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OCC PREEMPTION RULES

OCC Should Further Clarify the Applicability of State Consumer Protection Laws to National Banks

GAO-06-387

Highlights

Highlights of GAO-06-387, a report to the Subcommittee on Oversight and Investigations, Committee on Financial Services, U.S. House of Representatives

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Why GAO Did This Study

In January 2004, the Office of the Comptroller of the Currency (OCC)—the federal supervisor of federally chartered or "national" banks—issued two final rules referred to jointly as the preemption rules. The "bank activities" rule addressed the applicability of state laws to national banking activities, while the "visitorial powers" rule set forth OCC's view of its authority to inspect, examine, supervise, and regulate national banks and their operating subsidiaries. The rules raised concerns among some state officials and consumer advocates. GAO examined (1) how the rules clarify the applicability of state laws to national banks, (2) how the rules have affected state-level consumer protection efforts, (3) the rules' potential effects on banks' choices of a federal or state charter, and (4) measures that could address states' concerns regarding consumer protection.

What GAO Recommends

GAO recommends that the OCC undertake an initiative to clarify the characteristics of state consumer protection laws that would make them subject to federal preemption.

OCC generally concurred with the report and agreed with the recommendation.

www.gao.gov/cgi-bin/getrpt?GAO-06-387.

To view the full product, including the scope and methodology, click on the link above. For more information, contact David G. Wood at (202) 512-8678 or woodd@gao.gov.

What GAO Found

In the bank activities rule, OCC sought to clarify the applicability of state laws by relating them to certain categories, or subjects, of activity conducted by national banks and their operating subsidiaries. However, the rule does not fully resolve uncertainties about the applicability of state consumer protection laws, particularly those aimed at preventing unfair and deceptive acts and practices. OCC has indicated that, even under the standard for preemption set forth in the rules, state consumer protection laws can apply; for example, OCC has said that state consumer protection laws, and specifically fair lending laws, may apply to national banks and their operating subsidiaries.

State officials reacted differently to the rules' effect on relationships with national banks. In the views of most officials GAO contacted, the preemption rules have had the effects of limiting the actions states can take to resolve consumer issues, as well as adversely changing the way national banks respond to consumer complaints and inquiries from state officials. OCC has issued guidance to national banks and proposed an agreement with the states designed to facilitate the resolution of, and sharing information about, individual consumer complaints. Other state officials said that they still have good working relationships with national banks and their operating subsidiaries, and some national bank officials stated that they view cooperation with state attorneys general as good business practice.

Because many factors, including the size and complexity of banking operations and an institution's business needs, can affect a bank's choice of a federal or state charter, it is difficult to isolate the effects, if any, of the preemption rules. GAO's analysis of OCC and other data shows that, from 1990 to 2004, less than 2 percent of the nation's thousands of banks changed between the federal and state charters. Because OCC and state regulators are funded by fees paid by entities they supervise, however, the shift of a large bank can affect their budgets. In response to the perceived disadvantages of the state charter, some states have reported actions to address potential charter changes by their state banks.

Measures that could address states' concerns about protecting consumers include providing for some state jurisdiction over operating subsidiaries, establishing a consensus-based national consumer protection lending standard, and further clarifying the applicability of state consumer protection laws. The first two measures present complex legal and policy issues, as well as implementation challenges. However, an OCC initiative to clarify the rules' applicability would be consistent with one of OCC's strategic goals and could assist both the states and the OCC in their consumer protection efforts—for example, by providing a means to systematically share relevant information on local conditions.

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Abbreviations

CAG	Customer Assistance Group
CSBS	Conference of State Bank Supervisors
FCA	Farm Credit Administration
FDIC	Federal Deposit Insurance Corporation
FHFB	Federal Housing Finance Board
FRB	Board of Governors of the Federal Reserve System
FTC	Federal Trade Commission
GDPIPD	Gross Domestic Product Implicit Price Deflator
GLBA	Gramm Leach Bliley Act
HOLA	Home Owners Loan Act
MOU	Memorandum of Understanding
NAAG	National Association of Attorneys General
NCUA	National Credit Union Administration
OCC	Office of the Comptroller of the Currency
OFHEO	Office of Federal Housing Enterprise Oversight
OTS	Office of Thrift Supervision
SEC	Securities and Exchange Commission
UDAP	Unfair and Deceptive Acts and Practices

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United States Government Accountability Office
Washington, D.C. 20548

April 28, 2006

The Honorable Sue W. Kelly
Chairwoman
The Honorable Luis V. Gutierrez
Ranking Minority Member
Subcommittee on Oversight and Investigations
Committee on Financial Services
House of Representatives

On January 13, 2004, the Treasury Department's Office of the Comptroller of the Currency (OCC), which supervises federally chartered "national" banks, issued two sets of final rules: one covering the preemption of state laws relating to the banking activities of national banks and their operating subsidiaries ("bank activities rule") and one concerning OCC's supervisory authority over those institutions ("visitorial powers rule"). Together, these rules are commonly referred to as the OCC preemption rules.[1] The bank activities rule addresses the applicability of state laws to lending, deposit-taking, and all other activities of national banks authorized by the National Bank Act. The visitorial powers rule clarifies OCC's view of its supervisory authority over national banks and their operating subsidiaries, which OCC interprets to be its exclusive power to inspect, examine, supervise, and regulate the business activities of national banks.

The rules drew strong opposition from a number of state legislators, attorneys general, consumer group representatives, and Members of Congress. Some opposed OCC's legal justification for issuing the proposed rules. Others opposed the rules because of what they viewed as potentially adverse effects on consumer protection and the dual banking system.[2] More specifically, opponents stated that the scope of preemption of state law under the rules would weaken consumer protections and that the rules could undermine the dual banking system because, for example, state-chartered banks located in states with regulatory schemes more stringent than that for national banks would have an incentive to change their charters from state to federal. Supporters of the rules asserted that

[1]69 *Fed. Reg.* 1895 (Jan. 13, 2004) (visitorial powers); 69 *Fed. Reg.* 1904 (Jan. 13, 2004) (national bank activities).

[2]Because the nation's banking system includes both federally and state-chartered banks, it is generally referred to as the "dual banking system."

providing uniform regulation for national banks, rather than differing state regulatory regimes, was necessary to ensure efficient nationwide operation of national banks.

In your letter, you requested that we review OCC's rulemaking process for promulgating the bank activities and the visitorial powers rules; examine OCC's process and capacity to handle consumer complaints; and assess the impact and potential impact of the rules on consumer protection and the dual banking system. On October 17, 2005, and February 23, 2006, respectively, we provided you with reports on the rulemaking process and OCC's consumer complaints process and capacity.[3] This final report focuses on the impact and the potential impact of the rules on consumer protection and the dual banking system. Specifically, the report examines (1) how the preemption rules clarify the applicability of state laws to national banks; (2) how the rules have affected state-level consumer protection efforts; (3) the rules' potential effects on banks' decisions to seek the federal, versus state, charters; and (4) measures that could address states' concerns regarding consumer protection.[4] Additionally, we provide information on how OCC and other federal regulators, as well as state bank regulators, are funded. We provide this additional information in appendixes IV, V, and VI.

To address these objectives, we analyzed the content of comment letters submitted to OCC during the rulemaking process and reviewed transcripts of congressional hearings on the rules to identify issues raised. We conducted site visits or phone interviews with officials and representatives of state attorneys general offices, state banking departments, consumer groups, state bankers associations, and national and state banks in six states (California, Georgia, New York, North Carolina, Idaho, and Iowa). In addition, we interviewed legal and academic individuals and conducted our own legal research. We selected these states, among other reasons, because of their interest in the preemption issue, as identified by congressional testimony, comment letters, and referrals from

[3]See GAO, *OCC Preemption Rulemaking: Opportunities Existed to Enhance the Consultative Efforts and Better Document the Rulemaking Process*, GAO-06-8 (Washington, D.C.: Oct. 17, 2005); and GAO, *OCC Consumer Assistance: Process Is Similar to That of Other Regulators but Could Be Improved by Enhanced Outreach*, GAO-06-293 (Washington, D.C.: Feb. 23, 2006).

[4]Unless otherwise noted, throughout this report, the term "bank" includes state-chartered and federally chartered commercial banks and does not include credit unions, thrifts, and savings and loan institutions.

representatives of national organizations. Therefore, the views expressed by officials in these six states may not be representative of all state officials. In Washington, D.C., we interviewed the national associations comprising state attorneys general and state bank regulators; representatives of national consumer groups; and officials at OCC and other federal bank regulatory agencies, including the Board of Governors of the Federal Reserve System (FRB) and the Federal Deposit Insurance Corporation (FDIC). To assess trends in chartering decisions and their effects on OCC's and states' budgets, we obtained and analyzed data on charter conversions, mergers, assets, and assessment payments from OCC, FRB, and certain state bank regulators. To describe how the OCC and state banking departments are funded, we interviewed OCC and state bank regulators, and reviewed annual reports, past GAO reports, and the Conference of State Bank Supervisors' (CSBS) Profile of State-Chartered Banking.[5] We conducted our audit work in the previously mentioned six states and Washington, D.C., from August 2004 through March 2006 in accordance with generally accepted government auditing standards. Appendix I provides a detailed description of our objectives, scope, and methodology.

Background

Regulation and Structure of Banking Organizations

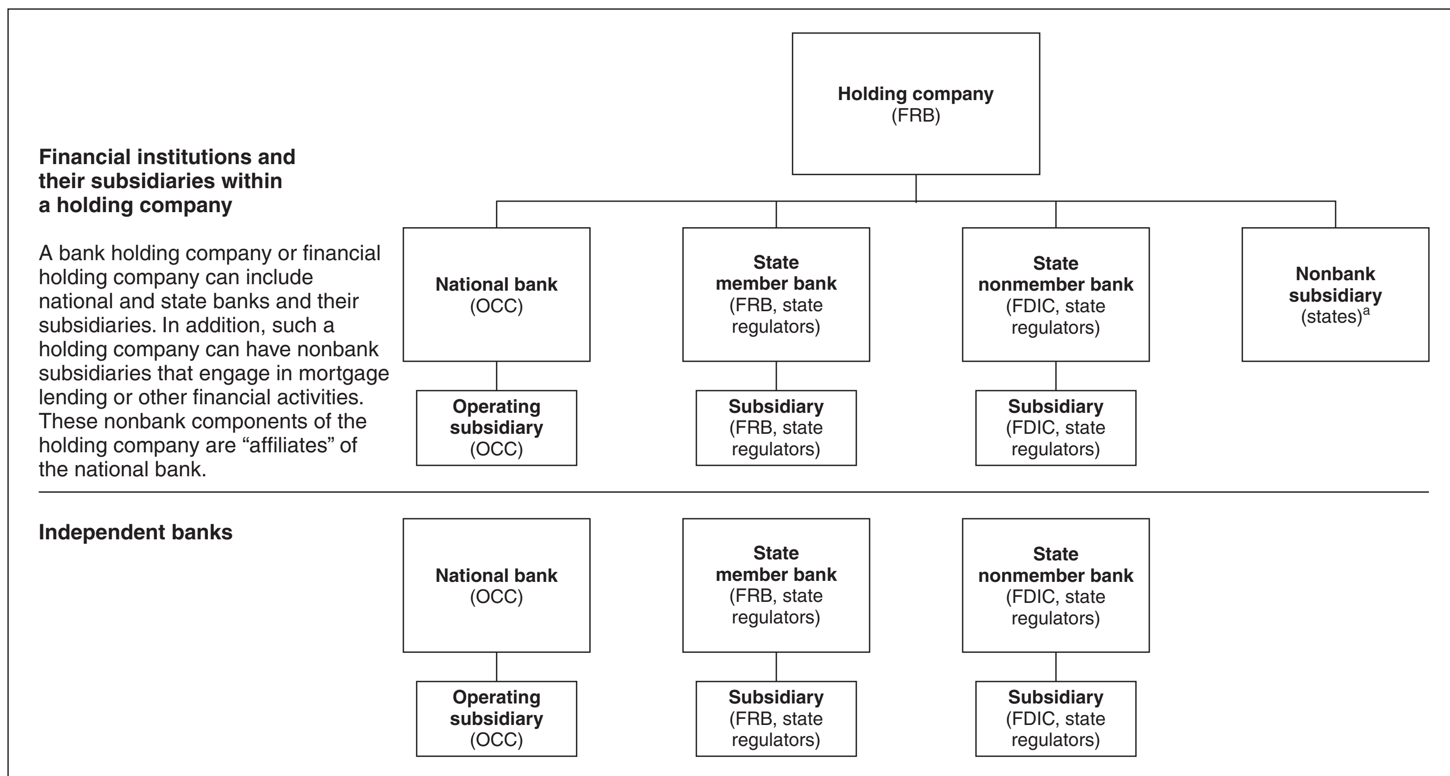
The regulatory system for banks in the United States is known as the "dual banking system" because banks can be either federally or state-chartered. As of September 30, 2005, there were 1,846 federally chartered banks and 5,695 state-chartered banks.[6] National banks are federally chartered under the National Bank Act. The act sets forth the types of activities permissible for national banks and, together with other federal law, provides OCC with supervisory and enforcement authority over those institutions. State banks receive their powers from their chartering states, subject to activities restrictions and other restrictions and requirements imposed by federal

[5]The Conference of State Bank Supervisors was founded in 1902 as a clearinghouse for ideas to solve common problems of state bank regulators. One of the goals of the organization is to represent the interests of the state banking system to federal and state legislative and regulatory agencies.

[6]These data on the numbers of federally and state-chartered banks were obtained from FDIC's Statistics on Depository Institutions.

law. State banks are chartered and supervised by the individual states but also have a primary federal regulator (see fig. 1). FRB is the primary federal regulator of state banks that are members of the Federal Reserve System. FDIC is the primary federal regulator of state banks that are not members of the Federal Reserve System. OCC and state regulators collect assessments and other fees from banks to cover the costs of supervising these entities. OCC does not receive congressional appropriations.

Figure 1: Structure and Supervision of Banks



Source: GAO.

Note: The primary supervisor(s) are shown in parentheses.

[a]As discussed elsewhere in this report, financial subsidiaries of national banks, which may engage in nonbanking financial activities, are subject to regulation by OCC, but certain activities are subject to functional regulation by the Securities and Exchange Commission, the Commodity Futures Trading Commission, and state insurance regulators. Nonbank holding company subsidiaries may also be subject to federal supervision and under the jurisdiction of the Federal Trade Commission. The Federal Trade Commission is responsible for enforcing federal laws for lenders that are not depository institutions but it is not a supervisory agency and does not conduct routine examinations.

Banks chartered in the United States can exist independently or as part of a bank holding company. OCC, which administers the National Bank Act, permits national banks to conduct their activities through operating subsidiaries, which typically are state-chartered businesses. OCC has concluded that a national bank's use of an operating subsidiary is a power permitted by the National Bank Act and that national banks' exercise of their powers through operating subsidiaries is subject to the same laws that apply to the national banks directly. Because OCC supervises national banks, the agency also supervises national bank operating subsidiaries.[7] Further, many federally and state-chartered banks exist as parts of bank holding companies. Bank holding companies may also include nonbank financial companies, such as finance and mortgage companies that are subsidiaries of the holding companies.[8] These holding company subsidiaries are referred to as affiliates of the banks because of their common ownership or control by the holding company. Unlike national bank operating subsidiaries, nonbank subsidiaries of bank holding companies often are subject to regulation by states and their activities may be subject to federal supervision as well.

OCC's Mission and Regulatory Responsibilities

OCC's mission focuses on the chartering and oversight of national banks to assure their safety and soundness and on fair access to financial services and fair treatment of bank customers. OCC groups its regulatory responsibilities into three program areas: chartering, regulation, and supervision. Chartering activities include not only review and approval of charters but also review and approval of mergers, acquisitions, and reorganizations. Regulatory activities result in the establishment of regulations, policies, operating guidance, interpretations, and examination

[7]An operating subsidiary of a national bank is defined to be under control or majority ownership by the bank. Federal regulations contain additional criteria for qualification as a national bank operating subsidiary. See 12 C.F.R. § 5.34(2005). Under the Gramm Leach Bliley Act, qualifying national banks may own or control "financial subsidiaries," through which the banks may conduct certain nonbanking financial activities. By definition, financial subsidiaries are not operating subsidiaries. Pub. L. No. 106-102 §121 (Nov. 12, 1999), 12 U.S.C. § 24a(g)(3).

[8]For the purposes of this report, the term "holding company" refers to both (traditional) bank holding companies and bank holding companies that qualify as financial holding companies as defined by FRB. Under the Gramm Leach Bliley Act, bank holding companies that satisfy standards contained in the Bank Holding Company Act of 1956, as amended, 12 U.S.C. §§ 1841–1850, can qualify as financial holding companies and in that capacity may own or control entities engaged in a wider variety of financial services than those permitted for traditional bank holding companies and their subsidiaries.

policies and handbooks. OCC's supervisory activities encompass bank examinations and enforcement activities, dispute resolution, ongoing monitoring of banks, and analysis of systemic risk and market trends.

As of March 2005, the assets of the banks that OCC supervises accounted for approximately 67 percent—about $5.8 trillion—of assets in the nation's banks. Among the banks OCC supervises are 14 of the top 20 banks in asset size. OCC also supervises federal branches and agencies of foreign banks.

As the supervisor of national banks, OCC has regulatory and enforcement authority to protect national bank consumers. In addition to exercising its supervisory responsibilities under the National Bank Act, which include consumer protection, OCC enforces other consumer protection laws. These include the Federal Trade Commission Act or FTC Act, which prohibits unfair and deceptive practices, and the Federal Home Ownership and Equity Protection Act, which addresses predatory practices in residential mortgage lending. With respect to real estate lending, other consumer protection laws that national banks and their operating subsidiaries are subject to include, but are not limited to, the Truth in Lending Act, the Home Mortgage Disclosure Act, the Fair Housing Act, and the Equal Credit Opportunity Act.

One of OCC's strategic goals is to ensure that all customers of national banks have equal access to financial services and are treated fairly. The agency's strategic plan lists objectives and strategies to achieve this goal and includes fostering fair treatment through OCC guidance and supervisory enforcement actions, where appropriate, and providing an avenue for customers of national banks to resolve complaints. The main division within OCC tasked with handling consumer complaints is the Customer Assistance Group (CAG); its mission is to ensure that bank customers receive fair treatment in resolving their complaints with national banks. In our recent report on OCC consumer assistance efforts, we found that, in addition to resolving individual complaints, OCC uses consumer complaint data collected by CAG (1) to assess risks and identify potential safety, soundness, or compliance issues at banks; (2) to provide feedback to banks on complaint trends; (3) and to inform policy guidance for the banks it supervises. OCC's bank examiners use consumer complaint information to focus examinations they are planning or to alter examinations in progress.[9]

[9]GAO-06-293.

OCC and Preemption

Preemption of state law is rooted in the U.S. Constitution's Supremacy Clause, which provides that federal law is the "supreme law of the land." Because both the federal and state governments have roles in supervising financial institutions, questions can arise about whether federal law applicable to a depository institution preempts the application of a state's law to the institution. Before promulgating the preemption rules in January 2004, OCC primarily addressed preemption issues through opinion letters issued in response to specific inquiries from banks or states. According to OCC, the preemption rules "codified" judicial decisions and OCC opinions on preemption of particular state laws by making those determinations generally applicable to state laws and clarifying certain related issues.

However, the preemption rules were controversial. In commenting on the proposed rules, some opponents questioned whether OCC, in issuing the bank activities rule, interpreted the National Bank Act too broadly, particularly with respect to the act's effect on the applicability of state law to national bank operating subsidiaries.[10] Others opposed the rules because of what they viewed as potentially adverse effects on consumer protection and the dual banking system. For example, consumer groups and state legislators feared that the preemption of state law, particularly with respect to predatory lending practices, would weaken consumer protections. In comments on the proposed visitorial powers rule, most opponents questioned OCC's assertion of exclusive visitorial authority with respect to national bank operating subsidiaries. Opponents expressed concern that the visitorial powers rule eliminates states' ability to oversee and take enforcement actions against national bank operating subsidiaries, even though those entities may be state-licensed businesses.

Supporters of the proposed bank activities rule, a group consisting largely of national banks, asserted that subjecting national banks to uniform regulation, rather than differing state regulatory regimes, was necessary to ensure efficient nationwide operation of national banks. According to these commenters, national banks operating under varied state laws would face increased costs, compliance burdens, and exposure to litigation based on differing, and sometimes conflicting, state laws. In comments on the proposed visitorial powers rule, most proponents suggested that OCC

[10]As OCC stated in the preamble to the bank activities rule, OCC regulations in effect before promulgation of the preemption rules provided that national bank operating subsidiaries are subject to the same terms and conditions as apply to national banks, unless federal law provides otherwise. 69 *Fed. Reg.* 1905, 1906, 1913.

make technical clarifications to the rule, specifically related to the exclusivity of OCC's visitorial powers with respect to national banks' operating subsidiaries.[11]

Results in Brief

In issuing the preemption rules, OCC sought to clarify the applicability of state laws by relating them to certain categories, or subjects, of activity conducted by national banks and their operating subsidiaries and the nature of its visitorial powers over those institutions. However, the bank activities rule does not fully resolve uncertainties about the applicability of state consumer protection laws to national banks and their operating subsidiaries. This is because OCC has indicated that, even under the standard for preemption set forth in the rules, state consumer protection laws can apply; for example, OCC has said that state consumer protection laws, and specifically fair lending laws, may apply to national banks and their operating subsidiaries. Some state officials questioned the extent to which state consumer protection laws, particularly those aimed at preventing unfair and deceptive acts and practices, are preempted for national banks and their operating subsidiaries. Some national bank representatives with whom we spoke had mixed views about the applicability of state laws regarding unfair and deceptive acts and practices.

State officials reacted differently to the rules' effect on their relationships with national banks. In the views of most state officials we contacted, the preemption rules have had the effect of limiting the actions states can take to resolve consumer issues, as well as adversely changing the way national banks respond to consumer complaints and inquiries from state officials. Those officials said that since the rules were promulgated, some national banks and operating subsidiaries have become less inclined to respond to actions by state officials to resolve consumer complaints. However, OCC has issued guidance to national banks and proposed an agreement with the states designed to facilitate the resolution of and information sharing about individual consumer complaints and to address broader consumer protection issues that state officials believe warrant attention. Further, some state officials reported that, prior to the rules, they examined operating subsidiaries and were not challenged by either those entities or OCC, yet since the visitorial powers rule was issued some national bank

[11]We conducted a content analysis of comment letters that OCC received in response to its proposed rulemaking to obtain these views. See appendix I.

operating subsidiaries have declined to submit to state examinations or have relinquished their state licenses. Other state officials said that they still have good working relationships with national banks and their operating subsidiaries, and some national bank officials stated that they view cooperation with state attorneys general as good business practice. Some state officials also expressed the view that the preemption rules might prompt holding companies that have national bank subsidiaries to move lines of business from a national bank's holding company affiliate into a national bank operating subsidiary in order to avoid state regulation.

Because the financial services industry has undergone significant changes—involving interstate banking, globalization, and mergers and consolidations—it is difficult to determine what effects, if any, the preemption rules—apart from other aspects of the federal charter—might have on banks' choices of charter. Factors affecting charter choice can include the size and complexity of an institution's banking operations, the institution's business needs, and the extent to which supervisory and regulatory competence and expertise are tailored to the scale of the bank's operations. Our analysis of FRB and OCC data shows that, from 1990 to 2004, less than 2 percent of the nation's thousands of banks changed between the federal and state charters. However, the portion of total bank assets under the supervision of state bank regulators declined substantially in 2004 due to two large formerly state-chartered banks changing to the federal charter, and such shifts in assets have budgetary implications for both state regulators and OCC. Based on our work, no conclusion can be made about the role, if any, the preemption rules had in those events or will have on future charter choices. Nevertheless, several state officials expressed the view that federal charters likely bestow competitive advantages in light of the preemption rules, and some states reported actions to address potential charter changes by their state banks.

State officials and consumer groups identified three general measures they believed could address their concerns about protecting consumers of national banks and operating subsidiaries: (1) clarifying the National Bank Act to provide specifically for some state jurisdiction over operating subsidiaries; (2) establishing a consensus-based national consumer protection lending standard; and (3) working more closely with OCC, in part to clarify the applicability of state consumer protection laws to national banks and their operating subsidiaries. In light of OCC regulations and judicial decisions recognizing operating subsidiaries to be authorized by the National Bank Act as vehicles through which national banks may operate, the first measure would likely require amending the National Bank

Act to specify either that the states and OCC share jurisdiction over operating subsidiaries, or that operating subsidiaries are to be treated as national bank affiliates. Moreover, providing for state involvement in the supervision of operating subsidiaries, even if only for consumer protection purposes, raises both policy and practical questions—for example, in drawing a line clearly defining states' authority. Some officials suggested that a national consumer protection lending standard applicable to lending activities by all state-chartered and federally chartered financial institutions would avoid disputes about preemption and serve to satisfy concerns about the effectiveness of current efforts to protect consumers from lending abuses. A uniform standard, however, could limit states' abilities to enact standards of their own. The third measure would involve OCC initiating efforts to involve the states in addressing their concerns. This would be consistent with one of OCC's strategic goals and could assist both the states and the OCC in their consumer protection efforts—for example, by providing a means to systematically share relevant information on local conditions.

This report makes a recommendation to the Comptroller of the Currency that is designed to clarify the applicability of state consumer protection laws to national banks. We provided a draft of this report to OCC for review and comment. In a letter (reprinted in app. VII), the Comptroller of the Currency agreed with our recommendation, specifically recognizing that OCC should find more opportunities to work cooperatively with the states to address issues that affect the institutions it regulates, enhance existing information concerning the principles that guide its preemption analysis, and look for opportunities to generally address the preemption status of state laws. OCC also provided technical comments which we incorporated as appropriate.

OCC Described Types of State Laws That Would Be Preempted, but Questions Remain Regarding the Rules' Scope and Effect

In the bank activities rule, OCC attempted to clarify the types of state laws that would be preempted by relating them to certain categories, or subjects, of activity conducted by national banks and their operating subsidiaries. Specifically, OCC (1) listed subjects of national bank activity—for example, checking accounts, lending disclosure, and mortgage origination and mortgage-related activities such as processing, servicing, purchasing, and selling—to which state laws do not apply; (2) listed subjects to which state laws generally apply; and (3) described the federal standard for preemption under the National Bank Act that it would

apply with respect to state laws that do not relate to the listed subjects.[12] Although OCC's purpose in proposing the regulations was "to add provisions clarifying the applicability of state law to national banks,"[13] we found that grounds for uncertainty remain regarding the applicability of state consumer protection laws to national banks, particularly state statutes that generally prohibit unfair and deceptive practices by businesses. In addition, because they disagree with OCC's legal analysis underlying the rules, some state officials we interviewed said they are unsure of how to proceed with legal measures, such as proposing, enacting, or enforcing laws or issuing and enforcing regulations that could relate to activities conducted by national banks and their operating subsidiaries.

OCC Sought to Clarify the Applicability of State Laws to National Banks and Their Operating Subsidiaries by Interpreting Preemption and Visitorial Powers under the National Bank Act

In the bank activities rulemaking, OCC amended or added rules in parts of its regulations applicable to four categories of national bank activity authorized by the National Bank Act: (1) real estate lending; (2) non-real estate lending; (3) deposit-taking; and (4) the general business of banking, which includes activities OCC determines to be incidental to the business of banking. For each of the first three categories, OCC listed subjects that it concluded are not subject to state law because state laws concerning those subjects already had been preempted under OCC interpretations of the National Bank Act, or by judicial decisions, or were found to be preempted by OTS for federal thrifts. For state laws relating to any of the three categories but not to subjects specified in the lists, OCC announced that it would apply the test for federal preemption established by Supreme Court precedents. According to OCC, that test calls for a determination of whether a state law "obstructs, impairs, or conditions" a national bank's ability to perform a federally authorized activity. For the fourth category—a "catch all" provision for state laws that do not specifically relate to any of the other three categories—the rule states that OCC will apply its articulation of the test for preemption under the National Bank Act. Finally, for each of the four categories of banking activity, the rule lists subjects to which state laws generally apply. These include torts, contracts, the rights to collect debts, taxation, and zoning. The rules also provide that a state law applies to a national bank if OCC determines that the law has only "an

[12]For each of the categories, OCC specified that preemption does not occur if a federal law makes state law applicable to national banks.

[13]69 *Fed. Reg.* 1905 (Jan. 13, 2004).

incidental effect" on the bank's activity or "is otherwise consistent with" powers authorized under the National Bank Act.

Although it is referred to as part of the "preemption rules," the visitorial powers rule does not announce the preemption of state laws that affect a particular subject or activity. Instead it is OCC's refinement of how it interprets the federal statute that establishes OCC's visitorial power over national banks. OCC's view of its visitorial powers is as follows:

> [F]ederal law and OCC regulations vest the OCC with exclusive "visitorial" powers over national banks and their operating subsidiaries. (*Citation omitted*) Those powers include examining national banks, inspecting their books and records, regulating and supervising their activities pursuant to federal banking law, and enforcing compliance with federal or any applicable state law concerning those activities. (*Citation omitted*) Federal law thus limits the extent to which any other governmental entity may exercise visitorial powers over national banks and their operating subsidiaries.[14]

In the visitorial powers rulemaking, OCC sought to clarify the extent of its supervisory authority. The agency amended its rule setting forth OCC's visitorial powers so that the rule: (1) expressly states that OCC has exclusive visitorial authority with respect to the content and conduct of activities authorized for national banks under federal law, unless otherwise provided by federal law; (2) recognizes the jurisdiction of functional regulators under the Gramm Leach Bliley Act (GLBA); and (3) clarifies OCC's interpretation of the statute establishing its visitorial powers, 12 U.S.C. § 484. That provision makes national banks subject to the visitorial powers vested in courts of justice, such as a state court's authority to issue orders or writs compelling the production of information or witnesses, but according to OCC, does not authorize states or other governmental entities to exercise visitorial powers over national banks.

Questions Remain Concerning the Applicability of State Consumer Protection Laws

Although OCC issued the bank activities rule to clarify the applicability of state laws to national banks and their operating subsidiaries, many of the state officials, consumer groups, and law professionals we interviewed said that the preemption rules did not resolve questions about the applicability of certain types of state law to national banks and their operating subsidiaries. One set of concerns, discussed in appendix II of this report, reflects differences about how the rules and OCC's authority under the

[14]OCC Interpretive Letter No. 971 (Jan. 16, 2003). OCC's visitorial powers are set forth at 12 U.S.C. § 484 and OCC's implementing regulation, 12 C.F.R. § 7.4000.

National Bank Act should be interpreted. In OCC's view, the rules resolved many uncertainties that had existed before the rules but did not resolve all issues about the extent of preemption. A second set of concerns regarding uncertainty over the applicability of state consumer protection laws, particularly those prohibiting unfair and deceptive acts and practices (UDAP) exists, at least in part, because of OCC's statements that under the preemption rules such laws may apply to national banks.

Statements by OCC Suggest That State Consumer Protection Laws Can Be Consistent with Federal Law

In the bank activities rulemaking, OCC specified that a state law relating to a subject listed as preempted, as well as any other state law determined to be preempted by OCC or a court, does not apply to national banks and their operating subsidiaries regardless of how the law is characterized.[15] Accordingly, a state law would not escape preemption simply because the state describes it as a consumer protection law. However, OCC has indicated that even under the standard for preemption set forth in the rules, state consumer protection laws can apply to national banks and their operating subsidiaries. Moreover, to the extent that a state's consumer protection law might apply to a subject on one of the preemption lists, OCC has not specifically indicated what characteristics of the state law would cause it to be preempted.

Some state officials and consumer groups we met with were unclear as to whether or not a state consumer protection law would apply to national banks because it is "otherwise consistent with" the National Bank Act, even if the law were to have more than an incidental effect on a national bank's activity. Some referred to a long-standing decision by a Federal Court of Appeals, discussed below, holding that a state's law restricting discriminatory real estate lending practices applied to national banks. They said that the court's reasoning could justify the application of other types of state laws, such as consumer protection laws, to national bank business practices. Moreover, on several occasions, OCC has made statements that reasonably could be interpreted to indicate that state consumer protection laws can be consistent with federal law and, therefore, not preempted, even if they directly affect a national bank's business activity.

[15] 69 *Fed. Reg.* 1912 n. 59 (stating, in pertinent part, as follows: "The label a state attaches to its laws will not affect the analysis of whether that law is preempted.").

In *National State Bank of Elizabeth, N.J. v. Long*, the United States Court of Appeals for the Third Circuit ruled that a provision of a New Jersey law prohibiting redlining in mortgage lending applied to a national bank.[16] Recognizing that prohibiting redlining was consistent with federal policy, the court ruled that the bank's compliance with the New Jersey statute would not frustrate the "aims of the federal banking system" or "impair a national bank's efficiency" in conducting activities permitted by federal law.[17] This decision demonstrates that a state law determined to be consistent with federal policy can govern a national bank's exercise of a federally granted power, even if the law directly affects the way in which the bank conducts its activity. According to some of the individuals we interviewed, the same analysis justifies application of state consumer protection laws to national bank activities such as real estate lending.

Some of the individuals we interviewed asserted that the Long court's analysis justifies the application of state consumer protection laws to national banks, at least to the extent that the laws are consistent with federal policy. They pointed out, moreover, that federal consumer protection laws applicable to banking activities (discussed later in this report) accommodate state laws that impose standards and requirements stricter than those contained in the federal laws themselves, provided the state laws are otherwise consistent with the federal law. Those federal laws contain savings clauses preserving from preemption state laws that impose stricter standards than in the federal laws. However, courts have recognized that those savings clauses do not necessarily preserve such state laws from preemption by the National Bank Act.[18] Several consumer groups and state officials also referred to OCC statements as indications of OCC's recognition that, to some extent, the application of consumer protection laws to national banks is consistent with federal policy. For example, since the promulgation of the preemption rules, OCC has said that state consumer protection laws, and specifically fair lending laws, may apply to national banks and their operating subsidiaries. Also, while the

[16]630 F.2d 981 (3rd Cir. 1980). In general terms, redlining can be described as the practice of denying or increasing the cost of credit or other financial products to residents of certain areas based on prohibited factors such as race, religion, or gender.

[17]Id. at 987. Although the court found the New Jersey law applicable to a national bank's lending activity, the court also held that OCC has exclusive jurisdiction to enforce the law with respect to national banks.

[18]Bank One v. Guttau, 190 F.3d 844 (8th Cir. 1999); see also, Bank of America v. City and County of San Francisco, 309 F.3d 551, 565 (9th Cir. 2002).

bank activities rule specifies that national banks may engage in real estate lending without regard to state law limitations concerning the "terms of credit," the Comptroller recently referred to the agency's responsibility to enforce "applicable state consumer protection laws" and referred to state fair lending laws as an example.[19]

OCC held this position before it promulgated the preemption rules. In a 2002 Advisory Letter to national banks, their operating subsidiaries, and others entitled "Guidance on Unfair or Deceptive Acts or Practices," OCC advised the recipients that "[t]he consequences of engaging in practices that may be unfair or deceptive under federal or state law can include litigation, enforcement actions, monetary judgments, and harm to the institution's reputation." The letter alerted the recipients to the potential that the activities of national banks and their operating subsidiaries could be subject to state UDAP laws, stating as follows:

> A number of state laws prohibit unfair or deceptive acts or practices, and such laws may be applicable to insured depository institutions. *See*, *e.g.*, Cal. Bus. Prof. Code 17200 *et seq.* and 17500 *et seq.* Operating subsidiaries, which operate effectively as divisions or departments of their parent national bank, also may be subject to such state laws. . . . Pursuant to 12 CFR 7.4006, state laws apply to national bank operating subsidiaries to the same extent that those laws apply to the parent national bank, unless otherwise provided by federal law or OCC regulation.

[19]Letter to the Honorable Barney Frank from Comptroller of the Currency John Dugan, Nov. 21, 2005.

Although OCC published this guidance before it issued the bank activities rule, at the time of the guidance OCC had been following the same preemption standard it applied in the rulemaking.[20]

Officials Expressed Differing Views on Applicability of State Consumer Protection Laws

We found differing views among state officials with respect to the applicability of state consumer protection laws, particularly their UDAP laws, to national banks. Officials from some state attorney general offices said that their states' UDAP laws probably are preempted by the bank activities rule, while officials in one state were unclear. State banking department officials we spoke with also had mixed views regarding the applicability of state UDAP laws. In one state, a banking department official said that the state's UDAP statute would likely be preempted. In another state, an official said that state's UDAP laws would not be preempted. Two other state banking department officials were unclear about the status of their states' UDAP laws.

Representatives of national banks also had mixed views about the applicability of state UDAP laws. Representatives of one national bank stated that state UDAP laws were preempted, whereas representatives of two other national banks stated that state UDAP laws were, in fact, applicable to national banks and their operating subsidiaries. The status of state UDAP laws is not clear because, some argued, those laws generally are consistent with federal laws and policies and, therefore, might not obstruct, impair, or condition the ability of national banks and operating subsidiaries to carry out activities authorized by the National Bank Act.

[20]In a 1997 interpretive letter, an OCC official made the following point about Supreme Court decisions concerning preemption under the National Bank Act:

> In reviewing these decisions, a recurrent theme is apparent. The Court has repeatedly used words and phrases such as "impair," "interfere with," "conflict with," "frustrate," "infringe," and "burden" to describe the effect of state laws that it has found to be preempted with respect to national banks. The lesson to be derived is that state laws apply to national banks only if they do not conflict with federal law, which includes impairing or interfering with the powers granted to national banks by federal law. . . .

OCC Interpretive Letter No. 789 (June 27, 1997). Also, in 2003, OCC stated that, with respect to requests for a preemption opinion, "[w]e will continue to review these requests on a case-by-case basis and, in so doing, we will continue to apply the preemption standards articulated by the United States Supreme Court in Barnett Bank of Marion County, N.A. v. Nelson, 517 U.S. 25 (1996) and other applicable Federal judicial precedents." OCC Advisory Letter 2002—3 (Mar. 22, 2002).

In addition to uncertainty over the applicability of state consumer protection laws, state officials, consumer groups, and others asserted that the effects of the preemption rules will remain unclear until legal arguments are resolved. The legal disputes pertain to whether OCC correctly articulated and applied the federal preemption standard, OCC's reasons for including certain subjects of state law in the preemption lists, and the application of state laws to national bank operating subsidiaries. These issues, which essentially concern OCC's legal authority and rationale for the rules, are summarized in appendix II.

According to Most State Officials We Contacted, the Preemption Rules Have Diminished State Consumer Protection Efforts

According to most state officials we contacted, the preemption rules have limited the actions states can take to resolve consumer issues and negatively affected the way national banks respond to consumer complaints and inquiries from state officials. More specifically, the state officials asserted that, after the preemption rules went into effect, some national banks and operating subsidiaries became less responsive to actions by state officials to resolve consumer complaints. In addition, some state officials noted that they previously had been able to examine operating subsidiaries without challenge, but after the visitorial powers rule was issued some national bank operating subsidiaries declined to submit to state examinations or relinquished their state licenses. However, other state officials reported good working relationships with national banks and their operating subsidiaries, and some national bank officials said that cooperation with state attorneys general was good business practice. While we found some examples of operating subsidiaries that did not comply with state regulatory requirements after the preemption rules were issued, we note that others had not complied with state requirements before the rules were issued. Some state officials also believed that the preemption rules might prompt holding companies with national bank subsidiaries to move lines of business from a national banks' holding company affiliate into an operating subsidiary to avoid state regulation. No data are available that would allow us to determine the extent of any such activity, and state officials did not provide conclusive documentary evidence to support their concerns.

State Officials Expressed Differing Reactions to the Rules' Effect on Relationships with National Banks

While all state officials we interviewed agreed that the preemption rules have changed the environment in which they relate to national banks and their operating subsidiaries, they have responded differently to the changes. Officials from some state attorney general offices and state banking departments told us that the preemption rules have caused them to approach national banks and their operating subsidiaries about consumer protection issues differently than they did in the past. For example, one state banking department official said that, instead of approaching a national bank operating subsidiary from a regulatory posture, the department now will try to resolve a consumer complaint with a national bank operating subsidiary only if the department has a contact at that particular operating subsidiary, but having a contact is the exception rather than the rule. Other state officials told us that the preemption rules have not caused them to change their practices, either because they continued to attempt resolution at the local level or because they continued to forward unresolved complaints to OCC as they had done prior to the issuance of the preemption rules.

Both before and after issuing the preemption rules, OCC issued guidance that, among other things, addressed how banks should handle contacts from state officials. Specifically, OCC issued guidance in 2002—prior to the visitorial powers rule—encouraging national banks to consult the agency about information requests by state officials to determine whether the request constituted an attempt to exercise visitorial or enforcement power over the bank.[21] The guidance also advised national banks that state officials were to contact OCC, rather than the bank itself, if they had information to indicate that the bank might be violating federal law or an applicable state law. In February 2004, approximately 1 month after the visitorial powers rule became effective, OCC updated its 2002 guidance to clarify how national banks should respond to consumer complaints referred directly to the bank by state officials.[22] While the 2002 guidance was silent on consumer complaint handling specifically, the 2004 guidance stated that OCC does not regard referral of complaints by state officials as an exercise of supervisory powers by the states and that national banks should deal with the complaining customer directly. The 2004 guidance advised national banks to contact OCC if (1) the bank considers a referral to be a state effort to direct the bank's conduct or otherwise to exercise

[21] OCC Advisory Letter 2002-9 (Nov. 25, 2002).

[22] OCC Advisory Letter 2004-2 (Feb. 26, 2004).

visitorial authority over the national bank or (2) the state-referred complaint deals with the applicability of a state law or issues of preemption. Further, the guidance notifies national banks that state officials are encouraged to send individual consumer complaints to OCC's Customer Assistance Group, and as outlined in the 2002 guidance, reiterates that state officials should communicate any information related to a national bank's involvement in unfair or deceptive practices to OCC's Office of Chief Counsel.

Further, in July 2003—prior to the visitorial powers rule—OCC suggested a "Memorandum of Understanding" (MOU) between itself and state attorneys general and other relevant state officials that could, in OCC's words, "greatly facilitate" its ability to provide information on the status and resolution of specific consumer complaints and broader consumer protection matters state officials might refer to them. The MOU was sent to all state attorneys general as well as the National Association of Attorneys General (NAAG) and CSBS. Some of the officials from banking departments and the offices of attorneys general that we interviewed, as well as representatives of CSBS, said they viewed OCC's proposed MOU as unsatisfactory because, in their view, it essentially favored the OCC. In addition, some of the state officials with whom we spoke believed that signing the proposed MOU would amount to a tacit agreement to the principles of the banking activities and the visitorial powers rules.

According to OCC, states' attorneys general—in informal comments on the proposed MOU—felt that the proposal was unilateral, imposing certain conditions upon states that received information from OCC but not upon OCC when it received information from state officials. Also, OCC noted that the proposed MOU did not provide for referrals from OCC to state agencies of consumer complaints OCC received pertaining to state-regulated entities. Therefore, in 2004, OCC attempted to address these concerns in a revised MOU, which it provided to CSBS and the Chairman of the NAAG Consumer Protection Committee. According to OCC, the revised MOU expressly says that an exchange of information does not involve any concession of jurisdiction by either the states or by OCC to the other. Only one state official signed the original 2003 MOU, and according to OCC, to date, no additional state officials have signed the 2004 version.

Some State Officials Believe That National Banks and Operating Subsidiaries Are Less Inclined to Cooperate

Some state officials asserted that before the preemption rules they were able to deal with national banks on more than merely a complaint-referral basis. They said that, through their regular dealings with national banks and their operating subsidiaries, consumer complaints typically had been

resolved effectively and expeditiously. Among the anecdotes they provided are the following:

- State officials in two states said that they treated national banks and their operating subsidiaries just like any other state-regulated business; they would simply approach the institution about consumer complaints and jointly work with the institution to resolve them.
- An official in one state attorney general's office referred to an effort in which the attorney general's office successfully resolved complaints about a national bank's transmittal of customer account information to telemarketers.
- Officials from another attorney general's office said that, before the visitorial powers rule was amended, they often were able to persuade national banks to change their business practices; for example, they said they were able to encourage a national bank to discontinue including solicitations that they viewed as deceptive in consumers' credit card statements. These officials also stated that, in the past, they were able to speak informally with national banks to get them to alter the way certain products were advertised.

As further examples of national banks cooperating with state officials prior to the preemption rules, state officials in two states cited voluntary settlements that national banks entered with states concerning telemarketing to bank credit card holders and the sharing of bank customer information with third parties. In each of two settlements, one in March 2002 and the other in January 2003, national banks entered an agreement with 29 states in connection with judicial proceedings brought by the states concerning telemarketing practices and the disclosure of cardholder information to third parties. Also, in an October 2000 settlement made in connection with judicial proceedings initiated by a state, a national bank agreed to follow certain practices concerning the sharing of customer information with third parties. Although these settlements were made voluntarily and do not represent a judicial determination that the states had authority to enforce laws against the national banks, state officials used them to illustrate that they had some influence over the banks prior to the preemption rules. In addition, some state officials said that prior to the visitorial powers rule, many operating subsidiaries submitted to state requirements regulating the conduct of their business, such as license requirements for mortgage brokering. Also, according to some state officials, prior to the issuance of the visitorial powers rule their states

examined and took enforcement actions against operating subsidiaries because they were state-licensed and regulated, and OCC did not interfere.[23]

Some state authorities maintained, however, that by removing uncertainties about state jurisdiction and the applicability of state law that may have served as an incentive for cooperation, the preemption rules made it opportune for the institutions to be less cooperative. One official from an attorney general's office, emphasizing the importance of consumer protection at the local level, stated that the preemption rules have in effect precluded the state from obtaining information from national banks that could assist the state in protecting consumers. The official pointed out that the state's ability to obtain information from operating subsidiaries enhanced state consumer protection efforts because the institutions would refrain from abusive practices to avoid reputation risk associated with the disclosure of adverse information.[24] Further, many state officials we spoke with expressed a concern that, because of the preemption rules, national bank operating subsidiaries that formerly submitted to state supervision no longer do so.

According to some state officials, because of the preemption rules, operating subsidiaries either threatened to relinquish or actually

[23]One example of state regulation of a national bank operating subsidiary can be found in Wells Fargo Bank, N.A. v. Boutris, 419 F.3d 949 (9th Cir. 2005). The case involved a national bank operating subsidiary engaged in the business of mortgage lending, which became licensed by California in 1997 and underwent an examination by the state in 2002 for compliance with state laws. In 2003, the state agency demanded that the subsidiary conduct an audit of its residential mortgage loans made in California during a certain time period. The subsidiary refused, asserting that in connection with its mortgage lending it was subject to OCC's exclusive jurisdiction even though the entity had submitted to the state examination. The court held in favor of the operating subsidiary, permanently enjoining the state from exercising visitorial powers over the subsidiary. See also, National City Bank of Indiana v. Boutris, 2003 U.S. Dist. LEXIS 25852 (E.D. Cal. July 2, 2003).

[24]A federal court has ruled that this type of policy concern does not undermine the exclusiveness of OCC's supervisory authority. In OCC v. Spitzer, 396 F. Supp. 2d 383 (S.D. N.Y. 2005), the court held that the Attorney General for the State of New York is permanently enjoined from issuing subpoenas or demanding inspection of the books and records of any national bank in connection with an investigation into residential lending practices; from instituting any enforcement actions to compel compliance with informational demands; and from instituting actions in the courts of justice against national banks to enforce state fair lending laws.

relinquished their state licenses, or did not register for or renew their licenses.[25] Specifically:

- State officials in two states provided copies of letters they received from operating subsidiaries, citing the visitorial powers rule as the basis for relinquishing their state licenses.

- An official in one state attorney general's office provided a list of 27 national bank operating subsidiaries that notified the office that they would no longer maintain their state licenses.

- Banking department officials in one state estimated that 50-100 operating subsidiaries had not renewed their licenses.

While the preemption rules may have prompted some national bank operating subsidiaries to relinquish their state licenses or otherwise choose not to comply with state licensing laws, we note that others did so before the preemption rules were issued. For example, in January 2003 an entity licensed by the State of Michigan that engaged in making first mortgage loans became a national bank operating subsidiary. In April 2003, the entity advised the state that it was surrendering its lending registration for Michigan.[26]

Some state officials said that because the visitorial powers rule precludes state banking departments from examining operating subsidiaries, the potential exists for a "gap" in the supervision of operating subsidiaries. According to them, without state examination, consumers may be harmed because unfair and deceptive, or abusive, activities occurring within operating subsidiaries may not be identified. Although OCC's procedures state that any risks posed by an operating subsidiary are considered in the conduct of bank examinations and other supervisory activities, state officials nonetheless doubted OCC's willingness to detect compliance with applicable state laws. Some questioned how examiners would know what

[25]In the bank activities rule, OCC listed as preempted state licensing or registration requirements (except for purposes of service of process) with respect to deposit-taking, non-real estate lending, and real estate lending. 69 *Fed. Reg.* at 1916-1917.

[26]See Wachovia Bank, N.A. v. Watters, 334 F. Supp. 2d 957 (D. Mich. 2004) (upholding OCC rule declaring that state laws apply to national bank operating subsidiaries to the same extent that they apply to their parent national banks); *aff'd*, Wachovia Bank, N.A. v. Watters, 431 F.3d 556 (6th Cir. 2005).

state laws, if any, apply to national banks and how examiners would review compliance with such laws. While OCC examiners noted that they generally did not have procedures for examining compliance with state laws, OCC officials explained that if they identify a state law requirement that is applicable to national banks and operating subsidiaries, examiners are advised so that they can take the requirement into account as they determine the scope of their examinations.

Other State Officials Reported Little Change in Relationships with National Banks

The above-described concerns of state officials are not universal. In one state, officials with whom we spoke acknowledged that they still have good working relationships with national banks and their operating subsidiaries. Further, officials of some national banks with whom we spoke stated that they viewed cooperation with state laws and attorneys general as good business practice. For example, one national bank representative stated that knowing about problems that consumers were having helped to provide better services and reduce the potential for litigation. The individual added that the bank wants to maintain relationships with state attorneys general, and if they make an honest effort to engage the bank, then the bank also would engage the attorneys general. Another national bank representative stated that the bank typically tries to focus on resolving the concern rather than quibble about whose jurisdiction—federal or state—the issue falls under.

Some State Officials Were Concerned That the Preemption Rules Could Prompt the Creation of Operating Subsidiaries to Avoid State Regulation

Some state officials with whom we spoke expressed concern that the preemption rules might cause national banks to bring into the bank lines of business traditionally regulated by states. According to this view, nonsubsidiary affiliates of national banks, such as a mortgage broker controlled by a holding company that also controls a national bank, could be restructured as operating subsidiaries to avoid state supervision and licensing requirements. According to FRB officials, movements of bank holding company subsidiaries to national bank operating subsidiaries have occurred for some time, including before OCC issued the preemption rules.[27] However, FRB does not collect data specifically on such movements.

Many lines of business that constitute the business of banking under the National Bank Act, such as mortgage lending and brokering and various

[27]FRB supervises bank holding companies and their nonbank subsidiaries.

types of consumer lending, are conducted by nonbank entities. According to some individuals we spoke with, a bank holding company controlling both a national bank and such a nonbank entity might perceive some benefit in having the nonbank's business take place through the bank and, therefore, cause the bank to acquire the nonbank as an operating subsidiary.

Federal courts considering the status of national bank operating subsidiaries have upheld OCC's position that operating subsidiaries are a federally authorized means through which national banks exercise federally authorized powers, holding that operating subsidiaries are subject to the same regulatory regime that applies to national banks, unless a federal law specifically provides for state regulation.[28] Under these precedents, converting a nonsubsidiary affiliate or unaffiliated entity into a national bank operating subsidiary would subject the entity to OCC's exclusive supervision. Moreover, state laws preempted from applying to national banks would be preempted with respect to the entity once it were to become an operating subsidiary.[29]

FRB individuals with whom we spoke said that a national bank's cost of conducting a business activity in an operating subsidiary could be less than the cost of conducting that activity through a holding company affiliate. Therefore, a bank holding company could have an incentive to place a state-regulated activity in a national bank operating subsidiary. However, this would be true both before and after the preemption rules, all else being equal. As discussed in the following section, the financial services industry has undergone many technological, structural, and regulatory changes during the past decade and longer. Determining how the preemption rules, in comparison with any number of other factors that might influence how banks or holding companies are structured, would factor into the national bank's decision to acquire a nonbank entity was beyond the scope of our work.[30]

[28]See, e.g., Wells Fargo Bank, N.A. v. Boutris, 419 F.3d 949 (9th Cir. 2005); Wachovia Bank, N.A. v. Burke, 414 F.3d 305 (2d Cir. 2005); Wachovia Bank, N.A. v. Watters, 431 F.3d 556 (6th Cir. 2005).

[29]See, e.g., Wachovia Bank, N.A. v. Watters, 431 F.3d 556 (6th Cir. 2005).

[30]According to OCC, many other factors drive the decision about where an entity is placed—whether it will be a subsidiary or affiliate of the bank—including, among others, statutory and regulatory restrictions on transactions with affiliates, regulatory capital requirements, and accounting considerations.

The Rules' Effect on Charter Choice Is Uncertain, but Some States Are Addressing Potential Charter Changes

Many factors affect charter choice, and we could not isolate the effect of the preemption rules, if any, on charter changes. According to some state regulators and participants in the banking industry, federal bank regulation could be advantageous to banks when compliance with state laws would be more costly, thereby creating an incentive for banks to change charters. However, because the financial services industry has undergone significant changes--involving interstate banking, globalization, mergers, and consolidations—it is difficult to isolate the effects of regulation from other factors that could affect choice of charter. According to our analysis of FRB and OCC data from 1990 to 2004, the number of banks that changed between the federal and state charters was relatively small compared with all banks. However, total bank assets under state supervision declined substantially in 2004 because two large state-chartered banks changed to the federal charter; further, such shifts in assets have budgetary implications for both state regulators and OCC. Based on our work, no conclusion can be made about the extent to which OCC's preemption rules had any effect on those events or will have on future charter choices. Nevertheless, several state officials expressed the view that federal charters likely bestow competitive advantages in light of the preemption rules; in response, some states addressed potential charter changes by their state banks. For example, one state changed its method of collecting assessments.

Industry Changes and Other Factors May Affect Charter Choice

A discussion of any effect or perceptions of the effect of the preemption rules on charter choices by state-chartered banks has to be viewed in the broader environment of the evolution of the financial services industry over the past approximately 20 years—changes that make it difficult to assess the impact of the preemption rules. Some of the bank officials and other bank industry participants we interviewed noted these industry changes when discussing their views on the preemption rules and acknowledged that many factors may affect banks' choices between federal and state charters.

Banking Business Has Changed in Many Ways

Like other parts of the financial services industry, which includes the securities and insurance sectors, modern banking has undergone significant changes. Interstate banking and globalization have become characteristics of modern economic life. On both the national and international levels, banks have a greater capacity and increased regulatory freedom to cross borders, creating markets that either eliminate or substantially reduce the effect of national and state borders. Deregulation

and technological changes have also facilitated globalization. Consolidation (merging of firms in the same sector) and conglomeration (merging of firms in other sectors) have increasingly come to characterize the large players in the financial services industry. The roles of banks and other financial institutions and the products and services they offer have converged so that these institutions often offer customers similar services. As a result, the financial services industry has become more complex and competition sharper.

In our October 2004 report on changes in the financial services industry, we cited technological change and deregulation as important drivers of consolidation in the banking industry.[31] For example, in the early 1980s, bank holding companies faced limitations on their ability to own banks located in different states. Some states did not allow banks to branch at all. With the advent of regional interstate compacts in the late 1980s, some banks began to merge regionally. Additionally, the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 removed restrictions on bank holding companies' ability to acquire banks located in different states and permitted banks in different states to merge, subject to a process that permitted states to opt out of that authority.[32] While the U.S. banking industry is characterized by a large number of small banks, the larger banking organizations grew significantly through mergers after 1995.

Convergence of products and services in the banking industry means that now many consumers can make deposits, obtain a mortgage or other loan, and purchase insurance or mutual funds at their bank. Other market factors have made some banks rely more on fee-based income from, among other services and products, servicing on loans they sold to other institutions and fees on deposit and credit card activity (including account holder fees, late fees, and transactions fees). Thus, consumer protection issues have become increasingly important to the industry.

Many Factors May Affect Choice of Charters

Bank and banking industry association officials and state and federal regulators we interviewed told us that choice of charter is influenced by many factors. For example, the size and complexity of banking operations are important factors in determining which charter will service an

[31]GAO, *Financial Regulation: Industry Changes Prompt Need to Reconsider U.S. Regulatory Structure*, GAO-05-61 (Washington, D.C.: Oct. 6, 2004).

[32]Pub. L. No. 103-328, 108 Stat. 2238 (1994).

institution's business needs. Bank and other officials also cited the importance of supervisory and regulatory competence and expertise tailored to the scale of a bank's operations. For example, officials of some large national banks stated that they valued OCC's ability to effectively supervise and regulate large scale banks with complex financial products and services. Officials from one large state bank said that they valued federal supervision by FDIC and, at the holding company level, FRB. Some bank and state and federal regulatory officials said that smaller banks prefer the generally lower examination fees charged by state regulators and lower regulatory compliance costs associated with their state charters relative to the federal charter. For example, officials of one small state bank, which was previously federally chartered, said that they had to undertake more administrative tasks under the federal charter, such as greater reporting requirements needed to demonstrate compliance with federal laws, and that such tasks were relatively burdensome for a small bank.

Some bank officials and state and federal regulators agreed that smaller banks with few or no operations in other states value accessibility to and convenient interaction with state regulators.[33] Additionally, officials of smaller banks said they value the state regulators' understanding of local market conditions and participants and the needs of small-scale banking. Officials of one small state bank said that, when their bank switched from the federal charter to a state charter, one important consideration was the state regulators' frequent visits to the bank and their responsiveness and accessibility. Bank officials, industry representatives, and regulators also agreed that new banks tend to be state-chartered because state regulators tend to play an important role in fostering the development and growth of start-up banks.

Bank and state regulatory officials noted that a pre-existing relationship between a bank's senior management and a regulator or management's knowledge about a particular regulator can play an important role in choosing or maintaining a charter. For example, officials noted that if management has already established a good, long-term relationship with a particular regulator, or if they were familiar with a regulator, they would likely remain with that regulator when considering charter options. Officials from two large, state-chartered banks operating in multiple states

[33]OCC officials, in commenting on a draft of this report, noted that OCC, too, has a local presence with four district offices and numerous field offices throughout the United States.

said that they valued their relationship with their home state regulators because they were very responsive and provided quality services. Officials from one of the banks stated that they knew the staff of their state banking department very well, and they respected the banking commissioner's "hands-on" approach to supervision.

Mergers and acquisitions of banking institutions also influence charter choice. For example, officials from a large banking institution stated that, because their merger with another large banking institution combined federally and state-chartered entities, they decided to convert from a state to the federal charter to maintain only one charter type in the resulting company. As a result, they believed they would be able to simplify their operations, reduce inefficiencies, and lower risks to the financial safety and soundness of the merged company and have the advantages of the federal charter companywide. The history of acquisitions in a company also may affect charter choice. For instance, officials of one bank said they obtained their federal charter by acquiring a federally chartered bank and then continued to acquire more federally chartered banks. Similarly, according to officials of a state bank, they typically integrate banks they acquire into their existing state charter.

Few Banks Have Changed Charters, but Shifts in Bank Assets Have Budgetary Implications for State Regulators and OCC

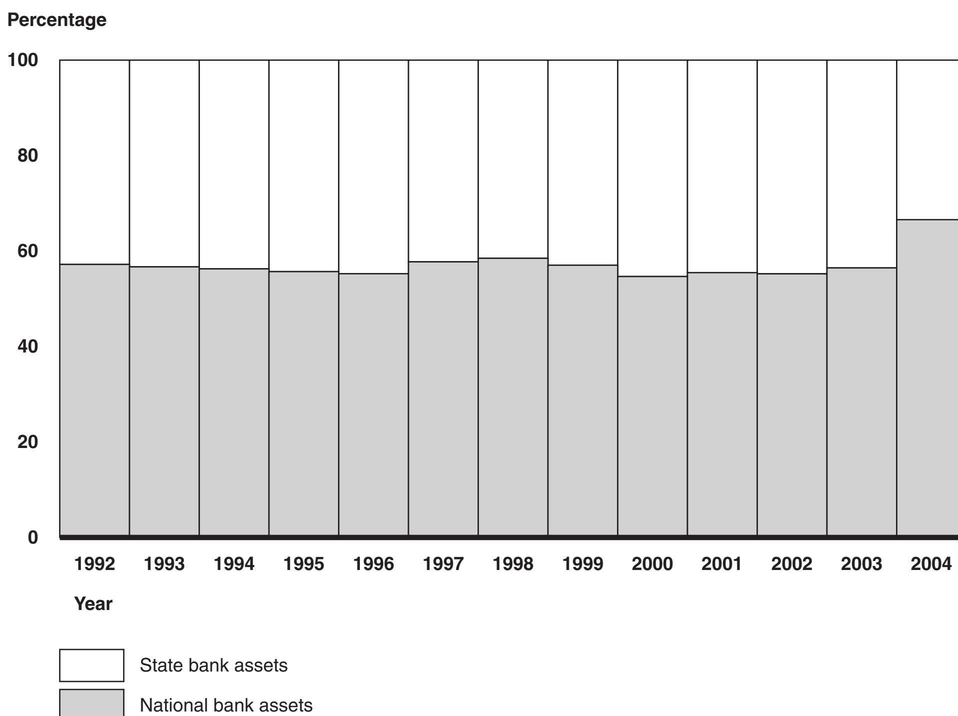
Our analysis of data on charter changes among federally and state-chartered banks from 1990 through 2004 showed that few banks overall changed charters—either switching from federal to state or state to federal—during that period.[34] About 2 percent or less of all banks in these years changed charters; 60 percent of all changes were to the federal charter. Most charter changes occurred in connection with mergers rather than conversions.[35] Appendix III provides details on charter changes.

[34]Data on charter changes for 2005 were not available at the time of our study. The category "state-chartered bank" includes state member banks, state nonmember banks, and state savings banks. According to an FRB official, both FRB and FDIC data for state banks include state-chartered savings banks that are regulated by FDIC. Therefore, we included state-chartered savings banks in the category "state-chartered bank" to make the data we used from OCC, FRB, and FDIC as comparable as possible.

[35]According to OCC and FRB officials, a charter change resulting from a conversion is a business decision involving one entity changing to another charter whereas a charter change resulting from a merger is a business transaction involving the consolidation of two or more entities into one entity under a state or federal charter.

While the numerical shift in bank charters was not significant from 1990 through 2004, there was a major shift in the distribution of bank assets in 2004 to the federal charter. As illustrated in figure 2, the share of assets divided among federally chartered and state-chartered banks remained relatively steady for a decade; between 1992 and 2003, national banks held an average of about 56 percent of all bank assets, and state banks held an average of about 44 percent. However, in 2004, the share of bank assets of banks with the federal charter increased to 67 percent, and the share of bank assets of banks with state charters decreased to 33 percent.

Figure 2: Assets of National and State Banks as a Percentage of Assets of All Banks, 1992–2004



Source: GAO analysis of FDIC data.

Note: FDIC data were only available beginning in 1992.

While part of this increase may be explained by the growth of federally chartered banks, two charter changes in 2004— JP Morgan Chase Bank and HSBC Bank—substantially increased the share of all bank assets under the federal charter.

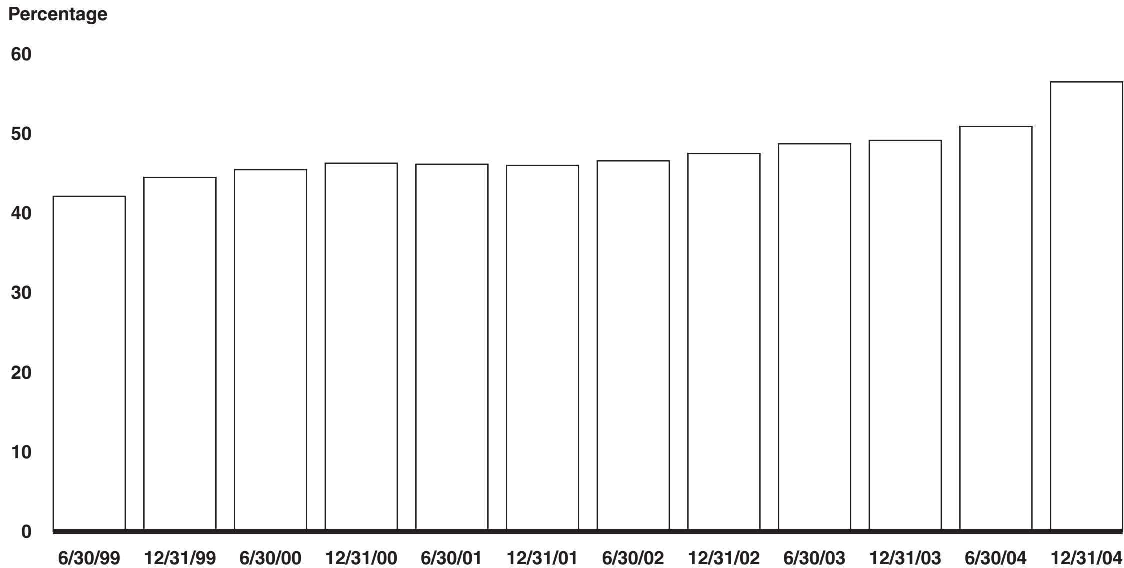
Changes in bank assets among state and federal regulators have budgetary implications because of the way the regulators are funded. Most state regulators are funded by assessments paid by the banks they oversee. The state banking departments collect assessments, often based on the supervised bank's asset size. As a result, a department's budget may be vulnerable when the department collects a significant portion of its revenue from a few large banks if one or more change to the federal charter. For instance, when two of the largest banks in one state changed to the federal charter, the state regulator lost about 30 percent of its revenue.

We analyzed funding information in two states we visited to estimate how a change to the federal charter by the largest state bank in each state could affect those state regulators' budgets. In the first state, if the largest state bank were to change to the federal charter, the state regulator's assessment revenue would decrease by 43 percent. In the second state, the charter change of the largest state bank would decrease assessment revenue by 39 percent. Some state banking department officials told us that loss of revenue has caused or may cause them to adjust their assessment formula and find other sources of revenue. Others suggested that budget volatility also might make hiring and retaining the expert staff that they needed difficult.

OCC is funded primarily from assessments it charges the banks it supervises; it does not receive any appropriations from Congress. (See app. IV for details on OCC's assessment formula and app. V for information on how some other federal regulators are funded.) Between 1999 and 2004, the assessments collected from national banks funded an average of 96 percent of OCC's budget. Thus, its budget also could be affected by charter changes. OCC derives much of its assessments from a relatively small number of institutions. Although OCC oversees about 1,900 national banks, the 20 largest banks accounted for approximately 57 percent of OCC's assessments in December 2004.[36] Since 1999, the percentage of OCC's budget paid by its largest banks has been increasing (see fig. 3).

[36]According to OCC's *Fiscal Year 2005 Annual Report*, OCC was responsible for regulating and supervising 1,933 national banks.

Figure 3: Percentage of OCC's Total Assessments from the 20 Largest National Banks, from June 30, 1999 through December 31, 2004

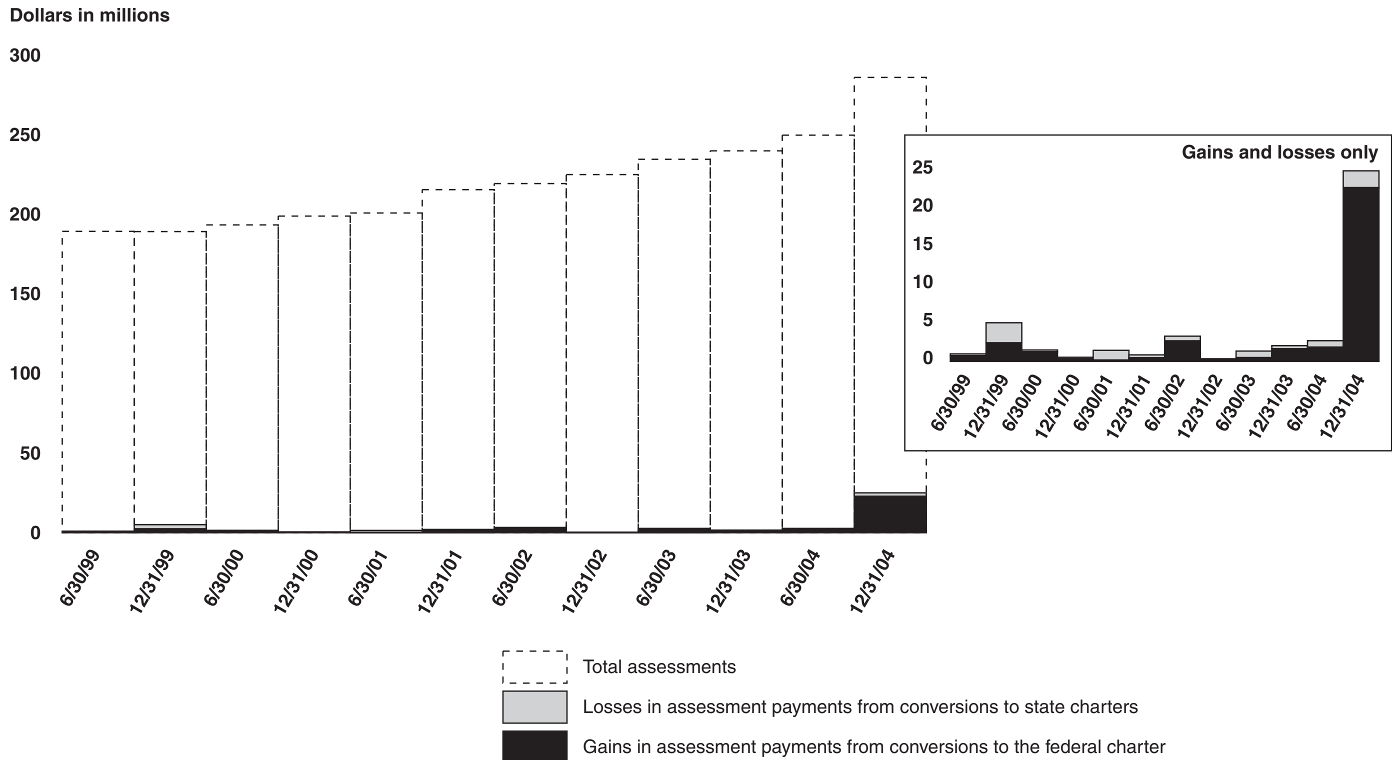


Source: OCC.

The potential exists for OCC to experience budget repercussions if large national banks decided to change to a state charter, resulting in fewer assets under OCC's supervision. However, before December 2004, conversions generally affected less than 1 percent of OCC's assessment revenue. Figure 4 shows gains and losses in assessments paid to OCC relative to the total amount collected in assessment payments. OCC's assessment revenue from conversions to the federal charter jumped by about 8 percent, or about $23 million, as of December 31, 2004.[37] The increase is largely attributable to the conversion of one of the two large state banks mentioned previously, which accounted for about 98 percent of the increase in OCC's assessment revenue from charter conversions.

[37]Assessments are due January 31 and July 31 of each year based on asset balances as reported in call reports dated December 31 and June 30, respectively. Reports of Condition (call reports) provide details on assets, liabilities, and capital accounts.

Figure 4: Gains and Losses in Assessment Payments to OCC Relative to Total Assessments OCC Collected, from June 30, 1999 through December 31, 2004



Source: OCC.

According to OCC officials, the agency is in a position to sustain any serious decrease to its revenue stream. OCC's financial strategy includes establishing reserves to address unexpected fluctuations in assessment revenue and an increase in demand on resources.[38] According to OCC, its "contingency reserve" would be used to counter any adverse budgetary effects of a large national bank changing charters. OCC's policy is to

[38]OCC has three reserves that can be used at the discretion of the Comptroller. According to OCC officials, the "contingency reserve" supports OCC's ability to fund generally foreseeable, but rare, events that may interfere with OCC's ability to accomplish its mission. The "special reserve" supplements revenue from assessments and other sources to fund OCC's annual budget authority. The "asset replacement reserve" was established to fund leasehold improvements and replacement of furniture and equipment scheduled for future years.

maintain the contingency reserve at between 40 and 60 percent of its budget. According to OCC, at the beginning of fiscal year 2006, the contingency reserve was 49 percent of OCC's budget. According to OCC, having a reserve allows the agency to handle any change in revenue in a controlled way and reduce the impact of budget volatility and any need to suddenly increase assessments charged to the banks they supervise.

Some Officials Perceive Competitive Advantages in the Federal Charter and Have Taken Actions to Address Potential Charter Changes by State Banks

According to some state officials, because of federal preemption, national banks do not have to comply with state laws that apply to banking activities and, to the extent that compliance with federal law is less costly or burdensome than state regulation, the federal charter provides for lower regulatory costs and easier access to markets. Therefore, some state regulators and banking industry officials expressed concern that the federal charter, and particularly the preemption of state laws, will result in competitive advantages for federally chartered banks over state chartered banks. According to some state officials, state chartered banks that operate in multiple states could be at the greatest competitive disadvantage. In contrast, according to OCC and many banking industry participants, from a legal perspective, the preemption rules did not change anything; state laws always have been subject to preemption under the National Bank Act and the Supremacy Clause of the U.S. Constitution and, therefore, state banks historically have faced the possibility that a federal charter could be more beneficial than a state charter.

As noted above, many factors may influence banks' choice of a state or federal charter. Substantiating claims about any competitive advantage for federally chartered banks would involve, among other things, comparisons of states' laws and regulations with federal law and regulations, conclusions about which set of laws and regulations overall would be less burdensome or costly for a particular bank, and obtaining and analyzing data and individual opinions about whether differences in burden and compliance costs, if any, would be significant enough to limit a state bank's ability to compete with national banks. A study of this magnitude was beyond the scope of this report and, during our work, we did not learn of any study demonstrating that the preemption-related aspects of a national bank charter generally give national banks a competitive advantage over state-chartered institutions.

Officials Perceived Some Competitive Advantages for the Federal Charter

Many officials that we spoke with said that preemption of state law could make the federal bank charter attractive for some state banks. Representatives of a number of federally and state-chartered banking

institutions and industry associations stressed the value of not having to comply with different state laws and of having more regulatory uniformity throughout the country under a federal charter. They stated that large banks and banks with operations in multiple states prefer the federal charter because it makes it easier and less costly to do business. Some bank officials stated that OCC preemption also makes the federal charter attractive because the rules clarify supervisory and regulatory authority for national banks and their operating subsidiaries and also encourage more standardized banking practices. For example, officials from one national bank said that changes in the banking industry, such as interstate banking, make it more important for banks with multistate operations to have uniform federal regulations to operate across states and to achieve economies of scale. Similarly, an official from another large national bank noted that having a consistent set of national regulations also facilitates banks in offering consumers, who are becoming increasingly mobile, financial products and services across the country.

Officials from one large federally chartered bank said that a state charter for them would be impractical because it would be expensive to develop and maintain different operational systems for different state laws. Officials from one large, state-chartered bank operating in multiple states said that they need to tailor their products, fees, forms, disclosures, and staff training to the requirements of each state and that the requirements could be conflicting. In contrast, they said, for national banks, there are fewer legal discrepancies when operating under the federal charter. Officials from one state-chartered bank with multistate operations also said that they invest significant resources to keep abreast of and monitor state regulatory matters in the various states where they operate. Furthermore, some bank officials noted that mistakes are more likely to occur when business operations must be tailored to the multiple and different requirements of different states. Despite these challenges, officials from these state-chartered banks believed the benefits of being state-chartered outweighed the challenges.

Some States Have Made Efforts to Address the Potential Impact of Charter Changes

State officials noted two efforts to address potential charter changes by their state banks: strengthening their state parity laws, which generally confer on state banks the same powers given to national banks, and changing their funding sources.

Parity Laws

Some individuals we interviewed suggested that the use of state "parity" statutes could help even the regulatory playing field between federal and state regulation. Parity statutes generally grant state-chartered banks the same powers given to national banks and treat state banks like national banks in other ways. According to data from CSBS, prior to the rules, 46 states had parity statutes granting state-chartered banks parity with national banks.[39] Of those, 11 states had parity statutes that were triggered automatically; that is, when national banks were granted certain powers, state banks in that state were automatically granted the same powers.[40]

According to CSBS, the remaining 35 states' parity laws require the state bank regulator's permission before a state bank is allowed to operate under the parity law's provisions. Representatives of one state bankers association told us in their state—where regulator approval for parity is required—there are often long delays, with some state bank's parity applications pending for 2-3 years. Further, according to state regulators many states' parity laws include other restrictions that some say may make it difficult for a state bank to be competitive with national banks. After the preemption rules were promulgated, one state bank regulator proposed to enhance the state's current parity statute to include an automatic trigger for state-chartered banks when national banks are given certain powers by the OCC. Thus, in the view of many industry participants and observers we spoke with, state parity laws are not an ideal solution to leveling any competitive advantage federally chartered banks might have over state-chartered banks. However, an effective parity law could provide an incentive for existing state-chartered banks to maintain their state charters.

We note that views about the rationale for parity laws generally did not address other possible explanations for those laws, such as a belief that federal regulation is an appropriate model for regulating and supervising state banks. Regardless of a state's reasons for having a parity law, many

[39]Data taken from the "CSBS 2002 Profile of State-Chartered Banking," a compendium of information on the structure and condition of the state bank regulatory system developed through a survey. New Hampshire and South Carolina did not respond to survey questions about wildcard authority; the District of Columbia and Puerto Rico were not included because they are not states; Iowa and North Carolina responded "no" to having a parity statute for commercial banks.

[40]According to the CSBS information, Kentucky grants automatic parity to those banks that receive the highest examination ratings.

participants and regulators in the banking industry maintain that without regulatory parity the dual banking system will suffer because banks will migrate to the regulatory regime they consider to be most advantageous. In recent testimony before FDIC, some regulatory officials and banking industry representatives testified that unless efforts were made to restore parity between federal and state bank regulation, the dual banking system, which they described as having encouraged economic development especially at the community level, would be adversely affected, as would healthy competition, regulatory innovation, and checks and balances among state and federal regulators.[41]

Budget Concerns

Some state regulatory officials with whom we spoke recognized the budgetary consequences associated with state banks changing to the federal charter. To reduce the impact on their budgets if one of their largest state-chartered banks changed charters, some state regulators we spoke with have taken steps to limit the potential for instability. For example, one state banking department has changed its method of collecting assessments. Prior to 2005, this state banking department was not collecting assessments from sources other than approximately 300 depository institutions, a small portion of the approximately 3,400 bank and nonbank institutions such as check cashers and money transmitters that it oversaw. Now this state regulator collects assessments from all of its regulated entities. Other officials have said they were considering alternative methods of determining assessments to decrease the banking department's reliance on one or a few banks to sustain their budgets.

Although state banking departments would experience smaller budgets if assessments were lost, the decrease in assessments would be somewhat offset by the decreased costs of supervising a smaller group of banks and other financial entities. There are other factors that could mitigate the consequences of any loss of revenue to a state regulator; for example, funding formulas that cushion the impact of charter conversions. For instance, in one state that we visited, each bank effectively paid a proportionate amount of the banking department's expenses as its assessment, with consideration given for asset size. As a result, assessments varied directly with changes in the department's spending and

[41]FDIC Public Hearing on the Financial Services Roundtable's Petition for Rulemaking to Preempt Certain State Laws, May 24, 2005, Washington, D.C.

with the number of state-chartered banks. Banking department officials in this state believed that it would take about 100 state-to-federal charter conversions to affect funding significantly. (See app. VI for information on how state bank regulators are funded.)

Suggested Measures for Addressing State Consumer Protection Concerns Include Shared Regulation, Which Raises Complex Policy Issues, and Greater Coordination between OCC and States

Some state officials and consumer groups identified three general measures that they believed could help address their concerns about protecting consumers of national banks and operating subsidiaries: (1) providing for some state jurisdiction over operating subsidiaries; (2) establishing a consensus-based national consumer protection lending standard; and (3) working more closely with OCC, in part to clarify the applicability of state consumer protection laws to national banks and their operating subsidiaries. The first measure would most likely involve amending the National Bank Act and, along with the second measure, raises a number of legal and policy issues. The third measure would involve OCC's clarification of the effect of the bank activities rule on state consumer protection laws.

Shared Supervisory Authority over Operating Subsidiaries Would Assist State Officials with Consumer Protection Efforts, but the Concept Raises Questions about the Supervision of National Bank Activities

Some state officials we interviewed suggested that states should have a direct monitoring or supervisory role over operating subsidiaries, particularly with respect to consumer protection matters, because the subsidiaries are state chartered. Providing such a role would likely require amending the National Bank Act to specify either that (1) the states and OCC share jurisdiction over operating subsidiaries or (2) operating subsidiaries are to be treated as national bank affiliates. However, providing for state involvement in the supervision of operating subsidiaries, even if only for consumer protection purposes, raises difficult questions. Some individuals we interviewed said that doing so would significantly interfere with Congress' objectives in establishing a national banking system. Others maintained that state and federal supervisory interests could be balanced without undermining national banks' ability to conduct business.

Some supporters of state supervision maintain that the National Bank Act currently does not preempt the application of state laws to operating subsidiaries. Those subscribing to this view maintain that OCC's interpretation of the act is wrong because the preemption standards and

visitorial powers limitations under the act pertain specifically to national banks, not to their operating subsidiaries. According to this position, under the National Bank Act and other federal banking laws, operating subsidiaries should be treated as "affiliates" of national banks, and federal law recognizes the authority of states to regulate affiliates. However, several recent federal court decisions have held that OCC has reasonably interpreted the National Bank Act to permit a national bank's use of operating subsidiaries to conduct its business.[42] Some authorities assert that Congress agrees with OCC's regulatory scheme for operating subsidiaries, pointing out that Congress has let the interpretation stand for more than 30 years. They also refer to a provision of GLBA, in which Congress specifically recognized the existence of operating subsidiaries by using OCC's interpretation to describe them.[43] Further, they maintain that, in GLBA, Congress implicitly recognized that OCC's authority over operating subsidiaries is exclusive unless Congress specifically says otherwise.[44]

Because operating subsidiaries are, by definition, a part of a national bank's business activity, amending the National Bank Act to provide states with authority to regulate them concurrently with OCC would set the stage for state regulation of a national bank in exercising its federally granted powers. One possible effect of this approach is that, even if a state's authority over an operating subsidiary were limited to consumer protection, it would be difficult to limit state supervision of the bank. Assuming that a regulatory line could be drawn to separate the activities of the operating subsidiary from those of the bank, states would need to monitor, if not supervise, the activities that trigger consumer protection concerns. To the extent that these activities reflect business decisions, policies, or practices by the national bank, an opportunity would exist for state intrusion into the bank itself. This could lead to, among other things, regulatory disputes over jurisdiction, differing views about the safety and soundness of the bank, or other points of contention arising from regulatory policies and objectives of OCC and the states.

[42]See, e.g., Wells Fargo Bank, N.A. v. Boutris, 419 F.3d 949 (9th Cir. 2005); Wachovia Bank, N.A. v. Burke, 414 F.3d 305 (2d Cir. 2005); Wachovia Bank, N.A. v. Watters, 431 F.3d 556 (6th Cir. 2005); National City Bank of Indiana v. Turnbaugh, 367 F. Supp. 2d 805 (D. MD 2005).

[43]Pub. L. No. 106-102 § 121, *codified at* 12 U.S.C. 24A(g)(3).

[44]See Id. § 133(a), *codified at* 15 U.S.C. § 41 note.

Similarly, amending the National Bank Act to specify that operating subsidiaries are affiliates of national banks could have unintended consequences. Assuming that the activities of an operating subsidiary continued to be limited to activities permissible for its parent bank, the bank simply could move those activities into the bank, in which case the efficiencies gained from conducting those activities through a separate unit, if any, would be lost. Alternatively, those activities could be shifted to an affiliate of the bank. The potential impact on the national bank's delivery of products and services, its costs, and its safety and soundness could be significant.

Some state officials noted that states already work effectively with other federal regulators to monitor and enforce compliance with consumer protection laws. They described efforts their offices took with federal regulators, such as FTC, to identify and take enforcement actions against unlawful practices. One official said FTC works with state officials by meeting periodically with state regulators to discuss issues of mutual concern and, when appropriate, to divide investigative responsibilities. In one instance, the state attorney general coordinated efforts with FTC to investigate and reach settlement with certain entities that had engaged in deceptive practices. Some state officials said that their relationships with federal regulators were based on shared regulatory authority over state-chartered entities and that a similar relationship with OCC should exist with respect to national bank operating subsidiaries.

We were told of similar federal-state arrangements with respect to state-chartered depository institutions that are subject to both federal and state supervision. State officials said that they work with FDIC and FRB regularly to conduct bank examinations and identify and stop practices that violate applicable laws. As an example, one official said that state regulators, FDIC, and FRB have entered into cooperative regulatory agreements to supervise interstate operations of state-chartered banks that conduct activities in other (host) states. Some state officials said that having the same kind of relationship with OCC concerning national bank operating subsidiaries would enhance consumer protection in their states.

All of the above examples involve state-chartered entities that are outside of a national bank and are subject to supervision by both federal and state authorities. Although those entities are subject to some federal laws that preempt or can have a preemptive effect on state laws, state officials generally believed that states have enough supervisory authority over the institutions to ensure their conformity with state policies as expressed in

state laws. The extent to which those examples should serve as models for national bank regulation depends on several considerations, not the least of which would involve policy judgments about the autonomy, if not the purpose, of the national bank charter.

A Consensus-Based National Consumer Protection Lending Standard Applicable to All Lending Institutions Would Provide Uniformity but Limit State Autonomy

During our work, we asked state officials and others for their opinions on whether it is desirable to have a federal lending law ensuring the same level of consumer protection to customers of all lending institutions, including banks and regardless of charter. Officials from state bankers' associations asserted that a national standard may already exist, for example, in the FTC Act, which among other things prohibits businesses from engaging in unfair and deceptive acts and practices.[45] In addition, officials referred to other federal consumer protection laws that apply to national banks and national bank operating subsidiaries.[46] Others stated that existing consumer protection standards in federal lending laws are weak and suggested a stricter, consensus-based national consumer protection standard applicable to lending activities by all state-chartered and federally chartered financial institutions. Assuming such a standard could be set, lenders and consumers could rely upon protections that would not change based upon the lending institution's charter. A consensus-based national consumer protection lending standard, however, would appear to limit states' abilities to enact standards of their own.

The rationale for a consensus-based national consumer protection lending standard generally is that (1) developing such a standard would protect consumers more than existing laws do and (2) having the right type of standard would help reduce concerns about the preemptive effect of federal laws on state consumer protection programs. However, some of the individuals we interviewed agreed that adopting a consensus-based national consumer protection lending standard, even if sound policy, would be difficult to accomplish. Among other things, defining the conduct subject to a standard could be difficult. While some individuals referred to

[45] 15 U.S.C. § 45(a)(1).

[46] Other federal laws include: Truth in Lending Act; Fair Housing Act; Equal Credit Opportunity Act; Real Estate Settlement Procedures Act; Community Reinvestment Act; Truth in Savings Act; Electronic Fund Transfer Act; Expedited Funds Availability Act; Flood Disaster Protection Act; Home Mortgage Disclosure Act; Fair Housing Home Loan Data System; Fair Credit Reporting Act; Federal Privacy Laws; and the Fair Debt Collection Practices Act.

certain antipredatory lending bills pending in Congress as appropriate models, others stated that it would be difficult to find a uniform solution to practices that are viewed as predatory.

We also found mixed views on whether a consensus-based national consumer protection lending standard should serve as a ceiling (which would not allow state authorities to impose more stringent standards) or a floor (which would so allow). Some officials stated they would prefer a floor so that states could go farther to address the particular needs of their states. One state attorney general official stated that the benefits of having a floor would be realized when there were more specific practices that needed to be addressed, such as predatory lending. On the other hand, another attorney general official said that floor-type standards such as those contained in federal laws, such as the Truth in Lending Act and the FTC Act, do not themselves impose adequate protections and often have not led to more protective state laws.

Under either approach, valid regulatory objectives could be compromised. A federal "ceiling" could deprive states of the ability to address practices and implement policies unique to local conditions. State officials and consumer groups maintain that the states serve as laboratories for regulatory innovation necessary for adequately policing financial industry products and practices. A uniform national "ceiling" could deprive states of the ability to act independently. Conversely, a limitation of the "floor" approach is that states could impose differing standards that would defeat the objective of uniformity.

An OCC Initiative to Clarify Preemption With Respect to State Consumer Protection Laws Could Assist in Achieving Consumer Protection Goals

As discussed earlier in this report, many state officials and consumer groups have expressed uncertainty over the extent to which state consumer protection laws apply to national banks and their operating subsidiaries. At the same time, OCC stated that the agency would like to work cooperatively with the states to further the goal of protecting consumers. Based on our work, it appears that OCC's clarification of the effect of the preemption rules on state consumer protection laws would assist states in their consumer protection efforts and could provide an opportunity for the agency to work with states more broadly on consumer protection concerns.

OCC informed us of their efforts to work with states on preemption issues. For example, an OCC representative stated that OCC hoped to harmonize the OCC's and states' authorities to provide effective and efficient

protections for consumers. Also, in 2004 testimony before the Senate, the Comptroller described OCC's commitment to protect consumers and welcomed opportunities to share information and cooperate and coordinate with states to address customer complaints and consumer protection issues.[47] However, OCC has no formal initiative specifically addressing the applicability of state consumer protection laws.

State officials and others suggested that OCC undertake an initiative to work with the states in clarifying the scope of preemption with respect to state consumer protection laws and to coordinate OCC and state consumer protection objectives. Clarifying the applicability of state consumer protection laws would be consistent with a strategy for achieving one of OCC's strategic goals, which is to enhance communication with state officials to facilitate better coordination on state law issues affecting national banks. Further, unlike the two measures discussed previously, such an OCC initiative would not involve statutory amendments.

One state official cited an example of cooperation between OCC and the state to protect consumers: a case in which OCC and the State of California coordinated their efforts to initiate proceedings against a national bank and some of its state-chartered affiliates. The actions were based on alleged unfair and deceptive practices that violated the FTC Act, the California Business and Professions Code, the Fair Credit Reporting Act, and other applicable laws. OCC instituted an enforcement action against the national bank, while the state filed a civil judicial action against the national bank's state-chartered parent—a financial corporation—and two other state-chartered affiliates.[48] In June 2000, both actions were settled. The defendants did not admit or deny the allegations against them, but in both proceedings they agreed to payment of a $300 million "restitution floor" as seed money for a restitution account. Under the settlement, any payment made by a defendant in one proceeding would discharge any identical payment obligation by the other defendants in the other proceedings. Even though OCC and the state initiated separate proceedings against separately supervised institutions, they worked together to treat the restitution floor obligation as a joint settlement.

[47]Senate, John D. Hawke, Jr., Comptroller of the Currency, speaking to Committee on Banking, Housing and Urban Affairs, *Congressional Record* (7 April 2004).

[48]See In the Matter of Providian National Bank, Tilton, NH, OCC EA No. 2000-53 (June 28, 2000).

According to some state officials and others, an OCC initiative to clarify the applicability of state consumer protection laws could assist both OCC and the states in their consumer protection efforts. It could also have the added benefit of facilitating the sharing of information among the states and OCC on conditions in a state or a location that might be conducive to predatory lending or other abuses and could help individual states, as well as OCC. State officials told us that states have knowledge of local conditions that allow them to identify abusive practices within their jurisdictions. A means for the states to systematically share this kind of information with OCC could help the agency in its supervision of national banks and operating subsidiaries.

Conclusions

Although the preemption rules were intended to provide a clear statement of OCC's standard for preemption and its exclusive visitorial powers authority, the bank activities rule does not fully resolve uncertainties about the applicability of state consumer protection laws to national banks and their operating subsidiaries. Based on OCC's own statements, the scope and the effects of the rules are not entirely clear. It is, therefore, not surprising that some state officials said they are uncertain as to what state consumer protection laws apply to national banks and their operating subsidiaries.

Many state officials we spoke with maintain that their ability to protect consumers by directly contacting national banks and their operating subsidiaries has been diminished by the preemption rules. However, to date, courts have upheld OCC's view that it has exclusive authority to supervise national bank operating subsidiaries. State officials reported that they have maintained cooperative relationships with national banks and/or operating subsidiaries since OCC issued the preemption rules. While state officials expressed particular concerns that the rules could prompt national banks, or their holding companies, to move activities into operating subsidiaries in order to avoid state regulation, such movements occurred prior to the rules and can result from many factors. OCC has issued guidance to national banks designed to facilitate the resolution of individual consumer complaints and address broader consumer protection issues that state officials believe warrant attention.

Changes in charter type—federal or state—are influenced by many factors including whether or not a bank has operations in multiple states. Consistent federal laws throughout the country are an attraction to banks with a presence in more than one state and especially banks with a national

presence. Preemption of state law is part of that attraction for such banks but cannot be attributed as the sole reason some banks choose the federal charter. While the number of charter changes has been relatively small during the period we reviewed (1990 through 2004), the amount of the corresponding bank assets that moved from state bank regulators' supervision to that of OCC as a result of charter changes did increase noticeably in 2004, albeit largely because of the charter conversion of one large bank. Because both OCC and state banking departments are funded by the entities they regulate and their formulas for the assessments charged are based partially, if not totally, on the assets of the banks and other entities they regulate, their budgets and workloads can be affected by changes in bank charters. OCC has a reserve fund to protect itself from any dramatic shifts away from the federal charter, but some state banking departments' budgets and workloads could face reductions if large state banks changed to the federal charter.

Our work identified three general measures that, while not necessarily exhaustive of all potential measures, could help address state officials' concerns about protecting consumers of national banks and operating subsidiaries. Two of these—providing for some state jurisdiction over operating subsidiaries and establishing a consensus-based national consumer protection lending standard—raise a number of complex legal and policy issues of their own and could be difficult to achieve. The third measure, in contrast to the first two, would not raise complex issues such as the potential need to amend the National Bank Act. Rather, it would require OCC to clarify the characteristics of state consumer protection laws that would make them subject to federal preemption. We recognize the impracticality of specifying precisely which provisions of state laws are, or are not, preempted, and acknowledge that some uncertainty may always exist. Nevertheless, we believe that an OCC outreach effort to describe in more detail which characteristics of state consumer protection laws would make them subject to preemption could help state officials better understand the effect of the rules and help allay their concerns. OCC has expressed a willingness to reach out to states regarding consumer protection issues. Further, such efforts would be consistent with OCC's strategic goal of enhancing communication with state officials to facilitate better coordination on state law issues affecting national banks.

Recommendation for Executive Action

We recommend that the Comptroller of the Currency undertake an initiative to clarify the characteristics of state consumer protection laws that would make them subject to federal preemption. Such an initiative

could serve as an opportunity for dialogue between OCC and the states on consumer protection matters. For example, OCC could hold forums where consumer protection issues related to federal and state laws could be discussed with state officials and consumer advocates. This could improve communication and coordination between OCC and state officials with respect to the impact of the preemption rules on the applicability of state consumer protection laws and could also assist both OCC and the states in their consumer protection efforts.

Agency Comments and Our Evaluation

We provided a draft of this report to OCC for review and comment. In written comments (see app. VII), the Comptroller of the Currency generally concurred with the report and agreed with the recommendation. Specifically, the Comptroller stated that the report contained a number of observations that were consistent with OCC's views on the relationship between the preemption rules and a bank's choice between the federal and state charters. OCC commented that the preemption rules provided clarification regarding the types of state laws listed in the regulations, and noted that recent court decisions reflect a growing judicial consensus about uniform federal standards that form the core of the national banking system. OCC agreed with our observation that it may be impractical to specify precisely which provisions of state laws are, or are not, preempted. However, OCC recognized that it should find more opportunities to work cooperatively with the states to address issues that affect the institutions it regulates, enhance existing information concerning the principles that guide its preemption analysis, and look for opportunities to generally address the preemption status of state laws. Accordingly, OCC described one new initiative intended to enhance federal and state dialogue and coordination on consumer issues. OCC stated that the Consumer Financial Protection Forum, chaired by the U.S. Department of the Treasury, was established to bring federal and state regulators together to focus exclusively on consumer protection issues and to provide a permanent forum for communication on those issues. OCC also provided technical comments which we incorporated as appropriate.

As agreed with your offices, unless you publicly announce the contents of this report earlier, we plan no further distribution until 30 days from the report date. At that time, we will send copies of this report to the Comptroller of the Currency and interested congressional committees. We also will make copies available to others upon request. In addition, the report will be available at no charge on the GAO Web site at http://www.gao.gov.

If you or your staff have any questions concerning this report, please contact me at (202) 512-8678 or woodd@gao.gov. Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this report. Key contributors are acknowledged in appendix VIII.

David G. Wood

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Objectives, Scope, and Methodology

On January 13, 2004, the Treasury Department's Office of the Comptroller of the Currency (OCC), which supervises federally chartered "national" banks, issued two sets of final rules covering the preemption of state laws relating to the banking activities of national banks and their operating subsidiaries ("bank activities rule") and OCC's exclusive supervisory authority over those institutions ("visitorial powers rule"). The rules drew strong opposition from a number of state legislators, attorneys general, consumer group representatives, and Members of Congress, who opposed the rules because of what they viewed as potentially adverse effects on consumer protection and the dual banking system. In this report, we examine (1) how the preemption rules clarify the applicability of state laws to national banks; (2) how the rules have affected state-level consumer protection efforts; (3) the rules' potential effects on banks' decisions to seek the federal, versus state, charters; and (4) measures that could address states' concerns regarding consumer protection. Additionally, this report provides information on how OCC and other federal regulators, as well as state bank regulators, are funded.

Identification of Key Issues and Legal Review of Preemption Standard

Many of the arguments supporting and opposing OCC's preemption rules related to legal opinions and policy objectives. Therefore, to identify key concerns and questions about the preemption rules, we conducted a content analysis of comment letters that OCC received in response to its rulemaking.[1] In addition to the analysis we conducted for our previous report on OCC's rulemaking process, we reviewed the 55 comment letters OCC received on its visitorial powers proposal and conducted a content analysis on 30 of the letters.[2] To analyze the comments, we first separated the 30 letters into two categories: letters that supported the visitorial powers rule (17) and letters that opposed the rule (13). We then randomly selected a test set of letters from each category and established an initial set of codes that would further characterize comments within each category. We applied these codes to the test set of letters and made refinements to establish the final codes for each category. A pair of trained coders independently coded the remaining sets of letters and resolved discrepancies to 100 percent agreement. The coders regularly performed

[1]See GAO-06-8 for a detailed description of the content analysis we conducted on the comments for the bank activities rule.

[2]Of the 55 letters, we identified 25 as concurring letters; that is, the letter writers expressed agreement with their national trade or consumer group organization, which also had submitted a comment letter.

reliability checks throughout the coding process and recorded results in an electronic data file, in which the data were verified for accuracy. Descriptive statistics for the codes were computed by an analyst using SPSS statistical software and a second, independent analyst reviewed the data analysis.

To further identify stakeholder concerns, we also reviewed three congressional hearings on the preemption rules. We grouped statements from these hearings under the following categories: issue, implication, or suggestion. The "issue" category included statements that described the nature of the commenters' concerns. The "implication" category included statements that explained the perceived effect the rules would have relative to a specific issue or concern. The "suggestion" category included statements that described ways certain issues or concerns could be resolved, as well as measures that could facilitate state and federal authorities working together to protect consumers. We also categorized the statements by source and whether the statements were made in support of or opposition to the rules.

Finally, to obtain more in-depth information on the issues identified by stakeholders, we conducted site visits or phone interviews with officials and representatives of state attorneys general offices, state banking departments, consumer groups, state bankers associations, and national and state banks in six states (California, Georgia, New York, North Carolina, Idaho, and Iowa). We judgmentally selected the states based on the following characteristics: state officials' interest in the issue; location of noteworthy federally or state-chartered banks (that is, large banks based on asset size or banks that experienced a recent charter conversion); notable consumer group presence or consumer protection laws; and geographic dispersion. We gauged state officials' interest in the issue and identified state contacts by reviewing congressional hearings and reviewing comment letters on the proposed rules. We also solicited appropriate state contacts from officials we interviewed, such as the National Association of Attorneys General (NAAG), the Conference of State Bank Supervisors (CSBS), and several consumer group representatives. In Washington, D.C., we interviewed the national associations comprising state attorneys general and state bank regulators; representatives of national consumer groups; and officials at OCC and other federal bank regulatory agencies, including the Board of Governors of the Federal Reserve System (FRB) and the Federal Deposit Insurance Corporation (FDIC).

With the information obtained from the content analysis, review of congressional hearings, and the site visits and interviews, we conducted a legal review of the preemption rules, past OCC preemption determinations, relevant case law, and relevant federal and state regulations to determine how OCC clarified the applicability of state laws to national banks.

Effects of Preemption Rules on State Consumer Protection Efforts and the Dual Banking System

In the discussions with officials noted above, we solicited their views on the effects and potential effects of the rules on consumer protection and asked them how the preemption rules have affected the dual banking system (for example, charter choice and the distribution of assets among the national and state banks).

To obtain an industrywide view of how bank assets are divided among state-chartered and federally chartered banks, we obtained data from FDIC's online database, Statistics on Depository Institutions, and its online version of Historical Statistics on Banking. We extracted data on the number and asset sizes of all banks from 1990 through 2004. To assess the extent to which banks have changed between the federal charter and state charters from 1990 through 2004, we collected and analyzed data from OCC and FRB on the annual number of charter changes and asset sizes of banks experiencing charter changes during this period. According to agency officials, OCC data came from its Corporate Applications Information System and FRB data came from the National Information Center database. To determine the total number of conversions to the federal charter each year, we used OCC data to sum the total number of conversions that occurred in each year from 1990 through 2004 for each type of financial institution as listed in the data. We also summed the corresponding assets for each type of entity. In order to find the total number of conversions out of the federal charter, we separated charter terminations resulting from conversions from charter terminations listed as occurring for other reasons. We then summed the total number of all charter terminations due to conversions out of the federal charter and their total corresponding assets each year.[3]

For charter additions to the federal charter resulting from mergers, we used OCC data to sum the total number of additions that occurred in each year from 1990 through 2004 for each type of financial institution (as listed

[3]OCC's data did not identify the type of institution involved in terminations from the federal charter resulting from conversions.

in the data) involved in the merger. Using FRB data, we summed the total assets of banks that changed to the federal charter from state charters as a result of mergers in each year. For deletions from the federal charter resulting from mergers, we first separated charter terminations that OCC categorized as resulting from mergers from charter terminations listed as occurring for other reasons. We then, using OCC data, summed the total number of all charter terminations attributed to mergers.[4] Using FRB data, we summed the total assets of banks that changed from the federal charter to state charters as a result of mergers in each year.

To determine how bank chartering decisions affected OCC's budget, we summarized data provided by OCC on assessments paid by institutions that converted charters between 1999 and 2004 to determine how choice of charter and fees assessed from each type of charter affected OCC's total revenue. We also collected data from certain states and applied their respective assessment formulas to analyze the effects of chartering decisions on the state regulators' budgets. To describe how the OCC and state banking departments are funded, we interviewed OCC officials, reviewed agency annual reports, past GAO reports, and CSBS' Profile of State-Chartered Banking. We also interviewed federal and state regulators to understand their funding mechanisms.

Measures to Address States' Concerns Regarding Consumer Protection

As noted previously, we conducted site visits and reviews of congressional hearings to obtain information on ways state and federal authorities could work together to protect consumers. During our site visits, we asked officials and representatives of state attorneys general offices, state banking departments, consumer groups, and state bankers associations to identify measures that would facilitate state and federal authorities working together to protect consumers. When measures were identified, we asked follow-up questions to determine perceived advantages and disadvantages of the measure and challenges to implementing the measure. We then obtained and reviewed relevant information, such as statutes, judicial opinions, and related documents.

[4]OCC data for terminations from the federal bank charter resulting from mergers were listed under the category "Transaction Form," which did not have specific information on institution type; rather, it classified the termination as "National Bank to State."

Overall Data Reliability

We assessed the reliability of all data used in this report in conformance with generally accepted government auditing standards. To assess the reliability of the data on bank charters, assets, and assessments, we (1) interviewed OCC, FRB, and FDIC agency officials who are knowledgeable about the data; (2) reviewed information about the data and the systems that produced them; and (3) for certain data, reviewed documentation provided by agency officials on the electronic criteria used to extract data used in this report.

For OCC data on the yearly number and assets of banks experiencing charter changes between the federal and state charters, we performed some basic reasonableness checks of the data against FRB data and data reported in a research study by an economist at OCC. We found that the data differed among these three data sources. We identified discrepancies and discussed these with agency officials. We also found that OCC data on assets of banks that changed charters as a result of mergers were very different from both FRB data and data in the research study. Furthermore, according to OCC officials, asset data based on call report information was considered more reasonable for the purposes of our report.[5] Therefore, we did not use OCC data on assets of banks that changed charters as a result of mergers. Instead, we decided to use FRB data because they were more reasonable in comparison to those in the research study and because they were based entirely on call report information. Although OCC data on assets of banks that changed charters as a result of conversions was not based on call report information, we decided to use that data because it was reasonable in comparison with those reported in the research study. After reviewing possible limitations in OCC's Corporate Applications Information System, we determined that all data provided, with the exception of OCC assets data noted above, were sufficiently reliable for the purposes of this report.

We conducted our work in California, Georgia, New York, North Carolina, Idaho, Iowa, and Washington, D.C., from August 2004 through March 2006 in accordance with generally accepted government auditing standards.

[5]Reports of Condition and Income collect basic financial data from commercial banks in the form of a balance sheet, an income statement, and supporting schedules. These reports are required by statute and collected by the FDIC under the provision of Section 1817(a)(1) of the Federal Deposit Insurance Act. The Report of Condition (call report) schedules provide details on assets, liabilities, and capital accounts.

Legal Arguments Regarding the Preemption Rules

In addition to expressing uncertainty about the applicability of state consumer protection laws to national banks, some opponents of the preemption rules disagreed with the Office of the Comptroller of the Currency's (OCC) legal interpretations of the National Bank Act in support of the rules. They asserted that the effects of the preemption rules will remain unclear until these legal arguments are resolved. As discussed below, legal challenges to the preemption rules consistently have been rejected by federal courts.

OCC's Interpretation of the Preemption Standard

Many critics of the bank activities rule disagreed with OCC's articulation of the standard for federal preemption, asserting that the agency misinterpreted controlling Supreme Court precedents as well as the regulatory scheme Congress has established for national banks. The regulations contained in the bank activities rule provide that, except where made applicable by federal law, state laws that "obstruct, impair or condition" a national bank's ability to fully exercise its federally authorized powers do not apply to national banks.[1] Opponents of the bank activities rule asserted that this standard misstates the test for preemption under the National Bank Act.

The preemption doctrine is rooted in the Supremacy Clause of the U.S. Constitution, which states as follows;

> This Constitution, and the laws of the United States which shall be made in pursuance thereof; and all treaties made, or which shall be made, under the authority of the United States, shall be the supreme law of the land; and the judges in every state shall be bound thereby, anything in the Constitution or laws of any State to the contrary notwithstanding.[2]

Under the Supremacy Clause, state law is preempted by federal law when Congress intends preemption to occur.[3] Preemption may be either express—where Congress specifically states in a statute that the statute preempts state law—or implied in a statute's structure and purpose. Implied preemption occurs through either "field preemption" or "conflict

[1] 69 *Fed. Reg.* at 1916-1917.

[2] U.S. Constitution Article VI.

[3] Chicago & N. W. Transp. Co. v. Kalo Brick & Tile Co., 450 U.S. 311 (1981) (Supremacy Clause invalidates state laws that interfere with or are contrary to the laws of Congress); see also, Bank of America v. City & County of San Francisco, 309 F.3d 551, 558 (9th Cir. 2002) (determining preemptive effect of federal law requires ascertaining intent of Congress).

preemption." Field preemption occurs when Congress (1) has established a scheme of federal regulation so pervasive that there is no room left for states to supplement it or (2) has enacted a statute that touches a field in which the federal interest is so dominant that the federal system will be assumed to preclude enforcement of state laws on the same subject. In contrast, conflict preemption occurs when a state law actually conflicts with federal law. To determine whether a conflict exists, courts consider whether compliance with both federal and state law is a physical impossibility or whether the state law stands as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress.[4] Despite these separate analytical approaches, in practice the differences between the two are not always exclusive or distinct. Rather, as a practical matter, there can be a substantial overlap between the categories, with courts using a similar analysis to address field and conflict preemption.[5]

Even though field preemption and conflict preemption are not mutually exclusive concepts, the Supreme Court and federal courts traditionally have applied the conflict analysis to determine preemption questions arising under the National Bank Act. Supreme Court and other federal court cases addressing preemption under the act have been decided on the basis of whether a conflict exists between the federal law and a state law. It is well settled that with respect to national banks, the National Bank Act preempts a state law that stands as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress. Critics of the bank activities rule asserted that (1) the controlling Supreme Court precedent for finding this type of conflict preemption under the National Bank Act is set forth in the Supreme Court's opinion in *Barnett Bank of Marion County v. Nelson* and (2) the *Barnett Bank* decision sets a standard for preemption that is stricter than the one applied by OCC, so that under that standard fewer state laws would be preempted.[6]

The decision in *Barnett Bank* states, in part, as follows:

[4]Bank of America v. San Francisco, 309 F.3d at 558.

[5]See GAO letter, *Role of the Office of Thrift Supervision and Office of the Comptroller of the Currency in the Preemption of State Law (Feb. 7, 2000)*, GAO-B-284372.

[6]Barnett Bank of Marion County v. Nelson, 517 U.S. 25 (1996).

In defining the pre-emptive scope of statutes and regulations granting a power to national banks, these [Supreme Court] cases take the view that normally Congress would not want States to forbid, or to impair significantly, the exercise of a power that Congress explicitly granted. To say this is not to deprive States of the power to regulate national banks, where (unlike here) doing so does not prevent or significantly interfere with the national bank's exercise of its powers.[7]

Several critics of the bank activities rule interpret this passage to mean that state law applies to national banks if the law does not "prevent or significantly interfere with" the banks' ability to engage in activities authorized by the National Bank Act. They said that, in the *Barnett* decision, the Supreme Court clarified its earlier articulations of conflict preemption under the National Bank Act and that this standard tolerates state regulation of national banks to a greater extent than OCC's "obstruct, impair or condition" test. According to this argument, state law governs a national bank's exercise of its federally granted powers unless applying the law would at least significantly interfere with the bank's ability to engage in banking. OCC interprets the *Barnett* language to be one of many ways in which the Supreme Court has articulated the standard for preemption under the National Bank Act.[8] In the preamble accompanying publication of the final bank activities rule, OCC explained that its articulation of the standard does not differ in substance from the language used in *Barnett* or any other Supreme Court test for preemption under the National Bank Act, stating that "[t]he variety of formulations quoted by the Court, . . . defeats any suggestion that any one phrase constitutes the exclusive standard for preemption."[9]

[7]Id. at 33 (*citations omitted*).

[8]69 *Fed. Reg.* at 1910 (stating that "(t)he words of the (OCC preemption standard) are drawn directly from applicable Supreme Court precedents . . . .").

[9]Id. OCC's recognition and use of various terms invoked by the Supreme Court to apply the preemption test was not a new position announced in the preemption rulemaking but reflects the agency's standing interpretation of Supreme Court precedents. See OCC Interpretive Letter No. 789 (June 27, 1997) (preempting portions of a Colorado banking law that would have caused a national bank to remove its name and logo from an off-site ATM owned by the bank and operated in Colorado). In that letter, OCC's Chief Counsel reviewed several Supreme Court decisions addressing preemption under the National Bank Act, observing that the decisions used various words to state the general principle of conflict preemption, which, according to the Chief Counsel, is that "state laws apply to national banks only if they do not conflict with federal law, which includes impairing or interfering with the powers granted to national banks by federal law."

According to some of the sources we consulted, primarily state regulators and consumer groups, under the Barnett decision the application of state laws to national bank activities can be consistent with the National Bank Act. Referring to the rule that state law is preempted when applying it would create "an obstacle to the accomplishment of the full purposes and objectives of Congress," one legal individual asserted that since at least the early twentieth century it has been an objective of Congress to provide for state regulation of banking activities regardless of whether a bank has a federal or state charter. The individual described this objective as a congressionally established "competitive equilibrium" within the U.S. banking system. According to this perspective, allowing a state law to govern a national bank's exercise of its federally granted powers would be consistent with the purposes and objectives of Congress.

In support of this position, several state officials and consumer groups we interviewed referred to a provision of the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 (Interstate Banking Act). In that legislation, Congress specified that host state laws regarding community reinvestment, consumer protection, fair lending, and the establishment of intrastate branches apply to branches of out-of-state national banks except when, among other things, federal law preempts their application to a national bank.[10] In the conference report accompanying the legislation, the conferees stated that preemption determinations made by the federal banking agencies through opinion letters and interpretive regulations "play an important role in maintaining the balance of Federal and State law under the dual banking system."[11] The conference report did not discuss how preemption determinations affect the dual banking system. Instead, the discussion referred to state interests in protecting individuals, businesses and communities in their dealings with depository institutions. However, some parties we interviewed maintained that the Interstate Banking Act and its legislative history show that Congress intends states to have a role in regulating national bank activities and that this relationship is a feature of the dual banking system.

Several individuals and industry participants we interviewed said that, while Congress may not have prohibited some state regulation of national banks, Congress consistently has endorsed the concept that state laws do

[10]Pub. L. No. 103-328 § 102(b)(1)(B), *codified at* 12 U.S.C. § 36(f).

[11]H.R. Conf. Rep. No. 103-651 at 53-54.

not apply to national banking when those laws are inconsistent with federal law. This, they said, is because Congress established the national bank system to be separate from state banking systems. According to this view, the concept of a dual banking system does not contemplate state regulation of national banks, but recognizes that states have authority to regulate the banks they charter.

Those sharing this perspective, including OCC representatives, referred to various authorities to demonstrate that Congress established the national bank system to be independent of state regulation, except to the extent provided by federal law. They relied primarily on Supreme Court decisions that referred to the National Bank Act and its legislative history as an expression of Congress' intent to have a national charter separate from state regulation.[12] For example, in one of those decisions the Supreme Court indicated that the National Bank Act does not contemplate state regulation as a component of the national bank regulatory system. Describing national banks as "federal instrumentalities," the Supreme Court concluded that a state law was preempted under the National Bank Act because, among other things, Congress had not expressed its intent that a federally authorized national bank activity be subject to local restrictions. In that decision, the Supreme Court held that the National Bank Act preempted a state law forbidding national banks from using "saving" or "savings" in their names or advertising. The Supreme Court said

[12]Supreme Court decisions addressing this subject include: Easton v. Iowa, 188 U.S. 220, 229, 232 (1903). (the National Bank Act "has in view the erection of a system extending throughout the country, and independent, so far as powers conferred are concerned, of state legislation which, if permitted to be applicable, might impose limitations and restrictions as various and as numerous as the states. . . . If [the states] had such power it would have to be exercised and limited by their own discretion, and confusion would necessarily result from control possessed and exercised by two independent authorities."); see also, Marquette Nat'l Bank v. First of Omaha Serv. Corp., 439 U.S. 299, 314-315 (1978) ("Close examination of the National Bank Act of 1864, its legislative history, and its historical context makes clear that, . . .Congress intended to facilitate . . . a 'national banking system.'" *(citation omitted)*); Franklin Nat'l Bank of Franklin Square v. New York, 347 U.S. 373, 375 (1954) ("The United States has set up a system of national banks as federal instrumentalities to perform various functions such as providing circulating medium and government credit, as well as financing commerce and acting as private depositories."); Davis v. Elmira Sav. Bank, 161 U.S. 275, 283 (1896) ("National banks are instrumentalities of the Federal government, created for a public purpose, and as such necessarily are subject to the paramount authority of the United States."). In Farmers' & Mechanics' Bank v. Dearing, 91 U.S. 29, 34 (1875), the Court similarly found that "(s)tates can exercise no control over [national banks] nor in anywise affect their operation, except in so far as Congress may see proper to permit. Anything beyond this is 'an abuse, because it is the usurpation of power which a single State cannot give.'"

that it found "no indication that Congress intended to make this phase of national banking subject to local restrictions, as it has done by express language in several other instances."[13]

Several individuals, including OCC representatives, also said that even if Congress, in the 1994 Interstate Banking Act, contemplated the potential application of state laws to national bank activities, Congress clearly did not intend state laws to apply if they conflict with federal law. They said that, although the Interstate Banking Act demonstrates Congress' belief that states have an interest in how national banks conduct their activities in the four areas specified in the act, neither the act nor its legislative history suggest that state laws in those four areas override federal preemption. In their view, Congress' recognition that state laws are subject to preemption signifies that Congress did not intend the application of state laws covering those four areas to be a purpose or objective of national bank regulation when such state laws conflict with federal law.

In the conference report accompanying the Interstate Banking Act, the conferees questioned OCC's preemption of a New Jersey law relating to consumer checking accounts and the agency's preemption of state laws that prohibit, limit, or restrict deposit account service charges. However, the conferees recognized that despite the states' interests in regulating bank activities concerning consumer protection, fair lending, and the other two areas mentioned previously, state laws in those areas are subject to preemption under the National Bank Act. In the legislation, Congress established a process for federal banking agencies to follow when they preempt state laws concerning those four areas.[14] In describing the process, which includes publication for public comment of federal banking agency preemption determinations regarding state laws applicable to any of the four areas of state interest, the Conferees specified that the legislation was not intended to change "the substantive theories of preemption as set forth in existing law."[15] At the time, OCC's standard for preemption was the same as the agency applied in the bank activities rule. For example, in a 1989 interpretive letter, OCC stated the federal preemption standard under the National Bank Act as follows:

[13]Franklin National Bank v. New York, 347 U.S. at 378.

[14]Pub. L. No. 103-328 § 114, *codified* at 12 U.S.C. § 43.

[15]H. R. Conf. Rep. No. 103-651 at 55.

The general rule governing preemption under the National Bank Act is that state law applies to national banks unless that law conflicts with federal law, unduly burdens the operations of national banks, or interferes with the objectives of the national banking system. (citations omitted).

In addition to disagreement over the regulatory objectives of the National Bank Act, we also encountered differences of opinion over the scope of the preemption rules. Some individuals we interviewed asserted that, despite OCC's invocation of the conflict preemption standard, in fact OCC has preempted the field of national bank regulation. That is, under OCC's test, there is no room for state law in the regulation of the business activities of national banks because those activities are solely a matter of federal law. OCC, on the other hand, maintains that it applies the conflict preemption standard with the objective of enabling national banks to operate to the full extent of their powers under federal law "without interference from inconsistent state laws."[16] As discussed previously, courts sometimes apply field and conflict preemption analyses interchangeably. To date, however, federal courts have recognized that OCC preemption determinations are based on an analysis of whether a conflict exists between federal and state law. Courts addressing the preemption regulations have not questioned OCC's determination that conflict between state and federal laws is the predicate for the preemption rules.

Breadth of the Preemption Lists in the Bank Activities Rule

In the bank activities rule, OCC explained that state laws concerning the subjects listed as preempted already had been preempted, either by OCC administrative determinations, or by federal court decisions or precedents applicable to federal thrifts.[17] However, some of the subjects listed as preempted have not been specifically addressed in precedents applying the National Bank Act. Rather, information from OCC shows that some subjects of state law were included on the preemption lists because they

[16]69 *Fed. Reg.* at 1908. In the bank activities rule, OCC specifically declined to occupy the fields of national banks' real estate lending, other lending, and deposit-taking activities because it concluded that labeling its preemption rules in those areas as "field preemption" is immaterial to the objectives of the regulations. 69 *Fed. Reg.* at 1911.

[17]OCC stated that the lists of preempted state laws "reflect judicial precedents and OCC interpretations" concerning the types of state laws subject to preemption because they conflict with national banks' exercise of powers granted in the National Bank Act. 69 *Fed. Reg.* 1906.

had been preempted by the Office of Thrift Supervision (OTS).[18] In issuing the bank activities rule, OCC concluded that with respect to the applicability of state law, Congress used the same scheme for both national banks and federally chartered thrifts under the Home Owners Loan Act (HOLA).[19] Opponents of the bank activities rule criticized this approach. They questioned the applicability of OTS precedents to preemption under the National Bank Act, asserting that Congress did not intend HOLA and the National Bank Act to have identical preemptive effects. In addition, several state officials and consumer groups said that the terms OCC used to describe preempted subjects of state law are too broad.

Those questioning OCC's reliance on OTS regulations asserted that preemption under the National Bank Act is not as expansive as it is under HOLA, and thus OCC wrongly concluded that state laws preempted under HOLA also are preempted under the National Bank Act. They maintained that the Supreme Court's description of OTS' preemptive authority recognizes the broad preemptive impact of HOLA, which some federal courts have characterized as field preemption.[20] Critics of the bank activities rule said that, because preemption under the National Bank Act is conflict-based, it calls for an analysis of whether a state law covering an OTS-preempted subject conflicts with the National Bank Act. They maintained that OTS, using a field preemption analysis, would not have considered whether a conflict exists. They asserted that the National Bank

[18]These subjects include: (1) escrow, impound, and similar accounts; (2) access to, and use of, credit reports; and (3) processing, originating, servicing, sale or purchase of mortgages and investment or participation in mortgages.

[19]See OCC Interpretive Letter No. 999 (August 2004) (stating that some of the types of laws listed in the preemption regulation "have been determined to be preempted with respect to Federal thrifts by the Federal thrift supervisor, the OTS.") In the bank activities rule, OCC stated as follows: "The extent of Federal regulation and supervision of Federal savings associations under the Home Owners' Loan Act is substantially the same as for national banks under the national banking laws, a fact that warrants similar conclusions about the applicability of state laws to the conduct of the Federally authorized activities of both types of entities." 69 *Fed. Reg.* 1912, n. 62.

[20]See Fidelity Savings and Loan Ass'n v. de la Cuesta, 45 U.S. 141, 160-162 (1982) (concluding that HOLA gave OTS' predecessor agency, the Federal Home Loan Bank Board, "plenary authority to issue regulations governing federal savings and loans" that contemplates the [agency's] promulgation of regulations superseding state law); see also, Bank of America v. City and County of San Francisco, 309 F.3d 551, 558-559 (9th Cir., 2002), (stating that field preemption applies under HOLA because"the regulation of federal savings associations by the OTS has been so pervasive as to leave no room for state regulatory control," *(citations omitted)*, but the National Bank Act provides for conflict preemption).

Act, unlike HOLA, contemplates that states have a role in regulating activities of national banks, and particularly those of national bank operating subsidiaries, which typically are formed under state laws governing the establishment of business entities. According to OCC, for purposes of the bank activities rule labeling preemption as either "field preemption" or "conflict based" is "largely immaterial to whether a state law is preempted under the National Bank Act.[21]

Other Aspects of the Preemption Rulemaking

State representatives, consumer groups, and others challenged the bank activities rule with respect to real estate lending. Referring to the grant of real estate lending powers in the National Bank Act and past versions of OCC's real estate lending rule, these individuals asserted that in the bank activities rule OCC broadened the scope of preemption beyond what Congress intends. One argument was based on the provision in the National Bank Act that authorizes national banks to make real estate loans. The provision permits national banks to conduct real estate lending "subject to section 1828(o) of this title (12 U.S. Code) and such restrictions and requirements as the Comptroller of the Currency may prescribe by regulation or order."[22] Section 1828(o) requires the federal banking agencies to have uniform regulations prescribing standards for real estate loans.[23] The standards include a requirement that lenders comply with "all real estate related laws and regulations." Some individuals we interviewed said that this standard means that the same real estate lending laws must apply to all federally insured depository institutions and that, because state laws apply to one set of institutions—specifically state banks— those same laws apply to national banks.

Opponents also argued that OCC, by broadening the scope of preemption for real estate lending, acted contrary to its previous determinations of limited preemption for this activity. Before the bank activities rule was issued, OCC's regulations specifically preempted state law with respect to only five aspects of real estate lending.[24] In interpretive letters describing

[21] 69 *Fed. Reg.* at 1911.

[22] 12 U.S.C. § 371(a).

[23] 12 U.S.C. § 1828(o). See 12 C.F.R. § 34.62 (OCC Real Estate Lending Standards).

[24] These were: loan-to-value ratios, amortization requirements, maturity requirements, aggregate limits, and certain terms of loans secured by leaseholds.

the preemptive effect of the rule, OCC officials sometimes stated that its purpose was to preempt only five categories of state law restrictions on national bank real estate lending, and that "[i]t was not the intention of [OCC], however, to preempt all state regulation of real estate lending."[25] OCC stated that the rule clarified the "limited scope" of preemption with respect to real estate lending, thus "any state regulations outside of the five areas cited continue to apply to national banks, unless preempted by other regulation."[26] OCC maintained this position while applying the same preemption standard it applied in the bank activities rule.

Critics of the bank activities rule asserted that OCC's past statements were correctly based on the conclusion that the National Bank Act has a limited preemptive effect with respect to real estate lending and that OCC has not adequately justified its new, contrary interpretation. According to OCC, the substance of the bank activities rule is not new; it reiterates preemption determinations that had been made before the rule was promulgated. Therefore, the rule does not represent a change in OCC's application of preemption principles with respect to real estate lending. Moreover, OCC revised the rule in 1995 to say that OCC would apply principles of federal preemption to state laws concerning aspects of national bank real estate lending not listed in the regulation. OCC had been following this approach in its interpretive letters on preemption since at least 1985.[27]

Some critics of the bank activities rule also challenged preemption with respect to deposit-taking, which is one of the four categories of bank activity set forth in the bank activities rule. They asserted that (1) deposits are personal property and deposit accounts are contracts between the depositor and the bank and (2) Congress did not intend the National Bank Act to supersede state property and contract laws. The bank activities rule provides that state laws on the subjects of contracts and the acquisition and transfer of property are not inconsistent with national bank powers and apply to national banks "to the extent that they only incidentally affect

[25]See OCC Unpublished Interpretive Letter (Dec. 5, 1985).

[26]Id.; see also, OCC Interpretive Letter No. 354 (Nov. 18, 1985).

[27]See OCC Unpublished Interpretive Letter, Dec. 5, 1985, stating: "It has long been recognized that national banks are federal instrumentalities governed by a comprehensive set of federal laws and regulations, As such, they are subject to only those state laws that are not inconsistent with the federal provisions and that do not unduly burden the operations of national banks or interfere with the purposes of their creation." (*Supreme Court citations omitted*).

the exercise" of the bank's powers. The disagreement with OCC's preemption concerning deposit-taking focuses on whether a particular state law that could be preempted (because it relates to deposit-taking) might not be preempted (because it is a state contract or property law). We found one case in which a California state court held that a state law relating to deposit taking was not preempted because, among other things, the court concluded it was a law governing contracts having only an incidental effect on the bank's deposit-taking. However, in that decision, the court did not question OCC's authority to preempt state laws applicable to bank deposits.[28]

Applicability of Rules to National Bank Operating Subsidiaries

State officials and their representative groups disputed OCC's assertion that the preemptive effects of the National Bank Act extend to national bank operating subsidiaries. They also disagreed with OCC's assertion of exclusive supervisory and enforcement jurisdiction over national bank operating subsidiaries. These disagreements arise mainly from the contention that OCC has improperly interpreted the status of operating subsidiaries under the National Bank Act.

Although a national bank operating subsidiary typically is formed under state business association laws, under OCC's interpretation of the National Bank Act the entity exists only as a means through which national banks may conduct federally authorized banking activities. This is because OCC permits national banks to have operating subsidiaries on the theory that conducting business through an operating subsidiary is an activity permitted by the National Bank Act.[29] According to OCC, because operating subsidiaries exist and are utilized as a national bank activity, they may not be used by national banks to engage in activities not authorized by the National Bank Act and, correspondingly, are subject to the same laws, terms, and conditions that govern national banks.[30]

In several recent cases, federal courts have upheld OCC's rationale for permitting national banks to use operating subsidiaries and, consequently, have held that operating subsidiaries are subject to the same laws and

[28]Smith v. Wells Fargo Bank, N.A., 135 Cal. App. 4th 1463 (Cal. Ct. App. 2006).

[29]See 12 C.F.R. § 5.34.

[30]69 *Fed. Reg.* at 1905.

restrictions that apply to national banks; one of those decisions is under review by the Supreme Court.[31] Opponents of OCC's position believe that the National Bank Act does not treat national bank operating subsidiaries the same as national banks, regardless of OCC's rationale for their existence. They maintain that national bank operating subsidiaries are legally independent entities, not banks, and as such they are subject to state laws and supervision by state agencies. OCC has permitted national bank operating subsidiaries since at least 1966, during which time Congress has not enacted legislation to override OCC's position.[32]

Disagreement with OCC's Interpretation of Its Visitorial Powers

In the visitorial powers rulemaking, OCC clarified its position regarding its supervisory authority over national banks and their operating subsidiaries.[33] As discussed in the body of this report, the agency amended its visitorial powers rule to clarify the terms of its exclusive visitorial power over national banks and their operating subsidiaries with respect to the content and conduct of their federally authorized activities. OCC also amended the rule to recognize the jurisdiction of functional regulators and articulate OCC's interpretation of a part of the visitorial powers provision, 12 U.S.C. § 484, that makes national banks subject to the visitorial powers vested in courts of justice.[34]

[31]Wachovia Bank, N.A. v. Burke, 414 F.3[d] 305 (2d Cir. 2005); Wells Fargo Bank, N.A. v. Boutris, 419 F.3d. 949 (9th Cir., 2005); Wachovia Bank v. Watters, 432 F.3d. 556 (6th Cir. 2005); OCC v. Spitzer, 396 F.Supp. 2d. 383 (S.D. N.Y. 2005); National City Bank v. Turnbaugh, 367 F.Supp.2d 805 (D. MD 2005).

[32]See Acquisition of Controlling Sock Interest in Subsidiary Operations Corporation, 31 *Fed. Reg.* 11,459 (Aug. 31, 1966).

[33]The OCC's Visitorial Powers regulation defines visitorial powers to include: (1) examination of a bank; (2) inspection of a bank's books and records; (3) regulation and supervision of activities authorized or permitted pursuant to federal law; and (4) enforcing compliance with any applicable federal or state laws concerning those activities. 12 C.F.R. § 7.4000(a)(2).

[34]The pertinent portion of 12 U.S.C. § 484 provides as follows:

(a) No national bank shall be subject to any visitorial powers except as authorized by Federal law, vested in the courts of justice or such as shall be, or have been exercised or directed by Congress or by either House thereof or by any committee of Congress or of either House duly authorized.

During our work, we encountered disagreements with OCC's assertion of exclusive supervisory authority over national bank operating subsidiaries and the agency's view of the nature of the visitorial powers vested in courts of justice.[35] Those disagreeing with the rule described it as an attempt by OCC to limit both state supervision of activities conducted by state-chartered entities and the ways in which states can rely on their courts to take legal action against operating subsidiaries. These disagreements raise complicated legal analyses and policy concerns, but based on our interviews and research, there does not appear to be significant uncertainty over OCC's view of its visitorial powers as expressed in the visitorial powers regulation. As discussed above, in several recent cases, federal courts have upheld OCC's conclusion that its visitorial powers confer exclusive supervisory jurisdiction with respect to the banking activities of national banks and their operating subsidiaries.

[35]Those disagreeing with the rule generally did not assert that states have supervisory authority over national banks themselves. The concern over visitorial powers was limited to state jurisdiction over operating subsidiaries.

Bank Charter Changes from 1990 to 2004

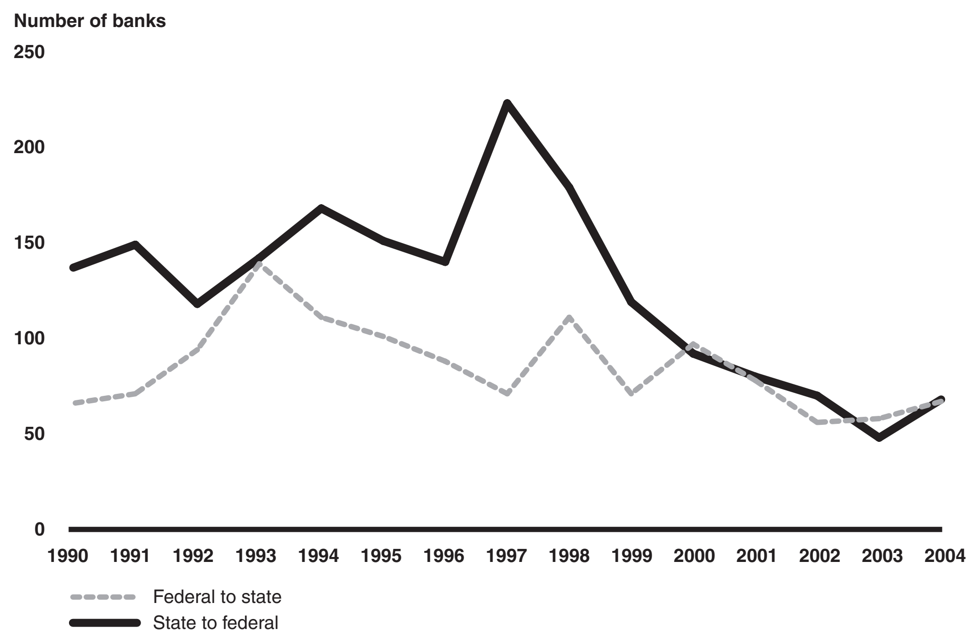
From 1990 to 2004, More Banks Changed to the Federal Charter, but Most Changes Resulted from Mergers

From 1990 to 2004, the number of bank charter changes to the federal charter outnumbered changes to a state charter. Figure 5 shows the total annual changes resulting from conversions and mergers between federal and state bank charters according to data from Office of the Comptroller of the Currency (OCC). Of 3,163 charter changes for that period, 1,884 involved moving from state charters to the federal charter, and 1,279 involved moving from the federal to a state charter, a net increase of 605 to the federal charter.

Annual changes between the two types of charters tended to be similar in number, with the exception of 1994–1999, when noticeably more state banks changed to the federal charter.[1] According to industry observers and academics we interviewed, the greater number of changes to the federal charter in 1997 could be attributed to the easing of individual state restrictions on interstate banking and the passage of the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994, which removed remaining state restrictions on interstate banking.

[1] In addition to state-chartered banks, nonbank depositories such as thrifts and federal savings banks, also converted to the federal bank charter in 1990-2004.

Figure 5: Total Annual Changes between Federal and State Charters, 1990-2004



Source: GAO analysis of OCC data.

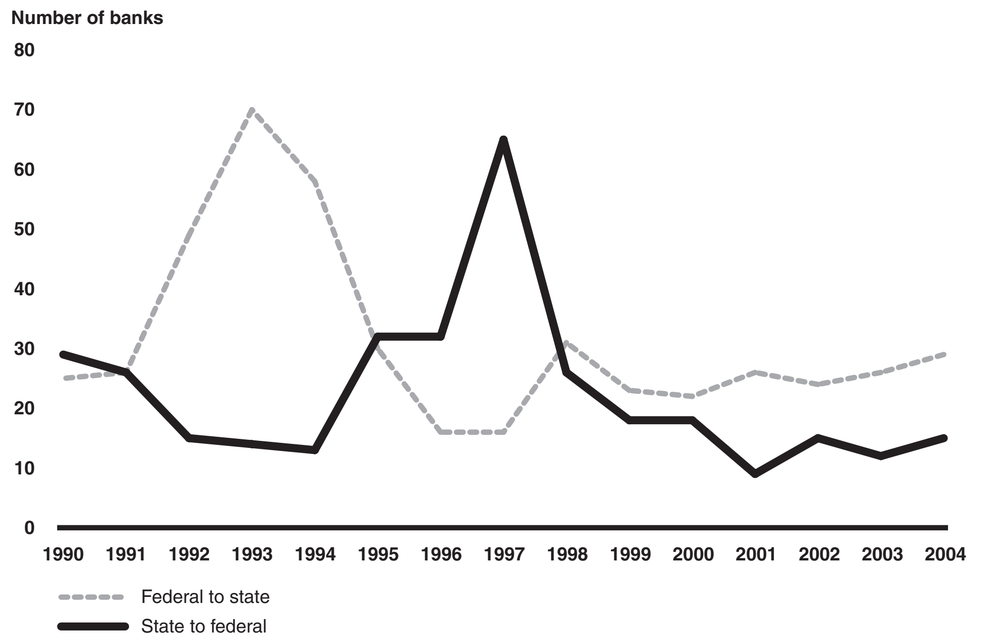
The majority of changes between the federal and state charters during this period resulted from mergers rather than conversions.[2] Of the 3,163 charter changes in that period, 2,353 (or 74 percent) involved mergers. Further, 1,545 (82 percent) of the 1,884 changes from a state to the federal charter involved mergers. Changes from the federal to a state charter involved somewhat fewer mergers: 808 (63 percent) of 1,279 changes.

Focusing only on conversions, we found that, over the entire period, there was a net increase in state-chartered banks. Figure 6 shows the number of annual changes resulting from conversions between the two types of charters from 1990 through 2004. There were a total of 339 conversions to the federal charter and a total of 471 conversions to state charters. Thus,

[2]According to OCC and the Board of Governors of the Federal Reserve System officials, a charter change resulting from a conversion is a business decision involving one entity changing to another charter whereas a charter change resulting from a merger is a business transaction involving the consolidation of two or more entities into one entity under a state or federal charter.

there were 132 more conversions to state charters than to the federal charter.

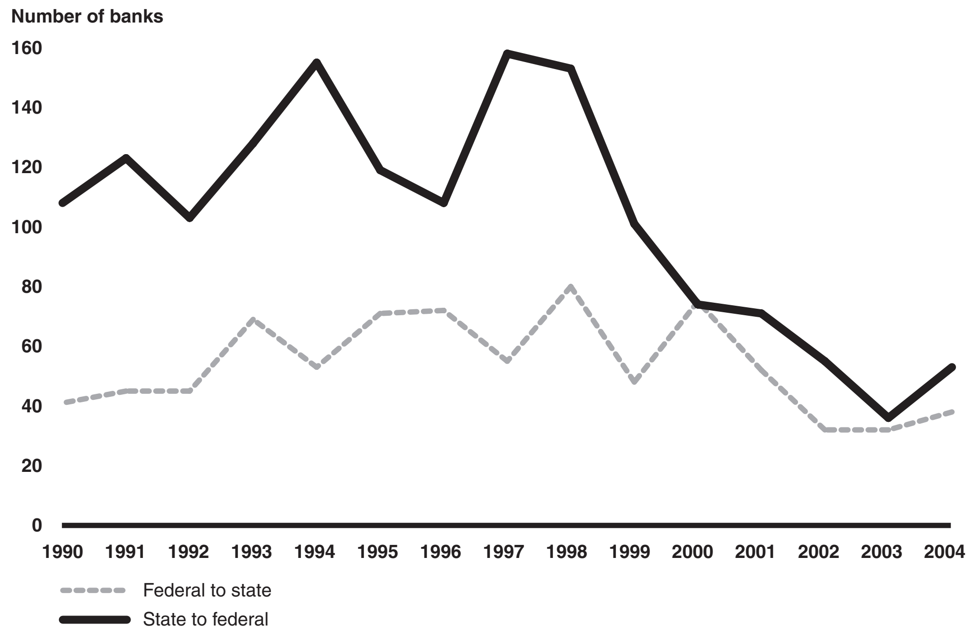
Figure 6: Annual Changes between Federal and State Charters Resulting from Conversions, 1990–2004



Source: GAO analysis of OCC data.

Looking only at mergers, we found the opposite—a net increase in federal charters. Figure 7 shows the number of annual changes resulting from mergers between the federal and state bank charters from 1990 through 2004. Over the entire period, there were a total of 1,545 mergers into the federal charter and 808 mergers into state charters. Thus, there were 737 more mergers into the federal charter than into state charters.

Figure 7: Annual Changes between Federal and State Charters Resulting from Mergers, 1990–2004

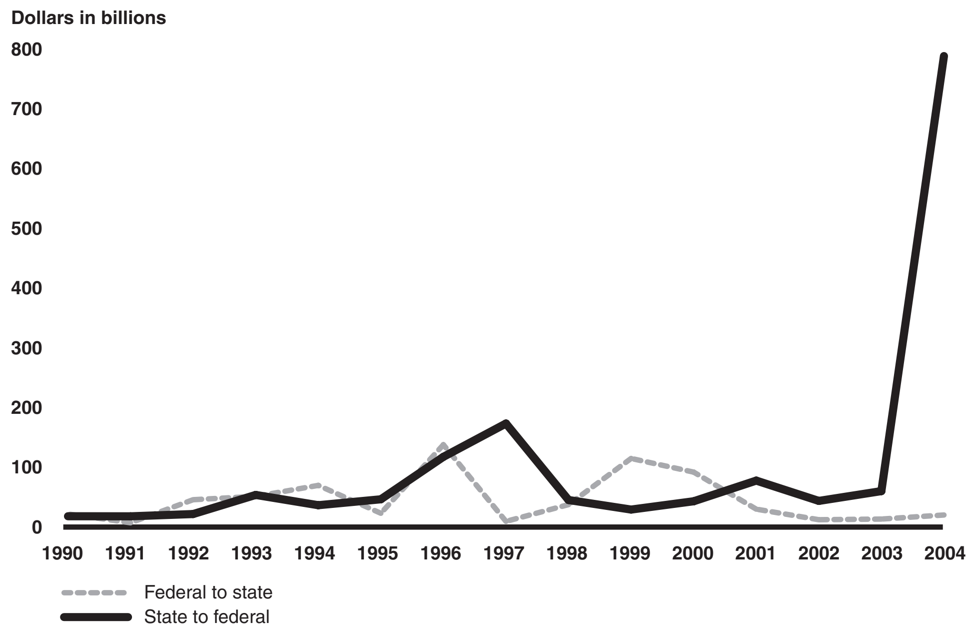


Source: GAO analysis of OCC data.

Recent Charter Changes Substantially Increased the National Bank Share of All Bank Assets

When banks change charters, the share of bank assets under the supervision of OCC and different state bank regulators also changes. Figure 8 shows the total assets of banks that changed charters annually from 1990 through 2004 according to data from OCC and the Board of Governors of the Federal Reserve System (FRB). In 1990-2003, the total assets of all banks that changed charters were less than $200 billion annually. However, in 2004 total assets of all state-chartered banks that changed to the federal charter increased to about $789 billion, largely due to the charter changes of JP Morgan Chase Bank and HSBC Bank. The assets of these banks constituted about 96 percent (about $759 billion) of the total assets of banks that changed to the federal charter, or 82 and 14 percent, respectively. Over the entire period, total assets that shifted to the federal charter amounted to about $1,574 billion, and total assets that shifted to state charters amounted to about $687 billion. Thus, about $887 billion more in assets shifted to the federal charter than to state charters.

Figure 8: Assets of Banks That Changed between Federal and State Charters, 1990–2004

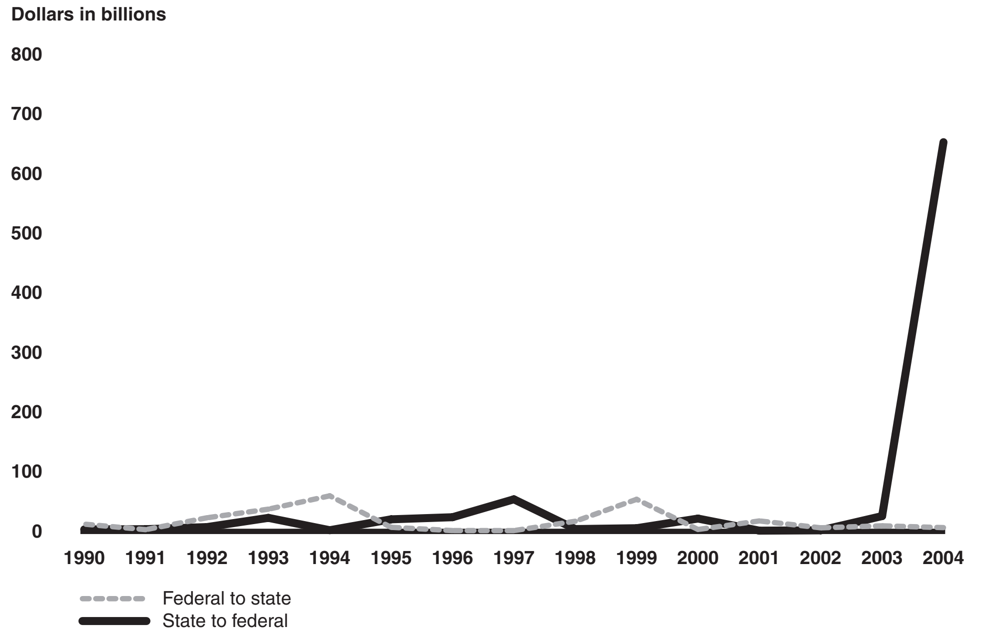


Sources: GAO analysis of OCC and Federal Reserve Board data.

Note: For the purpose of describing assets associated with all charter changes, asset data points were computed by adding OCC data on charter changes resulting from conversions to FRB data on charter changes resulting from mergers. However, we discovered that HSBC's charter change was recorded by OCC as a merger and by FRB as a conversion. To resolve this discrepancy and ensure that HSBC's assets were included, we added in HSBC's change from the state to federal charter in 2004 after consulting the FDIC "Statistics on Depository Institutions" for an approximate asset figure. There may be other such instances of discrepancies in recording methods, which we were not able to identify.

We also looked at the movement of assets depending on whether charter changes resulted from conversions or mergers. Figure 9 shows the assets of banks that converted annually between the federal and state charters from 1990 through 2004, according to data from OCC. In 1990-2003, about $55 billion more in assets shifted to state charters than to the federal charter. During that period, total assets of banks that converted charters remained below $100 billion annually. However, when 2004 figures are included, about $590 billion more in assets shifted to the federal charter than to state charters. This is largely due to the conversion of one formerly state-chartered bank (JP Morgan Chase Bank), which alone contributed 99 percent (about $649 billion) of all assets in 2004 of state banks that converted to the federal charter. The assets of JP Morgan Chase Bank represented almost 8 percent of all bank assets in that year.

Figure 9: Assets of Banks That Changed between Federal and State Charters as a Result of Conversions, 1990–2004

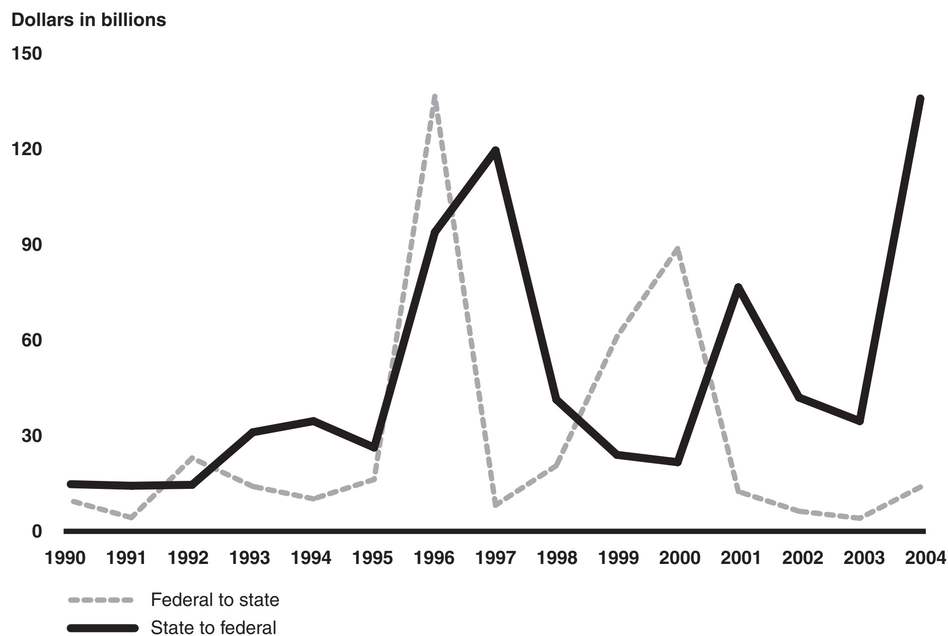


Source: GAO analysis of OCC data.

Similarly, figure 10 shows the assets of banks that experienced mergers between the federal and state charters annually in 1990-2004, according to data from FRB.[3] In 1990-2004, about $296 billion more in assets shifted to the federal charter than to state charters as a result of mergers.

[3]These annual assets do not correspond to the annual number of charter changes resulting from mergers as reported earlier because these assets are data from FRB, while the number of charter changes is data from OCC. We decided to use these two different sources of data as we understand these data to be most reliable for the purposes of this study.

Figure 10: Assets of Banks That Changed between Federal and State Charters as a Result of Mergers, 1990–2004



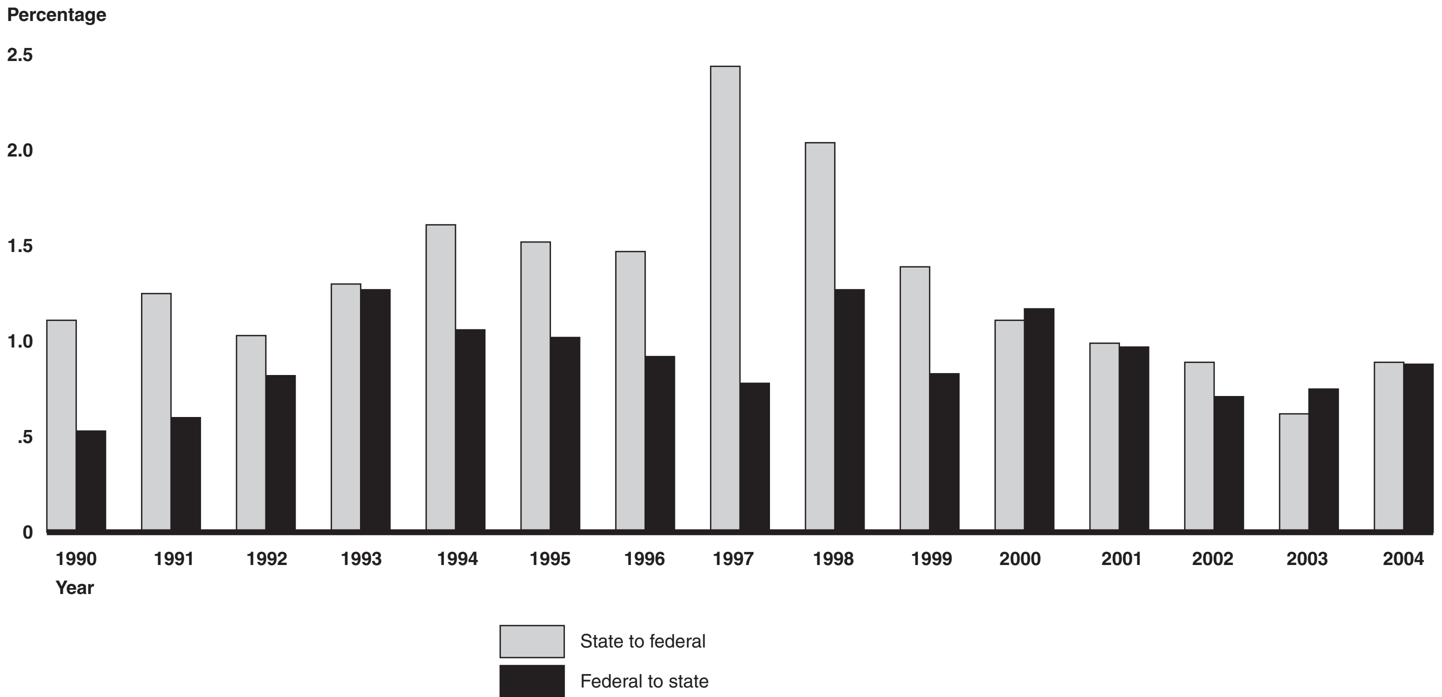
Source: GAO analysis of Federal Reserve Board data.

Note: For the purpose of describing assets associated with all charter changes, asset data points were computed by adding OCC data on charter changes resulting from conversions to FRB data on charter changes resulting from mergers. However, we discovered that HSBC's charter change was recorded by OCC as a merger and by FRB as a conversion. To resolve this discrepancy and ensure that HSBC's assets were included, we added in HSBC's change from the state to federal charter in 2004 after consulting the FDIC "Statistics on Depository Institutions" for an approximate asset figure. There may be other such instances of discrepancies in recording methods, which we were not able to identify.

The Annual Number and Assets of Banks That Changed between Federal and State Charters Was Small Relative to All Banks and All Bank Assets

From 1990 through 2004, the annual number and assets of banks that changed between the federal and state charters constituted a small percentage of all banks and all bank assets in those years. During that period, the annual number of changes between the federal and state bank charters was about 2 percent or less of all banks in those years. For example, the number of changes to the federal charter as a percentage of all banks was 2.4 percent in 1997, when there were 223 changes. The number of changes to the state charter as a percentage of all banks was 1.3 percent in 1993, when there were 139 changes. Figure 11 shows the total annual changes between the federal and state bank charters as a percentage of all banks in each year from 1990 through 2004.

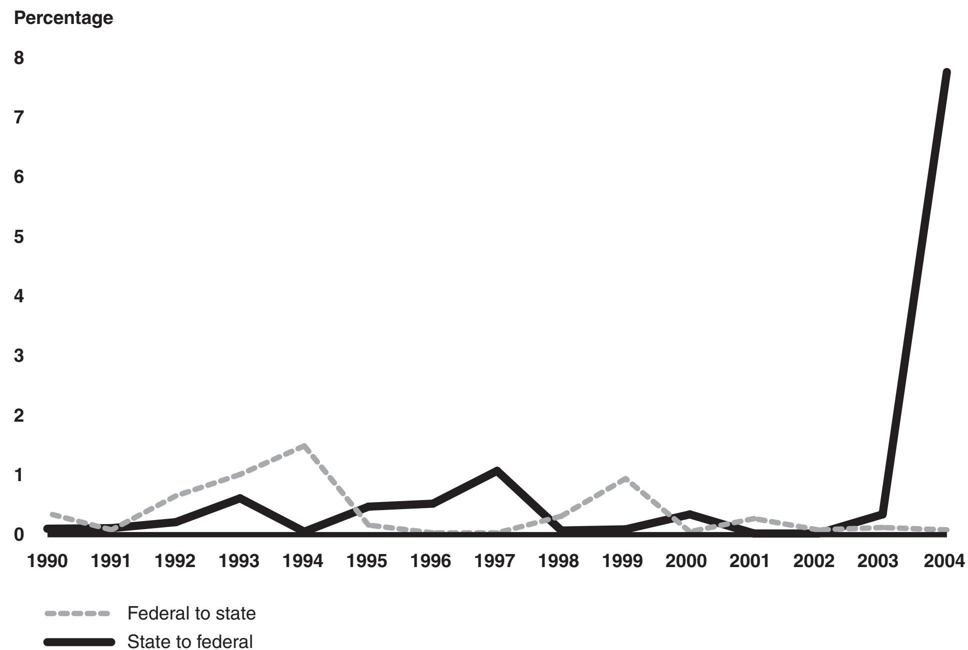
Figure 11: Total Annual Changes between Federal and State Charters, as a Percentage of All Banks, 1990–2004



Sources: GAO analysis of OCC and FDIC data.

We found that the percentage of assets involved in charter changes was also small relative to all bank assets. Figure 12 shows the annual assets of banks from 1990 to 2004 that converted between the federal and state charters as a percentage of all bank assets. From 1990 to 2004, total assets of banks that converted from the federal charter to state charters were about 1.5 percent or less of all bank assets annually. For example, assets were highest in 1994 at about $59.6 billion, which was 1.49 percent of all bank assets that year. Similarly, from 1990 through 2003, the total annual assets of banks that converted from state charters to the federal charter were about 1 percent or less of all bank assets each year. For example, during this period assets were highest in 1997 at about $54 billion, which was about 1.07 percent of all bank assets that year. In 2004, however, assets for state to federal conversions reached their highest since 1990 at about $653 billion, which was about 7.8 percent of all bank assets that year.

Figure 12: Assets of Banks That Converted between Federal and State Charters, as a Percentage of All Bank Assets, 1990–2004



Sources: GAO analysis of OCC and FDIC data.

Similarly, the annual charter changes and assets of banks involved in mergers have also been a small percentage of all banks and all bank assets for those years. During the period, the number of mergers between the two types of charters is less than 2 percent of all banks per year. For example, as shown in figure 7, the highest number of mergers into state charters from the federal charter was 80 in 1998, which was 0.91 percent of all banks that year. The highest number of mergers into the federal charter from state charters was 158 in 1997, which was 1.73 percent of all banks that year. The annual assets of banks experiencing mergers between the two types of charters were less than 3 percent of all bank assets each year.[4] For example, as shown in figure 10, assets for mergers into state charters from

[4]These asset figures do not correspond to the number of charter changes resulting from mergers as reported earlier because these figures are based on data from FRB, while the number of charter changes is based on data from OCC. We decided to use these two different sources of data as we understand these data to be most reliable for the purposes of this study.

the federal charter were highest in 1996 at about $136.6 billion, which was about 2.98 percent of all bank assets that year. Assets for mergers into the federal charter from state charters were highest in 2004 at about $135.9 billion, which was about 1.62 percent of all bank assets that year.

How OCC is Funded

The Office of the Comptroller of the Currency (OCC) is funded primarily by the assessments and fees that it collects from the institutions it oversees. The amounts assessed for OCC oversight are primarily based on a bank's asset size, but other factors are included in OCC's assessment formula. Under the formula, bank assessments decrease as asset size increases. As a result, mergers and consolidations among banks result in a smaller assessment paid to OCC by the resulting bank.

OCC Is Funded Primarily by the Assessments It Charges National Banks

As of fiscal year 2004, assessments made up almost all of OCC's revenue — about 97 percent. As shown in figure 13, since 1999 assessments have constituted no less than 94 percent of OCC's revenue. OCC also receives revenue from other sources: corporate fees banks pay primarily for licensing, investment income from gains on U.S. Treasury securities, income from the sale of OCC publications, and income from miscellaneous internal operations such as parking fees paid by OCC employees.

Figure 13: Sources of OCC Revenue, 1999-2004

Sources of revenue	CY 1999		CY 2000		FY 2001		FY 2002		FY 2003		FY 2004	
Assessments	$378,562,988	95.8%	$382,728,368	94.8%	$395,522,295	95.1%	$425,802,749	96.2%	$452,165,500	97.0%	$482,278,444	96.9%
Corporate fees	2,025,886	0.5	1,628,110	0.4	1,501,795	0.4	1,410,105	0.3	1,250,648	0.3	1,371,899	0.3
Investment income	13,040,584	3.3	17,466,934	4.3	16,792,570	4.0	12,846,135	2.9	10,222,726	2.2	11,289,755	2.3
Publications	967,370	0.2	807,442	0.2	1,159,913	0.3	663,460	0.1	541,639	0.1	515,503	0.1
Other	718,124	0.2	923,352	0.2	899,411	0.2	1,932,661	0.4	1,929,782	0.4	2,308,874	0.5
Total	**$395,314,952**	**100.0%**	**$403,554,206**	**100.0%**	**$415,875,984**	**100.0%**	**$442,655,110**	**100.0%**	**$466,110,295**	**100.0%**	**$497,764,475**	**100.0%**

Source: OCC.

Note: In October 2001, OCC changed its reporting period from a calendar to a fiscal year basis. Percentages may not add to 100 percent because of rounding.

OCC's Assessment Formula Is Based on Asset Size but Includes Other Factors

The assessment formula, changed in the mid-1970s from a flat rate per dollar of assets to its current regressive structure, determines how much each national bank must pay for OCC supervision. The relationships between bank size (assets) and assessments are shown in table 1. Every national bank falls into one of the 10 asset-size brackets denoted by columns A and B. The semiannual assessment is composed of two parts.[1] The first part is the calculation of a base amount of the assessment, which is computed on the assets of the bank as reported on the bank's Consolidated Report of Condition (or call report) up to the lower end point (column A) of the bracket in which it falls.[2] This base amount of the assessment is calculated by OCC in column C. The second part is the calculation by the bank of assessments due on the remaining assets of the bank in excess of column E. The excess is assessed at the marginal rate shown in column D. The total semiannual assessment is the amount in column C, plus the amount of the bank's assets in excess of column E multiplied by the marginal rate in column D: Assessments = C+[(Assets - E) x D].

Table 1: OCC's Assessment Formula

If the amount of total balance sheet assets (consolidated domestic and foreign subsidiaries) is:		The semiannual assessment will be:		
A	B	C	D	E
Over	But not over	This amount	Plus	Of excess over
$0	$2,000,000	$5,075	0.000000000	$0
2,000,000	20,000,000	5,075	0.000210603	2,000,000
20,000,000	100,000,000	8,866	0.000168481	20,000,000
100,000,000	200,000,000	22,344	0.000109512	100,000,000

[1]Per federal regulation, each national bank and each District of Columbia bank shall pay to the Comptroller of the Currency a semiannual assessment fee, due by January 31 and July 31 of each year, for the 6-month period beginning 30 days before each payment date, 12 C.F.R. 8.2(a).

[2]Reports of Condition and Income are required by statute and collected by the Federal Deposit Insurance Corporation under the provision of Section 1817(a)(1) of the Federal Deposit Insurance Act. This report collects basic financial data from commercial banks in the form of a balance sheet, an income statement, and supporting schedules. The Report of Condition schedules provide details on assets, liabilities, and capital accounts.

(Continued From Previous Page)

If the amount of total balance sheet assets (consolidated domestic and foreign subsidiaries) is:		The semiannual assessment will be:		
A	B	C	D	E
Over	But not over	This amount	Plus	Of excess over
200,000,000	1,000,000,000	33,295	0.000092663	200,000,000
1,000,000,000	2,000,000,000	107,425	0.000075816	1,000,000,000
2,000,000,000	6,000,000,000	183,241	0.000067393	2,000,000,000
6,000,000,000	20,000,000,000	452,813	0.000057343	6,000,000,000
20,000,000,000	$40,000,000,000	1,255,615	0.000050403	20,000,000,000
$40,000,000,000		$2,263,675	0.000033005	$40,000,000,000

Source: OCC 2003-45, Notice of Comptroller of the Currency Fees for Year 2004.

OCC also levies a surcharge for banks that require increased supervisory resources as reflected in the bank's last OCC-assigned CAMELS rating.[3] The CAMELS score is a numerical rating assigned by supervisors to reflect their assessment of the overall financial condition of a bank. The score takes on integer values ranging from 1 (best) to 5 (worst). Surcharges are calculated by multiplying the assessment, based on the institution's reported assets up to $20 billion, by 50 percent for a CAMELS 3-rated institution and 100 percent for 4- and 5- rated institutions. For example, a national bank, with a 4 supervisory rating, $15 billion in assets, and no independent trust or credit card operations would be charged a standard assessment of $968,900 plus a 100 percent surcharge of $968,900, for a total assessment of $1,937,800. Since January 1, 2003, OCC special examinations and investigations have been subject to an additional charge of $110 per hour.

Each year OCC issues a notice with updates on changes and adjustments, if any, to the assessment formula. It may adjust the marginal rates in column D and the amounts in column C; most adjustments are made based on the percentage change in the level of prices, as measured by changes in the Gross Domestic Products Implicit Price Deflator (GDPIPD). GDPIPD is sensitive to changes in inflation, and OCC has discretion to adjust marginal rates by amounts less than the percentage change in GDPIPD for that time

[3]OCC also collects fines and civil monetary penalties, primarily from lawsuits against corporations, corporate officers, and directors for impropriety. These funds are collected on behalf of the U.S. Treasury and have no effect on OCC's income or annual budget.

period. For example, the GDPIPD adjustment was 1.5 percent in 2004 and 1.1 percent in 2003.

OCC also has the authority to reduce the semiannual assessment for banks other than the largest national bank controlled by a company; these nonlead banks may receive a lesser assessment.[4] For example, in the 2004 Notice of Comptroller of the Currency Fees, OCC reduced the assessment of nonlead national banks by 12 percent.

The Price of OCC Supervision Decreases with Asset Size

Because the multipliers used to compute assessments beyond the base assessment decrease as asset size increases, (see column D in table 1), the price of supervision is less per million dollars in assets for larger banks than for smaller banks.[5] To illustrate this point, we calculated the price per million dollars in assets for the largest possible total asset size within each assessment range (see table 2).

Table 2: Price of Supervision per Million Dollars in Assets

Bank asset size	Bank assessment amount	Price per $1 million of supervision
$2,000,000	$5,075	$2,537.50
20,000,000	8,866	443.29
100,000,000	22,344	223.44
200,000,000	33,295	166.48
1,000,000,000	107,425	107.43
2,000,000,000	183,241	91.62
6,000,000,000	452,813	75.47
20,000,000,000	1,255,615	62.78
$40,000,000,000	$2,263,675	$56.59

Source: GAO analysis based on OCC 2003-45, Notice of Comptroller of the Currency Fees for Year 2004.

[4]This determination is based on a comparison of the total assets held by each national bank controlled by one company as reported in each bank's call report filed for the quarter immediately preceding the payment of a semiannual assessment.

[5]This is true of those national banks, federal branches and agencies of foreign banks and District of Columbia banks with a satisfactory supervisory rating. However, banks with less than satisfactory performance are required to pay an additional surcharge that may result in a direct relationship between the price of supervision and asset size.

For example, table 2 shows that a national bank with about $2 million in total assets would pay about $2,500 per million dollars of assets for supervision, while the price of supervision for a national bank of about $2 billion is less than $100 per million dollars of assets.

Mergers and Consolidations Result in Less Revenue for OCC

OCC's assessment formula prices supervision for merged national banks at a rate less than that of individual national banks with equivalent total assets. In cases where there is a merger between two national banks, for example, bank A is a national bank and bank B is a national bank, the merged bank C may have total assets equal to bank A plus those of bank B, but the assessment for bank C could be less than the assessment of bank A plus the assessment of bank C.

To illustrate this point, we selected 10 merger transactions and applied OCC's assessment formula. In all cases, OCC received less revenue in assessments after the merger occurred, compared with individual assessments prior to the merger. Table 3 shows the asset amounts of the banks in one of our examples and the effect of OCC's formula. In this example, the impact is a change in OCC's budget that decreases assessment revenue by about $76,500.

Table 3: Effect of Mergers and Consolidations

	Assets	Individual assessments	Bank A assessments + Bank B assessments	(Bank A+ Bank B) – Bank C = decrease in OCC budget
A (Acquiring bank)	$14,304,670,000	$929,028		
B (Target bank	2,794,586,000	236,791	**$1,165,819**	
C (Combined bank)	$17,099,256,000	$1,089,278		$76,541

Sources: OCC and GAO.

An OCC official acknowledged that the regressive nature of its assessment formula could reduce the assessment paid by merged banks compared with individual bank assessments prior to a merger. However, the official stated that costs associated with supervising merged banks were dependent on specific characteristics of the merged bank. For example, if a national bank located in California merged with a national bank located in New York, OCC may need to continue to maintain bicoastal bank examination teams. In this case, assessments would decrease, but costs would remain the

same. In most cases however, over time, mergers of roughly equal-sized banks would realize savings and other synergies that do not require extra resources. For example, certain fixed costs could be spread across the merged banks; thus, as the bank's assets grow larger, average costs generally decrease.

How Selected Federal Financial Industry Regulators Are Funded

Regulator	Mission and regulatory role	Funding
Federal Deposit Insurance Corporation (FDIC)	FDIC is to contribute to the stability of and public confidence in the nation's financial system by insuring deposits, examining and supervising financial institutions, and managing receiverships. In cooperation with state bank regulators, FDIC regulates federally insured, state-chartered banks that are not members of the Federal Reserve and federally insured state savings banks.	FDIC funds its operations by premiums that banks and thrifts pay for deposit insurance and earnings on its investments in U.S. Treasury securities. FDIC has permanent budget authority and, therefore, is not subject to the congressional appropriations process.
Board of Governors of the Federal Reserve System (FRB)	As the nation's independent, decentralized central bank, the FRB is responsible for conducting monetary policy, maintaining the stability of the financial markets, and supporting a stable economy. The FRB supervises and regulates bank holding companies and, in cooperation with state bank regulators, examines and supervises state-chartered banks that are FRB members.	FRB funds its operations primarily from the earnings on its investments in Treasury securities. FRB has permanent budget authority and, therefore, is not subject to the congressional appropriations process.
Office of Thrift Supervision (OTS)	OTS's mission is to effectively and efficiently supervise thrift institutions to maintain their safety and soundness in a manner that encourages a competitive industry. OTS examines and supervises all federally chartered and insured thrifts and thrift holding companies. In cooperation with state regulators, OTS examines and supervises all state-chartered, federally insured thrifts.	OTS funds its operations primarily from assessments on the federal financial institutions it regulates. It has permanent budget authority and, therefore, is not subject to the congressional appropriations process.
National Credit Union Administration (NCUA)	NCUA's mission is to foster the safety and soundness of federally insured credit unions and to better enable the credit union community to extend credit. It charters, regulates, and insures federally chartered credit unions. It also insures the majority of state-chartered credit unions. In cooperation with state regulators, it supervises federally insured, state-chartered credit unions.	NCUA funds its operations primarily from assessments on the federal credit unions it regulates. It has permanent budget authority and, therefore, is not subject to the congressional appropriations process.
Securities and Exchange Commission (SEC)	SEC's mission is to (1) promote full and fair disclosure; (2) prevent and suppress fraud; (3) supervise and regulate the securities markets; and (4) regulate and oversee investment companies, investment advisers, and public utility holding companies.	SEC is funded by the fees it collects from the entities it regulates subject to limits set by the congressional authorizations and appropriations processes. Excess fees are put into an offset fund and may be administered by Congress for other purposes. SEC is subject to the Office of Management and Budget process.
Office of Federal Housing Enterprise Oversight (OFHEO)	OFHEO is to ensure the capital adequacy and financial safety and soundness of Fannie Mae and Freddie Mac, two government-sponsored enterprises, privately owned and operated corporations established by Congress to enhance the availability of mortgage credit. OFHEO examines and regulates the two enterprises.	OFHEO is funded through assessments paid by Fannie Mae and Freddie Mac and subject to limits set by the congressional authorizations and appropriations process. OFHEO must deposit collected assessments into the Oversight Fund, an account held in the Treasury.

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Regulator	Mission and regulatory role	Funding
Federal Housing Finance Board (FHFB)	FHFB is to ensure the safety and soundness of the Federal Home Loan Bank System, a government-sponsored enterprise whose mission is to support housing finance, and ensure that the system carries out its housing finance mission. FHFB examines and regulates the 12 Federal Home Loan Banks.	FHFB is supported by assessments from the 12 Federal Home Loan Banks. No tax dollars or other appropriations support the operations of the FHFB or the Federal Home Loan Bank System.
Farm Credit Administration (FCA)	FCA is an independent federal regulatory agency responsible for supervising, regulating, and examining institutions operating under the Farm Credit Act of 1971; the institutions that it regulates make up a system that is designed to provide a dependable and affordable source of credit and related services to the agriculture industry.	FCA's expenses are paid through assessments on the institutions it examines and regulates. No federally appropriated funds are involved.

Source: GAO.

Information on Funding of States' Bank Regulators

Information gathered by the Conference of State Bank Supervisors (CSBS) indicates that most state bank regulators levy assessments to fund their operations. Forty-three states used some type of asset-based assessment formula to collect funds from banks and/or other entities they regulated, according to the CSBS data for 2004-2005.[1] Of the other seven states, two based their assessments on department costs, and two levied assessments only for shortfalls in the departments' budgets. The remaining three states did not report information. Most state bank regulators (40 of 49 that reported such information) indicated that their legislatures determined how those funds would be allocated, appropriated, or spent. Table 4 provides more detailed information on the funding arrangements for six state bank regulators that we interviewed.

Table 4: Information on Funding for Selected State Bank Regulators

State	Formula	Who determines how funds are spent
California		
The California Department of Financial Institutions levies assessments on the bank and nonbank entities it regulates using a formula set by the commissioner. The assessment formula is based on assets and the department's costs (using past budgets) and projected expenses. Assessments are deposited into a special account for the department and a reserve can be, and is now, maintained. The department does not have authority to rebate assessed fees. The assessment (minimum of $5,000 and a maximum of $2.20 per $1,000 of assets on a sliding scale) reflects a statutory limit applicable to banks.	Flat rate	The legislature must approve the department's appropriation each fiscal year. The department has general autonomy within the appropriated amounts of the budget categories.
Georgia		
The Georgia Department of Banking and Finance is funded primarily through assessments based on asset size, as provided by statute and set via agency regulations. Some specialty banks, such as credit card banks, pay an hourly rate. The department also collects fees for examinations of other financial entities, for licenses, and for certain transactions.	Regressive schedule	Authority is controlled by the legislature and statute, with requests made by the commissioner during the budget process.

[1]2004-2005 CSBS "Profile of State-Chartered Banking," available for purchase from CSBS.

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State	Formula	Who determines how funds are spent
Idaho		
The Idaho Department of Finance is funded by assessments of regulated financial institutions set by the director within a statutory limit. The assessment structure includes a graduated base fee and excess fee based on total assets and $100 per branch office. The department also collects licensing fees from other financial entities it regulates. It does not have authority to rebate assessments; it maintains a reserve account.	Regressive schedule	The department's budget must be approved by the Governor, and funds must be appropriated by the legislature.
Iowa		
Iowa's Division of Banking, within the Department of Commerce, is funded primarily by assessments and fees paid by the banks it supervises. In addition, the division supervises nonbank entities that pay fees for licenses, examinations, and investigations. The division determines its budget and establishes a formula that includes a bank's assets and other factors, such as increases for CAMELS ratings over 2, to calculate the assessment. The assessed amounts are collected quarterly and may fluctuate since they are based on the actual operating expenses of the division. The "break even" approach does not provide the state's general fund with excess revenue from the division. However, the division may rebate excess assessments. The actual cost of the division's operations is the statutory limit to the assessments.	Regressive schedule	The division's budget must be approved by the Governor and the Department of Management. Funds paid to the division go into the state's general fund and are appropriated by the legislature.
New York		
The New York State Banking Department levies assessments on the banks and nonbank entities it supervises based on the cost to supervise them plus a regulatory assessment. Each company reports a measure of the business size, called the financial basis in the calculation. The supervisory cost is calculated on the average number of hours needed to supervise like size and type institutions, times the hourly rate for employees responsible for all institutions in the billing group. The amount to be collected through the regulatory calculation is determined by subtracting the supervisory amount from the total budget allocated to the group. The rate is established by dividing the total to be collected by the financial basis for the group. That rate is then multiplied by the financial basis for each company to determine the regulatory portion of the assessment. The sum of the regulatory and supervisory amounts is the total annual assessment.	N/A	The legislature establishes a maximum budget annually.

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State	Formula	Who determines how funds are spent
North Carolina		
The North Carolina Commission on Banking levies an annual assessment based on year-end assets of the banks and certain nonbank entities it supervises. The regressive assessment formula for banks and a flat rate assessment for consumer finance licensees are set by statute. All entities pay application fees at entrance while most nonbank entities pay annual and other specific fees for continued operations within the State. Nonbank entities include check cashers, mortgage brokers and bankers, money transmitters, and others. The commissioner may recommend to the commission discounts and premiums to apply to the statutory assessment rate.	Regressive schedule (for banks) Flat rate (for consumer finance companies)	Funds are directed into a special account for the commission and are available without legislative action. A reserve can be maintained.

Sources: Respective state bank regulators and the Conference of State Bank Supervisors.

Comments from the Office of the Comptroller of the Currency

Comptroller of the Currency
Administrator of National Banks

Washington, DC 20219

April 12, 2006

Mr. David G. Wood
Director, Financial Markets and Community Investment
United States Government Accountability Office
Washington, DC 20548

Dear Mr. Wood:

Thank you for the opportunity to review the draft report prepared by the United States Government Accountability Office (GAO) concerning the effect on consumer protection and the dual banking system of the preemption and visitorial powers rules that we issued in January, 2004.[1] The draft report contains a number of observations that are consistent with the OCC's views about the relationship between those rules and a depository institution's choice of charter. For example, the report indicates that an institution's charter choice usually is based not on one single factor but on a variety of considerations, including the size and complexity of the bank's operations, the quality of the bank's relationship with its federal or state regulator, and the charter type of institutions that the bank has acquired or with which it has merged. We draw the same conclusion based on the supervisory experience we have had with banks that have both entered and departed the national banking system.

The report recounts that state officials continue to express both uncertainty about the scope of preemption under the National Bank Act and concern about the OCC protecting the interests of national bank customers. Some state officials interviewed by the GAO also believed that the preemption and visitorial powers rules did not fully resolve questions about the applicability of state consumer protection laws and believed that protections for the customers of national banks and national bank operating subsidiaries would be diminished. The GAO recommends that the OCC undertake initiatives to enhance coordination with the states and to clarify the applicability of state consumer protection law to national banks.

We believe the preemption rules themselves provided clarification regarding the types of laws listed in the regulations. Under the rules, a state law relating to a subject listed as preempted does not apply to a national bank or its operating subsidiary. Moreover, recent court decisions have been remarkably consistent in finding that particular types of state laws aimed at national

[1] 69 Fed. Reg. 1904 (January 13, 2004) (the "preemption rules") (rules clarifying the applicability of certain types of state law to national bank operations) (*codified at* 12 C.F.R. §§ 7.4007, 7.4008, 7.4009, 34.3, and 34.4); 69 Fed. Reg. 1895) (January 13, 2004) (the "visitorial powers rule") (clarifying the scope of the exclusivity of the OCC's visitorial powers) (*codified at* 12 C.F.R. § 7.4000).

banking activities are preempted. These court decisions reflect a growing judicial consensus about the uniform federal standards that form the core of the national banking system. By reconfirming the principles underlying the preemption and visitorial powers rules, the decisions also should help dispel uncertainties about the scope of applicability of state law to national banks.

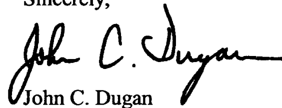
At the same time, we fully recognize that the preemption of state law imposes on the OCC a significant responsibility to implement a federal regulatory regime that is applied credibly and uniformly. We also recognize that we can, and should, find more opportunities to work cooperatively with the states to address issues that affect all of the institutions we regulate. We therefore welcome the GAO's recommendation to enhance outreach to the states on the interplay of state laws and federal preemption and on our respective consumer protection efforts.

The draft report observes that it is impractical for the OCC to specify precisely the particular provisions of each state's laws that are, or are not, preempted. We agree. Nevertheless, we will look for ways to enhance the information that is available concerning the preemption precedents that guide our analysis and for opportunities where it may be fruitful to address the preemption status of types of state laws on a generic basis.

One important new forum for this type of exchange, and for enhanced federal and state dialogue and coordination on consumer issues, is the new Consumer Financial Protection Forum (CFPF) recently initiated by the Department of the Treasury. The CFPF was established to bring federal and state regulators together to focus exclusively on consumer protection issues in the financial services sector and to provide a permanent forum for communication on these issues. It is chaired by the Treasury Department and participants include the OCC, other federal banking and credit union regulators, the Federal Trade Commission, and representatives from state supervisory organizations. The CFPF supplements existing OCC efforts to coordinate with the states on a variety of issues related to consumer protections in several areas, including formal and informal information sharing with state banking supervisors, consumer complaint referrals, and coordination with state insurance regulators. We are optimistic that the CFPF will help to encourage the type of expanded dialogue and coordination on consumer protection issues that the report recommends.

I appreciate this opportunity to provide the OCC's comments on the draft report, and I extend my thanks for the professionalism with which you and your staff have conducted this review.

Sincerely,



John C. Dugan
Comptroller of the Currency

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GAO Contact and Staff Acknowledgments

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Staff Acknowledgments

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