AMERICAN PREDATORY LENDING AND THE GLOBAL FINANCIAL CRISIS

ORAL HISTORY PROJECT

Interview with

Arthur Wilmarth

Bass Connections

Duke University

2020

PREFACE

The following Oral History is the result of a recorded interview with Arthur Wilmarth conducted by Andrew O'Shaughnessy on August 11, 2020. This interview is part of the Bass Connections American Predatory Lending and the Global Financial Crisis Project.

Readers are asked to bear in mind that they are reading a transcript of spoken word, rather than written prose. The transcript has been reviewed and approved by the interviewee.

Transcriber: Patrick Rochelle Session: 1
Interviewee: Arthur Wilmarth Location: By Zoom
Interviewer: Andrew O'Shaughnessy Date: August 11, 2020

Andrew O'Shaughnessy: My name is Andrew O'Shaughnessy. I am a JD candidate at the Duke University School of Law. I am also a research assistant for the Global Financial Market Center's American Predatory Lending project. It is Tuesday, August 11th, 2020. I am speaking remotely with professor Arthur Wilmarth to conduct an oral history interview. Professor Wilmarth. Thank you for joining me today.

Arthur Wilmarth: Well, thank you for inviting me. It's a pleasure.

Andrew O'Shaughnessy: We'd like to start by establishing a little bit about your background. So, I understand you got your bachelor's from Yale and your JD from Harvard. So what led you from law school to the faculty at GW?

Arthur Wilmarth: Well, I graduated from Harvard in '75 and joined a Washington law firm to practice there for four years, with [an intervening period] of several months working as … an exchange lawyer with a firm of solicitors in London. After four years, I had started primarily as a litigation associate, and I decided that I really wanted to switch to a more transactional practice. So I joined the Washington office of Jones Day, what was then Jones Day, Reavis & Pogue. They needed help in their corporate [and securities] practice. … One of those things [I've discovered is] that life is very often a matter of serendipity. And one of my first projects when I [arrived at Jones Day] was to work on an amicus brief in the D.C. Circuit for a group called the Conference of State Bank Supervisors (CSBS), which is an association that represents all the state commissioners of banking. And [CSBS] was opposing the OCC [Office of the Comptroller of the Currency] on a preemptive regulation on a matter of banking structure. And it was my first exposure to banking law.

All I knew about banking law – this was 1979 at that point – was how to use my checking account and how to use my credit card. I knew a little bit about banks, but had not studied them in any extent. There were no courses in banking law that I can recall at law school. I certainly didn't take any. I found the case absolutely fascinating. And partly because it dealt with issues of federalism, which had always interested me and issues of constitutional law, particularly preemption, the supremacy clause, and so on. And I [concluded that banking law] is a terrific area. I really want to get involved with this. So that was sort of my introduction to banking law.

And I continued for the remaining seven years I was at Jones Day to work very closely with the Conference of State Bank Supervisors [and] with other banking clients [on] a range of both regulatory and transactional matters. And I really became increasingly interested in the regulatory practice, the whole theory of regulation. Why do we regulate banks? How should we regulate them? Does it make sense to have, what was then, a highly decentralized system? Does it make sense to have both federal and state regulation of these institutions? How should that system work and how did the federal regulatory agencies carry out their responsibilities? Particularly for me, the contrast between how the OCC was acting and how, for example, the Fed [Federal Reserve] acted under Chairman Paul Volcker, how the FDIC [Federal Depository Insurance Corporation] acted. You could see these very strong cultural and policy differences at that time between the different federal agencies. It wasn't just federal versus state. There was also quite a bit of variation among the federal agencies.

Then in 1985, I became a partner at Jones Day, but I always had in the back of my mind, the idea of entering the academy if that opportunity arose. And through a series of, again, very fortunate, serendipitous circumstances, I was able to join the [law] faculty of George Washington in 1986 and continue there until – I've just taken Emeritus status as of July 1, [2020]. I continued at GW during those years and again continued to focus on banking and financial regulation as my primary areas of interest. Although I [also] did work in corporate law, contracts, and history of the U.S. Constitution, which fits very naturally with banking because banking has sort of been one of the continuing motifs in American constitutional history.

Andrew O'Shaughnessy: One of the things that we're really excited to talk with you about is your participation in the legal battles over preemption in the 2000s. But to sort of set the stage, I'm curious about your academic work in the '80s and '90s and how it set the table for that debate in the 2000s. Could you just tell me a little bit about your work regarding the role of states in the dual banking system and your mounting concerns about nationwide consolidation?

Arthur Wilmarth: Sure. As you sort of indicated, the 1980s and '90s were primarily a time, a fight, a struggle, over bank structure. Should Congress take down the historic barriers to interstate banking? How should they do that? As you say, did nationwide consolidation make good sense? In my work with CSBS, and I continued to work as a consultant for them after I joined GW, a lot of the disputes in the '80s and '90s were over bank structure. One of the key issues was [whether] interstate banking [should] be done through state experimentation under the Bank Holding Company Act, a provision called the Douglas Amendment, which essentially allowed states, if they wanted to, to permit entry by out-of-state bank holding companies, to allow acquisitions of local banks by out-of-state holding companies. And a number of states began to do that. Of course, North Carolina was one of those states that entered into what were called regional compacts. … Toward the end of my time at Jones Day, I was involved in the famous Northeast Bancorp case,[1] [where] the New York-so-called money center banks were challenging the rights of the states to [establish] these regional compacts that allowed regional banks to come in, but did not allow New York banks [and] west coast California banks to come in. And they said that was unlawful. And the case, Northeast Bancorp, went to the Supreme Court in 1985. And the Supreme Court said, no, the Douglas Amendment did allow the states to do that, to allow regional entry but not nationwide entry. That [decision] certainly accelerated the movement toward interstate banking.

Of course, it wasn't very long before the big regional banks, including those in North Carolina decided, okay, now we're ready to go nationwide. We now want nationwide banking and most of the states did not want nationwide banking. At least I think a very significant majority did not. So there was a lot of resistance to that. One of the early articles I wrote was a 1992 article in the Iowa Law Review, in which I argued nationwide banking consolidation was a bad idea.[2] … The regional movement to me made sense, [and I argued] that the Congress should allow these regional movements to go forward. If there were states that wanted to allow nationwide entry, and I think Maine was one of them, that's fine. Let the states experiment with nationwide entry if they wanted, but I thought that the evidence as to the benefits of [nationwide] consolidation … was not yet clear and that it would be wrong for Congress to sort of preempt [that issue] by [allowing interstate banking] nationwide without more evidence.

And I've raised a number of issues as to why I thought having a small number of very large nationwide banks was a bad idea. Of course, the too-big-to-fail problem was one of the major issues. But I also thought that the larger banks had done a very poor job in supporting small businesses and in supporting smaller communities, more rural communities, or smaller midsize towns. And that to see the local banks disappear would be quite damaging to the economies of smaller midsize cities [and] rural areas. I, of course, predicted that a lot of the regional banks would be gobbled up by the big nationwide banks so that you wouldn't have that many, you could say, mid-sized regional banks either. So I was very concerned about the economic impact. I pointed out that antitrust law in the banking area was not at all well suited to stop either statewide concentration or particularly nationwide concentration. And the big guys had not established a good track

[1] Northeast Bancorp, Inc. v. Board of Governors of the Federal Reserve System, 472 U.S. 159 (1985)
[2] Wilmarth, Arthur E., Jr., "Too Big to Fail: Too Few to Serve? The Potential Risks of Nationwide Banks," 77 Iowa L. Rev. 957 (1992).

record. I was looking mainly at the banking crises of the 1980s and early 1990s, and of course, I think 11 of the 50 largest banks either failed or were bailed out. The Fed was forced to cut interest rates to extremely low levels in 1990 to … prop up the big banks, help them survive. And [there had] been massive forbearance for the big banks, all through the 1980s with their foreign lending problems and then their domestic lending problems. If these big guys were so wonderful, why were they having so much trouble and needing so much support?

So the arguments that were made on the other side of course were, bigger is better, bigger is more efficient, [due to] economies of scale [and] economies of scope. That everything would be hunky dory, if you just had a relatively small number of really big banks serving the whole country. And I kept saying, well, that's not what the evidence shows. But as you know, Congress then passed the Riegle-Neal Act in 1994, which over a three-year period moved us to nationwide banking. Fortunately, they imposed a 10% cap on nationwide bank deposits, although that cap could be evaded through emergency acquisitions, which became a reality during the financial crisis of 2007-09. But [the Riegle-Neal Act] allowed nationwide banks to emerge. And as I expected, they emerged relatively rapidly during the '90s and early 2000s and began to display many of the risks and concerns I thought they would create. And of course, when the global financial crisis came, it proved to be even more devastating than even I, a skeptic and a pessimist, had predicted.

Andrew O'Shaughnessy: Well, so you mentioned earlier that bank regulation has been a feature of American legal and political history for quite some time. And some of your first scholarship looked at that early history. How do you feel like your background in that history informs the way you were thinking about these issues up through 2000 or so?

Arthur Wilmarth: … There've been a lot of arguments and debates about whether the First and Second Banks of United States were a good thing or not. I think that one could have defended the Bank of the United States in its first or second configurations, if it had been purely what we would now view as a central bank. It was obviously conducting central bank functions through monetary policies. … It could restrain the state banks by presenting their notes for redemption in specie, in gold or silver, and that allowed it to restrain excessive credit creation by state banks. And on the other hand, if it wanted to allow more money creation, it could be more liberal about allowing state banks to issue bank notes. … At that time, bank notes were essentially the currency, deposit banking wasn't yet that well established. It was pretty minimal. [Issuing] bank notes [was] the main, the major function of banks and the major way they provided credit. That, I think, was a positive function. And I think the country suffered when the second [bank's charter] … was not renewed … due to Andrew Jackson's veto. And I think you can also make an argument that certainly the government needed a fiscal agent for its payments and for its collections. And so on. … Where I thought [both Banks of the United States] got off on a wrong foot was that the charters allowed them to engage in direct banking business in direct competition with state banks. And that's of course where most of the opposition came from.

Most of the people were not complaining about the fact that the government had a fiscal agent or a collection agent. Some people argued about whether the bank had good monetary policies, but what they really didn't like was that here was a bank that could conduct business across the nation. It wasn't limited by state lines, unlike the state banks. And it could engage in direct competition with the state banks, meanwhile, putting pressure on them through its monetary functions. And there was certainly evidence that it acted in its own interest in that way. … I think I didn't probably see it quite as clearly then as I see it now, but this idea of private, mixing of private and public functions, and the idea that the government is somehow subsidizing private financial functions, to me has always raised huge issues.

One might call it a form of crony capitalism, right? The government is putting … more than a thumb on the scale. It's putting a fist on the scale in favor of certain entities that are competing with other entities that don't have the same access to government largesse. I think that creates a whole series of problems, both financially, economically, and politically. So, count me as a skeptic of the first and second banks, while recognizing … some of their benefits.

Of course, one could draw one set of lines to the Fannie and Freddie problem and say that the GSEs (Government Sponsored Enterprises), had, again, this problem of mixed public and private functions with a perceived government backstop. But to me, as you saw these big nationwide banks emerge again, with tremendous power and presumptively "too big to fail" status, and with all the advantages they seem to get from federal policy, to me, this brought back the same problem of we're not really keeping private and public [functions] appropriately separated in our banking and financial policy and the perception that the government is going to be more willing to help or bail out the big guys creates a whole series of inequalities and disparities that I think is not appropriate and really damages again, both our political system and our economic and financial system.

Andrew O'Shaughnessy: So, during the 2000s, you were active in debates about the federal preemption of states' ability to regulate and enforce banking activity. How did you first become involved?

Arthur Wilmarth: Well, it's interesting. I wrote this very long article, took me about [four] years to do it. … [It] was published in 2002 by the *Illinois Law Review*.[3] And I'm lucky they took it. It's 260 pages long. But that was my attempt to understand what was happening to the banking system after Riegle-Neal. You had nationwide banking rapidly emerging. And the other thing that was happening was that the Glass-Steagall Act of 1933, which separated banks from the capital markets was being rapidly eroded through a series of administrative actions that opened loopholes either to let banks into the securities markets or to let securities firms into the banking markets, particularly through things like money market funds. And so the Glass-Steagall Act was being eroded. And you saw these large financial conglomerates being developed. Of course, this came to a climax in 1999 when Congress passed the Gramm-Leach-Bliley Act [and repealed the core provisions of the Glass-Steagall Act].[4]

Now why is that important? Well, because one of the first things the banks wanted to do was to get back into the securities underwriting business and why [did] they want to do that? Well, they wanted to take their loans and securitize them. First they started with credit card loans, and they securitized those. Then they quickly moved onto mortgage loans and began to securitize those. For a while, their mortgage securitizations were all done for Fannie [Mae] and Freddie [Mac]. They were taking conforming mortgages and creating prime mortgage-backed securities.

That by itself, might not have been disastrous, although I think it would have created some problems of its own. But of course, quickly they decided: “Hey, we can actually make more money, make more fees, more income if we take nonconforming mortgages, mortgages that don't comply with Fannie and Freddie's underwriting standards. … If we can package those into securities and get AAA ratings for them, at least most of them, and sell those out, we can get much higher fees and much higher underwriting spreads than Fannie or Freddie will pay us.” And so, beginning in the middle to late 1990s, and I talked about this in the 2002 article, you saw the banks getting much more involved in both subprime credit card underwriting, really risky subprime credit card loans and subprime or non-prime mortgage underwriting of mortgage backed securities.

And in 1998, there was a very significant financial market disruption when unexpectedly Russia defaulted on its debt. And that was

---

[3] Wilmarth, Jr., Arthur E. “The Transformation of the U.S. Financial Services Industry, 1975-2000.” 2002 U. Ill. L. Rev. 215. February 28, 2002. https://illinoislawreview.org/print/volume-2002-issue-2/the-transformation-of-the-u-s-financial-services-industry-1975-2000/

[4] Wilmarth describes the twenty-year campaign by big banks and federal regulators to undermine and repeal the Glass-Steagall Act in Chapters 7 and 8 of his recently-published book, *Taming the Megabanks: Why We Need a New Glass-Steagall Act* (Oxford University Press, 2020).

unexpected, (although it should have been expected) but it was unexpected because the IMF with the U.S. help, had rescued Mexico in 1995 and several East Asian countries in 1997 and 1998 from what otherwise would have been systemic defaults on their sovereign debt. … The U.S. and the IMF rushed in and essentially arranged bailouts, which largely protected foreign creditors, imposed very serious, severe austerity measures on the governments that accepted the bailouts, but protected international investors. And, it's funny, if you go look back at 1998, there were discussions that Russia was "too nuclear to fail".

But the IMF, I think, after coming close to a bailout, realized that it would just be throwing good money after bad. … At that time, Russia's government was extremely chaotic and extremely corrupt. And they simply, it was too big a hole to fill. They weren't going to throw good money after bad. They allowed Russia to default. That caused an enormous shock in the financial markets. And there was a sudden rush to safety, [a] rush to Treasuries. And institutions that had been taking very large risks based upon the notion that … things were going to be very calm in '98. It was going to be a very calm, good year. There were going to be no problems. Institutions that took those risks were suddenly in great trouble. Of course, one of them was Long-Term Capital Management, which was, I think the largest, but certainly the most spectacular hedge fund at the time that had made huge amounts of money over the prior three or four years based in part upon the computer models developed by Robert Merton and Myron Scholes and Fischer Black. And it seemed like they were, this was the rocket science of new finance, and they were, they had the market cornered and many other large financial institutions began to copy them. … Long-Term Capital Management basically was wiped out in just a matter of a couple [of] months, and the Fed realized what was going on. Now, why the Fed didn't realize what was going on [previously] is an interesting question. They seemed to have had no idea about the kind of risks that Long-Term Capital Management was taking, even though Long-Term Capital Management was a huge counterparty on most of the major [classes] of derivatives that were being [traded] at that time. So they were linked into all the major institutions, banks, and securities firms. But when [the Fed] figured out how bad it was, they arranged a bailout because they realized if Long-Term Capital Management went under, possibly some other major institutions would have been close to failure or severely shaken.

So [the Fed] arranged a bail out of Long-Term Capital Management by fourteen of the biggest banks and securities firms. Now at the same time, [the Russian debt default] caused a huge shock to the subprime market and a number of subprime lenders. At that time, most of whom were smaller and more aggressive thrift institutions, nonbank lenders, and something called industrial loan companies. A number of them failed. And suddenly the big guys bought up their operations, bought up the remnants of their operations. So you see two things happening. One is, "Hey, this non-prime mortgage market is risky." And for those institutions that had limited resources, they failed or had to sell out. And at the same time, the big guy is saying, "Oh, this is a big opportunity for us." And they rush in and buy up the operations. [Banks] like Citigroup, HSBC, Washington Mutual, they rush in and buy up the remnants of these organizations. And I'm thinking, why are these big guys getting into this so deeply? What are the risks of this? So I was already seeing this in 2002. Again, I didn't imagine the magnitude that it would grow to, but I could already see the problems here. The risks being taken. Very risky loans being securitized. And the question is, who's holding the bag on those loans? What if they go bad? And then we can talk about securitization.

So nationwide banking meant now these banks were everywhere across the country. They were either funding or owning large subprime operations. They were taking all these mortgages and credit cards, but especially mortgages and packaging them up into securities and spreading those securities out to investors across the country and around the world. And of course, I had begun looking back at what had happened during the 1920s and '30s, which was the last time we had so-called universal banking in the United States.

And [during] that time, [universal] packaged up a lot of really high risk, particularly foreign loans, but also domestic loans and spread them around the world to investors. And when that blew up in 1929, 1930, 1931, it was totally devastating.[5] So, I began to say, why wouldn't this happen again? We're seeing the same movement by the banks into this kind of activity. And it's even more concentrated. The banking system has become more concentrated than it was in the 1920s. Although that was certainly a period of some consolidation that was significant, but this is much more so. Why wouldn't we have the same problems again? Now I didn't know enough about Glass-Steagall. And again, I didn't foresee the magnitude of what was coming in 2007 to say we are definitely on the road to another 1929 to 1933, but I was saying this sure looks like it could lead to something like that.

Why [weren't] we concerned about it? Again, everybody [raised the] same arguments. Economies of scale, economies of scope, diversified is better. Bigger is better. This is just getting all financial services under one big umbrella in the case of Travelers Citigroup – one big financial supermarket. This will be great for everybody. And I thought, no. This is

[5] *See* Wilmarth, Arthur E., Jr., "Did Universal Banks Play a Significant Role in the U.S. Economy's Boom-and-Bust Cycle of 1921-33? A Preliminary Assessment," 4 *Current Developments in Monetary and Financial Law* 559-645 (International Monetary Fund, 2005), available at http://ssrn.com/abstract=838267. Wilmarth provides a more detailed analysis of the role that U.S. universal banks played in promoting the domestic and foreign lending booms of the 1920s in Chapters 2-4 of *Taming the Megabanks*.

a little bit of a digression, but a lot of these ideas came out of a Treasury report [Modernizing the Financial System] that was published in January 1991, where the Treasury proposed nationwide banking without restrictions, and also proposed repeal of Glass-Steagall. So you'd have unrestricted universal banking, financial conglomerates. And I was talking to the staff director on that project, and he wasn't really a financial expert, but he had been briefed by financial experts and he was telling me "Well diversification is great. More diversification is wonderful. It just takes care of all the risks and look at all the benefits." And I said, this is January, 1991, I said, "[Do] you know what the most diversified organization is in the world today?" And he said, "no, what?" I said, "the Soviet Union, how well does that work?" And … I caught him absolutely flat footed. He just hadn't considered it. And I thought, the Soviet Union is like the best argument against everything you're trying to do. The human intellect, human talent, can't manage organizations [that] try to do so many different things under enormous umbrellas. It's just not possible for the human mind or human beings to manage these things. And why would we think that these financial conglomerates would be any more successful? But of course I was [considered as] sort of the crazy uncle in the attic until 2007 came along and then people said, wait a minute, he was sort of warning that this stuff could happen. But up until then they thought, well, you just don't understand, you just don't understand what's really going on.

Andrew O'Shaughnessy: Did the reception of your work and admonitions vary from sectors to sector? So, the regulatory world is a large one. There are many players. I imagine industry would have a different perspective, your fellow academics and others. What was that like?

Arthur Wilmarth: … I don't want to make it too dramatic. I often felt like the voice in the wilderness or the prophet in sackcloth outside the city gates. I wasn't the only one obviously who was raising some of these concerns, but most of us who were dissenters about the value of repealing Glass-Steagall and the value of allowing these enormous financial conglomerates, and the value of securitizing consumer loans that were definitely high risk loans. We were all sort of treated as kind of outliers and people who essentially didn't get it. … Simon Johnson and James Kwak wrote this great book, *13 Bankers*. And they [explained] that the people who didn't like how things were going in the 1990s and 2000s, people thought, "well, you just don't understand this new, bright, shiny, new world of advanced kind of rocket finance and you're just sort of troglodytes or Neanderthals."

Obviously, the community banks liked what I was doing because I'm a great believer and supporter in community banks. Probably because I grew up in a small town and I saw the value of banks in that small town – it was a small city [in northwestern Pennsylvania] of about … when I was growing up about 15 to 20,000. It's about half that [size] now. But I saw how valuable banks were in that community. And I saw what happened when many of the banks either closed up or were sold off and were no longer [locally owned]. I saw what that did. It wasn't good. So I was a big community bank fan. Obviously, the states, most of them, except perhaps for the ones who were pushing for nationwide banking, liked what I was doing. But of course, everybody at the Wall Street level obviously thought I was nuts. Among the federal regulators, I didn't have real close relationships with federal regulators at that time. But … the OCC would have certainly seen me as an enemy. I think the Fed would have been skeptical.

I will tell you another anecdote, which again, in retrospect was interesting. So Dan Tarullo,[6] whom you know or certainly know about, was teaching at Georgetown. … right across the town from me. And I hadn't really gotten to know him, but he published this really interesting book called *Banking on Basel* in 2008, right as the crisis had begun but hadn't gotten real bad. It came out like in January. But he had seen my 2002 article and among other things, I was very skeptical about Basel II and its focus on so-called internal risk models that would allow the banks to establish their own risk models to figure out how risky they were. And they would tell the examiners, "Here's how risky we were and here's how much capital we should have."

And I think I made some irreverent observations such as, "well doesn't that sound like the IRS asking you to tell them how much taxes you owe, and they would just accept what you said, [and] they really wouldn't need to particularly audit you. They would just rely on, okay. You tell us, you owe this many taxes. We believe you. And okay, good." … And I said, that big banks look at capital the way that all of us, all the rest of us look at taxes. The last thing they want to do is post more capital. We could talk about why, but they don't want to. They hate it. And so this was of course an Alan Greenspan brainstorm, and of course you could predict that the banks were going to manipulate their models so they would have as little capital as possible. There were conflicts of interest built into it that there was no way that regulators could rely on it. And of course the longer I've lived and the longer I've seen how the financial industry works, generally, two things you have to figure out right up front are, okay, what are the incentives? What are the financial incentives for the key players in the system? And where are the conflicts of interest? And almost always whenever a disaster happens, you will find perverse incentives and horrendous conflicts of interest. And so, to me, this was a conflict of interest and a perverse incentive waiting to happen. Well, Dan saw that, and of course that was his point. That was a big point of his book; it's a very much an attack on the internal model

[6] Tarullo was a member of the Federal Reserve Board of Governors from 2009-2017. As oversight governor for supervision and regulation, he led the Board's financial regulatory reforms, including implementation of the Dodd-Frank Act.

approach that Basel II adopted and a warning that this is not going to end well.

He invited me to a workshop and I think it was in probably 2005 or early 2006, that everything seemed to be hunky dory at that point. There were no problems, except for those of us who were looking for them. There were no problems on the horizon, apparently. It was a very interesting roundtable. There were many Fed economists there, including some very prominent, senior Fed economists and he made his presentation. And it shall we say, got a pretty cool, if not frosty reception. I chimed in and said, “Dan, you're absolutely right. These internal models are going to be a disaster. The conflicts of interest are terrible. The incentives are terrible. Why would these banks possibly do anything but try to minimize their capital? And this modeling is, it's not been tested. It's unreliable. It's not based upon any really solid past experience.” And I remember one of the Fed people spoke up and he said, well, “this is all very interesting, but we believe in these models. And we've tested them very carefully and we've run them through all the algorithms, all the computer simulations. And we're very confident in them.”

He said something like the following: “I think when … we gain experience [with] this, you and Dan are going to find that your concerns are really not justified.” And I kind of wish we could have sort of, zoomed the same group of people into the same room three or four years later and say, “remember when you said that there weren't going to be any problems and that Dan and I just didn't understand?” And we were going to be shown to be the, he didn't come out and say you're a troglodyte or a Neanderthal, but that's what he was implying. You just don't understand. And at the time, I didn't get into a debate with him, but I thought, no, I understand very well. And I remember saying to myself, I'll be interested to see in some time just whether you were proven to be right or Dan and I are proven to be right. But there's another, I think that's kind of a revealing indication of how my views were seen at that time.

Andrew O’Shaughnessy: Well, so is this the context in which the OCC announces its new doctrine in 2004?

Arthur Wilmarth: Yeah. So then the other thing that’s happening at this time, and this kind of ties into Gramm-Leach-Bliley. So there was a huge fight between the Fed and the OCC in the late ‘90s. Now, they were very much in sync on deregulation, expanding powers, deemphasizing supervision, lightening supervision, “light touch” supervision, reliance on internal risk models, reliance on internal risk management. They were very much in sync on that. But there was one thing that they were not in sync on. They fought a lot over, which [agency was] going to regulate these new deregulated expanded powers? And the question was: would you allow national banks to form direct subsidiaries where they could engage in securities, insurance, other broader activities? And so … the national bank would become kind of a self-contained unit, which would give the OCC and the Treasury complete control. Or would you require them to do it through separate holding company subsidiaries under the umbrella of a financial holding company so the Fed would be in control?

So there was a huge battle between Alan Greenspan and Robert Rubin of the Treasury over this issue. Eventually, in Gramm-Leach-Bliley, Greenspan won. Yes, national banks were allowed to form financial subsidiaries to do securities activities, but not insurance. [And] the limitations on the financial subsidiaries were so restrictive that it made it completely … unattractive at least, for the biggest banks to do it through financial subs of the bank. But if you did it through a holding company subsidiary, you had much broader authority and the Fed could broaden out the authority even further through the so-called "complementary to financial" concept. So clearly the financial holding company became the way to go for the big guys. Well, that meant that the Fed's power, which was already more significant than the OCC's, expanded even further because they continued to have top level control over all the major institutions. So the OCC lost that battle.

And in fact, during this time, some large institutions had converted to state-Fed member charters, one of the most important being what was then J.P. Morgan was holding a state member charter. And when it merged with Chemical Bank, it kept its state member charter. The OCC was desperately afraid that more of the big banks might decide: "Hey, let's get state member charters. Then we'll be dealing with the Fed. The OCC really won't be in the picture. Yes, we'll have to deal with the FDIC, but they're not so important." The OCC had been pushing preemption right along, but they decided, "Oh, wait a minute, preemption, that's the way for us to get the allegiance of these big nationwide banks, because if we can't get the Fed out of the picture, we can obliterate state laws and we can say, 'Hey, take a national bank charter and you won't have to worry about any of these state laws anymore. Come to us.'"

The other background to this is that the thrifts, the federal thrifts, had used exactly the same playbook during the 1990s while Julie Williams was the [Senior Deputy] Chief Counsel of the OTS [Office of Thrift Supervision]. They obliterated state laws through preemption. The federal, the Home Owners' Loan Act, which governs federal thrifts, does not have any significant deference to or incorporation of state law, because it was adopted at a different time [during] the Great Depression. And there's just virtually no deference to state law. So it was much easier for the OTS to say, "preempt everything." And they did it in a series of orders and rulings and rules in the 1990s. And then you see a migration where virtually all [of] the [state] thrift institutions converted to federal charters. There were very few state-chartered savings associations left by the late '90s. Julie Williams [came] over to the OCC in 1996, and then almost immediately the same playbook starts getting played at the OCC. The same arguments, the same assertions that were made at the OTS are now being made by the OCC. Of course, it's a completely different statute with a much greater history of deference to state law, but they just say, "no – in fact, there's no deference to state law." So they begin a series of court cases beginning in the late '90s. Of course, invoking Chevron deference,[7] right along the way. And Chevron deference, as I described in … my 2002 article, was used to break down Glass-Steagall. And that's a big theme in my forthcoming book that of course, Chevron deference was now used to say, "Hey, as long as we say preemption, we don't have to prove that Congress said 'yes'. The states have to prove that Congress said 'no'." Now to me, this turned the whole idea of administrative law on its head. Wait a minute, don't you have to have authority for what you're doing?[8]

How can an agency do something on its own without delegated authority? And that was the approach until Chevron. But once Chevron got established, the approach became no – as long as the statute is silent or ambiguous, which means Congress hasn't delegated any authority, they can assert authority. And the person challenging the preemption has to prove the negative – in this case, the states. And, proving the negative is a very difficult thing to do. So, of course, the OCC began winning many of these cases. And then, after they won enough of those cases, they said, okay, now we're ready for across the board rules. And they issued these across-the-board rules in 2004, which preempted most state laws with a few exceptions.

And, Comptroller Hawke at that time – John D. Hawke Jr. – who was formerly Fed general counsel, was then the Comptroller. He had made a speech and given an interview about 18 months earlier saying, "yes, preemption's a major advantage of the national bank charter, and I'm not the least bit ashamed to promote it. And in fact, we're trying to invite large institutions to come to national charters. We're concerned that they've been going to state charters. We want them to come back." So it was clearly, it was very transparent. It was a move to get the biggest guys into the national charter. Again, talking about incentives. Of course, the OCC had a huge financial incentive beyond the normal bureaucratic empire-building turf issue. It had a direct budget impact

[7] Brannon, Valerie C. and Jared P. Cole. "Chevron Deference: A Primer." Congressional Research Service. September 19, 2017. https://fas.org/sgp/crs/misc/R44954.pdf

[8] *See* Wilmarth, Arthur E., 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 *Annual Review of Banking and Financial Law* 225 (2004), available at http://ssrn.com/abstract=577863. In Chapters 7 and 8 of *Taming the Megabanks*, Wilmarth discusses the crucial role that *Chevron* deference played in supporting the campaign by federal regulators to undermine the Glass-Steagall Act during the 1980s and 1990s.

because the OCC is not funded by Congressional appropriations. It's funded by assessments paid by the national banks. So the more big guys you have in your stable, the more money you can put into your budget. In 2005, JPMorgan Chase, which had just merged with Bank One. And Jamie Dimon, who had been Bank One's CEO, became CEO of JPMorgan. They converted to a federal charter. And HSBC and Bank of Montreal, which were two big foreign banks with big U.S. operations, they converted their operations from state charter to federal charter. Those three conversions moved something between $1 trillion and $2 trillion of bank assets into the OCC system. And their budget went up 15% in one year.

So this was a way of the OCC increasing its clout, partly, saying to the Fed, "Hey, we're not irrelevant yet. We're going to become more relevant because we're not done trying to be the number one federal regulator." And "hey, let's obliterate the states, get all the big banks into our system. And to do that, right, we're going to offer them life-time supervision, friendly regulator, and we're going to obliterate all state consumer protection laws. And we're going to tell the country, oh, just trust us. We'll take care of the consumer issues. We will make sure that consumers aren't harmed by this. … Just trust us."

Of course, they had an enforcement record that was almost nonexistent. I think I did a study and other people did studies [showing] that between 1995 and 2007, they brought only 13 enforcement actions against national banks that were at least publicly disclosed. And I think one of them might've been against a bank that [had] about $100 billion of assets, but none, none against the eight largest banks, the eight largest national banks. Oh, surprise, surprise, [none against the] eight largest national banks. They also used to have what was a complaint website. You could go to their website and see the complaints. The eight largest national banks had about 60% or 65% of the national bank assets, somewhere in that range. But they had more than 80% of the customer complaints. So here's where all the customer complaints were, and they hadn't taken any action against any of these guys. So that tells you a little bit about their enforcement philosophy at the time.

Andrew O'Shaughnessy: So what chronologically from your perspective, what was the next major legal development in this area?

Arthur Wilmarth: Okay. So now you have the 2004 blanket preemption. You have already the universal banks, securitization of high-risk mortgages. And there [are] some other regulatory actions that are taken at this time, particularly on the capital side, which are kind of complicated. The federal regulators at the same time adopted extremely liberal, lenient capital requirements for securitized mortgages if you held the so-called AAA strips. [Those capital rules] allowed the big banks to hold these AAA tranches on their balance sheets with virtually no capital at all, with very little capital on their balance sheets. Or if they pushed them off their balance sheet to so-called asset-backed securities conduits, off-balance-sheet conduits, they didn't have to have any capital. So you had … extremely lenient supervision, basically no enforcement, extremely low capital levels through the internal models approach and these … further concessions on AAA tranches of MBS and CDOs. And what you see is an explosion, an explosion of non-prime high-risk mortgages and derivative securities, like the CDOs, and of course then the credit default swaps, which were ways of taking further bets on mortgages. So we could say a little bit about the chain of securitization and how that could possibly have been allowed to develop without the regulators saying "boo" right? So you take a pool of high risk mortgages and the way that they would structure them would be that 80% or so of the so called strips or tranches would be AAA. They'd get AAA ratings from the credit ratings agencies, of course, to whom they paid fees.

They also paid consulting fees [and said] to the agencies, "Hey, we'll pay you rating fees, but we'll also pay you consulting fees, if you show us how to get more AAA." So here again, bad fee incentives, bad conflicts of interest at the ratings agencies. Then they would have about 15% in the so-called mezzanine tranches and about 5% down in what were called the equity or toxic trash tranches. So the question is: the 80% AAAs, you could sell those anywhere, right? People wanted those. Oh, I know again, you could say, okay, these were AAA securities, these mortgage-backed securities, and yet they paid yields that were considerably higher than any comparable AAA securities. Why was that? Because they were more risky, but people thought, okay, AAA. It won't default. We'll buy them.

Now. The toxic or equity tranche. That was tough because in the old days, the banks used to keep that. Well, that didn't turn out well after the 1998 episode that I mentioned. And after 1998, the regulators said, no, no, no. If you keep the lowest, the equity toxic trash tranche, you'll have to almost keep dollar for dollar capital. So they had to get rid of that. What do they do? They found hedge funds. There were plenty of hedge funds that were willing to take high risk debt like this, these equity tranches. So they sold them to the hedge funds, but in many cases, they would make loans to the hedge funds that would allow them to buy the equity tranches. So, okay, they're not holding them, but they're holding the loans from the equity, the hedge funds that hold this stuff. And of course, when the crisis came along, many of these hedge funds blew up and failed. And of course, many of the loans then came back and defaulted on the big guys. So it was just [a] shell game.

Now the mezzanine was another shell game because nobody wanted those. The mezzanine tranche didn't pay a high enough yield to interest the really high-risk hedge fund people. And it was too risky for, and not at a high enough rating for, most institutional investors, like insurance companies, pension funds, that have to buy AAA. So what are they going to do? They created the investor. That's where the CDOs first came from. Because, "Oh, well, if we create these CDOs, they'll buy all the mezzanine tranches, they'll put those in a pool. And then they'll create a new set of tranches, 80% AAA, 15% mezzanine, 5% equity. We can get rid of all the mezzanine tranches off the mortgage backed securities and send them over to CDOs," which of course they were underwriting as well. Well, this is a little bit harder because certainly the triple A's for CDOs were more, much more risky than the triple A's for MBS, because now your AAA for the CDO is really based upon the mezzanine tranche of the MBS, which is very risky.

So they needed something to help them out. "Oh, we'll get AIG," and then later, the monoline bond insurers "to give us credit default swaps [and] guarantees that back up the mezzanines. And if we get these credit default swap guarantees, then the ratings agencies, of course, greased with appropriate fees will give us the triple A's for all the top tranches of the CDOs." Now then you'd say, "oh … now you've got mezzanine tranches of CDOs. What do you do with those? Oh, let's create CDO squared." So the whole thing just went on and on — it was an infernal machine.

Arthur Wilmarth: And the risk was always being apparently shuttled to somebody else. But in many cases, not really fully transferred because what happens if the hedge funds default on their loans for their toxic trash? What happens if AIG can't pay off its credit default swaps? Or the monoline bond insurers can't pay off their guarantees? Now toward the end, they were not even able to sell all the AAA tranches of the CDOs. That's when the big guys began getting high on their own supply. They began putting the AAA strips of the CDOs on their own balance sheets or in these off-balance-sheet conduits. And so, [in] 2007, [when] the subprime market blows up, Citigroup is sitting there holding $50 billion of high-risk mortgages and mortgage-backed securities, mostly CDOs and kind of offshoots of CDOs. Merrill Lynch is holding more than $50 billion. UBS is holding more than $50 billion. Of the $640 billion of CDOs outstanding in 2007, about $430 [to] $450 billion eventually defaulted. And again, I didn't understand this until after the crisis. I knew some of it was happening, but I didn't understand the full extent of it. When I finally [understood], and I think the first book that gave me [that] insight was *The Big Short* because in *The Big Short*, Michael Lewis kind of goes through the infernal machine, how the CDOs were created and what they meant. And when I read that book, I thought, "Oh my God, how did this happen?"

Arthur Wilmarth: And the regulators, the federal regulators just stood by and said nothing. And then the question is, did they know? Now the regulators, the federal regulators, were adopting the internal models, internal risk-based approach, where they seem to simply say: "Do you have a model?

What does it say? Do you have a risk policy? Okay, does the risk policy say what it's supposed to say?" They were not doing [transaction testing] – Tom Hoenig has talked about this. Tom Hoenig is someone you should talk to. Tom Hoenig, who was the President of the Federal Reserve Bank of Kansas City for 20 years. And then was the Vice Chair of the FDIC for six years. Tom Hoenig said, "look, we're not doing transaction testing anymore. We're not getting into the loan files." Now, interestingly, they had been doing transaction testing on community banks forever. Let's look at your loan file. Do you have appraisals? Do you have the proper documentation, right? Do you have any guarantees that you need? But they weren't doing transaction testing on RMBS and CDOs. My view is if I've been an examiner and had seen one of these, you [would] say, this is insane, right? I mean, this as I've described it, it's insane on its face. But nobody said boo. Now of course, the states were seeing … the types of mortgages that were being pushed out to borrowers to get the raw material for the RMBS and eventually for the CDOs. Because this is an underwriting machine, right? What the big guys want is they want the underwriting fees. In order to get the underwriting fees, they have to get the raw material, the mortgages.

So they were either making the mortgages themselves or buying them from the nonprime, sorry, the nondepository lenders like Ameriquest or Century One or New Century or Option One. To whom they of course gave warehouse loans to fund the mortgages or get them from brokers. What the states were seeing is what kind of mortgages [they] were making. And they were insane mortgages, right? You've probably had prior descriptions of the so-called hybrid subprime mortgage – the 2/28s and the 3/27s. Or the option ARMs, which were doomed, right? They were Ponzi schemes, where in many cases I read that the borrower would say to the lending officer or the broker, "I can pay the teaser rate, right? The introductory teaser rate. I can't pay the full amortized rate. I won't be able to do it. I'll default." And the loan officer or the broker would say to them, "Oh, don't worry. We'll refinance you before the teaser rate period runs out or refinance you into a new hybrid subprime or a new option ARM." Of course, there'll be a lot of fees involved for us and for the people up top. … What this created was a system where, unless you had a continual refinancing of these mortgages, you are going to have, predictably, an enormous cascade of defaults. And … if the mortgages defaulted, eventually the RMBS or particularly the CDOs were going to default and whoever held those were going to blow up. And the CDS were going to be called on these securities.

So AIG and the mono-line bond insurers were going to be in great difficulty. The states saw the mortgages and they began to take action to stop it. Now here's where the OCC comes in and says, "Oh, if you're a national bank, pay no attention to what the states are doing." Federal thrifts, same thing. "We're going to allow you to roll up your mortgage lending [into] a direct operating subsidiary, right? If you put your mortgage company [into] a direct operating subsidiary, which keeps it within the national bank or federal thrift family, then preemption applies to the op-sub just the way it does to the bank. And you're thinking, “now wait a minute, this isn't a national bank. It doesn't have a national charter.” “Oh, it doesn't matter,” they said. “It's like a division of the bank.” But it isn't a division of the bank. It's a separate corporation. Why are you doing that? Well, in fact, the banks didn't want this mortgage lending activity within the bank. They knew how risky it was.

And they also knew it was a boom and bust business. They often had to fire people quickly when the business fell off and they didn't want those people inside the bank. They wanted them in a separate company where they could fire them easier and where the liabilities could be dealt with easier and you'd have a corporate wall between them. So they didn't want [them] in the national bank, but the OCC said, “Don't worry. If it's a state-chartered op-sub owned by the national bank, it's just the same.” And of course it wasn't. Of course that led to the Watters versus Wachovia case,[9] which we can talk about. And then the OCC said, “Oh, [the states don’t get to enforce] state laws that we kind of have to admit apply even to national banks.”… Barney Frank had sort of put Comptroller Hawke on the hot seat and said, “Are you telling me,” he said, “that even state fair lending laws, state anti-discrimination laws don't apply to national banks? Are you telling me that?” And Comptroller Hawke, to his credit, said, “No, if it's really a bona fide fair lending, anti-discrimination law, it's a state [law that applies to national banks as long as] it doesn't discriminate against national banks. Yeah, we admit that that applies to us.”

So then what happened is Eliot Spitzer, who was then the Attorney General [of] New York, sent out a series of inquiries to the biggest banks in New York, saying, “Hey, I see you're HMDA [Home Mortgage Disclosure Act] data that you put out and it seems to show a lot of disparities [for mortgage lending] by race and ethnicity and sex. I want to see your underlying information about these loans because I think you violated the New York fair lending law.” And, of course, then the OCC charged in and said, “Oh, no, no, not only do we preempt state law, we also preempt state enforcement. So even if it’s a valid law,” they said, “only we get to enforce it. We, the OCC, because trust us, we'll enforce it. You, the state, don't get to enforce it.”

And of course that led to the Cuomo versus Clearing House case.[10] The states are seeing the [mortgage lending] problems and they're responding. And, as people have said, it's much harder to capture 50 or 51 state regulators than it is to capture one federal regulator or two.

---

[9] Watters v. Wachovia Bank, N.A., 550 U.S. 1 (2008).
[10] Cuomo v. Clearing House, LLC, 557 U.S. 519 (2009).

And the state AGs are elected and – all being aspiring governors – they want to show the people that they're doing an effective job helping consumers. So they have the right incentives to come in and protect the consumers where the OCC had no incentives to protect consumers. And so the OCC had to fight the AGs and try to stop them as well as trying to block [the enforcement of] any of these state laws from up high. The states to their credit, or at least many of them, are seeing these problems and trying to respond. And the federal people keep saying, no, no, no, no. It's not a problem. Don't worry. And of course, then we know what happened.

Andrew O'Shaughnessy: So, when these legal cases are really coming under scrutiny, Watters and then Clearing House, how did you wind up deciding to contribute an amicus brief to each?

Arthur Wilmarth: … Again, it was of course largely through my continuing relationship with CSBS, [and] I … was one of the advocates who argued a couple of the lower court cases that led to Watters. I had kind of hoped that they would let me argue the case itself in the Supreme Court, but for political reasons I didn't get that chance. I don't think [my advocacy] would have – would have made the difference, but it would have been fun to try. And then I … helped [to] prepare an amicus brief that was filed in the Supreme Court in Watters.

… When [the] Cuomo [case] came along, now New York was firmly in control of that case, but of course, I was supporting them. And I wrote an article about the District Court decision, about how bad it was and how wrong it was.[11] And at the Second Circuit level, they didn't cite my article, but [the dissent] cited some of the same things I had argued. And there was a strong dissent in the Second Circuit, which I think was crucial because to my astonishment, we couldn't get any dissents [in the lower court decisions that led to the Watters case]. There were three [decisions by] Courts of Appeals. No, actually four. There [were decisions from the] Second Circuit, the Fourth Circuit, the Sixth Circuit, and the Ninth Circuit that – four cases that led up to Watters. And we couldn't get any dissents from any of those courts. And they all just kept saying Chevron, Chevron, Chevron. But in the Second Circuit case in Cuomo, we got a very strong dissent saying, this is nuts. [The OCC is] saying the state law applies, that they admit it applies, but the state doesn't get to enforce it. Isn't there something called the 10th amendment? And so at least we got a very strong dissent in Cuomo, which really helped us. But I saw both of these cases as absolutely crucial, partly because I thought there will be no role for state law anymore. If we lose these cases, state law will be irrelevant. Everybody will convert their operations either to a national bank or federal thrift or

---

[11] Wilmarth, Jr., Arthur E., "*OCC v. Spitzer*: An Erroneous Application of *Chevron* That Should Be Reversed," 86 *BNA's Banking Report* No. 8, at 379-94 (Feb. 20, 2006), available at http://ssrn.com/abstract=886380.

an op-sub. And the states won't – simply won't have a meaningful role to play for anyone of any size. And at the same time, we've got to sort of somehow get the federal policy makers to understand what a disaster is waiting to happen. In other words, we've got to stop this predatory nonprime lending. And at least these cases, well – particularly Watters – provided a good vehicle to raise those alarms. Because Watters – the cases leading up to Watters were being litigated [in] 2003, 2004, 2005, 2006. [Watters] finally gets to the Supreme Court in 2007, but there was plenty of time to sort of focus on what was going on. And of course, the OCC kept saying, "Don't worry. No, we're in control of it."

This [takes us] to the oral argument at Watters, which I attended. And the OCC gets up and says, repeatedly, "the states are interfering, the states don't know what they're doing, the states are causing all this trouble. We're in control. Don't worry about it. We've never steered you wrong. Just trust us." Well, that was convincing to the majority. But Justice Stevens, who knew a lot about banking law. I'm not sure whether he learned about it in practice, but he's always had a really strong interest in banking law. He's written a number of interesting opinions on banking law. He wrote the dissent [in Watters], and he was just stinging. I remember him asking the Solicitor General, whoever was arguing for the OCC from the Solicitor General's office. He said, "Can you tell me how many additional examiners the OCC has hired to take on all these mortgage operating subsidiaries that you've invited into the system? How many additional examiners have you hired?" "I don't know, Mr. Justice, how many we've hired." And he was not pleased by that response. [In effect, he was admonishing the OCC.] "Tell me how you're managing this. Tell me how you're dealing with the risks." Justice Scalia, interestingly. I don't know, he had written a very favorable opinion for the OCC back in a case called Smiley (Smiley v. Citibank), which was a credit card case in 1996. And I don't know if something happened between Smiley and Cuomo, but something must have happened to really sour Scalia on the OCC because he was also very, very tough. And Chief Justice Roberts was sort of focused on the federalism issue. And he says, "How can you take a state corporation that's chartered by the state and somehow turn it into a federal vehicle? I don't see how you can do that." So for Roberts, it was more of a federalism issue. I don't see [how] I can take a state-chartered corporation and treat it as if it was federally chartered. So the case came out five to three, unfortunately against the states, which meant that the mania continued, right? The frenzy continued. And the market blew up.

Interestingly, who were the national banks involved in [the cases that led to the Watters decision]? Okay. One of them was National City out of Cleveland. National City, which was big in subprime. And then in … 2006, [it got even] bigger by buying First Franklin from Merrill where

Merrill thought, “Oh, good, we’ll dump this dog on, on National City.” So National City, which was a pretty good-sized bank, [with] over $100 billion [in assets], got into terrible trouble. And eventually [it] was sold in a distress sale to PNC, which got some TARP money to help them take them over. But essentially, it was a managed failure.

Wachovia. We all know how Wachovia ended up, right? That was an outright failure, which Wells Fargo had to take over. Wachovia was the lead [respondent in the Watters case]. Very ironic that Wachovia, which had been the first case, they become the poster child for what happens. Wells Fargo. Okay. Wells Fargo. At that time, everybody thought, well, they seemed to come through the financial crisis okay. Of course, we now know that actually they were not so okay. So I'm sorry. Those are the three banks. Two failed and the [other] one, Wells Fargo, didn't fail, but certainly has been highly tarnished since then. And it was interesting because even at the time I remember talking to people and saying, “Wells Fargo didn't seem to be in great trouble during this crisis.” And people kept saying, “No, no, no, they've got huge problems particularly in the consumer side. Eventually, it's going to come out,” they kept saying. “They've got huge problems. It's going to come out.” And I thought, “Okay, well that's news to me.” But a few years later it turns out they did have huge problems.

So that's Wachovia. Well then, Cuomo [was] argued up through the Second Circuit, mainly in 2007 and 2008, and then gets to the Supreme Court in the spring of 2009. So there's almost a two-year lapse between the Wachovia case (Watters versus Wachovia) and the Cuomo versus Clearing House case. And I went to that oral argument after filing an amicus brief, and the atmosphere was completely different. I've written about that in a book chapter.[12] Now clearly the OCC comes in, the advocate. [There were] separate arguments for the Clearing House and for the Solicitor General. I remember the Clearing House advocate gets up and starts quoting from Watters. “Here's why this is just the same as Watters and you have to hold that Watters controls.” … And he didn't get very far into his argument when Justice Ginsburg, who had written the majority opinion in Watters … says, “This is a different case.” She says, “This is not the same case as Watters … The only thing we decided at Watters is whether you could have an operating subsidiary getting the same preemption as the parent bank.” “We didn't decide anything else”, she says. “Don't quote that language to me.” She says, “don't quote it, it’s not applicable.” Now, in fact, it was highly applicable, but she was mad. I haven't talked to Justice Ginsburg, but I suspect she thought, “I was snookered,” right? Or a Western Pennsylvania

---

[12] Wilmarth, Jr., Arthur E., “*Cuomo v. Clearing House*: The Supreme Court Responds to the to the Subprime Financial Crisis and Delivers a Major Victory for the Dual Banking System and Consumer Protection,” in *The Panic of 2008: Causes, Consequences and Implications for Reform* 295-345 (Lawrence E. Mitchell & Arthur E. Wilmarth, Jr., eds., Edward Elgar Publishing, 2010) (working paper version available at http://ssrn.com/abstract=1499216).

expression: I was hornswoggled, right? I mean, they totally misled me. They led me to think that they were in total control of this matter and that there was no problem.

And then everything blows up, including Wachovia itself, and I got a bunch of egg on my face metaphorically. I'm not going to let that happen again. And of course, Stevens and Scalia were just as scathing as they had been in Watters. Breyer was sort of interesting because Breyer seemed quite skeptical of … Attorney General [Cuomo's] arguments. Souter was clearly aligned against the OCC. On the other hand, Roberts had switched because Roberts said, "Okay, this is a different case now because you're talking about [a] direct enforcement action by a state Attorney General against a national bank, not against an op-sub. And to me, McCulloch versus Maryland tells me that the state can't do that."

So, it was an interesting situation where Stevens and Scalia stay in the same position [against the OCC's preemption argument]. They attract Ginsburg, Souter, and Breyer. And I've always thought that it must be that Ginsburg and Souter went to Breyer and said, "We know that you're not really that comfortable with this, but we need your vote on this. You got to come with us." And obviously, in this case, Roberts switches to the dissent, which Thomas writes. Thomas had recused himself from Wachovia because I think his son, I think maybe worked for Wachovia or something. But he had been recused. So Thomas writes the dissent. Alito and Kennedy stay where they were [in support of the OCC], which was in the majority – on the [dissenting side in Cuomo] where they had been in the majority in Watters. Scalia's opinion [in Cuomo] is very interesting because it shows that he's, at one time he was a fervent defender of Chevron. By Cuomo he's – he's become, I think, disenchanted with Chevron. And he takes a very narrow view of Chevron. He doesn't say it doesn't apply, but he basically says, "Look, the language and history here [are] clear enough that the states have always had the right to enforce their valid laws against national banks, including a 1924 Supreme Court opinion on the exact same issue that said, yes, the state can enforce its valid law against the national bank." So he said that this is not an issue where we would defer to any agency expertise.

Of course, Thomas takes the more conventional view [under Chevron], which is, "Well, the statute isn't crystal clear. It says visitorial powers. What does that mean? It's not crystal clear and okay, there's a Supreme Court case [in 1924], but we don't always follow Supreme Court cases. The agency has some ability not to follow them if they think that they're not really controlling. … Chevron says … we have to defer on an ambiguous statute." So [Cuomo is] a fascinating case on what Chevron means and how it should be applied. But I think the background is that if the financial crisis had not occurred between Watters and Cuomo, probably, Breyer would have gone with the majority and … probably the states would have lost Cuomo.[13] [Even so,] I was astonished that, after the financial crisis, right, how could a single Supreme Court Justice back up the OCC this time, right? How can even one? And it was a five-four decision.

Now thank heavens [that] Congress did some very valuable things in the Dodd Frank Act. And one of them was [to] specifically incorporate Cuomo by name in subsection (i) of 12 U.S.C. 25b which says, "Yes, the states get to enforce – the state AGs get to enforce valid state laws against national banks as held in Cuomo versus Clearing House," which is very valuable because Justice Souter is gone now, Justice Scalia is gone now, Justice Stevens has gone now. Three of the [Justices that joined the] majority [opinion] in Cuomo are no longer on the Court. So I'm delighted that Congress has incorporated it.

There was one other thing I was going to say about Cuomo. Let's see if I can recapture that. … We can talk about then how the drafting of 12 U.S.C. 25b [in] the Dodd Frank Act, which restricted the preemption powers of national banks, because that in itself is an interesting story about how that statute got drafted and passed.

Andrew O'Shaughnessy: Please.

Arthur Wilmarth: Despite the intense opposition … of the OCC and the industry.

Andrew O'Shaughnessy: That would be great.

Arthur Wilmarth: Okay. So, I got a [telephone] call in 2009. It was after the Cuomo decision had been decided. I got a series of calls from Treasury staff [members] who were working on the Dodd Frank Act. And they said, "Gee, We see this preemption issue as really a bad problem." And I said, "Yeah, it is a bad problem. If you don't fix it, you'll – we'll be no better off than we were before."

… One thing I was going to go back and talk about [was that] Justice Scalia's majority opinion [in Cuomo] took the position I had advocated in my amicus brief because the OCC position was: the states can't enforce any law or [take] any type of enforcement [action] against national banks, even if it's a valid state law. New York, which I thought was mistaken, said "No, we can enforce a valid state law by every means, including administrative enforcement, as well as judicial enforcement." And I had said to New York, "I think that's a mistake. I think that there's

---

[13] See Wilmarth, Arthur E., Jr., "*Cuomo v. Clearing House*: The Supreme Court Responds to the Subprime Financial Crisis and Delivers a Major Victory for the Dual Banking System and Consumer Protection," in *The Panic of 2008: Causes, Consequences and Implications for Reform* 295-345 (Lawrence E. Mitchell & Arthur E. Wilmarth, Jr., eds., Edward Elgar Publishing, 2010) (working paper version available at http://ssrn.com/abstract=1499216).

a very strong and robust tradition of states not examining national banks except for escheat laws. It's the only real exception. And I just think you're asking the court to turn its back on … the language of the statute [saying] that you can't examine national banks. And if you can do administrative enforcement, then that's like examination." … I said, "I think you're asking for too much." So, I made the argument and there was one district court case that I found that supported it, which was … "There's a real huge difference between administrative enforcement [and] examination [by] subpoena where there's no judicial supervision, and judicial enforcement, where you have to sue through the courts. You have to follow discovery rules. The court can decide how much discovery you get. The court can stop abusive discovery."

So [judicial enforcement would give] protection for the national banks against the unjustified, unwarranted fishing expedition. That is exactly the line that Scalia took. That judicial enforcement is good because there is this [judicial] oversight [to stop an] unwarranted fishing expedition. But administrative enforcement is not good. That would be too intrusive. I don't claim to be any genius, but I could see that there was no way they were going to win the administrative enforcement. And I was afraid by making that argument, they were going to lose the judicial enforcement argument. Luckily, Scalia saw that distinction and upheld it in his opinion. So that's what's incorporated in 12 U.S.C. 25b, subsection (i): the right of judicial enforcement by state attorneys general [against national banks].

… I began to get these calls [from Treasury staff members] in 2009, [which] continued in 2010, about what we should do about preemption. And I said, "Well, the first thing," I said, "is you've got to protect Cuomo. You can't let that be lost." And I said, "You've got to go back to the Barnett prevent or significantly interfere with preemption standard."[14] That in order for a state law to be preempted, you have to show that [it] either prevents the national bank, or at least significantly interferes with the ability of a national bank to conduct its authorized powers. That's a well-established 1996 Supreme Court case. The OCC has never accepted that [standard]. They always say, "No, no, Barnett's out there, but it means preempt everything." They just refuse to accept the "prevent or significantly interfere" language, because it does restrict how much they can preempt. So you've got to get that in there. And I said, "And you've got to close down the op-sub [preemption]. You've got to say … no preemption for subsidiaries." … I'm sure I was not, by far, not the only person saying that to them, telling them that. But if you look at [Section] 25b, those things are in there. [Congress] expressly incorporated the Barnett prevent or significantly interfere standard. They expressly incorporated the Cuomo judicial enforcement by state AG standard.[15]

[14] Barnett Bank of Marion County, N.A. v. Nelson, 517 U.S. 25 (1996)
[15] *See* 12 U.S.C. § 25b.

And in three places, which kind of surprised me, there are three different provisions that say in different ways, there is no preemption for subsidiaries, affiliates, or agents of national banks, unless they are themselves chartered as national banks.

Because, in addition to Watters, there had been some bad cases before Dodd-Frank saying that even agents of national banks were entitled to preemption, which was shocking and horrible. So [including] those three things were really important. Well, even though the Treasury Department was all behind this, and it was part of the Dodd-Frank package, the industry fought it, of course, tooth and nail. They fought the preemption issue just about as hard as they fought the Consumer Financial Protection Bureau. Because, they realized, “If we can defeat the Consumer Financial Protection Bureau and if we can make the preemption standard so watered down that it's meaningless, and if the OCC is left in charge … most of the harm can be avoided.” The OCC [is formally] an autonomous Bureau of the Treasury Department. But everybody has known for years that they're [not] autonomous, they follow what Treasury wants. Until this example, I've never ever seen the OCC take a position that was contrary to the position of the Treasury Secretary and the senior Treasury staff. Never. And in many cases, [the OCC] were echoing – with Bob Rubin or with [Nicholas Brady], … the Treasury secretary under [George H.W.] Bush when the 1991 report was issued. They were echoing what the Treasury Secretary said. In this case, they came out in public opposition to the Treasury Secretary [Tim Geithner] and aligned themselves completely with the big banks on [Section 25b. The OCC said], “This is terrible. We can't accept this. This has got to be voted down. And they came really, really close. In fact, GW and Better Markets had a recent 10th anniversary Dodd-Frank program and Barney Frank spoke. And … when they asked him, did you ever think that the bill wasn't going to get through? And he said, “Yeah, on this preemption issue.” He said, “The industry fought it so hard.” And there were so-called moderate Blue Dog Democrats. Melissa Bean, who was [a] Congresswoman from Illinois, was one of the leaders. They were aligned with the industry. And [Barney Frank] said, “I thought we weren't going to make it.” But he said, “We finally got the [preemption] language in.” I was aware that this was an extremely difficult go. And to me, the preemption provisions of 12 U.S.C. 25b are one of the great accomplishments of Dodd-Frank along with the Bureau of Consumer Financial Protection.[16]

Now, again, not surprisingly, [Section 25b and the CFPB have] been subject to continuing attacks by the industry. And then, most shockingly, the OCC then was told [in 2010], “You’ve got to adopt new

---

[16] For further analysis of the significance of 12 U.S.C. § 25b, see Wilmarth, Arthur E., Jr., “The Dodd-Frank Act’s Expansion of State Authority to Protect Consumers of Financial Services,” 36 *Journal of Corporation Law* 893 (2011), available at http://ssrn.com/abstract=1891970.

rules. Your existing rules are not good." So notice it took them a full year to do it. When they finally put out the 2011 rules, they made a few concessions, they made a few concessions they had to make. But they didn't make a lot of important concessions. They continued to take the position that the "prevent or significantly interfere" standard in [Section 25b] is not a stand-alone preemption standard, even though it's there in black and white in the statute. "Oh, no, no, no. It's just there once. We don't have to pay attention to it. It's only there once." You can't even imagine an agency making these kinds of arguments. And then they … [re-]adopted three blanket rules that came from their 2004 rules. One is on deposit taking, preempting a lot of state laws [on] deposit taking. One is on non-real estate lending, which would [include] credit card lending, personal lending. Again, preempting a lot of state laws … which they don't have the authority to preempt. And then one is on real estate lending. Preempting, again, a lot of state laws that they don't have authority to preempt. Now the preemption standards of 25b have … three other really important provisions. One is: If you're going to preempt, you have to do [so] on a case-by-case basis, state-by-state. You have to show state-by-state that you're [justified in your] preemption. Second, you have to show substantial evidence supporting your claims for why you're preempting [state] law. That to me means substantial factual evidence. And third – and this was something else I talked about with the Treasury people – I said, "Chevron deference is killing the states on preemption. You've got to do something about Chevron deference."

To my delight, they put in a special provision saying [that], from now on, OCC preemption determinations will not get Chevron deference. They will only get Skidmore deference, which means, "Hey, if the OCC makes a good showing that's persuasive, [that] carries the burden of persuasion, fine. If they don't, no." Which means that now it's no longer [sufficient] that Congress [failed to say] no [to preemption]. Now the OCC has to prove that Congress said yes, which is to me [a] huge [win].[17]

So what did the OCC do? First of all, they refuse to acknowledge the prevent or significantly interfere standard. Secondly, they adopt these three blanket rules without any case-by-case analysis of state laws and without any substantial evidence, any factual … evidence. They make some blanket allegations about interference, burden, whatever, but no empirical showing of any kind. And then they [assert], "Oh, well, we don't need to do this because we're just reissuing existing rules. Dodd Frank has an exception, which says – Section 1043 – it says, "The provisions of [Section] 25b do not apply to any preexisting contracts of national banks." Those will be covered by the old existing rules. Now

---

[17] For further analysis of the significance of 12 U.S.C. § 25b, see Wilmarth, Arthur E., Jr., "The Dodd-Frank Act's Expansion of State Authority to Protect Consumers of Financial Services," 36 *Journal of Corporation Law* 893 (2011), available at http://ssrn.com/abstract=1891970.

doesn't Section 1043 make it pretty clear that after July 21, 2010, [Section 25b] applies and you've got to comply with the new laws? “Oh no,” they say, “we don't need to worry about case-by-case or substantial evidence. We're just repeating what we already said [in 2004].” It's just – astonishing. And then in there – you may have heard about their current “valid when made” and “true lender” rules. They're asserting, “We get Chevron deference … for these rules.” This is an agency that just refuses to learn even when they're defeated and kind of pummeled around a bit.

Some of my friends and I have joked, “There must be something in the water or Kool-Aid over there.” But I can't imagine an agency just refusing to follow what is crystal clear statutory language. What that means is the preemption battles are not over. They're continuing. … They adopted this “valid when made” rule. And they've [proposed] a “true lender” rule that they're going to adopt that would say [a] national bank could make [a] loan and sell it to anybody, and [the buyer will] get all the preemption that the national bank originally got even if the national bank only holds the loan for one day. One day. … You've heard about the so-called rent-a-charter schemes. If the national bank forms a rent-a-charter scheme with a non-bank and just serves as a conduit, right? The national bank just holds the loan for one day and then passes it along, [and according to the OCC], … the rent-a-charter partner, which is usually a payday lender, auto title lender, or some kind of really bad operator, they get all the preemption. Does this sound like an agency that has learned anything? They're just on the same campaign. It's really sad.

So, the good news [is] that Cuomo was a major victory that really saved the state [banking] system in my opinion [by upholding the] ability of the states to [enforce their valid laws against national banks]. And 12 U.S.C. 25b along with the Bureau of Consumer Protection [are also] major victories. But no victory is ever final when you're up against [the OCC] – and this is, of course, another reason why I oppose our current system. You have these enormous multi-trillion-dollar institutions that have unbelievable power within the regulatory system, within the political system, and unlimited resources to unleash how many, self-created studies, policy papers that are completely skewed, non-objective. But they can just flood regulators and politicians. And what about the [resources of the] people who are up against them? It's a huge disparity. So it's not only too big to fail that's [a huge problem] – that was proven in both 2008 and 2009. And then most recently when they got bailed out again [in March 2020], but [also the problems of] too big to manage, too big to regulate. These are huge continuing problems until we change the system. My forthcoming book[18] argues

[18] Wilmarth, Jr., Arthur E., *Taming the Megabanks: Why We Need a New Glass-Steagall Act* (Oxford University Press, 2020).

[that] the best way to change the system is to say, banks have to be banks, capital markets have to be capital markets. You've got to break up these enormous financial conglomerates that [are] just too dangerous, too powerful, too unaccountable to allow to exist. And this, of course, [raises] the same problem about holding senior executives accountable. Tell me the last example of a senior top executive [of a megabank] who was held criminally liable, or even civilly liable for a significant amount. Okay. The Wells Fargo case, again, maybe. They hit the big people with some civil money penalty orders, but that's the exception, not the rule.

Andrew O'Shaughnessy: Well, that seems like a good segue to a conclusion to – one of the questions that we ask in conclusion of all of our interviews, which is – what do you think that state level policy makers, in particular, should take away from the mortgage crisis and its resolution in Dodd Frank and related policies and regulations today? Do you feel like there were lessons that went unlearned?

Arthur Wilmarth: … Certainly, what has been done in the mortgage space has generally been very good in terms of, we don't have hybrid exploding nonprime and option ARM mortgages anymore. There is an ability to repay standard. I worry about [that standard] being watered down. And I think that we have to be careful that – I think we should have learned from the mortgage crisis that there are worse things than not being able to afford a house. To be put into a house that you can't afford and then being foreclosed upon, ejected, and having your credit history destroyed for several years strikes me as a very bad proposition. So I'm all for expanding housing opportunities, but not where they're unaffordable. I just think that's a terrible trap to put people in. So I think mortgage credit has been significantly improved.

Nonmortgage credit, I think, is a huge problem. We still have terrible patterns of payday lending, auto title lending. I [see] overdraft policies that are incredibly abusive and they haven't been fixed. And of course, one of the sad things is that [CFPB] Director [Richard] Cordray adopted – it took him too long, but he adopted – a pretty strong payday lending rule, which [now has] been rescinded by Director Kraninger. Mandatory arbitration, another terrible problem. Again, Director Cordray to his credit adopted a mandatory arbitration rule, which was then overridden by Congress … including Democrats. It wasn't just Republicans. That to me was a terrible disaster. I think mandatory arbitration is one of the real scourges of consumers because they can't get a fair tribunal. They can't get a public tribunal. There's no precedent even if they win. … No one else would know that they won. It's a complete — it's a kangaroo court system. So I would say the predatory nonmortgage credit products have not been solved and desperately need to be dealt with. The mandatory arbitration is certainly an issue that needs to be dealt with. And it can only be dealt with by Congress because the Supreme

Court – unfortunately, and not to Justice Scalia's credit – [has] made mandatory arbitration sort of a fortress, so it would take Congressional action to change it.

…

On a systemic basis, I think what you're seeing is that the system we have … is dominated by huge universal banks and almost as equally huge shadow banks, which effectively are treated as banks whenever problems come. [Shadow banks include] the private equity firms in the world, the big asset managers, the big hedge funds. … The Fed and the federal government bailed out the entire financial system [in 2008], including the capital markets. But [in 2020] they've gone even further. And now they're starting to bail out the corporate debt market and that gets you into the real economy. Again, because these asset managers have taken huge risks with corporate debt. Corporate debt was underwritten by either the big universal banks or the big private equity firms. And the regulator stood by over the last decade while this huge corporate debt machine was cranking, much of which was used to fund stock buybacks. You're issuing debt to fund stock buybacks? That doesn't make any sense. Why would the regulators allow the banks to underwrite debt for that purpose? Knowing that eventually, the piper is going to have to be paid. And that's what happened here. The corporations were so overleveraged, [and] much of that corporate debt was taken up into exchange traded funds … So now we're bailing out exchange traded funds and these highly leveraged corporations. … What I'm saying is that the safety net, the bailout net keeps getting broader and broader and broader, and it won't stop as long as we have this system that's dominated by these enormous institutions that aren't properly regulated, that can't be properly regulated and keep arbitraging on the assumption that they're going to be bailed out if they get into trouble. I [have] told my students [about] the history of federal financial policy, certainly going back to 1998 and arguably going back to … 1987 with the Fed's intervention after the stock market crash. It's created this asymmetric risk curve, right? That [you can] shoot the moon. We won't stop you. Take risk, risk, risk. But then as the market comes into crisis, and we think that the markets [are] going to crash, we rush in and stabilize everything. So we create a floor [under the market]. … So there's no limit to the upside.

[But] there's a definite limit to the downside. What are most people going to do? They're going to take more and more and more risk. And I think that monetary policy has been terribly distorted in the process. And the only way I can think of to get out of this cycle is to break up the structure that creates it by saying, "Banks need to go back to being banks, and then they're going to be strongly regulated, and we're not going to allow nonbanks to do banking type stuff." So my proposal is [that] if any debt instrument is payable [at par – 100% of face value] …

in less than 90 days or 91 days, it has to be in a bank. No more money market funds, no more short-term repos, no more short-term commercial paper, no more short-term anything. The capital markets people, if they want to fund themselves [at] 91 days plus, fine. And hopefully we would make it more clear that they're not going to be necessarily bailed out, that they'll be much less likely to [be] bailed out. Then you might actually get some market discipline again, and you might stop this sort of endless cycle of speculative risk-taking and bailout, which [it] seems to me we've been on that cycle now for far too long.

Andrew O'Shaughnessy: Could you elaborate a little bit on what you just described? I think in your work, you describe it as the distinction between banking and commerce.

Arthur Wilmarth: Yes. … There's another issue [created by combinations between banking and commercial activities conducted by] nonfinancial corporations. [I strongly support separating banking and commerce for] the same reason I think it's [a] terrible idea to combine capital markets and banking, because it increases speculative risk taking, it creates these giant too big to fail institutions, too big to manage, too big to regulate institutions. It creates these perceived subsidies that distort market signals and market risk taking.

Imagine then if you allow [combinations of banks with] Apple, Google, Amazon, take your pick. Of course, 15 years ago, it was Walmart. You allow one of these giant commercial firms to acquire banks and become a commercial-banking conglomerate. Now it seems to me you're distorting competition significantly in the commercial sector by [allowing] everybody who can get a bank [charter to obtain] huge advantages because they have cheap deposits, the cheapest money that you can get anywhere in the private market. And they have access to the Fed's payment system, those subsidies, access to the Fed's discount window, too big to fail subsidies. So now they're going to be at a huge advantage [compared] to any company that's too small or otherwise unable to control a bank. They're going to have a huge advantage. And then now you're extending the safety net to cover the entire economy, essentially.

So again, you'd have this – more concentration, more consolidation, more domination [by] huge institutions. More conflicts of interest. Of course, there are huge problems [created by the fact that] if you're a commercial entity and you own a bank, how are you going to use your credit? You're going to use your credit to support your business operations. So … you're not going to make sound loans. You're not going to make objective loans. You're going to make preferential loans and even risky loans to back up your commercial side. So [allowing combinations between banks and commercial firms] just multiplies the conflict of interest, perverse incentives, subsidy extension, [and] market distortion. So to me, banking – merging banking and commerce is even worse than merging banking and capital markets. And I'm very worried of course that you still have the industrial loan company or industrial bank charter. The FDIC is proposing to open that up more broadly to commercial firms.[19]

And then you now have the OCC saying, "Oh, let's offer a nondepository charter to lenders and payment [service providers so] that they get all the advantages of national banks except for deposits." And of course, the assumption is that [the OCC] will force the Fed to let these [nondepository national banks] get Fed services over time. Again, do we really want Google, Amazon, Apple, Microsoft, Facebook [to become directly involved in] banking? I think that's a terrible idea. I have no problem with them developing technological products or services and selling them to banks. That's fine. But why should we want them controlling banks? [Take a] look at the Wirecard debacle that has just occurred in Germany, where you had Wirecard, a payment processor bank, connected to [what] sounds like a bunch of scoundrels at the parent company that were engaged in all sorts of terrible things like pornographic sites and very high-risk activities and very unsavory activities. And when the Wirecard bank blew up, it's caused tremendous damage. And then the German regulator says, "Oh, well, we really couldn't stop that because we didn't have control over the parent company. We only had control over the bank." Well, that strikes me as an object lesson that we ought to pay attention to.

[END OF SESSION]

---

[19] See Wilmarth, Arthur E., Jr., "The FDIC Should Not Allow Commercial Firms to Acquire Industrial Banks," 39 *Banking & Financial Services Policy Report* No. 5 (May 2020), at 1-17, available at http://ssrn.com/abstract=3613022.