

Remarks by
John D. Hawke, Jr.
Comptroller of the Currency
Before
The Federalist Society
Washington, D.C.
July 24, 2003

For more than two decades, the Federalist Society has been aiding in the analysis and understanding of complex policy issues. This morning's sessions brought together a particularly distinguished group of experts to discuss the problem of predatory lending and federalism. I'd like to express my gratitude to Jerry Loeser for the opportunity to address this important subject from my vantage point as the supervisor of the national banking system.

I should point out that the perspective of the Comptroller's Office embraces many others, including some that you've already heard this morning. It includes the interests of the national banking system itself. But it also embraces the interests of the communities and consumers the system serves, as well as the larger interests of the national economy that system was created to support.

For 140 years, the OCC has been an instrument of federal authority in an arena that, throughout that period, has been the subject of particularly vigorous controversy with the states. That's because the stakes in the financial arena – political as well as economic – are enormous. It's sometimes forgotten that the 1819 Supreme Court decision in McCulloch vs. Maryland, a great test case of our fledgling federalism, was at heart a banking case -- the first of many federal court decisions in which efforts by a state to assert control over a federally created banking institution have been overturned. Today,

the OCC continues to occupy a position at the leading edge of this historic confrontation between state and federal authority.

It should also be remembered, of course, that if the Congress that created the national banking system had had its way, federal dominance in banking would today be an accomplished fact and state banking would be a long faded memory. In the McCulloch decision, Chief Justice Marshall had memorably written that “the States have no power, by taxation or otherwise, to retard, impede, burden, or in any manner control the operations” of any agency created by lawful exercise of federal authority – in that case, the federally chartered Second Bank of the United States.

Specifically, the state of Maryland sought to tax the Second Bank, an effort that the Court firmly rejected, declaring that “the power to tax involves the power to destroy.” And destruction was exactly what Congress had in mind 46 years later when – disappointed with the volume of conversions from state charter to the new national charter – it passed the 1865 “death tax” on the notes of state banks.

As we know, state banks lived on by reverting to deposit banking. And as a result of their tenacity and adaptability, the dual banking system survived, eventually attaining a level of theological importance comparable to the family farm.

Today the relationship between state and federal banking authorities can perhaps best be described as one of constructive competition. To be sure, Congress has asserted far reaching control over state banks, primarily using the jurisdictional nexus of federal deposit insurance to subject state banks to a broad range of federal regulation relating not only to safety and soundness, but consumer protection among other areas.

But while Congress has ample authority to assert jurisdiction over state banks, the states' ability to affect the business of national banks is severely limited. It is a Constitutional principle as old and as hallowed as the Constitution itself, deriving from the Supremacy Clause, that creations of federal authority such as national banks are subject to state law only to a limited extent. State-imposed restrictions may not diminish their powers, but non-discriminatory state laws in areas such as contracts and torts – laws that facilitate rather than obstruct their ability to do business – are applicable.

So the Supreme Court has repeatedly declared over the past 140 years. Yet scarcely a month passes that the Court's previous rulings on the subject are not the subject of confrontation, as state lawmakers and enforcement authorities continue to attempt to push the boundary back by asserting the right to subject the business of national banks to state restrictions and to subject national banks to the enforcement programs of state agencies.

The OCC will, of course, continue to defend the right of national banks to be free from state efforts to regulate their business, even though our consistent record of success in court – not to mention some very explicit statutory language assigning OCC exclusive visitorial authority over national banks -- doesn't seem to prevent this issue from arising again and again.

Perhaps the most interesting of the current challenges to the immunity of the national charter from state regulation centers on the subject of today's conference. Enough has probably been said in this context about the Georgia Fair Lending Act (GFLA) to dispense with a detailed discussion of its particulars. But for those who will

be reading these remarks instead of listening to them, let me provide a brief summary of the Georgia law.

The GFLA imposes severe restrictions on so-called “high-cost” mortgage loans, requiring lenders who offer them to comply with a range of substantive and procedural requirements. The practices proscribed under the Georgia law include the financing of credit insurance, debt cancellation or suspension coverage, limitations on late fees and payoff statement fees, pre-payment penalties, negative amortization, increases in interest rates after default, and balloon payments. Certain categories of loans are restricted as to the number of times they could be refinanced and the circumstances under which a refinancing could occur.

Among the GFLA’s most controversial provisions is that relating to rights of action for damages against the purchasers and assignees – as well as the originators -- of the mortgages covered by the law. This provision threatened to do such harm to the secondary market for covered real estate loans that the Georgia legislature amended the law to modify the standard and narrow the kinds of loans to which the law would apply.

Since the law was passed and amended, much of the focus has been on whether or not federally chartered financial institutions would be subject to it. Shortly after the GFLA was enacted, the Office of Thrift Supervision determined summarily that it was inapplicable to federal savings institutions and their operating subsidiaries. In response to a petition from a national bank for a ruling on whether the GFLA would be preempted, the OCC, as required by the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994, gave public notice of the bank’s petition and asked for comment. Some 75

comments — representing a wide range of interested parties -- were received, and we expect our final decision to be released in the very near future.

There is a danger, however, that legal disputation over the preemption of state anti-predatory lending laws may distract us from the more important question: How do we best deal with the problem of predatory lending in our communities while avoiding the creation of impediments to the availability of nonpredatory subprime credit?

There's no question that predatory lending exists — and my definition of predatory lending is the aggressive marketing of credit to people who simply cannot afford it. Unscrupulous originators — almost always entities that are not banks or owned by banks — market such credit not based on the borrower's ability to handle it, but on the basis of the borrower's equity — a home. It's no surprise that such loans frequently result in foreclosures.

But the responses of many states and localities, while well-intentioned and aimed at driving financial predators out of business, may have the unintended effect of also making nonpredatory subprime credit harder to come by for those who may most need and deserve it. In Chicago, a municipal law that applied to banks, among others, had the perverse effect of driving more subprime mortgage lending into the nonbank sector, which is precisely where predatory practices are most prevalent. A Philadelphia law that was intended to target predatory lenders apparently persuaded some legitimate subprime lenders to withdraw from that market before the law had even gone into effect — and before the state itself enacted a law that prohibited the Philadelphia law from taking effect.

The North Carolina law has been especially well studied, and the results of those studies are revealing. Based on OCC's analysis, among the mainstream group of subprime borrowers – those with FICO scores between 580 and 660 – mortgage loan originations dropped a stunning 30 percent in the 18 months after the North Carolina law was passed. For the sake of comparison, the same kinds of loans in neighboring states without similar laws fell a scant 3 percent in the same period.

It's no mystery why so many fewer subprime loans are being made – or will be made -- in jurisdictions subject to anti-predatory statutes. Studies point to increased compliance costs, especially for banks operating in multiple jurisdictions, increased underwriting expenses, and legal liability issues that have persuaded subprime lenders to curtail that business or take it to places where no such laws exist. And there has been a reduced willingness on the part of securitizers and aggregators to buy loans originated in covered jurisdictions.

In Georgia, New York, and New Jersey, for example, where particularly stringent anti-predatory laws are in effect, both Fannie Mae and Freddie Mac have drastically reduced or even eliminated altogether their purchase of so-called “high cost” and other real estate loans. And the private investor secondary mortgage market in those states has been hard hit, particularly for subprime mortgages, because of actions taken by the rating agencies in reaction to those states' predatory lending laws. Moody's, Standard and Poors, and Fitch Ratings have all adopted policies that make it difficult, if not impossible, to pool loans originating in Georgia, New York, or New Jersey unless the issuer provides costly credit enhancements and/or certifications that the pool contains no proscribed loans.

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

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

That's exactly the approach we have taken. The OCC has put out the most comprehensive guidance produced by any of the federal banking agencies – and, I suspect, by any banking regulator – describing the kinds of abusive or predatory practices that will cause us to take action, making clear what our powers are, and urging all our banks to adopt policies to assure they do not get involved in such practices. In the past, we haven't hesitated to use our enforcement authority to combat unsafe, unsound, unfair, or deceptive practices. Indeed, OCC enforcement actions have resulted in restitution totaling hundreds of millions of dollars to consumers. And we have served notice that we will continue to do so in the area of predatory lending.

Our guidance makes clear that we expect national banks not only to adopt, but to adhere to policies and procedures designed to prevent predatory lending practices in both direct lending and in transactions involving brokered and purchased loans. We emphasize that it is the bank's responsibility to set standards that address – and avoid -- the central characteristics of predatory lending. Each national bank must make the kind of basic underwriting decision we would expect in the case of any loan – namely, that the

borrower has the capacity to service and repay the loan without resort to the collateral securing the loan. The guidance also requires national banks to perform adequate due diligence prior to entering into any relationships with loan brokers, third party originators, and the issuers of mortgage-backed securities, to ensure that the bank doesn't do business with companies that fail to employ appropriate safeguards against predatory lending.

It's also essential to recognize that while regulated banks have generally been brought within the scope of these laws, banks are not where the real problem exists. A joint Treasury Department-HUD report issued in 2000 found that predatory practices are least prevalent among institutions operating under federal oversight. "The subprime mortgage and finance companies that dominate mortgage lending in many low-income and minority communities, while subject to the same consumer protection law, are not subject to as much federal oversight as their prime market counterparts," the report notes. "The absence of such accountability may create an environment where predatory practices flourish because they are unlikely to be detected." In comments submitted in connection with an OTS rulemaking concerning preemption of state lending standards, 46 State Attorneys General echoed this view that predatory lending was largely confined to mortgage brokers and finance companies.

A coalition of State Attorneys General repeated the same position more recently in a brief filed earlier this year in connection with a challenge to that OTS rulemaking. "Based on consumer complaints received," the AGs stated to a federal court, "as well as investigations and enforcement actions undertaken by Attorneys General, predatory lending abuses are largely confined to the subprime mortgage lending market and to non-

depository institutions. Almost all of the leading subprime lenders are mortgage companies and finance companies, not banks or direct bank subsidiaries.”

From this perspective, then, I think it can be understood why we believe that national bank preemption of the Georgia Fair Lending Act should not be viewed with alarm. The interests of those this law intends to protect are effectively protected – at least as far as national banks are concerned -- through our supervisory process. Our approach not only protects consumers where abusive practices are found, it also avoids the overbroad and unintended adverse effects of those one-size-fits-all laws – effects that, as we’ve seen, can be almost as harmful as the problem those laws were designed to address.

Preemption is a doctrine with almost 200 years of history and constitutional precedent behind it. The OCC didn’t invent it; we apply it. In preemption situations, the only relevant issue is whether the state law would impair or interfere with the national bank’s exercise of powers granted to it under federal law. If such an impact is found to exist, federal law must prevail – just as it has prevailed for two centuries.



Comptroller of the Currency
Administrator of National Banks

Washington, DC 20219

July 30, 2003

Clarification

The statistic concerning a decline in loan originations for North Carolina borrowers with FICO scores in the 580 – 660 range mentioned in the Comptroller's speech was based on data presented in tables contained in a study by Quercia, Stegman, and Davis. We have since learned, from discussions with the authors, and our own continuing analysis of material presented in the paper, that the database from which the tables were derived is more complex and involves variables and uncertainties not apparent from the tables themselves. Based on our current understanding of the data, we now believe that our initial conclusion regarding a specific percentage decline in originations could not properly be derived from the study's tables and therefore was mistaken.

The basic point the Comptroller was making continues to be valid, namely that there is a danger that broad-based laws, however well-intentioned, may have an unintended adverse impact on the availability of non-predatory subprime credit. This view is supported by other studies that provide evidence that subprime lending has declined in states and localities following adoption of predatory lending legislation.



BNA's

Banking Report

Volume 81 Number 04
Monday, July 28, 2003
ISSN 1522-5984

Page 160

Legal News

National Banks

Chicago-Style Fair Lending Ordinances Do Not Raise Preemption Issues, Hawke Says

State and local laws that require business-hungry banks to sign anti-predatory lending pledges are not subject to preemption by federal law, Comptroller of the Currency John D. Hawke Jr. said July 24.

Hawke, speaking one day after federal thrift regulators said federal law overrides a New Jersey fair lending statute, cited a Chicago ordinance as a "wrongheaded" but usable way to discourage abusive lending practices.

In August 2000, the Chicago City Council passed a measure that bars banks from accepting city deposits unless they sign a pledge not to engage in predatory lending as defined by the city's municipal code.

The pledge also binds bank affiliates. A similar pledge is required in connection with any other kind of contract with the city.

OCC Called Aggressive on Preemption

The OCC has drawn fire for what state regulators and other critics call an aggressive use of federal preemption when defending its regulation of the national banking system.

But according to Hawke, although the OCC may conclude that federal law preempts particular state laws or local ordinances, preemption issues are not implicated in Chicago-style measures that give lenders a choice.

"I don't think a preemption issue is raised by a state or municipality setting down the standards as to whom it will choose to do business with," Hawke said during a conference sponsored by the Federalist Society. "The bank can decide whether it wants to observe those conditions or not and the municipality or the state can deal with the consequences of eliminating certain kinds of providers of various sorts of services. I don't see that as raising a preemption issue," Hawke said.


Preemption Ruling on Georgia Law Due Soon

In other remarks, Hawke said the OCC will soon issue an opinion on whether federal law preempts the Georgia Fair Lending Act, a controversial statute that battles predatory lending by putting significant restrictions on "high-cost" mortgage loans.

The OCC has asked for comment on the matter, and will issue a final decision "in the very near future," Hawke said.

The Georgia law, while called onerous by the lending community, is less threatening than it

once was. As originally passed, the law made loan purchasers and assignees liable for predatory practices committed by loan originators. Georgia legislators, in response to intense lobbying from bankers, have since amended the law to ease some of those provisions.

Hawke's remarks came one day after the Office of Thrift Supervision released a legal opinion that said the federal Home Owners' Loan Act preempts the New Jersey Home Ownership Security Act of 2002. 

By R. Christian Bruce

Copyright © 2003 by The Bureau of National Affairs, Inc., Washington D.C.





NEWS RELEASE

Comptroller of the Currency
Administrator of National Banks

NR 2003-57

FOR IMMEDIATE RELEASE
July 24, 2003

Contact: Robert M. Garsson
(202) 874-5770

Comptroller Hawke Urges New Approach to Combating Predatory Lending

WASHINGTON -- Comptroller of the Currency John D. Hawke, Jr. said today that many well-intentioned efforts to combat predatory lending may be having the unintended result of impeding the flow of credit to creditworthy subprime borrowers.

In the first 18 months following passage of a predatory lending law in North Carolina, he said, it appears that mortgage loan originations to mainstream subprime borrowers dropped 30 percent. By contrast, the same kinds of loans in neighboring states dropped by only 3 percent in the same period.

“It’s no mystery why so many fewer subprime loans are being made – or will be made – in jurisdictions subject to anti-predatory statutes,” Mr. Hawke said. “Studies point to increased compliance costs, especially for banks operating in multiple jurisdictions, increased underwriting expenses, and legal liability issues that have persuaded subprime lenders to curtail that business or take it to places where no such laws exist.”

In addition, he noted that, “In Georgia, New York, and New Jersey, for example, where particularly stringent anti-predatory laws are in effect, both Fannie Mae and Freddie Mac have drastically reduced or even eliminated altogether their purchase of so-called “high cost” and other real estate loans.”

Moreover, he added, the rating agencies have all adopted policies that make it very difficult to pool loans originating in Georgia, New York, or New Jersey unless the issuer provides costly credit enhancements and/or certifications that the pool contains no proscribed loans.

Mr. Hawke said state laws have generally failed because they take an “across-the-board, one-size-fits-all approach that punishes the good as well as the wrongdoers.”

There is widespread recognition – including affirmations by almost all state Attorneys General – that federally regulated financial institutions and their subsidiaries are not part of the problem. Yet most of these laws include such institutions, including those chartered under federal law, within their scope.

Mr. Hawke said a far more effective approach would be to focus on the abusive practitioners and let federal regulators bring to bear their formidable enforcement powers where they find abusive practices among the institutions they supervise.

The Comptroller said the OCC has put out the most comprehensive guidance produced by any of the federal banking agencies – and probably by any banking regulator – describing the kinds of abusive practices that will result in action by the OCC.

“In the past, we haven’t hesitated to use our enforcement authority to combat unsafe, unsound, unfair, or deceptive practices,” Mr. Hawke said. “Indeed, OCC enforcement actions have resulted in restitution totaling hundreds of millions of dollars to consumers. And we have served notice that we will continue to do so in the area of predatory lending.”

In addition to taking action against lenders that engage in unfair or deceptive marketing practices, the OCC has told banks that it is impermissible to make loans that cannot be repaid without recourse to the collateral – especially if that collateral is the borrower’s home.

The Comptroller noted that it is widely acknowledged that predatory lending is a problem that exists almost exclusively outside the banking industry – among mortgage bankers or finance companies. Indeed, a recent court brief filed by a coalition of nearly two dozen state Attorneys General stressed that they had not found predatory lending practices at banks or bank subsidiaries.

“From this perspective, then, I think it can be understood why we believe that national bank preemption of the Georgia Fair Lending Act should not be viewed with alarm,” he said, alluding to the possibility that Georgia’s anti-predatory lending law might be found to be inapplicable to national banks.

George customers of national banks and their subsidiaries will enjoy the substantial protections afforded by the OCC’s supervisory process, Mr. Hawke said.

“Our approach not only protects consumers where abusive practices are found, it also avoids the overbroad and unintended adverse effects of those one-size-fits-all laws – effects that, as we’ve seen, can be almost as harmful as the problem those laws were designed to address,” he added.

#

The OCC charters, regulates and examines approximately 2,100 national banks and 52 federal branches of foreign banks in the U.S., accounting for more than 55 percent of the nation’s banking assets. Its mission is to ensure a safe and sound and competitive national banking system that supports the citizens, communities and economy of the United States.