Hydraulic Regulation: Regulating Credit Markets Upstream

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Consumer protection in financial services has failed. A crisis is now playing itself out in the mortgage, credit card, auto loan, title loan, refund anticipation loan, and payday loan markets. Consumer protection was a traditional element of states' regulatory power until federal preemption ousted states from almost all direct regulation of federally chartered banks without substituting equivalent protections and enforcement.

This Article argues that one avenue may remain to permit states to engage in consumer-protection regulation of federally chartered banks. Recent changes in financial markets have placed the majority of consumer debt in the hands of secondary-market entities, such as securitization trusts and debt collectors, which are not protected by federal preemption. States' ability to regulate the secondary consumer debt market directly also gives them the ability to regulate the primary market indirectly, even when direct regulation of the primary market would be preempted.

States can impose targeted regulatory costs on the secondary market tied to the presence or absence of particular terms in consumer debts, regardless of what type of institution initiated the debt. By tying regulation to the terms of the debt, states can channel the hydraulic force of the market, which will pass these costs on to the originators of the debts—including federally chartered banks. This channeling would create an incentive for originating lenders to adjust the terms under which they originate consumer debts to avoid state regulatory costs. This Article contends that such regulation would not run afoul of preemption doctrine because it does not directly regulate federally chartered banks; it affects them only indirectly, through the market.

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Introduction

Consumer protection is an essential part of states’ police power.\(^1\) The banking industry, however, has been largely removed from states’ regulatory ken by federal preemption. States cannot directly regulate federally chartered banks, thrifts, or credit unions, their operating subsidiaries, or even some of their agents beyond subjecting them to “state laws of general application . . . to the extent such laws do not conflict with the letter or the general purposes” of federal banking law.\(^2\) Instead, consumer-protection regulation of federally chartered financial institutions has become the preserve of a dispersed group of federal agencies. This arrangement is made more problematic by the fact that preempted state consumer-protection regulations have often not been replaced by equivalent federal protections,\(^3\) and federal enforcement of existing regulations has been lax. For much of the consumer financial product market, the preemption experience has effectively been a deregulation experience.

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1 Watters v. Wachovia Bank, N.A., 127 S. Ct. 1559, 1581 (2007) (Stevens, J., dissenting) (“Consumer protection is quintessentially a field which the States have traditionally occupied.”) (internal quotation marks omitted).
2 Watters, 127 S. Ct. at 1567.
The home mortgage crisis and growing concern over credit card issuers’ pricing and billing practices, payday lending, and title loans have underscored the shortcomings in federal consumer-protection regulation in the financial-services area. As Representative Barney Frank, Chairman of the House Financial Services Committee, stated, “When [Federal Reserve] Chairman Bernanke testified [before this Committee at a recent hearing] . . . he said something I hadn’t heard in my 28 years in this body, a Chairman of the Federal Reserve Board uttering the words, ‘consumer protection.’ It had not happened since 1981.”

There are two possible (and non-exclusive) regulatory architecture solutions to the current consumer-protection problem. One solution that has been discussed is to concentrate the consumer-protection mission at the federal level in the hands of a single federal agency.

This Article proposes an alternative solution to the regulatory architecture problem: reinvigorating the role of state regulators as consumer-protection advocates. While preemption doctrine is presumed to have foreclosed meaningful state regulation of federally chartered financial institutions, this Article argues that states possess a major, untapped regulatory tool: the regulation of secondary-market purchasers of consumer debt from federally chartered financial institutions. Preemption doctrine prevents only direct state regulation of federally chartered financial institutions. It does not prevent states from regulating secondary-market purchasers of debt from federally chartered financial institutions.

States can go farther than regulating the secondary market itself, however. States can pass what this Article terms “hydraulic regulations”—regulations of a secondary market that have a net positive social welfare effect by imposing negative externalities on a primary market that will shift primary market actors’ incentives. Because preemption doctrine prevents only the direct regulation of federally chartered financial institutions, it does not prevent states from channeling the pressures of the market in order to use regulation of the non-federally-chartered secondary market as a tool to regulate upstream in the origination market indirectly.

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6 The “hydraulic” terminology is inspired by Benjamin Sachs, Employment Law as Labor Law, 29 CARDOZO L. REV. 2685 (2008), where it is used to describe the process whereby the constricting of labor-law relief to plaintiffs led to the use of employment law to attempt to remedy the same wrongs.
Hydraulic regulation aims to impose targeted regulatory costs, tied to specific terms in consumer debt, on secondary market purchasers of the debt, such as securitization trusts and debt collectors. Because the regulatory costs are tied to the terms of the debt, these costs will be passed on to the federally chartered financial institutions that originate the debt in the form of lower secondary-market prices.\(^7\) Faced with a less robust and profitable secondary market, banks will have a strong incentive either to alter the terms of the debts they originate to avoid the hydraulic regulation or to keep the debts on their own books.

Either outcome improves social welfare. If financial institutions remove the offensive terms from their debts, consumers benefit, as there will be less inefficient rent-extraction caused by asymmetric bargaining power and informational advantages. And if financial institutions keep loans on their own books, they will have stronger incentives to engage in careful and prudent underwriting and to avoid abusive terms likely to trigger defaults and make consumer debt more volatile. States can thus effectively regulate federally chartered financial institutions without running afoul of federal preemption doctrine.

This Article proceeds as follows. Part I briefly reviews the current state of bank regulation and the crisis in consumer protection in financial services. The structure of banking regulation and the current consumer-protection crisis have been amply explored elsewhere,\(^8\) so this Article seeks to provide only a general background for readers. Part II considers the scope of preemption doctrine in the financial-services industry and examines the extent to which states currently can regulate national banks and thrifts. Part III presents the idea of hydraulic regulation and shows how it would change the dynamics of regulatory architecture and capture. Part IV considers potential obstacles to hydraulic regulation—specifically the uncertain reach of preemption doctrine, the nature of securitization, the holder-in-due-course doctrine, and the ability of financial institutions to structure around hydraulic regulation. Part V concludes.

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\(^7\) It is important to note that the secondary market will not disappear, as at a minimum there will be a secondary market among federally chartered financial institutions.

I. The Consumer-Protection Regulatory Crisis

A. The Current Regulatory Architecture of Consumer Protection

"Consumer protection" is an elusive concept; while it is easy to provide examples of consumer-protection legislation and litigation, it is much harder to define consumer protection. This Article uses the term "consumer protection" to refer to laws, regulations, and enforcement actions that aim to protect consumers both from unsafe or potentially unsafe products and services and from products, services, or sales methods designed to exploit informational or bargaining-power asymmetries, including cognitive biases and lack of self-control, such that consumers do not receive what they expected from their bargains. Thus, consumer protection is both about prohibiting or restricting dangerous products (such as lead-based paint or non-purchase-money security interests in consumer goods) and leveling the playing field between consumers and the professional sellers (or purchasers) of goods and services.

Consumer protection is an inherently paternalistic endeavor. While it can sometimes be done with a light touch, such as by shifting default rules and menu choices,\(^9\) it often requires greater intervention in the market, including outright prohibition of particular practices and products.\(^10\) The reasons animating this paternalistic response vary depending on the particular regulation or enforcement at issue, but typically include both preventing direct injury (including fraud) to consumers, the risk of which stifles economic exchange, and deterring third-party externalities caused by product use.

Consumer-protection roles are dispersed among regulatory agencies depending on the industry and on the nature of the consumer protection (advertising versus contractual terms, for example).\(^11\) Moreover, enforcement powers may not lie in the same hands as regulatory powers do. This situation is very much the case in banking services. Consumer protection in banking services is divided among several agencies, some of which have the ability to promulgate regulations, and others of which may only enforce existing regulations.

The United States has a dual banking system, meaning that banks may be chartered by either the federal government or a state government. Regulatory

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\(^10\) As Eyal Zamir has noted, however, paternalism's general efficiency is indeterminate; at times it can increase efficiency. See Eyal Zamir, The Efficiency of Paternalism, 84 Va. L. Rev. 229 (1998).

authority over banks for consumer protection depends on whether a bank has a federal or state charter, what type of charter the bank has, whether the bank has federal deposit insurance, whether the bank is a member of the Federal Reserve system, what activity is involved (real-estate lending or non-real-estate lending, for example), and whether the consumer-protection issue arises in advertising and solicitation.

If a bank has a state charter and is neither federally insured nor a member of the Federal Reserve system, its primary regulator for consumer protection will be the state banking regulator and/or state attorney general. There are few banks in this category because the lack of federal deposit insurance is a major competitive disadvantage. Non-member insured state-chartered banks are regulated by the Federal Depository Insurance Corporation. State-chartered member banks are regulated by the Board of Governors of the Federal Reserve.

For federally chartered banks, the regulator depends on the type of charter. The Office of the Comptroller of the Currency (OCC), a bureau of the Treasury Department, has primary authority over entities with national bank charters ("national banks"). Another Treasury office, the Office of Thrift Supervision (OTS) has authority over entities with a federal thrift charter, such as savings associations, savings banks, and savings and loans ("national thrifts"). Although the OCC and the OTS are part of the Treasury Department, they are autonomous, and the Treasury Secretary lacks authority to compel the Comptroller of the Currency or the Director of the OTS to promulgate any rule. Additionally, an independent agency, the National Credit Union Administration (NCUA), has authority over federal credit unions.

Banking operations are often supported by affiliates and by third-party service companies and agents. Bank operating subsidiaries (which have state-issued corporate charters and are limited to engaging in functions in which national banks may themselves engage), financial subsidiaries (which are state-chartered and may engage in functions not authorized under the National Bank Act (NBA)), and independent bank and thrift service companies are subject to the same regulatory oversight as the parent institution or the institution they service. Additionally, bank holding companies and financial holding companies are regulated by the Federal Reserve, while thrift holding

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13 This Article uses the term "national thrifts" for stylistic convenience and parallelism with "national banks," but the more common terms are "federal thrifts," "federal savings associations," "federal savings banks," and "federal savings and loan associations."
companies are regulated by the OTS.\textsuperscript{17} Other various non-banking affiliates of federal financial institutions may or may not fall under primary federal or state regulators, depending on their activities. Other lending institutions, like state-chartered finance companies, are not subject to banking regulations at all, except to the extent they are bank service companies. Instead, finance companies are subject to Federal Trade Commission (FTC) and state regulation and enforcement, but not to supervisory oversight.

Additionally, several other agencies are involved in consumer-protection regulation and enforcement for real-estate lending, some of which are part of the Department of Housing and Urban Development: the Federal Housing Administration, the Office of Federal Housing Enterprise Oversight (OFHEO),\textsuperscript{18} the Government National Mortgage Association, and the Federal Home Loan Finance Board. The FTC and the Department of Justice have authority to address ancillary issues like false advertising, deceptive marketing, credit reporting, and fraud. Moreover, Congress itself can pass legislation regulating any banks that fall under any federal regulator's authority.

The role of states in regulating the banking industry has declined considerably in the past few decades. Non-insured, non-member banks make up only a small, unimportant corner of the consumer credit economy; consumer lending is now dominated by federally chartered institutions, especially national banks. For example, the ten largest credit card issuers, which account for the vast majority of the card market in terms of total card debt outstanding, all have federal banking or thrift charters.\textsuperscript{19} The banks that conduct the overwhelming majority of consumer lending now have a federal agency as their primary regulator.

This shift has brought the tension between state and federal regulation to the fore. As Howell E. Jackson and Stacy A. Anderson have observed:

The nationalization of consumer lending markets has imposed considerable pressure on the traditional structure of consumer protection laws in the United States, most significantly in the application of these laws to national banks. In the past, there was relatively little conflict between state consumer protection laws and national bank powers. Consumer protection was generally understood to be the province of state governments, and national banks routinely complied with local consumer protection rules.\textsuperscript{20}

Beginning in the 1970s, however, as banks began to engage in large-scale interstate consumer lending, courts began to hold that state consumer-

\textsuperscript{17} Id. § 1467a (2006).
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protection laws were preempted as applied to federally chartered financial institutions.  These court holdings in turn created strong incentives for banks to opt in to federal charters instead of state charters. The easing of restrictions on interstate branch banking in 1994 further increased incentives for banks to opt in to federal charters and then argue that they were not subject to different sets of legal regimes in different states. Thus, as Jackson and Anderson note, as "federally chartered entities play an increasingly dominant role in the nation’s lending market, the capacity of states to engage in direct regulation of the financial activities of their residents has been curtailed dramatically."

B. Shortcomings of the Current Consumer-Protection Regime

The current consumer-protection regime in financial services has several serious shortcomings, which have been amply documented elsewhere. While the financial-services industry and a few libertarian academics have argued that current regime is sufficient or even too invasive, this Article takes the general failure of the financial-services regulatory regime as its starting point. Accordingly, for background purposes, this Article reviews some of the highlights of the failure of the current consumer-protection regime in financial services rather than engaging in an exhaustive documentation.

The events of the past year have laid bare the shortcomings of our current system of financial-institution regulation. These shortcomings have played out on two levels: consumer protection and systemic risk. Millions of Americans are losing their homes in foreclosure because of unaffordable mortgages. Some of these foreclosures involve speculators who knowingly gambled with the market, but many others involve consumers who were placed in affirmatively unsuitable mortgages. At the same time, systemic risk—the failure of a single institution causing a domino chain of failures—has arisen repeatedly in 2008-2009: with the collapse of AIG, the world’s largest insurer, which had significant exposure to mortgage markets; with the failure of Bear Stearns and Lehman Brothers, investment banks with large exposure to

21 Id. at 837.
23 Jackson & Anderson, supra note 20, at 833-34.
24 See, e.g., Bar-Gill & Warren, supra note 5.
27 Zywicki & Adamson, supra note 25.
mortgage markets; with the failure of Wachovia National Bank, Washington Mutual Federal Savings Bank, and IndyMac Federal Savings Bank; and with the near collapse (but for government intervention) of many other large financial institutions in the country, including Fannie Mae, Freddie Mac, Bank of America, and Citigroup. The events of 2007-2008 have also shown that these two problems are intimately connected—it was troubles in the mortgage market, stemming in part from unscrupulous lending practices, amplified by various new and untested financial products, that brought down or nearly brought down a wide range of interconnected financial institutions. Consumer protection must be seen as an essential component of systemic-risk protection. The failure to protect consumers has systemic externalities.

1. Case Study: The Office of the Comptroller of the Currency

The actions of the OCC, the primary regulator of the nation's largest banks, are illustrative of the shortcomings of the current consumer-protection system. The OCC has consistently intervened on the side of national banks to prevent any state regulation or enforcement action against national banks for consumer-protection purposes. For example, in 2005, New York Attorney General Eliot Spitzer requested nonpublic information from several national banks regarding their mortgage lending policies and practices. Spitzer's request came as part of an investigation into possible racial discrimination in residential real-estate lending based on Home Mortgage Disclosure Act data that indicated that the banks issued a significantly higher percentage of their high-interest home mortgage loans to minorities than to whites. The OCC responded by suing to enjoin the Attorney General's investigation. The OCC did not take up the investigation itself.

Statistics on OCC enforcement actions also reflect an agency that has not prioritized consumer protection. In 2005, only three of the OCC's 2650 employees had investigating and resolving consumer complaints as their primary job. This figure contrasts with the resident teams of perhaps twenty to forty bank examiners at each of the largest national banks, engaged primarily, if not exclusively, in safety-and-soundness regulation.

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31 Clearing House Ass'n, 510 F.3d 105.
Another measure of OCC involvement in consumer protection is the number and amount of fines it has levied on national banks for various violations. As Stephanie Mencimer has noted:

In 2003 alone, state bank agencies brought 4,035 consumer enforcement actions. Since 2000, the OCC has brought just 11 consumer enforcement actions. The biggest two involved cases that were initiated and investigated by state attorneys general and that the OCC initially tried to prevent from going forward.\(^{33}\) Indeed, from January 2000 to April 2009, the OCC has levied a mere seventy-three fines, only six of which were for consumer-protection violations.\(^{34}\) The others were for safety-and-soundness violations (46, almost all for failure to require flood insurance for mortgage loans against collateral in flood plains), money laundering violations (10), or unspecified in the stipulation and consent order (11). Of the consumer-protection violations, two related to payday lending, two related to discriminatory lending (including Home Mortgage Disclosure Act violations), one related to telemarketing, and one related to data security. The OCC's fines are generally miniscule, often no more than several hundred or several thousand dollars, only a small fraction compared to a bank's balance sheet. Only eight penalties have topped one million dollars, and of those only two were for consumer-protection violations; the others were for money-laundering violations. Since 1994, the OCC has brought only one formal enforcement action on consumer-protection grounds against any of the top ten national banks,\(^{35}\) which collectively hold seventy-six percent of OCC-regulated assets.\(^{36}\)

To be sure, formal enforcement actions and civil fines are not the full measure of OCC consumer-protection activities, but in light of the myriad complaints about mortgage, credit card, auto, payday, title, and refund

\(^{33}\) Id.; see also Credit Card Practices: Current Consumer and Regulatory Issues: Hearing Before the Subcomm. on Financial Institutions and Consumer Credit of the H. Comm. on Financial Servs., 110th Cong. 14 (2007) (statement of Arthur E. Wilmarth, Jr., Professor of Law, George Washington University Law School); Wilmarth, supra note 8; Robert Berner & Brian Grow, They Warned Us, BUSINESSWEEK, Oct. 20, 2008, at 36, 39, available at http://www.businessweek.com/magazine/content/08_42/b4104036827981.htm (stating that 13 of 495 OCC enforcement actions were consumer-related and only one involved subprime mortgage lending).


\(^{35}\) Id.

complaints about mortgage, credit card, auto, payday, title, and refund anticipation lenders, the OCC's bringing only eleven formal consumer-protection actions and six consumer-protection-related fines (and only one against a major institution) over the past seven-plus years creates an extremely strong inference of enforcement apathy, if not outright disinclination.

Moreover, the OCC has thrown its regulatory weight behind an attempt to protect national banks from consumer-protection regulation by other federal agencies.\textsuperscript{37} The Federal Trade Commission Act prohibits unfair and deceptive acts and practices ("UDAP") in interstate commerce\textsuperscript{38} and gives the Federal Reserve Board the power to define those acts for national banks.\textsuperscript{39} In July 2008, the Federal Reserve proposed an expansion of its UDAP regulations for national banks' credit card lending practices.\textsuperscript{40} Parallel regulations were promulgated by the OTS and the NCUA for national thrifts and credit unions.\textsuperscript{41}

The OCC's reaction to the proposed regulations, which many consumer advocates did not feel went far enough,\textsuperscript{42} was to write a letter to the Federal Reserve Board registering its opposition.\textsuperscript{43} In its letter, the OCC argued (without evidence) that the proposed regulations would harm consumers because they would reduce available credit.\textsuperscript{44} It is not clear what bearing an economic efficiency concern like the reduction in credit availability has on the

\footnotesize{\textsuperscript{37} Vincent DiLorenzo, \textit{Federalism, Consumer Protection and Regulatory Preemption: A Case for Heightened Judicial Review}, 10 U. PA. J. OF BUS. & EMP. L. 274, 281 (2008) ("[T]he OCC has not acted as a neutral forum to resolve conflicting policies. Rather it has acted as an advocate for the interests of national banks and therefore an advocate for the broadest possible preemption of state law."). DiLorenzo provides a lucid discussion of the OCC's reliance on the non-acquiescence doctrine, and the knowledge that the Supreme Court rarely grants certiorari, to ignore adverse lower court decisions. \textit{Id.} at 304.}

\footnotesize{\textsuperscript{38} 15 U.S.C. § 45(a) (2006).}

\footnotesize{\textsuperscript{39} 15 U.S.C. § 57a(f) (2006).}

\footnotesize{\textsuperscript{40} Unfair or Deceptive Acts or Practices Regulations for the Federal Reserve System Board of Governors, 73 Fed. Reg. 28,904 (proposed May 19, 2008) (to be codified at 12 C.F.R. pt. 227).}

\footnotesize{\textsuperscript{41} Unfair or Deceptive Acts or Practices Regulations for the Department of Treasury, Office of Thrift Supervision, 73 Fed. Reg. 28,904 (proposed May 19, 2008) (to be codified at 12 C.F.R. pt. 535); Unfair or Deceptive Acts or Practices Regulations for the National Credit Union Administration, 73 Fed. Reg. 28,904 (proposed May 19, 2008) (to be codified at 12 C.F.R. pt. 706).}


\footnotesize{\textsuperscript{43} Cheyenne Hopkins, \textit{OCC Presses Fed To Alter Proposal on Card Reform}, AM. BANKER, Aug. 21, 2008, at 1.}

\footnotesize{\textsuperscript{44} See \textit{id.} It is not clear what bearing a reduction in credit availability would have on consumer welfare or the public interest. It is far from clear that a glut of credit is a boon to consumers; it was a surfeit of easy credit that led to the mortgage bubble. Indeed, had the OCC done a better job restraining aggressive mortgage lending practices, national banks would be in better shape financially and would be better equipped to handle reduced profitability from their credit card operations.}
essential fairness of a business practice, which is what a UDAP regulation aims to address. Irrespectively, the OCC’s real concern is evident elsewhere in the letter—that the proposed UDAP regulations will reduce bank profitability, which would hurt bank safety and soundness, particularly in light of the weakened conditions of national banks because of the mortgage crisis. Left unstated is the OCC’s assumption that it is acceptable for a national bank to engage in unfair and deceptive acts and practices if that is the only way for the national bank to make a profit. UDAP regulations are explicitly about consumer protection, but the OCC’s letter to the Federal Reserve shows that the OCC believes that bank profitability trumps consumer protection.

The OCC’s failure to engage in meaningful consumer-protection regulation and enforcement is symptomatic of larger structural problems in banking regulation. The OCC is hardly an isolated case; its sister agency, the OTS, has an equally unimpressive track record for consumer protection. Consumer protection is ultimately a substantive field. The substantive shortcomings, exemplified by the OCC, stem, however, from organizational architecture issues.

2. Structural Flaws in the Current Consumer-Protection Regime

Structurally, the current consumer-protection regime has a number of flaws. First, the present architecture of consumer protection inevitably leads to consumer protection falling through the cracks and taking a back seat to agencies’ primary missions. The plethora of agencies, each given a small piece of the consumer-protection field to police along with its other duties, has the effect of making consumer protection an orphan in the banking regulation system. Because consumer protection is everybody’s responsibility, but each agency is responsible for a very limited piece of the system, it becomes nobody’s responsibility.

Second, there is a conflict between federal banking regulators’ missions. Federal banking regulators’ primary mission is to ensure the safety and soundness of financial institutions. Safety and soundness ultimately means profitability because only profitable financial institutions can be safe and sound. Unfortunately, unfair and abusive practices can often be quite profitable. For example, banks might not engage in the most strenuous anti-

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45 Id.


47 To be sure, consumer-protection concerns can align with safety-and-soundness concerns because predatory loans can lead to excessive defaults. But as banks have shifted from relational lending to originate-to-distribute business models, the default risk may not be borne by the national bank any more. Moreover, for some financial products, like credit cards, defaults are actually an important source of bank profit, as late fees and penalty interest can more than offset lost principal. See Ronald J. Mann, Bankruptcy Reform and the “Sweat Box” of Credit Card Debt, 2007 U. ILL. L. REV. 375.
fraud practices because it might not be as profitable as allowing a certain level of fraud. From a bank’s perspective, there may be a nonzero optimal level of fraud. After a certain point, the cost of preventing the marginal fraud outweighs its benefit. From a safety-and-soundness perspective, a bank should not overinvest in anti-fraud security. But from a consumer perspective, the optimal level of fraud is likely zero, especially if consumers bear the costs of the fraud. Safety and soundness and consumer protection would thus push for different regulatory outcomes. Placing the two missions together in a single agency ensures that one will trump the other, and historically consumer protection has not won out. Regulators have permitted profitability-protection to trump consumer protection for all but the most egregious behavior.

This conflict creates a problem, as Oren Bar-Gill and Elizabeth Warren have identified, because regulatory authority ends up misaligned with regulatory motivation. Federal banking regulators have the authority to regulate for consumer protection but are not motivated to do so, in part because of its conflict with their safety-and-soundness mission (as well as regulatory capture issues, discussed below). The FTC, on the other hand, has consumer protection as one of its major missions and does not lack motivation, but has no authority to regulate banks.

Third, the dispersion of authority that is the salient feature of the current regulatory architecture has allowed for regulatory arbitrage by financial institutions, setting off a race to the bottom among regulators competing for regulatory turf. Federal banking authorities compete with state regulators and with each other for the business of chartering banks. Banks can and do switch their charters from state to federal and vice versa, as well as change the type of federal charter they have, such as from a banking to a thrift charter.

Chartering is a crucial business for banking regulatory agencies for two reasons. First, their primary authority is largely coextensive with the extent of their chartering. A regulator that charters few institutions has little regulatory turf. And second, relatedly, federal and some state banking regulators receive

It is also important to note that even practices that create systemic risk can be profitable in the short-term and at smaller scales. In other words, banks’ incentives are temporally misaligned between the short term and the long term. Bank executive compensation exacerbates this problem because it often has a significant short-term component. Likewise, bank officers and directors are sensitive to short-term stock prices because of concerns over their tenure. Thus, there is strong pressure for banks to opt for certain short-term benefits over long-term stability.

48 Bar-Gill & Warren, supra note 5, at 85-98.
the majority of their budgets from their chartering fees, unlike other potential consumer-protection regulators.50

Charter competition among charter-issuing banking regulators creates a race to the bottom with respect to consumer protection.51 As Arthur Burns, a former Chairman of the Federal Reserve Board, has noted, the federal bank regulation system is nothing less than "competition in laxity,"52 especially in the area of consumer protection. Consumer-protection regulation and enforcement imposes regulatory costs that banks want to avoid. Because no single regulator has complete primary authority over the entire banking system, any single regulator moving by itself for more vigorous consumer-protection regulations or enforcement would put its regulatees at a disadvantage relative to the entities regulated by other banking regulators. These relative costs would cause a flight of charters from the first-mover regulator, which would affect the regulator's budget. Similarly, a regulator that adopts a more lax consumer-protection stance will find itself receiving more chartering business and a greater budget. Thus, there is a coordination problem among banking regulators that works strongly against consumer-protection regulation.

One example of how chartering competition has created a race to the bottom is the fate of state usury laws, which capped the maximum rate of interest on loans. Usury laws were historically the major form of consumer protection in banking because they shielded borrowers from assuming obligations that they could not afford. State usury laws were largely eviscerated following the Supreme Court's 1978 decision in Marquette National Bank of Minneapolis v. First of Omaha Service Corp.53 Marquette held that because the NBA preempted state law, the usury ceiling that applied to a national bank's lending operations was that of the state in which the bank is located, as provided by the NBA, not the state of the borrower. This ruling meant that

50 Bar-Gill & Warren, supra note 5, at 93 ("Assessments comprise 95% of OCC's budget, with the twenty largest national banks covering nearly three-fifths of these assessments."). In 2007, the assessments paid by a single institution, Washington Mutual, made up 12% of OTS's budget. Cheyenne Hopkins, Side Effect: Questions on Future of OTS, AM. BANKER, Jan. 14, 2008, at 1; Corrections, AM. BANKER, Jan. 15, 2008, at 20. Washington Mutual comprised 20.41% of the assets regulated by the OTS. FDIC, Statistics on Depository Institutions, http://www2.fdic.gov/sdi/main.asp (last visited April 10, 2009). Washington Mutual's failure in September 2008 has cast severe doubt on OTS's future viability. See Cheyenne Hopkins & Joe Adler, As Thrifts Stagger, OTS Faces Tough Questions, AM. BANKER, Sept. 15, 2008, at 1. The FDIC and Federal Reserve do not issue charters. State banking regulators are also largely funded by charter assessments (directly or indirectly). Consumer protection on the state level, however, is primarily the ken of attorneys'-general offices, which are not budgetarily beholden to the entities they regulate. See Wilmarth, supra note 8, at 276 (discussing the OCC's explicit recognition that preemption provided a strong incentive for large multistate banks to select national charters).

51 Non-chartering regulators, such as the FDIC, have been more aggressive on the consumer-protection front, perhaps because of the reduced conflict of interest.


national banks could base themselves in states with high or nonexistent usury ceilings, like Delaware and South Dakota, and export the rate ceilings to other states.

This situation in turn set off a two-part regulatory race toward the bottom, as banks began to switch to federal charters and look for states with high or no usury ceilings. Some states responded by eliminating or raising usury ceilings to keep national bank operations in their states. Other states adopted parity laws that would allow their state-chartered banks the same leeway as national banks. As Jackson and Anderson note, "the Marquette decision, coupled with the cooperation of several state legislatures, effectively ended interest rate regulation for certain kinds of consumer credit in the United States." Moreover, subsequent court rulings have extended Marquette to preempt state regulation of late fees, various loan closing fees, and disclosures in credit agreements.

This trend has been strengthened in recent years by OCC regulations preempting state mortgage-lending regulations and by the increasing entrance of national banks into insurance, an area traditionally regulated solely by states. Likewise, state regulations of mortgage-broker subsidiaries of national banks, check-cashing fees, giftcards, tax refund anticipation loans, and credit card convenience checks have all been preempted.


55 Jackson & Anderson, supra note 20, at 838; see also Beneficial Nat'l Bank v. Anderson, 539 U.S. 1, 10 (2003) (holding that the NBA is the exclusive cause of action for usury against national banks). Usury, of course, can be a defense as well as a counterclaim. It is not clear whether Beneficial National Bank preempts state-law usury defenses or counterclaims. See Vaden v. Discover Bank, No. 07-773, slip op. at 19 (U.S. Mar. 9, 2009).

56 Smiley v. Citibank (South Dakota), N.A., 517 U.S. 735 (1996) (deferring to the OCC's interpretation of its regulation as providing that late fees are treated like interest).


58 Am. Bankers Ass'n v. Lockyer, 239 F. Supp. 2d 1000 (E.D. Cal. 2002) (holding that a California statute requiring warning statements about implications of making only minimum payments was preempted, despite the Truth in Lending Act's provision permitting more stringent state disclosure laws, 15 U.S.C. § 1610(a) (2006)).

59 E.g., Nat'l City Bank of Ind. v. Turnbaugh, 463 F.3d 325 (4th Cir. 2006) (holding that Maryland's attempt to exercise visitorial powers and limit prepayment penalties on adjustable-rate mortgage loans originated by a national bank operating subsidiary was preempted).

60 Wells Fargo Bank of Tex., N.A. v. James, 321 F.3d 488 (5th Cir. 2003) (holding that a Texas law prohibiting banks from charging check-cashing fees was preempted by an OCC regulation permitting national banks to charge "non-interest charges and fees").

61 SPGGC, LLC v. Ayotte, 488 F.3d 525 (1st Cir. 2007) (holding preempted a New Hampshire law prohibiting expiration dates on giftcards).
Fourth, there are general problems of regulatory capture. Consumer protection is essentially a public good. Financial institutions aim to capture control of consumer-protection policymaking to steer it to their economic interest, which is generally deregulation. Interest groups like financial institutions have a concentrated financial stake in consumer-protection policymaking. This stake incentivizes them to find the means to capture policymakers, including by creating indirect incentive structures, such as revolving-door employment, for policymakers. Revolving-door employment between government and industry is not particularly unique to the banking industry, although salary differentials between government and private employers may be more pronounced for banking regulators. The danger with revolving-door employment is that government regulators might work with an eye toward pleasing their future private employers.

Other problems are unique to bank regulation, however. Federal bank regulators have permanent resident teams of bank examiners at the largest banks, which are also the largest consumer lenders. The regulators’ presence bears an uncanny resemblance to those of outside accountants at Enron and WorldCom, who abdicated their regulatory role to become enablers. Because the safety-and-soundness mission often translates into a mission of protecting profitability, federal banking regulators inevitably find themselves regulating in the interests of the regulated industry as a whole, rather than protecting consumers.

In addition to traditional modes, regulatory capture has manifested itself in a novel way in financial-services regulation: regulators who cater to financial institutions’ concerns by promising lax regulation can benefit personally through career promotions. For example, in the late 1980s, Darryl W. Dochow served as the head of supervision and regulation at the Federal

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64 A public good is a good that is non-rivaled and non-excludable. Non-rivaled goods are those whose consumption by one individual does not affect their availability for other individuals. Non-excludable goods are those that individuals cannot be excluded from consuming. Consumer protection appears to be non-rivaled—the consumption of consumer protection does not reduce its availability for others, although that is only in a world of unlimited enforcement resources. As a generic matter, consumer protection is also non-excludable—it is available for all consumers—although specific protections can be limited to certain classes of consumers.

65 The philosophy behind regulatory agencies catering to regulatees can be seen in a formalized fashion in the Clinton-Gore “Reinventing Government Initiative,” which casts government as being in the “customer service” business with regulatees as the “customers.” National Partnership for Reinventing Government, Who We Are, http://govinfo.library.unt.edu/npr/whoweare/history2.html (last visited Apr. 10, 2009).
Home Loan Bank Board (FHLBB) responsible for Charles Keating’s Lincoln Savings & Loan of Irvine. When Lincoln Savings & Loan failed in 1989, it was the largest and costliest thrift failure to date. In the ensuing inquiry, federal investigators concluded that Dochow “played a key role” in the thrift’s collapse “by delaying and impeding proper oversight of that thrift’s operations.” Yet, by 2005, Dochow was back in a major regulatory role for the thrift industry, serving as the OTS’s Deputy Regional Director for the Western Region.

In 2006, Dochow and OTS colleagues met with Countrywide Financial, the nation’s largest mortgage lender, which at that point had a national banking charter from the OCC. Countrywide was interested in switching its charter to the OTS. Dochow pitched the OTS as “a more natural, less antagonistic regulator than OCC.” In particular, Dochow suggested that the OTS would permit Countrywide’s loan officers to choose their own property appraisers—including a property appraisal affiliate of Countrywide—unlike other banking regulators. Countrywide shifted to a thrift charter in 2007. Countrywide’s assessments accounted for five percent of the OTS’s budget.

Six months after Countrywide changed its charter, Dochow was promoted to the OTS’s Regional Director for the Western region. Bringing the Countrywide business to the OTS was a major coup for Dochow, and the promotion appears to have been a reward. The Dochow example indicates that at least some banking regulatory agencies view themselves as a business in which supervised institutions are customers, and salespersons who bring in business are personally rewarded.

There may also be legislative, as well as regulatory, capture. The financial-services industry has been the single largest contributor to

68 Id.
69 Id. OTS officials dispute that Countrywide changed its charter because of the promise of weaker regulation. Id.
70 Id.
71 Id. Notably, the largest thrift failures of the current financial crisis have been entities based in the western United States: Washington Mutual, IndyMac Bank, and Downey Savings & Loan Association. See FDIC: Failed Bank List, http://www.fdic.gov/bank/individual/failed/banklist.html (last visited Apr. 10, 2009). Countrywide Financial, which narrowly averted failure by means of a forced sale to Bank of America, see William Heisel & Tiffany Hsu, Future Cloudy for Downey Savings, L.A. TIMES, October 23, 2008, at C1, was also a thrift based in the western United States. So was Golden West Financial, which was sold to Wachovia before the current financial crisis, and whose problematic Golden West Adjustable Rate Mortgage portfolio was a major factor in the failure of Wachovia. See Paul Tharp, Wild, Wild Waste—Wachovia’s MesS, N.Y. POST, Apr. 15, 2008, at 38.
72 Dochow was fired in December 2008, after it emerged that he permitted IndyMac Federal Savings Bank to backdate capital infusions, which allowed IndyMac to maintain its well-capitalized status and to continue to solicit brokered deposits (creating greater risk for the FDIC deposit insurance fund). See Pallavi Gogoi, Regulator Ousted over Backdating at Indymac, USA TODAY, Dec. 23, 2008, at 1B.
congressional campaigns since 1990. Legislative capture of even a portion of Congress can significantly forestall attempts to regulate via legislation.

Finally, issues of capture aside, the congressional backstop to the regulatory system is not nimble or expert enough to keep up with the details of consumer-protection regulation on a quotidian basis. At best, Congress can be reactive to major developments, but the delay between the origins of a problematic business practice and a legislative response can be considerable.

In short, consumer protection in banking services is structurally subordinated to the safety-and-soundness mission in several ways. The divided and captured regulatory structure for financial services has left consumers with limited protection against abusive financial-services practices, stemming from disparate bargaining power and sophistication of financial institutions and consumers. Consumer protection in financial services has suffered both in terms of statutory and regulatory provisions and in terms of public enforcement actions. These practices range from usurious interest rates to improperly disclosed fee provisions to universal cross-default provisions in credit cardholder agreements to penalty fees unrelated to costs, to the underwriting of mortgage products that are affirmatively unsuitable for the borrower and which will likely end in a default and foreclosure. Unless consumer protection is separated from safety-and-soundness, it will inevitably lose out.

3. Regulatory Architecture Solutions

There are two possible (and non-exclusive) regulatory architecture solutions to the current consumer-protection problem. One solution is to concentrate the consumer-protection mission at the federal level in the hands of a single federal agency, either the FTC, as Heidi Mandanis Schooner has proposed, or a new federal consumer financial product safety commission, as Oren Bar-Gill and Elizabeth Warren have proposed. The virtue of these proposals is to terminate intra-agency conflict between profit-protection and

73 Sunlight Foundation, Industry Sector Campaign Contributions, 1990-2008, http://media.sunlightfoundation.com/viz/sector_contributions.html; see also Glenn Greenwald, Top Senate Democrat: Bankers “Own” the U.S. Congress, SALON.COM, April 30, 2009, http://www.salon.com/opinion/greenwald/2009/04/30/ownership/ (quoting Senator Dick Durbin as stating, “And the banks—hard to believe in a time when we’re facing a banking crisis that many of the banks created—are still the most powerful lobby on Capitol Hill. And they frankly own the place.”).

74 Credit Cardholders’ Hearing, supra note 4, at 117-39 (statement of Adam J. Levitin, Associate Professor of Law, Georgetown University Law Center); cf. U.C.C. § 2-718(1) (2005) (requiring liquidated damages to be reasonable in light of actual or anticipated harms caused by breach); RESTATEMENT (SECOND) OF CONTRACTS § 356 (1979) (requiring liquidated damages to be reasonable in light of actual or anticipated loss caused by breach).

75 Schooner, supra note 5, at 82.

consumer protection. They would also have the benefits of concentrating consumer-protection resources in one agency so that the agency might develop expertise and attract a professional staff deeply interested in consumer protection.

The effectiveness of any proposal ultimately rests in the details, and neither the Schooner nor the Bar-Gill and Warren proposal offers a detailed policy prescription. Instead, they both offer important insights into the regulatory architecture of consumer protection. Even as a general approach, however, there are dangers inherent in these proposals, namely, that the single agency could easily be captured itself, perhaps more easily than multiple agencies, and that the effectiveness of the agency would depend heavily on the sympathies of a particular presidential administration. Consider, for example, the Consumer Product Safety Commission. At times it has been an extremely effective advocate for consumer protection, but budget and staff cutbacks in the Bush administration, coupled with leadership of a decisively anti-regulatory mindset, have rendered it incapable of proactively meeting public safety dangers, like lead in children’s toys.77

Moreover, by moving consumer protection to a separate agency, the Schooner proposal and the Bar-Gill and Warren proposal would merely shift the conflict between profit protection and consumer protection from the intra-agency to the inter-agency level. Disputes would be resolved at the White House policy staff level. This structure would increase political accountability, but do little to resolve the conflicts. Indeed, because consumer protection would no longer be presumptively subordinated to safety and soundness, such a move might create more open conflict.78

Finally, as a practical matter, creation of a separate federal financial-services consumer-protection agency might be impossible. Agencies’ and their legislative patrons’ reluctance to cede any jurisdiction would impede legislative action. Moreover, the financial-services industry could be expected to oppose regulatory consolidation. With focused opposition and only diffuse “good-government” support, any move to consolidate consumer protection might be doomed before it could be launched.

77 See, e.g., Stephen Labaton, Bigger Budget? No, Responds Safety Agency, N.Y. TIMES, Oct. 30, 2007, at C1 (detailing Consumer Product Safety Commission’s Acting Chairman’s opposition to legislation that would double agency budget, increase maximum fines agency could levy, expand agency authority to protect whistleblowers, increase agency ability to prosecute executives of companies that willfully violate laws, and ease agency ability to publicize faulty products).

78 Technically, if there were an independent consumer protection agency, conflicting policies would have to be reconciled by the courts. In practice, however, independent agencies are often susceptible to pressure from the administration. Thus, in 1998, the Commodity Futures Trading Commission, an independent agency, was pressured by the Treasury Department, Federal Reserve, and Securities and Exchange Commission (SEC) into backing off a plan to regulate over-the-counter derivatives. Jacob M. Schlesinger, Inside 5 Momentous Decisions, WALL ST. J., Oct. 17, 2002, at A1. Already a similar conflict exists between the SEC (an independent agency) and federal bank regulators.
Either the Schooner proposal or the Bar-Gill and Warren proposal would be a substantial improvement over the current regulatory landscape, but they would not resolve every issue. Most importantly, though, they would require affirmative political action to implement, and imperfect implementation could undermine the strength of the proposals' regulatory architecture.

Another option would be to separate the safety-and-soundness and consumer protections by dividing them between federal and state authorities. This was the traditional regulatory divide, but, as Part II discusses, the growth of federal preemption has severely curtailed states' consumer-protection activities in financial services. As we will see in Part III, however, changes in the market have made a reinvigoration of state consumer-protection regulation in financial services possible.

II. Federal Preemption Doctrine in Banking Law

Federal preemption is a major obstacle for states seeking to regulate federally chartered financial institutions. State laws regulating financial institutions have nearly all been invalidated as applied to national banks and thrifts on preemption grounds, and preemption risk has chilled other potential state attempts to regulate financial institutions.

As a general matter, federal preemption of state law can occur in three ways: when a federal statute explicitly preempts state law (explicit preemption), when there would be a conflict between state and federal law (conflict preemption), and when a federal statute so completely occupies the field that it leaves no room for state regulation (field preemption). For national banks, federal courts have not yet declared that any federal statute so

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80 Hilary Johnson, N.Y. Official Gives Views on Subprime, Preemption, AM. BANKER, May 14, 2007, at 2 (quoting New York State Superintendent of Banks Richard Neiman, "In addition to making the national charter more attractive, the [Watters v. Wachovia] decision is likely to chill state regulation and/or encourage the migration of state institutions to states with less regulation.... No state wants to put their own state institutions at a competitive disadvantage. Certainly with New York's vibrant financial markets, this is a critical issue for us.... [The ruling] will further impede local efforts to respond quickly and with innovative measures.").

81 E.g., Watters v. Wachovia Bank, N.A., 127 S. Ct. 1559, 1585-86 (Stevens, J., dissenting).
completely occupies the field of banking regulation that it leaves no room for state regulation. For national thrifts, however, some lower courts have found field preemption, even though the Supreme Court has pointedly declined to make such a finding instead finding instances of conflict preemption. Thus, in the banking system, state laws are preempted either expressly by specific federal statutes and regulations or implicitly by inherent conflicts between state and federal law, although there might be field preemption for national thrifts. Accordingly, the statutory structure of federal banking law provides the sources of preemption.

The enabling statutes and regulations for federally chartered financial institutions depend on the institutions' specific type of charter. National banks' powers are governed by the NBA; national thrifts' powers are governed by the Home Owners Loan Act (HOLA), and federal credit unions are governed by the Federal Credit Union Act (FCUA). While there are differences in the preemption for national banks, thrifts, and federal credit unions, the differences do not affect this Article's proposal for reinvigorating state consumer-protection powers through hydraulic regulation. Because much of the case law on preemption has dealt with either national banks or thrifts, this Article focuses on these institutions and their enabling acts.


83 Fidelity Fed. Sav. & Loan Ass'n v. de la Cuesta, 458 U.S. 141, 159 n.14 (1982) ("Because we find an actual conflict between federal and state law, we need not decide whether the HOLA or the [FHLBB's] regulations occupy the field of due-on-sale law or the entire field of federal savings and loan regulation."); id. at 171-72 (O'Connor, J., concurring) ("I join in the Court's opinion but write separately to emphasize that the authority of the Federal Home Loan Bank Board to pre-empt state laws is not limitless.").


85 De la Cuesta, 458 U.S. at 153 ("Federal regulations have no less pre-emptive effect than federal statutes.").

86 Watters, 127 S. Ct. at 1572 (majority opinion).


A. National Banks

The NBA vests federally chartered banks with certain enumerated powers, as well as:

all such incidental powers as shall be necessary to carry on the business of banking; by discounting and negotiating promissory notes, drafts, bills of exchange, and other evidences of debt; by receiving deposits; by buying and selling exchange, coin, and bullion; by loaning money on personal security; and by obtaining, issuing, and circulating notes. . .

The Supreme Court has noted that the NBA's "grants of both enumerated and incidental 'powers' to national banks [are] . . . grants of authority not normally limited by, but rather ordinarily pre-empting, contrary state law." The policy concern animating preemption is the fear of "[d]iverse and duplicative superintendence of national banks' engagement in the business of banking." The aim is to "prevent inconsistent or intrusive state regulation from impairing the national system." Indeed, the NBA provides that "[n]o national bank shall be subject to any visitorial powers except as authorized by Federal law . . . ."

The NBA also authorizes the Comptroller of the Currency, the Treasury Department official who heads the OCC and is in charge of chartering and regulating national banks, to promulgate rules and regulations to carry out the provisions of the NBA. The OCC receives Chevron deference in its interpretations of statutes embodied in its properly promulgated regulations, and Auer/Seminole Rock deference in its informal interpretation of its own regulations. Among the regulations promulgated by the OCC are a set

98 See Clearing House Ass'n v. Cuomo, 510 F.3d 105, 112-14 (2d Cir. 2007), cert. granted, 129 S. Ct. 987 (U.S. Jan. 16, 2009) (No. 08-453); Nat'l City Bank of Ind. v. Turnbaugh, 463 F.3d 325, 328-32 (4th Cir. 2006); Burke, 414 F.3d at 315; see also NationsBank of N.C., N.A. v. Variable Annuity Life Ins. Co., 513 U.S. 251, 257-58 (1995) (applying the Chevron doctrine to determine whether the OCC was authorized to grant a national bank's application to sell annuities); Wells Fargo Bank of Tex., N.A. v. James, 321 F.3d 488, 492-95 (5th Cir. 2003) (applying Chevron and deferring to agency rule preempting state law concerning check-cashing fees).
99 See Auer v. Robbins, 519 U.S. 452, 461-62 (1997) (holding that the format of an agency's interpretation of its own regulation does not affect the level of deference on review); Bowles v. Seminole Rock & Sand Co., 325 U.S. 410, 414 (1945) (holding that a reviewing court should grant "controlling weight" to an agency's interpretation of its own regulation "unless it is plainly erroneous or inconsistent with the regulation.").
specifically on preemption. These regulations define visitorial powers over national banks, which are prohibited to states by the NBA, as:

(i) Examination of a bank; (ii) Inspection of a bank’s books and records; (iii) Regulation and supervision of activities authorized or permitted pursuant to federal banking law; and (iv) Enforcing compliance with any applicable federal or state laws concerning those activities.

Courts have held that registration requirements, investigation, and enforcement actions and other forms of administrative supervision by states are all preempted by the OCC’s exclusive visitorial authority. Thus, even when a state law is not substantively preempted by a federal law, the enforcement of the state law may still be preempted by OCC regulations.

OCC regulations also preempt state laws on interest and usury, non-interest fees and charges, ATMs, deposit taking, non-real-estate lending, and real-estate lending. Finally, there is a catch-all non-specific preemption of state law. The ultimate importance of all of these regulations is uncertain, however. Regulations that have been duly promulgated after notice-and-comment rulemaking have the “force of law” and bind the agency, the public, and the courts. All federal banking regulators, including the OCC, are required to publish in the Federal Register both advanced notice and "any final opinion letter or interpretive rule concluding that Federal law preempts the application of any State law regarding community reinvestment, consumer protection, fair lending, or establishment of intrastate branches to a national bank." Yet, the Supreme Court has never held that regulations promulgated by the OCC or any other administrative agency have preemptive force (excluding specific cases where the agency has been explicitly delegated preemption powers by statute). The status of the OCC preemption regulations is therefore uncertain.

100 12 C.F.R. § 7.4000-09 (2008) (these sections compose Subpart D).
101 Id. § 7.4000(a)(2) (2008).
102 See, e.g., Watters, 127 S. Ct. at 1564, 1568-69 (registration and other administrative supervision); Clearing House Ass'n, 510 F.3d at 116 (investigation and enforcement).
103 See Clearing House Ass'n, 510 F.3d at 116-17.
105 Id. § 7.4002.
106 Id. § 7.4003.
107 Id. § 7.4007.
108 Id. § 7.4008.
109 Id. § 34.4(a).
110 Id. § 7.4009. The OTS has similar preemption rules. See id. §§ 560.2, 557.11, 545.2 (2008).
111 Robert A. Anthony, Which Agency Interpretations Should Bind Citizens and the Courts?, 7 YALE J. ON REG. 1, 3-4 n.6 (1990).
112 12 U.S.C. § 43(a)-(b), § 1813q (2006) (defining "appropriate federal banking agency").
B. National Thrifts

National thrifts are supervised by the OTS and are governed primarily by the Home Owners Loan Act. HOLA grants national thrifts a wide range of lending powers, permitting thrifts to engage in virtually all the activities of national banks. The major difference between a national bank charter and a national thrift charter is that national thrifts are prohibited from making commercial, corporate, business, and agricultural loans that, in the aggregate, exceed twenty percent of the thrift’s total assets. As a result, national thrifts concentrate primarily on consumer lending.

HOLA explicitly preempts only state usury laws as applied to national thrifts, otherwise, it contains no explicit preemption of state law. Despite the negative implication of HOLA’s explicit preemption of only one specific type of state law, the OTS has been quite aggressive in claiming preemptive authority; the OTS’s preemption claim is much broader than that of the OCC. The OTS not only claims that its own (proper) exercise of regulatory authority preempts contrary state law, but it has also enacted a regulation that claims the OTS occupies the field for all regulation of national thrifts. While there is reason to question the validity of this regulation, not the least being the negative implication of HOLA’s explicit preemption of a specific type of state law, the OTS’s ability to enact field preemption via regulatory proclamation has never been directly challenged and has been accepted by lower federal courts.

114 Id. § 1464(c)(2)(A).
115 Id. § 1463(g).
117 Id. § 560.2(a) (2008) (“To enhance safety and soundness and to enable federal savings associations to conduct their operations in accordance with best practices (by efficiently delivering low-cost credit to the public free from undue regulatory duplication and burden), OTS hereby occupies the entire field of lending regulation for federal savings associations. OTS intends to give federal savings associations maximum flexibility to exercise their lending powers in accordance with a uniform federal scheme of regulation. Accordingly, federal savings associations may extend credit as authorized under federal law, including this part, without regard to state laws purporting to regulate or otherwise affect their credit activities . . . .”). OTS also claims to occupy the field for deposit-taking activities of federal savings associations. Id. § 557.11 (2008) (“To further these [safety-and-soundness] purposes without undue regulatory duplication and burden, OTS hereby occupies the entire field of federal savings associations’ deposit-related regulations.”).

For the purposes of hydraulic regulation, however, the specific nature of the OTS preemption is immaterial.

118 See supra note 82. The Ninth Circuit recently gave credence to the OTS’s claim of field preemption, noting that:

Through HOLA, Congress gave the Office of Thrift Supervision (“OTS”) broad authority to issue regulations governing thrifts. As the principal regulator for federal savings associations, OTS promulgated a preemption regulation in 12 C.F.R. § 560.2. That the preemption is expressed in OTS’s regulation, instead of HOLA, makes no difference because, “[f]ederal regulations have no less preemptive effect than federal statutes.” Silvas v. E*Trade Mortgage Corp., 514 F.3d 1001, 1004 (9th Cir. 2008) (alteration in original) (quoting Fid. Fed. Sav. & Loan Ass’n v. de la Cuesta, 458 U.S. 141 (1982)) (citation omitted); see also Bank of Am. v. City & County of S.F., 309 F.3d 551, 560-66 (9th Cir. 2002).

Notably, the authority cited by the Ninth Circuit, Fidelity Federal Savings & Loan Association v. de la Cuesta, upheld the preemptive authority of the OTS’s predecessor agency, the Federal Home Loan Bank Board (FHLBB). 458 U.S. 141 (1982). But de la Cuesta dealt with a question of conflict preemption, not field preemption. In de la Cuesta, the issue was whether a specific substantive FHLBB regulation was authorized under Congress’s delegation of authority to the FHLBB, not whether the FHLBB occupied the field because of the pervasive nature of the Home Owners Loan Act. See id. at 153-54.

The statements made in the conflict preemption context in de la Cuesta should not be read as applying to field preemption. State, not federal, regulation is the default setting in most areas of law. See O’Melveny & Myers v. FDIC, 512 U.S. 79 (1994) (refusing to apply federal common law to fill “gaps” in a detailed federal statutory scheme). While Congress can act to shift that balance, a regulatory agency cannot do so on its own. A federal regulatory agency’s proclamation of field preemption should not create field preemption.

If Congress has duly authorized an agency to pass specific substantive regulations in a field, those regulations, if within the scope of Congress’s authorization, will have a preemptive effect to the extent of a conflict with state law. But the mere fact that Congress has authorized an agency to regulate a field ought not to confer on the agency the right to arrogate to itself all regulating power in the field. Field preemption must be the result of congressional action, or else agencies are given a blank check to prohibit state regulation without filling in the regulatory void with their own regulations. See Cal. Fed. Sav. & Loan Ass’n v. Guerra, 479 U.S. 272, 281 (1987) (noting that field preemption “may be inferred where the scheme of federal regulation is sufficiently comprehensive to make reasonable the inference that Congress left no room for supplementary state regulation.”) (emphasis added) (internal quotation marks omitted); see also R. J. Reynolds Tobacco Co. v. Durham County, 479 U.S. 130, 149 (1986) (“Although the regulations are not themselves controlling on the pre-emption issue, where, as in this case, Congress has entrusted an agency with the task of promulgating regulations to carry out the purposes of a statute, as part of the pre-emption analysis we must consider whether the regulations evidence a desire to occupy a field completely. Pre-emption should not be inferred, however, simply because the agency’s regulations are comprehensive.”) (internal citations omitted); cf. de la Cuesta, 458 U.S. at 154 (addressing conflict preemption: “A pre-emptive regulation’s force does not depend on express congressional authorization to displace state law.... Thus, the Court of Appeal’s narrow focus on Congress’ intent to supersede state law was misdirected. Rather, the questions upon which resolution of this case rests are whether the Board meant to pre-empt California’s due-on-sale law, and, if so, whether that action is within the scope of the Board’s delegated authority.”).

The OTS’s claims to preemption by preamble are of dubious authority. In Wyeth v. Levine, the Supreme Court noted that although it had “recognized that an agency regulation with the force of law can pre-empt conflicting state requirements,” the Court always performs “its own conflict determination, relying on the substance of state and federal law and not on agency proclamations of pre-emption.” No 06-1249, slip op. at 19 (U.S. Mar. 4, 2009). The Court also noted that although agencies have no special authority to pronounce on pre-emption absent delegation by Congress, they do have a unique understanding of the statutes they administer and an attendant ability to make informed determinations about how state requirements may pose an ‘obstacle to the accomplishment and execution of the full purposes and objectives of Congress.’ The weight we accord the agency’s explanation of state law’s impact on the federal scheme depends on its thoroughness, consistency, and persuasiveness.
Unfortunately, the OTS’s ostensible field preemption only furthers the deregulatory race to the bottom. Whenever the OTS permits an additional thrift activity or preempts another state law, the OCC is able to piggyback on the OTS’s action and argue that the deregulatory move must be allowed for national banks to place them, as historically favored lenders, on an equal playing field with their parvenu cousins, the national thrifts. For example, when the OCC adopted its preemption rules in January 2004, it specifically referred to similar rules previously adopted by the OTS. This downward ratchet can also work when the OCC makes the first deregulatory move and the OTS matches. As soon as the OTS matches the OCC, the OCC gains additional cover for its initial move. OTS field preemption claims have furthered the race to the bottom in financial-services consumer protection.

C. Residual State Authority

OCC and OTS regulations carve out an exception for state laws of general applicability, to the extent that they only incidentally affect the exercise of national bank powers. The OCC and OTS exceptions are virtually identical. OCC regulations provide:

State laws on the following subjects are not inconsistent with the deposit-taking powers of national banks and apply to national banks to the extent that they only incidentally affect the exercise of national banks’ deposit-taking powers: (1) Contracts; (2) Torts; (3) Criminal law; (4) Rights to collect debts; (5) Acquisition and transfer of property; (6) Taxation; (7) Zoning; and (8) Any other law the effect of which the OCC determines to be incidental to the deposit-taking operations of national bank powers or otherwise consistent with the powers set out in this section. Thus, while states cannot regulate national banks directly, the Supreme Court has held that national banks “are subject to state laws of general application in

Id. at 67. The mere fact that OTS claims preemption and has enacted a regulation to that effect does not mean that OTS actually has preemption authority. The same is true for the OCC’s more limited preemption regulations. See also Catherine M. Sharkey, Preemption by Preamble: Federal Agencies and the Federalization of Tort Law, 56 DEPAUL L. REV. 227 (2007). Many scholars have argued that agency power to displace state lawmaking is and should be more limited than Congress’s own power. See, e.g., Thomas W. Merrill, Rethinking Article I, Section 1: From Nondelegation to Exclusive Delegation, 104 COLUM. L. REV. 2097 (2004); Cass R. Sunstein, Nondelegation Canons, 67 U. CHI. L. REV. 315, 317-18 (2000); Cass R. Sunstein, Law and Administration After Chevron, 90 COLUM. L. REV. 2071, 2110 (1990). But see Brian Galle & Mark Seidenfeld, Administrative Law’s Federalism: Preemption, Delegation, and Agencies at the Edge of Federal Power, 57 DUKE L.J. 2023 (2008).

119 Wilmarth, supra note 8, at 284-85 (discussing 12 C.F.R. §§ 560.2, 557.11 (2008)).

120 12 C.F.R. §§ 7.4007(c); 7.4008(e); 7.4009(c)(2) (2008) (OCC); id. § 560.2(c) (2008) (OTS).

121 Id. § 7.4007(c) (2008) (deposit taking); see also id. § 7.4008(e) (lending); id. § 7.4009(c)(2) (applicability of state law to particular national bank activities); id. § 34.4(b) (real-estate activities).
their daily business to the extent such laws do not conflict with the letter or the
general purposes of the” federal banking law.\footnote{122}

Accordingly, national banks’ contracts are governed by state contract law
and their property transfers by state law. National banks pay sales tax on
purchases. Thus, in \textit{Jefferson v. Chase Home Finance},\footnote{123} the District Court for
the Northern District of California recently held that a California law
prohibiting all businesses from making misleading representations was not
preempted as applied to a national bank because it was a law of general
applicability.

In \textit{Jefferson}, the plaintiff alleged that Chase, a national bank, violated
California’s False Advertising Act (and therefore California’s Unfair
Competition Law) by making false statements about the way it would apply
prepayments on a mortgage loan.\footnote{124} Chase raised a preemption defense,
contending that OCC regulations under the NBA permitted national banks
to make real estate loans without regard to state-law limitations on the terms
of credit, schedule for repayment, and servicing and processing of loans.\footnote{125} The
court held that OCC regulations did not preempt California consumer-
protection laws because “such laws of general application, which merely
require all businesses (including banks) to refrain from misrepresentations and
abide by contracts and representations to customers do not impair a bank’s
ability to exercise its lending powers.”\footnote{126} The California Unfair Competition
Law and its trigger, the California False Advertising Act, were laws of general
applicability, not designed to regulate lending, and without a disproportionate
effect on lending.\footnote{127} In contrast, cases in which courts have found preemption
involved either state laws specifically directed at regulating banking activities
such as lending\footnote{128} or specific conflicts with federal law.\footnote{129} Moreover, the

\begin{footnotes}
\item 123 Jefferson v. Chase Home Fin., No. C 06-6510 TEH, 2007 U.S. Dist. LEXIS 94652 (N.D.
\item 124 \textit{Id.} at *9.
\item 125 \textit{Id.} at *20-21.
\item 126 \textit{Id.} at *29.
\item 127 \textit{Id.} at *36-37.
\item 128 Wachovia Bank, N.A. v. Burke, 414 F.3d 305 (2d Cir. 2005) (holding that a state law
requiring mortgage-lender licensing and record keeping was preempted); Bank of Am. v. City & County
of S.F., 309 F.3d 551 (9th Cir. 2002) (holding that a local ATM fee limitation law was preempted);
Competition Law claim alleging that bank fees were too high was preempted by a federal regulation
giving banks discretion to set non-interest fees); Johnson v. Chase Manhattan Bank USA, N.A., No. 07-
Pennsylvania consumer protection statute prohibiting various non-interest charges and combination of
home improvement and cash loans); Rose v. Chase Manhattan Bank USA, 396 F. Supp. 2d 1116, 1122
(C.D. Cal. 2005), aff’d, 513 F.3d 1032 (9th Cir. 2008) (holding that California Unfair Competition Law
claims predicated on violation of state law requiring disclosures for credit card convenience checks were
776 (Ct. App. 2002) (holding that an Unfair Competition Law claim based on violation of state law

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plaintiff's claims in Jefferson were not general allegations that a lender's practices were unfair and that the harm from the practices outweighed their utility. Such allegations would necessitate "an individual analysis of the lender's acts, untethered to any rule of general application (such as a prohibition on misrepresentation to consumers)."

Instead, the plaintiff alleged that Chase had violated a specific, generally applicable state law. Because California's Unfair Competition Law was a law of general applicability and only "incidentally affect[ed]" the exercise of national bank powers, the claims were not preempted.

The relationship between residual state-law authority and federal banking regulation was also explored by the Seventh Circuit in In re Ocwen Loan Servicing, LLC Mortgage Servicing Litigation. Ocwen hinged on the question of whether OTS regulations preempted various claims in the complaint. The trial court had denied the motion to dismiss based on the preemption defense, and Judge Posner, writing for the Seventh Circuit, affirmed. Noting that the validity of OTS regulation had not been questioned, Judge Posner observed that although the OTS has:

- exclusive authority to regulate the savings and loan industry in the sense of fixing fees (including penalties), setting licensing requirements, prescribing certain terms in mortgages, establishing requirements of disclosure of credit information to consumers, and setting standards for processing and servicing mortgages... [it] has no power to adjudicate disputes between the S&Ls and their customers.... So it cannot provide a remedy to persons injured by wrongful acts of savings and loan associations, and furthermore HOLA creates no private right to sue to enforce the provisions of the statute or the OTS's regulations.

Given the OTS's limited remedial authority, the Seventh Circuit read OTS's preemption regulations "to mean that OTS's assertion of plenary regulatory authority does not deprive persons harmed by the wrongful acts of savings and loan associations of their basic state common-law-type

prohibiting interest on mortgages during certain periods was preempted); Mayor of N.Y. v. Council of N.Y., 780 N.Y.S.2d 266, 272 (Sup. Ct. 2004) (holding a local predatory lending ordinance preempted).

129 Cj. Silvas v. E*Trade Mortgage Corp., 514 F.3d 1001, 1007-08 (9th Cir. 2008) (holding that the California Unfair Competition Law was preempted by the Home Owners Loan Act because the alleged trigger violation was of the federal Truth in Lending Act, a specific lending regulation); Martinez v. Wells Fargo Bank, N.A., No. C-06-03327 RMW, 2007 U.S. Dist. LEXIS 27388 (N.D. Cal. Mar. 30, 2007) (holding that California Unfair Competition Law claims alleging that it is an unfair practice to charge above cost for underwriting were preempted by an OCC regulation that permitted banks to set non-interest charges and fees).

131 Id. at *29.
132 491 F.3d 638, 642 (7th Cir. 2007).
134 Ocwen, 491 F.3d at 642.
135 Id. at 643.
remedies." Because of the vague drafting of the complaint, however, the Seventh Circuit was unable to determine whether many specific claims were in fact preempted under its heuristic.

As a result, it is not clear how the Seventh Circuit's distinction between regulatory and common-law claims applies to state statutory claims, including codified common-law claims. For example, if a state statute defined certain contract terms as unconscionable, a claim under the statute would appear to be akin to a common-law-type claim, but it would have a regulatory effect of prohibiting certain types of terms. This problem is directly raised by unfair and deceptive acts and practices (UDAP) laws, a staple of state-law consumer-protection statutes. The Seventh Circuit's heuristic simply does not fit the ambiguous nature of much of statutory law; Ocwen does not provide guidance on whether states can regulate by creating rights of action.

The thin case law on residual state regulatory authority over national banks and thrifts does not provide much guidance about which generally applicable state laws are preempted. Nonetheless, there appears to be little residual state authority to regulate national banks directly. Residual state direct regulatory authority over national banks seems limited to enforcing laws of general applicability, and even then only when their enforcement would not prevent a national bank from exercising its powers. Laws specifically enacted to protect consumers in dealings with financial institutions, where informational and bargaining power asymmetries are immense, are preempted as applied to national banks and thrifts.

D. Preemption's Reach Beyond National Banks and Federal Thrifts

The preemptive reach of the NBA, HOLA, OCC, and OTS regulations extends beyond the "federal instrumentalities" of national banks and thrifts. It

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136 "Id.

137 Id. at 648.

138 Federal credit unions appear to fit the same pattern, but there is much more limited case law on preemption involving federal credit unions. The regulations of the NCUA under the Federal Credit Union Act, 12 U.S.C. §§ 1751-1795 (2006), provide that the NCUA has "exclusive authority . . . to regulate the rates, terms of repayment and other conditions of Federal credit union loans and lines of credit (including credit cards) to members." 12 C.F.R. § 701.21(b) (2008). This authority "preempts any state law purporting to limit or affect" rates of interest and terms of repayment, including the amount, uniformity, and frequency of payments. Id. The regulation does not "preempt state laws affecting aspects of credit transactions that are primarily regulated by Federal law other than the Federal Credit Union Act, for example, state laws concerning credit cost disclosure requirements." Id. § 701.21(b)(3) (2008); see Am. Bankers Ass'n v. Lockyer, 239 F. Supp. 2d 1000, 1018-19 (E.D. Cal. 2002) (holding that FCUA and NCUA regulations preempted a state credit disclosure requirement that effectively created a minimum monthly repayment percentage); Neal v. Redstone Fed. Credit Union, 447 So. 2d 805, 807-08 (Ala. Civ. App. 1984) (holding that FCUA usury provisions preempted a state usury law). Moreover, there is no field preemption for federally insured state credit unions. See Golden I Credit Union v. H & B Group, Inc., No. 1:06-cv-1717 OWW TAG, 2007 U.S. Dist. LEXIS 31142, at *22-23 (E.D. Cal. Apr. 27, 2007).
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also extends to operating subsidiaries, their agents, and even, in some cases, independent third parties who are indispensable for the exercise of national banks' and thrifts' powers.

1. Operating Subsidiaries

The Supreme Court has held that preemption shields operating subsidiaries of national banks from state regulation. Operating subsidiaries are a particular type of national bank subsidiary, indirectly authorized under the NBA. Although operating subsidiaries are state-chartered corporations, the NBA limits their powers to those of national banks. The OCC exercises the same regulatory oversight of national bank operating subsidiaries as it does of national banks, and it treats operating subsidiaries as single economic entities with national banks.

In Watters v. Wachovia Bank, N.A., Wachovia Bank, N.A. ("Wachovia"), a national bank, sought to enjoin the state of Michigan from enforcing its mortgage lender registration and auditing requirements against Wachovia Mortgage Corporation ("WMC"), Wachovia's wholly owned North Carolina-chartered operating subsidiary that was engaged in mortgage lending.

139 See Watters v. Wachovia Bank, N.A., 127 S. Ct. 1559 (2007); 12 C.F.R. § 7.4006 (2008); see also Wells Fargo Bank, N.A. v. Boutris, 419 F.3d 949 (9th Cir. 2005) (holding that the NBA preempts state regulation of national bank operating subsidiaries); Wachovia Bank, N.A. v. Burke, 414 F.3d 305 (2d Cir. 2005) (holding that the NBA preempts state regulation of national bank operating subsidiaries); WFS Fin., Inc. v. Dean, 79 F. Supp. 2d 1024, 1024-25 (W.D. Wis. 1999) (holding that OTS regulations under HOLA preempt state regulation of national thrift operating subsidiaries).

140 None of the cases involving agents have actually conducted an analysis of whether the regulated entities were in fact agents of the federally chartered financial institutions. See, e.g., Pac. Capital Bank, N.A. v. Connecticut, 542 F.3d 341, 349 (2d Cir. 2008) (agent of a national bank); State Farm Bank, FSB v. Reardon, 539 F.3d 336, 347 n.6 (6th Cir. 2008) (agents of a national thrift); SPGGC, LLC v. Ayotte, 488 F.3d 525 (1st Cir. 2007) (agents of a national bank); State Farm Bank, FSB v. Burke, 445 F. Supp. 2d 207 (D. Conn. 2006) (agents of a national thrift); see also Peterson, supra note 8, at 541-50 (discussing agency costs and incentives to engage in predatory lending).


142 Watters, 127 S. Ct. 1559. For thrifts, see WFS, 79 F. Supp. 2d at 1024.

143 The majority in Watters based its decision on operating subsidiaries being authorized under national banks' general incidental powers under § 24 (Seventh). 127 S. Ct. at 1569-70. The majority also noted that the statute regarding financial subsidiaries, 12 U.S.C. § 24a(g)(3)(A), contained an oblique reference to operating subsidiaries. Id. ("The term 'financial subsidiary' means any company that is controlled by 1 or more insured depository institutions other than a subsidiary that—(A) engages solely in activities that national banks are permitted to engage in directly and are conducted subject to the same terms and conditions that govern the conduct of such activities by national banks . . . ."); see Watters, 127 S. Ct. at 1581 (Stevens, J., dissenting).


145 Watters, 127 S. Ct. at 1569-70.

146 Id. at 1565 (majority opinion).
Wachovia argued that national bank operating subsidiaries are exempt from state regulation because the NBA and OCC regulations preempt state law as applied to national bank operating subsidiaries.\(^{147}\) Michigan contended that because WMC was not itself a national bank, that preemption did not apply. The District Court granted Wachovia summary judgment\(^ {148}\) and the Sixth Circuit affirmed.\(^ {149}\) The Supreme Court in turn affirmed, holding that states are preempted from regulating operating subsidiaries of national banks.\(^ {150}\)

The Supreme Court noted that a long line of decisions had repeatedly made clear that federal control shields national banking from "unduly burdensome and duplicative state regulation."\(^ {151}\) And "just as duplicative state examination, supervision, and regulation would significantly burden mortgage lending when engaged in by national banks, so too would those state controls interfere with that same activity when engaged in by an operating subsidiary."\(^ {152}\) The Court rejected a formalist approach to preemption based on corporate entity type. Instead, the Court noted that "[w]e have never held that the preemptive reach of the NBA extends only to a national bank itself. Rather, in analyzing whether state law hampers the federally permitted activities of a national bank, we have focused on the exercise of a national bank’s powers, not on its corporate structure."\(^ {153}\)

Notably, the Supreme Court had also never held before *Watters* that preemption extended beyond national banks. Historically, preemption for national banks was based on national banks’ special status as federal instrumentalities, deriving from their role between 1863 and 1935 in creating the national currency. Prior to the Civil War, most paper currency was in the form of individual banks’ notes, which cleared at a discount from face value.\(^ {154}\) The NBA of 1863 allowed the creation of national banks, which were authorized to issue national bank notes, backed by U.S. government securities deposited with the Treasury Department. Shortly after the promulgation of the

\(^{147}\) The Supreme Court’s majority sidestepped the question of whether the OCC regulation at issue exceeded the scope of Congress’s delegation of power to the OCC. *Id.* at 1572. The majority based its decision on the statutory provisions of the NBA granting incidental powers to national banks, 12 U.S.C. § 24 (Seventh) (2006), and prohibiting the states from exercising visitorial powers over national banks, *id.* § 484(a). The majority did not respond to the claim in Justice Stevens’s dissent, *Id.* at 1579, 1582-83 (Stevens, J., dissenting), that the OCC did not have the power to pass the regulation or that the regulation should not receive *Chevron* deference because it was not reasonable. The opinion’s holding of preemption, however, appears to be a tacit endorsement of the OCC’s preemption power.


\(^{150}\) *Watters*, 127 S. Ct. 1559.

\(^{151}\) *Id.* at 1566-67.

\(^{152}\) *Id.* at 1570.

\(^{153}\) *Id.* at 1570.

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NBA, Congress moved to suppress state bank notes by taxing them out of existence.\(^{155}\) With the 1913 creation of the Federal Reserve, which issues the United States currency in the form of uniform par-clearing notes,\(^{156}\) national bank notes declined in importance, and they were phased out in 1935.\(^{157}\) This means, as Arthur E. Wilmarth, Jr. has cogently argued, that federal instrumentality status, and thus preemption, should have ended for national banks in 1913, or at the latest 1935.\(^{158}\)

Despite laying out a functionalist test for preemption, the Court hinted that a formalist approach might be appropriate if the line were drawn differently. The Court emphasized that Congress distinguished among different types of national bank affiliates, and that operating subsidiaries were more like national banks than other affiliates: "unlike affiliates that may engage in functions not authorized by the NBA, e.g., financial subsidiaries, an operating subsidiary is tightly tied to its parent by the specification that it may engage only in 'the business of banking' as authorized by the Act."\(^{159}\) Because the "OCC licenses and oversees national bank operating subsidiaries just as it does national banks,"\(^{160}\) preempting state regulation of national bank operating subsidiaries would merely be undoing "[d]iverse and duplicative superintendence,"\(^{161}\) and would still leave operating subsidiaries subject to regulation by the OCC. Thus, it might be that preemption does depend on formal corporate entity distinctions, despite the Court's protestations otherwise.\(^{162}\)

In fact, a formalist approach is quite sensible for banking regulation preemption, because banking regulation is centered on corporate form. In banking law, substantive issues depend on form; form is substance in banking law and engenders significant reliance. For example, regulatory authority over financial institutions is dependent on corporate structure—the regulation of a national bank is done by the OCC, but the regulation of a bank holding

\(^{155}\) 12 Stat. 712 (1863) (taxing state bank notes at 2%); 14 Stat. 146 (1866) (providing for a 10% tax on state bank notes), upheld by Veazie Bank v. Fenno, 75 U.S. 533 (1869). For an alternative view that argues the state bank note tax was instituted merely to offset inflationary effects of national banknotes, see Selgin, supra note 154.


\(^{158}\) Wilmarth, supra note 8, at 241-42.

\(^{159}\) Watters, 127 S. Ct. at 1571-72.

\(^{160}\) Id. at 1569 (citing 12 C.F.R. § 5.34(e)(3) (2006)).

\(^{161}\) Watters, 127 S. Ct. at 1567.

\(^{162}\) The Supreme Court has previously given great weight to corporate separation. See, e.g., Dole Food Co. v. Patrickson, 538 U.S. 468 (2003); United States v. Bestfoods, 524 U.S. 51 (1998). Moreover, as Justice Stevens's dissent noted, a major reason national banks create operating subsidiaries is to benefit from the risk separation created by an operating subsidiary's corporate veil. Watters, 550 U.S. at 43 (Stevens, J., dissenting).
company is done by the Federal Reserve.\textsuperscript{163} The FTC’s authority to regulate is limited by the corporate form of the entity.\textsuperscript{164} Likewise, reserve and capital requirements are keyed to the formal corporate status of an entity. Only national banks and their operating affiliates are subject to reserve requirements,\textsuperscript{165} while there are different capital requirements for national banks and bank holding companies.\textsuperscript{166} And the capital structure of financial institutions depends on corporate form, because formal corporate divisions create structural subordination of creditors, including the Federal Deposit Insurance Corporation and Securities Investor Protection Corporation (SIPC). General unsecured creditors are subordinated to insured deposit creditors, but only for FDIC- and SIPC-insured entities,\textsuperscript{167} and not every entity within a financial institution’s corporate structure is FDIC- or SIPC-insured. A functional preemption analysis, like the one \textit{Watters} endorsed, is inconsistent with the nature of banking regulation.

\textit{Watters}’s functional banking law preemption heuristic also proves too much when taken by itself. The Supreme Court explained that banking law preemption analysis looks to the exercise of national bank powers rather than to corporate structures. But when this mode of analysis is applied to contexts beyond national banks’ operating subsidiaries, it creates regulatory vacuums. There are third parties such as agents and counterparties involved in national bank operations, and their regulation inevitably affects and limits national bank powers. But these third parties are not subject to federal regulatory oversight, unlike operating subsidiaries. Extending preemption to them would shield them from state regulation without substituting federal regulation. Given that the major policy concern animating federal preemption of state banking regulation is the concern about duplicative and potentially contradictory regulatory regimes, there is no reason to expand preemption beyond the extent of federal regulatory authority. Concerns about duplicative regulation simply do not exist when there is no federal regulatory oversight of the entity being subjected to state regulation, such as with the agents or counterparties of national banks and thrifts.\textsuperscript{168}

\begin{footnotesize}
\begin{itemize}
\item\textsuperscript{163} 12 C.F.R. pt. 225 (2008); see also Whitney Bank v. New Orleans Bank, 379 U.S. 411 (1965) (drawing a distinction between Federal Reserve Board authority over bank holding companies and OCC authority over national banks).
\item\textsuperscript{164} See \textit{supra} note 49 and accompanying text.
\item\textsuperscript{165} 12 C.F.R. § 204.1(c) (2008).
\item\textsuperscript{166} Compare id. pt. 3 app. (national banks), with id. pt. 225 app. (bank holding companies).
\item\textsuperscript{168} It is also worth recalling that national banks are not a policy end in and of themselves. Instead, they are federal instrumentalities that have been authorized to serve the public interest by facilitating commerce. To the extent that preemption hurts the public interest, it undercuts the ultimate policy behind having national banks.
\end{itemize}
\end{footnotesize}
A broader view of banking preemption issues makes clear that the *Watters* powers analysis must have the unstated corollary that preemption can extend no farther than federal regulatory oversight. The preemptive reach of the NBA must ultimately be tethered to the regulatory reach of federal banking regulators, lest preemption create a regulatory no-man's-land of entities not subject to federal banking laws, but still shielded from state laws by preemption.\footnote{Clearing House Ass'n, LLC v. Cuomo, 510 F.3d 105, 116 n.7 (2d Cir. 2007), cert granted, 129 S. Ct. 987 (Jan. 16, 2009) (No. 08-453) (noting that preemption might not extend to national bank affiliates other than operating subsidiaries and focusing on difference between regulating conduct and qualifications of agents and prohibiting agents from facilitating authorized activities of national banks); see also State Farm Bank, FSB v. Reardon, 539 F.3d 336, 347 n.6 (6th Cir. 2008) (holding that a state law regulating mortgage brokers was preempted by HOLA as applied to a federal savings bank's exclusive agent, which was itself subject to OTS examination per HOLA: "[W]e are not confronted today with a situation where a federal savings association has contracted with non-exclusive, untrained, and unsupervised individuals, over whom it has no control, for the purpose of marketing and soliciting mortgage products in Ohio. Instead, we are confronted with a situation where Ohio is attempting to regulate a federal savings association's exclusive agents who are already subject to regulation by the OTS and [the federal savings bank] itself."); State Farm Bank, FSB v. Burke, 445 F. Supp. 2d 207 (D. Conn. 2006) (holding that a state law regulating mortgage brokers was preempted by HOLA as applied to a federal savings bank's exclusive agent, which was itself subject to OTS examination per HOLA).}

The contours of this corollary have begun to emerge in recent case law, although the doctrinal picture is not perfectly neat. As the following review of the case law elucidates, while preemption of state consumer protection in financial services extends to the agents of national banks and thrifts, who are themselves subject to federal regulation or under the control of a federally regulated institution, the preemption does not extend to their counterparties. This distinction is crucial, as we shall see, for it allows for a sensible doctrinal resolution to the preemption question and enables hydraulic regulation.

2. Agents and Counterparties

   a. *The SPGGC Giftcard Cases*

   In 2007, the First and Second Circuits decided cases involving nearly identical New Hampshire and Connecticut state laws barring expiration dates on giftcards.\footnote{SPGGC, LLC v. Blumenthal, 505 F.3d 183 (2d Cir. 2007); SPGGC, LLC v. Ayotte, 488 F.3d 525 (1st Cir. 2007).} Giftcards are electronic stored-value cards that may be used like a gift certificate for purchases at all accepting merchants. In both cases, a national bank (as well as a national thrift in one case) had entered into agreements with SPGGC, a subsidiary of Simon Properties, which owns a chain of shopping malls, to sell Visa-branded giftcards. Visa requires expiration dates on all cards carrying its logo as an antifraud measure.\footnote{Blumenthal, 505 F.3d at 187.} SPGGC and the national banks and thrift involved with SPGGC brought suit to...
enjoin the enforcement of the state statutes, and the OCC filed amicus briefs on behalf of the national banks.

In the First Circuit case, the arrangement between SPGGC and the national bank, USB, was that the national bank would issue the giftcards and provide a stock of the cards to SPGGC, which would then market them to consumers.\textsuperscript{172} SPGGC received a commission on each sale. When a consumer purchased a giftcard, SPGGC would remit the payment to the national bank.\textsuperscript{173} SPGGC would then load the purchased value amount onto the card.\textsuperscript{174} As the First Circuit noted:

From this point forward, the purchaser of the gift card has a contractual relationship only with USB. USB is responsible for servicing the card and is liable for charges upon it. Any fees associated with the card are set and collected by USB, and if the card is reported lost or misused, USB may be liable to the consumer for fraudulent charges. [SPGGC] has no authority under the contract to alter the terms and conditions of the agreement between USB and the consumer.\textsuperscript{175}

SPGGC functioned merely as a sales agent of the national bank (and thrift).

The First Circuit noted that national banks have the power to issue stored-value cards that carry expiration dates\textsuperscript{176} and to use agents,\textsuperscript{177} and need not choose between these powers.\textsuperscript{178} Although the New Hampshire statute regulated SPGGC, a non-bank, it effectively regulated the terms and conditions of cards issued by USB that govern the relationship between the purchaser of the giftcard and USB. The New Hampshire statute, the First Circuit held, is not concerned with [SPGGC's] activity, which is limited to how and where the giftcards are marketed, but rather with the sale of certain giftcards through a third party agent, which is the activity of USB, a national bank. Even if the [statute] does not directly prohibit USB from engaging in such activity, it does so indirectly by prohibiting [SPGGC] from acting as USB's agent.\textsuperscript{179}

The New Hampshire statute thus "significantly interfere[d]" with the exercise of a national bank's powers.\textsuperscript{180} The First Circuit undertook a similar analysis for HOLA preemption for the New Hampshire statute's application to the federal thrift.\textsuperscript{181}

\begin{footnotesize}
\begin{enumerate}
\item\textsuperscript{172} Ayotte, 488 F.3d at 529. The arrangement with Metabank, a national thrift, was identical.
\item\textsuperscript{173} Id. at 530 n.3.
\item\textsuperscript{174} Id. at 528.
\item\textsuperscript{175} Id. at 529.
\item\textsuperscript{176} Id. at 530.
\item\textsuperscript{177} Id. at 531.
\item\textsuperscript{178} Id. at 532 (citing 12 U.S.C. § 24 (2006)).
\item\textsuperscript{179} Ayotte, 488 F.3d at 532.
\item\textsuperscript{177} Id. at 533 (footnote omitted).
\item\textsuperscript{180} Id.
\item\textsuperscript{181} HOLA differs from the NBA in that it does not authorize the use of agents by federal thrifts. See 12 U.S.C. § 24 (Seventh) (2006) (permitting national banks to use "duly authorized officers or agents" to carry out their incidental powers). Instead, the only authority under which federal thrifts utilize agents is an opinion letter signed by OTS's general counsel. Office of Thrift Supervision Opinion
\end{enumerate}
\end{footnotesize}
In the Second Circuit case, the agreement between a national bank, Bank of America, and SPGGC was different. It provided that Bank of America would receive all interchange fees from transactions on the cards, but SPGGC received all other types of fee revenue directly. The agreement provided that all of SPGGC's revenue from the giftcards derived from the fees associated with the cards, such as upfront handling and loading fees, maintenance fees, card replacement fees, and call center fees.

SPGGC set the original terms and conditions of the cards, although Bank of America retained review and approval authority over the terms and conditions of the cards as well as the design of the cards and the carriers with which they were sold.

The Second Circuit noted that SPGGC had at best "a close agency or business relationship with [Bank of America]; but that is not sufficient to entitle it to protection under the [National Bank Act]." Although the Supreme Court had emphasized the need to analyze the effect of a state law on the exercise of national bank powers, rather than the entity being regulated, the Second Circuit stated that "it would be a mistake to read Watters so broadly as to obscure the unique role assigned to operating subsidiaries in the context of national banking regulation." Operating subsidiaries are limited to engaging only in the business of banking, and the authority to do business through operating subsidiaries is one explicitly granted to national banks. SPGGC, however, was outside the scope of the OCC's exclusive oversight, unlike an operating subsidiary.

The Second Circuit thus concluded that the Connecticut statute was not preempted insofar as it prohibited SPGGC from imposing inactivity and other fees on consumers. It remanded the question of preemption in regard to the statute's prohibition on expiration dates.

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Interchange fees are a combination of a flat per-transaction fee and a percentage fee for each transaction made using the card. See Adam J. Levitin, Priceless? The Economic Costs of Credit Card Merchant Restraints, 55 UCLA L. REV. 1321, 1333 (2008).

SPGGC, LLC v. Blumenthal, 505 F.3d 183, 187 (2d Cir. 2007).

Id.

Id. at 191.

Id.

Id. at 190 (internal quotations and modifications omitted).

Id.

Id.

Id. at 191.

Id. at 191-92. Query whether the states could enforce the giftcard expiration-date bans against Visa, U.S.A., which is not a national bank, but a Delaware corporation.
The *SPGGC* circuit court decisions can be reconciled by exploiting a distinction hinted at, but not explicit, in the cases—that of enabling agent versus counterparty. These cases can be read together as holding that preemption extends to a national bank's agents when the state law would frustrate the exercise of a national bank's powers. Preemption does not extend to a national bank's business partners, however, when there is no agency relationship.

Doctrinally, this solution is sensible. The power granted to national banks is a power to employ "agents."[^192] "Agent" is a legal term and covers only a limited subset of business relationships. As the *Restatement (Third) of Agency* defines it, “[a]gency is the fiduciary relationship that arises when one person (a ‘principal’) manifests assent to another person (an ‘agent’) that the agent shall act on the principal’s behalf and subject to the principal’s control, and the agent manifests assent or otherwise consents so to act.”[^193] In an agency relationship, the principal has control over the agent and the relationship creates respondeat superior liability for the principal for harms caused by the agent within the scope of the agency relationship.[^194] Thus, the agent of a national bank is subject to the national bank’s control, and the national bank is liable for its agent’s actions within the scope of the agency relationship.

Respondeat superior liability creates a powerful incentive for national banks to select and monitor their agents carefully. It also creates an incentive for national banks' regulators to review carefully the identities and activities of national banks’ agents as part of their safety-and-soundness inspections, as the liability that comes from being the principal in an agency relationship is part of the bank’s overall risk profile. Banks’ respondeat superior liability means that the activities of national banks’ agents would effectively be subject to regulatory oversight. Preemption would make sense doctrinally here because the agents’ behavior is already policed (at least in theory) by federal banking regulators, for the national bank is responsible for the agents’ actions. But even with agents, preemption is triggered only when state regulation would impede the exercise of a national bank’s powers—otherwise there is no conflict.

In contrast, when there is simply a contract relationship, not an agency relationship, the national bank is unlikely to be held liable for its contractual counterparty’s actions, and bank regulators have little cause or ability to examine the counterparty’s activities. In these circumstances, there is no reason to extend preemption doctrine to shield counterparties from state regulation, because there is no replacement regulation by federal banking regulators. And when the state regulations do not impede national bank powers, there is no conflict to preempt.

[^194]: *id.* §§ 2.04, 7.03.
b. The State Farm Mortgage Broker Cases

Different aspects of the enabling agent versus counterparty distinction are supported by a number of other recent banking law preemption decisions. First, another pair of cases involving the application of state mortgage broker licensing laws to the exclusive agents of State Farm Federal Savings Bank, a national thrift, emphasizes that preemption is appropriate when a non-bank agent is subject to federal regulatory oversight and oversight by the bank principal.195

In both State Farm cases, State Farm objected to state laws that imposed licensing requirements on mortgage brokers.196 State Farm utilized exclusive brokers to sell its mortgages.197 The brokers worked solely for State Farm, but were not State Farm employees.198 Instead, even though they were referred to colloquially as State Farm agents, their contracts specifically labeled them as independent contractors.199 Nonetheless, the brokers were under the supervisory authority of both State Farm and, crucially, the OTS, although it is not clear if the OTS ever exercised any supervision of the brokers.200 Both the Sixth Circuit and the District Court for the District of Connecticut accepted the characterization of the brokers as agents of State Farm.201 Emphasizing that the exclusive State Farm agents were subject to OTS supervision, the Sixth Circuit and the District of Connecticut both held that the state mortgage broker licensing requirements were preempted as applied to the agents.

The State Farm cases are consistent with the SPGCC cases—only parties subject to federal regulatory regimes may raise preemption as a defense to state consumer-protection laws. A party may be subject to a federal regulatory regime either through direct federal regulation or through an agency relationship that entails supervision by a federally regulated principal and respondeat superior liability by that principal for the agent's actions. Either way, preemption runs only as far as federal regulatory writ.202

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195 State Farm Bank, FSB v. Reardon, 539 F.3d 336 (6th Cir. 2008); State Farm Bank, FSB v. Burke, 445 F. Supp. 2d 207 (D. Conn. 2006).

196 Reardon, 539 F.3d at 338; Burke, 445 F. Supp. 2d at 212.

197 Reardon, 539 F.3d at 338; Burke, 445 F. Supp. 2d at 211.

198 Reardon, 539 F.3d at 339.

199 Id. at 339; Burke, 445 F. Supp. 2d at 211.

200 Reardon, 539 F.3d at 339; Burke, 445 F. Supp. 2d at 212. The respondeat superior liability of State Farm for the "agents" was never addressed in the OTS opinion or the court opinions. Since respondeat superior is a common-law doctrine, it is not clear whether it applies to "federal instrumentalities" like national banks and federal thrifts. Nonetheless, there is a strong argument that it should be required as a condition of preemptive immunity for agents.

201 Reardon, 539 F.3d at 339; Burke, 445 F. Supp. 2d at 211-12. Notably, State Farm Bank, F.S.B. v. Reardon, 512 F. Supp. 2d 1107 (S.D. Ohio 2007), which held that the Ohio state mortgage broker regulation was not preempted, repeatedly emphasized that the brokers were independent contractors, rather than agents.

202 Reardon, 539 F.3d at 347 n.6 (specifically noting that non-exclusive agents present a separate issue, as there would not be undue regulatory duplication).
c. The Pacific Capital Bank Refund Anticipation Loan Cases

A third pair of cases, Pacific Capital Bank, N.A. v. Connecticut\(^{203}\) and Pacific Capital Bank, N.A. v. Milgram,\(^{204}\) both involving state regulation of tax refund anticipation loans ("RALs"), underscores that preemption is triggered, as in SPGGC v. Ayotte, if application of state law to non-bank agents of national banks would impede the exercise of a national bank power.\(^{205}\) RALs are very short-term loans (often less than two weeks), consisting of high-interest-rate loans collateralized by an anticipated tax refund. The loans are typically sold to consumers by tax preparers working with a bank that assumes the credit risk. The size of the RAL is based on the size of the refund anticipated by the tax preparer. The bank will then lend out some amount less than the anticipated refund, taking the refund as collateral. Most RALs are issued to consumers with very low income who are expecting to receive an Earned Income Tax Credit.

The RAL cases do not spell out the economic relationship between the tax preparer and the national bank, but it appears to be similar to that of SPGGC to the national bank in Ayotte. The tax preparer does not make the loan itself or bear the credit risk on the loan and does not set the terms and conditions of the loan. It merely receives a commission-like fee for each loan. This arrangement would make tax preparers agents, rather than counterparties or partners. With this reading of the transaction, the rulings on RALs are easy to reconcile with the agent versus counterparty/partner paradigm.

Thus, in Pacific Capital Bank, N.A. v. Connecticut, the District Court for the District of Connecticut denied a preemption challenge against a Connecticut statute that limited the interest rate on RALs, required that certain disclosures be made when marketing RALs, and required that RALs be offered only at locations where the principal business was tax preparation.\(^{206}\) The statute created civil liability for "facilitators" of RALs who violated the statute;\(^{207}\) "facilitator" was defined to exclude national banks.\(^{208}\) The district


\(^{204}\) No. 08-0223 (FLW), 2008 U.S. Dist. LEXIS 19639 (D.N.J. Mar. 13, 2008).

\(^{205}\) See also Carson v. H&R Block, 250 F. Supp. 2d 669 (S.D. Miss. 2003) (rejecting a third-party tax preparer's preemption challenge to a state statute prohibiting a third-party agent from making misrepresentations); H&R Block Tax Servs., Inc. v. N.Y. State Div. of Human Rights, 2008 N.Y. Misc. LEXIS 2096, at *11 (Sup. Ct. Mar. 6, 2008) (No. 1726/2007) (denying preemption challenge to investigation of a tax preparer's marketing practices of RALs made by national bank because only the third-party preparer's marketing activities were being investigated: "A close agency or business relationship with a federal bank is not sufficient by itself under the National Bank Act to entitle the agent to protection from investigation or regulation by a state authority.").

\(^{206}\) CONN. GEN. STAT. § 42-480 (2006).


court held that the state statute’s disclosure requirements were not a significant burden on national banks, because the disclosures required by the statute were required not of the national bank but of the facilitators and did “not request much information, so it should not be burdensome to collect and disclose.”

Likewise, the requirement of making RALs only at locations (other than national bank branches) whose principal business was tax preparation was not a significant burden on national banks, which still had “thousands of potential partners across the state.” And the district court construed the usury limitation on RALs as applying only when the lender itself was not the national bank. As with *SPGGC v. Blumenthal*, to the extent that the tax preparer functioned as an agent of a national bank, it was protected by preemption; to the extent that it functioned own its own, it was not. The statute was preempted only to the extent that it affected a national bank or its agent.

On appeal, the Second Circuit affirmed that the usury limitation was preempted as applied “to RAL facilitators that are assisting national banks.” The Second Circuit noted,

> If a state statute subjects non-bank entities to punishment for acting as agents for national banks with respect to a particular NBA-authorized activity and thereby significantly interferes with national banks’ ability to carry on that activity, the state statute does not escape preemption on the theory that, on its face, it regulates only non-bank entities.

Accordingly, the Second Circuit upheld the district court’s ruling that the usury limitation was preempted if the RAL facilitator was working with a national bank. The Second Circuit did not address the disclosure requirement issue.

Curiously, the Second Circuit paid no attention to its careful prior discussion in *SPGGC v. Blumenthal*. In *Pacific Capital Bank v. Connecticut*, the Second Circuit quoted one sentence from *SPGGC v. Blumenthal*, but did not engage with the substance of the opinion. Instead, like the First Circuit in *SPGGC v. Ayotte*, the Second Circuit adopted a rule that was based on the power of national banks to employ agents, but then never engaged in an analysis of whether the tax preparers at issue were agents of the national bank. Indeed, it is not clear whether such a conclusion could have been reached from the record. If one adopts the courts’ reasoning, then preemption turns on the question of agency, which is really a mark of the extent of federal banking supervision. To take these decisions seriously, there needs to be an examination of whether the business relationship in question is agency or something else. And if the courts’ logic is to stand, then it cannot suffice for there to be simply

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210 *Id.* at *29.
211 *Id.* at *30-34.
213 *Id.* at 353.
214 *Id.*
an undefined business relationship. Only a reading that incorporates agency and its implications permits a synthesis of the SPGGC cases and *Pacific Capital Bank v. Connecticut*.

Yet, as in *Ayotte*, the lack of any judicial references to respondeat superior liability or the need for federal regulatory oversight of agents is very troubling. Absent a tether of preemption to federal regulatory oversight, either directly or through respondeat superior liability, the reasoning in *Ayotte* and the *Pacific Capital* cases could potentially be extended to any contract "partner" of a national bank or federal thrift. Either direct federal supervision or respondeat superior liability of a federally-supervised entity should be prerequisites for preemption-conferring agency status.

The agency terminology was not featured in *Pacific Capital Bank, N.A. v. Milgram*, the second RAL case involving Pacific Capital Bank. Nonetheless, the case is consistent with an agency rationale for preemption. In *Milgram*, the national bank filed suit seeking a declaratory judgment that a New Jersey law that imposed a thirty percent APR limit on RALs and created civil and criminal penalties for its violation was preempted by the NBA. The New Jersey statute applied both to RAL lenders and to third-party independent tax preparers who assisted in making the RALs. Thus, even though national banks would obviously be exempt from the statute under *Marquette*, a tax preparer assisting the national bank would likely face criminal liabilities for usury.

The District Court for the District of New Jersey held that the statute was preempted, not only as applied to national banks, but also as applied to tax preparers. The court reasoned that applying the statute to tax preparers "directly restricts and frustrates [national banks'] power to make RALs under the National Bank Act, and does not merely 'incidentally affect' [national banks] because "the services of an experienced tax preparer are 'indispensable' for the good faith and error free preparation of an RAL."

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216 *Id.* at *8.
217 *Id.*
218 *Id.* at *19.

In theory, there are two key functions served by the third-party tax preparers in the RAL industry. The actual preparation of the tax return, which could be done by anyone, is not one of these key functions. Instead, first, tax preparers are important for RALs because they provide a marketing conduit for the bank to reach consumers. Using professional tax preparers to reach out to consumers provides an efficient way for banks to contact their target customers.

The second and more crucial function of a tax preparer in RALs is to provide a valuation of the anticipated refund. If the anticipated refund is overvalued, the bank could find itself undersecured, and if
Imposition of criminal penalties on independent third-party tax preparers would be “an obstacle to allowing [national banks] to charge the interest rates permitted under the NBA.”\footnote{Milgram, 2008 U.S. Dist. LEXIS 19639, at *24.} Whereas the Connecticut statute merely restricted national banks’ pool of agents to assist in making RALs, the New Jersey statute’s criminal sanctions for making usurious RALs (practically meaning making any RAL) prevented national banks from exercising their statutory power of employing agents,\footnote{Id. at *19.} as no tax preparer would reasonably face criminal penalties to work with a national bank on RALs. Yet, as in Ayotte, the State Farm cases, and the other Pacific Capital Bank RAL cases, there was no showing that national banks had any respondeat superior liability for these “agents” or that the tax preparers were subject to OCC supervision.

d. The Capital One Subpoena Case

As the RAL cases show, state regulation of national banks’ agents is preempted only when state regulation would impede national banks’ power to employ agents. This rule is consistent with another recent preemption case, this time involving state regulation of credit card lending. In Capital One Bank (USA), N.A. v. McGraw,\footnote{563 F. Supp. 2d 613 (S.D. W. Va. 2008).} the District Court for the Southern District of West Virginia denied a national bank’s motion to quash a subpoena duces tecum issued by West Virginia to an affiliated agent of a national bank.\footnote{Id. at 623-29.} In response to some 264 consumer complaints, West Virginia undertook an investigation of the credit card lending practices of Capital One Bank (USA), N.A. ("Capital One"), a national bank, and its servicing agent, Capital One Services, Inc. ("COSI").\footnote{Id. at 614.} COSI is a non-bank affiliate of Capital One and shares a common parent, Capital One Financial Corporation, a bank holding company.\footnote{Id. at 623.} As part of the investigation, West Virginia subpoenaed documents from Capital One and COSI.\footnote{Id. at 615-16.} Capital One moved to enjoin the enforcement of the subpoenas against COSI because “the protections of the National Bank Act the loan is non-recourse, incur a loss. Notably, the valuation function is one that could be done in-house at the bank or by an agent of the bank, rather than by an independent third party. Use of in-house appraisers or agents might provide preemption protection to RALs along the lines of Ayotte.

\footnote{At the time the subpoenas were issued, Capital One was a Virginia state-chartered bank. Capital One failed to respond to the subpoenas at the time and, after its conversion to a national bank charter nearly three years later, moved to prevent the enforcement of the subpoenas on the basis of its status as national bank. Id. at 615.}
extend to agents of national banks carrying out banking activities at the behest of those banks." 228 Notably, only the ability of the state to investigate, not the exercise of national bank powers, was at issue.

The Southern District of West Virginia determined that the subpoena constituted an exercise of visitatorial powers by the state that was prohibited against Capital One, as a national bank, 229 but dismissed the motion to enjoin the enforcement of the subpoenas as against COSI. 230 The court noted that COSI was not an operating subsidiary of Capital One, but merely an affiliated third-party agent, 231 and emphasized the distinction between operating subsidiaries, which are subject to OCC regulation and whose powers are limited to those of national banks, and other bank affiliates. It also underscored the dissent's observations in Watters that "it would be anomalous if 'a state corporation can avoid complying with state regulations, yet nevertheless take advantage of state [corporation] laws insulating its owners from liability,'" 232 and that construing preemption expansively "may drive companies seeking refuge from state regulation into the arms of federal parents, harm those state competitors who are not lucky enough to find a federal benefactor, and hamstring States' ability to regulate the affairs of state corporations." 233

Accordingly, the court noted that if it were to extend preemption to "third-party corporations such as COSI, the term 'national bank' would not longer mean 'national bank.' Rather, it would mean 'national bank and any entity that can find a way to graft itself, remora-like, to a national bank.'" 234 The court found that expanding preemption was contrary to public policy, because every time preemption is broadened and state regulation is supplanted by that of the OCC, state sovereignty erodes, political accountability dissipates, and a federal agency's role in shaping state policy increases. [Courts] must be especially cognizant of these dangers in cases, like this one, involving a state's ability to enforce its consumer protections laws. 235 Therefore, the court dismissed the motion to enjoin enforcement of the subpoena against the national bank's non-bank affiliate-agent. National bank agents are not protected from preemption when national bank powers are not at stake.

228 Id. at 623 (quoting Capital One's filings).
229 Id. at 621-22.
230 Id. at 623, 628.
231 COSI is likely a bank service company, in which case it is possible that it is subject to non-exclusive OCC regulation. See 12 U.S.C. § 1867(a) (2006) (regulating oversight of bank service companies); cf. Id. § 1464(d)(7)(A) (regulating oversight of thrift service companies).
234 Id.
235 Id.
Hydraulic Regulation

e. The Goleta National Bank Payday Loan Rent-a-Charter Cases

The agent versus business partner or counterparty distinction is perhaps clearest in payday lending rent-a-charter cases. Prior to 2004, many payday lenders began “renting” national banks’ charters to circumvent state usury laws. The payday lenders were state-chartered finance companies that were subject to state usury laws. The payday lenders sought to piggyback on national banks’ ability to export their home states’ higher or nonexistent usury caps. They did this by structuring transactions so that a national bank or thrift would make the loan to the consumer followed by the payday lender’s automatically purchasing the loan from the bank. Under significant political pressure, the OCC and OTS curtailed rent-a-charter activities in 2004.236

In 2000-2001, a series of suits were filed in state courts by state government agencies and consumers challenging national banks’ ability to “rent” their charters to payday lenders in order to circumvent state usury laws and small loan laws. These suits centered around the rent-a-charter arrangement between the California-based Goleta National Bank and ACE Cash Express, Inc. (“ACE”), a non-bank finance company.237 Consumers would apply for a payday loan by going to an ACE branch and deal solely with ACE personnel, but the documentation for the payday loans would list Goleta as the lender. Goleta also established the underwriting criteria and controlled loan approval. Goleta, however, automatically also sold ACE a 90-95% interest in each loan, and ACE maintained all loan records and serviced the loans.238 Goleta’s rent-a-charter arrangement with ACE was crucial to its operations; in 2001 the arrangement accounted for approximately 20% of Goleta’s profit.239 ACE removed the suits to federal court, arguing that the claims against it were preempted by the NBA. The plaintiffs then filed motions for remand, on the grounds that ACE could not take shelter in the NBA, as it was not a national bank. In a series of opinions, the motions for remand were granted.240

238 Id. at 747-48.
When Ohio sought to undertake a regulatory usury action against ACE, however, Goleta brought suit in the District Court for the Southern District of Ohio to enjoin the action. Goleta argued it was the actual lender for the payday loans and that ACE was merely acting as its agent. Therefore, Goleta contended, the NBA as interpreted by Marquette National Bank v. First of Omaha Service Corp. preempted the application of Ohio's usury laws because application of the laws to ACE would represent a prohibited indirect enforcement of such laws against Goleta.

The court rejected Goleta's arguments and dismissed the suit for lack of standing. The court reasoned that because ACE bore 90% of the loan risk, it was not acting as Goleta's agent; even if Goleta was the titular lender, the economic reality was otherwise. ACE was the functional lender, and its relationship with Goleta was that of a counterparty, not an agent. Therefore, Goleta lacked standing because, among other reasons, it could not show injury to itself. O'Donnell likewise supports the principle that national banks' exclusive agents are protected by preemption when the exercise of a national bank's powers is at stake, but national banks' counterparties are never able to shelter in preemption.

SPGGC v. Ayotte, the remand in SPGGC v. Blumenthal, the State Farm cases, the Second Circuit's ruling in Pacific Capital Bank, N.A. v. Connecticut, and Pacific Capital Bank, N.A. v. Milgram indicate that third parties in contractual relationships with national banks are protected from state regulation by preemption only if their relationship is sufficiently close to being a national bank's agent and if the state regulation would frustrate a national bank's power to employ an agent. If, as indicated in the SPGGC v. Blumenthal dismissal, Pacific Capital Bank, N.A. v. Connecticut, and Capital One, state regulation would not frustrate the exercise of a national bank's powers, however, then the agent is not protected by preemption. Thus, a regulatory investigation of an agent is different from a statute limiting a lending or payments practice. And if the relationship is more like that of a business partner, as in SPGGC v. Blumenthal, or more like that of a counterparty, as in O'Donnell and Capital One, then preemption will not apply to the nonbank entity. Thus, preemption case law indicates that preemption is at best coextensive with the run of federal regulatory writ. A regulatory vacuum would exist absent either direct regulation of a nonbank counterparty to a national bank or an agency completely preempted by 12 U.S.C. §§ 85-86 (2006) and therefore can be removed to federal court. Beneficial Nat'l Bank v. Anderson, 539 U.S. 1 (2003).

243 O'Donnell, 239 F. Supp. 2d at 749.
244 Id. at 748. Injury-in-fact analysis for standing is separate from preemption analysis, but the standing analysis has a lower threshold than preemption, so to the extent that standing is not found, there will not be preemption.
245 Id. at 753-54.
relationship that creates respondeat superior liability for the bank “principal” and thus makes a strong incentive for both the principal and its regulator to monitor the agent’s activities. Banking entities that are not subject (either directly, or indirectly via agency relationships) to federal regulation cannot benefit from federal preemption, as the entire purpose of preemption in banking law is to avoid duplicative and potentially contradictory regulatory regimes. This concern simply does not exist when there is no federal regulatory oversight.

III. Hydraulic Regulation

Because of preemption doctrine, states’ ability to regulate national banks and thrifts, their operating subsidiaries, and their agents directly is severely restricted; states cannot directly regulate federally chartered financial institutions in any meaningful way. States, however, still have the ability to regulate federally chartered financial institutions indirectly, by channeling market forces to incentivize changes in bank behavior.

Changes in financial market structures have placed the majority of consumer debt within the ken of state regulation. These changes have made it possible for states to regulate the majority of holders of consumer debt directly. They have also made it possible for states to regulate national banks and thrifts indirectly, in spite of preemption doctrine, by channeling market forces to create incentives for national banks and thrifts to comply with state regulations.

A. The Fundamental Change in the Consumer Finance Business Model: Securitization

Over the past quarter century, the banking industry has undergone a major change. The previous dominant business model in banking was relational banking—banks engaged in conservative underwriting, maintained long-term customer relationships, and held the debts they originated on their own books. That business model has changed. Today, the dominant model is originate-to-distribute. Banks originate as many loans as possible and sell them into the secondary market. Banks immediately monetize on loans, rather than holding the credit risk and maintaining a relationship with consumers.

As shown in Figures 1 and 2, the shift to an originate-to-distribute lending model has created a huge secondary market in consumer debt. Some of this market consists of debt collection agencies that buy defaulted debts for cents on the dollar, but by far the biggest component is securitization trusts. These

247 Id.
trusts, as the following two charts show, now hold the majority of mortgage and credit-card debt, as well as a sizeable amount of automobile and student-loan debt.

Figure 1: Percentage of 1-4 Family Residential Mortgage Debt Securitized

The basic structure of securitization is relatively simple. A bank or other entity (the “originator”) originates multiple loans. It then sells a bundle of loans to a specially created entity (the “special purpose vehicle” or “SPV”). This entity is often a wholly owned subsidiary of the originator. The SPV pays for the loans by selling them to a second SPV, typically a trust (a “securitization trust”). The trust pays for the loans by issuing securities, collateralized by the loans. Thus, the ultimate holder of the securitized loans is generally a counterparty to the originating bank’s own subsidiary-counterparty. There is no direct transaction between the originator and the trust.250

The originating entity sometimes serves as the SPV’s “servicer”—an agent that manages and collects the loans.251 The originating bank also

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250 Securitization can be done with only a single SPV, but two-step securitizations are thought to provide better protection of the trust’s assets against the originator’s creditors. David Baranick & Richard Bennet, Generally Accepted Accounting Principles for Issuers of and Investors in CMBS, in HANDBOOK OF COMMERCIAL MORTGAGE-BACKED SECURITIES 417, 422 (Frank J. Fabozzi et al. eds., 2d ed. 1998).

sometimes retains an interest in the SPV, either a last-out, first-loss position or a vertical strip.\textsuperscript{252} The trust's interests are guarded by a securitization trustee, typically a financial institution other than the originator.

There are many advantages to banks and investors from securitization. For banks, securitization can be a lower-cost way to raise funds than issuing securities directly because the price of the SPV's securities reflects only the value of a dedicated group of assets rather than the originator's total assets and liabilities. Selling loan assets reduces banks' capital requirements, thus providing greater liquidity and enabling greater lending. And, because the loans are held by the SPV, not the originator, the originator no longer bears the risk of the loans, except to the extent of its interest in the trust and position within the trust's priority scheme.\textsuperscript{253}

For investors, securitization offers a way to make targeted investments in specific asset pools without having to assume all the risks of investing in the originator. The securities issued by the SPV are typically tranched—divided into a subordination series in which lower-priority tranches do not receive a return unless the higher-priority tranches are paid in full. Tranching enables the creation of higher-yield securities and investment-grade securities from the same asset pool, allowing a middling pool of assets to be used to tap high-yield, middle, and investment-grade investment markets. Additionally, for investors and originators, there may be accounting and tax benefits from securitization.\textsuperscript{254}

While securitization is a significant development in consumer debt origination, it is not the only one. Increasingly, consumer debts are sold, even outside of the securitization context,\textsuperscript{255} particularly if the debts are past due. A sizeable industry has developed around purchasing nonperforming loans for pennies on the dollar and trying to collect at a few cents more.\textsuperscript{256} These loans will often be flipped multiple times as they age, as some businesses wish to invest in debts that are 90 days past due, but not 180 days past due. In 2008, credit card issuers sold over $55.5 billion of charged-off credit card debt to third-party debt buyers for $2.7 billion or an average of 4.8 cents on the dollar; the largest debt-buying firms purchased another $15 billion in other charged-
off consumer debt (such as medical, utility, auto, and government debt). And these past-due debts can themselves be securitized by a party other than the originator.

Consumers rarely, if ever, know if the debts they owe have been securitized or sold, but securitization and debt sales can significantly affect consumers. Securitization and sales change the incentives of loan originators; because they do not hold the ultimate risk on the loans, they may engage in less careful underwriting. As banks move from a relational, interest-based lending model to an origination- and fee-based lending model, origination volume has increased in importance relative to origination quality. This shift in incentives and business models has fueled the subprime lending market and the mortgage bubble, as lenders have been willing to offer more credit to more consumers than ever before.

B. Hydraulic Regulation: Using the Market To Regulate Consumer Credit Upstream

1. Securitization’s Unremarked Consequence: The Loss of the Preemption Defense

The change in the business model for consumer lending has a significant and unremarked consequence. It has placed a tremendous percentage of consumer debt in the hands of largely unregulated entities outside the traditional banking system. In so doing, it has placed the majority of consumer debt in the hands of entities that cannot claim federal preemption as a defense against the application of state law.

Securitization depends on the fiction that form is substance. Crucial for securitization is that the SPVs involved be considered completely separate entities from the originator and each other for bankruptcy, accounting, and tax purposes. Thus, every securitization transaction requires a “true sale” opinion letter from the originator’s law firm that affirms the transaction is actually a sale of the assets by the originator, rather than a disguised secured loan used to defraud the originator’s creditors by removing assets from their reach. Because most securitizations are now “two-step” securitizations in which the

257 Id.


260 See supra figs. 1 & 2.

assets are sold from the originator to a first SPV and then to a second one, the assets are ultimately held by an entity that does not necessarily have either an affiliation or a contractual agency relationship with the originator. The true sale is thus the linchpin of securitization’s emphasis on formal structures, but also securitization’s vulnerability. For by removing the assets (consumer debt receivables) from an originator that is a national bank, the true sale also removes the assets’ protection from state regulation under federal preemption doctrine.

Developments in the market have thus given states an important regulatory lever for consumer protection. While states cannot, with few exceptions, regulate the national banks and thrifts that originate debts, they can regulate the purchasers of debt from those banks and thrifts and, more importantly, they can regulate the national banks and thrifts indirectly by channeling the hydraulic pressures of the market to incentivize changes in national banks’ and thrifts’ behavior.

2. Hydraulic Regulation: Regulating Markets Upstream

Because of the existence of a secondary market that is not protected by preemption, states can harness market forces to regulate not only the secondary market, but also the primary market in consumer debt. Specifically, states can craft generally applicable regulations that impose costs on secondary-market purchasers of consumer debt from national banks and thrifts tied to the terms of the consumer debt.

States could impose targeted regulatory costs by making consumer debt with various offensive terms unenforceable or subject to various defenses, or by creating public or private rights of action against parties that attempt to enforce consumer debts with the offensive terms. Or, less aggressively, states could simply provide that the offensive terms themselves are not enforceable, although this route raises severability issues. The goal of the state’s regulation would be to decrease the value of the debt in the hands of a secondary market purchaser. The market will ensure that secondary-market purchasers pass these regulatory costs along to the national banks and thrifts that originated the debts.

The hydraulic forces of the market will thus force a choice on national banks and thrifts: eliminate the offensive terms in the consumer debt, accept a

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262 See supra note 250.

263 The Supreme Court ignored the legally separate status of operating subsidiaries in Watters, eschewing the fundamental formalism upon which banking law and capital markets generally rely, see supra text accompanying notes 163-167, but the difference between a subsidiary and a non-affiliated counterparty to a counterparty (such as the second SPV in a two-step securitization) is a formalism so essential to law that it cannot be ignored. Although the formal divisions between parents and subsidiaries or between affiliates are sometimes collapsed in substantive consolidations, see In re Owens Corning, 419 F.3d 195, 199 (3d Cir. 2005), this is an extraordinary remedy, id., and not one exercised to combine bona fide entities with no affiliation.
lower resale price for the debts, or keep the debt (and credit risk) on their own
books—thereby reducing their lending capacity, interrupting cash flow, and
encouraging better underwriting practices. Reduced resale prices and retention
of debts are unattractive options for national banks and thrifts. If national banks
and thrifts wish to continue to receive the benefits of securitization and debt
sales, they will have to change the terms under which they originate debts. By
adjusting the costs imposed on secondary-market purchasers, states can
strongly incentivize national banks and thrifts to eliminate the offensive terms.
If this Article’s reading of a necessary limitation on preemption to entities
under federal regulation or in a respondeat superior liability-creating
relationship with a federally regulated principal is correct, this would provide a
method for regulating federally chartered financial institutions indirectly. Of
course, a broad reading of *Watters, Ayotte,* and *Pacific Capital Bank, N.A. v. Connecticut* would seem to bar such regulation.²⁶⁴

To illustrate how hydraulic regulation would work in practice, consider a
state legislature that wished to ban universal cross-default clauses in consumer
credit contracts.²⁶⁵ The state could pass a law of general applicability providing
that all consumer contracts with universal cross-default clauses are
unenforceable against the consumer and providing various penalties for
attempted enforcement. This law would be preempted as applied to national
banks,²⁶⁶ but not as applied to securitization trusts.²⁶⁷ Securitization trusts
would not be able to enforce consumer debts, like credit card receivables, that
contained universal cross-default clauses, at least in the state in question. This
unenforceability would make the debt less valuable to securitization trusts (or,
more precisely, to investors in the trust), as the trust’s securities would either
have a lower rating, but the same yield, or a lower yield, but the same rating.
Therefore, going forward, the trust would be willing to pay less to purchase
consumer debts with cross-default clauses or, more precisely, the investment
banks that serve as underwriters for the trust’s securities issuance would
demand different deal terms to make the trust’s securities marketable. These
demands would force the national banks that originate such debts to accept a
lower sale price unless they either kept the debts on their books (decreasing
lending capacity) or stopped issuing debt with cross-default clauses. The likely
result, if the state imposed sufficient regulatory costs, would be that cross-
default clauses would disappear from that state’s market.

²⁶⁴ See *supra* notes 234, 235 and accompanying text.

²⁶⁵ A universal cross-default clause (also known as cross-default clause or universal default
clause) is a loan provision that defines an event of default to include a default on another obligation.


F.3d 977, 1009-10 (9th Cir. 2006) (affirming state law aiding and abetting liability of non-federally
chartered warehouse lender to mortgage bank that participated in the securitization of fraudulently
originated mortgage loans).
Similarly, this regulation could be done with state usury laws, except to the extent that federal law, such as the Depository Institutions Deregulation and Monetary Control Act, prohibits state usury laws as applied to any entity.\textsuperscript{268} Old negotiable instrument law in many states provided that usury was a real defense that travels with the paper.\textsuperscript{269} A usury defense would likely be unusable against a national bank because of \textit{Marquette},\textsuperscript{270} but it could be asserted against purchasers of consumer debt paper from the national bank. Statutory provisions clarifying that usury is a real defense that may always be raised against a claim holder (but to which there may be an affirmative counter-defense of preemption) would impose regulatory costs on secondary-market debt holders, which would have a hydraulic effect of raising the costs of lending at usurious rates for national banks. Likewise, a state could bar certain prepayment penalties or create various requirements for the enforceability of mortgages. By regulating the secondary market, state government can affect changes upstream, in the primary market.

This mode of regulation already exists in other contexts, where it has been extremely effective. The federal government regulates the primary mortgage market by regulating government-sponsored entities (GSEs) like Fannie Mae and Freddie Mac that comprise the bulk of the secondary mortgage market.\textsuperscript{271} When FHFA sets the conforming loan limits or creates other requirements for GSEs, it functionally shapes the primary market because there is a much more limited market for non-conforming mortgages, making them less liquid and potentially less profitable than conforming mortgages.\textsuperscript{272} Thus, when congressional Democrats let GSEs know that they were unhappy with binding mandatory arbitration provisions in mortgages, the GSEs responded by refusing to buy mortgages with binding mandatory arbitration provisions, and these provisions disappeared from the conforming (GSE-purchase eligible) mortgage market almost overnight.\textsuperscript{273} Likewise, the GSEs’ indication that they would not purchase loans that contain certain terms they deem abusive, such as harsh


\textsuperscript{269} See, e.g., JAMES BARR Ames, LYMAN BREWSTER & CHARLES L. MCKEEHAN, THE NEGOTIABLE INSTRUMENTS LAW 149 (1908) (referring to “usury or other statutory real defense”).


\textsuperscript{271} This regulation occurs through the Federal Housing Finance Agency (FHFA) as of July 30, 2008 and was formerly carried out by the Office of Federal Housing Enterprise Oversight (OFHEO). See Federal Housing Finance Regulatory Reform Act of 2008, §§ 1101, 1301-04, Pub. L. No. 110-289, 122 Stat. 2654.

\textsuperscript{272} The very standardization of conforming mortgages adds substantially to their secondary-market value.

Hydraulic regulation is a tool that can be used in any industry that relies on the existence of a secondary market—almost any industry with a wholesale and retail level. It need not be confined to financial services. Consumer goods markets function like a secondary market to manufacturers’ primary market. If a state (or the federal government) wishes to regulate a product, it can (within the scope of its police powers) regulate the manufacturer directly. Jurisdictional issues might be an impediment, however, such as with foreign manufacturers. The state could get around this impediment by regulating at various points downstream of the manufacturer, either by regulating the importers, the retail sellers, or the purchasers of the product, or anyone else in the chain of sale from manufacturer to consumer.275

For example, consider restrictions on leaded gasoline. Gasoline is refined both domestically and abroad. American governmental units have no ability to regulate overseas oil refineries directly. Therefore, when the government decided to ban leaded gasoline, it was necessary to impose a ban on the sale of the gasoline, rather than on its manufacture.276 Banning gas stations’ sale of leaded gasoline had an upstream effect—oil companies stopped producing leaded gasoline.

Likewise, if drivers and passengers are required to wear seatbelts in vehicles, this requirement creates a pressure on automobile manufacturers to produce only vehicles with seatbelts. Hydraulic regulation can also work with positive incentives, not just negative ones. When states offer rebates for recycling aluminum cans, it effectively lowers the cost of purchasing beverages in aluminum cans, which creates an incentive for beverage manufacturers to use aluminum.277

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274 Reiss, supra note 251, at 987. Rating agencies have played a similar role to the GSEs, but without the intention of affecting social welfare. A credit rating by a nationally recognized statistical rating organization like Fitch’s, Moody’s, or Standard & Poor’s is necessary for a securitization trust to be able to issue securities, as the rating is the key to the securities’ offering price. As Reiss has noted, the key position of the rating agencies in the securitization process has given them the power to shape lending regulations—if they are dissatisfied with a regulation, they can simply refuse to rate securities backed by assets subject to the regulations. Id. at 1024-25. The ratings of secondary market securities are thus able to impact the primary market upstream.

275 See, e.g., RESTATEMENT (SECOND) OF TORTS § 402A (1964) (imposing strict liability on all sellers of products that ultimately injure the end consumer).

276 40 C.F.R. § 80.22(b) (2008) (a person cannot “sell, offer for sale, supply, offer for supply, dispense, transport, or introduce into commerce” leaded gasoline, but manufacture or usage is not regulated).

277 Hydraulic regulation also appears in criminal law, where criminalization of consumption markets is used to affect the harder-to-police origination markets. For example, the possession of child pornography (a close proxy for its consumption), abhorrent though it might be, may not by itself harm children. Criminalizing the possession (and thus consumption) of child pornography, however, helps to combat the very harmful production of child pornography, as the increased cost of child pornography may reduce the demand (unless the demand curve is flat), and thereby the incentive to make child
Hydraulic regulation is a process that already exists quite effectively in many areas of the economy. Regulating the secondary market to regulate the primary market is a powerful tool that can be used to bypass jurisdictional obstacles (either legal or practical), including preemption. It can also be a sensible regulatory method when it is more efficient to regulate a small number of secondary market parties (like GSEs) that can be easily monitored than to regulate thousands of dispersed originators. The process of hydraulic regulation is quite familiar—so familiar, indeed, that it has not been recognized as a formally distinct regulatory strategy and alternative to direct regulation. Nor has hydraulic regulation been applied to the question of consumer protection in financial services.

We can generalize these examples and define hydraulic regulation as the regulation of a secondary market that aims to produce a net positive social welfare effect by imposing an externality on a primary market. Thus, not all regulation of the secondary market is hydraulic regulation. Only if the regulation of the secondary market seeks to impose a social-welfare-enhancing externality on the primary market would the regulation be hydraulic.

Notably, a hydraulic regulation aimed at improving consumer protection in financial services imposes a negative externality on the primary market in consumer credit. But this negative externality on the primary market changes incentives in the primary market in such a way that it will have a positive net social benefit. The question in any hydraulic regulation scheme is whether the net social-welfare benefit outweighs the costs from the externality. In the case of consumer credit, this is a question of whether the benefits of greater consumer protection outweigh the costs to financial institutions and any impact on credit availability and cost. This trade-off, of course, will be at the center of any policy debate on consumer credit, but to the extent that states wish to express a preference in the debate, hydraulic regulation is a method that can reinvigorate their role in financial-services consumer protection.

3. Hydraulic Regulation’s Limitation to Consumer Protection

Hydraulic regulation of credit-market consumer protection is inherently limited to laws regulating the terms of consumer debts, because the terms of the debts are the link that channels the market pressure toward the originating institution rather than toward the investors in the secondary market holder. Absent this link, states cannot expect that the result of regulation would be a change in originating market behavior, rather than a lower return to the investors in secondary market purchasers’ securities. Hydraulic regulation must look to the paper, not the institution. This means that hydraulic regulation must

pornography. In theory, at least, criminalization of child pornography possession functions as a hydraulic regulation of the child pornography production market.
Hydraulic Regulation apply irrespective of the originating institution's nature. Therefore, it could not be used to impose general banking regulations, such as capital and liquidity levels of national banks or creating rights to inspect books and records.

Hydraulic regulation offers states an important, but limited, avenue toward the immediate regulation of the consumer debt terms. It creates the possibility of reinvigorating state usury laws and other substantive debt regulations. But it does not open the door to state control over national banks' safety and soundness. As such, it strikes an appropriate balance between states' traditional interest in consumer-protection regulation and federal interests in ensuring the safety and soundness of the national payment and credit systems.

C. The Architecture of Regulatory Capture

Hydraulic regulation could revive states' critical role in consumer protection in banking services. In so doing, it would help solve the regulatory capture problem that has undermined the effectiveness of federal banking regulators.

Architecturally, hydraulic regulation has five key features that help avoid regulatory capture. First, it enlists the energies of normative entrepreneurs like elected officials who are driven to attract the median voter, which makes them less susceptible to regulatory capture. Second, entrusting consumer protection to normative entrepreneurs ensures the spread of successful hydraulic regulations through bandwagon, cascade, and yardsticking effects. Third, this success need spread only to a limited number of jurisdictions for there to be a nationwide effect, because differing states' regulation would create uncertainty about the state of the law, which would in turn limit secondary market liquidity. Fourth, state-by-state hydraulic regulation would produce dispersed targets for regulatory capture and necessitate total or near total capture of all these targets to be effective. Accordingly, capture would be greatly delayed, if not made impossible. And fifth, to the extent that it also permits the enlistment of financial entrepreneurs, like plaintiffs' attorneys, in enforcement, hydraulic regulation further avoids capture.

1. Harnessing Normative Entrepreneurship

Architecturally, hydraulic regulation puts consumer-protection legislation and enforcement in the hands of political figures striving for higher office. This arrangement allows the public choice dynamics of state politics to ensure the enactment and enforcement of hydraulic consumer-protection regulations.

While state banking commissions oversee chartering processes, enforcement authority typically rests in the hands of the attorney general. State attorneys general are elected officials who often harbor ambitions to become
governors or senators.\textsuperscript{278} They have direct political accountability to citizens, unlike federal or state banking regulators. High-profile consumer-protection enforcement, particularly in the context of financial institutions, is frequently a politically popular move that would appeal to attorneys general who aspire to higher office. Moreover, the offices of state attorneys general, unlike most federal and state banking regulatory agencies, are funded by taxpayer revenues rather than bank chartering assessments. These arrangements make attorneys general much more sensitive to electoral concerns and less beholden to financial industry interests than federal regulators.

Because consumer protection is a strong electoral issue, it creates different incentives for vigorous enforcement for state officials than for federal regulatory agencies. Elected officials like state legislators and attorneys general are normative entrepreneurs who seek to promote certain policy norms as part of their political ambitions.\textsuperscript{279} To do so, they strive to appeal to median voters.

Just like middle-class tax breaks, middle-class protections in financial services attract median voters. Consumer protection is a proven method for appealing to median voters, which rewards elected officials' political careers.\textsuperscript{280} Accordingly, elected officials will strive for more stringent consumer protections because of the personal political benefits.

Federal agency normative entrepreneurship, however, is weaker than states' because federal agency enforcement is less politically accountable and there is greater interest group concentration and thus capture risks at the federal level. The particular nature of normative entrepreneurship in state legislative and enforcement processes are especially well-suited for hydraulic regulation. The dynamics of state politics can thus be harnessed to ensure that states would enact and enforce hydraulic consumer-protection laws.

2. Bandwagons, Cascades, and Yardsticks

By placing consumer-protection enforcement in the hands of normative entrepreneurs, hydraulic regulation can take advantage of what Cass Sunstein has termed "norm bandwagons" and "norm cascades."\textsuperscript{281} As Sunstein has explained, "Norm bandwagons occur when small shifts lead to large ones, as

\begin{footnotesize}
\begin{enumerate}
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\item The National Association of Attorneys General is often jocularly referred to as the National Association of Aspiring Governors.
\item An example of this process of normative entrepreneurship can be observed at the federal level in the enactment of the Sarbanes-Oxley Act in the wake of the Enron, WorldCom, and Adelphia scandals. The combination of headline-grabbing corporate scandals and an impending election incentivized Congress to appeal to median voters by enacting corporate governance legislation. See generally William W. Bratton & Joseph A. McCahery, \textit{The Equilibrium Content of Corporate Federalism}, 41 WAKE FOREST L. REV. 619, 667 (2006).
\item Sunstein, \textit{supra} note 279.
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people join the ‘bandwagon’; norm cascades occur when there are rapid shifts in norms.”

Normative entrepreneurs, such as state legislators and attorneys general, are eager to copy successful methods of appealing to median voters from their peers in other states. Thus, if hydraulic regulation is successful in one state, it will likely produce a bandwagon or cascade effect into other states or to other elected officials in the state.

A single successful experiment with consumer protection from a politician in a state can inspire other politicians to do the same, as normative entrepreneurs unhesitatingly copy good ideas. Thus, when Andrew Cuomo succeeded Eliot Spitzer as New York’s Attorney General, he continued Spitzer’s focus on consumer protection in financial services. Spitzer set up the standard by which Cuomo would be judged, but Cuomo was also able to see the political reward (the governorship) that Spitzer reaped from making consumer protection in financial services a hallmark of his tenure as Attorney General. Likewise, states copy other states in such diverse consumer-protection areas as foreclosure moratoria, securities regulations, Internet commerce, environmental protection, and three-strikes laws. The very

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282 Id. at 909.


284 Frederick Tung, Before Competition: Origins of the Internal Affairs Doctrine, 32 J. CORP. L. 33, 92 (2006) (stating that within two years after Kansas enacted the first blue sky law, twenty-three other states followed suit with laws patterned after Kansas’s).


similarity of most state laws speaks to the replicative tendency of normative entrepreneurs in state government. Hydraulic regulation is thus able to harness the power of normative entrepreneurship in state government.

The spread of hydraulic regulations among states could also be spurred on by yardsticking, as voters compare their own protections with those of other states. For example, state sales tax rates are often driven not by what might be an objectively good rate, but by comparison with, and competition with, the rates of neighboring states. Citizens see their tax rates as high or low relative to neighboring states, not relative to an absolute or to a national average. It is not known whether this type of yardsticking extends to non-fiscal matters, such as consumer-protection regulation. In theory, though, a yardsticking effect could create popular demand for a leveling up to neighboring states’ practices.

3. Cost Efficiency of the Highest Common Denominator: Regulatory Costs from Variation in Levels of Regulation

Because of bandwagon and cascade effects, state hydraulic regulation would likely produce a substantially uniformly high level of consumer protection nationwide. To do so would not require uniform law among the states; indeed, uniform law is unlikely even with bandwagon and cascade effects. There is no guarantee that state attorneys general or legislatures would uniformly perform better than federal banking regulators. Not all attorneys general and legislators are likely to see populist consumer protection as outweighing bank campaign contributions, and attorneys general are limited to enforcing the laws enacted by state legislatures. There might not be sufficient motivation or authority for hydraulic consumer-protection regulation to be effective in many states.

For hydraulic regulation to be effective, uniformity is not necessary. Instead, it would merely require a sufficient threshold of states in terms of population to pursue rigorous standards. Any variation in state law applicable to the secondary market would create uncertainty as to which state’s laws

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Massachusetts first enacted its Habitual Criminal Act in 1818. See Note, Attempts to Combat the Habitual Offender, 80 U. PA. L. REV. 565, 566 (1932). By 1842, Connecticut, Maine, Maryland, Michigan, Mississippi, Missouri, New Hampshire, New York, Pennsylvania, Vermont, and Virginia had enacted similar laws. Case of Samuel H. Hopkins, 5 LAW REP. 97 (1842). In 1926, New York enacted a new form of habitual offender legislation that became known as the Baumes Law, which provided for enhanced penalties upon a second conviction and mandatory life imprisonment upon a fourth conviction. Note, Attempts To Combat the Habitual Offender, supra, at 565. Other states followed New York’s example and enacted their own version of the Baumes Law; “[b]y 1939, such statutes were in effect in 43 jurisdictions of the United States.” Note, Court Treatment of General Recidivist Statutes, 48 COLUM. L. REV. 238, 238 (1948).

This is a very real problem for non-real-estate consumer credit products, because consumers can move and because of the vagaries of state choice-of-law laws. The uncertainty caused by variation in law would force secondary market investors either to demand a discount on their investment or, if they could not value the uncertainty within a reasonable range, simply refuse to invest.

Thus, if only a few states enacted hydraulic regulations, it could still have the effect of forcing a nationwide leveling up of standards in the secondary debt market. Originating institutions would therefore find it efficient to level up to the most stringent state's standards, not only because it would increase their access to secondary market liquidity, but also because it would produce economies of scale through uniformity. Thus, when California sought to go above the federal floor for vehicle fuel efficiency standards, it "would have forced the car companies either to sell two separate fleets of vehicles—one for states with the higher standard, one that met the federal standard—or more likely, to achieve the higher standard across all vehicles."290 It appears that many auto manufacturers have chosen to produce only "50-state" cars that meet the California standards, rather than produce both "49-state" cars and "California" cars.291

Reputation pressures could also play a role in encouraging originating institutions to comply with the strictest state's consumer-protection standards nationwide. Not all financial institutions will necessarily want to do so, but to the extent that they do not and their competition does, it could place them at a comparative disadvantage to their competitors, who could advertise that they had "safer" or "cleaner" products.292

There is no certainty in this; competition can forestall voluntary leveling up. For example, with credit cards, competition among issuers is on the basis of

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289 To be sure, this uncertainty would reduce federally chartered financial institutions' welfare. Preemption doctrine is focused on promoting federally chartered financial institutions' welfare, but this emphasis loses sight of the purpose of federally chartered financial institutions—increasing the public's welfare. Banks are but a mere instrumentality for doing so, and to the extent that preemption is contrary to the public interest, it lacks any ultimate justification.


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... teaser interest rates and rewards programs, not the total net cost of the card, which would include other interest rates and fees. The nature of competition in the credit card industry prevents any card issuer from offering a product with transparent total net cost, as it would be priced much higher than the teaser rates and at a tremendous competitive disadvantage.293 Problems in markets' competitive structure could render specific applications of hydraulic regulation ineffective.294 We cannot be sure in the abstract of how hydraulic regulation would affect the overall level of regulation, but it is reasonable to anticipate that it would often result in industry compliance with the highest common denominator effect of state financial institution regulation in a national economy.

4. Avoidance of Capture Through Target Dispersion

The ability of even one or two states to set the standard for the nation is the third architectural benefit of hydraulic regulation. It creates dispersed targets for regulatory capture, which makes capture harder because in order to be effective, there would need to be complete or near complete capture of all the targets. Instead of industry having to capture one federal consumer-protection agency or a handful of banking regulators, there would be fifty state legislatures and attorneys general that would have to be captured.295 At best, this situation presents a permanent bulwark against capture, and at worst it resets the state of capture and significantly delays its reappearance.

5. Avoidance of Capture Through Private Enforcement

While the statutory basis for hydraulic regulation requires the efforts of elected officials, the enforcement of hydraulic regulation does not. Hydraulic regulation could take the form of private rights of action or defenses to claims. Especially if combined with statutory damages and class-action facilitation provisions, hydraulic regulation could be self-executing without state enforcement.

Private enforcement of hydraulic regulation would harness the energies of a different type of entrepreneur—the plaintiffs' bar—to ensure enforcement. While plaintiffs' attorneys' interests are not always aligned with the public interest, the plaintiffs' bar is not subject to industry capture, even if it is subject

293 Credit Cardholders' Hearing, supra note 4, at 117-39 (statement of Adam J. Levitin, Associate Professor of Law, Georgetown Univ. Law Center).
294 Moreover, multiple regulatory equilibria might emerge, with some states adopting a high regulatory standard and others with a low one. While this might cause efficiency losses, as it would impose limits on economies of scale, it would still result in the high-standard states being able to protect their own citizens as they see fit, rather than having lax regulation imposed upon them.
295 See infra text accompanying notes 354-356 regarding choice-of-law issues.
to industry settlement offers. Private enforcement would also increase the effectiveness of hydraulic regulation.

D. The Costs of Hydraulic Regulation

Hydraulic regulation is a regulatory response of the possible, not the perfect. It has a variety of costs that should be taken into account when evaluating it as a policy response to the crisis in consumer protection in the lending industry.

First, hydraulic regulation would impose non-targeted regulatory costs in the form of multiplicity of regulation. While hydraulic regulation aims to impose costs, its purpose is to create costs tied to specific substantive provisions of consumer debt, not general regulatory costs, which might be borne by consumers. Further, duplicative state regulation would waste limited enforcement resources, to the extent that private enforcement must be augmented by state enforcement. For these reasons, hydraulic regulation would not be as efficient as a single federal regulatory agency, although its efficiencies might compare reasonably well to the current spread of federal consumer protection. Even if hydraulic regulation would not be the most efficient regulatory regime, its inefficiencies would have to be considered together with its significant relative benefits.

Hydraulic regulation would also impose costs on the democratic process. With hydraulic regulation, the least protective states would free-ride off the most protective ones, but they would also bear the costs imposed by the most protective ones. Alabama residents might face higher borrowing costs, because national banks would have to absorb costs imposed by the California legislature on the secondary market. From a democratic standpoint, this situation is troubling. Alabama residents should have a voice in the policies that affect them. The undemocratic impact of hydraulic regulation is an important concern about hydraulic regulation, but is also a problem endemic to the federal system that this Article does not claim to resolve. It is worth noting, however, the difference between this problem and that of the exportation of lax or nonexistent usury regulation by Delaware, South Dakota, Utah, and Arizona after Marquette. The extraterritorial usury law problem is a function of federal preemption enabling industry to flock to the laxest regulatory regime. It is not a case of industry moving to a highest-common-denominator regulation to avoid dealing with multiple regulatory regimes.

It is important to note, however, that hydraulic regulation will not affect states in their competition with each other or with federal agencies to issue banking charters. Hydraulic regulation is tied to consumer debts, not to a bank's charter type or location. By focusing the regulation on the debtor and not the lender, hydraulic regulation avoids the charter competition problem. An argument might even be made that hydraulic regulation invites banks to base
themselves in states with more aggressive regulation, as that will increase their leverage in those states to temper the regulation. Thus, while there might be a leveling up in industry standards, it might be tempered by increased political leverage for savvy banks. And for states with parity concerns—that their state-chartered lenders be on equal competitive footing with federally chartered lenders—an exemption for state-chartered banking institutions (but not trusts and general corporations) would be unlikely to seriously undermine the hydraulic effect of the law, since state-chartered banking institutions would be subject to the same market forces as the national banks.

At its core, hydraulic regulation aims to create a negative externality on the origination market through regulating the secondary market. The hope is that this negative externality will induce a change in behavior that will result in a net positive social externality. It is possible, of course, that the externality created by state regulation would result in a net negative externality for social welfare, rather than a net positive externality.

Fortunately, the federal government serves as a check against this danger. If state hydraulic regulation turned out to be negative innovation, there would be political pressure from median voters nationwide for the federal government to squelch the negative state innovation by passing clear preemption legislation. This action is precisely what the federal government did in response to states’ opening their courts to securities law claimants. The federal government reacted to what it saw as negative innovation by passing the Private Securities Litigation Reform Act of 1995,296 the National Securities Markets Improvement Act of 1996,297 and the Securities Litigation Uniform Standards Act of 1998,298 which sharply curtailed state securities law claims.

IV. Is Hydraulic Regulation Viable?

A. Preemption Problems for Hydraulic Regulation

The key challenge for hydraulic regulation is preemption doctrine. Hydraulic regulation is viable only if state regulations are not preempted as applied to non-federally chartered secondary-market consumer debt holders. The preemption danger for hydraulic regulation is twofold: first, that any regulation not of general applicability that has more than an incidental indirect impact on federally chartered financial institutions would be preempted; and second, that any regulation that seeks to have such an effect would be preempted.

1. Impact of the Regulation

Consider a state law that limits the enforceability of debts containing or missing particular terms when in the hands of entities other than national banks or federal thrifts. Such a law would severely limit the secondary market for debts containing this sort of term. Would that regulation frustrate a national bank’s exercise of its powers?

Case law makes clear that state regulations, even if applied to an entity other than a national bank or thrift, cannot impair the bank or thrift’s statutory powers, nor can state regulation force banks to choose among their powers. But as Pacific Capital Bank, N.A. v. Connecticut observes, limiting the number of potential business partners for a bank is not a sufficient impairment of bank powers to trigger preemption. Among the undisputed powers of national banks and thrifts are the power to set the terms under which they originate loans and the power to sell loans into the secondary market.

Whether current case law is correctly decided and cohesive is debatable. But if we accept it as such, it would set the highest threshold for hydraulic regulation to meet, and would allow us to discern some basic principles:

(1) states cannot impair banks’ ability to set the terms of loans;
(2) states cannot impair banks’ ability to sell the loans into the secondary market;
(3) states cannot force banks to choose between setting the terms under which they make loans or selling them into the secondary market.

Accepting current case law, any hydraulic regulation that did any of these would be preempted. So would hydraulic regulation pass this shibboleth?

First, if a limited reading of Watters, Ayotte, and Blumenthal is correct, then we can differentiate between banks’ agents and banks’ counterparties. Hydraulic regulation is of banks’ counterparties, not their agents. Arguably this alone differentiates Ayotte, the State Farm cases, the RAL cases, and the Blumenthal remand issue, and makes hydraulic regulation more like O'Donnell or the Blumenthal dismissal of the bank’s action. Ayotte, the State Farm cases, and the RAL cases can be cabined off by limiting them to regulation of banks’ agents, not banks’ counterparties or counterparties of counterparties (such as regulation of securitization trusts). Regulation of counterparties of counterparties might simply be too far removed from a national bank or thrift.

299 Ayotte, the State Farm cases, the RAL cases, and possibly Blumenthal, on the remand of the banks’ action, support this proposition. See supra Parts II.D.2.a-c.
300 See supra Part II.D.2.a.
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to merit preemption, and the concern over duplicative regulation that animates preemption would not exist in such a case.

But even without the agent/counterparty distinction, hydraulic regulation would not limit the terms under which national banks and thrifts could originate loans or their ability to sell them into the secondary market or force a choice between these powers. By imposing costs on the secondary market keyed to the terms of consumer debt paper, a hydraulic regulation would lower the price that the secondary market would pay for the paper. Even if the regulatory costs were criminal sanctions, like in Pacific Capital Bank, N.A. v. Milgram, however, the secondary market price would not be reduced to zero, because there are certain secondary market purchasers that states cannot regulate—national banks and thrifts. National banks and thrifts are themselves secondary market purchasers, and no matter how draconian a state regulation of the secondary market might be, they would be exempt from it, which means that state regulation could not shut down the secondary market. Accordingly, state hydraulic regulation could impose costs that might constrict the secondary market for consumer debt and thereby lower the resale price of the debt, but they cannot destroy the market.

Hydraulic regulation therefore does not trigger preemption by frustrating national banks’ and thrifts’ power to resell loans into the secondary market. Hydraulic regulation merely constricts the size of the secondary market. This situation is like that in Pacific Capital Bank, N.A. v. Connecticut, where the requirement that RALs be made only in tax preparer offices limited the number of potential business partners for national banks and thrifts, but did not frustrate their ability to issue RALs, and thus did not trigger preemption. The NBA and HOLA and regulations thereunder do not guarantee a robust secondary debt market, much less a price floor for that market.

Because a secondary market would still exist for consumer debts, even with the most extreme regulatory costs, hydraulic regulation would not frustrate national banks’ and thrifts’ power to set the terms under which they originate loans. National banks and thrifts would remain free to originate loans under whatever terms they wanted. Loans containing certain terms would face more restricted secondary markets, but that is no different than the current situation—the resaleability of debt paper always depends on its terms.

Thus, hydraulic regulation would not actually force national banks and thrifts to choose among their powers—they could issue loans on whatever terms they chose, and sell those loans into the secondary market. However, the secondary market for loans containing certain terms would be more restricted, so resale prices might be lower. Even the most severe regulatory costs would make the sale or securitization of debts containing or lacking the regulation’s targeted terms only less profitable. Depending on individual banks’ circumstances, this situation might make it more profitable for the bank to
either keep the loans on its books, or to cease originating loans with the targeted term and enjoy a more robust secondary market.

Hydraulic regulation should not be viewed as an impermissible restraint on national banks’ and thrifts’ powers. It constricts, but does not eliminate, their and other lenders’ resale markets, which merely alters banks’ financial calculus. Regulatory costs that are felt indirectly, through the market, should not be preempted.

2. Intent of the Regulation

Regardless of the actual impact of hydraulic regulation, an argument could be made that its express purpose is to end-run around preemption, and states should not be able to do indirectly what they cannot do directly. This argument misconceives hydraulic regulation. Hydraulic regulation is not an end run around preemption. Instead, it is maximizing state power within what is permitted by preemption doctrine. There are reasons to be concerned about the scope of preemption doctrine in financial services, but until and unless the federal government occupies the field, there are still areas subject to state regulation.

Moreover, there are good, independent reasons irrespective of hydraulic impacts for states to regulate securitization trusts and debt collectors. Consumers choose their lender, but not their lender’s counterparties, so consumers have no control over who ends up owning or servicing their loans, even though this ultimate party can greatly affect the consumer. The traditional relational lending contract protects the consumer through social norms and reputational constraints, which are absent from securitization trusts and debt collectors, who do not contract with consumers and therefore are not concerned about maintaining relationships with them. Securitization trusts and debt collectors will likely be much less constrained in their debt-enforcement and debt-workout behavior than originating institutions. Thus, states have good cause to regulate: to compensate for the loss of the unwritten relational contract elements of a traditional lending relationship.

In any case, the intent of legislation should be irrelevant for preemption analysis. There is no “intention preemption.” The intent behind a state law does not create a conflict between federal and state laws; the laws either conflict or they do not. The intent behind a state law does not determine whether the

305 If there is such a thing as “legislative intent,” it can be very difficult to divine. See, e.g., Frank H. Easterbrook, Text, History, and Structure in Statutory Interpretation, 17 HARV. J. L. & PUB.
federal government occupies a regulatory field. And state legislative intent is irrelevant to determining whether Congress specifically preempted state action. State legislative intent may be relevant for determining the scope of the state law, but the scope of the law and whether it is preempted are separate inquiries.

3. When Hydraulic Regulation Should Be Preempted: A Heuristic

The proper heuristic for preemption analysis of hydraulic regulation is the same one that emerges from banking preemption case law: whether the regulation is being applied to an entity that is under federal regulatory supervision. This could be through direct regulation, formal corporate affiliation (parent/operating subsidiary) or through true agency status (including respondeat superior liability for the principal). Watters, the State Farm Bank cases, and Ayotte all hold that where there is (1) either (a) direct federal regulatory authority or (b) oversight via agency and federal regulation of the principal; plus (2) impairment of a bank or thrift’s powers, there is preemption. Conversely, Capital One, O’Donnell, and Blumenthal indicate that that where there is (1) neither (a) direct federal regulatory authority nor (b) oversight via an agency relationship and federal regulation of the principal; and also (2) no impairment of powers, then there is no preemption. Absent federal regulatory authority over an entity either directly or else indirectly via agency, there is no risk of duplicative and potentially contradictory regulatory regimes, and hence no need for preemption. Likewise, absent impairment of a bank’s...
powers, the burden imposed by state regulation is not sufficient to merit preemption.

This preemption heuristic could be posed in either a weak, formalist form or a strong, realist form. The weak form would simply ask whether there is a federal regulatory agency with direct authority to undertake regulation (and enforcement thereof) equivalent to the one the state passed. The stronger form would further inquire whether the federal agency with authority had established a sufficiently reasonable record of exercising that authority. In either form, the aim of this heuristic is to establish whether preemption would create a regulatory vacuum, either in theory or in practice.

The implications of the heuristic are clear: hydraulic regulations are not preempted as applied to counterparties of federally chartered financial institutions (such as debt purchasers), much less to counterparties of counterparties (as in the case of securitization). Were it otherwise, and preemption were not limited to the run of federal regulatory writ, it would invite the sort of abusive practices that flourish in regulatory vacuums.

4. Hydraulic Regulation in Non-Financial Contexts

Two Supreme Court decisions have both recently rejected two state attempts at hydraulic regulation, albeit not in the banking regulation context. There appear to be reasonable grounds to distinguish both cases, and doing so illuminates some of what is unique about hydraulic regulation in the financial-services context—that the regulation must be tied to the terms of the debt and that hydraulic regulation neither eliminates the secondary market in consumer debt nor makes the origination of such debt unprofitable. Instead, it merely affects the costs of one way of doing business, just like a state tax of general applicability on paper supplies that would get passed up to financial institutions through the market. Such a tax would not prevent a financial institution from using paper, but it would shift its incentive structure and discourage paper usage.

a. Rowe v. New Hampshire Motor Transport Ass’n

In Rowe v. New Hampshire Motor Transport Ass’n,306 the Supreme Court held that a Maine law “To Regulate the Delivery and Sales of Tobacco Products and To Prevent the Sale of Tobacco Products to Minors” was preempted by federal law. Maine wished to keep minors from obtaining tobacco and maintain its tobacco tax base, so it needed to find a way to prevent Internet tobacco sellers from reaching minors and evading taxes. Maine therefore prohibited the sale of tobacco from non-licensed retailers, and

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required licensed retailers to “utilize a delivery service” that provided a “special kind of recipient-verification service.”

Motor carrier associations challenged the Maine law, arguing that it was preempted by the ICC Termination Act of 1995 and the Federal Aviation Administration Authorization Act of 1994. The ICC Termination Act provides that “[A] State ... may not enact or enforce a law ... related to a price, route, or service of any motor carrier ... with respect to the transportation of property.” The district court and court of appeals both found the Maine law preempted, and the Supreme Court unanimously agreed. The Supreme Court dismissed Maine’s argument that the regulation was of the retailer and permissible under its general police power to regulate for public health. Instead, the Supreme Court noted that the effect of the law was to impose a burden on interstate shippers:

The Maine law ... produces the very effect that the federal law sought to avoid, namely, a State's direct substitution of its own governmental commands for “competitive market forces” in determining (to a significant degree) the services that motor carriers will provide.

We concede that the regulation here is less “direct” than it might be, for it tells shippers what to choose rather than carriers what to do. Nonetheless, the effect of the regulation is that carriers will have to offer tobacco delivery services that differ significantly from those that, in the absence of the regulation, the market might dictate. And that being so, “treating sales restrictions and purchase restrictions differently for pre-emption purposes would make no sense.”

Rowe is not supportive of hydraulic regulation, but it can be distinguished from hydraulic regulation of credit markets on several grounds. First, Rowe dealt with an express (or even field) preemption situation, not a case of conflict preemption. There was also a clear policy behind the ICC Termination Act: “helping assure transportation rates, routes, and services that reflect ‘maximum reliance on competitive market forces,’ thereby stimulating ‘efficiency, innovation, and low prices,’ as well as ‘variety’ and ‘quality.’”

There is neither express statutory preemption nor field preemption in banking regulation. Nor can any particular regulatory policy be divined from the National Bank Act of 1863 or the Home Owners Loan Act of 1933. Both Acts were written against a backdrop of state regulatory powers and with the

307 Id. at 993-94.
311 Rowe, 128 S. Ct. at 995.
312 Id. at 995-96 (quoting Engine Mfrs. Ass'n v. S. Coast Air Quality Mgmt. Dist., 541 U.S. 246, 255 (2004) (citation omitted)).
313 Rowe, 128 S. Ct. at 995.
anticipation that state regulatory powers would continue for matters beyond safety and soundness regulation. Therefore, there is a much weaker basis for finding preemption in the banking arena. The preemption comes either from potentially ultra vires federal regulations\textsuperscript{314} or from conflicts with the enabling statutes, but there is a presumption against finding conflict preemption.\textsuperscript{315}

Second, and perhaps most importantly, the mechanics of the regulation in \textit{Rowe} are simply different than in hydraulic regulation as proposed by this Article. In \textit{Rowe}, the regulatory costs were tied to the absence of procedures to verify the age of the tobacco purchasers, rather than a regulation of the tobacco product's quality per se or disclosures about the product's risks. The Maine regulation, translated into banking terms, would make it illegal to enforce a debt if the originator did not engage in a certain type of underwriting, say income verification.\textsuperscript{316} That is a regulation aimed at the actor that originated the debt; it is not tied to the terms of the debt itself or the disclosures about the financial product.\textsuperscript{317} For hydraulic regulation to work, it must be tied to the terms of the debt itself, not the origination process. The difference is important, as it is the difference between consumer-protection and safety-and-soundness regulation. While the former is permitted to the states, the latter is not.

b. Engine Manufacturers Ass’n v. South Coast Air Quality Management District

\textit{Rowe} relied in part on the Supreme Court's earlier decision in \textit{Engine Manufacturers Ass’n v. South Coast Air Quality Management District}.\textsuperscript{318} In \textit{Engine Manufacturers}, the Air Quality Management District, part of the California state government, had prohibited local fleet operators from buying vehicles that did not comply with strict air quality standards. The federal Clean Air Act preempts state and local emissions standards for vehicles, but the District tried to sidestep this preemption by regulating the buyers of the vehicles instead of the manufacturers. The Engine Manufacturers Association sued the District, claiming that the District’s rules were preempted. The district court granted the District summary judgment, on the grounds that the rules affected only the purchase of vehicles and did not compel manufacturers to

\begin{itemize}
  \item \textsuperscript{314} See supra note 118.
  \item \textsuperscript{315} Wyeth v. Levine, No. 06-1249, slip op. at n.3 (U.S. Mar. 4, 2009).
  \item \textsuperscript{316} The equivalent hydraulic regulation would be a prohibition on the sale of cigarettes unless the cigarettes themselves meet certain quality standards. That regulation, however, would not have accomplished what Maine wanted, which was really keeping cigarettes out of part of the downstream market, rather than ensuring a quality product. Had Maine been interested in regulating for quality, it would likely have passed muster with ICC Termination Act preemption.
  \item \textsuperscript{317} Cf. Wyeth v. Levine, No. 06-1249, slip op. at 25 (U.S. Mar. 4, 2009) (upholding state-law failure-to-warn claims for drug labeling over a claim of preemption by FDA labeling requirements).
  \item \textsuperscript{318} 541 U.S. 246 (2004).
\end{itemize}
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take any action. The Ninth Circuit Court of Appeals affirmed on these grounds.

In an 8-1 decision, the Supreme Court found that the District’s rules were preempted, and reversed the circuit court, noting that:

In addition to having no basis in the text of the statute, treating sales restrictions and purchase restrictions differently for pre-emption purposes would make no sense. The manufacturer’s right to sell federally approved vehicles is meaningless in the absence of a purchaser’s right to buy them. It is true that the Fleet Rules at issue here cover only certain purchasers and certain federally certified vehicles, and thus do not eliminate all demand for covered vehicles. But if one State or political subdivision may enact such rules, then so may any other; and the end result would undo Congress’s carefully calibrated regulatory scheme.

Engine Manufacturers is founded on a dubious concern about a slippery slope of regulation. Absent this slippery slope assumption, the Court would have to engage in the analysis proposed in Justice Souter’s dissent, which would require an inquiry into which of the rules being challenged “in fact coerce manufacture and which do not.” The slippery slope assumption not only runs contrary to the standard presumption against finding preemption, but it is also illogical. If enough states were willing to pass such rules, there would be significant pressure for change in federal law. It is hard to imagine a situation in which a majority of states would opt for a different standard, and yet the federal standard would remain unmoved. Therefore, a concern about the collective effect of state regulation seems overstated.

Irrespective of the reasonableness of the Engine Manufacturers slippery slope concern, hydraulic regulation designed to protect consumers in financial services can be differentiated from the vehicle emission standards regulation in Engine Manufacturers. Even assuming the slipperiest slope, with every state imposing an identical regulation on securitization trusts, that would still not coerce the origination of any particular type of debt. Securitization is but a part of the secondary consumer debt market. It is an important part, no doubt, but consumer debts could still be profitably originated without securitization, and there would still be a robust secondary market among federally-chartered institutions trading in the debt amongst themselves. This contrasts with automobile manufacturing. Automobile manufacturers must sell their cars to make a profit. They cannot make money just by building cars. Any regulation that restricts their sale market if they do not comply with certain terms would have a definitive coercive effect. A bank, however, does not need to sell its

320 Engine Mfrs. Ass’n v. S. Coast Air Quality Mgmt. Dist., 309 F.3d 550 (9th Cir. 2002).
321 Engine Mfrs., 541 U.S. at 255.
322 Id. at 256.
debt assets to make a profit. Loans generate income by themselves. Therefore, there is a weaker coercive effect in the banking context, which argues against the presumption made by the *Engine Manufacturers* majority.

*Engine Manufacturers* is also differentiable because it deals with express preemption against the background of a "carefully calibrated regulatory scheme" in the same area—public health. Express preemption does not exist in the bank regulation world, aside from a few specific instances, such as preemption of state usury laws for federal thrifts, and the only "carefully calibrated regulatory scheme" in banking regulation is that for bank safety and soundness, not for consumer protection. When states engage in hydraulic regulation for consumer protection in financial services, they are not trying to go above a floor set by Congress, but are instead operating in an entirely different area.

*Rowe* and *Engine Manufacturers* show that the Supreme Court has been hesitant to embrace hydraulic regulation schemes, but that hesitancy might well depend on the specific nature of the regulation.

**B. Other Potential Obstacles to Hydraulic Regulation**

Preemption doctrine is the most significant potential obstacle for hydraulic regulation, but it is not the only one. Certain features of securitization as well as holder-in-due-course doctrine and the dormant commerce clause also present potential issues.

1. **Securitization of Receivables, Not Accounts**

Some securitizations involve the sale solely of receivables ("flow securitization"), not of the underlying account. The account is retained by the originator. This is the typical method for credit-card securitizations and other types of revolving debt. This arrangement creates a potential problem for hydraulic regulation. If a regulation affects the terms of the account, rather than the terms of the receivable, it would no longer be indirect regulation and would be preempted. Of course, the difference between affecting the terms of a credit card account and the terms of a debt owed on that account is semantic at best. Credit card receivables accrue interest and fees solely per the terms of the account. Affecting the terms of the receivable is impossible without affecting the terms of the account. Traditional preemption doctrine provides the solution, however. State law should be preempted as applied to the account (future debt originations), but not as applied to the receivable (existing debt sold into the

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secondary market). So long as the latter is not preempted, hydraulic regulation will ensure that market pressure will affect the terms of the account itself.

2. Retained Interests in Securitization

Another problem is created when banks retain an interest in the debt they securitize. In many securitizations, the originator retains either a credit-enhancing, interest-only strip or holds the last-out, first-lost tranche in the securitization structure. Additionally, in most credit card securitizations, the originator maintains at least a seven percent undivided interest in the trust. Is this a sufficient interest of a national bank in a securitization trust to place the trust under the aegis of preemption? Federal banking regulations require certain credit-enhancing, interest-only strips to be included in capital adequacy requirements.

The connection between national banks and securitization trusts through retained interests seems too tenuous to engender preemption. A national bank’s interest in a securitization trust that it originates is, as a formal matter, no different than an interest in an asset-backed security that it purchases on the open market or any other security held by a national bank. For example, if a national bank bought a ten percent share of IBM, IBM would not gain preemption protection. Similarly in the O'Donnell rent-a-charter payday lending case, Goleta, the national bank, held less than ten percent of the loans. The same would go for the securitization trust. Neither OCC nor OTS regulations nor case law have yet extended preemption to non-operating affiliates of national banks and thrifts, much less to entities in which the national bank’s or thrift’s ownership interest is insufficient for it to qualify as an affiliate. Were it otherwise, we would see national banks and thrifts being paid to purchase single corporate shares to rent out preemption. Preemption’s limits must be set to be coextensive with the regulatory authority of federal banking regulators and either (1) formal corporate affiliation or (2) true agency status, including respondeat superior liability.

3. National Banks as Securitization Trustees and Servicers

Another potential complication for hydraulic regulation is whether securitization trusts would benefit from preemption when national banks and thrifts serve as securitization trustees or servicers. The special purpose

328 12 U.S.C. § 221a (2006) (defining “affiliate” for NBA purposes as, inter alia, an entity in which a national bank owns or controls, directly or indirectly, over fifty percent of the stock).
vehicle—the entity, typically a trust, which technically purchases the securitized assets from the originator and which issues securities against them—is a legal fiction that exists on paper only. It does not have any true independence in its actions. Instead, the collection of debt assets (accounts receivable) is managed by an agent, called a servicer, and the overall interests of the SPV are guarded by a securitization trustee. The involvement of national banks and thrifts in the securitization process not just as originators, but also as servicers and trustees, raises a different set of preemption questions.

It is hard to see hydraulic regulation as infringing on national banks’ and thrifts’ trust powers—enforcing usury limits or mortgage suitability requirements against securitization trusts does not affect the capacity of national banks and thrifts to serve as trustees for special purpose vehicles. Trustees exercise legal title over trust assets, but they do not actually own the assets. Securitization trustees do not even actively manage the securitized assets. Instead, they are corporate trustees with very limited ministerial duties and little, if any, discretion.

Likewise, it is hard to see hydraulic regulation as infringing on national banks’ and thrifts’ trust powers—enforcing usury limits or mortgage suitability requirements against securitization trusts does not affect the capacity of national banks and thrifts to serve as trustees for special purpose vehicles. Trustees exercise legal title over trust assets, but they do not actually own the assets. A trustee does not carry trust assets and liabilities on its own books. The interests that are being infringed upon by hydraulic regulation are the trust’s, not the trustee’s. Just as a trust does not obtain the tax status of its trustee, so too does it make little sense for the trust to gain the preemption status of its trustee.

Nonetheless, the separation of debt servicing from debt ownership creates a complication for hydraulic regulation schemes. As a result of this separation, consumers almost never know that their debts are held by a securitization trust. The consumers’ contact is with only the servicer, which is often the same entity or part of the same corporate family as the originator. The servicer typically collects in its own name or the name of the originating entity. It almost never collects in the name of the ultimate holder of the debt. Even if the consumer sends payment (and writes a check or directs an electronic funds transfer) to the originator, the payment might go to a lockbox account for the benefit of the ultimate holder. This situation creates a technical problem for hydraulic regulation. If consumers do not know that their debt is being held by an entity that does not benefit from preemption status, it will be hard for them to exercise any rights created under a hydraulic regulation scheme.

Securitization trustees do not even actively manage the securitized assets. Instead, they are corporate trustees with very limited ministerial duties and little, if any, discretion.


See, e.g., Allen v. Scott, 135 N.E. 683, 684-85 (Ohio 1922) ("The power of an agent cannot be greater than that of the principal. This doctrine has the sanction of Holy Writ: ‘The servant is not greater than his Lord; neither is he that is sent greater than he that sent him.’ (John 13:16)").
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The mystery of the holder’s identity could easily be solved by requiring all servicers (or debt collectors in general) to state on all collection notices that they are operating as collection agent for the entity that owns the debt and to disclose the name and legal service address of that entity. The Fair Debt Collection Practices Act specifically allows states to enact more stringent laws,\(^{332}\) and such laws would seem to fit into the OCC’s and OTS’s preemption exceptions for state debt collection laws of general applicability.\(^{333}\)

Federally chartered financial institutions’ activities as securitization trustees and servicers cannot extend the preemption protection to securitization trusts. Preemption does not work like the mummy’s curse, afflicting all who touch the preemption entity.

4. Negotiability and Holder-in-Due-Course Status

The question of the transitive properties of NBA and HOLA preemption raises the question of whether negotiability, another system with transitive properties of immunity, could forestall hydraulic regulation. A holder in due course ("HDC") of a debt instrument is immune from certain “personal” claims and defenses that can be raised only against the originator of the negotiable instrument.\(^{334}\) HDCs are still subject to “real” defenses. Traditionally, personal defenses were limited to breach of contract, fraud in the inducement, voidability due to illegality (including usury and other consumer-protection laws) or mental defect, discharge of an instrument by payment or cancellation, and ordinary duress or undue influence.\(^{335}\) Real defenses include infancy, mental incapacity, illegality, duress, bankruptcy discharge, fraud in the inception, forgery, and material alteration.\(^{336}\)

The Uniform Commercial Code limits HDC protection to good faith purchasers of negotiable instruments.\(^{337}\) Would good faith purchasers of debts originated by national banks and thrifts be protected as HDCs from claims of illegality due to loan terms that violated state laws?

A negotiable instrument must include an unconditional promise or order to pay a fixed amount of money.\(^{338}\) It must be payable to bearer or order at the


\(^{334}\) U.C.C. § 3-305 (2005).


\(^{336}\) Id.

\(^{337}\) U.C.C. § 3-302 (2005) (stating that a HDC must hold a negotiable note, properly endorsed, that it took for value in good faith without notice of defects). For a consideration of expanded definitions of negotiability to match commercial realities, see Levitin, supra note 335, at 166-75.

\(^{338}\) U.C.C. § 3-104(a) (2005).
time of issue or when it first comes into possession of a holder.\(^{339}\) It must also be payable on demand or at a definite time, and it may not state any other undertaking or instruction by the person promising or ordering payment with some express qualifications.\(^{340}\) As Ronald Mann has shown, however, virtually no modern consumer credit instruments fit this definition of negotiability.\(^{341}\) Moreover, notes for purchases of goods and services, such as purchase money automobile loans, are subject to the FTC's HDC Rule, which cuts off HDC status for loan assignees.\(^{342}\) There is no equivalent legal prohibition against HDC status for mortgage and credit card debt, but the debt instruments for these types of loans do not typically meet the requirements for negotiability.\(^{343}\) To be sure, some instruments like credit card slips could easily be altered to be negotiable, but it would be at the expense of increased fraud risk.

Although, as Mann has shown, GSE-conforming mortgage notes do not meet the requirements of negotiability, most courts routinely hold mortgage notes to be negotiable,\(^{344}\) and, for mortgages, HDC status appears to shield securitization trusts from most litigation over predatory loan terms.\(^{345}\) Yet, even if and when HDC status is available to assignees of consumer debts, it shields them only from those defenses specified by state law. States are free to define what claims and defenses are good against an HDC,\(^{346}\) and in some states usury

\(^{339}\) \textit{Id.} § 3-104(a)(1) (2005).

\(^{340}\) \textit{Id.} § 3-104(a)(2)-(3) (2005). A negotiable instrument may contain “(i) an undertaking or power to give, maintain, or protect collateral to secure payment, (ii) an authorization or power to the holder to confess judgment or realize on or dispose of collateral, or (iii) a waiver of the benefit of any law intended for the advantage or protection of an obligor.” \textit{Id.} § 3-104(a)(3) (2005).


\(^{342}\) FTC Preservation of Consumers' Claims and Defenses Rule, 16 C.F.R. § 433.2(a) (2008).

\(^{343}\) Mann, \textit{supra} note 341, at 963-65 (credit cards), 970-73 (mortgages). Notably, courts routinely hold mortgage notes to be negotiable instruments (often with no inquiry into the subject).


\(^{345}\) Engel & McCoy, \textit{supra} note 8, at 2041. \textit{See also} Kurt Eggert, \textit{Held Up in Due Course: Predatory Lending, Securitization, and the Holder in Due Course Doctrine}, 35 CREIGHTON L. REV. 503 (2002).

\(^{346}\) For certain mortgage debts, state and federal law already creates explicit assignee liability. The federal Home Ownership and Equity Protection Act (HOEPA) provides that assignees of covered mortgage loans are subject to all claims and defenses the consumer could assert against the originator. HOEPA assignee liability, however, applies only to a very limited body of mortgages. HOEPA applies only to refinances. \textit{See 12 C.F.R.} § 226.32(a)(2) (2008) (stating that HOEPA does not apply to “residential mortgage transaction[s],” “reverse mortgage transaction[s],” or “open-end credit plan[s]”); \textit{see also} 15 U.S.C. §§ 1602(i), (w), (bb) (2006) (defining these three terms so that “residential mortgage transaction” includes any purchase-money mortgage transaction, “reverse mortgage transaction” includes typical reverse mortgages, and “open-end credit plan” includes typical home equity lines of credit). Even for refinances, HOEPA only applies if: (1) the annual percentage rate at origination is greater than the yield of Treasury securities of comparable maturity plus either eight percent (for first-lien loans); or (2) total fees and points exceed eight percent of the greater of the total loan amount or $400. 15 U.S.C. §§ 1602(aa)(1)-(aa)(4) (2006); 12 C.F.R. §§ 226.32(a)(1) (2008). As a result, HOEPA covers at most five percent of subprime, first-lien home mortgage loans and does not cover the prime or Alt-A markets at all. Engel & McCoy, \textit{supra} note 8, at 2053. State assignee
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was historically a real defense that traveled with a claim.\textsuperscript{347} HDC status is an obstacle to effective hydraulic regulation, especially in the mortgage market, but not an insurmountable one.

5. Dormant Commerce Clause Issues

The use of state consumer-protection laws for hydraulic regulation might also face dormant commerce clause challenges, as the regulations would have extraterritorial effects.\textsuperscript{348} Yet, the Supreme Court has given states considerable leeway in the face of commerce clause challenges, where state laws do not overtly discriminate against interstate commerce,\textsuperscript{349} and existing state consumer-protection laws have failed to apply to national banks and thrifts only because of specific preemption statutes (or regulations), not because of commerce clause issues.

Most likely, the dormant commerce clause issues involved in hydraulic regulation would have to be decided on a case-by-case basis; it is extremely unlikely that hydraulic regulation is per se an overreaching extraterritorial maneuver. Instead, the constitutionality will depend heavily on the specifics of the regulation.

The uncertainty regarding the constitutionality of a hydraulic regulation is itself sufficient for the regulation to have its intended effect. A regulation is presumptively constitutional unless ruled otherwise; unless it is challenged, the regulation stands. Ratings agencies, underwriters, and investors will shy away from any consumer debt that would be devalued if a hydraulic regulation \textit{might}

liability laws often go further than HOEPA and prohibit specific abusive terms in mortgages, although these are often preempted. Raphael W. Bostic et al., \textit{The Impact of State Anti-Predatory Lending Laws: Policy Implications and Insights} (Harvard Univ. Joint Ctr. for Hous. Studies, Report No. UCC08-9, 2008), available at http://www.jchs.harvard.edu/publications/finance/understanding_consumer_credit/papers/ucc08-9_bostic_et_al.pdf. HDC status is an obstacle to effective hydraulic regulation, especially in the mortgage market, but not an insurmountable one.

\textsuperscript{347} See, e.g., Andrews v. Martin, 436 S.W.2d 285 (Ark. 1969); Lucas v. Beco Homes, Inc., 494 S.W.2d 417 (Mo. Ct. App. 1973); see also Ames, Brewster & McKeehan, supra note 269, at 149 (referring to "usury or other statutory real defense"); James Matlock Ogden, \textit{The Law of Negotiable Instruments} 160 (2d ed. 1922).


\textsuperscript{349} See Dept’ of Revenue v. Davis, 128 S. Ct. 1801, 1808 (2008) (upholding Kentucky law that excluded from taxation interest from in-state municipal bonds and noting that absent discrimination for a forbidden purpose, state laws “will be upheld unless the burden imposed on [interstate] commerce is clearly excessive in relation to the putative local benefits.”) (citing Pike v. Bruce Church, 397 U.S. 137, 142 (1970)); United Haulers Ass’n v. Oneida-Herkimer Solid Waste Mgmt. Auth., 127 S. Ct. 1786, 1796 (2007) (“[W]e should be particularly hesitant to interfere with [traditional local government functions] under the guise of the Commerce Clause.”); Minn. v. Clover Leaf Creamery Co., 449 U.S. 456 (1981) (reversing injunction against enforcement of Minnesota law that banned the retail sale of milk in plastic nonreturnable, nonrefillable containers); Exxon Corp. v. Governor of Md., 437 U.S. 117 (1978) (upholding Maryland statute prohibiting producers or refiners of petroleum products from operating retail service stations within the state, and requiring producers or refiners to extend voluntary price reductions uniformly to all service stations supplied).
apply. The mere possibility that a hydraulic regulation could apply is sufficient to impose an externality on the primary market in the form of lower-rated secondary-market securities that make securitization a less-profitable and less-efficient funding mechanism.350

C. Can Banks Structure Around Hydraulic Regulations?

Hydraulic regulation depends on the formalities necessary to maintain a secondary market in consumer debt. Absent these formalities, state regulations that affect national banks through the market might be preempted. This fact raises a serious concern that hydraulic regulation could be vitiated by clever transaction structuring or contractual choice of law.

1. Transaction Structuring

It is entirely possible that a transactional end run around hydraulic regulation could be devised; bank attorneys would have an incentive to do so. But structuring around hydraulic regulation would have its own costs, which might dissuade banks from engaging in abusive practices, particularly at the margin.

A potential end run around hydraulic regulation would be the use of “covered bonds.” In the basic covered-bond transaction (upon which many variations can exist), a national bank or thrift sells bonds, secured by a pool of mortgage loans (or other assets), to an SPV. The SPV then issues securities backed by the bonds. Covered-bond transactions thus substitute a sale of assets to the SPV with a sale of asset-backed securities. Crucially, the mortgage loans remain as assets on the national bank’s balance sheet, so they will be sheltered by preemption doctrine.

Covered bonds lower the cost of funds for a national bank relative to the general issuance of unsecured bonds, because in the event of the bank’s insolvency, the SPV’s claim on the bank’s assets would come ahead of both insured depositors’ claims and general unsecured debt claims, like unsecured bonds.351 The FDIC would also exempt covered bonds from the Federal Depository Insurance Act’s conservancy/receivership stay.352 Therefore, in the event of the bank’s insolvency, the SPV’s trustee could seize the bonds’ collateral (the mortgage loans) and continue to make payments to the SPV’s own bond investors.

350 There might also be a Contracts Clause problem, at least for the initial round of hydraulic regulations, to the extent that they apply new regulations to void existing contracts.
There is a cost to issuing covered bonds, however, as they must remain on the bank’s balance sheet, increasing the bank’s capital requirements and thus reducing its lending capacity.\textsuperscript{353} It also means (unless the bonds are nonrecourse) that the bank will be responsible for any deficiency in the collateral securing the covered bonds. If the collateral is a pool of loans, then a decline in the loan pool’s value, such as from high default rates, would create a potential deficiency in the event of a default and seizure. This possibility will in turn encourage the bank to engage in more careful underwriting and servicing, which, although good from a social policy perspective, will further limit the bank’s lending activity and impose additional costs on the bank. The tradeoff involved with covered bonds is illustrative of the costs involved with structuring consumer finance around hydraulic regulation. While hydraulic regulation may not be able to prevent all abusive consumer debt practices, by adding costs to such practices it will help prevent those practices that are only marginally profitable.

Structural avoidance of hydraulic regulation is also unlikely to happen immediately, which could potentially reset the calculus of abusive consumer debt practices. The non-immediacy of a transactional countermove to hydraulic regulation is quite important. Imagine that it takes two years for a solution to be devised and another few years before financial markets feel sufficiently comfortable that they have uncovered all the risks and costs inherent in the new transactional structure. During this entire time period, hydraulic regulation would be effective, and various abusive terms would largely disappear from consumer debts.

Once abusive terms have disappeared from consumer debts, it will be difficult for banks to reintroduce them without incurring reputational hits. Because of past experience with certain abusive consumer debt terms, consumer advocates and consumers themselves will be more alert to their reintroduction following an absence, making it harder for the terms to be reintroduced into the market without objection.

In particular, first movers at reintroducing abusive terms will be at a disadvantage, and competition could develop among banks on the basis of consumer-friendly terms. For example, if bank $X$ is the first to reintroduce a problematic term into its contracts, it might receive negative media attention, whereas once bank $X$ breaks that barrier, subsequent banks to do so will attract less attention. This creates a disincentive to be a first-mover in negative re-innovation. Further, if banks are able to operate profitably without abusive

\textsuperscript{353} Covered bonds are widely used instead of securitization in European mortgage financings, but European banking regulation has much looser capital requirements than American banking regulation, so the cost to banks of keeping loan assets on the balance sheet is much lower in Europe than in America. Other factors, like the level of deposit insurance and the percentage of mortgage loans that are adjustable rate or have high prepayment penalties, also affect the ability to issue covered bonds.
terms in consumer debts, political arguments that these terms are necessary for their viability will be undercut.

Banks can structure around hydraulic regulation, but it will come at a cost, and that cost is precisely what might deter banks from insisting on the offensive terms targeted by hydraulic regulations.


Alternatively, banks might attempt to avoid hydraulic regulation through contractual choice-of-law provisions. Potentially, banks could fix the law governing their loans to be that of states that would not pass consumer-friendly regulations. This outcome is what banks have effectively achieved by moving lending operations to states without usury caps to take advantage of Marquette's choice-of-law ruling.354

Whether this endeavor would be successful would, of course, depend on individual states' choice-of-law analysis. While contractual choice-of-law provisions are generally respected,355 the degree to which choice-of-law provisions can be used to opt out of state consumer-protection law is unsettled.356 Courts might be reluctant to allow consumers to waive their states' explicit consumer-protection laws, and at least for mortgages, the law of the state in which the mortgaged property is located will be applied, as foreclosure procedures are all a function of state law. While application of local laws would frustrate the race-to-the-top benefit of hydraulic regulation, it would still allow states to protect their own citizens, which is more than they can do today.

3. Opting Out of Specific State Markets

Finally, banks could simply opt out of specific state markets to avoid hydraulic regulation. If states A, B, and C were the leaders in hydraulic consumer-protection regulation, banks could refuse to lend in those states. Therefore, these states would have no ability to regulate securitization trusts (other than those indentured in the states).

As a practical matter, an opt-out strategy might not work. Although loan offers might proclaim "offer not valid in states A, B, and C," banks lack control over the location of the borrower after the loan is made. This fact is especially true for unsecured loans like credit cards and student loans. A consumer could maintain a mailing address in Texarkana, Texas, but reside in Texarkana,

354 See supra text accompanying notes 53-58.
Arkansas. So long as the billing address does not change, the lender has little ability to control in which market it is making the loan. For secured loans, such as home mortgages and automobile loans, the lender has greater control, as the loan is based around property that is either in a fixed location or that must be registered in a specific state. Thus, a lender could provide that an automobile loan would terminate and accelerate upon a change in state of vehicle registration, but that would likely not be enough to keep the lender out of the new market because states allow a grace period to new residents to change vehicle registration.

   Even if banks could make each state market a hermetically sealed affair, opting out of some markets would itself impose a cost on banks and thus might not be practical as a business matter. Although national banks could viably refuse to lend in smaller states, it would be much harder for them to opt out of populous states with strong consumer-protection traditions like California, New York, New Jersey, Illinois, and Massachusetts. California in particular has a tradition of progressive consumer-protection regulation and its economic output constitutes approximately thirteen percent of U.S. GDP. Refusing to lend in California is simply not viable for national lenders. Banks can limit their exposure to hydraulic regulation by opting-out of specific state markets, but it would come at a cost, and as with transaction structure, that cost is precisely what might deter banks from insisting on the offensive terms targeted by hydraulic regulations.

V. Conclusion

   The ongoing mortgage crisis has shown there to be a serious failing in consumer protection in financial services. While the failing is substantive, it stems from the architecture of regulation. Revitalizing the role of states in financial-services consumer protection is one major architectural solution. Unlike the creation of a new federal financial-services consumer-protection agency or the consolidation of consumer protection in an existing federal agency, a revitalized role for the states is immediately possible without any federal legislation and poses less risk of regulatory capture. Changes in the consumer finance market have placed the majority of consumer debt in the hands of entities that should not be not shielded from state regulation under a proper interpretation of current federal preemption doctrine. This change permits states to regulate the secondary market, which holds the bulk of consumer debt, directly. It also enables indirect, hydraulic regulation upstream

357 The residents of these states would still gain the consumer protection intended by the regulation, although it would come at the cost of less competition in the states’ credit markets and potentially less credit availability or higher credit cost.
of the preemption-shielded primary market by imposing targeted regulatory costs on the secondary market that will be passed along by market pressure to the primary market and thus create a disincentive to originate consumer debts containing the targeted terms.

Although the process of hydraulic regulation has not previously been recognized as a distinct regulatory strategy, it already exists as an effective regulatory tool in numerous markets, where it is used either as a method of avoiding legal and practical jurisdictional limitations on regulation or to increase the administrability of regulatory schemes. Applied to the financial-services market, hydraulic regulation would provide an important tool for correcting the consumer-protection problems created by regulatory capture and the unique deregulatory competition among banking regulators. Hydraulic regulation would enable states to regulate national banks effectively for consumer-protection purposes without running afoul of federal preemption doctrine.

To be sure, hydraulic regulation by the states would not solve all consumer-protection problems in financial services, and regulation would remain largely reactive. States could not analyze and license new financial products before their introduction into the market in the way a federal agency perhaps could do. The different regulatory models presented by hydraulic regulation or a federal financial-services consumer-protection agency both present trade-offs. A single federal regulator is more susceptible to regulatory capture but can pool resources and would speak in a single voice, creating clear standards for industry behavior. State regulation is less susceptible to total capture, but this benefit comes at the price of forcing businesses to deal with fifty sets of (potentially conflicting) regulations and unnecessary duplication of limited consumer-protection resources. These regulatory models are not necessarily exclusive, but in practice they would likely be difficult to integrate, and the benefits for simultaneous state and federal regulation might not outweigh the costs.

However one views the federal-state trade-off in the abstract, though, it is necessary to recognize that both are not equally available options. Regulatory architecture is a matter not just of ideals, but also of the practical and the possible. For all of its merits, the creation of a federal financial-services consumer-protection regulatory agency would require considerable political action in Congress, and, even then, its efficacy would depend heavily on the precise authority given to it. Hydraulic regulation is the immediately available solution that is limited only by whatever substantive terms states require or prohibit in consumer debts. It does not require the two levels of political action—regulatory authorization and subsequent substantive regulation—necessary for a federal solution.

The interlinked mortgage and credit crises have shown the need for a serious consideration of the best way to ensure strong consumer protection in
financial services, both for its own merits and because of its implications for systemic risk. 359 Hydraulic regulation offers a reinvigorated role for states that would restore the balance between the twin financial-institution regulation policy goals of consumer protection and the safety and soundness of banks without the creation of new agencies or administrative structures.

Postscript

As this Article goes to press, the Supreme Court is deliberating Cuomo v. The Clearinghouse Association LLC, which poses the question of whether the OCC has sole authority to enforce state laws of general applicability against national banks. If the OCC’s claim is upheld, states will have lost any vestige of direct regulatory control over national banks, and hydraulic regulation will be the last possible route for state consumer-protection regulation in financial services.
