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Federal Preemption and Consumer Financial Protection: Past and Future

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FEDERAL PREEMPTION AND CONSUMER FINANCIAL PROTECTION: PAST AND
FUTURE*

3 Banking & Financial Services Policy Report 25
March, 2012

Kathleen C. Engel, Patricia A. McCoy**

Starting in 1995 and throughout the subprime boom during the next decade, Congress failed to take action to curb predatory lending. States and cities filled the void by passing anti-predatory lending laws of their own. Lenders, worried about potential liability, quickly organized a full-scale attack on the state and local initiatives. Lobbyists from the lending industry descended on statehouses and convinced legislators to water down or defeat proposed laws. When municipalities passed subprime lending ordinances, the American Financial Services Association and its allies challenged the constitutionality of those ordinances--and won.¹

Lenders' most potent strategy lay in challenging the state and local laws under an obscure doctrine known as federal preemption. When a federal law "preempts" a state or local law, it partially or completely overrides the application of that law. Federal preemption proceeds from the idea that some policy areas demand one federal law, not fifty different state laws. When Congress or the executive branch invokes federal preemption, it is deciding that the country needs national uniformity in that area.

Federal preemption can sometimes preclude states from enforcing their own laws in certain areas.

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¹ See, e.g., *American Financial Services Ass'n v. City of Toledo*, 112 Ohio St.3d 323 (2006) (overturning Toledo's ordinance); *American Financial Services Ass'n v. City of Cleveland*, 112 Ohio St.3d 170 (2006) (overturning Cleveland's ordinance); *American Financial Services Ass'n v. City of Oakland*, 34 Cal. 4th 1239 (2005) (overturning Oakland's ordinance); *Mayor of the City of New York v. Council of the City of New York*, 4 Misc. 3d 151 (N.Y. Sup. Ct. 2004) (overturning New York City ordinance); Robert Berner & Brian Grow, *They Warned Us*, *BUSINESS WEEK*, Oct. 20, 2008, at 36; *American Financial Services Ass'n v. Burke*, 169 F. Supp.2d 62 (D. Conn. 2001) (successfully challenging state law prohibiting mandatory arbitration clauses in high-cost mortgages as violating the Federal Arbitration Act).

The result is a shift in the balance of power, taking power away from the states and putting it in the hands of the federal government.

Federal Preemption by the OTS and OCC

In the early 1990s, all banks and thrifts had to obey state laws that governed mortgage lending. Nonbank mortgage lenders had to comply with those laws as well. In 1996, however, the landscape changed when the former US Office of Thrift Supervision (OTS) issued two federal preemption rules, declaring that state mortgage laws no longer applied to federal thrifts or their subsidiaries.² As a result, federal thrifts were able to operate under one set of laws wherever they did business across the nation.

By exempting federal thrifts from state mortgage laws, OTS took a level playing field and tilted it. Other lenders had to comply with state laws, but federal thrift institutions did not. At first, this competitive advantage for federal thrifts had relatively little bite. In the late 1990s, few states had laws restricting predatory lending and the laws that did exist were quite narrow. In addition, federal banking regulators were cracking down on abusive lenders and OTS was not using the OTS preemption rule as an escape from regulation.³

The OTS reversed its approach to preemption in 2001, when the George W. Bush administration decided to use the OTS preemption rule to halt state efforts to restrict unfair lending practices. Overnight, in the name of preemption, the OTS created a “safe zone” for federal thrifts.

In the meantime, the Office of the Comptroller of the Currency was hungrily eyeing the OTS, eager to give the same competitive advantage to national banks. As state anti-predatory lending laws proliferated, national banks lobbied the OCC for federal preemption privileges.⁴ In 2004, the comptroller of the currency, John D. Hawke Jr., issued a comparable preemption rule for national

² Office of Thrift Supervision, Lending and Investment: Final Rule, 61 Fed. Reg. 50951 (September 30, 1996) (formerly codified at 12 U.S.C. § 560.2); Office of Thrift Supervision, Subsidiaries and Equity Investments: Final Rule, 61 Fed. Reg. 66561 (December 18, 1996) (formerly codified at 12 C.F.R. § 559.3(h)); James Edward Gilleran, Director, Office of Thrift Supervision, Remarks before the Exchequer Club (May 21, 2003).

³ Raphael Bostic et al., *State and Local Anti-Predatory Lending Laws: The Effect of Legal Enforcement Mechanisms*, 60 J. ECON. & BUS. 47 (2008); Office of Thrift Supervision, Responsible Alternative Mortgage Lending: Advance Notice of Proposed Rule Making, 65 Fed. Reg. 17811, 17814-17816 (April 5, 2000).

⁴ National City Corporation, the parent of National City Bank, N.A., and a major subprime lender, spearheaded the campaign for OCC preemption. *Predatory Lending Laws Neutered*, ATLANTA JOURNAL-CONSTITUTION, Aug. 6, 2003; Berner & Grow, *supra* note 1, at 36.

banks. The rule excused national banks and their subsidiaries from having to comply with state consumer protection laws related to mortgage lending.⁵ Under a sister regulation, called the visitorial powers rule, the comptroller even barred the states from enforcing certain other state laws that were not preempted--such as state lending discrimination laws--against national banks and their subsidiaries.⁶

The OCC rule sparked a firestorm of controversy. States had regulated consumer protection at national banks for over a century. With its preemption rule, the OCC toppled that tradition by disabling the states' ability to redress consumer protection violations by national banks. What is more, the OCC extended federal preemption to the nonbank subsidiaries of national banks, even though they were chartered by the states.

In the ensuing controversy, OCC officials went on the offensive, accusing states and consumer groups of bad faith. Questioning why states tried to apply their anti-predatory lending laws to banks, comptroller Hawke asserted: "Surely there's a political dimension to it. Kicking banks around has been something of a national pastime since the days of Andrew Johnson." Julie Williams, the OCC's chief counsel and the architect of OCC preemption, upbraided those who opposed the rule, complaining that the OCC's "motives" had been "impugned" and that "allegation and innuendo" against the OCC was "standard fare." She even accused the states of fiscal irresponsibility, charging: "States are spending time and money that *could* be directed at practices by [nonbanks]."⁷ Eventually, the validity of the OCC's preemption rule worked its way to the US Supreme Court, which voted to affirm OCC preemption.⁸

⁵ Office of the Comptroller of the Currency, Bank Activities and Operations; Real Estate Lending and Appraisals; Final Rule, 69 Fed. Reg. 1904 (Jan. 13, 2004) (formerly codified at 12 C.F.R. §§ 7.4007-7.4009, 34.4).

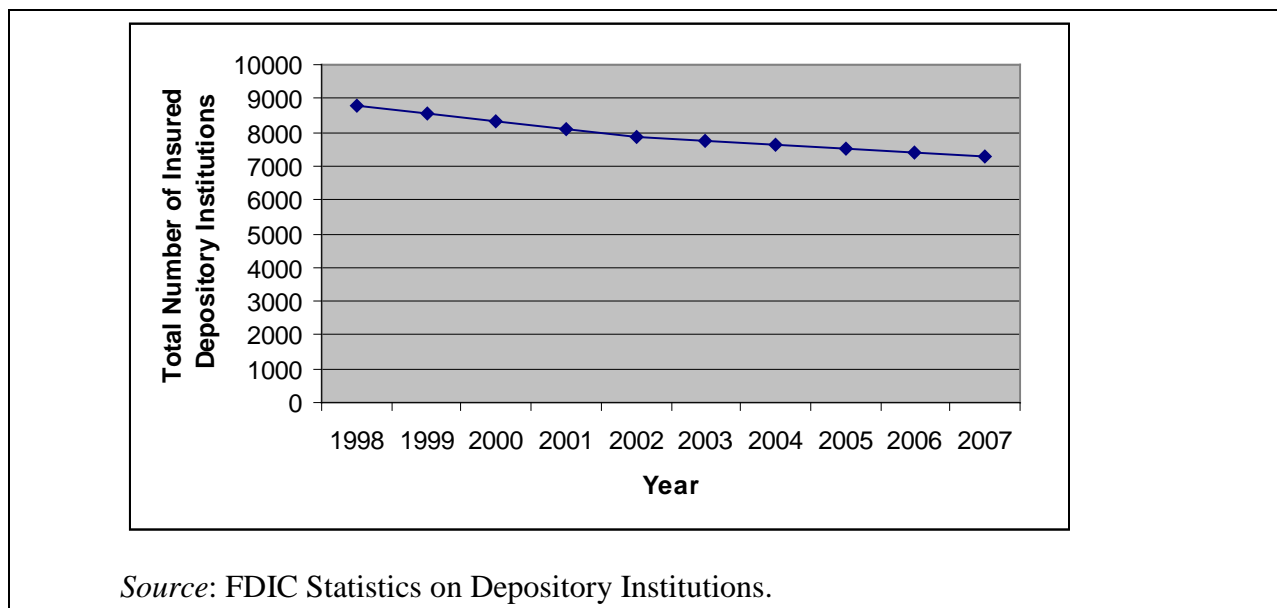
⁶ Office of the Comptroller of the Currency, Bank Activities and Operations; Final Rule, 69 Fed. Reg. 1895 (Jan. 13, 2004) (formerly codified at 12 C.F.R. § 7.4000). For the OTS counterpart of the visitorial powers rule, see *Fidelity Fed. Sav. & Loan Ass'n v. de la Cuesta*, 458 U.S. 141 (1982).

⁷ John D. Hawke, Jr., Comptroller of the Currency, Remarks before the American Bankers Association (September 22, 2003); Julie L. Williams, Chief Counsel and First Senior Deputy Comptroller, Remarks before the Consumer Federation of America, 15th Annual Consumer Financial Services Conference (December 5, 2003) (emphasis in original).

⁸ *Watters v. Wachovia Bank, N.A.*, 550 U.S. 1 (2007); Christopher L. Peterson, *Federalism and Predatory Lending: Unmasking the Deregulatory Agenda*, 78 TEMP. L. REV. 1 (2007); Arthur E. Wilmarth, Jr., *The OCC's Preemption Rules Exceed the Agency's Authority and Present a Serious Threat to the Dual Banking Systems*, 23 ANN. REV. BANKING & FIN. L. 225 (2004). The *Watters* case only upheld OCC preemption. Later, the Supreme Court affirmed a challenge to the OCC visitorial powers rule by Andrew Cuomo, the Attorney General of New York. *Cuomo v.*

The OCC preemption campaign played out against the backdrop of massive consolidation in the banking industry. During the late 1990s and throughout the subprime boom, the total number of depository institutions had steadily shrunk, as seen in *Figure 1*.

Figure 1: Total number of insured depository institutions: 1998-2007.



As the number of institutions dwindled, state and federal chartering authorities for banks and thrifts locked horns to preserve their turf. The best way for a regulator to preserve turf was to entice bigger institutions to its charter. And the best way to do that was to offer them a bigger menu of legally permissible banking activities and gentler regulation and laws.

There were several ways that preemption helped the OCC lure banks to its fold. First, many state chartered banks had historically preferred their state charters because they paid lower fees to their regulators than they would with a national charter.⁹ Once OCC issued its preemption rule, the

Clearing House Ass'n et al., 557 U.S. 519 (2009).

The OCC and the OTS left some areas of state law untouched, namely, state criminal law and state law regulating contracts, torts, homestead rights, debt collection, property, taxation, and zoning. Both agencies, though, reserved the right to declare that any state laws in those areas are preempted in the future. For fuller discussion, see Patricia A. McCoy & Elizabeth Renuart, *The Legal Infrastructure of Subprime and Nontraditional Mortgage Lending*, BORROWING TO LIVE: CONSUMER AND MORTGAGE CREDIT REVISITED 110, 120-121 (Nicolas P. Retsinas & Eric S. Belsky eds., 2008).

⁹ Comptroller Hawke stated, for example, that the average national bank paid two and a quarter

value to these banks of switching from a state charter to a national charter increased despite the higher fees. Second, OCC had been concerned that the OTS would draw national banks into its domain because of its earlier preemption rule. By adopting its own preemption rule, the OCC reduced the risk that national banks would convert to thrifts. Lastly, the OCC hoped that nonbank lenders would be attracted to the benefits of preemption and might seek national bank charters.

For both the OCC- and OTS-regulated institutions, preemption provided uniform laws nationwide, which was especially attractive to large national banks with coast-to-coast operations that otherwise had to comply with fifty state laws.

An Unlevel Playing Field

By 2004, with OTS and OCC preemption firmly ensconced, competitive inequities became set in stone. National banks, federal savings associations, and their mortgage lending subsidiaries were supervised by federal banking regulators, but could ignore state laws. Independent mortgage lenders were free from federal banking regulation, but had to obey a patchwork of state laws, some of which were weak and some of which were strong. State banks, state thrifts, and their non-depository mortgage-lending subsidiaries were subject to both state and federal regulation.¹⁰ The disparity was so severe that in 2005, under chairman Donald Powell, the FDIC flirted with its own preemption rule for state banks.¹¹

Federal preemption created incentives for mortgage lenders to shop for the easiest regulators and laws. Even before the preemption rulings, lenders had the ability to pick their regulator. But preemption gave the OCC and OTS a powerful extra lure to entice lenders to their charters, in the form of relief from state anti-predatory lending laws.

Charter shopping was not a hypothetical concern. The story of Countrywide--back then the nation's number one mortgage lender--illustrates the corrosive effect of competition for laxity. From 1990 to 2007, Countrywide's parent company, Countrywide Financial Corporation, owned a national bank named Countrywide Bank, N.A. In 2005, Angelo Mozilo, the CEO of Countrywide,

times more in supervisory fees than the average state bank. Office of the Comptroller of the Currency, News Release NR 2002-40: Comptroller Welcomes Growing Consensus that Fee Disparity Problem Must Be Fixed, (May 9, 2002).

¹⁰ Some states, such as Georgia, created exemptions in their anti-predatory lending laws for state banks, state thrifts, and their mortgage lending subsidiaries. See, e.g., Ga. Code Ann. § 7-6A-12. Those institutions, however, otherwise remained subject to state and federal banking regulation.

¹¹ After Sheila Bair succeeded Donald Powell as chairman of the FDIC, the agency did not pursue the proposal any further.

began to chafe under the OCC's regulation of its bank.¹² Hearing of Countrywide's discontent, OTS decided to try to persuade Countrywide Bank to turn in its national bank charter and become a thrift. In 2006, OTS staff, including Darrel Dochow, then the regional deputy director of the West Region of OTS, traveled to Calabasas, California, to meet with the executives at Countrywide's headquarters. There, according to the *Washington Post*, "OTS pitched itself as a more natural, less antagonistic regulator than OCC."¹³ Among other things, OTS representatives reportedly portrayed OTS as more willing than the OCC or the Federal Reserve to allow loan officers to pick property appraisers.

The pitch succeeded. Not long after, Countrywide Bank, N.A., applied to convert to a thrift charter. It handily won approval and made the switch from a national bank to a federal savings association on March 12, 2007. The conversion was good for Countrywide because it was able to ditch the OCC. The conversion was also good for OTS, which was able to collect fees from Countrywide covering about 3 percent of the agency's budget that year. And, in turn, the conversion was good for Darrel Dochow. Just six months later, in September 2007, John Reich, the director of OTS, promoted Dochow to be head of the West Region.¹⁴

Although landing Countrywide was a huge coup for OTS, the OCC was the biggest beneficiary of charter shopping after 2003. Within months after adopting the preemption rule, comptroller Hawke boasted that "the past several months have seen some notable movements of state banks into the national system."¹⁵ JPMorgan Chase, HSBC, and the Bank of Montreal (Harris Trust) were the largest banks that converted from state bank to national bank charters in 2004 and 2005. Of the three, JPMorgan Chase and HSBC were major subprime lenders.

There is additional evidence of charter shopping. When we look at state bank conversions to national banks in terms of assets, the conversions peaked at two critical times: in 1999-2000, around the time that Congress passed the Gramm-Leach-Bliley Act that granted broader powers to national banks, and in 2003-2004, when the OCC proposed and then adopted its preemption rule.

¹² Office of the Attorney General of the State of New York, Countrywide Agrees to New Measures to Combat Racial and Ethnic Disparities in Mortgage Loan Pricing (Dec. 6, 2006), *available at* http://oag.state.ny.us/media_center/2006/dec/dec05a_06.html; Binyamin Appelbaum & Ellen Nakashima, *Banking Regulator Played Advocate Over Enforcer*, *Washington Post*, Nov. 23, 2008.

¹³ Appelbaum & Nakashima, *Id.*

¹⁴ Appelbaum & Nakashima, *supra* note 12; *A System That Invited Bankers to Make Bad Loans*, *USA Today*, Jan. 5, 2009; David Enrich, *Banks Find New Ways to Ease Pain of Bad Loans*, *WALL STREET JOURNAL*, June 19, 2008.

¹⁵ John D. Hawke, Jr., Comptroller of the Currency, Remarks before the American Bankers Association (Oct. 4, 2004).

Figure 2: Conversions from state bank to national bank charters, by log of total assets.

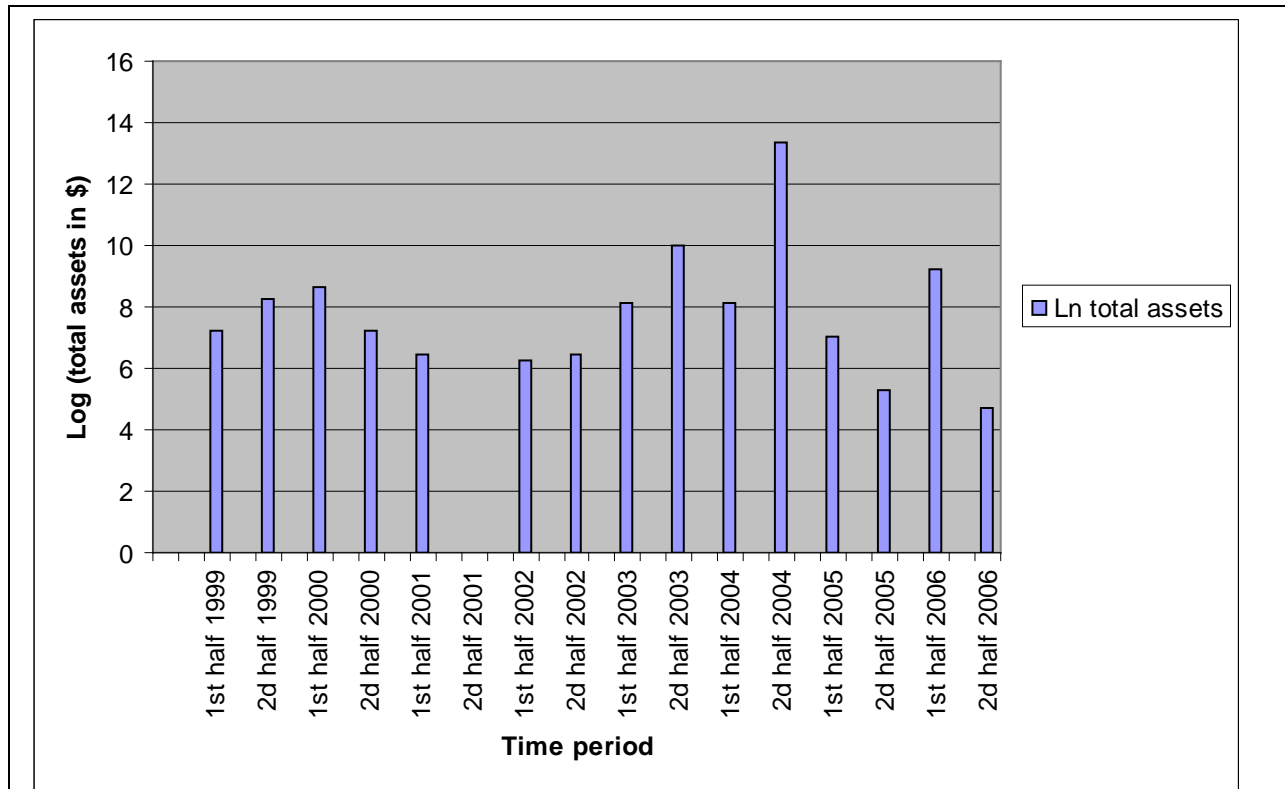
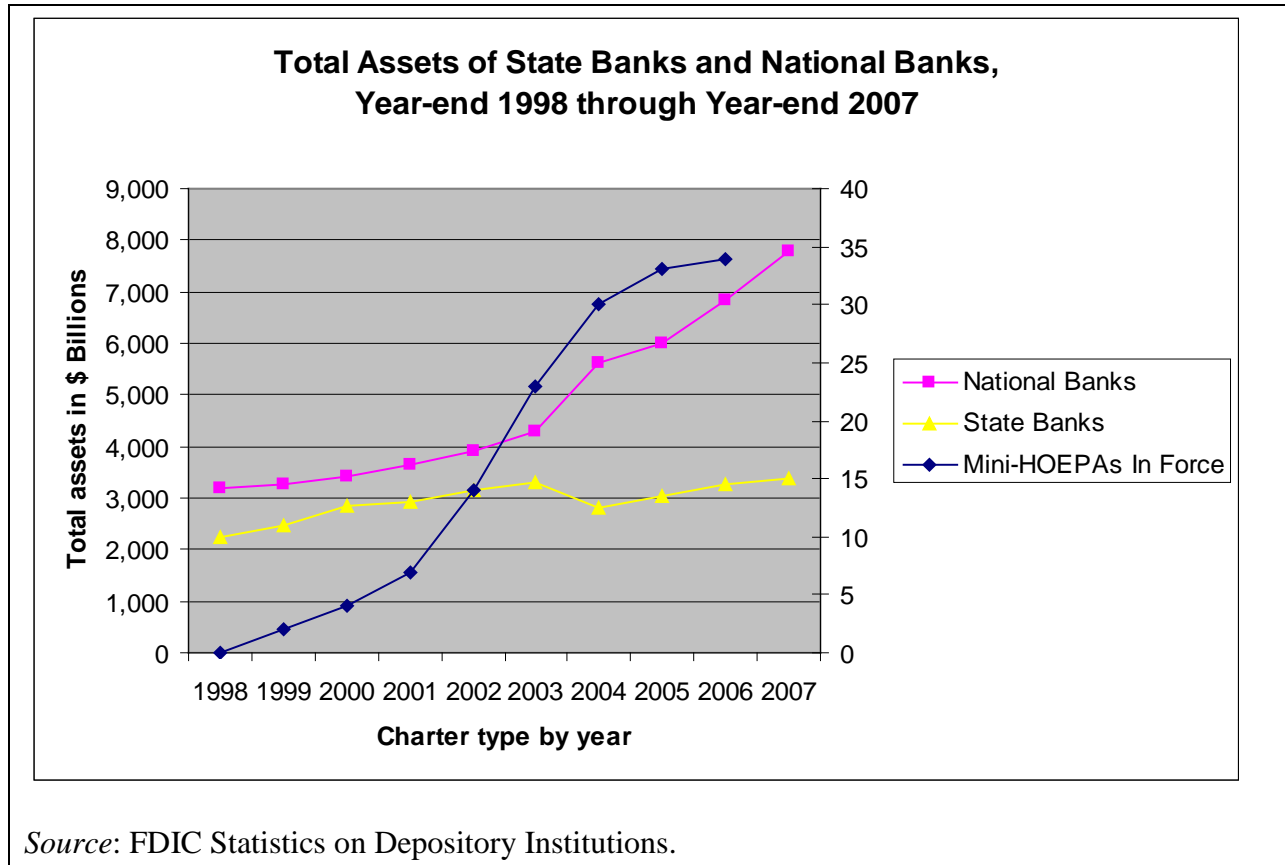


Figure 2 shows the log of total assets due to the large size of JPMorgan Chase, which converted to a national bank charter in the second half of 2004. At the time, JPMorgan Chase had \$649 billion dollars in assets.

Source: FDIC Statistics on Depository Institutions.

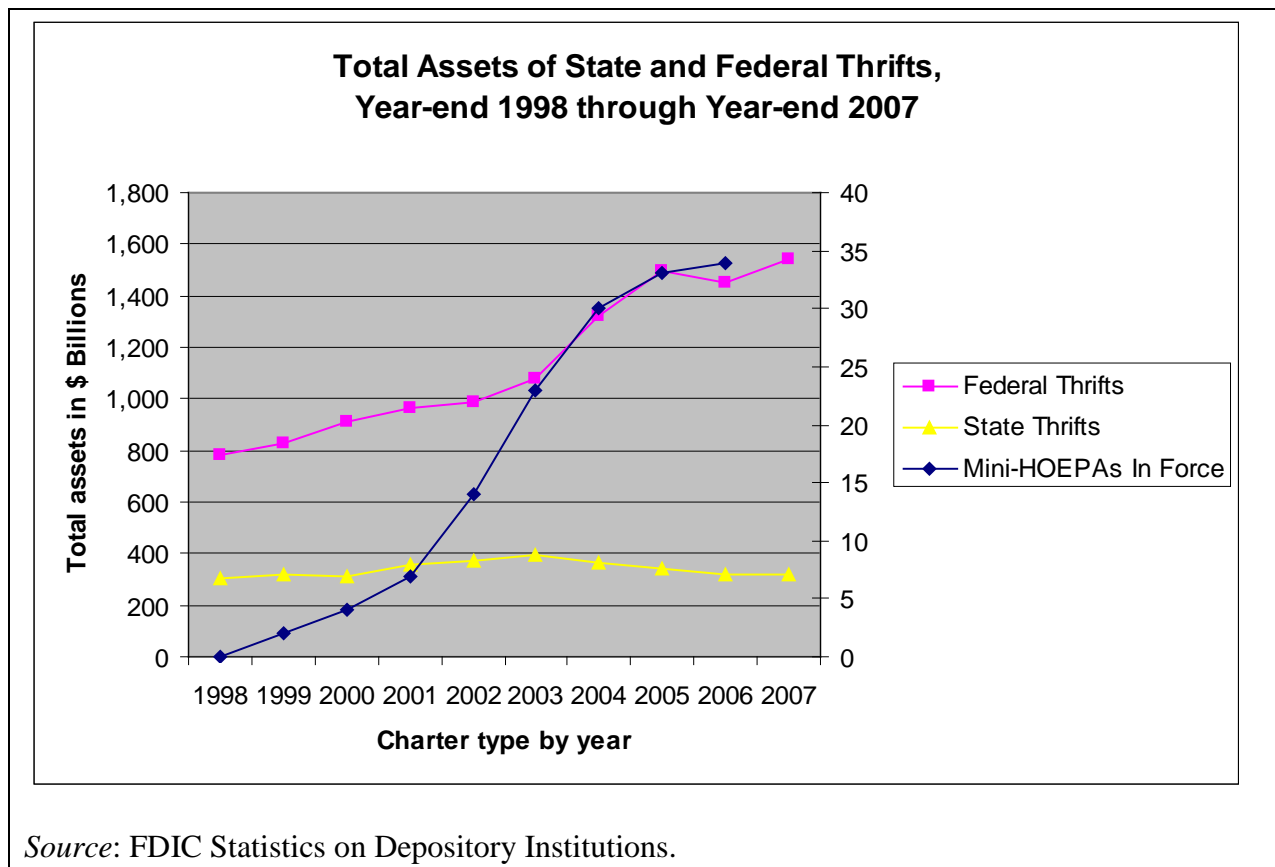
Another way to track charter shopping is to compare the growth in total assets under supervision by the OCC to total assets supervised by state banking regulators. The growth in state bank assets largely tracked the growth in national bank assets until 2004 seen in *Figure 3*, when their paths diverged. That year, the total assets of national banks surged, while the total assets of state banks dropped. It was a good time for banks to trade in their state charters for federal bank charters, which allowed them to avoid the growing body of state anti-predatory lending laws.

Figure 3: Growth of mini-HOEPA laws by growth in total assets of state and national banks: 1998-2007.



We can see a similar pattern around 2004 for state and federal thrifts, coinciding with the growth in state anti-predatory lending laws. OTS preemption was continuously in effect from 1997 through 2007 and beyond, but it was only when state anti-predatory lending laws multiplied that the number of federal savings associations began increasing while state thrift charters dropped. And, like banks, the dollar amount of assets regulated by the OTS steadily increased.

Figure 4: Growth in mini-HOEPA laws by growth in total assets of state and federal thrifts: 1998-2007.



From 2004 forward, national banks and federal savings associations attracted the lion's share of assets at the expense of state banks and thrifts. This suggests that the OCC and OTS successfully used preemption to boost the total amount of assets--and the fees levied on those assets--under their supervision. Relaxing regulation was the key to their success.

Preemption's Effect on Consumers

OCC and OTS preemption had three harmful effects on borrowers, the first being inadequate redress. Most state anti-predatory lending laws allowed injured borrowers to sue their lenders for violations. In contrast, federal preemption prevented borrowers who received loans from national banks, federal savings associations, or their subsidiaries from suing their lenders for lending abuses under state laws. Borrowers could not even raise state law violations as defenses to foreclosure. Similarly, state attorneys general and other state officials could not protect borrowers by enforcing state laws prohibiting predatory lending against national banks and thrifts. Borrowers had to settle for complaining to federal regulators' call centers, whose first response was to tell

customers, “If your case involves [a factual or contract dispute with the bank], consult an attorney for assistance.”¹⁶

Second, federal preemption meant that affected borrowers with loans from national banks and federal thrifts had virtually no remedy against abusive lenders because federal lending laws were extremely weak. This gap didn't bother federal regulators, like Hawke's successor as comptroller, John C. Dugan, who took the position that national banks shouldn't be subject to state laws even if they made sense. And, if there was a void, he and fellow regulators maintained, it was up to Congress to fill it.

Lastly, in response to the OCC and OTS preemption rules, state banks and thrifts lobbied state regulators for the same hands-off treatment so they would have competitive parity with their federally chartered counterparts. Some states acquiesced by not regulating subprime loans at all. Other states, like Georgia, waived their anti-predatory lending laws for state banks and thrifts. In these ways, preemption turned the playing field into one “with no rules.”¹⁷

Judging by the Results

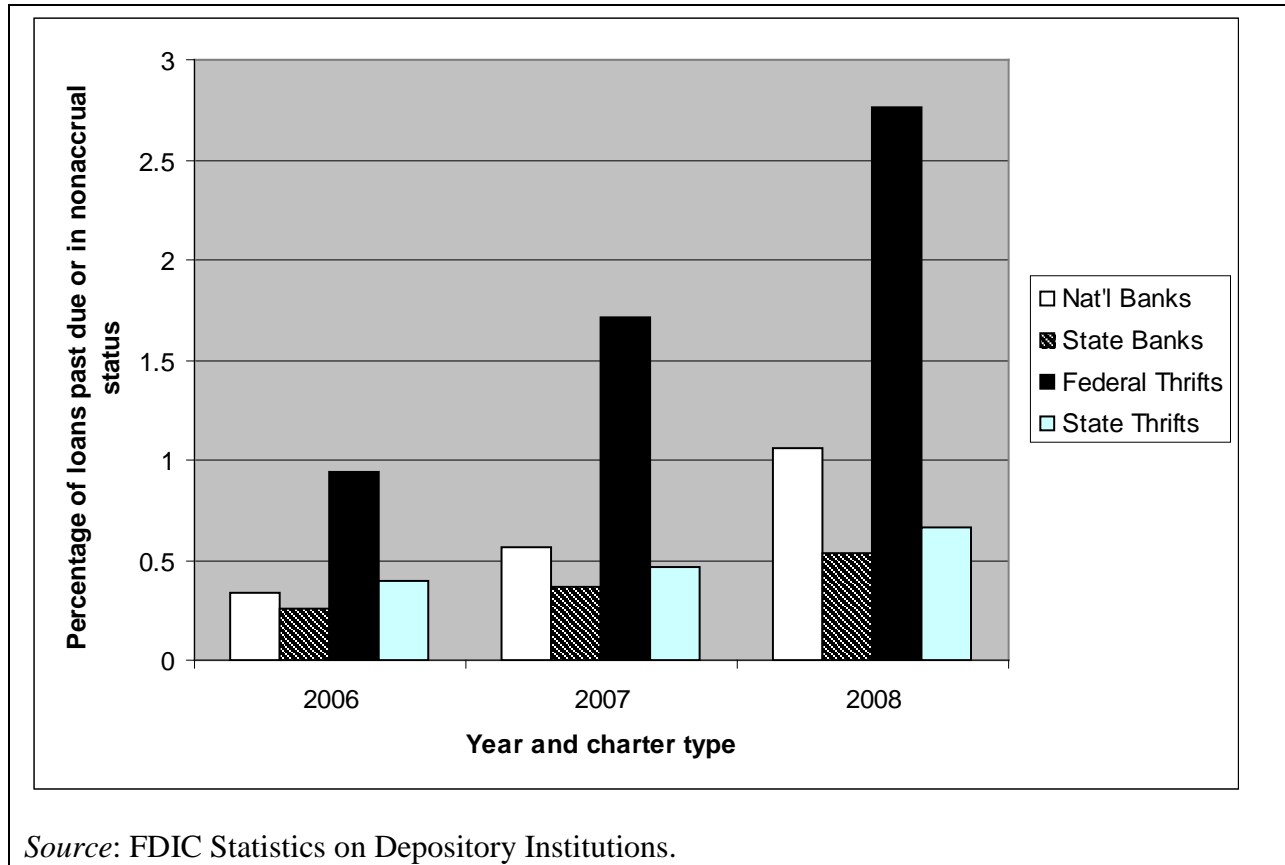
In defense of federal preemption, comptroller Dugan maintained that the OCC's “comprehensive” supervision resulted in lower mortgage default rates.¹⁸ The evidence suggests he was wrong. The FDIC reported that among depository institutions, federal savings associations regulated by OTS had the worst default record for one- to four-family residential mortgages from 2006 through 2008. In 2007 and 2008, OCC-regulated national banks had the second-worst record. Both years, state thrifts had better default rates than either national banks or federal thrifts. State banks invariably had the lowest default rates of all.

¹⁶ U.S. Government Accountability Office, *OCC Consumer Assistance: Process is Similar to that of Other Regulators but Could Be Improved by Enhanced Outreach*, Report No. GAO 06-293 (February 2006); Arthur E. Wilmarth, Jr., Testimony before the House Committee on Financial Services, Subcommittee on Financial Institutions and Consumer Credit (April 26, 2007); John C. Dugan, Comptroller of the Currency, Remarks before the Exchequer Club and Women in Housing and Finance (Jan. 17, 2007); Gilleran, *supra* note 2.

¹⁷ William P. Apgar, et al., *MORTGAGE MARKET CHANNELS AND FAIR LENDING: AN ANALYSIS OF HMDA DATA* (Harvard University, Joint Center for Housing Studies, 2007); Berner & Grow, *supra* note 1, at 36; Eric Stein, Testimony before the Senate Committee on Banking, Housing and Urban Affairs (Oct. 16, 2008).

¹⁸ John C. Dugan, Comptroller of the Currency, Remarks before the Greenlining Coalition's 14th Annual Economic Summit (April 19, 2007).

Figure 5: Residential mortgages at least 30 days past due or in nonaccrual status, by charter type: 2006-2008.



Of these four types of charters, only national banks regulated by the OCC and federal thrift institutions regulated by OTS enjoyed federal preemption. State banks and state thrift institutions did not. Thus, at least when we compare depository institutions, federal preemption was associated with *higher* default rates, not lower ones, from 2006 through 2008. Those were the years when loan underwriting was at its worst and the credit markets experienced a meltdown.

These statistics have limitations. They do not tell us whether independent nonbank lenders had higher default rates than banks or thrifts. Similarly, we do not control for the credit quality of loan portfolios or other factors. Despite these limitations, however, the statistics refute the claim that federal preemption lowered default rates on mortgage loans made by depository institutions. To the contrary, the best loan performance was at state banks and thrifts, which were subject to both state and federal regulation and did not enjoy preemption.

Regulatory Tools

During the furor over federal preemption, the OCC and the OTS were mindful of charges that they

were relaxing regulation. In response, both agencies went on the offensive, arguing that their brand of oversight was superior to state laws designed to restrict abusive lending.

States with anti-predatory lending laws regulated credit by restricting risky underwriting practices and harmful features in loan products. The laws were enforceable by state banking regulators, state attorneys general, and often aggrieved borrowers. Federal banking regulators used an entirely different toolkit. Bank examinations and agency enforcement, not lawsuits, were the mainstays of banking supervision. By law, regulators had to examine banks and thrifts for safety and soundness every twelve months, or every eighteen months for smaller institutions in good condition. In addition, bank and thrift examiners reviewed institutions for compliance with consumer and fair lending laws.¹⁹

If examiners found a violation of law or a safety and soundness problem, they could write it up in their examination reports. In addition, agencies could take enforcement measures. Most banking regulators preferred *informal enforcement*, in part because it was comparatively congenial and cooperative in nature. Informal enforcement could range from resolutions or commitment letters signed by a bank's board of directors to supervisory directives and voluntary written agreements negotiated between the regulator and the bank. Depending on the agency, these voluntary agreements were known as supervisory agreements or memoranda of understanding (MOUs). In contrast, *formal enforcement* was usually harsher and could be imposed by an agency unilaterally, over management's objections. Regulators had a variety of formal enforcement techniques at their disposal, including safety and soundness agreements, cease-and-desist orders, civil money penalties, and orders removing management.²⁰

Banking regulation depended on regulators, not consumers or elected officials, for enforcement. This regulatory structure put enormous discretion in regulators' hands. Zealous regulators could use their discretion in ways that were too harsh. Other times, regulators could do too little. Lax regulation was a particular concern because regulators often identified closely with the banks they supervised. There were different reasons for regulatory capture in the banking industry. Top regulators often were recruited from the ranks of bankers or lawyers for banks. Similarly, regulators wanted to keep their regulated institutions content to discourage them from converting to other charters.

If a regulator wanted to be lenient, there were lots of ways to do it. One was to delay examinations or forego them altogether. Another was to delay initiating enforcement actions. Still another was to refuse to ratchet up enforcement to formal action when an institution's condition was deteriorating but corrective steps had not been taken.

¹⁹ 12 U.S.C. § 1820(d).

²⁰ Patricia A. McCoy, BANKING LAW MANUAL: FEDERAL REGULATION OF FINANCIAL HOLDING COMPANIES, BANKS AND THRIFTS, §§ 13.02-13.03 (2d ed. 2000).

Regulators often shied away from formal action because informal enforcement was private and usually the product of consensus between the regulator and the bank. Informal enforcement, however, had major downsides. One was that bank management could drag its feet and try to water down a voluntary agreement during negotiations. Another was that some types of informal enforcement were not enforceable in court. If management eventually reneged on promises made during informal enforcement, regulators lost valuable time and losses could mount in the meantime. This scenario played out repeatedly during the 1980's savings and loan crisis, when foot-dragging by regulators and management of ailing thrifts alike multiplied the ultimate cost of the crisis to US taxpayers. Finally, informal enforcement was secret, which allowed slack regulators to cover their tracks.²¹

In spite of, or perhaps of, the deficiencies in bank examinations, the OCC and OTS liked to plug banking supervision as the best way to detect and stop careless lending practices. John Reich, the director of OTS, often stressed the “seamless supervision” of thrifts and their holding companies as an advantage of the thrift charter. Similarly, John Hawke at the OCC argued strenuously that banking supervision was better than state anti-predatory lending laws in policing abuses:

We know that it's possible to deal effectively with predatory lending *without* putting impediments in the way of those who provide legitimate subprime credit. It's an unnecessary consequence because the approach that's been followed is an across-the-board, one-size-fits-all approach that applies to the good as well as the wrongdoers.

We believe a far more effective approach would be to focus on the abusive practitioners, bringing to bear our formidable enforcement powers where we find abusive practices--after clearly articulating our expectations.²²

In Hawke's view, punishing wrongdoers after the fact was preferable to regulating underwriting practices up front.

Guidance over Rules

Federal regulators could have addressed abusive lending by adopting hard law in the form of binding rules prohibiting exploitative loan terms and careless underwriting of home mortgages, but they refused to take this step. Instead, during the Bush administration, all four federal banking regulators, including the OCC and OTS, addressed risky loans through advisory guidance and other types of soft law, not binding regulations. In fact, during this period, there was only one

²¹ *Id.*

²² John M. Reich, Director, Office of Thrift Supervision, Remarks to the New Jersey League of Community Bankers (May 3, 2007); John D. Hawke, Jr., Remarks before the Federalist Society (July 24, 2003) (emphasis in original).

toothless rule on abusive mortgage lending generally and that rule was issued solely by the OCC.

The paucity of rules was, in part, due to regulators' aversion to dictating underwriting standards to lenders. In addition, they did not want to give independent nonbank lenders a competitive edge by imposing rules that would apply solely to depository institutions.²³ And finally, guidance gave regulators discretion to sit tight and *not* institute enforcement actions. As the OCC explained:

If a national bank fails to meet a standard prescribed by a regulation, the OCC must require it to submit a plan specifying the steps it will take to comply with the standard. If a national bank fails to meet a standard prescribed by a guideline, the OCC has the discretion to decide whether to require the submission of such a plan.²⁴

Guidances, thus, allowed for slack regulation and permitted lenders to argue that compliance was optional. Dugan encouraged this type of thinking when, in October 2006, he stressed what the guidance on nontraditional mortgages did not do: “It is *not* a ban on the use of nontraditional mortgage products. It does *not* impose a limit on the number of nontraditional mortgages that an institution may hold. And it does *not* impose any new capital requirements.”²⁵

²³ The chief national bank examiner testified to Congress in 2007 about why the OCC had left subprime hybrid ARMs out of the September 2006 guidance on nontraditional mortgage products: “We [were] also concerned about the possibility of an ‘unlevel regulatory playing field’ if already highly-regulated, federally-regulated institutions [were] subject to stricter standards on subprime mortgage lending, but state-licensed nonbank lenders [were] not.” Emory W. Rushton, Senior Deputy Comptroller and Chief National Bank Examiner, OCC, Testimony before the U.S. House of Representatives, Committee on Financial Services, Subcommittee on Financial Institutions and Consumer Credit (March 27, 2007).

²⁴ Office of the Comptroller of the Currency, OCC Guidelines Establishing Standards for Residential Mortgage Lending Practices, 70 Fed. Reg. 6329, at 6330 (February 7, 2005) (emphasis in original); Department of the Treasury et al., Interagency Guidance on Nontraditional Mortgage Product Risks; Final Guidance, 71 Fed. Reg. 58609 (October 4, 2006); Department of the Treasury et al., Proposed Statement on Subprime Mortgage Lending, 72 Fed. Reg. 10533 (March 8, 2007); Department of the Treasury et al., Statement on Subprime Mortgage Lending; Final Guidance, 72 Fed. Reg. 37569 (July 10, 2007); Department of the Treasury et al., Illustrations of Consumer Information for Hybrid Adjustable Rate Mortgage Products; Final Guidance, 73 Fed. Reg. 30997 (May 29, 2008); Office of the Comptroller of the Currency, Advisory Letter 2000-7: Abusive Lending Practices (July 26, 2000); Office of the Comptroller of the Currency, Advisory Letter 2002-3: Guidance on Unfair and Deceptive Acts or Practices (March 22, 2002); Office of the Comptroller of the Currency, Advisory Letter 2003-2: Guidelines for National Banks to Guard Against Predatory and Abusive Lending Practices (Feb 21, 2003).

²⁵ John C. Dugan, Comptroller of the Currency, Remarks before America's Community Bankers (October 17, 2006) (emphasis in original).

Preemption Lessons

Federal preemption displaced state and local laws and gave the OCC and OTS sole enforcement power. They were the only entities who could protect consumers. During the George W. Bush years injured parties, thus, had no legal redress against national banks, federally chartered thrifts, or their lending subsidiaries.

When subprime was king, our system of fragmented regulation drove lenders to shop for the easiest legal regime. The ability of lenders to switch charters put pressure on regulators to relax credit standards. In the process, federal banking regulators sacrificed consumer protection.

The Dodd-Frank Act

In 2010, in response to these problems, Congress passed the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank” or “the Act”),²⁶ which transfers most of the responsibility for consumer financial protection from federal banking regulators to the newly-formed Consumer Financial Protection Bureau (the CFPB).²⁷

Under Dodd-Frank, all CFPB regulations pertaining to mortgages apply equally across the mortgage industry regardless of the type or size of institution. The Act also greatly reduces fragmented supervision. With one exception, the CFPB has supervisory and enforcement authority over every entity that originates, brokers, or services mortgage loans; the exception is small, insured depository institutions and credit unions with total assets of \$10 billion or less.²⁸ Thus, Dodd-Frank levels the playing field and reduces the incentives for lenders to switch charters in search of the easiest regulator.

Dodd-Frank also allows the states to protect consumers through consumer financial laws that exceed the standards set by federal law.²⁹ The statute defines a state consumer financial law as a law that “specifically regulates the manner, content, or terms and conditions of any financial transaction (as may be authorized for national banks to engage in), or any account related thereto,

²⁶ Public Law No. 111-203, 124 Stat. 1376 (2010) (“Dodd-Frank”). For a thorough and excellent discussion of Dodd-Frank and preemption, see Arthur E. Wilmarth, *The Dodd-Frank Act's Expansion of State Authority to Protect Consumers of Financial Services*, 36 JOURNAL OF CORPORATION LAW 893 (2011).

²⁷ Dodd-Frank § 1021(a).

²⁸ Dodd-Frank §§ 1021(b) and 1024-1026.

²⁹ Dodd-Frank § 1041(a)(2).

with respect to a consumer.”³⁰

By creating a federal floor above which states can pass more stringent consumer financial protection laws, Dodd-Frank safeguards against the possibility that the federal floor might be too weak or need updating. It also recognizes that states are closer to local conditions, often are more responsive to emerging problems and may be better able to protect their citizens. Lastly, by giving latitude to states to adopt stricter standards, the law preserves the states' key role as laboratories of experimentation.

Under Dodd-Frank, there are still situations where state laws can be federally preempted. First, State consumer financial laws are preempted if they “have a discriminatory effect on national banks [or federal savings associations], in comparison with the effect of the law on a bank [or thrift] chartered by that State.”³¹ In addition, Dodd-Frank prescribes a new federal preemption standard for state laws that “prevent or significantly interfere” with the powers of a national bank or federal savings association:

State consumer financial laws are preempted, only if--in accordance with the legal standard for preemption in the decision of the Supreme Court of the United States in *Barnett Bank of Marion County, N. A. v. Nelson, Florida Insurance Commissioner, et al.*, 517 U.S. 25 (1996), the State consumer financial law prevents or significantly interferes with the exercise by the national bank of its powers; and any preemption determination under this subparagraph may be made by a court, or by regulation or order of the Comptroller of the Currency on a case-by-case basis, in accordance with applicable law

No regulation or order of the Comptroller of the Currency [relating to preemption of consumer financial laws], shall be interpreted or applied so as to invalidate, or otherwise declare inapplicable to a national bank, the provision of the State consumer financial law, unless substantial evidence, made on the record of the

³⁰ Dodd-Frank § 1044(a).

Dodd-Frank does not address preemption of laws of general applicability such as laws banning unfair and deceptive acts and practices, fraud, and unconscionability, that are not related to specific loan terms and lending practices. Some commentators have suggested that Dodd-Frank's definition of a consumer financial law would permit OCC preemption of general laws. Others, including banking law expert Prof. Arthur Wilmarth, have relied on past cases to conclude that state laws of general applicability are unlikely to give rise to valid claims of preemption because they are subject to the *Barnett* standard. Jared Elost, *Dynamic Federalism and Consumer Financial Protection: How the Dodd-Frank Act Changes the Preemption Debate*, 89 NORTH CAROLINA LAW REVIEW 1273, 1295 (2011); Wilmarth, *supra* note 26 at 926 and 944-49.

³¹ Dodd-Frank §§ 1044(a) and 1046(a).

proceeding, supports the specific finding regarding the preemption of such provision in accordance with the legal standard of the decision of the Supreme Court of the United States in *Barnett Bank of Marion County, N.A. v. Nelson, Florida Insurance Commissioner, et al.*, 517 U.S. 25 (1996).³²

Notably, these preemption provisions only benefit federally chartered depository institutions; Dodd-Frank eliminates OCC preemption for subsidiaries and affiliates of national banks and federal savings associations (except for subsidiaries and affiliates that are national banks or federal savings associations).³³

Three features of this preemption provision are particularly noteworthy.³⁴ First, the *Barnett* standard limiting preemption to laws that “prevent[] or significantly interfere[] with the exercise by the national bank of its powers” is much narrower than the standard that the OCC and OTS used in their pre-Dodd-Frank preemption rules.³⁵ Second, Dodd-Frank states that OCC preemption does not occupy the field in any area of state law.³⁶ This means that the OCC cannot claim exclusive regulatory authority in any state law arena. Finally, Dodd-Frank spells out a process for OCC preemption orders and regulations, requiring that all such regulations and orders be made on a case-by-case basis and based on “substantial evidence, made on the record of the proceeding.”³⁷ As a result, any OCC preemption ruling must be made in response to a specific state law.³⁸ And, if the OCC wants its preemption ruling to apply to another state's consumer financial law that has

³² Dodd-Frank §§ 1044(a) (emphasis added) and 1046(a). Dodd-Frank also permits federal preemption where “the State consumer financial law is preempted by a provision of Federal law” other than title X of Dodd-Frank. *Id.*

Dodd-Frank refers solely to OCC rule-making because the OTS was absorbed into the OCC.

³³ Dodd-Frank §§ 1044(a), 1045, and 1046(a).

³⁴ For more in-depth analysis of the nuances of preemption under Dodd-Frank, *see* Wilmarth, *supra* note 26, at 920-48.

³⁵ *Supra* notes 2 and 5; *see also* Wilmarth, *supra* note 26, at 935-37

³⁶ Dodd-Frank §§ 1044(a) and 1046(a).

³⁷ Dodd-Frank § 1044(a).

³⁸ There are provisions that allow OCC preemption rules to extend to substantially equivalent laws in other states so long as the OCC confers with the CFPB and takes the CFPB's views into account when issuing the rules. Dodd-Frank § 1044(a).

substantively equivalent terms as the one the comptroller is preempting, the comptroller must first consult with the CFPB and take the Bureau's views into account when issuing its preemption ruling.

If an OCC preemption determination is challenged in court, the comptroller does not receive *Chevron* deference automatically; rather, before deciding whether to apply *Chevron*, the court must assess the thoroughness of the OCC's consideration, the validity of its reasoning, the consistency with other valid OCC preemption determinations, and any other factors that the court finds relevant and persuasive.³⁹

OCC Response to Dodd-Frank Preemption Provisions

Dodd-Frank's preemption standards became effective on July 21, 2011, at which point the OCC should have conformed its preemption rulings to the new law.⁴⁰ Instead, on that same date, the OCC issued a new preemption rule describing a category of state anti-predatory lending laws that would not be subject to OCC preemption. According to the rule, those laws are consistent with *Barnett* and are “applicable to national banks [or federal savings associations].”

Several aspects of this rule raise questions about the OCC's adherence to the requirements of Dodd-Frank.⁴¹ First, the OCC expressly declined to employ the case-by-case analysis of state laws that Dodd-Frank requires when making preemption determinations. Rather, the OCC turned Dodd-Frank on its head and issued a blanket ruling identifying categories of state laws that are *not* preempted. The implication is that all other categories of state consumer financial laws *are* subject to OCC preemption, notwithstanding the absence of case-by-case analysis. According to the OCC, it was justified in bypassing Dodd-Frank's procedural requirements because its “[a]ctions and regulations in effect prior to the effective date [July 21, 2011] [were] not subject to the case-by-case requirement.” In other words, the OCC took the position that its old preemption rulings regarding existing state anti-predatory lending laws are still good law and need not be re-examined. Only “*future* preemption determinations would be subject to the new Dodd-Frank Act procedural provisions,” in the comptroller's view.⁴²

Second, the OCC rule does not mention Dodd-Frank's crucial injunction that in order for the OCC to preempt a State consumer financial law under *Barnett*, the state law must “prevent[] or

³⁹ Dodd-Frank §§ 1044(a) and 1046(a)

⁴⁰ Dodd-Frank § 1048; Wilmarth, *supra* note 26, at 939-40.

⁴¹ 76 Fed. Reg. 43549-43569 (July 21, 2011) (codified at 12 C.F.R. §§ 7.4008(e)(8), 7.4010(a), 34.4(b)(9), 34.6).

⁴² *Id.* at 43557 (emphasis in original).

significantly interfere[] with the exercise by the national bank [or federal savings association] of its powers.” The OCC did not undergo this analysis when issuing its 2011 rule. In response, the United States Treasury Department wrote to the comptroller of the currency, saying that the OCC rule “essentially reads the ‘prevents or significantly interferes’ language out of the statute.”⁴³

The OCC's actions are not consistent with Congress's intent when it passed Dodd-Frank. In the conference report to Dodd-Frank, the drafters specifically stated that Congress meant to “revis[e] the standard the OCC will use to preempt state consumer protection laws” when it placed restrictions on OCC preemption.⁴⁴ Congressional intent could not be clearer. Yet, the OCC issued a rule that preempted broad swaths of existing state laws using its old preemption precedents, bypassing the Dodd-Frank procedures along the way.

For certain, there will be challenges to the substance of the OCC's new preemption rule and the process the OCC undertook when issuing the rule. And, it will take many years before the legality of the rule is resolved in the courts.

Conclusion

Regardless of the OCC's stance on preemption and how it plays out in the courts and Congress, one thing remains clear. The Dodd-Frank Act, by authorizing the CFPB to adopt minimum national consumer standards across the entire market, created real and lasting safeguards against another race to the bottom. While the preemption controversy will affect the extent to which states can exceed these minimum standards, it will not shape adoption of national lending standards.

⁴³ Letter from George W. Madison, General Counsel, United States Treasury Department, to the Honorable John Walsh, Comptroller of the Currency (June 27, 2011).

⁴⁴ H.R. Rep. No. 111-517, at 875 (Conf. Rep.).