Federal and State Regulation of Financial Services: Competition and the Search for Comity

By Joseph A. Smith, Jr.

I. Introduction

This article addresses the conflict and competition between the federal and state governments (and sometimes local governments) over the primacy of jurisdiction with regard to financial services. This issue has many manifestations. This article will focus on one in particular: the continuing debate about predatory lending.

II. Background

To begin with a statement of the obvious: in discussing federal/state relations, we are talking about the relationship of sovereign governments to each other. New York and North Carolina, for example, were sovereign states before the United States existed and were present at the creation of the federal government. Although most states do not share New York's and North Carolina's historical precedence of the United States, formation of a sovereign state always precedes entry into the Union.

Further, the states are traditionally the "senior circuit" in financial services regulation. Banking under state charters has been conducted continually in New York since 1791 and in North Carolina since 1804. At the time of enactment of the National Bank Act, state-chartered institutions had been in operation more than fifty years.

The authority of states in regulating and supervising banking organizations has been profoundly limited and challenged over time by the successful assertion of federal power, deregulation, and changes in the market place. These developments are related and it is difficult (and probably unnecessary) to determine which came first.

Notwithstanding the challenges just mentioned, state-chartered banking organizations currently comprise well over half the commercial banking organizations in the United States, over forty percent of the assets controlled by such organizations, and two-thirds of the new institutions formed in the recent past. The dual banking system is alive and well, and I believe there is general agreement that that's a good thing.

This is not the case with consumer protection. There is currently tension, if not conflict, between the federal government and at least some states involving the assertion by states of jurisdiction over the mortgage banking and brokerage subsidiaries of national banks and over the applicability to national banks and their subsidiaries of state laws that address predatory lending. The air is thick with learned and passionate correspondence. The Office of Thrift Supervision (OTS) has expressly preempted the field and the Office of the Comptroller of the Currency (OCC) is warming up to do the same. As custodian and enforcer of the oldest state predatory lending statute, I would like to respond to a recent statement of the federal case by the Comptroller of the Currency and to make a few suggestions about how we can move toward greater comity.

III. North Carolina's Response to Predatory Lending

Let me begin by discussing North Carolina's response to predatory lending. Changes in the financial services marketplace, including the growth and development of large national and international institutions with immense reach and power, led to a variety of policy responses to address the mismatch in bargaining power between these institutions and consumers. These concerns are not often raised with regard to "prime" customers, such as large businesses or well-heeled individuals; rather, they involve small businesses and low and moderate income folks. Residential mortgage lending is a case in point.

Residential mortgage lending, formerly a "local" activity governed by state law and conducted by local depository institutions, has been revolutionized by the activities of government sponsored enterprises, deregulation, and the explosive growth and expansion of the securitization market. Residential mortgage products are now offered by banks, thrifts, mortgage bankers and brokers, and consumer finance companies. The competence, sophistication and ethics of these firms vary from world class to low-class. Further, the residential mortgage business is fee-and-volume-driven. Given these market conditions, vulnerable and unsophisticated borrowers can and do get taken advantage of, with a devastating impact on their lives.

North Carolina's predatory lending law was a response to conduct by a variety of firms in respect of unsophisticated consumers that led to results that can only be described as unconscionable. Upon investigation, it was found that much of the conduct in question complied with then-applicable federal laws and regulations. It was then that the North Carolina General Assembly acted in 1999 to address these inequities. The North Carolina predatory lending statute does so by limiting or prohibiting: (1) certain fees and charges (including single premium credit life) applicable to high cost loans; and (2) unconscionable lender conduct such as "flipping."

In 2000, the North Carolina General Assembly enacted the Mortgage Lending Act (MLA), under which mortgage bankers, brokers and loan officers (other than those affiliated with exempt persons, including banks or subsidiaries of banks) must be licensed by my office. The MLA also confers on me expansive enforcement power to address market abuses. In 2001, the MLA was amended to allow "exclusive," meaning limited, licensing for the employees of firms such as consumer finance and insurance companies.

These two North Carolina statutes were the result of lengthy and detailed negotiations involving representatives of government, non-profit organizations, and the financial services industry, including banks and mortgage bankers and brokers. I believe that the result has been effective legislation that promotes the public interest without inhibiting the conduct of good business or access to home mortgage credit by those in need of it. This opinion is not universally shared.

IV. Comptroller Hawke's Exchequer Club Speech

On April 16, 2003, Comptroller of the Currency John D. Hawke, Jr. delivered remarks at the Exchequer Club in Washington, D. C. Among the topics he discussed were predatory lending and preemption.

Stating at the outset that "there is no question that predatory lending is a real concern," Comptroller Hawke then discussed the potential impact of the long-established doctrine of federal preemption as it affects the application of state and local predatory lending laws to national banks and their subsidiaries. He expressed concerns about the potential adverse impact of such laws on the subprime market in terms of (1) additional cost of compliance, and (2) the potential reduction of credit to deserving subprime borrowers. Comptroller Hawke then discussed OCC's handling of subprime lending, which he said was:

> … a better approach. Rather than focusing on the features of particular loan *products*, we focus on abusive *practices* – on preventing them in the first place, attacking them when they are found to exist, and providing restitution to those who have been victimized.

Comptroller Hawke went on to discuss the OCC's comprehensive guidance on predatory lending and the OCC's effectiveness in protecting consumers through its supervisory activities. He closed with a reiteration of the constitutional question raised by the application of state predatory lending laws to national banks and their subsidiaries.

As most readers are probably aware, the Comptroller's remarks on predatory lending and preemption were made in the context of an ongoing controversy regarding these issues, including: a pending request for a determination that Georgia's predatory lending statute is subject to federal preemption; a recent California case involving state licensure of the mortgage brokerage subsidiary of a national bank; and recent OCC guidance regarding, among other things, state "visitation" authority with respect to national banks and their subsidiaries. Although most of Comptroller Hawke's talk referred only to the Georgia statute, which has recently been substantially revised, it is important to note that he also commented critically on predatory lending laws generally and specifically referred to studies of laws adopted in Philadelphia, Chicago, and North Carolina, purporting to show that such laws adversely affect the availability of subprime credit.

V. A Response to the Comptroller

The Comptroller is an accomplished financial services lawyer and a distinguished public servant. Accordingly, what he says carries weight among policymakers. This being the case, a response to his Exchequer Club remarks is appropriate. This article will addresses in particular: (1) the impact of North Carolina's predatory lending law on the subprime market; and (2) the role state licensing legislation can play in policing the market.

A. Impact of North Carolina's Predatory Lending Law on the Subprime Market

Comptroller Hawke's assertion that the North Carolina law has reduced the availability of subprime credit is important for two reasons: (1) it can support an argument favoring preemption of the law; and (2) it suggests that provisions like those contained in the North Carolina law are not appropriate generally for adoption by other states or the federal government, should Congress choose to establish such standards. In his discussion, the Comptroller refers to a recent study by economists that, on the basis of a comparative analysis of Home Mortgage Disclosure Act (HMDA) data for the eighteen months before and after adoption of the North Carolina statute, concludes that "the North Carolina law decreased subprime lending in the state." While the Comptroller did not mention the study containing this analysis, one may assume for purposes of these remarks that he was referring to a study by Keith D. Harvey of Boise State and Peter J. Nigro of the OCC staff entitled "Do Predatory Lending Laws Influence Mortgage Lending? An Analysis of the North Carolina Predatory Lending Law," which I will refer to as the "OCC study."

Your author does not believe that a review of the actual impact of the North Carolina predatory lending law will support the conclusion that it has reduced needed credit to subprime borrowers. In support of that statement, I would point out that:

- Although my office gets over 1,200 formal consumer complaints a year, over two-thirds of which involve residential mortgage lending, we have not received even one complaint about a consumer's inability to obtain home mortgage credit. We get a lot of complaints about what happens when they do get credit.
- The number of mortgage bankers and brokers licensed by the Office of Commissioner of Banks under the Mortgage Lending Act today is approximately 1,300. The number of such enterprises registered with

my office in 1999 under prior law was approximately 1,300. Even correcting for formerly exempt enterprises (HUD approved mortgagees) that now must be licensed, which we estimate to be around 100, there has been little, if any, effect on the number of competitors in the market place. The OCC study agrees with this conclusion.

- A survey of 280 subprime branch managers and brokers by two analysts from that bastion of agrarian radicalism, Morgan Stanley, revealed that "84 percent of respondents thought changed lending practices were having a neutral to positive impact on volume … we have heard from a number of branch managers that the changes they have made to comply with the new lending laws may have increased origination volume, as potential customers feel more at ease with the loan process." Herewith a dirty little secret: perceived ethical operations can be a competitive advantage.
- A preliminary analysis of 2001 HMDA data by the Center for Community Self-Help suggests that subprime origination volume in North Carolina ($370 per person) is about six percent higher than in South Carolina, Tennessee, and Virginia combined ($347). The same analysis shows that subprime lending increased two and eight-tenths percent in North Carolina, while it was flat in South Carolina and down three and nine-tenths percent in Tennessee.
- It is of at least passing interest to note that predatory lending

legislation has been adopted or considered in each of the control states referred to in the OCC study.

While I understand the Comptroller's reasons for raising the issue of credit access, I do not believe that the case has been made that North Carolina's statute has had that effect. On the contrary, I believe a careful analysis of what's happening under our law is that North Carolina's statute has had a mild positive impact on the availability of credit or no impact at all.

B. How North Carolina's Mortgage Lending Act Addresses Broker Qualification and Conduct

While disagreeing with Comptroller Hawke's assessment of the predatory lending law, your author agrees strongly with his emphasis on prevention and remediation of abusive practices by mortgage lenders, brokers and loan officers. So does the North Carolina General Assembly. The North Carolina MLA, which supplements the state predatory lending law: requires market participants to be licensed by the Office of Commissioner of Banks; establishes industry standards for education, training and supervision; and provides my office with significant enforcement powers to address abusive practices. Here again, there is no evidence of an adverse impact on the market. To date, my office has processed 12,000 applications for various licenses under the MLA and new applications continue to arrive at a rate that has surprised us.

I believe that the MLA is "market friendly" in that it authorizes the Office of Commissioner of Banks to police the loan origination market. This should result in a better environment for well-run mortgage bankers and brokers and better product being sold into the secondary market. Despite some hiccups in the implementation of the MLA, the statute has the support of the mortgage industry, including three major participants that are affiliates of large national and multi-national banking organizations. Needless to say, I hope that state licensure has the support of the secondary market as well.

In spite of its benefits, I am concerned that the MLA will be made subject to federal preemption. The statute expressly exempts regulated financial institutions and their subsidiaries from the licensure requirement. It requires an exemption filing by such entities and does not exempt them from its provisions describing prohibited activities. I believe that the provisions of the MLA that apply to federally-chartered institutions and their subsidiaries should not be preempted, as they are not the assertion of regulatory power over such entities; rather, the MLA should provide a basis for cooperation between sovereigns in consumer protection. In particular, the exemption filing gives us a basis for referring consumer complaints to the applicable federal agency. This having been said, the National Credit Union Administration has already asserted preemption in its usual charming and flexible way; and I expect that OTS's response will be the same. This is unfortunate and counterproductive and I hope OCC will not follow suit.

VI. Conclusion

In his Exchequer Club speech, Comptroller Hawke ably analyzed the relationship of the preemption issue to overall public policy as follows:

> Unfortunately, the legal disputation over preemption tends to distract us from the real question: how best to deal with the problem of predatory lending in our communities, while ensuring that adequate credit remains available on reasonable terms to mortgage customers at all income levels. The nuances of preemption theory are unlikely to mean much to borrowers who either

have been burned by predatory lenders or denied credit in the first place.

Your author could not agree more. I believe that North Carolina's legislation to address predatory lending has been a valuable and successful experiment in balancing the twin policy goals to which he refers. I also believe that there are substantial bases for cooperation between state and federal agencies in this policy area that can be as effective as the cooperation that already exists in bank supervision. I hope that, with a display of discretion on the part of all parties, people of good will at all levels of government can devote their energies to addressing abusive and unconscionable conduct in the marketplace, rather than in disputes over preeminence.