Federal Savings Banks—The Vehicle of Choice

By Darrell L. Dreher* and Elizabeth L. Anstaett*

Darrell L. Dreher is a partner with the firm of Dreher Langer & Tomkies L.L.P. He engages primarily in the representation of banks, finance companies, and other financial institutions, as both Ohio and national counsel. His practice includes state and federal regulatory matters, development of credit card and lending programs, particularly on a multistate basis, transactional and business development matters, insurance matters, legislative matters involving financial institutions, and litigation involving banking and financing issues. He has worked with numerous lenders and retailers in developing strategic plans for and implementing nationwide credit programs.

He is a graduate of The Ohio State University (B.A. 1966) and The George Washington University (J.D. *with honors* 1973, Order of the Coif). He is a member and Secretary of the Governing Committee of the Conference on Consumer Finance Law, which publishes the Consumer Finance Law *Quarterly Report*. He is also a Founding Member and member of the Board of Regents of the American College of Consumer Financial Services Lawyers. He is a member of the American Financial Services Association (Law Committee), the Ohio Consumer Finance Association (Law Committee), the American Bar Association (Business Law Section, Consumer Financial Services Committee; Past Chairman, Interstate Delivery of Consumer Financial Services Subcommittee), the Ohio State Bar Association (Banking Law Committee) and the Columbus Bar Association (Past Chairman, Financial Institutions Committee). Mr. Dreher is listed in *The Best Lawyers in America* for banking and consumer finance law.

Elizabeth L. Anstaett is an associate with the firm of Dreher Langer & Tomkies L.L.P. She engages in the representation of banks, finance companies, and other financial institutions in Ohio and nationally. Her practice focuses on Ohio and federal regulatory matters, multistate compliance and the development of lending programs, general banking matters, deposit programs, privacy, debt collection matters, telemarketing compliance matters, and consumer finance litigation support.

She is a graduate of The Ohio State University (B.A. 1985; J.D. *summa cum laude* 1991, Order of the Coif; Editor, *Ohio State Law Journal*). She served as law clerk for the Honorable John D. Holschuh, Chief Judge, U.S. District Court, Southern District of Ohio, 1991-1993. She is a member of the American and Ohio State Bar Associations.

I. Introduction

Federal savings banks and their predecessors, federal savings and loan associations, have been part of the financial services quiltwork since the 1930s when the Home Owners' Loan Act was passed to provide additional credit to the American people for the financing of the American dream—ownership of the single family residence. In recent years, the federal savings bank has become a favored vehicle for providing consumer financial services to the American consumer, both because of the continuing expansion of federal preemption available to federally-insured entities generally and because of the reduced restrictions on the powers of federal savings banks in recent legislation. Today, there is no other vehicle –federal or state – better able to provide a broad range of consumer financial services to the American consumer provided that the qualified thrift lender test and investment restrictions can be satisfied. The federal savings bank, however, is not the answer for lenders desiring to offer only limited types of consumer financial services products, because the qualified thrift lender test and investment restrictions will prohibit some types of product concentrations.

This article outlines the scope of federal preemption available to a federal savings bank engaged in offering consumer credit to the American public and outlines the recent legislative changes that made federal savings banks the vehicle of choice for many types of lending. The terms "federal savings bank" and "federal savings association" are used interchangeably.

II. Preemption

Section 4(a) of the Home Owners' Loan Act authorizes the Office of Thrift Supervision to promulgate regulations that preempt state laws affecting the operations of federal savings banks.[1] The OTS regulations provide that federal savings banks may extend credit as authorized under federal law without regard to

1. 12 U.S.C. § 1463(a), 12 C.F.R. § 560.2(a).

state laws purporting to regulate or otherwise affect their credit activities, except to the extent provided in paragraph (c) of Section 560.2 (*see* below) or Section 560.110 (*see* III below).[2] For purposes of Section 560.2, "state law" includes any state statute, regulation, ruling, order or judicial decision.[3] Except as provided in Section 560.110 (permitting a federal savings bank to charge interest at the maximum rate permitted to state-chartered or licensed lending institutions under the laws of the state in which it is located), the types of state laws preempted by paragraph (a) of Section 560.2 include, without limitation, state laws purporting to impose requirements regarding:

1. Licensing, registration, filings or reports by creditors;
2. The ability of a creditor to require or obtain private mortgage insurance, insurance for other collateral or other credit enhancements;
3. Loan-to-value ratios;
4. The terms of credit, including amortization of loans and the deferral and capitalization of interest and adjustments to the interest rate, balance, payments due or term to maturity of the loan, including the circumstances under which a loan may be called due and payable upon the passage of time or a specified event external to the loan;
5. Loan-related fees, including without limitation, initial charges, late charges, prepayment penalties, servicing fees and overlimit fees;
6. Escrow accounts, impound accounts and similar accounts;
7. Security property, including leaseholds;
8. Access to and use of credit reports;
9. Disclosure and advertising, including laws requiring specific statements, information or other content to be included in credit application forms, credit solicitations, billing statements, credit contracts or other credit related documents and laws requiring creditors to supply copies of credit reports to borrowers or applicants;
10. Processing, origination, servicing, sale or purchase of, or investment or participation in, mortgages;
11. Disbursements and repayments;
12. Usury and interest rate ceilings to the extent provided in 12 U.S.C. § 1735f-7a and 12 C.F.R. Part 590 and 12 U.S.C. § 1463(g) and 12 C.F.R. § 560.110; and
13. Due-on-sale clauses to the extent provided in 12 U.S.C. § 1701j-3 and 12 C.F.R. Part 591.[4]

Thus, federal savings banks need not generally comply with state laws regarding the above matters, unless the savings bank has chosen to operate under a particular state law as authorized in Section 560.110.

Paragraph (c) of Section 560.2 provides that state laws of the following types are not preempted to the extent that they only incidentally affect the lending operations of federal savings banks or are otherwise consistent with the purposes of paragraph (a) of Section 560.2:

1. Contract and commercial law;
2. Real property law;
3. Homestead laws specified in 12 U.S.C. § 1462a(f);
4. Tort law;
5. Criminal law; and
6. Any other law that the Office of Thrift Supervision, upon review, finds:
   a. Furthers a vital state interest; and
   b. Either has only an incidental effect on lending operations or is not otherwise contrary to the purposes expressed in paragraph (a) of Section 560.2.[5]

These preemptions are broader than those of any other federally-insured lender.

III. Exportation

"Exportation" is the term used to describe the rights of certain federally-insured lenders to charge their home state interest rates and fees in loans to residents of other states. Federal savings banks have "exportation" rights based on 12 U.S.C. § 1463(g)(1), which provides:

> [n]otwithstanding any State law, a savings association may charge interest on any extension of credit at a rate of not more than one percent in excess of the discount rate on 90-day commercial paper in effect at the Federal Reserve bank in the Federal Reserve district in which such savings association is located or at the rate allowed by the laws of the

2. 12 C.F.R. § 560.2(a).
3. *Id.*
4. *Id.* § 560.2(b).
5. *Id.* § 560.2(c).

State in which such savings association is located, whichever is greater.[6]

Thus, a federal savings bank may choose the greater of the federal rate authorized or the state rate for the state in which the savings bank is located and export this rate into other states.

OTS regulation Section 560.110 defines "interest" for the purpose of Section 1463(g)(1) as including any payment compensating a creditor or prospective creditor for an extension of credit, making available of a line of credit, or any default or breach by a borrower of a condition upon which credit was extended.[7] It includes, among other things, the following fees connected with credit extension or availability: numerical periodic rates, late fees, not sufficient funds fees, overlimit fees, annual fees, cash advance fees and membership fees.[8] It does not ordinarily include appraisal fees, premiums and commissions attributable to insurance guaranteeing repayment of any extension of credit, finders' fees, fees for document preparation or notarization or fees incurred to obtain credit reports.[9]

Prior to the enactment of 12 U.S.C. § 1463(g), enacted as part of the Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA), preemption for federal savings banks was found in Section 522 of the Depository Institutions Deregulation and Monetary Control Act of 1980 (DIDMCA). Section 525 of DIDMCA permitted states to opt out of Section 522 preemption by the enactment of a state law explicitly opting out of the preemption. FIRREA repealed Section 522 and reenacted its substantive provisions in 12 U.S.C. § 1463(g). Section 525 was not amended to reflect the change. Thus, it appears that states can no longer opt out of the preemption available to federal savings banks.

A federal savings bank that has branches in more than one state also has great latitude in deciding where it books its loans and which host state's laws apply to the loans.[10]

IV. Most Favored Lender

The "most favored lender doctrine" is the authority based on federal statutes, regulations and case law for certain federally-insured lenders to charge the same rates and fees as any other lender in their home state. Based on 12 U.S.C. § 1463(g)(1), quoted above, OTS regulation section 560.110 provides that a federal savings bank located in a state may charge interest at the maximum rate permitted by any state-chartered or licensed lending institution by the law of that state.[11] Thus, a federal savings bank may comply with the state law that offers the best rate and fee authority. If state law permits different interest charges on specified classes of loans, a federal savings bank making such loans is subject only to the provisions of state law relating to that class of loans that are material to the determination of the permitted interest.[12] For example, a federal savings bank may lawfully charge the highest rate permitted to be charged by a state-licensed small loan company without being so licensed, but subject to state law limitations on the size of loans made by small loan companies.[13]

Preemption based on Section 560.2 and exportation and most favored lender status based on Section 560.110 taken together permit a federal savings bank to rely on the law of the federal savings bank's home state that provides the best rate authority in its lending activities in all states, without regard to the laws of other states of the types listed in Section 560.2(a) (*see* II above). Once a federal savings bank has selected a home state law from which it obtains its rate authority, the federal savings bank is subject to those provisions of the chosen state law in the home state that are material to the determination of the permitted interest rate. The federal savings bank also is limited to those "material" provisions of the chosen law of the home state in its lending in other states. Such provisions would clearly include restrictions on fees determined to be included in interest as defined in Section 560.110(a). What other types of state law provisions, beyond those relating to the fees identified in Section 560.110(a), that are "material" to the determination of interest is less certain.

V. First Mortgages

For first lien mortgage loans, Section 1735f-7a of federal banking law provides that the provisions of the constitution or the laws of any State expressly limiting the rate or amount of interest, discount points, finance charges or other charges which may be charged, taken, received or reserved shall not apply to any loan, mortgage, credit sale or advance which is:

1. secured by a first lien on residential real property;
2. made after March 31, 1980; and
3. described in Section 527(b) of the National Housing Act with certain exceptions, including provisions relating to first liens on residential manufactured homes and residential cooperative housing.[14]

Therefore, for first mortgage loans, a federal savings bank need not comply with state law provisions limiting the rate or amount of interest, discount points, finance charges or other charges even if it has chosen to operate under a state stat-

6. 12 U.S.C. § 1463(g)(1).
7. 12 C.F.R. § 560.110(a).
8. *Id.*
9. *Id.*
10. OTS Op. No. 92/CC-14 from Harris Weinstein, Chief Counsel (Apr. 2, 1992).
11. 12 C.F.R. § 560.110(b).
12. *Id.*
13. *Id.*
14. 12 U.S.C. § 1735f-7a(a).

ute containing such restrictions. The OTS regulations have clarified that this preemption is limited to interest rates and points.[15]

The preemption in Section 1735f-7a does not apply to any mortgage made in any state after the date on which such state adopts a law which states explicitly and by its terms that such state does not want the preemption in Section 1735f-7a to apply with respect to mortgages made in such state.[16] States are also permitted to adopt laws after March 31, 1980 placing limitations on discount points or such other charges on any mortgage described above.[17]

VI. Contract Law

As stated in Section 560.2(c) discussed above, a federal savings bank must comply with state contract law. If a federal savings bank purchases or services a loan contract that contains contract provisions that are different from the authorities described above, those provisions are binding and cannot be changed except by amendment of the contract by agreement of the parties.

VII. Qualified Thrift Lender Test and Investment Restrictions

Federal savings banks are required to meet the qualified thrift lender test ("QTL test").[18] Federal savings banks that fail to meet the QTL test must either become a bank other than a savings bank or comply with certain restrictions that basically treat them as a national bank.[19] To meet the QTL test a federal savings bank must either (i) qualify as a domestic building and loan association or (ii) have qualified thrift investments that equal or exceed 65% of its portfolio assets on a monthly average basis in 9 out of every 12 months.[20]

To qualify as a domestic building and loan association 60% of the amount of the association's total assets must consists of:

1. Cash;

2. Obligations of the United States or of a state or political subdivision thereof, and stock or obligations of a corporation which is an instrumentality of the United States or of a state or political subdivision thereof, but not including obligations the interest on which is excludable from gross income under section 103;

3. Certificates of deposit in, or obligations of, a corporation organized under a state law which specifically authorizes such corporation to insure the deposits or share accounts of member associations;

4. Loans secured by a deposit or share of a member;

5. Loans secured by an interest in real property which is (or, from the proceeds of the loan, will become) residential real property or real property used primarily for church purposes, loans made for the improvement of residential real property or real property used primarily for church purposes, provided that for purposes of this clause, residential real property includes single or multifamily dwellings, facilities in residential developments dedicated to public use or property used on a nonprofit basis for residents, and mobile homes not used on a transient basis;

6. Loans secured by an interest in real property located within an urban renewal area to be developed for predominantly residential use under an urban renewal plan approved by the Secretary of Housing and Urban Development or located within any area covered by a program eligible for assistance under section 103 of the Demonstration Cities and Metropolitan Development Act of 1996, and loans made for the improvement of any such real property;

7. Loans secured by an interest in educational, health, or welfare institutions or facilities, including structures designed or used primarily for residential purposes for students, residents, and persons under care, employees, or members of the staff of such institutions or facilities;

8. Property acquired through the liquidation of defaulted loans described in clause 5, 6, or 7;

9. Loans made for the payment of expenses of college or university education or vocational training, in accordance with such regulations as may be prescribed by the Secretary;

10. Property used by the association in the conduct of the business which consists principally of acquiring the savings of the public and investing in loans; and

11. Any regular or residual interest in a REMIC, and any regular interest in a FASIT, but only in the proportion which the assets of such REMIC or FASIT consist of property described in

15. 12 C.F.R. § 590.3.

16. 12 U.S.C. § 1735f-7a(b)(2).

17. *Id.* § 1735f-7a(b)(4).

18. *Id.* § 1467a(m).

19. *Id.* § 1467a(m)(3).

20. *Id.* § 1467a(m)(1).

any of the preceding clauses; except that if 95% or more of the assets of such REMIC or FASIT are assets described in clauses 1 through 10, the entire interest in the REMIC or FASIT qualifies.[21]

Alternatively, a federal savings bank can maintain the required percentage of qualified thrift investments. Qualified thrift investments are required to equal at least 65% of the bank's portfolio and can consist of the following without limit:

1. The aggregate amount of loans held by the savings bank that were made to purchase, refinance, construct, improve, or repair domestic residential housing or manufactured housing;
2. Home-equity loans;
3. Securities backed by or representing an interest in mortgages on domestic residential housing or manufactured housing;
4. Existing obligations of deposit insurance agencies;
5. New obligations of deposit insurance agencies;
6. Shares of stock issued by any Federal home loan bank; and
7. Loans for educational purposes, loans to small businesses and loans made through credit card or credit card accounts.[22]

The 1996 legislation added "loans for educational purposes, loans to small businesses and loans made through credit card or credit card accounts" to the list of permitted investments.[23] This amendment greatly expanded the value of federal savings banks as vehicles to provide consumer financial services, but it left out more types of consumer financial services than it incorporated.

In addition, the following assets may be included in determining qualified thrift investments not to exceed 20% of the savings bank's portfolio assets:

1. 50% of the dollar amount of the residential mortgage loans originated by such savings bank and sold within 90 days of origination;
2. Investments in the capital stock or obligations of, and any other security issued by, any service corporation if such service corporation derives at least 80% of its annual gross revenues from activities directly related to purchasing, refinance, constructing, improving, or repairing domestic residential real estate or manufactured housing;
3. 200% of the dollar amount of loans and investments made to acquire, develop, and construct 1-to-4-family residences the purchase price of which is or is guaranteed to be not greater than 60% of the median value of comparable newly constructed 1-to-4-family residences within the local community in which such real estate is located, except that not more than 25% of the amount included under this subclause may consist of commercial properties related to providing services to residents of the development;
4. 200% of the dollar amount of loans for the acquisition or improvement of residential real property, churches, schools, and nursing homes located within, and loans for any other purpose to any small businesses located within any area which has been identified by the Director, in connection with any review or examination of community reinvestment practices, as a geographic area or neighborhood in which the credit needs of the low-and moderate-income residents of such area or neighborhood are not being adequately met;
5. Loans for the purchase or construction or churches, schools, nursing homes, and hospitals, other than those qualifying under clause 4 and loans for the improvement and upkeep of such properties;
6. Loans for personal, family, or household purposes (other than loans for personal, family, or household purposes described above); and
7. Shares of stock issued by the Federal Home Loan Mortgage Corporation or the Federal National Mortgage Association.[24]

The 1996 amendments removed the prior limitation of 10% on loans for personal, family, or household purposes, thus doubling the amount of consumer loans that can be held in the savings bank's portfolio assets.[25] This expansion, however, is not nearly as useful as the unlimited amount of credit card assets that qualify under the QTL test.

In addition to the QTL test, federal savings banks are also subject to certain other limitations and conditions in their investments.[26] A federal savings bank's

21. 26 U.S.C. § 7701(a)(19)(C).

22. 12 U.S.C. § 1467a(m)(4)(C)(ii).

23. Pub. L. No. 104-208, § 2303(g)(2)(A) (1996).

24. 12 U.S.C. § 1467a(m)(4)(C)(iii), (iv).

25. Pub. L. No. 104-208, § 2303(g)(2)(B) (1996).

26. 12 U.S.C. § 1464(c), 12 C.F.R. § 560.30.

loans for personal, family or household purposes may not exceed 35% of the assets of the federal savings bank, but amounts in excess of 30% of the assets may be invested only in loans which are made by the federal savings bank directly to the original obligor and with respect to which the savings bank does not pay any finder, referral or other fee, directly or indirectly, to any third party.[27] Loans made through credit cards or credit card accounts are not limited as to a percentage of assets.[28]

The most notable exceptions to the classifications of loans that can be owned without limit by federal savings banks are (1) unsecured consumer loans not permitting credit card access and (2) motor vehicle and other personal property secured consumer loans. The public policy reasons for these differences in treatment are not apparent, but the result is that federal savings banks are not available as a vehicle to provide those types of consumer financial services products unless other products that meet the QTL test and investment restrictions are also held in sufficient quantity.

VIII. Conclusions

Federal savings banks are authorized under federal law to rely on federal law and ignore state laws regarding licensing, registration, filing or reports of creditors; creditors' ability to require or obtain private mortgage insurance or insurance for other collateral; loan-to-value ratios; the terms of credit; loan-related fees; escrow accounts and similar accounts; security property; access to and use of credit reports; disclosure and advertising; processing, originating, servicing, sale or purchase of mortgages; disbursements and repayments; usury and interest; and due-on-sale clauses. Federal savings banks are required to comply with state contract law, commercial law, real property law, homestead law, tort law and criminal law.

Federal savings banks are authorized to choose the rate of interest of the state in which they are located and export this rate in loans to residents of other states. As outlined above, "interest" for exportation purposes is defined broadly to include various fees, such as late fees and non-sufficient funds fees. Thus, these fees can also be exported.

Under the most favored lender doctrine, federal savings banks are authorized to operate under the law of the state in which the federal savings bank is located that offers the best rate and fee authority. The federal savings bank must then comply with the other requirements of the state law under which it chooses to operate. The federal savings bank also must then comply with the other requirements of the state law under which it chooses to operate. The federal savings bank also must comply with these provisions of the chosen law of its home state in its lending in other states. In no case, however, does the federal savings bank have to comply with state licensing, registration or filing requirements aimed at the corporate entity.

For first mortgage loans, in addition to the above, federal law preempts any state law limiting the rate or amount of interest or discount points. Thus, in selecting a state law to operate under for first mortgage loans, a federal savings bank would not be required to comply with state interest rate and point limitations unless the state opted out of federal preemption.

The preemptions discussed above apply to loans originated by a federal savings bank and carry over to its servicing of these loans and to its right to sell these loans. However, loans originated by other entities do not acquire "preemption" or "exportation" rights simply because a federal savings bank services them or acquires them. A federal savings bank is bound by the terms of the loan contract it acquires or services and the laws applicable to the loans when they were originated and cannot change that applicable law without some form of contract amendment.

Federal savings banks are subject to the QTL test, which is a unique restriction at the federal level. The QTL test requires that federal savings banks maintain certain types of assets or investments in specified percentages. The 1996 amendments permit loans for educational purposes and loans made through credit cards or credit card accounts to be included without limit in calculating qualified thrift investments, in addition to traditional mortgage related investments. In addition, other loans for personal, family or household purposes may be included in an amount equal to 20% of the federal savings bank's portfolio assets. There is also an investment restriction applicable to federal savings banks that limits consumer loans to 35% of assets, except that credit card loans are not limited as to percentage of assets.

The amendments to the QTL test make federal savings banks more attractive vehicles for consumer lending and in particular for credit card lending, but do not permit them to offer other types of consumer financial services, such as motor vehicle secured loans, as the major product offering of the bank.

There are, of course, numerous other federal laws that apply to federal savings banks and their relationships with consumers. Those statutes and regulations, however, apply fairly equally to all federally-insured depository institutions, so federal savings banks incur no competitive disadvantages as a result. The bottom line is that federal savings banks enjoy broader and clearer preemption powers than any other type of financial services provider. Thus, they inevitably have become the vehicle of choice to provide consumer financial services in the United States provided that the QTL test and investment restrictions can be satisfied—and the word is spreading quickly.

27. 12 U.S.C. § 1464(c)(2)(D).

28. *Id.* § 1464(c)(1)(T).