supra*.

134. 12 U.S.C. § 85 (Supp. IV 1980) (emphasis added) (quoted in pertinent part at note 12 *supra*). After authorizing national banks to charge either at the highest rate permitted in their state of location, or at 1% over the Federal Reserve discount rate, § 85 continues: “except that where by the laws of any State a different rate is limited for banks organized under State laws, the rate so limited shall be allowed for associations organized or existing in any such State under this chapter.”

of *any* state" where the bank is "existing." That is, a national bank is not limited to the rates of the state where it is located if some *other* state's law (applicable to the transaction because of the bank's operations there) permits higher rates for state banks. A second, and stronger ground, is by application of normal conflict of laws principles: if a state bank or small loan company in State *A* could validly contract at the rate permitted in State *B* for customers living there, a national bank in State *A* would have the same privilege.<sup>135</sup> This rationale would also apply to other lenders under DIDMCA.

Particularly important to a discussion of exporting rates is the question of which other provisions of the state's law apply in addition to the interest rate provision. Should banks that export rates under *Marquette* have to comply with nonrate consumer protection provisions of the other state's law? Or should the state of the bank's location govern incidental items such as balance assessment methods, methods for computing interest, and service fees? Which state's law controls disclosure, security, default charges, and the like? Should a bank, under the most favored lender doctrine, be permitted to select those provisions of each state's laws that are most favorable in order to maximize the yield on out-of-state transactions? *Marquette* reflects a narrow interpretation of section 85,<sup>136</sup> and arguably under either section 85, or DIDMCA, a bank with most favored lender status could pick the combination of rate limitations and other requirements which would provide the greatest revenue. The clear result, however, would be superiority over, and not equality with, the most favored lender both in the bank's home state and in the state where the bank's customer resides.

There are several possible paths through the thicket created by the *Marquette* holding. Taking the case at face value, even conceding that a national bank or other federally insured lender in Nebraska can charge Nebraska *small loan* rates as well as Nebraska bank card rates to Minnesota customers (an issue not decided in the case), the Nebraska lender should still be subject to all other Minnesota rules that normally apply to the lender dealing with Minnesota customers.<sup>137</sup> This would include, at a

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135. *Fitzgerald v. United Va. Bank of Roanoke*, 139 Ga. App. 664, 229 S.E.2d 138 (1976). See generally RESTATEMENT (SECOND) OF CONFLICT OF LAWS §§ 188, 203 (1971); OCC Interpretive Letter No. 116 (Donald A. Melby, Spec. Ass't for Cong. Affairs), [1978-1979 Transfer Binder] FED. BANKING L. REP. (CCH) ¶ 85,191.

136. The thrust of the Court's opinion was that the Congress of 1864 was aware of an interstate credit market and therefore must have intentionally written that national banks could charge the rate of the state where they were "located." 439 U.S. at 314-18.

137. This follows from the limited scope of § 85 itself which addresses only the permissible rates national banks must charge. There is ample authority that, with respect to other

minimum, disclosure, default and collection requirements. Since the Nebraska lender is relying on the rate law of Nebraska, the lender should also be bound by all provisions of that law that materially affect the rate, including balance assessment methods, closing costs, service charges, and rebate requirements.

A better approach, suggested elsewhere,<sup>138</sup> would be to overrule *Marquette*, legislatively if necessary. No Nebraska lender (except a national bank at the time, and other federally insured institutions now under DIDMCA) could rely on section 85 in dealing with Minnesota customers. Therefore, by application of the terms of the Minnesota rate statute and normal conflict of laws principles, no such Nebraska lender was favored with the right to charge Nebraska rates in Minnesota. If section 85 seeks parity between national banks and the "most favored" Nebraska lender, then the Court in *Marquette* should have limited the Nebraska national bank to the same rate ceiling that other Nebraska creditors would have confronted in Minnesota.

A third path would be to redefine where a bank is "located" to include all those locations where the bank does business. This interpretation would prevent the inequitable exporting of rates from one state to another. For example, while a federally insured bank located in State *A* could charge the state's most favored lender rate for customers in that state, when it did business with customers in State *B* it would be limited to the most favored lender rate for that state. This construction meets the congressional intent of providing equality with the most favored lender in each state without giving out-of-state lenders "an unconscionable and destructive advantage."<sup>139</sup> DIDMCA states that federally insured depository institutions may charge interest on "any loan . . . at the rate allowed by the laws of the State . . . where the [institution] is located. . . ."<sup>140</sup> In *Marquette*, the Supreme Court interpreted the term "located" in section 85 by reference to

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transactional matters, state law governs national banks. See, e.g., *McClellan v. Chipman*, 164 U.S. 347, 356-57 (1896). This would include state conflict of laws rules which, in the text example, would call for application of Minnesota law on non-rate aspects of the transaction. Shanks, *supra* note 51, at 489 n.11. See OCC Interpretive Letter No. 116, *supra* note 135. The Comptroller of the Currency has generally acknowledged the applicability of state consumer protection laws. See, e.g., Letter from John E. Shockey, Acting Chief Counsel, Office of the Comptroller of the Currency, to Charles E. White, Regional Counsel (July 14, 1976).

138. Rohner, *supra* note 129.

139. *Turner v. First of Omaha Serv. Corp.*, 269 N.W.2d 409, 415 (Iowa 1978). The Iowa court refused to permit the Nebraska national bank to use Nebraska rates for its Iowa cardholders. On appeal to the Supreme Court, this decision was vacated and remanded in light of *Marquette*, and the Iowa court subsequently held that Nebraska rates could be exported into Iowa. *Turner v. First of Omaha Serv. Corp.*, 281 N.W.2d 452 (Iowa 1979).

140. Equivalent language appears in §§ 521, 522, & 523. See note 8 *supra*.

the legislative history of the National Bank Act, in which it was assumed "that a national bank was 'located' for purposes of [section 85] in the State named in its organization certificate."<sup>141</sup> And in *Fisher v. First National Bank of Chicago*,<sup>142</sup> the Seventh Circuit found "located" synonymous with "established," and held that "located" under the venue provision of the National Bank Act<sup>143</sup> was the principal place of business for the bank. While these definitions of a bank's "location" enjoy judicial support, they are thin reeds in the current reality of interstate banking, and could readily be the subject of judicial rethinking or legislative correction.<sup>144</sup>

#### IV. THE "1% OVER DISCOUNT RATE" OPTION

Both section 85, as amended in 1933, and DIDMCA provide another interest rate option in addition to the rate permitted to the most favored lender under state law. That option is "1 per centum in excess of the discount rate on ninety-day commercial paper in effect at the Federal Reserve Bank" for that district.<sup>145</sup> The legislative history of DIDMCA refers exclusively to this option<sup>146</sup> as the advantage enjoyed by national banks

141. 439 U.S. at 310.

142. 538 F.2d at 1286.

143. 12 U.S.C. § 94 (1976).

144. The Supreme Court itself has already relaxed somewhat the test for where a national bank is located for venue purposes. *Citizens & Southern Nat'l Bank v. Bougas*, 434 U.S. 35 (1977) (bank is "located" either at the principal place of business designated in its charter, or wherever it has branch offices).

145. The pertinent statutory text is set out in notes 8 & 12 *supra*. According to one court, § 85 was amended in 1933 in order

to permit national banks to charge interest at a rate of 1% in excess of the discount rate on 90-day commercial paper in effect in the district Federal Reserve Bank. The amendment is phrased in the disjunctive, giving national banks the privilege of charging 'whichever may be the greater' between the state usury limit on the one hand, and a rate of 1% in excess of the 90-day commercial paper rate on the other.

*First Nat'l Bank of Kansas City v. Estate of Ward* (Est. No. 121,864, P. Ct. of Jackson County, Mo., Jan. 20, 1976), *reprinted in* 93 BANKING L.J. 593, 597 (1976). The FDIC has interpreted DIDMCA § 521 to allow federally insured state banks to choose between three permissible rates: "1 percent over the discount rate, the highest rate allowed to any lender under state law, or the rate specifically prescribed for state banks under state law, whichever of the three is greatest." FDIC Interpretive Letter, *supra* note 22, at 4.

146. The only mention of §§ 521-523 (in their final form) in the legislative history is the following reference in the House conference report:

State usury ceilings on all loans made by Federally insured depository institutions . . . will be permanently preempted subject to the right of affected states to override at any time and a ceiling of 1 percentage point above the appropriate Federal Reserve discount rate will apply, except to transactions subject to the preemptions of usury ceilings on mortgage loans and on business and agricultural loans . . . .

H. CONF. REP. NO. 842, 96th Cong., 2d Sess. 79-80 (1980), *reprinted in* [1980] U.S. CODE CONG. & AD. NEWS 236, 308-09 (emphasis added).



which DIDMCA was designed to extend to all federally insured depository institutions. A congressional sponsor likewise pointed to the 1% option as the basis for national bank favoritism: "National banks have been able to charge 1 percent over the Federal discount rate on all loans since 1933. State banks and all savings and loans have been at a distinct competitive disadvantage with national banks during this period of exorbitant interest rates."<sup>147</sup>

During a time of high interest rates, the discount-rate-plus-one may well be the most favorable rate. When the discount rate falls below the rates allowed any lenders in the state, the most favored lender doctrine under section 85 and DIDMCA operates to maintain a rate for federally insured institutions at least as high as the highest rate allowed by state law. As a practical matter, then, the most favored lender doctrine is useful only when the discount rate falls below the interest rates allowed to some lenders under state law.

#### *A. Relation to State Law "Most Favored Lender"*

There is no case law construing the 1% above the discount rate option under DIDMCA. Unofficial correspondence from the FHLBB,<sup>148</sup> however, discusses the similar option under section 85 and provides an interesting analysis of how generous the federal preemptions in DIDMCA may be. Interpreting section 522 of DIDMCA, the FHLBB staff addressed a Tennessee law that permitted a rate of 6% add-on or discount for home improvement loans made by savings associations, and provided for a maximum effective rate of 18%. Other lenders could charge up to 18% simple interest on any loan. The FHLBB staff first concluded that under DIDMCA's most favored lender concept, savings institutions could charge up to 18% simple-interest on home improvement loans. The staff then went on to discuss the 1% option under DIDMCA, and noted that this option was triggered when the 6% add-on rate "permitted" for savings and loans under state law would yield less than 1% above the current discount rate. Citing *Tiffany*,<sup>149</sup> the letter interpreted the rate "allowed" to mean the rate allowed the most favored lender in the state (18%), as distinguished from the rate permitted to savings and loans (6% add-on). This interpretation was believed necessary to give meaning to the phrase "whichever is greater." In other words, where the rate permitted savings

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147. Remarks of Sen. Bumpers, 126 CONG. REC. S3177 (daily ed. Mar. 27, 1980).

148. FHLBB Interpretive Letter from Milan C. Miskovsky, General Counsel (Sept. 29, 1980).

149. 85 U.S. (18 Wall.) 409 (1874).

and loans under state law is less than 1% above the discount rate, savings and loans can charge either the 1% option or the higher rate allowed another lender in the state, whichever is greater. For example, in Tennessee, 6% add-on will be less than 1% above the discount rate option (say 14%) for short term installment loans.<sup>150</sup> In such a case, the savings and loan could charge 14% or even 18% simple interest, instead of 6% add-on.

An obvious question is whether the 1% above discount rate is limited to a simple annual rate. Under the analysis suggested above, the answer is yes, as long as the resulting figure exceeds the most favored state effective rate of 18%. Surprisingly, however, the FHLBB staff concluded that the savings and loan could compute 1% over discount as an *add-on* under DIDMCA. While recognizing that the Act "does not specify whether the reference to one point over the ninety-day discount rate represents a simple interest, add-on or discount ceiling," the FHLBB's opinion letter cites *Evans*<sup>151</sup> and *Northway Lanes*<sup>152</sup> as construing section 85 to approve charging "add-on or discount in advance at the federal ceiling rate contained in that section."<sup>153</sup> Moreover, the FHLBB letter went on to note that the most favored lender rate under state law options in the DIDMCA would "probably not authorize" savings and loans to charge 18% add-on where the state's most favored lender was limited to 18% simple interest.

The FHLBB's reliance on *Evans*, as well as the reliance of the court in *Northway Lanes*, seems misplaced. The *Evans* decision came prior to 1933, when the 1% option was first put into the National Bank Act. The Court in *Evans* granted permission to discount interest in advance as an aspect of the most favored lender option where the controlling rate is set by state law.<sup>154</sup> Other courts have criticized *Evans* in light of the changed practices of the banking industry, especially in installment lending, which makes *Evans* unpersuasive even when institutions exercise the most favored lender option.<sup>155</sup> In addition, the legislative history of DIDMCA

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150. For example, \$6 interest added to a \$100 principal, and scheduled to be paid in 12 monthly installments of \$8.83 each, produces a "simple-interest" rate of 10.90%. For shorter periods, the simple-interest equivalent of 6% add-on is even less.

151. 251 U.S. 108 (1919).

152. 464 F.2d 855 (6th Cir. 1972).

153. FHLBB Interpretive Letter, *supra* note 148, at 3.

154. 251 U.S. at 114.

155. *E.g.*, the Eighth Circuit in *Nowlin*, 509 F.2d 872, 876 (8th Cir. 1975), questioned the soundness of the six to three decision in *Evans* and declared that:

The rationale of *Evans*, based on the long standing mercantile practice of discounting short-term single payment commercial paper, should not now be extended to permit usurious discounting practices on installment notes . . . .

Installment credit as it is extended and utilized today was for all practical purposes nonexistent at the time of *Evans*.

contains no indication that Congress intended the 1% option to be calculated as an add-on or discount. In a letter objecting to the FHLBB opinion, the Office of the Commissioner of Banking for Wisconsin argued:

There is not a shred of evidence in the legislative history to support the conclusion that the phrase 'one percentage point over the federal discount rate' refers to an add on of [*sic*] discount formula. The federal discount rate itself is not an add on or discount rate. Surely if Congress had intended that a rate of 1 percent above the federal discount rate were to be calculated on an add on or discount basis it would have said so in the statute as well as in the legislative history.<sup>156</sup>

Although the legislative history of DIDMCA indicates Congress' desire to equalize the positions of federally insured depository institutions and national banks, Congress focused on the 1% option and did not evidence any knowing extension of the broad court interpretations of the most favored lender doctrine in section 85 to other federally insured institutions under DIDMCA. Similarly, in a response to the Wisconsin letter,<sup>157</sup> the FHLBB recognized that recent court decisions reflect a criticism of the *Evans* decision and that the issue is controversial. Consequently, when the FHLBB issued its *official* interpretation on most favored lender,<sup>158</sup> it remained silent on computational questions and ignored the position expressed in the earlier staff letter. Whether this signals an outright reversal of that position is uncertain.

*Evans* and its progeny should not be followed. Neither the 1% option nor the most favored lender doctrine should be expanded to create an unwarranted disparity between federally insured and other state lenders. The two federal preemption options provide adequate rate relief and ought

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*See also* *Cohen v. District of Columbia Nat'l Bank*, 382 F. Supp. 270, 283 (D.D.C. 1974), where the court distinguished between an installment loan where periodic payments result in a declining balance, and a single-payment loan where the interest is withheld from the proceeds and the principal is repaid at the end of the year. The court held that combining the installment and discount features was usurious where the resultant charges exceeded the amount permitted under state law without discounting. The *Cohen* court acknowledged that *Fleckner*, 21 U.S. (8 Wheat.) 338 (1823), and *Evans*, 251 U.S. 108 (1919), found "an exception to the strict application of usury statutes . . . for discount-type loans." 382 F. Supp. at 283. The court then went on to limit that exception: "[H]owever, . . . the *Fleckner-Evans* exception is restricted to simple discount loans, and . . . combining discounting with any other means of exacting interest cannot excuse that loan from usury where the total amount of interest exacted exceeds that permitted by statute." *Id.* at 284.

156. Letter from Robert A. Patrick, General Counsel, Office of Comm'r of Banking of Wis., to Senator William Proxmire (January 5, 1981).

157. Letter from John H. Dalton, Chairman, FHLBB, to Senator William Proxmire (March 4, 1981).

158. 46 Fed. Reg. 13,987 (1981) (to be codified in 12 C.F.R. § 570.11).

to satisfy the intent of Congress to "level the playing field"<sup>159</sup> for federally insured lenders.

*B. Possible Problems Under the 1% Option*

It seems reasonable to conclude under the DIDMCA most favored lender provisions that a federally insured depository institution must charge interest both at the rate allowed and in accordance with state provisions affecting the rate. However, if the federally insured lender charges interest under the 1% above discount rate option, an argument might be made that the various state substantive consumer protection requirements, such as permissible charges, or methods of computing interest and balance assessment methods, are not applicable. The 1% above discount rate formula is a rate allowed by federal law, not state law, whereas the most favored lender rate is the rate allowed under and borrowed from state law. Arguably, then, the federally authorized rate is totally preemptive.<sup>160</sup> Unless the 1% option is designed to create a *super*-advantage for federally insured lenders, the more reasonable interpretation would be that the federal rate of 1% above discount was intended only to give competitive relief with regard to interest rate limits. Therefore the remaining provisions of state law which would otherwise govern the transaction should continue to apply, with regard to rate computations, types of credit offered, and other substantive customer protections.

Federally insured lenders (other than national banks) may also face a dilemma. The DIDMCA preemption of usury ceilings applies only in those states that have not elected to override it.<sup>161</sup> Where a federally insured institution is located in a state which has *not* enacted legislation superseding the federal preemption, the question may arise whether that institution is free to export its most favored state rate, or a rate of 1% above discount, to customers in states that *have* acted affirmatively to override the federal preemption. Or, alternatively, if the home state of a federally insured lender overrides the federal preemption, can the institution, when dealing with customers in other states, ignore that action and charge higher rates in those other states where the federal preemption enables lenders

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159. See note 5 *supra*.

160. Such a view has been universally adopted by the courts with respect to the usury penalty under § 86 of the National Bank Act: *i.e.*, the federal statutory remedy precludes imposition of *any* state sanction. See notes 118-19 and accompanying text *supra*. The problem with construing the 1% above discount option as totally preemptive of state law is that it creates a vacuum. Since § 85 speaks only of rates, national banks *must* rely on state contract law, such as the Uniform Commercial Code, to create binding obligations, to perfect security interests, to establish foreclosure and collection rights, and so forth.

161. See notes 32 & 33 *supra*.

located there to do so? Obviously, by allowing states to override the federal preemption, Congress recognized that states may, for reasons of public policy, wish to limit the amount of interest that can be charged to borrowers in the state, or at least restrict the rate competition among lenders.

This congressional deference to the states is a significant policy factor in evaluating a lender's claimed right to borrow rates from other jurisdictions. One of the criticisms of *Marquette* is that it permits disruption of a state's rate structure and creates competitive disadvantages for all local lenders when out-of-state banks can impose their home state rates on local consumers. This kind of economic jingoism is even more objectionable when, with congressional blessing, a state has affirmatively chosen to retain its own rates and competitive structure. It is doubtful whether Congress foresaw or intended an extension of most favored lender doctrine for other lenders, such as that created by *Marquette* for national banks.<sup>162</sup> Courts should proceed carefully in such an area where Congress has not given clear guidance. The DIDMCA usury preemptions came at a time when state usury ceilings were at below-market levels for many lenders. The Act offers the opportunity to reconsider and reset interest rate limits at realistic levels, thus enhancing the competitive atmosphere for all lenders who do business in the state. There is no evidence that Congress intended to provide any benefits to federally insured lenders beyond competitive equality with national banks when market rates exceed state usury restrictions.

## V. CURRENT LEGISLATIVE INITIATIVES

Since DIDMCA was passed, Congress has considered a number of legislative proposals to amend the 1980 Act. Two of those initiatives are currently under consideration by the Senate Banking, Housing, and Urban Affairs Committee: S. 963,<sup>163</sup> a bill which would authorize a federal interest rate of 1% above the discount rate for *any* lender on any loan, and S. 1406,<sup>164</sup> a bill which preempts *all* usury limits for consumer credit.

S. 963 is a limited, temporary preemption designed to provide interest

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162. Although the *Marquette* decision was handed down on Dec. 18, 1978, there is no acknowledgement of it in the legislative history of DIDMCA, through and including the President's signing of Pub. L. No. 96-221 on Mar. 31, 1980.

163. S. 963, 97th Cong., 1st Sess., 127 CONG. REC. S3789 (daily ed. Apr. 9, 1981).

164. S. 1406, 97th Cong., 1st Sess., 127 CONG. REC. S6627 (daily ed. June 22, 1981); reintroduced as Title IV of S. 1720, 127 CONG. REC. S11,265-66 (daily ed. Oct. 7, 1981). *Hearings on S. 1720 Before the Senate Comm. on Banking, Housing, and Urban Affairs*, 97th Cong., 1st Sess. (Oct. 20-22, 27-30, 1981). See Wash. Cred. Letter (Oct. 19, 1981).

rate relief to lenders who were not covered by DIDMCA in 1980.<sup>165</sup> The bill would amend Title V of DIDMCA by adding a new section that permits a "person" to charge for "any loan . . . interest at a rate of not more than one per centum in excess of the discount rate, including any surcharge thereon, on ninety-day commercial paper."<sup>166</sup> This provides to all creditors virtually the same federal interest rate option now available to federally insured depository institutions under Part C of Title V of DIDMCA. The penalties for exceeding the federal rate under S. 963 are identical to those in DIDMCA.<sup>167</sup> Although the preemption is universal, it is only temporary and would expire on April 1, 1983, or whenever a state steps in to override it and reimpose usury limits.<sup>168</sup> This proposed legislation does not contain any language which indicates, nor does its brief legislative history suggest, any intention to extend or clarify the most favored lender doctrine under DIDMCA. The passage of temporary legislation such as this, which also allows states to override the preemption, serves a purpose by putting pressure on states to enact comprehensive legislation to raise rate ceilings to realistically competitive levels.

S. 1406, jointly sponsored by the unlikely team of Senators Garn, Proxmire, D'Amato, and Lugar, represents broader legislation in its preemption of state usury limits, but, unlike S. 963, it does not cover all kinds of credit. S. 1406, titled the Credit Deregulation and Availability Act of 1981, would make permanent the preemptions for agricultural and business credit, and would add new sections to eliminate all state rate ceilings for consumer credit.<sup>169</sup> A similar bill has been introduced in the House (and was the subject of recent congressional hearings), but that bill has gathered less support and originally generated little activity.<sup>170</sup> Both the

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165. When S. 963 was introduced, Senators Bumper and Pryor (both from Arkansas, where there is a constitutional usury limit of 10%) expressed particular concern for automobile dealers and other retailers not covered by DIDMCA. 127 CONG. REC. S3789-92 (daily ed. Apr. 9, 1981).

166. S. 963, *supra* note 163, § 531(a).

167. *See* note 112 *supra*.

168. S. 963, *supra* note 163, § 531(b).

169. S. 1406 would amend Title V of DIDMCA by adding a new Part D entitled Consumer Credit. The proposed § 531 of that Part reads:

The provisions of the constitution or laws of any State prohibiting, restricting, or in any way limiting the rate, nature, type, amount of, or the manner of calculating or providing or contracting for covered charges that may be charged, taken, received or reserved shall not apply to an extension of consumer credit made by a creditor.

S. 1406, *supra* note 164, § 531.

170. H.R. 2501, 97th Cong., 1st Sess. (1981), 127 CONG. REC. H937-38 (daily ed. Mar. 12, 1981). H.R. 2501 was introduced by Congressman LaFalce. *Hearings on H.R. 2501 Before the Consumer Affairs Subcomm. of the House Comm. on Banking, Financial and Urban Affairs*, 97th Cong., 1st Sess. (Oct. 20, 1981). *See* Wash. Cred. Letter (Oct. 26, 1981). The

House and Senate bills are designed to make more credit available to consumers by giving lenders incentives to offer that type of credit.<sup>171</sup> In the Senate bill, S. 1406, those incentives include total preemption of restrictions on "covered charges" such as interest, points, annual fees, and service charges.<sup>172</sup> The preemption would be permanent unless a state elects to override it within three years of the effective date of the Act.<sup>173</sup> There is no penalty provision since there are no limits to exceed. The bill leaves in place all state-law consumer protections except those affecting rates and charges.<sup>174</sup> Under this proposed law, most favored lender status would become largely meaningless for consumer credit because every person would be a favored lender, entitled to charge whatever the traffic will bear.

The pending S. 1406 may offer the only realistic solution to the dilemma of unfair advantages enjoyed by some lenders under DIDMCA. As long as states can opt out of the federal preemption and restore their own rate structures, though, all of the issues discussed above remain problematic for lenders operating in those states. Furthermore, the bill unfortunately does not address the problems created by expansive court interpretations of the most favored lender doctrine under section 85 of the National Bank Act. Even if states override the federal preemption of this bill and the 1980 DIDMCA, there is no provision in the National Bank Act allowing states to override that Act's federal usury preemptions for national banks.

In addition, questions still remain concerning which state law provisions determine interest and which consumer protections are not displaced. S. 1406 defines "covered charges" but does not identify clearly which state

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LaFalce bill contains a similar federal preemption for consumer credit. It does not, however, have the support of chief banking committee members. Testimony of Rep. John LaFalce, in *Hearings on S. 963 and S. 1406, Subcomm. on Fin. Inst. of the Senate Comm. on Banking, Housing and Urban Affairs*, 97th Cong., 1st Sess. (July 9, 1981).

171. 127 CONG. REC. H937 (daily ed. Mar. 12, 1981) (remarks of Rep. LaFalce); 127 CONG. REC. S6626 (daily ed. June 22, 1981) (remarks of Sen. Lugar).

172. S. 1406, *supra* note 164, § 532(a).

173. *Id.* § 533(b)(1).

174. *Id.* § 532(a)(1). The section-by-section analysis explains:

The provision [defining preempted charges] does not extend to state consumer protection laws that deal with restrictions, limitations or prohibitions against certain types of creditor activity, which are unrelated to enumerated charges assessed in connection with credit transactions. That is true even if the state provision only applies to specific transactions that may be partially defined by the level or type of charges being assessed. For example, a state law providing that credit transactions with an interest rate in excess of 18% cannot be secured by real estate or a law that limits attorneys fees in those transactions would continue to apply.

127 CONG. REC. S6628 (daily ed., June 22, 1981).

law provisions are unaffected as consumer protections.<sup>175</sup>

## VI. CONCLUSION

No one seriously disputes that Congress acted with justification in providing usury relief for federally insured depository institutions under DIDMCA. Congress, however, acted as a firefighter, trying to resolve an immediate emergency without clearly understanding, or projecting, the guidance or precautions necessary to avoid future problems. Congress should have specified that permission to charge 1% above the discount rate does not authorize use of add-on or discount computations of that rate. In addition, most favored lender status should not extend beyond the advantages the entire state law allows for other lenders at a particular rate. In making those positions explicit, Congress could have avoided an implicit adoption of the case law under section 85 which has led to unwarranted superiority for federal lenders.

The federal preemption of all consumer credit rate ceilings proposed in S. 1406 should encourage states to write reasonable usury laws with appropriate consumer protections and will promote competitive equality for all lenders in the meantime. As S. 1406 moves toward passage, the addition of language clarifying which provisions of state law are considered consumer protections would be helpful. Obviously, this will not cure the problems created by unwise extension of the most favored lender doctrine under section 85 of the National Bank Act in cases like *Evans* and *Marquette*. While it may be unrealistic to expect Congress to amend the National Bank Act to allow states to override the federal preemptions created to "protect" those federal instrumentalities, the basic protections afforded

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175. The section-by-section analysis of S. 1406, *supra* note 164, is equivocal on which state-law limitations are preempted and which are retained as consumer protections. It is not clear, for example, whether a prohibition on the use of the Rule of 78s for calculating rebates of unearned interest would be preempted as "interest, . . . charges or any other compensation . . . arising out of the credit agreement or transaction"—proposed by § 532(a)(1)(A)—or would be preserved as consumer protection.

The explanation of the House bill, H.R. 2501, on the other hand, elaborates on what "consumer protections" would be affected:

[S]tate laws or regulations specifying that the Rule of 78's is an improper method of computing a rebate upon prepayment of a precomputed loan would not be preempted; laws limiting the prepayment penalties that may be imposed would not be preempted; State laws providing for limited periodic increases on variable rate loans would not be preempted, although a ceiling on the ultimate interest rate would be preempted; laws specifying maximum late charges would not be preempted; laws requiring specific disclosures or notices such as the use of plain English on default notices would not be preempted.

127 CONG. REC. H937 (daily ed. Mar. 12, 1981) (section-by-section analysis).



national banks through section 85, and other lenders through DIDMCA, would not be adversely affected if *Evans* and *Marquette* were legislatively overruled or qualified.<sup>176</sup> Consistency—genuine parity—among lenders operating in a state, in terms of interest rates as well as disclosures and other consumer protections, would enhance the competitive atmosphere which the DIDMCA was designed to improve.

Unless the courts begin to take a more restrictive view of most favored lender status, or unless Congress uses the pending usury preemption bills as a vehicle to clarify the doctrine under DIDMCA, a most ironic scenario is possible. Each of the preemption rules in DIDMCA, and the pending ones in S. 1406 and H.R. 2501, includes a state-override provision—a necessary political gesture to the states' rights advocates.<sup>177</sup> If a broad most favored lender rule emerges from DIDMCA (through agency interpretations or case law such as *Equitable Trust*), state after state may opt out of the federal legislation precisely to avoid what may be seen as unwarranted federal disruption of the competitive balance among financial institutions in the state. In such a case, the whole congressional exercise would have been futile.

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176. In *Marquette*, the Supreme Court concluded its interpretation of § 85, permitting national banks to export home-state rates, by suggesting that "any plea to alter § 85 . . . is better addressed to the wisdom of Congress than to the judgment of this Court." 439 U.S. at 319.

177. In floor statements accompanying the introduction of S. 1406, both Senator Lugar and Senator Garn stressed the importance of the state-override mechanism. 127 CONG. REC. S6626, S6630 (daily ed. June 22, 1981).