Statement by FDIC Chairman Jelena McWilliams on the Final Rule: Federal Interest Rate Authority

Last Updated: June 25, 2020

Today, the Board will vote on a final rule regarding Federal Interest Rate Authority implementing sections 27 and 24(j) of the Federal Deposit Insurance Act (FDI Act). Specifically, the final rule would codify longstanding FDIC guidance regarding interest rates that may be charged by state banks and address statutory ambiguities that have created legal uncertainty.

The final rule accomplishes three important safeguards for the stability of our financial system by promoting safety and soundness, solidifying the functioning of a robust secondary market, and enabling the FDIC to fulfill its statutory mandate to minimize risk to the Deposit Insurance Fund (DIF).

To understand how we got to where we are today requires a brief primer on the law. Congress passed Section 27 of the FDI Act in 1980 to provide parity between state and national banks. Modeled after Section 85 of the National Bank Act, Section 27 has been interpreted to provide state banks interest rate authority similar to that of national banks. In 1990s, Congress made further modifications in the Riegle-Neal Interstate Banking and Branching Efficiency Act which allowed national and state banks to establish bank branches across state lines.[1]

Despite these changes, there were many ambiguities within the interest rate authority granted to state banks under the FDI Act. To remedy this, in 1998 the FDIC Board adopted and published FDIC General Counsel's Opinion 11, *Interest Charges by Interstate State Banks*, in the Federal Register.[2] Banks, consumers, financial markets, and courts have relied upon this interpretation for over 20 years, and together with longstanding Supreme Court precedent interpreting contract law, have created a robust interstate banking system and credit markets.

However, recent court decisions, including the 2015 decision of the U.S. Court of Appeals for the Second Circuit in Madden v. Midland Funding, LLC, have called into question these longstanding principles, thus compelling the FDIC to issue clarifying regulations.

Safety and Soundness

The final rule supports longstanding regulatory safety and soundness principles by ensuring the enforceability of the interest rate terms of loans made by state banks following the sale, assignment, or transfer of the loans. The Madden decision questions this enforceability and has created a ripple effect in the secondary market for loan sales within the Second Circuit. One commenter pointed to a study showing this impact decreased the value of collateralized loan pools within the Second Circuit, leading to a reduction in credit for those with lower credit scores.[3] That uncertainty raises significant safety and soundness concerns for financial institutions that may be unable to sell loans to manage liquidity and capital on their balance sheets.

Secondary Market

Banks and financial institutions rely on a robust secondary market to manage exposure. For example, banks may need increased liquidity to meet unusual deposit demands or to make additional credit available, especially in a time of financial stress. If the secondary market is not available, it calls into question the value of loans on bank balance sheets, and could lead to significant safety and soundness concerns.

Deposit Insurance Fund

The functioning of a robust secondary market for loans is also essential to the FDIC's mission to resolve failed banks. In its capacity as receiver, the FDIC has a statutory obligation to maximize the return on sales of assets, such as loans, in order to minimize the loss to the DIF.

The FDIC cannot maximize the return on sales of failed bank assets if the ability of banks to sell loans on the secondary market is undermined. In fact, from 2008 to present the FDIC has sold over $44 billion of unpaid principal balance loan assets of failed banks, the proceeds of which were contributed to the DIF.

Valid-When-Made

The final rule reaffirms and codifies in regulation the so-called "valid-when-made" doctrine. It is important to distinguish what the final rule does not do.

First, the final rule does not address the question of which entity is the "true lender" when a bank and a non-bank partner in making a loan. While the FDIC received a number of comments encouraging the agency to address the "true lender" doctrine in this rulemaking, the agency intends to address those issues in a separate rulemaking given the variety of ways in which banks and non-banks establish and structure partnerships.

Second, nothing in the final rule prohibits or limits the statutory authority4 permitting states to opt out of coverage of Section 27 as some states have done.

I support the final rule and thank all the staff for the hard work and coordination with the Office of the Comptroller of the Currency.

Thank you.

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[1]12 U.S.C. § 1831a(j).

[2]Fed. Reg. 27,282 (May 18, 1998).

[3]*See* Colleen Honigsberg, Robert Jackson and Richard Squire, "How Does Legal Enforceability Affect Consumer lending? Evidence from a Natural Experiment," *Journal of Law and Economics*, vol. 60 (November 2017).

[4]*See* Depository Institutions Deregulation and Monetary Control Act of 1980, Pub. L. 96-221, 94 Stat. 132 (1980). Iowa and Puerto Rico have opted out of coverage for section 27. Colorado, Maine, Massachusetts, North Carolina, Nebraska, and Wisconsin have previously opted out of coverage of section 27, but either rescinded their respective opt-out statutes or allowed them to expire.