Dr. Dave: In April, a federal judge blocked my state (Maryland) from enforcing state consumer protection laws against a bank. Don't states have the right to regulate banks?

A. Historically, Congress has established minimum standards for banking regulations. States have been allowed to enact additional rules and higher standards, particularly with regard to consumer protection. Over the past 15 years, however, the federal government has allowed banks to skirt state laws, and used its authority to overturn dozens of state consumer protection laws.

The United States has a "dual banking system". Banks can choose whether to be state-chartered and thus regulated by state banking agencies or federally chartered and thus overseen by the Office of the Controller of the Currency (OCC).[1]

The first state banks were chartered in the late 1700s. The federal government began chartering banks with the passage of the National Bank Act of 1863.[2] That Act created the OCC as an office of the Treasury Department. Its job was to oversee the banks that were formed to circulate a national currency and finance the Union's military during the Civil War. Most observers believed state banking systems would disappear as a result of competition from national banks, in part because state banks were subject to higher taxes than the federal banks. But state banks and the state banking system innovated and persevered and a dual banking system came into existence.

In 2000 and 2001, 70 percent of new banks were chartered by states. This has been the general pattern since 1985.

In 2005, there are nearly 6,000 state-chartered banks, representing 73 percent of total U.S. banks and 44 percent of total bank assets.[3] Thus, the states regulate the largest number of banks, but the OCC regulates the majority of banking assets.

The fact that banks can choose whether to be regulated by a state or the federal government puts the OCC in competition with states for regulatory fees. States typically offer lower examining fees. The advantage of a federal charter is that it offers national banks uniform rules throughout the country, rather than their having to comply with laws that vary from state to state. Over the past 15 years, the OCC is also offering federally chartered banks the promise that it will intervene to defend national banks against state regulations.

The OCC is in an unusual position among federal regulatory agencies in that it is entirely funded by fees collected from the companies it regulates. The Securities and Exchange Commission is also funded in this way, but there a company does not have a choice between state and federal regulation. Other agencies receive only a fraction of their budgets from fees, and the rest from general tax dollars. According to the *Wall Street Journal*, Bank of America alone pays $40 million a year in fees to the OCC, or about 10 percent of the agency's $400 million budget.

The OCC increasingly intervenes on the side of banks it regulates against states and consumer agencies. In 1991, the OCC told national banks they did not have to adhere to a New Jersey law requiring banks to offer low-cost, no frills checking accounts to low-income consumers. It has fought a Michigan law requiring lenders to disclose car loan terms, a Texas law barring banks from charging check cashing fees for checks drawn on their own customers' accounts, and laws in Iowa and two California cities regarding ATM service charges. (See *Rogue Agencies Gut State Banking Laws*, by Stacy Mitchell of ILSR for a more detailed discussion of OCC's activities in the 1990s).

In 1994, Congress issued a report castigating federal banking agencies for actions that are "inappropriately aggressive, resulting in preemption of State law in situations where the federal interest did not warrant that result".[4] But it has been unwilling to step in a stop the OCC from engaging in such practices. Indeed, in 1999, Congress passed the Graham-Leach-Bliley Financial Modernization Act, which, among other things, allows banks to sell insurance. Congress inserted into the law a provision that denied states the right to "prevent or significantly interfere with" national banks' ability to sell insurance. This was the basis upon which the OCC preempted insurance laws in West Virginia, Rhode Island, and most recently Massachusetts in January 2005. These laws prohibited bank employees from receiving a fee for referring

loan customers to a bank's insurance company, and from discussing insurance with loan applicants until after the loan had been approved.

Over the past five years the OCC has continued to override state authority. For example, in 2002 the OCC successfully challenged a California law that required credit card companies to disclose in their bills the number of months it would take to pay off credit card debt if the customer makes only the minimum monthly payment. Most striking, however, were two rules issued in 2004. First, the "preemption rule" blocked states from enforcing their anti-predatory lending laws against national banks. Second, the OCC asserted its "exclusive authority to supervise, examine, and regulate the national banking system", including exclusive enforcement authority for consumer protection laws.[5]

The 2004 rules were the basis for a federal judge's April 2005 decision to block Maryland from enforcing a state law that restricts prepayment fees imposed by mortgage lender against national banks or their subsidiaries. "In the end, [Maryland Commissioner of Financial Regulation Charles Turnbaugh] essentially advances a policy reason for why his office should be able to regulate operating subsidiaries and impose the Maryland prepayment restriction on them: in order to better protect Maryland consumers," wrote Judge Catherine C. Blake. "While the commissioner's concerns may be legitimate, the do not overcome the fact that the National Bank Act and the regulations promulgated by the OCC thereunder preempt his efforts to regulate National City Bank's subsidiaries."

In this case, as in all the cases cited above, Maryland retains its right to enforce its mortgage lending laws against state-chartered banks. But it cannot enforce the same laws against national banks. Your community bank, managed by people who live in your community, would be subject to more laws designed to protect the community's interests than the national banks run from offices thousands of miles away. Thus while states do not lose their authority to enforce laws, it must choose between doing so and having a level playing field for state and national banks.

Some representatives of the financial services industry have decided that the only way to create a level playing field for state and national banks is to virtually prohibit states from regulating the industry. In late May, the FDIC held hearings on a petition to preempt state banking laws and allow state-chartered banks to operate nationally under the laws of their homes states. The Financial Services Roundtable says the change is necessary if state banks are to compete with national banks.

Seven state attorneys general have filed a statement with the FDIC charging that it lacks the authority to preempt states' authority to "police their borders and protect their citizens."[6] National banks have been allowed to operate in all states under the banking laws of their home states since the late 1970s. Since then, some states (including South Dakota and Delaware) have relaxed their banking laws to allow high interest rates and penalties. National banks have in turn moved their headquarters to these states. The state attorneys general say a similar would facilitate a "race to the bottom" in state banking regulation.

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[1] The Federal Reserve and the Federal Deposit Insurance Corporation have roles as secondary regulators and auditors for both state and national banks.

[2] Two central banks were previously chartered. The federal government created a 20-year charter for the First Bank of the United States in 1791 to deal with debt from the Revolutionary War. The Second Bank of the United States was established after the War of 1812. It too had a 20-year charter that was not renewed, in part because competition from state banks.

[3] National Conference of State Legislatures, 2004-2005 State Federal Policies for the Jurisdiction of the Financial Services Committee.

[4] Conference Report, Riegle-Neal Act of 1994.

[5] OCC News Release, April 7, 2004, NR 2004-28.

[6] Hannah Bergmann, "NY's Spitzer Talks Tough on OCC Preemption of His Lending Probe", *American Banker*, May 19, 2005.