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POWERED BY: LENDERS COMPLIANCE GROUP

Wednesday, June 6, 2018

Interest on Escrow

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The Dodd-Frank Wall Street Reform and Consumer Protection Act retained much of the existing framework regarding federal preemption of state laws. But included a number of significant changes that opened the door to a larger role for state involvement in the activities of federally chartered institutions.

For example, the Dodd-Frank Act clarified that states generally may, if they so choose, provide greater protection to consumers than Title X of Dodd-Frank (its Consumer Financial Protection Act) provides.

Specifically, Dodd-Frank § 1041 specifies that "a statute, regulation, order, or interpretation in effect in any state is not inconsistent with the provisions of this title if the protection that such statute, regulation, order, or interpretation affords to consumers is greater than the protection provided under this title."

Recently, a Chief Compliance Officer at a large financial services institution, a national bank, told me that he had received a call from a borrower who lives in California. The borrower contended that this financial institution should be paying him interest on his mortgage escrow account. The compliance officer was concerned about how this request should be met under Dodd-Frank.

After getting some facts regarding the institution's regulatory framework, I offered the following guidance.

Based on my call with him, it sounded as though the bank had made the decision to comply with state interest-on-escrow laws, even though the Office of the Comptroller of the Currency (OCC) and others have questioned whether a national bank is required to comply. A decision of the U.S.

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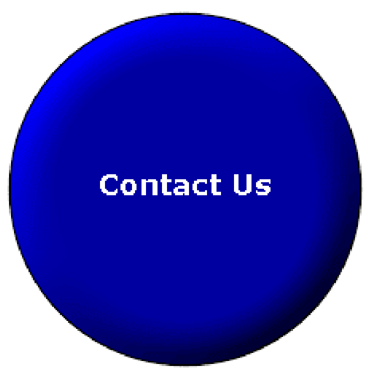

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Court of Appeals for the 9th Circuit suggests that compliance with state interest-on-escrow laws is a good idea, certainly for institutions located within the jurisdiction of the 9th Circuit (viz., Alaska, Arizona, California, Hawaii, Idaho, Montana, Nevada, Oregon, Washington, Guam, and the Northern Mariana Islands).

Suffice it to note that national banks and federal savings associations interested in avoiding litigation of the matter would be well-advised to comply with state interest-on-escrow laws.

Dodd-Frank § 1044 amended the National Bank Act to clarify the preemption standards for national banks and § 1046 amended the Home Owners' Loan Act to set the same preemption standards for federal savings associations. Dodd-Frank provides that state consumer financial laws are preempted only if:

- Application of a state consumer financial law would have a discriminatory effect on national banks (or federal savings associations), in comparison with the effect of the law on a bank (or savings association) chartered by that state;
- In accordance with the legal standard for preemption in the decision of the Supreme Court of the United States in Barnett Bank v. Nelson, 517 U.S. 25 (1996), the state consumer financial law prevents or significantly interferes with the exercise by the national bank (or federal savings association) of its powers; and any preemption determination may be made by a court, or by regulation or order of the Comptroller of the Currency (OCC), on a case-by-case basis in accordance with applicable law; or
- The state consumer financial law is preempted by a provision of federal law other than Title X of the Dodd-Frank Act.

On July 20, 2011, the OCC amended its regulations to reflect its understanding of the Dodd-Frank preemption standards as applied to national banks and federal savings associations (which Dodd-Frank moved from OTS to OCC control). Since 2011, several court decisions have considered how much change Dodd-Frank wrought.

The 9th Circuit noted that "[a]lthough Dodd-Frank significantly altered the regulatory framework governing financial institutions, with respect to NBA preemption, it merely codified the existing standard established in *Barnett Bank*…."

The 9th Circuit also addressed Dodd-Frank Act § 1461, the Act's "interest on escrow" amendment of the Truth-in-Lending Act (TILA). Section 1461 added 15 U.S.C. § 1639d(g)(3) to the escrow account provision of TILA that applies to any consumer credit transaction secured by a first lien on the principal dwelling of a consumer. This subsection provides that: "if prescribed by applicable State or Federal law, each creditor shall pay interest to the consumer on the amount held in any…escrow account that is subject to this section in the manner as prescribed by that applicable State or Federal law."

The State of California has an escrow interest law that requires financial institutions to pay at least two percent annual interest on the funds held in borrowers' escrow accounts (i.e., the type of escrow account often set up in

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conjunction with mortgage loans, either as a condition set by the lender or at the request of the borrower).

Here are the fine points. Lusnak, a borrower, sued Bank of America for failing to pay any interest on the positive balances in mortgage escrow accounts.[i] Lusnak's loan agreements provided that his mortgage loan "shall be governed by federal law and the law of the jurisdiction in which the Property is located." The parties agreed that his loan terms required Bank of America to pay interest on escrow funds if required by federal law or state law that is not preempted. They differed as to whether or not the state law was preempted. The bank acknowledged that it did not comply with state escrow interest laws and that its chief competitor (Wells Fargo) did, but it contended that no federal or "applicable" state law required it to pay interest on Lusnak's escrow account funds.

The district court dismissed the action, holding that the National Bank Act (NBA) preempted the state statute because the state law prevented or significantly interfered with banking powers. In so holding, the district court determined that TILA's interest-on-escrow provision did not affect the preemption analysis.

The 9th Circuit reversed. According to the 9th Circuit, the NBA did not preempt the California statute because no legal authority established that state escrow interest laws "prevent or significantly interfere" with the exercise of national bank powers. In addition, Congress, in enacting Dodd-Frank § 1461 (the TILA interest-on-escrow provision) indicated that they do not.

In the Dodd-Frank Act, Congress underscored that *Barnett Bank* continues to provide the preemption standard; that is, state consumer financial law is preempted only if it "prevents or significantly interferes with the exercise by the national bank of its powers."

The Court cited the Dodd-Frank interest-on-escrow provision quoted above. This language expressed Congress's view that such laws would not necessarily prevent or significantly interfere with a national bank's operations. Accordingly, the California statute did not prevent or significantly interfere with the bank's exercise of its powers.

The Court allowed Lusnak to proceed on a state law Unfair Competition Law (UCL) claim on the theory that the bank had violated the UCL by failing to comply with the escrow interest statute. It also allowed him to proceed on a breach of contract claim.

In 2011, the OCC amended § 34.4(a) to reflect the language of Dodd-Frank, but in the preamble to this amendment the OCC concluded that "the Dodd-Frank Act does not create a new, stand-alone "prevents or significantly interferes with" standard, but rather incorporates the conflict preemption legal standard and the reasoning that supports it in the Supreme Court's *Barnett* decision."

The OCC argued that the suggestion that Dodd-Frank intended to adopt a new "prevent or significantly interfere" preemption test failed to take account of the entire phrase of the Dodd-Frank provision, that is, that a state consumer financial law as applied to a national bank (or federal savings association) would be preempted only if "in accordance with the legal standard for preemption in the [Barnett] decision…, the State consumer financial law prevents or significantly interferes with the exercise by the national bank of its powers…." According to the OCC, the "legal standard for preemption" employed by *Barnett* was *conflict preemption* and "prevent or significantly interfere" was not the "legal standard for preemption in the decision."

In other words, as a first step, **a court must apply a conflict preemption standard in accordance with the Court's reasoning in *Barnett*. Then, the "prevent or significantly interferes" phrase would provide a "touchstone" to that conflict preemption standard and analysis.**

The net result, according to the OCC, was to leave in place precedents consistent with that analysis, such as the OCC rules. The OCC admitted, though, that its existing "obstruct, impair or condition" formulation of the *Barnett* standard had created confusion and that Dodd-Frank's use of the phrase "prevents or significantly interferes" may have been intended to reject the OCC's "obstruct, impair, or condition" approach. Accordingly, the OCC deleted that phrase when it amended its rules in 2011, although it insisted that the change did not "effect any substantive change" and specifically mentioned "escrow standards" as laws that would meaningfully interfere with the business of national banks.

The 9th Circuit, addressing this argument, stated that "to the extent that the OCC has largely reaffirmed its previous preemption conclusions without further analysis under the *Barnett Bank* standard [citing the preamble contained in 76 Federal Register 43549 (July 21, 2011)], we give it no greater deference than before Dodd-Frank's enactment, as the standard applied at that time **did not conform to** *Barnett Bank*" [boldface added]. In effect, the Court applied the "prevents or significantly interferes" as more than the "touchstone" mentioned by the OCC.

Perhaps the U.S. Supreme Court eventually will decide who is right - the 9th Circuit or the OCC.

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[i] Lusnak v. Bank of America, N.A., 2018 U.S. App.; 9th Cir. Mar. 2, 2018

Labels: Dodd-Frank, Escrows, Interest on Escrow, National Bank Act, OCC, TILA, Truth in Lending Act

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