

Chicago Fed Letter

Federal preemption of state bank regulation: A conference panel summary

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The Chicago Fed's 42nd Annual Conference on Bank Structure and Competition, which took place May 17–19, 2006, included a panel on federal preemption of state banking regulation. The panelists discussed the wide-ranging impact of rules issued by the Office of the Comptroller of the Currency, the federal agency that regulates national banks.

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In its new rules issued in 2004, the Office of the Comptroller of the Currency (OCC) said that its regulations “pre-empt”—that is, override—a number of state laws that conflict with a national bank’s exercise of its banking powers.¹ Preemption is a particularly timely issue in the Federal Reserve’s Seventh District, where the Illinois Speaker of the General Assembly recently requested that official state entities not patronize banks that do not comply with Illinois state law.² In this *Chicago Fed Letter*, we briefly review the issues surrounding the preemption debate and summarize the panelists’ comments.

The panel on preemption brought together banking and legal experts to discuss the implications for the U.S. banking industry. Among them were Philip Strahan, associate professor of finance, Carroll School of Management, Boston College; Arthur Murton, director, Division of Insurance and Research, Federal Deposit Insurance Corporation (FDIC); James Roselle, associate general counsel, Northern Trust Corporation; Arthur Wilmarth, professor of law, George Washington University Law School; and Hal Scott, the Nomura Professor and director of the Program on International Financial Systems at the Harvard Law School. Douglas Evanoff, senior financial economist and vice president, Federal Reserve Bank of Chicago, moderated

the session, which was cosponsored by the Chicago Fed and the George J. Stigler Center at the University of Chicago.

The preemption debate

In the United States, banking is regulated by a complex web of national and local regulatory bodies. State banks (those chartered at the state level) are supervised by either the Federal Reserve System (FRS) or the Federal Deposit Insurance Corporation and by their chartering state. In contrast, national banks (those chartered at the national level) are supervised by the OCC, a division of the U.S. Department of the Treasury, and (currently under debate) are subject to many of the laws of the states in which they, and their subsidiaries, operate.³ This two-charter model spawned the dual banking system, discussed in greater detail in this article.

For most of this nation’s history, banks were largely prohibited from expanding either inside or outside the state in which they were headquartered. While restrictions on *intrastate* expansion were gradually eliminated through changes in legislation, many restrictions remained with regard to *interstate* branching. The passage of the Riegle–Neal Interstate Banking and Branching Efficiency Act (IBBEA) of 1994⁴ removed the remaining federal restrictions on interstate

expansion. Strahan discussed the staggering expansion of multistate banks that has resulted; between 1995 and 2005, the number of out-of-state bank branches in the United States grew from under 100 to almost 25,000.⁵ As a result of their new multistate operations, banks found themselves subject to the regulations of every state in which they operate, in addition to various federal regulations.

The problem was that as banking organizations grew geographically, they found themselves subject to multiple, often contradictory, sets of state regulations. Banks then began to question whether they should be subject to state laws and began to lobby for a single set of regulations under which interstate banks and branches could operate. One result of this was the passage of the Riegle–Neal Amendments Act of 1997, which sought to streamline the regulations governing state banks by rectifying an unintended consequence of the original Riegle–Neal Act. The original act was thought to have disadvantaged state banks that branch into states with more restrictive laws by requiring these banks to adhere to the laws of their host states; meanwhile, national banks were, for the most part, not subject to the laws of their host states. The amendment sought to level the playing field by having host state laws apply to out-of-state state banks only to the extent that they apply to out-of-state national banks. The amendment also required the OCC to conduct an annual review of the applicability of state laws to national banks and to report its findings in its annual report.

The OCC increasingly asserted its power to preempt state laws for national banks and defended its right to do so in numerous court battles. It formalized its position on preemption in January 2004, when it issued rules that said state laws do not apply to national banks if such laws “obstruct, impair, or condition” the banks’ federally authorized activities and that only the OCC has “visitorial” powers for national banks.⁶ The problem for states was that the OCC’s regulations appear to preempt many state laws dealing with issues of fair lending and consumer protection.⁷ National banks

applauded the move, but state bank regulators argued that the OCC had overstepped its authority and, in so doing, had weakened consumer protections and fair lending requirements.

Benefits and costs of preemption

National banks typically favor preemption because it lowers their operating costs and eases the administrative burden of complying with multiple regulations. As Roselle explained, multiple sets of regulations are costly for banks not only because of the technology and training costs but also the increased likelihood of making costly administrative errors. As an illustration, he discussed the difficulty of complying with the state of Alabama’s regulations. If a bank inadvertently made a mortgage-backed real estate loan in Alabama without meeting the local business registration requirements, Roselle said, the loan could be declared void and uncollectible. Preemption helps banks avoid such risks by creating a single set of regulations for national banks operating across state lines. Those benefits should eventually be passed on to consumers in the form of lower prices.

to local risks. Finally, Strahan noted, it increases market oversight of financial institutions and improves the nation’s overall economic performance.

Preemption, however, could result in banks abandoning one regulatory system in favor of the other. If banks do so in large numbers, it could upset the balance of the dual banking system and alter its costs and benefits.

To some extent, such a shift has begun to occur. Preemption has intensified regulatory competition by making national charters more attractive, relative to state charters, to banks operating in multiple states. Increased competition, Strahan explained, could have one of two negative outcomes. First, it could result in a “race to the bottom,” in which banks play competing regulators off against one another, making the regulators unwilling to impose appropriate standards on the banks they regulate. Alternatively, it could result in a “single winner,” in which banks all migrate to a single regulator because that regulator relaxes its rules in some way to reduce the regulatory burden to banks. Strahan pointed out that in some markets this

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Preemption, Strahan argued, is part of a larger trend toward financial openness in banking, which in turn benefits both banks and consumers. For example, the increased openness allows firms to expand geographically and achieve greater economies of scale and scope. In fact, recent research has examined the effect of geographical deregulation on efficiency and pricing in the banking sector.⁸ These studies find that bank performance improves after geographical restrictions on bank expansion are lifted; operating costs are reduced and reductions are passed along to bank borrowers in the form of lower loan rates. Financial openness also allows banks to create more geographically diverse portfolios and become less vulnerable

has already happened; most credit card banks are now located in Delaware or South Dakota because of those states’ lenient usury laws.

Some level of regulatory competition, on the other hand, may be desirable. Strahan explained that competition is helpful because it limits regulators’ ability to tax an industry excessively. The dual banking system in the U.S., argued Wilmarth, has been successful largely because competition between regulators provides important checks and balances for oversight standards. These checks and balances are in danger of being lost, he suggested, because of the substantial threat to the dual banking system that OCC preemption raises.

State versus national charters

As a result of the OCC's new policy on preemption, this competitive balance has indeed shifted in favor of national banks, as they have opted for uniform OCC regulation; multistate banks are migrating to national charters. This trend has included several major banks,

Preemption: Recent events

As a direct result of the OCC's new regulations, the Financial Services Roundtable⁹ asked the FDIC to issue preemptive regulations that would restore some balance by giving state banks greater "parity" with national banks. The FDIC responded with its recent Notice of

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such as JPMorgan Chase and HSBC, which recently switched to national charters. Statistics also bear out this trend. For example, as Murton illustrated, the share of banking assets held by national banks had been around 55% since the mid-1980s but increased dramatically between 2003 and 2005 to 64% of assets. Similarly, Strahan showed that the share of deposits held by out-of-state national banks increased from 28% to 38% between 2004 and 2005 in states with predatory lending laws, while their market share in states without such laws remained fairly stable at around 29%. Meanwhile, the deposit share of in-state state banks fell from 37% to 30% over the same period in states with predatory lending laws. These statistics indicate that preemption has increased the attractiveness of the national charter for some banks and that banks are responding to these changes.

Not all banks, however, prefer national charters. In fact, the charter a bank chooses depends largely on its size. Murton showed that state charters still far outnumber national charters; in 2005 there were about 6,200 state-chartered banks versus only 1,800 nationally chartered banks. The lesson from these statistics is that smaller banks tend to choose state charters. Murton added that newly established (de novo) banks overwhelmingly choose state charters. Smaller-sized banks choose state charters in part, Roselle explained, because state regulators are seen as more accessible than national regulators and may be more responsive to banks' concerns.

Proposed Rulemaking.¹⁰ As Murton explained, the proposed rules would allow a state bank to operate anywhere under the laws of its home state to the same extent that a national bank operating in that host state can operate under national law.

The FDIC has received a mixed reaction to the proposal. Some letters praised the proposed rules because they would restore parity between state and national charters, while others argued that the FDIC does not have the authority to enforce the proposal. Wilmarth argued that the proposal does not go far enough to be truly effective. As he pointed out, the proposed rules would not apply to banks operating in states in which they do not have physical branches, nor would they apply to banks' operating subsidiaries.

Bank operations under the dual banking system

The panelists emphasized that banking has increasingly become a national, rather than a local, business. As stated earlier, the number of banks operating interstate branches has grown dramatically since IBBEA was enacted in 1994. This response, said Strahan, demonstrates that the ability to operate across state lines is valuable to banks.

Despite this growth, Roselle maintained that the current regulatory regime forces banks to build unnecessarily complex corporate structures to operate across state lines. He described Northern Trust Corporation's organizational structure, which is similar to that of many large banks. Its lead bank is an Illinois

state-chartered bank. But it also has national bank charters in four other states. The corporation operates trust companies in four states, one supervised by the OCC and the other three by state banking agencies. Finally, it has a federal savings bank (FSB) with branches in 16 states; it chose the FSB charter for the national branching capabilities associated with it. Such a complex organizational structure, Roselle argued, is undesirable for two reasons. First, operating multiple companies is costly and increases regulatory risks. Second, the complex framework makes it difficult for Northern Trust to meet its customers' expectation that they will be served seamlessly nationwide.

Alternatives to the current system

Several of the panelists suggested ways in which they thought the current regulatory system could be improved. Wilmarth argued that the courts should overturn earlier decisions allowing the OCC to preempt state laws. If they do not, he said, Congress should pass legislation to clarify that the OCC does not have the power of preemption. If neither occurs, Wilmarth argued, the viability of the dual banking system could be threatened.

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Another option would be to follow the Roundtable's proposal, which would allow a bank's home state to preempt the laws of other states in which that bank operates. This proposal would therefore increase parity between state and national charters by giving state banks an ability to operate under a single set of rules.

Unlike the other four panelists, Scott did not endorse modification of the current regulatory system for banks; instead, he advocated that this system be used as a model for regulation of the securities and insurance firms. Securities firms are regulated by both state and

federal authorities and are partially preempted from state laws, while insurance firms are regulated entirely by states and are exempt from federal regulations. Many of these firms, however, are operating in national markets and are subject to inefficient, overlapping regulation. Scott argued that they should be allowed to operate under federal regulation, preempted from state laws.

The debate goes to the Supreme Court

Shortly after this conference, the U.S. Supreme Court agreed to hear an appeal by the commissioner of the Michigan

Office of Insurance and Financial Services challenging the OCC's ability to preempt state laws. The commissioner is appealing a lower court's decision that upheld a national bank's right to operate in Michigan through an operating subsidiary that is subject to federal, and not state, laws and regulations. The outcome has not been decided; however, this case will likely set the stage for additional reaction by individual states.

¹ They explicitly preempt state laws governing deposit-taking and lending and also preempts other laws that interfere with a national bank's exercise of the powers granted to it by federal law. At the same time, the rules introduced stronger predatory lending regulations for national banks. The preemption regulations do not preempt state laws incidental to banking, such as contracts, torts, and zoning.

² Specifically, the Speaker asked that state agencies, pension funds, and state universities require banks, including national banks, to certify that they and their affiliates comply with the provisions of the Illinois High Risk Loan Act.

³ See Federal Reserve Board, 2005, *The Federal Reserve System: Purposes and Functions*, report, Washington, DC, June, available at www.federalreserve.gov/pf/pf.htm, for more information on bank regulation in the United States.

⁴ Pub. L. No. 103-328, 108 Stat. 2338 (1994) (codified in 12 U.S.C.).

⁵ These figures include only domestic branches of domestic commercial banking companies; see Christian Johnson and Tara Rice, 2006, "Assessing a decade of interstate bank branching," Federal Reserve Bank of Chicago, working paper, forthcoming.

⁶ Visitorial powers include examination of the bank, inspection of the bank's books and records, regulation and supervision of bank activities, and enforcement of compliance with applicable federal or state laws concerning those activities.

⁷ For contrasting views about the legality and wisdom of the OCC's regulations, see Arthur E. Wilmarth, Jr., 2004, "The OCC's preemption rules exceed the agency's authority and present a serious threat to the dual banking system and consumer protection," *Annual Review of Banking and Financial Law*, Vol. 23, pp. 225-364; and Howard N. Cayne and Nancy L. Perkins, 2004, "National Bank Act preemption: The OCC's new rules do not pose a threat to consumer

protection or the dual banking system," *Annual Review of Banking and Financial Law*, Vol. 23, pp. 365-410.

⁸ Sandra E. Black and Philip E. Strahan, 2002, "Entrepreneurship and the availability of bank credit," *Journal of Finance*, Vol. 67, No. 6, pp. 2807-2833; Jith Jayaratne and Philip E. Strahan, 1998, "Entry restrictions, industry evolution, and dynamic efficiency: Evidence from commercial banking," *Journal of Law and Economics*, Vol. 41, No. 1, pp. 239-273; Randall S. Kroszner and Philip E. Strahan, 1999, "What drives deregulation? Economics and politics of the relaxation of bank branching restrictions," *Quarterly Journal of Economics*, Vol. 114, No. 4, November, pp. 1437-1467.

⁹ The Roundtable is an industry group that represents 100 of the largest financial services companies that serve American consumers.

¹⁰ The FDIC notice is available at www.fdic.gov/news/news/financial/2005/fil10905.html.