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Legal Sidebar

Federal Banking Regulator Finalizes Rule on State Usury Laws

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On May 29, the Office of the Comptroller of the Currency (OCC) finalized a rule concerning federal banking regulation and state usury law that has pitted the financial industry against consumer advocacy groups. The OCC's rule addresses the scope of a federal law empowering national banks to "export" the maximum interest rates of their "home" states when lending to borrowers in other states with stricter usury laws. The finalized proposal—which abrogates a 2015 decision from the U.S. Court of Appeals for the Second Circuit—extends this "exportation power" to *non-banks* when they purchase loans originated by banks.

Industry groups have hailed the measure as providing regulatory certainty to banks, financial technology ("FinTech") firms, and the roughly $563 billion market for securitized consumer debt. In contrast, consumer organizations have criticized the rule for enabling predatory lending and exceeding the scope of the OCC's legal authority. But the agency is unlikely to have the final word: the rule will probably be challenged in court. This Legal Sidebar discusses the dispute's background, the issues that may play a role in any litigation challenging the OCC's rule, and the rule's implications if sustained.

Legal Background

To protect consumers, many states have adopted usury laws capping the interest rates that lenders can charge borrowers. There is significant variation among state interest-rate limits: some states have adopted strict usury laws, some have enacted more permissive rules, and others have eliminated usury laws altogether. But federal preemption of state law has diminished the relevance of these differences when it comes to bank lending. Section 85 of the National Bank Act (NBA) allows federally chartered banks to "export" the maximum interest rates of their "home" states, meaning they can charge those rates when lending to borrowers in other states with stricter usury laws. Accordingly, a national bank headquartered in South Dakota—which has no interest-rate limits—need not abide by New York usury law when it lends to New York borrowers. Predictably, this regime has made more permissive states attractive destinations for banks' credit-card operations. And these shifts have reduced the sway of states that favor stricter limits on high-cost lending.

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The "exportation power" is firmly established when a bank originates loans and holds them on its balance sheet. But Section 85's scope is complicated by the fact that banks routinely sell loans to manage risk and boost their liquidity. Often, the buyers of these loans are *non-bank* entities like debt purchasers or securitization trusts, which would lack the exportation power if they originated the loans themselves. These transactions naturally raise the question: can *non-banks*—which lack the exportation power when they *make* loans—benefit from that power when they *purchase* loans from banks? Or do the usury limits for a loan shift from those of *the bank's* state to those of *the borrower's* state when a bank sells a loan to a non-bank?

The issue has sparked controversy. Some commentators argue that non-banks can benefit from the exportation power in these circumstances because banks' power to sell loans includes the power to assign a loan's *original terms*. Industry groups separately contend that this conclusion follows from the general standard for evaluating NBA preemption. Under this standard—the *Barnett Bank* test—federal law preempts state laws that "significantly interfere" with national banks' powers. Applying this test, the financial industry has argued that the usury law governing a bank-originated loan "travels with" the loan when it is sold, because a contrary rule would "significantly interfere" with banks' power to sell loans. Finally, others have argued that non-banks can benefit from the exportation power because of a putative common law rule known as the "valid when made" doctrine. Proponents of this argument contend that, at common law, a loan that was non-usurious—and therefore "valid"—when originated could not later become usurious. The financial lobby argues that Congress incorporated this common law doctrine into the NBA when it enacted Section 85.

Others have rejected these arguments. Some critics of the financial industry argue that banks cannot assign the exportation power because it is a privilege attached to bank charters, not a contractual right. These commentators contend that the law of assignments allows banks to transfer the rights they possess *under their debt contracts*, but not extraneous rights they possess *because of their charters*. (The analogy: while car owners can sell their cars and any rights attached to them, they cannot assign the privileges attached to their driver's licenses.) Others have rejected the financial industry's reliance on *Barnett Bank*. These observers contend that denying non-banks the exportation power would only "marginally" affect the prices banks can obtain in secondary loan markets. And under this line of reasoning, such minor effects do not rise to the level of "significant interference" with banks' powers. Finally, others have challenged the historical pedigree of the "valid when made" doctrine. Skeptics of this doctrine contend that the 19th-century case law does not stand for the proposition that a non-usurious loan can *never* become usurious. Accordingly, these commentators argue that such a principle is a modern invention that was not incorporated into the NBA.

The *Madden* Decision

The OCC was not writing on a blank slate when it considered these arguments. In 2015, the U.S. Court of Appeals for the Second Circuit rejected the maximalist view of the exportation power in *Madden v. Midland Funding, LLC*. There, the court held that a non-bank debt purchaser could not benefit from the exportation power of a national bank from which it had purchased credit-card debt. As a result, the usury law of *the borrower's* state—not the more permissive law of *the bank's* state—governed that debt. In reaching this conclusion, the Second Circuit rejected the defendant-debt purchaser's reliance on *Barnett Bank*. The court reasoned that the usury law of the borrower's state would not "significantly interfere" with bank powers because it would not prevent banks from selling their loans, even if it "might" decrease the profitability of those sales.

Madden immediately proved contentious. After the Second Circuit issued the decision, several industry groups supported an unsuccessful petition for rehearing, arguing that the ruling would seriously disrupt credit markets. And after the defendant-debt purchaser petitioned the Supreme Court for a writ of certiorari, the OCC and the Office of the Solicitor General filed an amicus brief arguing that *Madden* was wrongly decided. However, the Supreme Court denied the petition, leaving the Second Circuit's decision undisturbed.

Madden has also attracted congressional interest. In June 2017, the House of Representatives passed the Financial CHOICE Act, a broad regulatory reform bill that included a provision abrogating *Madden* and codifying the "valid when made" principle. The House also passed a narrower bill limited to this so-called "*Madden*-fix" in February 2018. But neither bill became law, and similar legislation has not been introduced in the 116th Congress.

The OCC's Rule

The OCC's finalized proposal is the latest episode in the *Madden* saga. The rule straightforwardly abrogates the Second Circuit's decision, providing that "[i]nterest on a loan that is permissible under [Section 85 of the NBA] shall not be affected by the sale, assignment, or other transfer of the loan." The rule also includes an identical provision for loans originated by federal savings associations, which have the same exportation power as national banks. The OCC explained that it issued the rule to address regulatory uncertainty created by the *Madden* decision. And the agency identified several bases for its interpretation of the exportation power, including banks' powers to sell loans and make contracts, the "valid when made" doctrine, and Section 85's purpose to "facilitate[] national banks' ability to operate lending programs on a nationwide basis." Notably, the OCC did not invoke the *Barnett Bank* test to justify the rule.

Looking Forward: Possible Litigation

The OCC's rule will likely be challenged in court. During the rulemaking process, consumer groups and many state attorneys general vigorously objected to the OCC's proposal. Some commenters argued that the OCC lacks the statutory authority to extend the exportation power to non-banks for the reasons discussed above. The rule's critics also contended that the OCC is bound by *Madden* under administrative-law principles. Under the relevant case law, a judicial determination that a statute is unambiguous prohibits administrative agencies from adopting a contrary interpretation. And some observers read *Madden* as holding that Section 85 *unambiguously* limits the exportation power to banks, precluding the OCC from implementing a different reading of the statute. An assessment of this argument may require a close parsing of the Second Circuit's reasoning in *Madden*, which focused principally on the *Barnett Bank* test rather than Section 85's semantic content.

Other commenters attacked elements of the OCC's rulemaking process. Some critics alleged that the OCC failed to support its proposal with sufficient factual findings and adequately consider the rule's implications for predatory "rent-a-bank" schemes. Opponents of the rule also argued that the OCC flouted a provision in the Dodd-Frank Act imposing enhanced requirements on the agency's preemption rules. The relevant provision—Section 1044—places substantive limits on the OCC's power to issue rules preempting "State consumer financial laws." Section 1044 also imposes certain procedural requirements on the OCC's "preemption determinations" that the agency does not appear to have complied with in issuing its *Madden* rule.

However, the OCC has argued that the rule is not subject to Section 1044's requirements for two reasons. First, the agency claims that its *Madden* rule is not a "preemption determination" because it concerns Section 85's scope, rather than the "distinct" question of *whether* Section 85 preempts state law. Second, the OCC argues that rules concerning Section 85 are exempt from Dodd-Frank's requirements because of a provision in Section 1044 disavowing an intent to alter national banks' exportation power. This dispute over Dodd-Frank will likely be hashed out in court.

The Rule's Implications

Commentators disagree about the implications of the OCC's rule. As discussed, supporters of the agency's efforts have criticized *Madden* for threatening to disrupt secondary loan markets and the market for securitized consumer debt. Recent class-action usury lawsuits targeting the credit-card securitization programs of two national banks arguably underscore these concerns. Other supporters of the rule have criticized *Madden*'s effects on primary credit markets. These commentators argue that a narrow construction of the exportation power reduces credit availability for high-risk borrowers. And there is some evidence supporting this view: according to one empirical study, *Madden* reduced the flow of credit to borrowers in the Second Circuit with low FICO scores.

In contrast, critics of the OCC's rule have contested the claim that *Madden* creates significant uncertainty. These commentators argue that the Second Circuit's decision affects only the narrow market for securitized *credit-card* debt. Opponents of the rule also contend that restricting the exportation power's scope would merely limit the types of credit-card debt that can be sold, rather than eliminating the market for *all* credit-card debt. Finally, there is a large literature arguing that limits on high-cost credit can be welfare-enhancing, especially where borrowers underappreciate the costs of debt because of imperfect rationality or incomplete information. These considerations arguably serve as a rejoinder to the claim that *Madden* has limited credit availability. And this general view of consumer behavior has led supporters of stricter usury laws to criticize the OCC's rule for facilitating predatory lending.

The scope of the exportation power is likely to remain a hot topic in banking regulation and consumer protection. The Federal Deposit Insurance Corporation (FDIC) is reviewing comments on a proposal for federally insured state banks that largely mirrors the OCC's rule for national banks. If the FDIC finalizes the proposal, its rule may also face legal challenges that raise some of the same issues facing the OCC. Whether these measures will generate a resurgence of congressional interest in the exportation power or usury law more generally remains to be seen.

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