

Common Misconceptions in Bank Interstate Credit Transactions

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I. Introduction

If a loan program is operated by a national bank or FDIC-insured banking institution, the bank can rely on federal preemption and ignore state law.

Lenders who believe the above statement or rely on such an understanding of federal preemption are likely to find themselves in violation of numerous state laws.

National banks, federal savings banks, and Federal Deposit Insurance Corporation (FDIC)-insured state-chartered banking institutions all enjoy federal preemption, making them attractive entities from which to offer credit products on an interstate basis. However, the preemption available to each type of entity is based on different statutory and regulatory provisions as well as case law interpreting these provisions. Thus, the term "federal preemption" as applied to each entity encompasses differing degrees of federal authority to preempt state laws. The scope and effect of the federal preemption available in regard to a specific credit term is often misunderstood or subject to differing interpretations. Following is an examination of some common misconceptions relating to the federal preemption available to banking institutions.

II. True or False: FDIC-Insured State-Chartered Banks Can Rely Exclusively on Federal Preemption and Ignore State Law

False. The preemption available to FDIC-insured state-chartered banks is the narrowest preemption available to banking institutions. FDIC-insured state-chartered banks have federal preemption rights based on 12 U.S.C. section 1831d(a) which provides:

In order to prevent discrimination against state-chartered insured depository institutions, such state banks may, notwithstanding any state constitution or statute which is preempted, 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 the rate allowed by the laws of the state, territory or district where the bank is located.¹

Based on the above, FDIC-insured state-chartered banks can rely on federal law to preempt any state law limitation on interest rates and can use the interest rate authority permitted by the bank's home state law on loans made to residents of other states, subject to state opt-out considerations. Thus, FDIC-insured state-chartered banks can rely on federal preemption for "interest rate" authority. "Interest" has been defined by the FDIC as encompassing certain "interest-like" fees,² but that is the extent of the federal preemption available to FDIC-insured state-chartered banks.³ This preemption does not extend to licensing or loan terms not related to interest. State laws frequently apply to the activities of state-chartered banks in one state granting credit to residents of another state. Thus, FDIC-insured state-chartered banks must comply with state laws regarding licensing and other loan related restrictions as well as general state laws and consumer protection laws in each state in which they do business.

III. True or False: Interest Rate Preemption Available to FDIC-Insured State-Chartered Banks and National Banks Includes All Fees

False. National banks have federal interest rate preemption similar to FDIC-insured banks based on Section 85 of the National Bank Act (Section 85), which provides:

Any association may take, receive, reserve, and charge on any loan or discount made, or upon any notes, bills of exchange, or other evidence 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.⁴

The Office of the Comptroller of the Currency (OCC) has promulgated an interpretive ruling defining "interest" to include certain fees. Thus, based on Section 85, national banks can rely on federal preemption for interest rate authority and authority for charging certain interest-like fees.

The OCC rule provides that the term "interest" as used in Section 85 includes any payment compensating a creditor or prospective creditor for an extension of credit, making available a line of credit, or any default or breach by a borrower of a condition upon which credit was extended.⁵ It includes, among other things, the following fees connected with credit extension or availability: numerical periodic rates, late fees, non-sufficient funds fees, overlimit fees, annual fees, cash advance fees, and membership fees.⁶ It does not ordinarily include appraisal fees, premiums and commissions attributable to insurance guaranteeing repayment of any extension of credit, finders' fees, fees

for document preparation or notarization, or fees incurred to obtain credit reports.⁷

The OCC interpretive ruling goes on to provide that a national bank located in a state may charge interest at the maximum rate permitted to any state-chartered or licensed lending institution by the law of that state.⁸ This is referred to as the most favored lender doctrine. If state law permits different interest charges on specified classes of loans, a national bank making such loans is subject only to the provisions of state law relating to that class of loans that are material to the determination of the permitted interest.⁹ For example, a national bank may lawfully charge the highest rate permitted to be charged by a state-licensed small loan company, without being so licensed, but subject to state law limitations on the size of loans made by small loan companies.¹⁰

The OCC interpretation defining interest to include late fees and, thus, making late fees exportable, was upheld by the U.S. Supreme Court in *Smiley v. Citibank (South Dakota), N.A.*¹¹ This decision established the validity of the OCC interpretation of the term "interest" and of Section 85.

The OCC has also deemed certain additional fees to constitute interest in Interpretive Letters. A 1997 OCC Interpretive Letter discussed certain fees levied in connection with home equity loans and concluded that (1) an account opening fee, (2) a fee for exercising a fixed rate option, (3) a fee for prepaying a fixed rate option, and (4) a fee for early closure of the account, constitute "interest" for purposes of Section 85 and 12 C.F.R. section 7.4001(a).¹² The fees constituting interest may be assessed by a national bank if similar charges may be imposed by another lender in the state

1. 12 U.S.C. § 1831d(a) (also referred to as § 27 of the Federal Deposit Insurance Act or § 521 of the Depository Institutions Deregulation and Monetary Control Act of 1980).

2. See *infra* this text Pt. III.

3. There may be other types of preemption available based on loan type, such as preemption based on the Alternative Mortgage Transactions Parity Act or § 501 of the Depository Institutions Deregulation and Monetary Control Act of 1980 relating to federally related mortgage loans. See 12 U.S.C. §§ 3801 *et seq.*; 12 U.S.C. § 1735f-7a.

4. 12 U.S.C. § 85. See generally *Beneficial National Bank v. Anderson*, U.S. No. 02-306, 123 S. Ct. 2058, 2003 WL 21251449 (June 2, 2003).

5. 12 CFR § 7.4001(a).

6. *Id.*

7. *Id.*

8. *Id.* § 7.4001(b).

9. *Id.*

10. *Id.*

11. 116 S.Ct. 1730 (1996).

12. OCC Interpretive Letter from Julie L. Williams, Chief Counsel (Oct. 7, 1997).

where the national bank is located, without reference to whether these fees are denominated as "interest" under state law.¹³ These fees also may be charged without reference to whether they are permissible under the laws of another state where the borrower may reside.¹⁴ A 1998 OCC letter concluded that late fees and non-sufficient funds fees imposed by a national bank in connection with its credit card accounts after either the bank or the customer notifies the other that they are terminating credit privileges but before the outstanding balance is paid off constitute "interest" under Section 85 and thus are exportable if the bank's home state's law permits such fees.¹⁵ A 1996 OCC Interpretive Letter found that prepayment fees constitute interest for purposes of Section 85.¹⁶ Thus, certain fees beyond those listed in the OCC rule have been identified as "interest-like" fees.

In determining those fees that are interest, the OCC has cited the United States Supreme Court's decision in *Smiley v. Citibank (South Dakota) N.A.*, upholding the definition of interest in section 7.4001(a) and stating that it seems quite possible and rational to distinguish, as the regulation does, between those charges that are specifically assigned to expenses and those that are assessed for simply making the loan or for the borrower's default. The OCC has recognized a distinction between fees that compensate the lender for the use of money and therefore are "interest," and fees specifically assigned to cover the cost of an activity or service.¹⁷

The term interest does include certain interest-like fees, but does not include all fees. To determine if a fee is interest-like requires an examination of the fee

and the OCC letters and regulations providing guidance on this issue. In considering fees not specifically mentioned by the OCC and based on the OCC interpretive ruling and letters, fees closely related to the actual lending of money or features of a credit plan and that represent return to the lender are included in interest, whereas fees to cover the cost of an activity or service or to reimburse third parties are not interest.

The FDIC has opined that section 521 of the Depository Institutions Deregulation and Monetary Control Act of 1980 and Section 85 of the National Bank Act have been and should be construed in pari materia because section 521 is patterned after Section 85 and the provisions embody similar terms and concepts.¹⁸ According to the FDIC Congress also clearly intended to establish competitive equality between state-chartered lending institutions and national banks with regard to interest rates by enacting section 521.¹⁹ Thus, section 521 preemption of interest available to FDIC-insured state-chartered banks extends to interest-like fees in the same manner as Section 85.

IV. True or False: Interest Rate Preemption Available to FDIC-Insured State-Chartered and National Banks Extends to All Loan Terms and Disclosures

False. Preemption may apply to certain state law disclosure requirements and loan term restrictions that impact "interest."²⁰ However, a careful reading of the language of section 521 and Section 85

and an analysis of their impact is required to reach this conclusion. For example, state laws that impose notification periods or limitations on retroactive application in the context of changes in the interest rate may operate to delay or condition the imposition of "interest" charges otherwise permitted under section 521 or Section 85, applicable home state law, and the governing contract. To the extent that compliance with such foreign state laws could affect the rate, amount, or timing of interest that a bank may ultimately collect, such laws may be deemed preempted as impermissible restrictions on a bank's lending authority. Alternatively, such state law provisions can be characterized as consumer protection provisions designed to protect consumer borrowers from unconscionable changes in existing contracts, rather than as restrictions on permitted "interest."

In considering similar issues under the Depository Institutions Deregulation and Monetary Control Act of 1980, the United States District Court for the Northern District of Illinois took a narrow view of the scope of preemption available under section 501.²¹ Section 501 preempts state laws expressly limiting the rate or amount of interest, discount points, finance charges, or certain other charges. The court found that an Illinois statute prohibiting a lender from charging interest for any period after repayment of the principal was not preempted by section 501.²² The court found that the Illinois law did not limit the rate or amount of interest.²³ The court held that as the Illinois law did not restrict the rate or amount of interest, the Illinois law was not preempted by section 501, which only preempts state laws limiting the rate or amount of interest.²⁴

18. FDIC Letter No. 10 from James D. La Pierre, Dep. Exec. Sec. (Apr. 17, 1998).

19. *Id.*

20. This article was written prior to the release of the OCC proposed amendments to 12 CFR § 7.4000, 68 Fed. Reg. 6363 (2003). As the proposed rule has not been issued as a final rule, this article does not address the potential impact on national bank preemption of the proposed amendments to § 7.4000. This article was also written prior to the decision in *American Bankers Ass'n v. Lockyer*, No. CV 5-02-1138 FCD JFM, 2002 WL 31941511 (E.D. Cal., Dec. 23, 2002), in which a California federal district court invalidated on federal preemption grounds the entire California minimum payment periodic statement disclosure law (Cal. Civ. Code § 1748.13) with respect to national banks, federal savings banks, and federal credit unions. The case is on appeal to the U.S. Ninth Circuit Court of Appeals. The lower court decision supports the position that burdensome disclosure laws are preempted as to national banks.

21. 12 U.S.C. § 1735f-7a.

22. *Larsen v. Countrywide Home Loans*, 2001 WL 803689 (N.D. Ill. July 17, 2002).

23. *Id.*

24. *Id.*

13. *Id.*

14. *Id.*

15. OCC Interpretive Letter from Julie L. Williams, Chief Counsel (Jan. 7, 1998).

16. OCC Interpretive Letter No. 744 from Julie L. Williams, Chief Counsel (Aug. 21, 1996).

17. OCC Interpretive Letter from Julie L. Williams, Chief Counsel (Oct. 7, 1997).

V. True or False: The State Law of Any State in Which a Bank Has Offices Can Be Used for Purposes of Exporting Interest Rates

Not necessarily. Banks need to evaluate where various key functions of their lending operations occur prior to choosing to rely on the law of any particular state in which the bank has offices.

Section 85 of the National Bank Act, section 521 of the Depository Institutions Deregulation and Monetary Control Act of 1980, and section 1463(g) of the Home Owners' Loan Act permit exportation of the rate of interest of the state where the bank is "located."²⁵ Section 85 has been interpreted by the U.S. Supreme Court to authorize exportation of interest rates, and this analysis has been extended to FDIC-insured institutions and federal savings banks.²⁶

Since the Supreme Court's decision in *Marquette*, the OCC has issued several interpretive letters discussing the location issue. The OCC has recognized that a bank is "located" in more than one state for purposes of Section 85 if it has its main office and/or branches in more than one state.²⁷ Whether the laws of one of those states could be applied depends on whether there is a nexus between the loan transaction and the main office or a branch office of that bank located in the state the laws of which the national bank seeks to apply.²⁸ When a loan is originated and booked and loan funds are disbursed at a branch of a bank located in a state other than that bank's main office state, an appropriate nexus exists between that loan and the interstate branch office to justify imposition of interest rates permitted by the law of the state where the

branch is located.²⁹ The OCC has opined that a multistate national bank can charge "interest" under Section 85 at the rate allowed by the laws of the state where the bank has a branch to credit card customers no matter where they may reside.³⁰

Most recently, the OCC examined whether the state law of the home or host state applies when a national bank is making loans in a state in which it has a branch.³¹ The OCC found that the mere presence of a host state branch does not defeat the ability of a national bank to apply its home state's rate to loans made to borrowers who reside in the host state.³² The OCC identified three non-ministerial functions that needed to be evaluated: (1) approval; (2) disbursement; and (3) extension of credit.³³ The location of approval is where the person is located who makes the final judgment of approval or denial.³⁴ If a loan is subject to non-discretionary criteria that will be applied mechanically, the loan is approved where the decision to apply the criteria to the loan is made.³⁵ If a loan previously rejected by the non-discretionary criteria is then reviewed and approved at the branch, final approval is non-ministerial and the site of final approval is the location where the loan is granted.³⁶

The OCC recognized that disbursement can occur in many ways, but when a bank gives a customer the proceeds in person or credits the borrower's account at a branch, the funds are "disbursed" at the branch.³⁷ If the funds are disbursed to an escrow agent who disburses them, the disbursement to the customer becomes min-

isterial.³⁸ An extension of credit is located at the site from which the first communication of final approval comes.³⁸ The OCC stated that closing of loans is ministerial.⁴⁰ The OCC concluded that an interstate national bank may charge interest permitted by the laws of its home state unless the loan is made, that is the loan is approved, credit is extended, and funds are disbursed, in a branch or branches of the bank in a single host state. Likewise, loans by interstate banks could be considered to be "made" in a host state if each of the three non-ministerial functions occurs at a branch or branches in that host state.⁴¹ The FDIC has adopted the OCC location analysis and examines the location of non-ministerial functions in determining where a loan is made.⁴²

Based on the above, a bank may export interest rates from a branch state provided each of the three non-ministerial functions identified by the OCC occurs in that state. If less than all three occur in the branch state, the answer is less certain.

VI. True or False: National Banks Do Not Have to Comply with Any State Laws Outside Their Home State

False. National banks are not subject to state law if the state law conflicts with, or frustrates the purpose of, federal legislation or disrupts national banks in their performance as federal "agencies."⁴³ National banks are brought into existence under federal legislation, are instrumentalities of the federal government, and are necessarily subject to the paramount authority of the United States, but are also subject to laws of a state, unless such laws

25. 12 U.S.C. §§ 85, 1463(g), 1831(d).

26. See *Marquette Nat'l Bank of Minn. v. First Omaha Service Corp.*, 439 U.S. 299 (1978).

27. OCC Interpretive Letter No. 686 from Julie L. Williams, Chief Counsel (Sept. 11, 1995); OCC Interpretive Letter No. 707 from Julie L. Williams, Chief Counsel (Jan. 31, 1996).

28. *Id.*

29. *Id.*

30. OCC Interpretive Letter No. 782 from Julie L. Williams, Chief Counsel (May 21, 1997).

31. OCC Interpretive Letter from Julie L. Williams, Chief Counsel (Feb. 17, 1998).

32. *Id.*

33. *Id.*

34. *Id.*

35. *Id.*

36. *Id.*

37. *Id.*

38. *Id.*

39. *Id.*

40. *Id.*

41. *Id.*

42. FDIC Letter No. 11 from Robert E. Feldman, Executive Secretary (May 18, 1998).

43. *Anderson Nat'l Bank v. Lueckett*, 321 U.S. 233 (1944); *First Nat'l Bank v. Missouri*, 263 U.S. 640 (1924); *Davis v. Elmira Sav. Bank*, 161 U.S. 275 (1896).

interfere with the purposes of their creation, tend to impair or destroy their efficiency as federal agencies, or conflict with the paramount law of the United States.⁴⁴ This concept is referred to as the federal instrumentality doctrine.

Based on this doctrine, national banks are exempt from state licensing, supervision, and examination requirements, except with respect to state unclaimed property and escheat laws.⁴⁵ State licensing statutes and “any significant regulatory condition” placed on exercise of a national bank’s powers by state law are preempted by the comprehensive regulatory scheme of the National Bank Act, except where the National Bank Act specifically defers to state law as to certain issues.⁴⁶

National banks are also protected by the “visitorial powers doctrine.” In 1999, the OCC revised 12 C.F.R. section 7.4000 regarding Books and Records of National Banks to clarify the extent of the OCC’s visitorial powers under 12 U.S.C. section 484 and other federal statutes.⁴⁷ Section 7.4000 codifies the definition of visitorial powers, and illustrates what visitorial powers include by providing a non-exclusive list of these powers, including: (1) examination of a bank; (2) inspection of a bank’s books and records; (3) regulation and supervision of activities authorized or permitted under federal banking law; and (4) enforcing compliance with any applicable federal or state laws concerning those activities.⁴⁸ The rule states that only the OCC or an authorized representative of the OCC may exercise visitorial powers with respect to national banks, except as provided in paragraph (b) of section 7.4000. State officials may not exercise visitorial pow-

ers with respect to national banks, such as conducting examinations, inspecting or requiring the production of books or records of national banks, or prosecuting enforcement actions, except in limited circumstances authorized by federal law.

Thus, national banks are not required to obtain state licenses or subject themselves to state examinations. However, national banks must comply with other state laws that do not frustrate their purpose as a national bank, such as laws governing consumer protection, commercial relationships, contracts, real property, unfair and deceptive practices, insurance, the Uniform Commercial Code, and other statutory and case law restrictions, prohibitions, and requirements.

VII. True or False: Federal Savings Banks Do Not Have to Comply with Any State Laws

False. While federal savings banks have broad federal preemption based on federal statutes and regulations, the regulation that lists thirteen categories of state laws that are preempted also lists six categories of state laws that are generally not preempted.

Federal savings banks have interest rate preemption similar to national banks and FDIC-insured state-chartered banks based on section 1463(g)(1) of the Home Owners’ Loan Act and Office of Thrift Supervision (OTS) regulations section 560.110. In addition, section 4(a) of the Home Owners’ Loan Act authorizes the OTS to promulgate regulations affecting the operations of federal savings banks.⁴⁹ The United States Supreme Court found that the OTS regulation regarding due-on-sale clauses should be upheld as a valid exercise of the OTS’ plenary power to regulate lending practices by federal thrifts.⁵⁰ This ruling indicates that the OTS has the authority to issue regulations

that preempt state restrictions on lending otherwise applicable to a savings bank.

The OTS regulations provide that federal savings banks may extend credit as authorized under federal law without regard to state laws purporting to regulate or otherwise affect their credit activities, except to the extent provided in paragraph (c) of section 560.2 (*see below*) or section 560.110 (permitting a federal savings bank to charge interest and certain fees at the maximum rate permitted to state-chartered or licensed lending institutions under the laws of the state in which it is located).⁵¹ For purposes of section 560.2, “state law” includes any state statute, regulation, ruling, order or judicial decision.⁵² Except as provided in section 560.110, the types of state laws preempted by paragraph (a) of section 560.2 include, without limitation, state laws purporting to impose requirements regarding:

- Licensing, registration, filings, or reports by creditors;
- the ability of a creditor to require or obtain private mortgage insurance, insurance for other collateral, or other credit enhancements;
- loan-to-value ratios;
- the terms of credit, including amortization of loans and the deferral and capitalization of interest and adjustments to the interest rate, balance, payments due or term to maturity of the loan, including the circumstances under which a loan may be called due and payable upon the passage of time or a specified event external to the loan;
- loan-related fees, including without limitation, initial charges, late charges, prepay-

44. *Bank of America v. Lima*, 103 F. Supp. 916, 918 (D. Mass. 1952).

45. *See, e.g.*, 12 U.S.C. § 484; OCC Interpretive Letter from William B. Glidden, Ass’t. Dir., Legal Advisory Services Div. (Sept. 5, 1989).

46. *Id.*; *see also* OCC Interpretive Letter from Roberta W. Boylan, Asst. Dir., Legal Advisory Servs. Div. (Nov. 20, 1980).

47. 64 Fed. Reg. 60092-01. In February, 2003 the OCC issued a proposed rule amending § 7.4000 to further address the scope of the visitorial powers. *See* 68 Fed. Res. 6363; *supra* note 20.

48. 12 CFR § 7.4000.

49. 12 U.S.C. § 1463(a).

50. *See Fidelity Fed. Sav. & Loan Ass’n v. de la Cuesta*, 458 U.S. 141 (1982).

51. 12 CFR § 560.2(a).

52. *Id.*

