



June 25, 2020

MEMORANDUM TO: The Board of Directors

FROM: Nicholas J. Podsiadly
General Counsel

SUBJECT: Final Rule on Federal Interest Rate Authority

Recommendation

Staff recommends that the Board of Directors (Board) adopt the attached final rule and authorize its publication in the Federal Register. The final rule would implement sections 27 and 24(j) of the Federal Deposit Insurance Act (FDI Act), codifying guidance contained in General Counsel’s Opinion No. 11, which was adopted by the Board and published in the Federal Register in 1998. The final rule would clarify the law governing the interest rates that State-chartered banks and insured branches of foreign banks (collectively, State banks) may charge, address statutory ambiguities that were highlighted by the Second Circuit’s decision in *Madden v. Midland Funding, LLC*,¹ and continue to promote parity between State banks and national banks.

Background

Section 27 authorizes State banks to make loans charging interest at the maximum rate permitted by the State where the bank is located, or at one percent in excess of the 90-day commercial paper rate, whichever is greater. However, section 27 does not state at what point in time the validity of the interest rate should be determined in order to assess whether a State bank is taking or receiving interest in accordance with section 27. Furthermore, while section 27 expressly grants State banks the right to make loans at the rates permitted by their home States, it does not explicitly list all the components of that right. One such implicit component is the right to assign the loans made under the preemptive authority of section 27. Banks’ power to make loans has been traditionally viewed as carrying with it the power to assign loans. Interpreted within its proper historical and legal context, a State bank’s authority under section 27 to make loans at particular rates includes the power to assign the loans at those rates.

Safety and soundness concerns support clarification of the application of section 27 to State banks’ loans, because these statutory ambiguities expose State banks to increased risk in the event they need to sell their loans to satisfy their liquidity needs in a crisis. Left unaddressed, these statutory gaps could create legal uncertainty for State banks and confusion for the courts. One example of the concerns with leaving the statutory ambiguity unaddressed is the decision of the U.S. Court of Appeals for the Second Circuit in *Madden v. Midland Funding, LLC*. Reading the text of 12 U.S.C. 85 (section 85) in isolation, the *Madden* court concluded that section 85 –

¹ 786 F.3d 246 (2d. Cir. 2015).

which authorizes national banks to charge interest at the rate permitted by the law of the State in which the national bank is located – does not allow national banks to transfer enforceable rights in the loans they made under the preemptive authority of section 85. While *Madden* concerned the assignment of a loan by a national bank, the federal statutory provision governing State banks’ authority with respect to interest rates is patterned after and interpreted in the same manner as section 85. *Madden* therefore helped highlight the need to issue clarifying regulations addressing the legal ambiguity in section 27.

Statutory Framework

Section 27 of the FDI Act, 12 U.S.C. § 1831d, is the federal statutory provision that governs the interest rates State banks may charge on loans.² Section 27 allows State banks to charge interest at a rate permissible in “the State, territory, or district where the bank is located” or a rate one percent above the 90-day commercial paper discount rate, whichever is greater. Section 27 also expressly preempts any State constitution or statute to the extent that such State constitution or statute limits the interest rate a State bank may charge to less than the rate permitted by section 27. The statute also permits States to opt out of its coverage by adopting a law, or certifying that the voters of the State have voted in favor of a provision which states explicitly that the State does not want section 27 to apply with respect to loans made in such State.³

Section 27 was patterned after section 85 to provide State banks interest rate authority similar to that of national banks, and has been interpreted in the same manner. In particular, these provisions have been interpreted to allow State banks and national banks, respectively, to “export” the interest rates of their home States to borrowers residing in other States.⁴

In the 1990s, Congress enacted interstate banking laws that permitted national banks and State banks to establish branches across State lines. At that time, the FDI Act was amended to include section 24(j), 12 U.S.C. § 1831a(j), which governs the applicability of a host State’s laws to interstate branches of State banks. A *host State* is a State other than the State that chartered the bank, but in which the bank maintains a branch. Section 24(j) provides that the laws of a host State apply to branches of interstate State banks to the same extent they apply to branches of interstate national banks. Therefore, if the laws of the host State are inapplicable to a branch of an interstate national bank, they are equally inapplicable to a branch of an interstate State bank.

² Section 27 was enacted as part of the Depository Institutions Deregulation and Monetary Control Act of 1980, Pub. L. 96-221, 94 Stat. 132 (1980).

³ Iowa and Puerto Rico have opted out of the coverage of section 27. Colorado, Maine, Massachusetts, North Carolina, Nebraska, and Wisconsin have previously opted out of coverage of section 27, but either rescinded their respective opt-out statutes or allowed them to expire.

⁴ See *Marquette Nat’l Bank v. First of Omaha Service Corp.*, 439 U.S. 299 (1978); *Greenwood Trust Co. v. Massachusetts*, 971 F.2d 818, 827 (1st Cir. 1992).

FDIC General Counsel's Opinion No. 11

Following the enactment of the federal interstate banking laws, questions arose regarding the application of section 27 to interstate State banks. It was unclear in which State such a bank was “located” for purposes of section 27, leading to confusion regarding the permissible interest rate. The FDIC addressed this issue by publishing General Counsel’s Opinion No. 11, *Interest Charges by Interstate State Banks*.⁵

In this opinion, the FDIC’s General Counsel concluded, consistent with the OCC’s interpretation of section 85, that the determination of which State’s interest rate laws to apply to a loan depends upon the location where three “non-ministerial functions” involved in making the loan occur: loan approval; disbursement of the loan proceeds; and communication of the decision to lend. If all three non-ministerial functions were performed by a branch located in a host State, the host State’s interest restrictions would apply to the loan; otherwise, the law of the home State would apply. Where the three non-ministerial functions occur in different States or banking offices, host State rates may be applied if the loan has a clear nexus to the host State. This result, the opinion concluded, reflected the balance that Congress intended to strike between the application of host State interest rate restrictions and the exportation principle previously recognized by the courts.

The effect of FDIC General Counsel’s Opinion No. 11 was to promote parity between State banks and national banks with respect to interest rates. Importantly, in the context of interstate banking, the opinion confirmed that section 27 permits State banks to export interest charges allowed by the State where the bank is located to out-of-State borrowers, even if the bank maintains a branch in the State where the borrower resides.

Need for Rulemaking and the Proposed Rule

Madden highlighted the need to issue clarifying regulations addressing the ambiguities in section 27. The decision created legal uncertainty and a lack of uniformity in secondary credit markets. It also has prompted litigation challenging longstanding market practices.

Further, the *Madden* decision could potentially affect the FDIC’s resolution of failed insured depository institutions. One way the FDIC fulfills its mission to maintain stability and public confidence in the nation’s financial system is by carrying out all of the tasks triggered by the closure of an FDIC-insured depository institution. This includes attempting to find a purchaser for the institution and the liquidation of the assets held by the failed bank. Following a bank closing, the FDIC as conservator or receiver (FDIC-R) is often left with large portfolios of loans. The FDIC-R has a statutory obligation to (i) maximize the net present value return from the sale or disposition of such assets and (ii) minimize the amount of any loss, both in order to protect the Deposit Insurance Fund (DIF).⁶

⁵ See 63 Fed. Reg. 27,282 (May 18, 1998).

⁶ FDI Act, 12 U.S.C. 1821(d).

The DIF would be significantly impacted in a large bank failure scenario if the FDIC-R were forced to sell loans at a large discount to account for impairment in the value of those loans as a result of legal uncertainty caused by the *Madden* decision. This uncertainty would also increase legal and business risks to potential purchasers of bank loans, which in turn would likely reduce overall liquidity in the secondary loan markets upon which the FDIC-R relies for asset disposition, further limiting the ability of the FDIC-R to sell loans. The *Madden* decision, as it stands, could potentially significantly impact the FDIC's statutory obligation to resolve failed banks using the least costly resolution option and minimizing losses to the DIF.

In light of these developments, the FDIC published a notice of proposed rulemaking (NPR) in November 2019 to issue regulations implementing sections 27 and 24(j) of the FDI Act. The proposed regulations would reaffirm the enforceability of the interest rate terms of State banks' loans following the sale, assignment, or transfer of the loan.⁷ The OCC recently issued similar regulations implementing section 85 that reaffirm the enforceability of the interest rate terms of national banks' loans following the sale, assignment, or transfer of the loan.⁸

Summary of Comments

The comment period for the FDIC's NPR ended on February 4, 2020. The FDIC received 59 comment letters from a variety of individuals and entities, including trade associations, insured depository institutions, consumer and public interest groups, State banking regulators and officials, a city treasurer, marketplace lenders, law firms, members of Congress, academics, and think tanks.

Comments submitted by financial services trade associations, depository institutions, and marketplace lenders generally expressed support for the proposed rule. These commenters stated that the proposed rule would: address legal uncertainty created by the *Madden* decision; reaffirm longstanding views regarding the enforceability of interest rate terms on loans that are sold, transferred, or otherwise assigned; and reaffirm State banks' ability to engage in activities such as securitizations, loan sales, and sales of participation interests in loans, that are crucial to the safety and soundness of these banks' operations. These commenters indicated that the effect of the proposed rule would be to ensure that banks have the capacity to continue lending, as well as to promote the availability of credit to higher-risk borrowers.

A number of commenters were critical of the rule, asserting that it exceeded the FDIC's statutory authority, lacked a sufficient evidentiary basis, and would harm consumers. The preamble to the final rule addresses these comments in detail; some of the relevant arguments are also summarized below.

Statutory Authority

Some commenters asserted that the FDIC lacks the authority to issue the proposed rule because it would amount to regulation of non-banks. The rule would not regulate non-banks.

⁷ 84 Fed. Reg. 66,845 (Dec. 6, 2019).

⁸ 85 Fed. Reg. 33,530 (June 2, 2020).

Rather, it would clarify the application of section 27 to State banks' loans. To the extent a non-bank that obtained a State bank's loan would be permitted to charge the contractual interest rate, that is because a State bank's statutory authority under section 27 to make loans at particular rates necessarily includes the power to assign the loans at those rates. The regulation would not become a regulation of assignees simply because it would have an indirect effect on assignees.

Commenters argued that the FDIC cannot prescribe the effect of the assignment of a State bank loan made under the preemptive authority of section 27 because the statutory provision does not expressly refer to the "assignment" of loans. The statute's silence, however, reinforces the FDIC's authority to issue interpreting regulations. Agencies are permitted to issue regulations filling statutory gaps and routinely do so. The proposed interpretation of section 27 is grounded in the terms of the statute, read within their proper historical and legal context. The power to assign loans has been traditionally understood as a component of the power to make loans, and thus, State banks' power to assign loans at the interest rates permitted by section 27 is implicit in the terms of the statute.

One comment letter argued that the proposed rule is premised upon the assumption that the preemption of State law interest rate limits under section 27 is an assignable property interest. However, the proposed rule did not purport to allow State banks to assign the ability to preempt State law interest rate limits under section 27. Instead, the proposed rule would allow State banks to assign loans at their contractual interest rates. This is not the same as assigning the authority to preempt State law interest rate limits.

Evidentiary Basis for the Proposal

Some commenters asserted that the FDIC failed to demonstrate that the proposed rule is necessary to ensure the stability or liquidity of loan markets. However, agencies are permitted to adopt prophylactic rules to prevent potential problems before they arise. Staff believes that safety and soundness concerns warrant clarification of the application of section 27 to State banks' loans, even if particular State banks or the loan market more generally are not currently experiencing distress. Market conditions can change quickly and without warning, potentially exposing State banks to increased risk in the event they need to sell their loans.

Effects on Consumers

Several commenters asserted that the regulation of interest rate limits has historically been a State function, and the proposed rule would change that by allowing non-banks that buy loans from State banks to charge interest rates exceeding State law limits. However, the framework that governs the interest rates charged by State banks includes both State and federal laws. As noted above, section 27 generally authorizes State banks to charge interest at the rate permitted by the law of the State in which the bank is located, even if that rate exceeds the rate permitted by the law of the borrower's State. Congress also recognized States' interest in regulating interest rates within their jurisdictions, giving States the authority to opt out of the coverage of section 27. The proposed rule would clarify the application of this statutory framework.

Some commenters asserted that the proposal would facilitate predatory lending by non-bank lenders partnering with State banks. This concern appears to arise from perceived abuses of longstanding statutory authority, rather than the proposed rule. Federal court precedents have for decades allowed banks to charge interest at the rate permitted by the law of the bank's home State, even if that rate exceeds the rate permitted by the law of the borrower's State. Under longstanding views regarding the enforceability of interest rate terms on loans that a State bank has sold, transferred, or assigned, nonbanks also have been permitted to charge the contract rate when they obtain a loan made by a bank. The rule would reinforce the status quo, which was arguably unsettled by *Madden*, with respect to these authorities, but it is not the basis for them.

Some consumer advocates focused their comments on "true lender" theories under which it may be established that a non-bank lender, rather than its bank partner, is the true lender with respect to a loan, with the effect that section 27 would not govern the loan's interest rate. Some of these commenters requested that the FDIC issue rules for determining which party in such a partnership is the true lender. Courts have developed tests for making such determinations, but the FDIC's proposal did not address this issue or these tests. Determining which party is the true lender in a relationship may be challenging, given the variety of ways in which banks and non-banks might establish and structure partnerships. Given the policy issues associated with this type of partnership, consideration separate from this rulemaking is warranted. However, that should not delay this rulemaking, which would clarify the interest rates that may be charged with respect to State banks' loans and promote the safety and soundness of State banks.

Final Rule

After careful consideration of the comments received, staff recommends that the Board adopt the rule generally as proposed, with certain technical changes intended to clarify the rule's application and enhance consistency with the OCC's rule. Specifically, proposed section 331.4(e), defining the point in time when it is determined whether interest on a State bank's loan is permissible under section 27, as well as the effect of subsequent events such as the sale, assignment, or transfer of the loan, differed in certain respects from its counterpart in the OCC's rule. Commenters suggested that this risked varying judicial interpretations of statutes that have historically been interpreted consistently, and recommended that the agencies harmonize the language of these provisions to reinforce that they accomplish the same result. Staff is proposing non-substantive revisions to the text of § 331.4(e) to more closely align the provision with the text of the OCC's regulation.

The final rule implements sections 27 and 24(j) of the FDI Act. Consistent with section 27, the final rule would provide that a State bank or insured branch of a foreign bank may charge interest of up to the greater of: 1 percent more than the rate on 90-day commercial paper rate; or the rate allowed by the law of the State where the bank is located.

The final rule provides that whether interest on a loan is permissible under section 27 is determined as of the date the loan was made. Interest on a loan permissible under section 27 would not be affected by changes in State law, changes in the commercial paper rate after the loan was made, or the sale, assignment, or other transfer of the loan, in whole or in part.

The final rule is not intended to affect the application of State law in determining whether a State bank or insured branch of a foreign bank is a real party in interest with respect to a loan or has an economic interest in a loan.

Conclusion

Staff recommends that the Board adopt the attached final rule and authorize its publication in the *Federal Register* with an effective date 30 days from publication.

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