Comptroller of the Currency
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# The Importance of Preserving a System of National Standards For National Banks

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## I. Introduction

Since the establishment of the national banking system in 1863 and 1864, banks and their consumers have benefitted from the dynamic of the dual banking system. State banking systems can serve as laboratories of regulatory innovation, exploring new products and regulatory approaches to issues that, if successful, may be adopted at the federal level. The national banking system, operating under uniform federal standards across state lines, strongly fosters an open financial marketplace, the growth of national products and services in national and multi-state markets, and reduced costs.

The legal principle that supports uniform federal standards for national banks is the doctrine of federal "preemption," which flows directly from the Supremacy Clause of the U.S. Constitution. The Supreme Court has long held that, under the doctrine of federal preemption, any state law that conflicts, impedes, or interferes with national banks' federally-granted powers may not be applied to national banks – the state law is "preempted" by federal power. Preservation of the uniform federal standards has benefitted consumers of financial products by making a wider range of banking products and services available to more consumers and, overall, lowering the costs of credit and other banking products and services. In turn, the banking system benefits from greater economies of scale and improved risk management.

Critics of federal preemption have argued that it undermines the dual banking system. This argument, however, dismisses the clear benefits the system produces for consumers and banks alike, and shortchanges the state banking systems and the vital role they play in the dual banking system.

Other critics contend that federal preemption is contrary to consumers' interests and assert that preemption was one of the leading causes of the subprime mortgage lending crisis. The facts

simply do not bear this out. National banks and their subsidiaries originated only 12 to 14 percent of all subprime mortgages between 2005 and 2007. The vast majority of the subprime mortgages originated during these years were made by state licensed and supervised entities. The limited role that national banks and their subsidiaries played in the subprime mortgage lending crises strongly suggests that federal preemption had little to do with the crisis. This conclusion is bolstered by the track record of performance of subprime loans originated by national banks, which is better than the performance of subprime lending done by nonbanks in recent years.

## II. The National Banking System and Federal Preemption

Congress enacted the National Currency Act of 1863 and the National Bank Act of 1864 to establish a national banking system to operate distinctly and separately from the existing system of private state banks. In adopting these measures, Congress did not abolish state banking, but was concerned about state legislation hostile to banks that the states did not create and control. To shield the national banks from such legislation, Congress included explicit protections in the new framework to ensure that national banks would be governed by Federal standards administered exclusively by a new federal agency – the Office of the Comptroller of the Currency. With the establishment of the national banks, Congress created the "dual banking system," in which both the states and the federal government have the power to charter banks and the power to supervise and regulate independently the banks they have chartered. The dual banking system remains in place today.

### *A. Doctrine of Federal Preemption Flows Directly from the Supremacy Clause of the United States Constitution*

At the core of the national banking system is the principle that national banks, in carrying on the business of banking under a federal authorization, should be subject to uniform national

standards and uniform federal supervision.[1] The legal principle that produces such a result is the "preemption" of state law. The doctrine of preemption flows directly from the Supremacy Clause of the U.S. Constitution,[2] and provides that the Constitution and laws of the United States are the "Supreme Law" of the land, notwithstanding anything in the Constitution of laws of the States to the contrary. The Supremacy Clause was the basis for the landmark 1819 Supreme Court decision, *McCulloch v. Maryland*,[3] which established the bedrock principle that state law cannot stand as an obstacle to the accomplishment of federal legislative goals.

### *B. For Over 140 Years, the Supreme Court Has Held That State Laws Which Conflict, Impede, or Interfere with National Banks' Powers and Activities Are Preempted*

In the years following the National Bank Act's enactment, the Supreme Court recognized the clear intent on the part of Congress to limit the authority of states over national banks precisely so that the nationwide system of banking that was created in the National Bank Act could develop and flourish. This point was highlighted by the Supreme Court in 1903 in *Easton v. Iowa.*[4] The Court stressed that the application of multiple states' standards would undermine the uniform, national character of the powers of national banks, which operate in –

> a system extending throughout the country, and independent, so far as powers conferred are concerned, of state legislation which, if permitted to be applicable, might impose limitations and restrictions as various and as numerous as the states…. If [the states] had such power it would have to be exercised and limited by their own discretion, and confusion would necessarily result from control possessed and exercised by two independent authorities.[5]

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[1] In discussing the impact of the National Currency Act and National Bank Act, Senator Sumner stated that, "[c]learly, the [national] bank must not be subjected to any local government, State or municipal; it must be kept absolutely and exclusively under that Government from which it derives its functions." Cong. Globe, 38th Cong., 1st Sess., at 1893 (April 27, 1864).

[2] U.S. Constitution Article VI, cl. 2.

[3] *McCulloch v. Maryland*, 17 U.S. (4 Wheat) 316 (1819).

[4] 188 U.S. 220 (1903).

[5] *Id.* at 229, 230-31. A similar point was made by the Court in *Talbott v. Bd. of County Commissioners of Silver Bow County,* in which the court stressed that the entire body of the Statute respecting national banks, emphasize that which the character of the system implies - an intent to create a national banking system co-extensive with the territorial limits of the United States, and with uniform operation within those limits. 139 U.S. 438, 443 (1891).

The Supreme Court strongly reaffirmed this point in 2007 in *Watters v. Wachovia*,[6] stating:

> Diverse and duplicative superintendence [by the states ] of national banks' engagement in the business of banking, we observed over a century ago, is precisely what the [ National Bank Act ] was designed to prevent.[7]

The Supreme Court and lower federal courts have repeatedly made clear that state laws that conflict, impede, or interfere with national banks' powers and activities are preempted. For example, in *Davis v. Elmira Savings Bank*,[8] the Supreme Court stated: "National banks are instrumentalities of the Federal Government, … It follows that an attempt, by a state, to define their duties or control the conduct of their affairs, is absolutely void." In *Franklin National Bank v. New York*,[9] the Supreme Court held that a state could not prohibit a national bank from using the word "savings" in its advertising, since the state law conflicts with the power of national banks to accept savings deposits. More recently, in *Barnett Bank v. Nelson*,[10] the Supreme Court affirmed the preemptive effective of federal banking law under the Supremacy Clause and held that a state statute prohibiting banks from engaging in most insurance agency activities was preempted by Federal law that permitted national banks to engage in insurance agency activities. In reaching its conclusion, the Court explained that the history of the National Bank Act "is one of interpreting grants of both enumerated and incidental 'powers' to national banks as grants of authority not normally limited by, but rather ordinarily pre-empting, contrary state law."

### *C. However, the Supreme Court Also Has Recognized That Many Types of State Commercial and Infrastructure Laws Do Apply to National Banks*

The common thread running through these cases recited above is the preemption of a state law that impedes or interferes with national banks' powers. On the other hand, states are

[6] 550 U.S. 1 (2007).
[7] *Id.* at 14.
[8] 161 U.S. 275, 283 (1896).
[9] 347 U.S. 373 (1954).
[10] 517 U.S. 25, 32 (1996).

permitted to regulate the activities of national banks where doing so does not impair, encroach upon, significantly interfere with, or prevent the exercise of these powers.[11] Thus, many types of state commercial and business "infrastructure" laws are not preempted, and national banks remain subject to significant state statutory schemes, including contracts, torts, criminal justice, zoning, right to collect debt, and many other generally applicable commercial and business standards. The OCC has recognized that such laws are not preempted.[12]

The Supreme Court, only five years after the enactment of the National Bank Act, recognized that national banks may be subject to some state laws in the normal course of business if there is no conflict with Federal law.[13] In holding that national banks' contracts, their acquisition and transfer of property, their right to collect their debts, and their liability to be sued for debts, are based on State law, the Court noted that national banks "are subject to the laws of the State, and are governed in their daily course of business far more by the laws of the State than of the nation."[14] The OCC does not dispute this basic proposition.

The courts have continued to recognize that national banks are subject to state laws, unless those laws infringe upon the national banking laws or impose an undue burden on the performance of the banks' federally-authorized activities. In *McClellan v. Chipman*,[15] the Supreme Court held that the application to national banks of a state statute forbidding certain real estate transfers by insolvent transferees was not preempted as the statute would not impede or hamper national banks' functions. In *Wichita Royalty Co. v. City Nat. Bank of Wichita Falls*,[16] the Court upheld the application of state tort law to a claim by a bank depositor against bank

[11] *Barnett Bank*, 517 U.S. at 33 (1996).

[12] 12 C.F.R. § 7.4009(c) (2009). The OCC adopted this rule in 2004, noting that these laws do not attempt to regulate national banks' activities, but rather form the legal infrastructure that makes it practicable to exercise a permissible Federal power. 69 Fed.Reg. 1904, 1912 (Jan. 13, 2004).

[13] *National Bank v. Commonwealth*, 76 U.S. (9 Wall.) 353 (1869).

[14] *Id.* at 362 (1869).

[15] 164 U.S. 347 (1896).

[16] 306 U.S. 103 (1939).

directors. And in *Anderson Nat. Bank v. Luckett*,[17] the Supreme Court held that a state statute administering abandoned deposit accounts did not unlawfully encroach on the rights and privileges of national banks and, as a result, was not preempted.

As these cases demonstrate, there are numerous state laws to which national banks remain subject because the laws do not significantly impede or interfere with powers granted national banks under Federal Law. Yet, in reaching this conclusion, these cases serve to confirm the fundamental principle of federal preemption as applied to national banks: that is, that the banking business of national banks is governed by federal standards. These uniform national standards and the federal supervision under which national banks operate are the defining attributes of the national bank component of our dual banking system.

## III. The Dual Banking System and Uniform Federal Standards for National Banks

In establishing the national banking system, Congress opted not to abolish existing private state banks, but rather to adopt a new framework in which national banks would be governed by uniform federal standards.[18] With this design, the state and national banking systems have grown up around one another, creating the "dual banking system" we know today.

### *A. Benefits of the Dual Banking System*

Encompassing both large institutions that market products and services nationally and very small institutions that do business exclusively in their immediate communities, the dual banking system provides both banks and consumers with significant benefits. These benefits flow from the competitive dynamic between the national and state systems when each component system is allowed to function in accordance with its distinctive attributes.

[17] 321 U.S. 233 (1944).

[18] The "very core of the dual banking system is the simultaneous existence of different regulatory options that are not alike in terms of statutory provisions, regulatory implementation and administrative policy." Kenneth E. Scott, *The Dual Banking System: A Model of Competition in Regulation*, 20 Stan. L. Rev. 1, 41 (1977).

**1. States may serve as laboratories for innovative and new approaches**

One of the well-understood benefits of the dual banking systems is that, by having a separate system of state banks, states may serve as laboratories for innovation and for new approaches to an issue, without compelling adoption of a particular approach by all states or as a national standard. That is, the dual banking system is built on the ability of individual states experimenting with different kinds of laws, including new consumer protection laws that apply to state banks in a given state, but not to state banks in all states and not to national banks. Over time, some of these individual state laws have proven to be good ideas, while others have not. When Congress has believed that a particular state's experiment is worthwhile, it has enacted that approach to apply throughout the country, not only to all national banks, but to state banks operating in other states that have not yet adopted such laws.

The national banking system, on the other hand, is the venue for efficiencies and benefits that flow from uniform national standards. This role is increasingly important as the market for financial products and services has evolved, as advances in technology have enabled banks to do business with consumers in many states, and as consumer financial products have become commoditized and marketed nationally. In other words, the national banking system is a laboratory, too, but what it demonstrates is the value of applying uniform national standards to activities and products that, today, have national markets.

**2. Promotion of a diverse and flexible financial marketplace**

In large part attributable to the competitive dynamic between its national and state banking components, the dual banking system has produced a remarkably diverse and innovative financial marketplace. Bankers can make choices between state and national bank charters on the basis of their business needs and particular circumstances. Businesses and consumers have a wide range of options in the marketplace, as financial institutions are encouraged to respond dynamically to

the changing needs of borrowers and depositors and to provide services and products in an efficient and cost-effective manner. In short, the dual banking system has been critical in producing a banking system that is able to finance growth and meet customer needs through innovation, responsiveness, and flexibility.[19]

Each component of the dual banking system makes different, positive contributions to the overall strength of the U.S. banking system. Efforts to dilute – or eliminate – the unique characteristics of one component of the system undermine the collective strength that comes from the diverse contributions of the two systems. The U.S. banking system as a whole, including the state banking component, benefits from the national banking system's contributions, which flow from the efficiencies and benefits of operating under uniform national standards and a strong and uniform federal supervisory system.

### *B. The Existence of Federal Preemption as an Essential Characteristic of the Dual Banking System Established by Congress Does Not Disadvantage State Banks and the State Banking Charter*

Notwithstanding the role that both the state and national banking components play in the collective strength of the dual banking system, some argue that federal preemption of state laws which interfere or impede with national banks' activities – that is, the application of the Supremacy Clause of the U.S. Constitution – is somehow unfair to the state banking system.

This argument profoundly short-changes the State banking systems and the crucial role they play in the modern financial services marketplace. More fundamentally, however, the argument is backwards. National and State charters each have their own distinct advantages. Indeed, State banking supervisors vigorously assert that the State charter is superior. Numerous State banking department websites provide lists of the advantages of the State charter, often including a side-by-side comparison of fees and assessments to demonstrate the lower costs of a

[19] *See* Susan S. Bies, Governor, Board of Governors of the Federal Reserve System, Remarks Before the Conference of State Bank Supervisors (May 30, 2003).

State charter.[20] One state banking department, after a listing of ten advantages of the State charter, concludes that the "state banking charter the charter of choice" for banks in that state.[21] Some states have actively marketed the State bank charter, sending unsolicited letters, and even videos, touting the benefits of a State bank charter to national banks.

When all factors are considered, the number of national and state-chartered banks simply does not suggest that the principle of preemption has eroded the dual banking system.[22] As of June 30, 2009, there were 5,490 FDIC-insured, state-chartered commercial banks, and 1,505 FDIC-insured, OCC-chartered national banks.[23] Far from signaling that state-chartered institutions are disadvantaged, these figures amply demonstrate the important role played by the state banking systems and the vitality of the dual banking system.[24]

### *C. Benefits of the National Banking System and Uniform Standards of Operation and Supervision*

From its establishment, the national banking system has been governed by uniform federal standards of operation and supervision. When a state law has impeded or significantly interfered with powers granted national banks under Federal law, the courts have held that under the Supremacy Clause the state law is preempted. Over the years, preemption of state laws that

[20] *See, e.g.,* Texas Department of Banking, http://www.banking.state.tx.us/corp/charter/benefits.htm; California Department of Financial Institutions, http://www.dfi.ca.gov/cacharter/advantages.asp; South Dakota Division of Banking, http://www.state.sd.us/drr2/reg/bank/banktrust/State%20Charter%20Comparison.pdf;

[21] Tennessee Department of Financial Institutions, http://www.state.tn.us/tdfi/banking/charter.html.

[22] *See* "The Benefits of Charter Choice: The Dual Banking System As A Case Study," prepared by the Conference of State Bank Supervisors and the American Bankers Association (June 24, 2005) (concluding the dual banking system "works," fostering innovation, making products and services more widely available, and lowering costs). *See also* Testimony of Joseph A. Smith, Jr., North Carolina Commissioner of Banks, on behalf of the Conference of State Bank Supervisors, before the Committee on Financial Services of the U.S. House of Representatives (Sept. 23, 2009) (arguing that creation of a single federal financial regulator would undermine the dual banking system; state-chartered institutions and the financial system itself have benefited from the debate among state and federal regulators); Testimony of Jospeh A. Smith, Jr., North Carolina Commissioner of Banks, on behalf of the Conference of State Bank Supervisors, before the Committee on Financial Services of the U.S. House of Representatives (July 24, 2009) (stating that the dual banking system has produced a diverse, dynamic, and durable banking industry and broad access to affordable credit).

[23] FDIC Quarterly Banking Profile (June 30, 2009).

[24] Jeffery C. Vogel, Conference of State Bank Supervisors Chairman, 2007-08, "CSBS Year in Review," (May 21, 2008) (stating that "the state banking system is a significant and vital force in our local and national economies").

impede or interfere with national banks' activities has fostered the creation of a set of predictable rules for national banks, which has lowered the costs of interstate banking and opened the financial marketplace. Such openness benefits both consumers and banks alike.[25]

The banking system benefits from (1) greater economies of scale, as consumer products become commoditized and marketed in larger geographic areas; (2) improved risk management, as banks diversify across product offerings and across geographic markets; and (3) increased competition in the bank sector, a crucial factor in the continued vitality of the dual banking system. While these benefits accrue to all banks, they are especially important for smaller banking companies with customers in more than one state, where economies of scale and cost-effective risk management are critical if they are to operate efficiently.

### *D. Preemption and the Practical Impact of Applying State Laws to National Banks*

As demonstrated above, important benefits flow from the ability of national banks to conduct their banking business under uniform national standards. Federal preemption of state laws that impede or interfere with national banks' activities preserves these uniform standards. Repeal or removal of federal preemption would create the potential for national banks to be subject to myriad state and local regulations and restrictions with significant practical impact on their banking activities. Such a balkanized approach would give rise to considerable uncertainty about which sets of standards apply to institutions conducting a multistate business. That, in turn, would generate major legal and compliance costs and impediments to product delivery for all banks, large or small.

For example, there are a number of areas in which complying with different standards set by individual states would require a bank to determine which state's law governs – the law of the

[25] *Cf*. Jith Jayaratne & Philip E. Strahan, "The Benefits of Branching Deregulation," FRBNY Econ. Pol'y Rev. 13 (1997) (finding that, as geographic restrictions on interstate branching were removed between 1978 and 1992, bank efficiency improved greatly, with reduction in operating costs passed along to consumers in the form of lower loan rates).

state where a person provides a product or service; the law of the home state of the bank; or the law of the state where the customer is located. It is far from clear how a bank could do this based on objective analysis, and any conflicts could result in penalties and litigation in multiple jurisdictions. Practical problems could arise from different grace periods for credit cards; different internet advertising rules; different solicitation standards for telephone sales, with different duties for sales personnel; different employee compensation limits; and different licensing requirements for new products.

On this basis alone, the maintenance of uniform national standards is compelling. But on at a more granular level – at the level of potential types of state regulation of national banks' activities – the case in favor of preemption is forceful. In practical terms, there are generally three categories of state laws involved: 1) laws that prevent or impede the ability of a national bank to operate or offer a particular product or service; 2) laws that impose controls on pricing of particular products or indirectly affecting pricing by prohibiting specified terms; and 3) laws regulating the manner and means by which consumers are provided information about the bank's financial products and services.

**1. Preventing or impeding the ability of a national bank to operate or offer a particular product or service**

The banking business of national banks is controlled by Federal law, specifically the National Bank Act ("NBA"), 12 U.S.C. § 1 *et seq.*, and federal regulations. The NBA authorizes national banks to engage in activities that are part of, or incidental to, the business of banking, plus other specified activities set forth in the NBA. When a state attempts to regulate a national bank's activities by precluding national banks from operating within the state – where they are authorized to operate under Federal law – or to bar national banks from offering products or services – which they are authorized to offer under Federal law, the state is directly interfering with powers granted under Federal law. Such interference is fundamentally at odds with

Constitutional principles embodied in the Supremacy Clause. Examples of this type of state law include the following:

- Different states could impose licensing or product clearance requirements that could simply prevent national banks from providing certain products and services, or subject certain or new products and services to a state-by-state level pre-clearance.
- Different states could impose different capital or net worth requirements or security deposit requirements as preconditions for product providers operating in the state, such as net worth requirements for mortgage originators based on size or volume of business conducted in a state.
- Different states could specify requirements regarding the structures through which a bank must operate in order to provide certain products, based on a view that certain corporate structures or reporting lines are needed to effectively implement consumer protection objectives.

**2. Imposing controls on pricing of particular products or indirectly affecting pricing by prohibiting specified terms**

A second type of state law may attempt to impose controls on the pricing of particular products or indirectly affect pricing by prohibiting specified terms. A state could seek to impose direct price controls, by dictating how much a bank may charge for a product or service or when fees or other charges may be imposed, or may indirectly control prices, by prohibiting or conditioning the use of certain product features. Whether implemented directly or indirectly, such price controls represent the state telling a federally-chartered bank how much it can charge for particular products and services when no such pricing restriction exists under Federal law.

A national bank's authority to provide products or services to its customers necessarily encompasses the ability to charge a fee for the product or service.[26] This ability to charge a fee for the bank's products and services is expressly reaffirmed in OCC regulations.[27] As a result, state efforts to limit or otherwise control, directly or indirectly, the price a national bank may

[26] *Bank of America v. City and County of San Francisco*, 309 F.3d 551 (9th Cir. 2002), *cert. denied*, 538 U.S. 1069 (2003).

[27] 12 C.F.R. Section 7.4002(a) provides that "[a] national bank may charge its customers non-interest charges and fees, including deposit account service charges."

charge for its products and services are preempted and invalid under the Supremacy Clause.

Examples of these types of restrictions are:

- Different states could impose different limits on the rates of interest that may be charged to consumers in their states, and could prescribe different definitions of what types of charges constitute "interest" for purposes of each state's "interest" rate cap.
- Different states could impose other limits or directives on particular terms and conditions of any consumer financial product offered by the bank. Banks could be required to offer specified products and services that conform to specified terms. States also could dictate particular product features, such as minimum payment requirements, grace periods, minimum periods for loan repayment, and early termination of mortgage insurance.

**3. Regulating the manner and means by which consumers are provided information about financial products and services**

A third type of state law may attempt to regulate how national banks conduct business by dictating the manner and means by which consumers are provided information about financial products and services.[28] For example, states could impose different disclosure requirements in connection with sales and solicitations of products or even requirements dictating the presentation and format of such disclosures. Examples of this type of state law requirement include the following:

- Different states could impose different disclosure requirements in connection with sales and solicitations of particular products.
- Disclosure requirements could dictate not just substantive content, but also presentation and placement of disclosures, further impeding the ability of consumers to comparison shop.
- Different states could impose different standards concerning manner of negotiation, sales and solicitation of particular financial products and services with respect to consumers in each state.

In recent years, the federal government and agencies have developed a much-expanded rulewriting process for developing standards for consumer disclosures, and other

[28] This type of law does not include a state law that embodies a business conduct standard, such as a prohibition on offering products and services in a manner that is unfair or deceptive, comparable to the standards in section 5 of the Federal Trade Commission Act.

communications, which convey important financial information to consumers. The process incorporates nationwide public comment process and extensive consumer testing to identify the information most meaningful to consumers and the most effective way to convey it to them. In the absence of preemption, a state could require – on any basis – that disclosures or communications take a form other than that required by the federal standards produced by this robust federal process. There is no basis to assume that the disclosure requirements imposed by any state – which would not be based on the comment process and testing used to develop a federal rule – would be better than the federal rule. For a national bank that operates interstate, the least costly option may be to cede to the requirements of the state with the apparently most extensive disclosure requirements, if doing so would satisfy the remaining states' requirements. The practical result would then be that a single state's requirements displace the standards promulgated in the federal rulemaking process, not just in one state, but in multiple states.

Permitting the states to adopt different disclosure requirements also has real downsides for consumers. As compliance costs increase, some portion of these costs is passed on to consumers of financial products and services. Yet, at the same time, consumers' ability to look out for themselves and comparison shop for the best deal is undermined if differences in disclosure and communication requirements undermine their ability to compare products.

### *E. Preemption Incentivizes Robust Federal Standards*

A key to the benefits of preemption described above is strong consumer protection standards at the federal level – a position the OCC agrees with.[29] In fact, preemption, when coupled with robust federal standards for national banks, operates as an incentive for the application of robust standards at the federal level that will apply to all participants in the

[29] *See* Testimony of John C. Dugan, Comptroller of the Currency, before the Committee on Financial Services of the U.S. House of Representatives, (Jun. 13, 2007) (setting forth in detail the OCC's comprehensive approach to consumer protection regulation).

financial marketplace. With comprehensive robust federal standards in place to identify and resolve problems before they explode, there is no need for state "first responders" to arrive at the scene of a disaster, assess the damage and treat the wounded. Strong federal standards should prevent the disaster. Prevention, and not response, should be the first goal.

## IV. Preemption Did Not Cause the Subprime Mortgage Lending Crisis

Some critics of preemption allege that it was a primary cause of the subprime mortgage crisis. This argument crumbles when facts and hard numbers are analyzed. The vast majority of subprime loans were originated by state licensed and supervised lenders and mortgage brokers, not federally-regulated banks. National banks had a limited share of subprime lending during crucial recent years, and those loans have a better performance record than nonbank subprime lending. Indeed, a portion of national banks' loans labeled "subprime" was to low- and moderate-income borrowers in furtherance of banks' CRA obligations. Community advocates and Federal Reserve researchers agree that these loans are of higher quality and have performed better than mortgages made by lenders not covered by CRA.

### *A. National Banks Did Limited Subprime Lending, and when National Banks Originated Subprime Mortgage Loans, Those Loans Have Performed Better than Subprime Lending as a Whole*

On a nationwide basis, national banks and their subsidiaries accounted for approximately 12 to 14 percent of all non-prime originations, in the years 2005-2007, the peak years for non-prime lending.[30] The overwhelming majority of non-prime loans originated during this period were made by entities licensed and supervised by the states.[31]

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[30] Letter from John C. Dugan, Comptroller of the Currency, to Elizabeth Warren, Chair, Congressional Oversight Panel (Feb. 12, 2009) (analyzing data from Loan Performance Corporation and Home Mortgage Disclosure Act data).

[31] *Id. See also* Report and Recommendations by the Majority Staff of the Joint Economic Committee, "The Subprime Lending Crisis: The Economic Impact on Wealth, Property Values and Tax Revenues, and How We Got Here," at p. 17 (Oct. 2007) ("The mortgages underwritten by subprime lenders come from many sources, but the overwhelming majority is originated through mortgage brokers.")

The subprime loans originated by national banks and their subsidiaries generally have performed better than subprime lending as a whole, with lower foreclosure rates.[32] The OCC identified the ten mortgage orginators with the highest rate of subprime and Alt-A mortgage foreclosures in the ten metropolitan statistical areas ("MSAs") experiencing the highest foreclosure rates for the years 2005-2007. Of the 21 firms comprising the "worst 10" in those 10 MSAs, 12 firms – accounting for nearly 60 percent of non-prime mortgage loans and foreclosures – were exclusively supervised by the states. *See* Attachment A. The lower foreclosure rates generally indicate that the subprime loans originated by national banks were relatively higher quality and better underwritten mortgages.

### *B. A Portion of National Banks' Subprime Lending Was Made to Low- and Moderate-Income Borrowers in Furtherance of CRA Obligations*

A portion of the non-prime mortgage loan origination by national banks is traceable to efforts by national banks to fulfill their obligations to help meet the credit needs of their local communities, including low- and moderate-income ("LMI") areas, under the Community Reinvestment Act ("CRA"). Potential borrowers in LMI areas tend to have lower credit scores – average credit scores in LMI census tracts are about 90 points less than average scores in other census tracts – placing many of them in the "subprime" category. National banks can and do lend to borrowers with lower credit scores, but to do so prudently the banks generally price the loans to cover the higher risk associated with lower credit scores. The annual Home Mortgage Disclosure Act ("HMDA") data indicates that nearly 30 percent of mortgage loans with higher interest rates, so-called "rate spread loans,"[33] originated by national banks and their operating subsidiaries tended to be in LMI census tracts, even though those tracts account for only approximately 15

[32] Testimony of John C. Dugan, Comptroller of the Currency, before the Committee on Financial Services of the U.S. House of Representatives, *supra* note 29; Letter from John C. Dugan, Comptroller of the Currency, to Elizabeth Warren, Chair, Congressional Oversight Panel, *supra* note 30.

[33] Rate spread loans and subprime loans are not exactly the same thing, but the HMDA data are more comprehensive and of higher quality than other data sources that focus narrowly on subprime loans, and the results likely are a good indication of overall tendencies in the market.

percent of national banks' mortgage lending overall. These numbers suggest a discernible share of subprime lending done by banks was done for CRA purposes.[34]

This portion of subprime lending was not, as some have suggested, the cause of the subprime crisis. Where CRA-covered banking institutions made subprime loans in their assessment areas, in aggregate these subprime loans have performed better than subprime loans made by other types of lenders. For example, a study by the Federal Reserve Bank of San Francisco concluded that subprime origination volume by CRA-covered lenders within CRA assessment areas was relatively small, and that loans made by a CRA-covered lender within its assessment area are markedly less likely to go into foreclosure than loans made in the same area by lenders not subject to CRA.[35] A second Federal Reserve study found that mortgages originated and held in portfolio under the affordable lending programs operated by the NeighborWorks partners[36] across the country have, along any measure of delinquency or foreclosure, performed better than subprime and FHA-insured loans and have a lower foreclosure rate than prime loans.[37]

In summary, a portion of national banks' non-prime loans were made to fill their obligations under CRA, but these loans did not cause the mortgage crisis. Subprime origination in CRA assessment areas was too small relative to the overall mortgage market to be a primary cause of the crisis, and subprime lending by CRA-covered lenders has been shown to outperform mortgages made by lenders not covered by CRA.

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[34] These figures were derived through analysis of FFIEC data on credit scores and HMDA data on 1-4 family first lien mortgage origination.

[35] Elizabeth Laderman and Carolina Reid, Federal Reserve Bank of San Francisco, "Lending in Low- and Moderate-Income Neighborhoods in California: The Performance of CRA Lending During the Subprime Meltdown" (Nov. 14, 2008), at pp. 14-16.

[36] Many loans originated through NeighborWorks programs are done in connection with CRA-covered institutions.

[37] Glenn Canner and Neil Bhutta, Board of Governors of the Federal Reserve System, Division of Research and Statistics, "Staff Analysis of the Relationship between the CRA and the Subprime Crisis," p. 3 and p. 8 table 3 (Nov. 21, 2008), at p.5 and table 9, p. 10.

## VI. Conclusion

From its establishment, the national banking system has been governed by uniform federal standards of operation and supervision. These characteristics are fundamental to the distinctions that are the essence of the "dual banking system." These uniform federal standards have fostered the creation of a set of predictable rules and consistent federal oversight for national banks, which has lowered the costs of interstate banking and opened the financial marketplace. The banking system benefits from greater economies of scale, improved risk management, and increased competition in the bank sector. In turn, consumers have benefitted from nationally uniform standards of consumer protection, the availability of a wider range of banking products and services and, overall, lowering the costs of credit and other banking products and services.

Attachment A

# Worst Ten in the Worst Ten: Supervisory Status of Mortgage Originators

| Originator | Supervisor | Foreclosures in Worst 10 Metro Areas, based on 2005-07 Originations |
|---|---|---|
| New Century Mortgage Corp. | State supervised. Subsidiary of publicly-traded REIT, filed for bankruptcy in early 2007. | 14,120 |
| Long Beach Mortgage Co. | State and OTS supervised. Affiliate of WAMU, became a subsidiary of thrift in early 2006; closed in late 2007 / early 2008. | 11,736 |
| Argent Mortgage Co. | State supervised until Citigroup acquired certain assets of Argent in 08/07. Held by Citigroup, new lending curtailed and merged into CitiMortgage (NB opsub) shortly thereafter. | 10,728 |
| WMC Mortgage Corp. | State supervised. Subsidiary of General Electric, closed in late 2007. | 10,283 |
| Fremont Investment & Loan | FDIC supervised. California state chartered industrial bank. Liquidated, terminated deposit insurance, and surrendered charter in 2008. | 8,635 |
| Option One Mortgage Corp. | State supervised. Subsidiary of H&R Block, closed in late 2007. | 8,344 |
| First Franklin Corp. | OCC supervised. Subsidiary of National City Bank. Sold to Merrill Lynch 12/06. Closed in 2008. | 8,037 |
| Countrywide | Data includes loans originated by (1) Countrywide Home Loans, an FRB and state-supervised holding company affiliate until 03/07, and an OTS and state-supervised entity after 03/07; and (2) Countrywide Bank, an OCC supervised entity until 03/07, and an OTS supervised entity after 03/07. | 4,736 |
| Ameriquest Mortgage Co. | State supervised. Citigroup acquired certain assets of Ameriquest in 08/07. Merged into CitiMortgage (NB opsub) shortly thereafter. | 4,126 |
| ResMae Mortgage Corp. | State supervised. Filed for bankruptcy in late 2007. | 3,558 |
| American Home Mortgage Corp. | State supervised. Filed for bankruptcy in 2007. | 2,954 |
| IndyMac Bank, FSB | OTS supervised thrift. Closed in July 2008. | 2,882 |
| Greenpoint Mortgage Funding | FDIC supervised. Acquired by Capital One, NA, in mid 2007 as part of conversion and merger with North Fork, a state bank. Closed immediately thereafter in 08/07. | 2,815 |
| Wells Fargo | Data includes loans originated by (1) Wells Fargo Financial, Inc., an FRB and state-supervised entity, and (2) Wells Fargo Bank, an OCC supervised entity. | 2,697 |
| Ownit Mortgage Solutions, Inc. | State supervised. Closed in late 2006. | 2,533 |
| Aegis Funding Corp. | State supervised. Filed for bankruptcy in late 2007. | 2,058 |
| People's Choice Financial Corp. | State supervised. Filed for bankruptcy in early 2008. | 1,783 |
| BNC Mortgage | State and OTS supervised. Subsidiary of Lehman Brothers (S&L holding company), closed in August 2007. | 1,769 |
| Fieldstone Mortgage Co. | State supervised. Filed for bankruptcy in late 2007. | 1,561 |
| Decision One Mortgage | State and FRB supervised. Subsidiary of HSBC Finance Corp. Closed in late 2007. | 1,267 |
| Delta Funding Corp. | State supervised. Filed for bankruptcy in late 2007. | 598 |