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What's at Stake in Fight Over Preemption

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WASHINGTON - Lawmakers are paying scant attention to one of the most sweeping provisions in the Obama administration's regulatory reform plan - the elimination of national bank preemption.

Congress has focused primarily on other parts of the plan, including the drive to create a systemic risk regulator and a new consumer protection agency, but many industry observers argue that the plan to force national banks to comply with state consumer protection laws could have equal or greater impact.

Bankers and their representatives argue it would change the nature of U.S. banking to force any institution that operates in multiple states to comply with several standards, limiting product choice and raising costs.

"This provision will fundamentally alter the national bank system as envisioned during the Civil War," said Howard Cayne, a partner at Arnold & Porter. "It allows the states to act independently and separately and without regard to any type of uniformity. It will totally balkanize the industry."

But the administration has shown no sign of backing down, and Treasury Department officials downplay the expected impact of their plan, arguing that a new consumer protection agency would set standards so tough that most states would not go beyond them.

"Our judgment is, the federal standards are going to be high and protective of consumers, so I don't think you're going to see a lot of states jumping in with different kinds of laws," said Michael Barr, Treasury assistant secretary for financial institutions. "The experience in this area is that states have tried to step in where there has been significant failing at the federal level."

Whether the preemption provision ends up in the final legislation is anyone's guess. Comptroller of the Currency John Dugan has objected in two hearings to eliminating preemption, but it was unclear from lawmakers' comments whether he has much support.

Community banks, meanwhile, have focused their energies on lobbying against the proposed consumer protection agency, leaving a relative handful of larger banks to target preemption. Privately, some bank officials argue that the preemption language is the most important part of the plan.

Despite the absence of public signs, the conventional wisdom is that the House Financial Services Committee will succeed in passing a bill that eliminates national bank preemption. Chairman Barney Frank has long complained that

the Office of the Comptroller of the Currency overstepped its authority in 2004 by adopting rules that codified its preemption authority.

"Congressman Frank wants it in," said Ron Glancz, a partner at Venable LLP. "It may survive in the House."

Still, a few observers argue that the House may not approve language as sweeping as what the administration proposed. Several sources said a few House Democrats are preparing amendments that would water down the preemption language, though exactly how they would do so was unclear.

But most observers agree the banking industry's best hope to fight the provision lies in the Senate. Though the Democrats control 60 votes, enough to stop a Republican filibuster, many are pro-business moderates who would probably be receptive to bankers' arguments that eliminating preemption could disrupt their industry. Senate Banking Committee members like Tim Johnson, Mark Warner and Jon Tester are unlikely to support the preemption provision in its current form, observers said.

"It might get watered down to get the Testers and Warners on board," said Mark Calabria, a former Republican committee aide and now the director of financial regulations studies at the **Cato Institute.** "I think you are going to see pushback from members to get something they are more comfortable with."

Calabria suggested that Democrats could detail tougher consumer protection rules in legislation and continue to allow federal preemption - a tradeoff banks might accept. "I think there's a feeling on the part of the banking industry that they would take a stronger federal statute in exchange for making sure that it is preemptive," he said.

How successful bankers may be in pushing back against the preemption provision depends in part on whether they can persuade lawmakers it would significantly affect their business - a claim consumer groups dispute.

Under the administration's plan, a consumer protection agency would write and enforce federal protection standards for banks and nonbanks, but states could write tougher rules. States could also enforce both federal and state laws against national and state-chartered banks.

The provision won a boost in a recent Supreme Court decision, Cuomo v. Clearing House Association, which ruled that states could enforce nonpreempted state laws against national banks. But the administration's plan would remove many of the high court's restrictions, including limits on so-called "fishing expeditions" by state attorneys general.

Industry representatives argue that the provision would make business difficult for any banking company hoping to operate nationwide. Each of the 50 states could enact its own consumer protection laws on a range of topics, including mortgages, credit cards and other consumer loans.

Most observers concede it is highly unlikely that all 50 states would create their own standards but say that action by even a few could create a compliance nightmare.

"At the state level, legislatures tend to react to specific constituent issues," said Robert Cook, a partner in the Hudson Cook law firm, "and perhaps some of their reactions, and the constituent issues they come up with and need to address, are not uniform from state to state."

Though observers said California and New York are the states most likely to pass their own laws, Mark Tenhundfeld, the American Bankers Association's senior vice president of regulatory policy, said the situation would be unpredictable.

"I don't think anyone would think Georgia would be leading the charge on consumer protection, but they passed a very tough predatory lending law" in 2003, he said. "That's the problem with getting rid of preemption - you don't know what state will do what."

Comptroller Dugan has been the most vocal opponent of the provision, arguing repeatedly in congressional hearings that the outcome of ending preemption would be disastrous.

"Federally chartered banks would be subject to the multiplicity of state operating standards because the proposal sweepingly repeals the ability of national banks to conduct any retail banking business," Dugan said in a July hearing by the House Financial Services Committee.

But Art Wilmarth, a professor at George Washington Law School, said bankers are overdramatizing the impact of eliminating preemption. It would return the world to what it was before the OCC's 2004 rule, he said.

"I do not believe it does change what the system looked like before the rules were adopted," he said.

State supervisors said that their new powers would be used sparingly.

"If the federal standard is a good one, the states won't act," said Mark Pearce, the North Carolina bank commissioner. "By having a floor, not a ceiling, it ensures we will reach a good minimum standard at the federal level."

But this argument has done little to calm bankers.

"You will always have certain states that will go beyond the federal scheme," said Cathy Ghiglieri, the president of Ghiglieri & Co., a former OCC examiner and former Texas banking commissioner.

Industry representatives also argue that if states are so sure the consumer protection agency will write tough rules why do they want the power to go further?

"It's inconsistent if we are going to create this tough new regulator and not to trust it in being the tough cop on the beat," said Glancz.

For his part, the Treasury's Barr said the provision is meant to guard against cases of inaction by the consumer agency, not to express a lack of faith in it.

"I think it's unlikely that any agency all the time will get everything right," he said. "We ought to be a little bit humble about all institutions all the time to get everything right."

Still, even if only a few states enact tougher laws, bankers said, problems would arise. They cited increased compliance costs - which may be passed along to consumers - more expensive products in certain states and inequality of products offered state-by-state. In some cases, banks could choose to stop doing business in a state altogether. This happened with the Georgia predatory lending law, much of which was later repealed.

But Barr argued that the Georgia case is an example of the system working, since the state did change the law.

"If the state wants to pass a more protective consumer protection law, and it turns out the state has gone too far, the market will let that state know very, very quickly ... , and the states are going to adjust," he said.

L. Richard Fischer, a partner in the Morrison & Foerster law firm, said banks would probably do cost/benefit analyses on operating in each state, depending on

their consumer protection laws. Customers in small states with tough consumer protection laws would be at a disadvantage, he said.

"In big states, even though it's costly, at least there are enough customers to recoup costs, but in other states like Vermont, North Dakota, there's absolutely no incentive for anyone to lend there because the number of potential customers is just not big enough," he said. "Where the likely compliance costs are greater than another, you would be foolish to enter that state."

Steve Wilson, the CEO of LCNB National Bank in Lebanon, Ohio, said his bank has 25 offices in Ohio and has opened several in Indiana and Kentucky. It would be burdensome to comply with, in effect, four different standards - the three states' and the federal one, he said.

"I'm a smaller bank that would be hampered in our marketing efforts and products if it weren't for preemption," Wilson said. "It would greatly increase our costs, and either way we went, it could limit our product offering."

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