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E-Mail (comments@FDIC.gov)

Robert E. Feldman, Executive Secretary
Attention: Comments/Legal ESS
Federal Deposit Insurance Corporation
550 17th Street, NW.
Washington, DC 20429

Re: Proposed Rule: Interstate Banking; Federal Interest Rate Authority
RIN 3064-AC95

We are writing this comment letter on behalf of one of our clients, a state-chartered FDIC insured non-member bank that makes consumer loans throughout the country. As the FDIC has recognized, state banks have been disadvantaged in their interstate lending operations by the fact that they remain subject to a patchwork of state laws, while national banks and federal savings associations take advantage of the broad federal preemption created by their charters and the powers Congress has conferred upon them. For example, unlike national banks, state banks are subjected to unnecessary legal uncertainties in the offering of debt cancellation or suspension as part of their loan agreements. Accordingly, we respectfully request that the FDIC clarify through this rule-making process two issues arising under Section 27 of the Federal Deposit Insurance Act ("Section 27"), 12 U.S.C. § 1831d. One proposed clarification would be limited to debt cancellation/suspension, while the other clarification would apply both to debt cancellation/suspension and other loan features.

The FDIC proposes to adopt: (1) regulations addressing interstate banking; and (2) regulations under Section 27. At the outset, we would like to applaud the FDIC's efforts to reduce the competitive disadvantage between state banks and national banks through the adoption of interstate banking regulations. Absent decisive action, it is likely that the dual banking system will continue to wither. Of course, the petition submitted by the Financial Services Roundtable at the beginning of the instant rule-making process requested a determination that state banks are subject to the laws of states outside the state of their incorporation ("foreign states") to the same extent as national banks. In the main, the FDIC does not propose to adopt this request. Instead, under the proposed interstate banking rule, preemption of foreign state law would only apply in the narrow case where: (1) the bank maintains an interstate branch in a foreign state (a "host state"); (2) a bank activity is "conducted" at the host state branch; ***and*** (3) a federal court or the Office of the Comptroller of the Currency (the "OCC") has determined in writing that a particular host state law does not apply to the activity.

While the proposed interstate banking rule is worthwhile, we fear it will not suffice to stem the tide of state banks converting to national bank charters. Ironically, we believe that the inclusion of appropriate clarifications of existing law in the final Section 27 rule could go far towards addressing this problem. These clarifications would create the certainty required to narrow the competitive disadvantages suffered by state banks regarding their interstate lending operations.

Recommendation One

Proposed 12 C.F.R. § 331.2(a) broadly defines "interest," as used in Section 27, to include "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." It goes on to provide a laundry list of "interest" charges. Finally, it identifies loan-related charges that do not constitute "interest." Proposed 12 C.F.R. § 331.2(a) is substantially identical to12 C.F.R. § 7.4001(a), the corresponding regulation for national banks, issued by the OCC under 12 U.S.C. § 85 ("Section 85").[1]

Increasingly, banks and savings institutions are offering borrowers the opportunity to include in their loan documents provisions that would result in the cancellation of indebtedness or the suspension of payments upon the occurrence of specified events, such as death, disability, involuntary unemployment or damage to cars and other products purchased on credit. These provisions can provide important protections to borrowers and promote bank safety, soundness and profitability.

Neither the laundry list of "interest" charges nor the laundry list of non-"interest" charges contained in proposed 12 C.F.R. § 331.2(a) refers to the charges banks impose for these loan features. This silence on the question places state banks in a difficult position, because they will remain subject to foreign state limits on these charges if the charges are ultimately determined not to constitute "interest." By contrast, even if debt cancellation and suspension charges are not treated as "interest," a national bank will be able to argue federal preemption under 12 U.S.C. § 24 (Seventh) and 12 C.F.R. § 7.4002.

While debt cancellation and debt suspension charges are not explicitly addressed in proposed 12 C.F.R. § 331.2(a), they fall squarely within the ambit of payments "compensating a creditor . . . for an extension of credit." As set forth in the OCC's debt cancellation/suspension

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[1] As recognized by the FDIC in proposed 12 C.F.R. § 331.1 and the preamble to the proposed rule, Sections 27 and 85 and their accompanying regulations are meant to be interpreted in *pari materia.*

regulation, at 12 C.F.R. §§ 37.2(f) and (g), debt cancellation and suspension agreements are "loan term[s] or contractual arrangement[s] modifying loan terms." Just as banks may increase interest charges to reflect greater risks associated with particular loan terms – for example, a long-term loan with a balloon payment or a second mortgage loan without a prepayment penalty – they may charge more for a loan where the lender bears the risk of the borrower's death or other adverse event. In each case, it is proper to classify the increased charge as a charge "compensating a creditor . . . for an extension of credit" and, hence, a component of "interest."

The list of non-"interest" charges in proposed 12 C.F.R. § 331.2(a) does not compel a different result. While credit and GAP insurance fill much the same function as a debt cancellation or suspension provision, there is a critical difference between the insurance premiums that are excluded from "interest" under the last sentence of 12 C.F.R. § 331.2(a) and the debt cancellation or suspension charges that are properly classified as "interest." Insurance charges, like each and every other enumerated non-"interest" charge, represent ***fees attributable to services rendered by a third party***. Indeed, the OCC has expressly recognized that the basis of the distinction between "interest" and non-"interest" loan charges in 12 C.F.R. § 7.4001(a) is whether the fee results from third party services. *See* OCC Interpretive Letter No. 744, 1996 OCC Ltr. LEXIS 121, *6 (Aug. 21, 1996) (treating a prepayment penalty as "interest" because it does "not constitute a charge that 'is specifically assessed' to cover the cost of an activity or service, such as those listed in [the final sentence of] section 7.4001(a), pertinent to making the loan").

Unfortunately, the proper classification of debt cancellation and suspension charges as "interest" has been somewhat muddied by some language in the preamble of the OCC release adopting its debt cancellation/suspension rule. In rejecting comments to establish fee limits for these credit features – and ***not*** in addressing whether debt cancellation/suspension fees constitute "interest" subject to limits under the laws of the state where the bank is located – the OCC observed that perceived problems in the credit insurance market would not necessarily apply to debt cancellation and suspension contracts. It went on to explain that the OCC is not in the business of setting fee restrictions:

> The OCC's regulations reflect the fact that national banks may set fees subject to standards of prudent banking practices. Section 7.4002 of our rules authorizes national banks to establish non-interest charges and fees "according to sound banking judgment and safe and sound banking principles." A bank satisfies this standard if it employs a decision making process to set fees that involves consideration of four factors identified in the regulation. The standards of § 7.4002 apply to the fees charged by a national bank for a [debt cancellation contract or debt suspension agreement].

67 Fed. Reg. 58962, 58964 (Sept. 19, 2002) (citation omitted). In light of this passage, we believe the FDIC should clarify that these charges are a form of "interest" under Section 27.

Recommendation Two

Proposed 12 C.F.R. § 331.2(b) provides in part as follows:

> If state law permits different interest charges on specified classes of loans, an insured state 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. For example, an insured state 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.

Once again, this language is virtually identical with the language of the corresponding OCC regulation. *See* 12 C.F.R. § 7.4001(b). Just as the FDIC proposes to codify in its regulation the Section 27 guidance it previously provided in its General Counsel opinions, it would be useful for the FDIC to codify in the final rule (or at least articulate in the explanatory material for the rule) existing OCC guidance pertaining to the meaning of the phrase "material to the determination of the permitted interest." Specifically, we suggest that the FDIC state that: (1) a provision of the state law authorizing the interest the bank is charging is necessarily "material" if it defines the transaction or transaction feature for which the interest charge is authorized; and (2) foreign state laws are preempted if they conflict with the restrictive ***or permissive*** aspects of the laws that are material to the determination of the permitted interest. The increased certainty resulting from this clarification would greatly assist state banks in lending interstate. While this clarification would not affect deposit and other bank products, it would significantly reduce the competitive disparities in lending powers that are threatening our dual banking system.

We do not believe it would be productive to attempt a precise definition of the meaning of the "materiality" concept as it applies to Sections 27 and 85. However, we believe it would be extremely useful to describe some laws that are necessarily "material" to the determination of the permitted interest. As suggested above, we would characterize the principal category of laws that fits this description as laws that define the transaction or transaction feature authorizing the interest charge. The example in the current draft of the proposed rule – limitations on the size of loans made by small loan companies – is a perfect case of a law defining the transaction or transaction feature permitting the interest charge. But, in our view, what is required is a more general articulation, since loan size is just one defining characteristic out of many.

The formulation we are proposing would not be breaking new ground. Indeed, the OCC has repeatedly stated that provisions of this type are "material." Thus, in OCC Inter. Ltr. 178, 1981 WL 57784 (O.C.C.) (Jan. 12, 1981) (the "1981 Fitzgerald Letter"), Richard V. Fitzgerald, the Director of the OCC's Legal Advisory Services Division, explained that "the transactions to which a specific interest rate may or may not apply under state law are 'material' to the determination of the rate of rate of interest." Subsequently, the Assistant Director of the OCC's Bank Operations and Assets Division amplified this point: "It has been determined that the amount of the loan, maturity of the loan, size of the loan and classes of borrowers are material to the determination of the interest rate. The common element among all these provisions is that they are characteristics of either the loan or the borrower." Feb. 26, 1993 Letter of Peter Liebesman, 1993 WL 501557 (O.C.C.) (footnotes omitted) (citing unpublished Feb. 4, 1983 Letter of Peter Liebesman). *See also* June 27, 1986 Letter of Harry W. Quillian, Acting General Counsel of the Federal Home Loan Bank Board (the "Quillian Letter") ("The OCC has interpreted provisions to be 'material' if they either set forth the characteristics of a category of loans or establish how the most-favored-lender numerical rate of interest is determined.").[2]

Significantly, it is not just "restrictive" provisions of state law that are "material." In 1988, Robert Serino, Deputy Chief Counsel (Policy) of the OCC, quoted *Mena v. Nowlin,* 509 F.2d 872, 876 (8th Cir. 1975), for the proposition that Section 85 "adopts the entire case law of the state interpreting the state's limits on usury; it does not merely incorporate the numerical rate adopted by the state."[3] OCC Inter. Ltr. 452, 1988 WL 284823 (O.C.C.) (Aug. 11, 1988) (the "1988 Serino Letter"). Mr. Serino went on to add: "In my opinion, the foregoing principle

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2 While the proposed formulation represents a properly broad formulation of the "materiality" concept, it does have its limits. Thus, the OCC concluded in the 1981 Fitzgerald Letter that normally a state-law "disclosure requirement . . . is not material to the determination of the interest rate." And before it adopted 12 C.F.R. § 7.4001(a), dividing loan charges into "interest" and non-"interest" charges, the OCC struggled over the years in determining whether state-law limits on specified charges were "material." *Compare* the February 4, 1992 of William P. Bowden, Jr., OCC Chief Counsel, 1992 WL 136390 (the "1992 Bowden Letter") (concluding that "any permitted or prohibited charge could well be considered material to the interest rate under state law"); and the November 24, 1980 Letter of Richard V. Fitzgerald, Director, OCC Legal Advisory Services Division (the "1980 Fitzgerald Letter") (same), with the 1993 Liebesman Letter (concluding that appraisal fees, late charges, nonsufficient check charges, cash advance fees and attorney fees are not material). The concept of "materiality" under Section 27 is closely related to the broader concept of "significant impairment" under *Barnett Bank, N.A. v. Nelson*, 517 U.S. 25, 33 (1996). A provision is not "material" to the determination of the permitted interest if the provision does not "impair significantly" the bank's exercise of its rights under Section 27. In the right circumstances, an overly burdensome state-law disclosure requirement might impair significantly a state bank's right to export interest charges under Section 27 and, hence, be considered "material" to the determination of the permitted interest.

3 This, of course, is a concept of "materiality" that goes well beyond the defining characteristic formulation we are proposing.

applies whether the 'provision of State law' that is 'material to the determination of the interest rate' is a specific provision that sets restrictions on the rates and terms of loan transactions or allows for certain fees or charges, or instead, is legislative silence by the state." *Id.* (citing "*Hiatt v. San Francisco National Bank,* 361 F.2d 504 (9th Cir. 1966), *cert. denied,* 385 U.S. 948 (1967) (silence regarding maximum permissible interest rate had same effect as statute allowing any rate of interest)).

And the OCC has repeatedly instructed that, in their interstate lending operations, banks are subject to these "material" provisions – and not conflicting laws of foreign states – whether these provisions are viewed as restrictive or liberal. *See* Letter from Roberta W. Boylan, Director, OCC Legal Advisory Services Division (Nov. 18, 1985) (the "1985 Boylan Letter") (stating that "a state law governing, *inter alia,* the frequency of interest-rate changes, whether restrictive or permissive, is 'material to the determination of the interest rate'"); the 1988 Serino Letter (stating that "a national bank which adopts the maximum permissible interest rate under the law of the state in which it is located also is subject to ***that state's*** law pertaining to the fee or provision. As demonstrated above, this is so whether state law permits the provision by affirmative legislation or by lack of legislation prohibiting it.") (emphasis added); the 1992 Bowden Letter (stating that "to the extent that Iowa [a foreign state] law concerning credit card interest and fees that are material to the rate of interest conflicts with the laws of other states where national banks issuing credit cards are located, Iowa law is preempted by 12 U.S.C. § 85."); . *See also* the Quillian Letter ("Moreover, 'material' state-law provisions may be exported, regardless of whether such provisions are permissive or restrictive.") (citing the 1985 Boylan Letter).

This means that, when a state bank charges interest under Section 27 on the basis of a state law permitting the charge for a loan with specified characteristics, the permitted rate of interest and the defining characteristics of the loan are incorporated into Section 27. Whether these characteristics are restrictive (*e.g.,* loans below a specified dollar threshold; loans to charitable organizations) or liberal (*e.g.,* loans to consumers or any loans at all), banks must comply with these "material" provisions of state law. They are not required to comply with corresponding provisions of foreign state law.

This broad concept of "materiality" and exportability is required to effectuate Congress' pro-banking policies underlying Sections 27 and 85. *See Marquette Nat'l Bank of Minneapolis v. First of Omaha Service Corp.*, 439 U.S. 299, 313-14 (1978) (holding that a bank may "export" nationwide the interest charges allowed by the laws of its home state, without regard to any more restrictive usury laws of the borrowers' state, and proclaiming that, "For over a century, in matters of interest and usury, "National banks have been National favorites.") (*quoting Tiffany v. National Bank of Missouri*, 18 Wall. 409, 413 (1874)); *Northway Lanes v. Hackley Union National Bank & Trust Co.*, 464 F.2d 855, 862 (6th Cir. 1972) (under Section 85, national banks are "on precisely the same footing" as the most favored lender subject to state law).

As the OCC observed in the 1988 Serino Letter, "The permission given to national banks to charge interest at the rate allowed by the laws of the state where the bank is located is designed to place national banks on an equal footing with the most favored state-chartered lenders in that state, and to protect national banks from unfriendly state legislation." Mr. Serino went on to explain the problem of enforcing a provision of a foreign state law that would prohibit a loan feature (an annual fee, in the case in question) permitted by a law that is "material" to the determination of the permitted interest:

> [A] national bank could be faced with the anomalous situation of being a "least favored lender," since it might be governed by the lower interest rate ceiling of the state where it is located but still not be permitted to levy the annual fees allowable under that state's laws. This anomalous situation could not have been intended by the authors of the National Bank Act.

1988 Serino Letter (quoting the 1980 Fitzgerald Letter).

Application of the definition of "materiality" suggested herein makes eminent sense. Not only does it promote the "most favored lender" powers first afforded to national banks by Section 85 and then extended to state banks by Section 27, it is the only way that a bank can be assured of the right to export the interest allowed by the laws of the state where it is located. Manifestly, if the law of a foreign state would preclude a bank from making a particular class of loans altogether (because the defining characteristics of the loan are not regarded as "material"), *a fortiori* the state law would prohibit the bank from charging the interest on that loan explicitly authorized by Section 27. In the case of a conflict between state law and Section 27, state law is preempted.

Application to Debt Cancellation and Suspension

For a state bank located in a state that permits any lender to included debt cancellation or suspension in its loans, adoption of our recommended changes to the proposed rule would confirm the bank's ability to include debt cancellation or suspension in its loans to borrowers in other states. It would not be subject to limits on charges under the laws of other states. Because debt cancellation/suspension charges are a form of "interest," the bank would be subject to the limits on debt cancellation or suspension charges, if any, provided by the applicable law of the state where it is located, whether the bank is lending in-state or across state lines. Because the provisions of state law defining the characteristics of permitted loans or loan features are "material to the determination of the permitted interest," the bank would be subject to those provisions and *not* to any conflicting foreign state laws – for example, licensing provisions. As provided by proposed 12 C.F.R. § 331.2(b), the exercise of powers conferred by Section 27 expressly does not require state banks to be licensed, even when banks are borrowing their usury authority from a law containing a licensing requirement. Certainly, such an exercise does not require compliance with a licensing regimen under any other laws.

Conclusion

Recognition of the foregoing governing principles in the final rule, or at least in the explanatory material for the final rule, would provide needed certainty in the application of Section 27. It would substantially level the playing field with respect to interstate lending by state banks and national banks (although, unfortunately, it would not serve this same function with respect to interstate deposit-taking or other activities). Without a clear articulation of how the "materiality" concept applies in practice, state banks will inevitably fall further behind national banks in their ability to engage in interstate lending transactions.

We recognize that Section 27 must be interpreted in *pari materia* with Section 85. While we are recommending inclusion of language in the FDIC rule that is not currently present in the corresponding OCC rule, the substance of our proposal is contained in less formal OCC guidance. Because state banks cannot take advantage of 12 C.F.R. § 24 (Seventh) preemption, the precise contours of Sections 27 and 85 are more important to state banks than national banks. Accordingly, we do not believe that the FDIC should await changes in 12 C.F.R. § 7.4001 before providing guidance on important issues through its Section 27 regulations. We encourage the FDIC to adopt its Section 27 regulations promptly, with the clarifications suggested above.

Thank you for your attention to our views and for the effort you are making to reduce the competitive disadvantages state banks are facing in their interstate operations.

Sincerely,

Jeremy Rosenblum

Jeremy T. Rosenblum