THE ECONOMIC IMPACT OF ELIMINATING PREEMPTION OF STATE CONSUMER PROTECTION LAWS

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INTRODUCTION

In July 2009, the Obama Administration proposed legislation that would create a Consumer Financial Protection Agency ("CFPA"). Among other items, the proposed legislation would eliminate federal preemption of state consumer protection laws, which would encourage states to reintroduce a scattering of local rules and regulations. Federal rules promulgated by the newly created Consumer Financial Protection Agency would override "weaker" state laws, but the states would be free to adopt "stricter" laws. The National Bank Act ("NBA") and the Home Owners' Loan Act ("HOLA") would be amended to apply state consumer protection laws to national banks and federally chartered savings institutions. In addition, the NBA and HOLA would be amended to provide that their respective "visitorial" provisions would not prevent a state Attorney General's enforcement of federal or state law.

The legislation is an outgrowth of a recent—though largely non-economic—literature linking preemption to much of what ails the U.S. banking industry, including the subprime mortgage crisis. In Part I of this report, we briefly review the preemption debate, beginning with the passage of the National Bank Act of 1864. A review of the Supreme Court's decisions in preemption cases reveals that the Court has, based on statute and legal precedent, both implicitly and explicitly promoted economic efficiency through preemption. Through such rulings, the Court

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reduced local state efforts to erect barriers to competition, the denial of which increased consumer welfare and economic efficiency.

Next, we review the economic case for and against preemption. When preemption is considered from an economic efficiency standpoint, its merits become apparent. We review the literature supporting the OCC's regulatory policy. We also provide data showing that the overwhelming majority of subprime mortgage loans were originated by companies that were not subject to preemption, further undermining the argument that preemption is to blame for the subprime crisis. Our findings are corroborated by a recent white paper issued by the Treasury, noting that 94% of "high-priced loans" to "lower income borrowers" were originated by lenders not covered by the Community Reinvestment Act. Finally, we review the arguments put forward by critics of preemption. The arguments against preemption are generally characterized by a failure to consider the economic benefits of preemption and a lack of empirical validation.

In Part II, we analyze the economic benefits of preemption using examples from actual OCC interventions, academic studies, and case studies from industries with similar regulatory situations. We identify four specific economic benefits of preemption. First, preemption eliminates state-sponsored protectionism. We review the OCC's record of intervening to ensure that states do not protect local industries from out-of-state banks at the expense of consumers. For example, in 1993, the OCC issued an interpretive letter finding that a Connecticut law prohibiting national banks from selling annuities in Connecticut was preempted by the National Bank Act; in 1996, the OCC issued an interpretive letter concluding that a Texas state law restricting national banks' ability to sell annuities in the state was preempted by the National Bank Act; and in 2001, the OCC issued an interpretive letter finding that a Florida law prohibiting out-of-state banks from operating ATMs in the state was inconsistent with the National Bank Act and therefore preempted. Each of these actions facilitated increased price competition and increased availability of financial services for local consumers, despite efforts by entrenched local political interests to avoid increased competition.

Second, preemption increases the availability of credit while reducing its price. Preemption limits the ability of states to impose price controls. Price controls ultimately decrease the level and quality of banking services to consumers, increase prices, and inhibit economic growth. For example, in 2002, municipal ordinances in San Francisco and Santa Monica that prohibited banks from charging ATM fees to non-depositors were held to be preempted by the courts. This action increased consumer choice and decreased the price for ATM services. Preemption also removes obstacles to the creation of national credit markets.

Third, preemption creates a uniform regulatory climate for banks operating across state lines, allowing them to operate more efficiently. A review of the economic literature on state regulation of banks reveals that reducing barriers to bank services across state lines increases economic efficiency and social welfare.

A centralized regulatory regime is especially important in industries that are characterized by economies of scale, such as banking. In Part III, we present two case studies illustrating the benefits of imposing uniform regulatory standards in other U.S. industries: the wine industry and wireless telephony. Several states erected barriers to out-of-state wineries directly shipping their goods ordered online or over the phone to consumers without similar restrictions for in-state wineries; these barriers were overturned by the Supreme Court in 2005, creating what economists call a "natural experiment" designed to test the consumer-welfare effects of the state regulations. Economic research reveals that, soon after states' discriminatory regulations were repealed, wine prices at brick-and-mortar stores declined up to 40% relative to prices offered by online retailers. A similar episode occurred in the U.S. wireless industry. Before 1994, states and the federal government had concurrent power to regulate wireless services; in 1994, the Federal Communications Commission preempted the state laws regulating wireless telephony. Once again, economic research demonstrated that the change in regulatory oversight toward uniform, national standards increased economic efficiency. Before deregulation, consumers in states that regulated wireless telephony, such as California and New York, paid more. Furthermore, state regulations discouraged wireless providers from entering the market and slowed consumer adoption of cellular phones. Just as balkanized state laws hindered the growth of wireless networks and raised cellular prices for everyone, balkanized state branching laws inhibited the growth of ATM networks and bank branches, raising the cost of credit and banking services for consumers.

In Part IV, we offer two concrete policy implications that flow from our empirical findings. First, elimination of preemption would jeopardize the significant economic benefits created by a uniform regulatory environment. A careful review of the evidence indicates that preemption has been an important policy tool for opening up markets and increasing competition, benefiting both banks and their customers. Without preemption, there would be no federal check on state regulators and legislatures who may be swayed by local business or political interests and costly local protectionist measures would proliferate. Second, with preemption, policymakers can focus on creating new unified rules to better serve consumers and prevent the problems that led to the recent crisis from repeating themselves in the future. Preemption was not responsible for the consumer-protection failures associated with predatory lending and the subprime crisis and preemption does not preclude the Federal government from taking action to avoid repetition of the crisis. The gaps in regulation identified in the recent crisis can be plugged with more stringent federal rules that preserve a uniform (and rigorous) regulatory environment.

I. THE PREEMPTION DEBATE

The dual banking system of the United States divides the regulation of banks between the states and the federal government. Prior to the passage of the National Currency Act of 1863, private banks were exclusively state-chartered. But since the 1860s, banks have had the option of choosing whether to be state-chartered or nationally chartered.[1] Congress created this system during the Civil War by the National Currency Act, which was subsequently modified and reenacted as the National Bank Act of 1864 ("NBA").[2]

Under the NBA, the Office of the Comptroller of the Currency ("OCC"), a bureau within the Treasury Department, has the authority to charter and supervise all national banks.[3] In addition, the NBA vests broad rulemaking authority in the OCC.[4] An important issue throughout the history of the OCC has been the interplay between federal and state law with respect to the regulation and supervision of national banks.

This section briefly reviews the treatment of preemption by the judiciary. A review of the Supreme Court's decisions in preemption cases reveals that the Court has, based on statute and legal precedent, both implicitly and explicitly promoted economic efficiency through preemption. Through these rulings, the Court reduced state regulators' ability to manipulate the banking industry, and thereby increased the economic efficiency of the nation overall.

A. The roots of preemption of state laws in the banking industry

The Supreme Court and lower federal courts have determined that the National Bank Act and the associated regulations of the OCC preempt state laws. Federally chartered savings associations are also considered federal instrumentalities, and the congressional enactment authorizing the establishment of these institutions also has preemptive effect.

1. Hal. S. Scott, *What is the Proper Role of the States in Financial Regulation? in* FEDERALISM AND FINANCIAL REGULATION IN FEDERAL PREEMPTION: STATES' POWERS, NATIONAL INTERESTS 139 (Richard A. Epstein & Michael S. Greve eds., 2007).

2. *Id.*

3. *Id.*

4. *Id.*

1. National banks

The roots of the preemption doctrine may be found in the Supremacy Clause of the U.S. Constitution, which states that the Constitution and laws of the United States are the "Supreme Law" of the land, notwithstanding anything in the Constitution or laws of the States to the contrary.[5] This clause was the basis for the landmark 1819 Supreme Court decision in *McCulloch v. Maryland*, establishing the principle that state law cannot stand as an obstacle to the accomplishment of federal legislative goals, in that case by a state's attempt to tax the Bank of the United States.[6]

Over the years since that decision, the Supreme Court and lower federal courts have frequently determined that the National Bank Act and the implementing regulations of the OCC preempt state laws. For example, in 1874, just a few years after Congress adopted the National Bank Act, in *Tiffany v. National Bank of Missouri*, the Supreme Court stated,

> National banks have been national favorites. They were established for the purpose, in part, of providing a currency for the whole country, and in part to create a market for the loans of the General government. It could not have been intended, therefore, to expose them to the hazard of unfriendly legislation by the States, or to ruinous competition with State banks.[7]

More recent cases have affirmed the preemptive effect of the National Bank Act and OCC regulations. In *Franklin National Bank v. New York*, the Supreme Court held that a state could not prohibit a national bank from using the word "savings" in its advertising, since the state law conflicts with the power of national banks to accept savings deposits.[8] In *Marquette National Bank v. First of Omaha Corporation*, the Supreme Court held that under the National Bank Act, a national bank may charge a rate of interest permitted in the bank's home state, even if the loan is made through the use of a credit card to a customer residing in a different state with a lower usury limit.[9] In *Barnett Bank v. Nelson*, the Supreme Court summarized the preemption doctrine, explaining that a state law cannot "stand as an obstacle to the accomplishment" of the purposes of a federal law, such as the National Bank Act.[10] The Court also held that Congress would not want a state to "forbid, or to impair significantly, the exercise of a power that Congress has explicitly granted."[11] On the other hand, the Court stated

5. U.S. CONST. art. VI, cl. 2.
6. McCulloch v. Maryland, 17 U.S. 316 (1819).
7. Tiffany v. Nat'l Bank of Missouri, 85 U.S. 409, 413 (1874).
8. Franklin Nat'l Bank v. New York, 347 U.S. 373, 378-9 (1954).
9. Marquette Nat'l Bank v. First of Omaha Corp., 439 U.S. 299, 301 (1978).
10. Barnett Bank v. Nelson, 517 U.S. 25, 31 (1996).
11. *Id.* at 33.

that the states have the power to adopt laws that do not "significantly interfere" with national bank powers.[12] More recent Supreme Court cases have continued to follow these precedents with respect to substantive state requirements.[13] However, in 2009, the Court held that the National Bank Act does not preclude the ability of a state attorney general to bring an action in court to enforce applicable state or federal law against a national bank or its subsidiary.[14]

2. Federal savings associations

Federally chartered savings associations are also considered federal instrumentalities, and the congressional enactment authorizing the establishment of these institutions has preemptive effect. In 1982, in the case of *Fidelity Federal Savings and Loan Association v. De la Cuesta*, the Supreme Court held that both the statute and the implementing regulations of the Federal Home Loan Bank Board (the predecessor agency to the Office of Thrift Supervision) preempt conflicting state laws.[15] Specifically, the Court held that Board's due-on-sale regulation preempted conflicting state limitations on the due-on-sale practices of federal savings and loan associations.[16]

A due-on-sale clause is a common provision in a mortgage contract that gives the lender the right to declare the entire mortgage loan due and payable upon the sale of the home. In the early 1980s, when interest rates soared to extremely high levels, it became difficult to sell a home without a sharp discount in the sales price, merely because of the cost of financing the home with a new loan.[17] California courts at that time ruled that the economic situation made due-on-sale clauses unreasonable under California law, and therefore void, provided the creditworthiness of the new owner was acceptable to the lender.[18] However, while these actions helped the current homeowner sell his or her home for a higher price, it also added significant losses for the savings association lender, since the

12. *Id.*

13. *See, e.g.*, Watters v. Wachovia, 550 U.S. 1, 7 (2007) (holding that national banks and their operating subsidiaries are not required to register under state mortgage licensing law).

14. Cuomo v. Clearing House Ass'n, 129 S. Ct. 2710, 2722 (2009).

15. Fidelity Fed. Savings and Loan Ass'n v. De la Cuesta, 458 U.S. 141, 170 (1982).

16. *Id.*

17. *See, e.g.*, Federal Housing Finance Association, Housing Prices Continue to Grow at Healthy Rates, Figure 1: Real Gross Domestic Product and the OFHEO HPI Since 1975, *available at* http://www.fhfa.gov/webfiles/1066/Focus1Q02.pdf (showing that the real house price index declined in the early 1980s)).

18. *See, e.g.*, Wellenkamp v. Bank of America, 582 P.2d 970, (Cal. 1978) (holding that state chartered banks and savings and loan associations and other mortgage lenders were forbidden from making mortgages due on sale).

savings association had to pay market rates to fund the loan but was receiving a below market rate as long as the mortgage was outstanding.

The Federal Home Loan Bank Board recognized the safety and soundness implications of the California decision and issued a regulation preempting state laws (including judicial interpretations) that prevented federal savings associations from exercising due-on-sale provisions in existing mortgage contracts. In *De la Cuesta*, the Supreme Court affirmed the preemptive effect of this regulation.

From a policy perspective, this case illustrates the potential risks associated with imbalances between federal and state law. The *lack* of federal law created what economists call a "moral hazard" problem—namely, the federal government having to pay for the costs created by California's attempt at regulation; by creating a significant safety and soundness risk to California savings associations, the state endangered the federal insurance fund backing the deposits at these institutions. The imposition of a uniform standard solved the moral hazard problem. Furthermore, the story of *De La Cuesta* illustrates that preserving the safety and soundness of banks, on the one hand, and protecting consumers on the other are inseparable policy goals. Allowing banks to maximize their opportunities to operate efficiently is necessary for insuring that consumers have access to affordable credit.

B. The case for and against preemption

When preemption is considered from an efficiency standpoint, its merits become apparent. In a 2008 article in the University of Pennsylvania Law Review, Harvard Law Professor Elizabeth Warren, chair of the Congressional Oversight Panel which argued in favor of ending preemption, and her co-author Oren Bar-Gill, professor of New York University School of Law, wrote:

> The erosion of state power in itself need not be problematic from a consumer protection perspective. In an era of interstate banking, uniform regulation of consumer credit products at the federal level may well be more efficient than a litany of consumer protection rules that vary from state to state. *The problem is not in the federal preemption; it is in the failure of federal law to offer a suitable alternative to the preempted state law*.[19]

As we discuss in-depth below, the charge that federal law has failed to protect consumers is false. The overwhelming majority of instances of

19. Oren Bar-Gill & Elizabeth Warren, *Making Credit Safer*, 157 U PA. L. REV. 1, 83 (2008) (emphasis added).

predatory lending involved loans originated by institutions not subject to preemption, but instead under the purview of state laws. However, it is extremely salient that even an advocate of increased consumer protection like Professor Warren concluded that preemption, in and of itself, is likely justified in terms of the efficiencies it creates. A deeper examination of the economics of preemption reveals that Professor Warren had it right in her law review article: preemption has been a force for increasing the efficiency of the banking sector.

Those conclusions are well established. Professor Phillip Strahan of Boston College gave a presentation at the Chicago Fed's 42nd Annual Conference on Bank Structure and Competition in which he concluded that "preemption of state laws continues the process of financial opening by lowering [the] cost of interstate banking."[20] He also found that financial openness benefits both banks and the economy as a whole.[21] He averred that the financial openness had helped banks to achieve economies of scale and improve risk management, and had increased competition in the banking sector.[22] He documents a variety of benefits to consumers associated with preemption, including higher quality service from ATMs and bank branches, increased convenience, lower prices for loans, and lower underwriting fees.[23]

Similarly, Dr. Gary Whalen, an economist at the OCC, examined the consequences of preemption on national bank and state banks by examining the OCC's preemption of state anti-predatory lending statues, beginning with the preemption of the Georgia Fair Lending Act ("GLFA").[24] In 2003, a national bank asked the OCC to examine the GLFA; the OCC found that the law would "otherwise affect national banks' real estate lending" and, accordingly, concluded that federal law preempted GLFA.[25] In 2004, the OCC promulgated a new set of rules generally preempting state laws that regulate the credit terms offered by banks.[26] To a large extent, these rules codified prior court decisions, letters, and regulations, including those issued by the OTS, putting them all in one

20. Philip E. Strahan, Financial Openness and Regulatory Competition, Presentation at the Chicago Fed Bank Structure Conference (May 2006), *available at* http://www.chicagofed.org/news_and_conferences/conferences_and_events/files/2006_bsc_strahan.pdf.

21. *Id.*

22. *Id.* at 6.

23. *Id.* at 7.

24. Gary Whalen, *The Wealth Effects of Preemption Announcements by the Office of the Comptroller of the Currency After the Passage of the Georgia Fair Lending Act*, OFFICE OF THE COMPTROLLER OF THE CURRENCY (2005), *available at* http://ssrn.com/abstract=869038.

25. *Id.* at 1.

26. *Id.*

place.

To gauge the effect of preemption on national and state banks, Dr. Whalen employed an event study to examine how the stocks of holding companies associated with national banks and with state banks responded to the various public announcements surrounding these preemption decisions.[27] Dr. Whalen's event study focused on four events occurring from 2003 to 2004 where the OCC made a significant announcement concerning its intent to preempt state anti-predatory laws.[28]

Dr. Whalen reaches two salient conclusions. First, he finds that "[t]aken as a whole, the findings suggest that state anti-predatory lending laws like the GFLA impose a proportionately greater compliance burden on smaller, multistate companies unable to realize economies of scale, which is reduced by preemption."[29] Second, he finds no evidence that preemption places state banks at a competitive disadvantage.[30] Indeed, the results indicate that smaller holding companies associated with state chartered banks tended to show positive rather than negative excess returns around the announcement events; they did not "differ significantly from national bank companies with similar characteristics."[31] Thus, Dr. Whalen's empirical analysis suggests that the opponents of preemption have ignored the compliance costs that ending preemption will impose on smaller, national banks, while exaggerating its potential to harm state banks.

Julie Williams, First Senior Deputy Comptroller and Chief Counsel at the OCC, and Michael Bylsma, Director of the Community and Consumer Law Division at the OCC, described the OCC's approach to anti-predatory lending regulation in an article in the American Bar Association's *Business Lawyer*.[32] The authors explain that in 2003, "the OCC issued the most comprehensive supervisory standards to address predatory and abusive lending practices ever published by a federal banking agency."[33] Rather than attempting to ban specific loan or credit arrangements, the OCC's regulations forced banks to examine their own lending policies based on the potential they create for abusive, illegal, or unsound lending practices.[34] The OCC regulations covered a wide variety of subjects, including underwriting policies, abusive lending practices, high-risk transactions, loan flipping, and equity stripping.[35] The OCC enforces its regulations

27. *Id.* at 2.

28. *Id.* at 21.

29. *Id.* at 33.

30. *Id.*

31. *Id.* at 33-34.

32. Julie L. Williams & Michael S. Bylsma, *Federal Preemption and Federal Banking Agency Responses to Predatory Lending*, 59 BUS. LAW. 1193 (2004).

33. *Id.* at 1194.

34. *Id.* at 1195.

35. *Id.* at 1193-96.

with a staff of approximately 1,700 examiners who evaluate national banks and their subsidiaries.[36] The authors explain that "[i]n addition to on-site examinations of loan file reviews, OCC examiners look at bank policies and procedures as part of the supervisory process."[37] The evidence indicates that the OCC's anti-predatory lending measures have been effective. The authors aver "information available to the OCC from its consumer complaint database and supervisory activities does not suggest a general problem involving direct lending by national banks or their operating subsidiaries."[38] Indeed, a group of State Attorneys General recognized in an Amicus Brief submitted in *National Home Equity Mortgage Association v. OTS* that banks and their subsidiaries subject to OCC supervision were not responsible for predatory lending abuses:

> Based on consumer complaints received, as well as investigations and enforcement actions undertaken by the Attorneys General, predatory lending abuses are largely confined to the subprime mortgage lending market and to non-depository institutions. Almost all of the leading subprime lenders are mortgage companies and finance companies, not banks or direct bank subsidiaries.[39]

Notwithstanding such findings, critics of preemption continue to push three main arguments, including blaming federal regulation for the subprime crisis, alleging that federal regulation has been lax, and that preemption threatens the banking market's stability.

First, consumer groups like the Consumer Federation of America and Public Interest Research Groups have claimed that preemption is responsible for the increase in lax and predatory lending associated with the subprime crisis.[40] In particular, they argue that preemption of state banking laws allowed banks to originate predatory subprime and option-adjustable-rate mortgages ("ARMs"). According to the OCC, national banks and their operating subsidiaries originated only about 10% of the subprime loans made in 2006, and only 12% to 14% of the non-prime loans originated in the 2005-2007 period.[41] The foreclosure rates for loans originated by

36. *Id.* at 1200.

37. *Id.*

38. *Id.* at 1199.

39. *Id.* at n.29 (citing Brief for State Attorneys General as Amicus Curiae at 26, *Nat'l Home Equity Mortgage Ass'n v. OTS*, 271 F. Supp. 2d 264 (D.D.C. 2003)).

40. Edmund Mierzwinski, *Preemption of State Consumer Laws: Federal Interference is a Market Failure*, *as reprinted in* 6 GOV'T L. & POL'Y J. 6, 6-12 (2004); Allen Fishbein, Press Release, Consumer Federation of America, Consumer Groups Join to Persuade Congress to Protect State Banking Regulations (Mar. 17, 2004), *available at* http://www.consumerfed.org/pdfs/CFApreemption.pdf.

41. Letter from John Dugan, Comptroller of the Currency, to Elizabeth Warren, Chair, Congressional Oversight Panel (Feb. 14, 2009), *available at*

national banks were substantially lower than those issued by state regulated entities, indicating that these were higher quality and better underwritten mortgages.[42] Because the Community Reinvestment Act (CRA) applies only to banks, one can also examine the proportion of subprime loans made by non-CRA lenders to test the robustness of our findings. A recent white paper issued by the Treasury noted that 94% of "high-priced loans" to "lower income borrowers" were originated by lenders not covered by the CRA.[43] Even proponents of increased financial regulation, such as the Chairman of the House Committee on Financial Services, Barney Frank, have acknowledged that the loans that prompted the subprime crisis were "primarily being made outside the regular banking system."[44] Hence, it is hard to find a credible link between federal preemption and the credit crisis.

Second, some opponents of preemption have asserted that preemption is responsible for lax federal regulation of banking.[45] Yet this argument is also flawed because there is no necessary connection between preemption and the level of regulatory oversight. Preemption is about *uniform* regulation only. There is no reason why preemption and increased oversight (relative to the current standards) cannot go hand in hand. Indeed, the OCC is held in the industry to be one of the most stringent bank regulatory agencies.

Third, some critics have attempted to argue that preemption threatens the stability of the dual banking system.[46] This argument is both economically flawed and empirically inaccurate. From an economic perspective, this argument essentially boils down to an assertion that we should make national banks less efficient to prop up the dual-banking system. However, rendering national banks less efficient would weaken

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http://www.occ.treas.gov/ftp/occ_copre sponse_021209.pdf.

42. *Id.*

43. DEPARTMENT OF THE TREASURY, FINANCIAL REGULATORY REFORM, A NEW FOUNDATION: REBUILDING FINANCIAL SUPERVISION AND REGULATION, at 69-70 (June 17, 2009) ("Moreover, the Federal Reserve has reported that only six percent of all the higher-priced loans were extended by the CRA-covered lenders to lower income borrowers or neighborhoods in the local areas that are the focus of CRA evaluations.").

44. Barney Frank, Chairman, H.R. Comm. on Fin. Serv., Speech before the National Press Club: The "Loan Arrangers" Will Not Ride Again (Jul. 27, 2009), *available at* http://www.huffingtonpost.com/rep-barney-frank/the-loan-arrangers-will-n_b_247264.html.

45. CONGRESSIONAL OVERSIGHT PANEL ON REGULATORY REFORM, SPECIAL REPORT ON REGULATORY REFORM, MODERNIZING THE AMERICAN FINANCIAL REGULATORY SYSTEM: RECOMMENDATIONS FOR IMPROVING OVERSIGHT, PROTECTING CONSUMERS, AND ENSURING STABILITY, at 30-33 (Jan. 2009), *available at* http://cop.senate.gov/documents/cop-012909-report-regulatoryreform.pdf.

46. *See, e.g.*, Arthur E. Wilmarth, Jr., *The OCC's Preemption Rules Exceed the Agency's Authority and Present a Serious Threat to the Dual Banking System and Consumer Protection*, 23 ANN. REV. BANKING & FIN. L. 225, 229 (2004) (arguing that "the OCC's new rules, unless overturned by Congress or the courts, will do great harm to the state banking system, thereby threatening the viability of the dual banking system.").

the banking system as a whole. Furthermore, as Dr. Whalen's research made clear, there is no empirical basis for the claim that state banks are harmed by preemption.

II. ECONOMIC BENEFITS OF PREEMPTION

Under the proposed financial services act, federal laws governing the banking sector would as a regulatory "floor," and states would be invited to adopt stricter standards for anything that can be labeled "consumer protection." It is highly unlikely, however, that all states would respond in the same way. Disparate standards would cause banks' costs to rise and dampen innovation in the banking industry. Moreover, because the banking industry is competitive, increased costs would be largely passed onto banks' customers. In this section, we identify the economic benefits of uniform bank regulations using examples from actual OCC interventions and academic studies. We find that preemption generates three primary benefits for banking customers: (1) it prevents states from imposing protectionist measures, (2) it increases the availability and reduces the price of credit, and (3) it creates a uniform regulatory climate for multi-state banks, allowing them to operate more efficiently.

A. Preemption of protectionist measures

It is widely recognized as a matter of economics that the protection of *competitors* rather than *competition* decreases economic welfare. In a widely-used microeconomics textbook, Professor William Baumol of NYU and Alan Blinder of Princeton quote the Seventh Circuit's ruling in *Stamatakis Industries v. King*, which emphasizes this distinction: "[c]ompetition is ruthless, unprincipled, uncharitable, unforgiving—and a boon to society, Adam Smith reminds us, precisely because of these qualities that make it a bane to other producers."[47] Unfortunately, disadvantaged competitors often seek and obtain protection from competition under the guise of protecting consumers to the detriment of consumers and society as a whole.

Economic textbooks are replete with examples of how protectionism at the international level reduces consumer welfare. Protectionism within a country is similarly harmful. UCLA economists Harold Cole and Lee Ohanian examined the economic consequences of protecting certain industries and groups of workers during the New Deal. The authors point out that while falling productivity, a diminishing monetary base, and a

47. WILLIAM J. BAUMOL & ALAN S. BLINDER, MICROECONOMICS: PRINCIPLES AND POLICY 456 (The Dryden Press 7th ed. 1997) (*citing* Stamatakis Industries v. King, 965 F. 2d 469, 471 (1992)).

chaotic banking system wreaked havoc on the economy between 1929 and 1933, these "negative shocks . . . [became] positive after 1933."[48] Hence, the puzzle remains why, even after the turnaround, those factors failed to precipitate a recovery. The authors conclude that about half of the weakness of the recovery can be explained by New Deal policies that allowed industries to collude or create monopolies—thus increasing the prices of their products—in exchange for paying higher wages. The policies protected inefficient incumbent firms and workers who kept their jobs, but at high costs to would-be competitors, the ranks of the unemployed, and consumers.

Given that protectionism has strong negative economic consequences, it is essential to consider the National Bank Act and the OCC's role as the agency charged with implementing that Act in facilitating competition among banks. The OCC has played an important role in intervening to ensure that states do not protect local interests, like insurance companies, from competition at the expense of consumers. For example, in 1993, the OCC issued an interpretive letter that found that the National Bank Act preempts a Connecticut law that prohibited national banks from selling annuities in Connecticut.[49] The OCC also reached a similar conclusion with respect to a Connecticut requirement mandating that national banks dealing in annuities obtain a license from the state.[50] In 1996, the OCC issued an interpretive letter that also found that the National Bank Act preempted a Texas state law that restricted national banks' ability to sell annuities in the state. Indeed, the OCC found that the law at issue "effectively prohibit[ed] national banks from selling annuities as agents in Texas."[51] In essence, these state initiatives, which one can reasonably infer were adopted at the behest of local political interests to protect against vigorous competition, created inefficiencies in the marketplace, denying consumers the added choice and lower costs associated with more open markets.

In 1997, the OCC issued an interpretive letter that concluded that the National Bank Act preempted a Wisconsin law that precluded out-of-state national banks from acting as a fiduciary in the state.[52] The decision was prompted by a merger between two trust bank subsidiaries of Bank One,

48. Harold L. Cole & Lee E. Ohanian, *New Deal Policies and the Persistence of the Great Depression: A General Equilibrium Analysis*, 112 J. POL. ECON. 779, 781 (2004).

49. OFFICE OF THE COMPTROLLER OF THE CURRENCY, INTERPRETIVE LETTER #623 at 4, (May 10, 1993).

50. *Id.*

51. OFFICE OF THE COMPTROLLER OF THE CURRENCY, INTERPRETIVE LETTER #748 at 1, (Sept. 13, 1996).

52. OFFICE OF THE COMPTROLLER OF THE CURRENCY, CORPORATE DECISION #97-33 at 13, (Jun. 1, 1997).

operating separately in Wisconsin and Ohio.[53] Under Wisconsin's state law regarding trusts, Bank One would no longer have been able to act as a fiduciary in Wisconsin after the merger.[54] In 1998, the OCC issued an interpretive letter that found that a Missouri law that precluded out-of-state national banks from acting as a fiduciary in the state was inconsistent with the National Bank Act, and therefore preempted.[55] The decision was prompted by a merger in which North Carolina-based NationsBank subsumed its Missouri-based affiliate, Boatmen's Trust Company.[56]

In 2001, the OCC issued an interpretive letter that found a conflict between Federal law and a Massachusetts law that mandated that "an out-of-state bank may establish an ATM only if the laws of the state in which it has its main office would permit a bank with its main office in Massachusetts to establish an ATM in that state."[57] In the same year, the OCC also issued an interpretive letter that determined that a Florida law that prohibited out-of-state banks from operating ATMs in the state impermissibly interfered with the powers granted a national bank under the National Bank Act.[58] The decision was prompted by a request from a bank without branches in either state that was considering placing deposit-taking ATMs in those states.[59] In the absence of these interventions, ATM placements would likely have been much smaller in Massachusetts and Florida.

In sum, the benefits to consumers created via these OCC letters—which manifest themselves in the former of increased competition, lower prices, and greater access to ATMs—must be considered carefully when measuring the net benefits of ending preemption.

B. Preemption reduces the price of credit while increasing its availability

Preemption has increased the availability of credit (and reduced its price) by eliminating price controls and by promoting uniform national markets.

1. Price controls

In addition to eliminating protectionist statutes, preemption has

53. *Id.* at 1-2.
54. *Id.* at 13.
55. OFFICE OF THE COMPTROLLER OF THE CURRENCY, CORPORATE DECISION #98-16 at 6, (Mar. 4, 1998).
56. *Id.* at 1.
57. OFFICE OF THE COMPTROLLER OF THE CURRENCY, INTERPRETIVE LETTER #939 at 1, (Oct. 15, 2001).
58. *Id.* at 2.
59. *Id.* at 1.

prevented states from effectively imposing price controls on banking products. There is broad agreement among economists that price controls have harmful economic consequences.[60] As the late Nobel Laureate Milton Friedman observed, both the shortage of housing in New York and the gasoline shortages of the 1970s were caused by well-meaning legislation that imposed price controls.[61] Although these provisions often seem beneficial to consumers in that they guarantee lower prices, economics shows that price controls cause suppliers to reduce their output. The loss of economic value to consumers that this reduction in output creates exceeds any benefits that result from the lower prices, and thus, consumers are worse off. Economists refer to these losses of output as "deadweight loss" because of the economic value that is destroyed as a result of the dead weight of the regulation. Accordingly, it is reasonable to assume that the OCC's preemption decisions striking down state-enforced price controls have increased economic welfare.

An analysis of discussions surrounding city-level restrictions on ATM fees is edifying on this point. In 2002, the U.S. Circuit Court of Appeals for the Ninth Circuit upheld a district court ruling preempting municipal ordinances in San Francisco and Santa Monica that prohibited banks from charging ATM fees to non-depositors.[62] The ordinances, which were enacted in October and November of 1999 by Santa Monica and San Francisco, respectively, were challenged by a group of banks and the California Bankers Association.[63] The banks ceased allowing non-depositors to use their ATMs while the law was in place,[64] presumably because restrictions on surcharges eliminated the economic incentive to providing such services to non-customers. In essence, consumers were denied access to valuable financial services because of lobbying by parochial local concerns. Such "deadweight loss" destroyed the economic value of providing ATM service to non-customers, resulting in an overall loss of consumer benefits. While the Court of Appeals ruled the National Bank Act and the regulations of OCC permit national banks to charge

60. DENNIS W. CARLTON & JERRY M. PERLOFF, MODERN INDUSTRIAL ORGANIZATION 715 (Addison Wesley 4th ed. 2004) ("Regulation can reduce the efficiency of competitive markets. In many cities around the world, government agencies regulate apartment rental rates, using rent controls to keep rental rates below the competitive level. As a result, the demand for housing exceeds the supply."); MICHAEL L. KATZ & HARVEY S. ROSEN, MICROECONOMICS 365-66 (McGraw-Hill 3d ed. 1998) (demonstrating that total economic welfare (surplus) falls as a result of price controls).

61. MILTON FRIEDMAN & ROSE FRIEDMAN, FREE TO CHOOSE: A PERSONAL STATEMENT 219 (Houghton Mifflin Harcourt 1990).

62. Bank of America, et al. v. City and County of San Francisco, 309 F. 3d 551, 555-6 (9th Cir. 2002).

63. *Id.* at 556.

64. *Id.* at 557.

ATM fees,[65] it is instructive to note the significant impact a local municipality's action could have had on the provision of financial services in a given area. The exponential negative impact that differing actions by 50 state legislatures, as permitted under the Administration's proposals, could have on our national marketplace is thus particularly worrisome.

Academic analysis of state ATM fee restrictions further supports the case against local price regulation. Professor Gautaum Gowrisankaran and John Krainer of the San Francisco Federal Reserve provide empirical evidence that permitting surcharging *increases* access to ATMs.[66] The authors compared the behavior of ATM operators in Minnesota, where surcharging has been allowed since 1996, to ATM operators in Iowa, which upheld a surcharge ban until 2003.[67] The authors find that the Iowa surcharge ban reduced ATM entry by an average of approximately 12% in the counties along the Minnesota border.[68]

Economic logic also suggests that the negative consequences of restrictions on surcharging will fall primarily on smaller, interstate banks. Surcharging affects mainly bank customers using out-of-network ATMs. Faced with ATM surcharge restrictions, banks would most likely continue to operate (smaller) ATM networks, but they would allow only customers with accounts at the bank to use their ATMs. Consumers desiring quick, reliable access to cash would then be forced to switch to larger banks to insure uninterrupted access to ATM machines. Accordingly, state-level regulation of ATM fees may paradoxically burden smaller banks - the very banks that critics of preemption argue are essential to insure the health of the banking system.

Basic economics demonstrates that price controls have the perverse consequences of reducing output and actually increasing the final prices paid by consumers. By lowering the price firms can charge for the products they supply, price controls induce firms to reduce supply. As a result of the shortage, consumers are either forced to pay exorbitant rates in black markets or bid up the prices of substitutes.[69] As the prominent economist Dr. Robert Litan of the Brookings Institution explained in an article on anti-predatory lending laws, although price controls are often

65. *Id.* at 558.

66. Gautuam Gowrisankaran & John Krainer, *Bank ATMs and ATM Surcharges*, FRBSF ECON. LETTER 2005-36, Dec. 16, 2005, *available at* http://www.frbsf.org/publications/economics/letter/2005/el2005-36.html. Until 1996, the major ATM networks prohibited levying surcharges. From 1996 to 2001, five years after the ban on surcharging was lifted, ATM deployment roughly tripled. The authors note that "the regime change provided a kind of 'before and after' experiment commonly used to examine the predictions of economic models." *Id.* at 2.

67. *Id.*

68. *Id.*

69. MILTON FRIEDMAN, PRICE THEORY 18 (Transaction Publishers 2007).

instituted to protect consumers, as a rule, they end up harming the consumers they were intended to protect.[70]

2. National markets

The promotion of uniform, national markets has also increased the availability of credit at reduced cost to millions of American consumers. For example, preemption has helped ensure the efficient functioning of the national market for securitized mortgages. Securitization is vital to enhancing liquidity in the area of home loans, car loans, credit cards, and commercial loans. As Leon Kendall and Michael Fishman explained in their seminal book on securitization, securitization is "one of the most important and abiding innovations to emerge in financial markets since the 1930s."[71]

Kendall and Fishman list seven basic requirements of any successful securitization: "(1) standardized contract[]; (2) grading of risk via underwriting; (3) database of historic statistics; (4) *standardization of applicable laws*; (5) standardization of servicer quality; (6) reliable supply of quality credit enhancers; and (7) computers [to] handle complexity of analysis."[72] Uniform regulations not only directly implicate their fourth requirement, but they also permit securitizers to compile and analyze historical data by region *holding the regulations constant*, which is also a necessary condition for a successful securitization. Without uniform lending rules, it is impossible for securitizers to measure the risk of a pool of loans, which in turn, complicates the pricing of loans for the secondary market. Without uniform standards, including standard laws, the sales price would be prohibitive and the market would break down.

Moreover, disparate state laws in areas concerning what defines a "finance charge" or what constitutes an "acceptable" interest rate further undermine the ability to securitize the cash flows from mortgage loans. The principal payment and the finance charge are two primary cash flows in any securitization. If different jurisdictions define the finance charge differently, needless complexity would be added to the process of securitization. If some jurisdictions effectively prohibited securitization through assignee liability or limitations or restrictions on the ability to sell finance charge receivables, those jurisdictions would hamper local

70. Robert E. Litan, *Unintended Consequences: The Risk of Premature State Regulation of Predatory Lending*, AMERICAN BANKERS ASSOCIATION (2003), *available at* http://www.aba.com/NR/rdonlyres/1FAE5B14-C034-4FF7-8566-9664F0BDEDEC/28934/PredReport20093.pdf.

71. LEON KENDALL & MICHAEL FISHMAN, A PRIMER ON SECURITIZATION 1 (MIT Press 1996).

72. *Id.* at 7 (Table 1) (emphasis added).

economic performance at the expense of the Federal safety net for lending institutions, just like the attempts by California to nullify the due-on-sale clause referred to in earlier sections.

In the event of such disparate regulation, it would be nearly impossible to convert cash flows from disparately-regulated loans into standardized streams that could be securitized, resulting in significant negative implications for the U.S. economy. According to Securities Industry and Financial Markets Information, as of the second quarter 2009, there were $307.5 billion in outstanding asset-backed securities (ABS) for credit cards; $354.7 billion in outstanding ABS for home equity loans; and $132.0 billion in outstanding ABS for automobile loans.[73] Fannie Mae has been able to obtain a large base of low-cost funding by aggregating uniform loans that were originated throughout the United States. But Fannie Mae cannot achieve the requisite scale without uniform national rules.[74]

To be sure, there are structural problems in the mortgage market that must be resolved. But because securitization plays such an important role in increasing liquidity and lowering costs, it is essential that we perfect the securitization process rather than restrict the efficient functioning of the national mortgage market. Indeed, it has been noted in the media that with the recent "credit crunch" consumers have been forced to take out loans at extremely high rates of interest from loan sharks.[75] As Dr. Litan observed, state regulations that interfere with the functioning of credit markets often interfere with the "democratization" of credit.[76] In other words, interfering with credit markets by inhibiting the development of national markets for financial products like mortgages increases the prices and decreases the availability of credit.

73. SIFMA, *Asset-Backed Securities Outstanding*, *available at* http://www.sifma.org/uploadedFiles/Research/Statistics/SIFMA_USABSOutstanding.pdf.

74. In response to amended version of The Georgia Fair Lending Act introduced on March 7, 2003, Fannie Mae issued a statement explaining that it would not purchase any loans classified as "high-cost home loans" under the Act. Fannie Mae, Announcement 03-02, Purchase of Georgia and New York "High-Cost Home Loans" (Mar. 31, 2003) Freddie Mac also announced that it would not purchase high-cost loans in Georgia. *See* Industry Letter from Freddie Mac to All Freddie Mac Sellers and Servicers, Re: Revisions to Freddie Mac's Mortgage Purchase Requirements Based on the Enactment of Section 6-L of the New York State Banking Law and Amendments to the Georgia Fair Lending Act (Mar. 31, 2003), *available at www.mortgagebankers.org/files/Residential/2003/freddie_indyltr0331.pdf* (discussing the revisions of mortgage requirements in New York and Georgia due to the passing of enactments 6-L of the New York State Banking Law and amendment to the Georgia Fair Lending Act).

75. Alistair MacDonald & Jeanne Whalen, *Loan Sharks Circle Credit-Starved Consumers*, WALL ST. J., Sept. 1, 2009, *available at* http://online.wsj.com/article/SB125175126871273709.html.

76. Litan, *supra* note 70, at 18.

C. Preemption creates a uniform regulatory climate for multi-state banks, allowing them to operate more efficiently

By allowing banks to operate under a uniform regulatory structure, preemption increases the ability of national banks to operate efficiently throughout the United States. However, one can only speculate, what impact 50 different state laws on ATM fees, for example, would have on the cost of banking services to everyday consumers, let alone the effect on the national marketplace.

To prove empirical evidence of the negative impact that state actions can have on economic efficiencies and consumer benefits, we looked back to the lifting of state branching restrictions that occurred in the 1990s and the economic ramifications of such actions. A review of the economic literature on state regulation of banks reveals that reducing barriers to bank expansion across state lines increases the banking services available to consumers while lowering the price. To the extent that ending preemption will impose higher regulatory costs on national banks operating in several states, the economic literature suggests that both banks and consumers will suffer.

Jith Jayaratane and Philip Strahan, former senior economists at the Federal Reserve Bank of New York, analyzed the "impact of geographic restrictions on the banking industry" by looking at states' removal of geographic limits on bank branching from 1978 to 1992.[77] The authors found that "bank efficiency improved greatly once branching restrictions were lifted" and that "[l]oan losses and operating costs fell sharply and the reduction in banks' costs was largely passed along to bank borrowers in the form of lower loan rates."[78] The authors found that benefits were not only limited to bank customers; state economies also grew faster once branching was allowed.[79]

Astrid Dick, former economist in the Research Group of the Federal Reserve Bank of New York, examined the effects of the Riegle-Neal Act's deregulation of branching restrictions on market structure, service, and performance.[80] The author finds that "[a] significant portion of the observed

77. Jith Jayaratne & Philip E. Strahan, *The Benefits of Branching Deregulation*, 3 FRBNY ECON. POL'Y REV. 13 (Dec. 1997), *available at* http://www.ny.frb.org/research/epr/97v03n4/9712jaya.pdf.

78. *Id.*

79. *Id.* at 14 ("While the improvements to the banking system following deregulation helped bank customers directly, we also find important benefits to the rest of the economy. In particular, state economies grew significantly faster once branching was allowed—in part, we suggest, because deregulation permitted the expansion of those banks that were best able to route savings to the most productive uses.").

80. Astrid A. Dick, *Nationwide Branching and Its Impact on Market Structure, Quality, and Bank Performance*, 79 J. BUS. 567, 567 (2006).

increase in branch networks can be traced to the deregulation, allowing consumers to enjoy larger fee-free networks locally and regionally."[81] The author also finds that banking spreads fall in the context of deregulation while bank profit rates remain constant.[82] These findings, in conjunction with the research of Jayaratne and Strahan, bolster our thesis that preemption increases the ability of national banks to operate more efficiently, which redounds to the ultimate benefit of consumers and local economies.

III. CASE STUDIES OF THE BENEFITS OF IMPOSING UNIFORM REGULATORY STANDARDS IN OTHER U.S. INDUSTRIES

In evaluating the potential consequences of ending preemption for national banks, it is useful to consider real-world examples from other U.S. industries that have experienced a change in the uniformity of their regulatory oversight. We offer case studies from the wine and telecom industries, which demonstrate that eliminating state regulations that impair competition leads to greater economic efficiency.

A. The wine industry

Eight states, including Michigan and New York erected barriers to out-of-state wineries directly shipping their goods ordered online or over the phone to consumers without similar restrictions for in-state wineries. In 2005, the Supreme Court ruled that state alcohol laws may not discriminate between in-state and out-of-state producers because the 21st Amendment does not override the Commerce Clause.[83]

In 2003, lower court rulings forced Virginia to repeal a discriminatory law similar to New York's.[84] This change allowed economists Professor Alan Wiseman of Ohio State University and Professor Jerry Ellig of George Mason University to evaluate the effects of removing interstate trade barriers. The authors measured the price of the most popular wines both in traditional brick-and-mortar stores and on Internet retailers' websites before and after the court's decision. In both periods, online stores were cheaper and had a wider selection, though, before the decision,

81. *Id.*

82. *Id.* at 587-591.

83. Charles Lane, *Justices Reject Curbs on Wine Sales; 5-4 Ruling a Victory for Interstate Shippers*, WASHINGTON POST, May 17, 2005, at A1 (reporting on Granholm v. Heald, 544 U.S. 460 (2005)).

84. Alan E. Wiseman & Jerry Ellig, *Legislative Action, Market Reaction and Interstate Commerce: Results of Virginia's Natural Experiment with Direct Wine Shipment*, Mercatus Center (Dec. 15, 2005), at 2-3, *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=836364.

Virginians could not take advantage of these web sites. After the state's discriminatory law was repealed and in-state distributors and retailers faced out-of-state competition, wine prices at brick-and-mortar stores declined up to 40% relative to prices offered by online retailers. The authors conclude that the elimination of these regulations increased consumer welfare.

> [N]ot just by facilitating entry by out-of-state sellers, but also by placing competitive pressure on the in-state sellers. More broadly speaking, this result clearly supports theories that predict how government mandated market restrictions inhibit competition and facilitate higher prices, and how the removals of those bans will facilitate more efficient market outcomes.[85]

B. Wireless telephony

A centralized commercial policy is especially important in industries that are characterized by economies of scale—industries that can offer consumers lower prices or higher quality products as firms grow larger while earning the same or greater profit. The wireless telephony industry, like many other industries facing economies of scale, favors larger firms.[86] Consumers clearly place great value on the ability to access their carrier's network anywhere in the country. Thus, carriers with national networks had a significant competitive advantage as they offered consumers a superior product (free nationwide roaming). Before 1994, states and the federal government had concurrent power to regulate the services that wireless carriers offered to consumers; some states such as California and New York imposed price controls on the nascent industry.[87] However, in 1994, the Federal Communications Commission (FCC) preempted the state laws regulating wireless telephony. As in the wine example above, the

85. *Id.* at 29.

86. It bears noting that the banking industry is also characterized by significant economies of scale. *See* Allen N. Berger, et al., *Competition from Large, Multimarket Firms and the Performance of Small, Single-Market Firms: Evidence from the Banking Industry*, 39 J. MONEY, CREDIT AND BANKING 331, 332 (Mar.-Apr. 2007) (arguing that technological advances "may have also allowed multimarket banks to offer higher quality services to consumers—in the form of large branch and ATM networks, for instance—thereby putting greater competitive pressure on smaller, less geographically diversified banks."); Gregory Elliehausen, Staff, Board of Governors of the Federal Reserve System, Washington DC, *The Cost of Bank Regulation: A Review of the Evidence,* FRB STAFF STUDY 171 (Apr. 1998), at 25-27 (discussing whether regulatory costs in the banking industry exhibit economies of scale).

87. Thomas W. Hazlett, *Is Federal Preemption Efficient in Cellular Phone Regulation?*, 56 FED. COMM. L.J. 155, 157 (2003) (discussing the Omnibus Budget Reconciliation Act of 1993, 47 U.S.C. § 332(c)(3)(A) (2000), which revoked states' authority to "regulate the entry of or the rates charged by any commercial mobile service or any private mobile service.").

FCC created a "natural experiment" that economists were able to use to evaluate the effects of a change in policy. Thomas Hazlett, currently a Professor of Law and Economics at George Mason University, undertook a comprehensive review of the literature concerning the effects of the FCC's preemption of state regulation.[88] Professor Hazlett's review demonstrates that the change in regulatory oversight toward uniform, national standards unquestionably increased economic efficiency. Before deregulation, consumers in states that regulated wireless telephony, such as California and New York, paid more. Furthermore, state regulations discouraged rivals wireless providers from entering the market and slowed consumer adoption of cellular phones. Just as balkanized state laws hindered the growth of wireless networks and raised cellular prices for everyone, balkanized state laws stymied the growth of ATM and branch networks,[89] and thereby raise the cost of credit and banking services for consumers.

IV. POLICY IMPLICATIONS

Based on our findings above, we offer two concrete policy implications for financial regulators and policymakers. New regulations are sorely needed to avoid repeating consumer harm that helped contribute to the credit crisis, but myriad competing sets of new regulations will likely create more economic harm than good.

A. *Elimination of preemption would generate significant social cost*

Eliminating preemption for national banks is an inefficient way to achieve the worthy objective of protecting consumers. A careful review of the evidence indicates that preemption has been an important policy tool for opening up markets and increasing competition, leading to benefits for banks and their customers. Eliminating preemption would create a complex regulatory environment where banks are forced to operate under a patchwork of state regulations. At the very least, disparate standards would impose significant compliance costs on banks seeking to operate across state lines. The experience with Sarbanes-Oxley regulation has shown the burden of such compliance costs would be most difficult for small to mid-size banks operating in multiple states.[90] As the wine and wireless

88. *Id.* at 205-221.

89. Berger, *supra* note 86, at 337 ("The literature suggests that consumers value dense branch networks, both locally and over larger geographic areas.").

90. Sarbanes-Oxley imposed significant auditing requirements on publicly traded companies. The GAO, among other sources, has found that such regulation is particularly burdensome for small companies. GOVERNMENT ACCOUNTABILITY OFFICE, *Sarbanes-Oxley Act: Consideration of Key Principles Needed in Addressing Implementation for Smaller Public Companies, Report to S. Comm. on Small Business and Entrepreneurship*, GAO-06-

examples show, a sufficiently complex thicket of varying regulations could undermine banks incentives to operate across state lines. Under this scenario, banking customers would undoubtedly face higher prices as banks would no longer enjoy the cost-efficiencies associated with economies of scale.

Furthermore, many state regulations that have ostensibly been passed to protect consumers have in reality been protectionist measures that favor entrenched local political interests at the expense of consumers. State regulations are more likely than federal regulations to turn protectionist or otherwise be economically inefficient because a state regulator does not internalize the costs that protectionist measures impose on banks that operate both inside and outside of that state; nor does that regulator internalize the costs that such measures impose on the customers of those same banks who reside outside of the state. For example, a bank's inflated costs associated with conforming to myriad state rules or being denied certain economies of scale as a result of entry restrictions will not fully redound to the harm of residents within the state that issues a protectionist measure; those costs are spread throughout the banking system. Although a state regulator should, in theory, internalize the cost of bank customers inside of the state, in practice, state regulators can become unduly influenced by local interests that seek to protect their business from competition to the detriment of banking customers.

Historical state-level prohibitions against branching and other forms of entry—which were subsequently reversed by preemptive Federal legislation—were clearly motivated by protectionist concerns. For these reasons, a national regulator of banks engaging in multi-state activities plays a crucially important role in the banking industry. Because the national regulator can internalize the positive spillover effects associated with greater competition and enhanced economies of scope and scale, and because the national regulator is less influenced by local business interests, the scope and extent of banking regulation will look very different than that chosen by fifty disparate state regulators. Hence, without preemption there would be no federal check on state regulators and legislatures who have been "captured" by local interests like insurance companies, and costly protectionist measures would undoubtedly proliferate.

B. Creation of new federal rules for problem areas

The economic evidence also demonstrates that preemption is not responsible for the consumer-protection failures associated with predatory lending and the subprime crisis. Our analysis indicates that the vast

361 (Apr. 2006), *available at* http://www.gao.gov/new.items/d06361.pdf.

majority of subprime loans were originated by lenders outside of the banking system's regulatory apparatus. This fact does not mean that there is no need for increased consumer-protection measures—the rash of abusive lending practices that have come to light certainly require a concerted regulatory response. *It bears noting that preemption is not the same as non-regulation*. Preemption has been used to open markets and to simplify regulatory compliance, but it does not free banks from federal regulation, or even state-level regulations that do not conflict with federal law. Furthermore, predatory lending is not restricted to a few specific regional locales, but rather is a national problem. Thus, the optimal public policy solution is *uniform* regulation at the federal level, which could largely come from existing federal regulators.

In summary, to address the gaps that were painfully exposed by the 2008-09 financial crisis, new federal regulations are likely needed. But those potentially more stringent regulations should be *uniformly* imposed across the nation, so that banks and their customers can continue to reap the benefits of common regulatory standards.

CONCLUSION

Critics of preemption have focused on the straw-man issue of the subprime mortgage crisis while ignoring the empirical evidence that preemption has increased economic efficiency and consumer welfare. When considered from an economic perspective, consumer protection and preemption are not contrary policies, but rather are different means of ensuring that financial markets function to maximize the value of the banking services available to consumers. When markets are competitive, increasing the operating cost of firms through a patchwork of state regulation will result in higher prices for consumers. Likewise, protecting high-cost firms in a given state from competition against more efficient (out-of-state) firms will result in higher prices for consumers. These conclusions are supported by a wide body of economic research and empirical analysis. Indeed, our discussion probably understates the benefits of preemption policy because it is likely that many ill-advised state regulations were deterred by the fact that state legislators and regulators were aware that unduly burdensome state laws would be preempted.

Nonetheless, it bears emphasis that we do not oppose increased financial regulation to protect consumers. Indeed, it is clear that in certain instances mortgage lenders took advantage of ill-informed consumers in the interest of making short-term profits. However, protecting consumers does not require policymakers to eviscerate the framework of Federal banking regulation that has provided a substantial basis for banking industry stability and economic growth since 1863. Indeed, it would be counterproductive to revise those aspects of banking regulation that currently benefit consumers under the guise of "consumer protection." Preemption may be the status-quo, but this does not implicate it as a cause of the financial crisis or as bad public policy. Rather, the evidence indicates that preemption has increased the efficiency and quality of our banking system over time, and should remain a cornerstone of bank policy.