Kentucky Law Journal

Volume 99 | Issue 1 Article 2

2010

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Kentucky Law Journal

VOLUME 99 2010–2011 NUMBER 1

SPEECH

A Brief History of Banking and Investment Regulation in the US and A Challenge to Remain the Greatest Nation in the World

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The State of Kentucky and this great law school, in particular, have made more than their fair share of contributions to the legal profession. Two of the country's most influential Supreme Court justices, Justice Louis D. Brandeis and Justice John Marshall Harlan I, hail from this state. Your College of Law was one of our nation's first public law schools and the first to institute a trial practice program. Of course, outside of the legal profession, Kentucky is also known for thoroughbred horse racing and is

1 The University of Kentucky College of Law was proud to have William T. Coleman, Jr. speak on campus on April 8, 2010, as the Ray Distinguished Lecturer. Mr. Coleman is a senior partner and the senior counselor at O'Melveny and Myers, LLP, in Washington, D.C. Mr. Coleman's legal career has spanned over sixty years in both the public and private sectors. After graduating first in his class from Harvard Law School in 1946, where he was the third person of color accepted on the Harvard Law Review, Mr. Coleman clerked for the Honorable Herbert F. Goodrich in the United States Court of Appeals for the Third Circuit. He later clerked for Justice Felix Frankfurter, making him the first person of color to serve as a Supreme Court clerk.

Mr. Coleman practiced law in New York City and Philadelphia before being appointed secretary of the US Department of Transportation during the Ford administration. In addition to his legal practice, Mr. Coleman is a member of the Harvard Law School Dean's Advisory Board, as well as the boards of directors of several major corporations, including JPMorgan Chase, IBM, CIGNA, Penn Mutual Life Insurance Company, and PepsiCo.

Mr. Coleman is on the council of the American Law Institute, and his scholarly work has been published in numerous legal journals including the Harvard Law Review, the Tulane Law Review, and the University of Pennsylvania Law Review.

Devoted to civic and philanthropic work as well as an active legal practice, Mr. Coleman has served on the boards of trustees for the Carnegie Institution of Washington, the Brookings Institution, the Philadelphia Museum of Art, and the New York City Ballet, Inc. He has also been a member of the board of directors of the National Symphony Orchestra and a member of the Trustee Council for the National Gallery of Art. For years he was chairperson of the board of directors of the NAACP Legal Defense and Educational Fund, Inc. In 1995, Mr. Coleman received the Presidential Medal of Honor from President William Clinton.

the proud home to one of the country's most closely followed sporting events, which captures the attention of the entire nation with unmatched excitement and flair—and fashion—the Kentucky Derby.

First, I would like to begin by talking about the history of banking systems and investment firms in the United States. Then, I will turn my attention to a second topic of broader scope: namely, the challenges that face the next generation of American lawyers.

The history of banking in the United States began before we became a nation, when certain American colonies created banking systems. Later, as a young nation, many newly formed states created their own banks, and the United States Congress also created two national banks. You can find out more about these two banks by reading the Supreme Court's decisions in *McCulloch v. Maryland* and *Osborn v. Bank of the United States*. Personally, I first learned about these historical events when I was a student at the Wharton School of the University of Pennsylvania. On that campus, there is a building named for Stephen Girard. He purchased the assets of the First Bank of the United States when its charter expired. When he died, he was one of the wealthiest men in the United States, and he left large portions of his estate to support public education in Pennsylvania.

Soon after the Supreme Court decisions in *McCulloch* and *Osborn*, there were further important developments in American banking. Several states developed large banks, and eventually, the federal government decided that it had to get permanently involved in the banking business. The Federal Reserve Board was created. The McFadden Act, enacted in 1927, prohibited branch banking in an effort to level the playing field between the national and state banks. In 1933, the Glass-Steagall Act was passed, and it established the Federal Deposit Insurance Corporation and separated commercial and investment banking. As you may know, Glass-Steagall was amended in 1999 by the Gramm-Leach-Bliley Act, which allowed commercial banks, investment banks, securities firms, and insurance companies to consolidate. In the period between the enactments of Glass-Steagall and Gramm-Leach-Bliley and thereafter, Congress passed more than fifteen major federal statutes that regulate or carry significant implications for the banking industry in the United States. The National Housing Act of 1934, the Bank Holding Company Act of 1956, amended in 1970, the Bank Secrecy Act of 1970, the Community Reinvestment Act of 1977, the Financial Institutions Reform, Recovery, and Enforcement Act of 1989, and the Patriot Act of 2001 are just a few examples of relevant subsequent legislation.

At this time four different federal regulators—the Federal Reserve, the Office of the Comptroller of the Currency, the Office of Thrift Supervision, and the Federal Deposit Insurance Corporation—as well as state banking authorities are currently in the business of regulating the activities of national and state banks, federal and state savings and loan institutions, and bank holding companies.[2]

As you can imagine, these complex business relationships sometimes create problems. For instance, I faced an aspect of these problems when I argued before the Supreme Court of the United States in *Clarke v. Securities Industry Ass'n*. The legal issue before the court was whether the Security Pacific Bank, a California bank, could operate an investment firm at offices in California as well as in other states. The Court, in *Clarke*, decided that such business practices were legal.

As you may know, following the collapse of Wall Street giants Bear Stearns and Lehman Brothers and in the wake of what became known as the Great Financial Crisis of 2008, economists, politicians, lawyers, law professors, financial experts, and pundits of all stripes have offered various theories about of what caused the crisis and, even more important, why it was not prevented. While only time will allow studies of the causes of the crisis to attain the depth and detached objectivity necessary for discerning its true origins and scope, some of the ideas frequently trumpeted these days are made more of the stuff of myths than of a nuanced, fact-based analysis. I will discuss four such myths:

Myth #1: Banks were deregulated in the 1990s. It is often stated that the bank deregulation of the 1990s caused the crisis. That is a very broad statement, and it fails to consider the kinds of legislative changes that have been made in the last two decades and the relationship between those changes and the causes of the crisis as we understand it today. The criticism leveled at the so-called deregulation movement is largely directed at the federal level and is not significantly concerned with state regulation of banks. The critics' focus on the federal regulatory system is understandable because the overwhelming majority of the major banks, and all of the financial mega-institutions currently described as "too–big–to–fail," are federally chartered and regulated. But the categorical suggestion that the regulatory authority of banking regulators was dislocated in the 1990s is simplistic and inaccurate. It is true that the Gramm-Leach-Bliley Act changed the regulatory framework previously established by the Glass-Steagall Act, which prohibited any one institution from engaging in both commercial and investment banking. The Gramm-Leach-Bliley Act, however, did not *repeal* the Glass-Steagall Act, as it is so often claimed, but altered it to allow the merger of investment and commercial banks to create bank holding companies with commercial banking and investment banking businesses.

Even under the current regime of the Gramm-Leach-Bliley Act, commercial banks are prohibited from engaging in investment banking, and vice versa, unless the holding entity of the bank or the investment

2 The Dodd-Frank Act has introduced significant changes to the regulation of the financial services industry. The description herein reflects the law at the time these remarks were delivered.

firm becomes a Bank Holding Company subject to a very specific and complicated web of regulations. It is also important to note that even prior to the passage of the Gramm-Leach-Bliley Act, investment banks already held and actively traded in mortgage-backed securities: the heart of the financial crisis. Also, more than any increased access to liquidity available to commercial banks, what shifted the operational focus of many investment banks to speculative trading was the decision to go public; such trading activities were believed to assure maximum shareholder returns.

Myth #2: Federal banking regulators neglected signs of an approaching mortgage crisis. While books are still being written about what combination of specific actions should have been taken or would have been more effective in averting or ameliorating the financial crisis, critics fail to mention one often-neglected fact. Well before the failure of Lehman Brothers and the near-collapse of the financial system, the Federal Financial Institutions Examination Council, an interagency body established by an Act of Congress, issued multiple sets of guidance on the risks attendant to exotic mortgage products and an explosion of liberally-underwritten subprime mortgage loans. Indeed, a bigger driver of the toxic mortgage loans that culminated in the crisis of 2008 was non-banking lending institutions that underwrote the majority of such loans.

Myth #3: The mortgage crisis was brought on by predatory lenders. It is often stated that at the root of the financial crisis was irresponsible lending practices of subprime lenders that rested on the belief that the loans would never be repaid and the lender would seize the collateral. While lending practices at some financial institutions may indeed have been questionable, perhaps what contributed most to the collapse of the mortgage market was the unprecedented decline in real estate values in recent years. With prices of real estate falling at a level unseen in the last 80 years, it is hard to see how a lending strategy can be classified as predatory when the collateral that the lender can turn to in the event of default declines in value every day. It is the confluence of decline in real estate prices and the impetus to promote home ownership in America, spurred by the Community Reinvestment Act, which has led to conditions conducive to mortgage defaults.

Myth #4: The distortion of market forces masked by credit default swaps was a result of failure of banking regulation. Credit default swaps did encourage trading in and accumulation of mortgage-backed securities on the banks' proprietary lending books, but bank regulation is not to blame for that. Credit default swaps are derivative instruments that seek to mitigate the risk of failure of a security through purchase of insurance against the occurrence of such event. Essentially, a credit default swap is a life insurance policy on a security. The idea is that if the security depreciates in value, which would happen if the mortgages that collateralize the securities default, the holder of the credit default swap—the insurance on the security—will be protected. Of course, it was soon discovered that the sheer volume and poor quality of these toxic securities were so vast that rather than protect against the risk of default, these creative forms of insurance only spread the risk to affect large swathes of the financial services industry. And rather than protect toxic security holders against default, they put insurers like AIG on the brink of bankruptcy, threatening a colossal chain reaction of failures of interconnected financial institutions.

The problem with what happened with credit default swaps on asset-backed securities was that the companies that were selling insurance on securities were not regulated. Risk was sold to risk insurers, then to bond insurers, and so on, but the sale of these default swaps was never regulated by insurance authorities. As you may know, the McCarran-Ferguson Act, passed in 1945, exempts the business of insurance from most federal regulation, leaving it to state regulators. The entities selling credit default swaps were not registered with states, however, and thus were not subject to their regulation. Therefore, our recent financial crisis was not a failure of bank regulation; it was a failure of insurance regulation.

The pressing question today for lawyers and soon-to-be lawyers is to learn from the past to shape a more secure, prudent world tomorrow. The responsibility for the errors of the past will be mostly on your shoulders, but it will require many years of study and effort to understand the crisis fully and to take preventive steps against the next one that may be looming around the corner. It will also require an air of fresh thinking and a renewed capacity for adaptability to navigate a rapidly changing world successfully. But I do not leave you with a doomsday warning of difficulties to come; I am absolutely confident that you are up to the task.

Before going any further, I would like to give you my version of the basic constitutional principles that govern our nation, the states, and the people therein. The Constitution makes clear that there are certain powers the federal government has, and there are other instances in which the federal government cannot interfere with the various states. As the country grew, when there were problems, the federal government sometimes took steps to intervene, with a nod from the Supreme Court. The Court has held in some instances, however, that the federal government has exceeded its power.

If one really understands the Constitution and its Amendments, after having read the *Federalist* papers and the debates of the Continental Congress in Philadelphia, the person would reach the conclusion that there has always been a commitment that our society is to be a private economic capitalistic one; one where people have freedom to enter into certain businesses, create wealth, or even to fail in their attempts to do so. As a matter of fact, the federal government and most state governments have been failures at getting involved in business practices usually conducted by private corporations.

If you read *A History of the English-Speaking Peoples Since 1900* by Andrew Roberts, you will find out how a private, capitalistic system can create great wealth. Here is one example: the Rockefeller ancestors decided to build railroads in the Midwest, and they insisted that on each side of the railroad tracks there had to be land reserves. They purchased land to build their railroads; however, they soon discovered gas and oil on their property. This enterprise, of course, made the Rockefellers extremely rich. The family produced one US senator and two governors; one of the governors ultimately became vice president of the United States, and another became CEO and chairman of the board of one of the United States' greatest banks.

How much optimism we have for the future of our nation depends on whether we believe the federal government has the ability to become more effective. The strength of the government derives from the skill and training of the people who comprise its working parts. Some of you will choose careers in banking, investment, or insurance, and as your experience as lawyers and businesspeople grows and enormous responsibility is entrusted to you, you will need to consider two things. First, you must investigate whether the people already working for the government have the ability and the training to regulate our major financial institutions. And second, if you think that the government should be involved in regulating our banking system, you will face the question of what kind of regulatory system is best and how we train people to participate in that system.

As Justice Felix Frankfurter told me and Elliot Lee Richardson the last day of our Supreme Court clerkships, the greatest talent of a lawyer is the ability to see what went wrong and, thereafter, quickly determine what has to be done to prevent such a wrong from happening again. I have learned the truth of Justice Frankfurter's statement from personal experience. There is also an illustrative example from history in the federal government's attempt to get involved in the business of running passenger trains and freight railroads. About two years before I became secretary of transportation, the Pennsylvania Central Railroad went bankrupt. The plan devised by the government was to turn the passenger service over to Amtrak and the freight service over to Conrail. Before this was done, the United States Railroad operated both. After I took office, I soon determined that it made much more sense to sell half of the freight service to the Southern Railroad and the other half to the Chesapeake and Ohio Railroad. I could not get Congress to approve the plan and, for the next ten years, Conrail operated the freight railroad at a loss to the federal government of $30 million per year. Thereafter, the railroad was transferred to CSX; today, it is one of the most successful systems in the country.

I will now leave the subject of banking and investment firms and turn to a second, distinct subject. It is short but quite essential.

The United States is a great nation that has a glorious past. It has met just about all the challenges put upon it since its creation, and, in the main, it has done so with great style and consideration. We face new and unprecedented challenges in the twenty-first century. Our standing in the international community may change in the future because there is a lot of wealth in other parts of the world. We have access to some of it; some we do not. International trade agreements and our efforts at diplomacy will be of considerable importance. Changes to the geopolitical situation outside the United States have an inevitable impact on our domestic tranquility.

There are now about 146 million Americans in the United States registered to vote. It is my understanding that there is a consensus that in the next twenty years the majority of those registered to vote will be people of color–Americans with ancestral origins in Africa, Asia, the Middle East, the Pacific Islands, and Central and South America. Each of these voters will be an American citizen and will have tremendous intelligence and talent. If the composition of the American population changes as predicted, what will we have to do to make sure that our society is able to achieve outstanding success as it has in the past? It will be of paramount importance that we make pretty much irrelevant the sex of a voter, the color of a voter's skin, or the geographic origin of a voter's parents or grandparents. Certainly, our public schools face a great challenge. It is our collective responsibility to see that kids from all types of backgrounds who attend public schools achieve their potential and go on to college. In addition, we have to recognize that among human beings there are levels of ability in all groups, and we should make certain differentiations only when it is absolutely necessary.

I could go on talking, but I am pretty sure my time is up. I do hope, however, that this question becomes part of the discussions you have with your classmates, colleagues, and law professors. With the great human resources in talent and ingenuity that we have, I am confident that we will remain the outstanding nation in the world.

Thank you.