FDIC
Federal Deposit Insurance Corporation
550 17th Street NW, Washington, D.C. 20429-9990

November 19, 2019

MEMORANDUM TO: The Board of Directors

FROM: Nicholas J. Podsiadly
General Counsel

SUBJECT: Notice of Proposed Rulemaking on Federal Interest Rate Authority

Recommendation

Staff recommends that the FDIC Board of Directors (Board) approve the attached Notice of Proposed Rulemaking (NPR) and authorize its publication in the Federal Register for a 60-day comment period. The NPR proposes regulations implementing sections 27 and 24(j) of the Federal Deposit Insurance Act (FDI Act) codifying in regulation guidance in General Counsel's Opinion No. 11, which was adopted by the Board and published in the Federal Register in 1998. The proposed regulations would clarify the law governing the interest rates that State-chartered banks and insured branches of foreign banks (collectively, State banks) may charge, would address legal uncertainty resulting from the Second Circuit's decision in *Madden v. Midland Funding, LLC,*[1] and continue to promote parity between State banks and national banks.

Background

The decision of the U.S. Court of Appeals for the Second Circuit in *Madden v. Midland Funding, LLC* called into question the enforceability of the interest rate terms of loan agreements following a bank's assignment of a loan to a non-bank entity. In *Madden*, the court concluded that 12 U.S.C. § 85 (section 85) – which authorizes national banks to charge interest at the rate permitted by the law of the State in which the national bank is located, regardless of other States' interest rate restrictions – does not apply following assignment of a loan to a non-bank. While *Madden* concerned a loan made by a national bank, the federal statutory provision governing State banks' authority with respect to interest rates, section 27 of the FDI Act, is patterned after and interpreted in the same manner as section 85. Therefore, *Madden* also created uncertainty regarding the enforceability of loans originated and sold by State banks.

The uncertainty created by *Madden* may hinder or frustrate loan sales, which are crucial to the safety and soundness of State banks' operations for several reasons. Loan sales enable State banks to increase their liquidity in a crisis, to meet unusual deposit withdrawal demands, or to pay unexpected debts. Loan sales also enable banks to make additional loans and meet increased credit demand. Banks may need to sell loans to address excessive concentrations in particular asset classes, or in circumstances where it would be costly or inconvenient to pursue collection strategies. *Madden* also continues to cause ripples with pending litigation challenging longstanding market practices.

[1] 786 F.3d 246 (2d. Cir. 2015).

Statutory Framework

Section 27 of the FDI Act, 12 U.S.C. § 1831d, is the federal statutory provision that governs the interest rates State banks may charge on loans.[2] Section 27 allows State banks to charge interest at a rate permissible in "the State, territory, or district where the bank is located" or a rate one percent above the Federal Reserve 90-day commercial paper discount rate, whichever is greater. Section 27 also expressly preempts any State constitution or statute to the extent that it limits the interest rate a State bank may charge to less than the rate permitted by section 27.

Section 27 was patterned after section 85 to provide State banks interest rate authority similar to that of national banks, and has been interpreted in the same manner. In particular, these provisions have been interpreted to allow State banks and national banks, respectively, to "export" the interest rates of their home States to borrowers residing in other States.[3]

In the 1990s, Congress enacted interstate banking laws that permitted national banks and State banks to establish branches across State lines. At that time, the FDI Act was amended to include section 24(j), 12 U.S.C. § 1831a(j), which governs the applicability of a host State's laws to interstate branches of State banks. A *host State* is a State other than the State that chartered the bank, but in which the bank maintains a branch. Section 24(j) provides that the laws of a host State apply to branches of interstate State banks to the same extent they apply to branches of interstate national banks. Therefore, if the laws of the host State are inapplicable to a branch of an interstate national bank, they are equally inapplicable to a branch of an interstate State bank.

FDIC General Counsel's Opinion No. 11

Following the enactment of the federal interstate banking laws, questions arose regarding the application of section 27 to interstate State banks. It was unclear in which State such a bank was "located" for purposes of section 27, leading to confusion regarding the permissible interest rate. The FDIC addressed this issue by publishing General Counsel's Opinion No. 11, *Interest Charges by Interstate State Banks*.[4]

In this opinion, the FDIC's General Counsel concluded, consistent with the OCC's interpretation of section 85, that the determination of which State's interest rate laws to apply to a loan depends upon the location where three "non-ministerial functions" involved in making the loan occur: loan approval; disbursal of the loan proceeds; and communication of the decision to lend. If all three non-ministerial functions were performed by a branch located in a host State, the host State's interest restrictions would apply to the loan; otherwise, the law of the home State

[2] Section 27 was enacted as part of the Depository Institutions Deregulation and Monetary Control Act of 1980, Pub. L. 96-221, 94 Stat. 132 (1980).

[3] *See Marquette Nat'l Bank v. First of Omaha Service Corp.*, 439 U.S. 299 (1978); *Greenwood Trust Co. v. Massachusetts*, 971 F.2d 818, 827 (1st Cir. 1992).

[4] *See* 63 Fed. Reg. 27,282 (May 18, 1998).

would apply. Where the three non-ministerial functions occur in different States or banking offices, host State rates may be applied if the loan has a clear nexus to the host State. This result, the opinion concluded, reflected the balance that Congress intended to strike between the application of host State interest rate restrictions and the exportation principle previously recognized by the courts.

The effect of FDIC General Counsel's Opinion No. 11 was to promote parity between State banks and national banks with respect to interest charges. Importantly, in the context of interstate banking, the opinion confirmed that section 27 permits State banks to export interest charges allowed by the State where the bank is located to out-of-State borrowers, even if the bank maintains a branch in the State where the borrower resides.

Need for Rulemaking

The FDIC has previously proposed to issue regulations implementing sections 24(j) and 27 of the FDI Act. A petition for rulemaking was filed with the FDIC in 2004, seeking the issuance of regulations implementing these statutory provisions and clarifying the interest rates that interstate State banks may charge. The petitioners were concerned with restoring parity between State banks and national banks following the issuance of regulations by the OCC that preempted certain State laws with respect to national banks.

The FDIC held a public hearing on the petition in May 2005, and following this hearing, proposed regulations to implement sections 24(j) and 27. The FDIC did not finalize these regulations, but subsequent changes to the statutory and regulatory framework governing the preemption of State laws may have addressed the petitioners' concerns.

More recently, as discussed above, *Madden* called into question the ability of assignees to enforce the interest-rate provisions of loans originated by banks. This decision created legal uncertainty and a lack of uniformity in secondary credit markets. Through the proposed regulations implementing sections 27 and 24(j), the FDIC would clarify that the permissibility of interest under section 27 should be determined when a loan is made, and reaffirm that the interest-rate terms of loans are enforceable by assignees of State banks.

Interpretation of Section 27

Section 27 expressly provides that a State bank may charge the interest rate permitted by the laws of the State where it is located and that the usury laws of other States are preempted. However, section 27 is silent regarding the point in time when the permissibility of interest should be determined. For reasons detailed below, staff concludes that the permissibility of interest should be determined when the loan is made, and should not be affected by subsequent events, such as changes in State law or the assignment of the loan.

Determining the permissibility of interest as of the date the loan is made would protect the parties' expectations and reliance interests and would provide a logical, fair, and simple rule. This interpretation is not based on the longstanding common law "valid when made" rule, although it is consistent with it. That rule provides that usury must exist at the inception of the loan for a loan to be deemed usurious; as a corollary, if the loan was not usurious at inception, the loan cannot become usurious at a later time, such as upon assignment, and the assignee may lawfully charge interest at the rate contained in the transferred loan.[5]

Banks' power to make loans implicitly carries with it the power to assign loans, and thus, a State bank's authority under section 27 to make loans at particular rates necessarily includes the power to assign loans at those rates. Denying assignees the right to enforce a loan's terms would effectively prohibit assignment and render illusory the power to make the loan at the rate provided by section 27.

The inherent authority of State banks to assign loans that they make is also consistent with State banking laws, which typically grant State banks the power to sell or transfer loans, and more generally, to engage in banking activities similar to those listed in the National Bank Act and activities that are "incidental to banking."[6]

In addition, a nonbank assignee's ability to enforce interest-rate terms is consistent with fundamental principles of contract law. It is well settled that an assignee succeeds to all the assignor's rights in a contract, standing in the shoes of the assignor. This includes the right to receive the consideration agreed upon in the contract, which for a loan, includes the interest agreed upon by the parties.[7] Under this "stand-in-the-shoes" rule, the non-usurious character of a loan would not change when the loan changes hands, because the assignee is merely enforcing the rights of the assignor and stands in the assignor's shoes.

Assignees' reliance on the enforceability and collectability in full of a loan that is validly made is also central to the stability and liquidity of the domestic loan markets. Restrictions on assignees' abilities to enforce interest rate terms would result in extremely distressed market values for many loans, frustrating the purpose of the FDI Act.

Description of Proposed Rule

The proposed rule implements section 27 of the FDI Act. It would provide that a State bank or insured branch of a foreign bank may charge interest at the rate allowed by the law of the State where the bank is located, or one percent more than the rate on ninety-day commercial paper, whichever is greater. Where a State constitutional provision or statute prohibits a State bank from charging interest at the greater of these two rates, the State constitutional provision or statute is expressly preempted by section 27. To promote parity between State banks and

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[5] See *Nichols v. Fearson*, 32 U.S. (7. Pet.) 103, 109 (1833); *Gaither v. Farmers & Merchants Bank of Georgetown*, 26 U.S. 37, 43 (1828); *FDIC v. Lattimore Land Corp.*, 656 F.2d 139 (5th Cir 1981); *FDIC v. Tito Castro Constr. Co.*, 548 F. Supp. 1224, 1226 (D. P.R. 1982).

[6] The National Bank Act specifically authorizes national banks to sell or transfer loan contracts by allowing them to "negotiate[]" (i.e., transfer) "promissory notes, drafts, bills of exchange, and other evidences of debt." 12 U.S.C. § 24(Seventh).

[7] *See Olvera* v. *Blitt & Gaines, P.C.*, 431 F.3d 285, 286-88 (7th Cir. 2005) (assignee of a debt is free to charge the same interest rate that the assignor charged the debtor, even if, unlike the assignor, the assignee does not have a license that expressly permits the charging of a higher rate). As the *Olvera* court noted, "the common law puts the assignee in the assignor's shoes, whatever the shoe size." 431 F.3d at 289.

national banks, the proposed rule's definition of "interest" mirrors the definition found in the OCC's regulations. *See* 12 C.F.R. § 7.4001(a).

The proposed rule also clarifies the application of section 27 where State law provides different interest-rate restrictions for specific classes of institutions and loans. State banks would be permitted to charge interest at the maximum rate permitted to any State-chartered or licensed lending institution by the law of that State. This is generally referred to as "most favored lender" status, and the FDIC has long interpreted section 27 to include most favored lender protection for State banks.[8]

Under the proposed rule, the permissibility of interest for purposes of section 27 would be determined when a loan is made, and would not be affected by later events such as changes in State law or the sale, assignment, or other transfer of the loan. Therefore, an assignee could enforce a loan's interest-rate terms to the same extent as the assignor State bank, even if the assignee is not a bank. This is not intended to affect the application of State law in determining whether a State bank or insured branch of a foreign bank is a real party in interest with respect to a loan or has an economic interest in a loan. In other words, the proposed rule would not address which entity is the "true lender" when a State bank makes a loan and assigns the loan to a third party. The explanatory information in the proposed regulation also states that the FDIC views unfavorably entities that partner with a State bank with the sole goal of evading a lower interest rate established under the law of the entity's licensing state(s).

Conclusion

Staff recommends that the Board approve the attached Notice of Proposed Rulemaking for publication in the Federal Register for a 60-day comment period.

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[8] *See* FDIC Advisory Opinion No. 81-3 (Feb. 3, 1981) (opinion of FDIC's General Counsel).