‘Peeling the Onion’

Glass-Steagall Vs. the Casino

by Paul Gallagher

July 30—Tim Geithner’s Treasury must have been busy “reaching out” to bankers and journalists on July 26 and 27.

Geithner had just been shocked, in his July 25 House testimony, to find himself hit with multiple questions about restoring the Glass-Steagall Act, by members of the House Financial Services Committee. Geithner, along with Rep. Barney Frank (D-Mass.), twice, since mid-2010, has been in the middle of killing off any Congressional “green shoots” of Glass-Steagall’s re-enactment, by far-fetched arguments, backed up with threats. But now the demand for Glass-Steagall was being raised from every corner of the country—often mobilized by Lyndon LaRouche’s political action committee (LPAC)—and from influential bankers in the United Kingdom, and the House was starting to sound serious about it. Geithner, on his way to Europe to plan the next “big bailout bazooka” with European Central Bank head Mario Draghi, had to be alarmed.

And so, starting July 27, financial columnists, along with some Wall Street banking lobbyists, began to take to the airwaves and print to “debunk the Glass-Steagall myth,” now—as one of them desperately put it—“believed by millions of Americans.”

These worthies are all saying or writing the same thing: Had Glass-Steagall not been repealed in 1999, had we maintained its separation of commercial from casino banking, that would not have prevented bank collapse and bailout, because the biggest failures—investment bank Lehman, insurance company AIG, money-market fund Reliant—were not affiliated with commercial banks, but they triggered massive bailouts.

This, not coincidentally, has been Geithner’s own public argument against Glass-Steagall, when forced to address it as his loyalists are now.

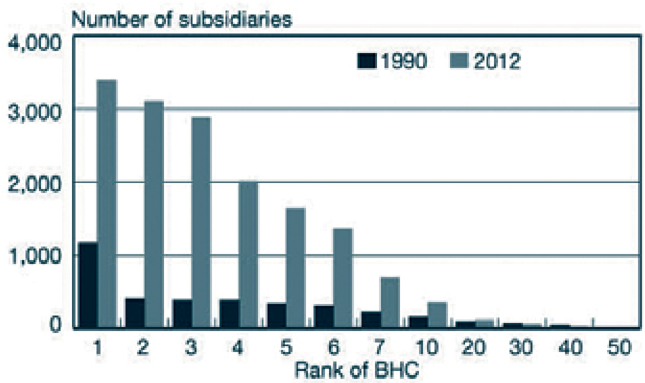
They might as well argue, when Spain’s bloated BBVA or Banco Santander goes belly-up by September, and multi-trillion-dollar new bank bailouts are launched to “prevent” chains of bank collapses, “Well, that has nothing to do with Glass-Steagall; that’s a *European* bank”!

In fact, when Glass-Steagall was still in full force through the early 1990s, European “universal banks” were prohibited from doing business in the United States, because their structure and securities activities violated Glass-Steagall. But by 2008, the Federal Reserve was bailing them out with hundreds of billions, to the point that its $600 billion “QEII” (Quantitative Easing II) bailout went overwhelmingly—perhaps entirely—to European banks.

The objective of restoring the Glass-Steagall Act is not to stop failures of speculative securities operations. It is to stop bailouts triggered by those failures; and to separate, protect, and regulate commercial banks so that they do not pour their large customer deposit-based capital into securities operations.

Glass-Steagall, for 60 years, had barred commercial banks from direct investment of any but a tiny fraction of their capital and surplus into speculative securities; and, from any large lending to merchant institutions that were so speculating. Had Glass-Steagall been in force in the first decade of this century, the big commercial banks would not have been trading “financial de-

Organizational Complexity of Large U.S. Bank Holding Companies



Sources: National Information Center; FR Y-10.

Note: Data are as of February 20, 2012, and December 31, 1990, and include the top fifty bank holding companies (BHCs) at each of these dates. See our paper, “A Structural View of U.S. Bank Holding Companies,” for more details.

rivatives" securities with Lehman and AIG on a massive scale; nor, like JPMorgan Chase, lending heavily to Lehman during its last months.

The Impact of Repeal

A report by three economists for the New York Federal Reserve Bank has made clear what a dramatic impact repealing Glass-Steagall had on the activities and investments of the large commercial banks' holding companies ("large BHCs"). Feeding into the Congressional mobilization for Glass-Steagall last week, the report was released July 20, and noted particularly by New York Members of Congress.

The report is "Peeling the Onion: A Structural View of U.S. Bank Holding Companies." It shows very large increases in the size, complexity, and speculative operations of these BHCs in the post-Glass-Steagall period, beginning in the mid-1990s, when its regulation of commercial banks was drastically loosened by then-Fed Chairman Alan Greenspan. (Greenspan's campaign to destroy Glass-Steagall lasted far longer and with greater tenacity than that of Citigroup's Sanford Weill. Unlike Weill, don't look for Greenspan to realize or admit that the current global crisis requires restoring Glass-Steagall.)

The New York Fed's report was covered July 23 in a Bloomberg News article, which drew its obvious Glass-Steagall implications.

"[Bank] critics including Thomas Hoenig, a Federal Deposit Insurance Corp. board member, say the biggest firms are too complicated to manage," Bloomberg noted. "The 1999 repeal of the Depression-era Glass-Steagall Act was the main catalyst for the biggest banks getting bigger, the Fed study concluded. The assets of the largest lenders have since tripled to $15 trillion. Hoenig has called for reinstating Glass-Steagall, which separated investment and commercial banking, while [Sen. Sherrod] Brown's proposal would limit asset size."

What the N.Y. Fed study showed is that after Glass-Steagall was weakened by Greenspan in the 1990s, leading to its repeal, the biggest U.S. bank holding companies started to explode the number of their subsidiary units. These typically rose from 100 or 200 (mainly for cross-state and foreign banking), to 2-3,000 by 2011, as big banks bought and created huge networks of subsidiaries, subject to overlapping but different regulatory regimes.

This is historically typical of investment banks, the New York Fed authors note, so Goldman Sachs and Morgan Stanley still lead the pack with 3,000 or more subsidiaries each; but matched now by JPMorgan Chase among the huge formerly commercial banks.

The six biggest U.S. commercial banks created, in the period since Glass-Steagall's weakening by Greenspan and its repeal, more than 10,000 subsidiaries overall, "using the legal structures to pay lower taxes and escape tighter regulation."

Bank Deposits into Shadow Capital

Even more importantly, as the study shows with asset tables, after Glass-Steagall's repeal the big bank holding companies shifted capital and assets from their commercial banks into the growing maze of securities and derivatives units, hedge funds, wealth management, etc., units they created or bought. By 2011, some 23% of Bank of America's $2.15 trillion in assets were in such "casino" units; 32% of Citigroup's $1.875 trillion in assets had gone gambling; as had 14% of JPMorgan Chase's $2.265 trillion in assets.

The N.Y. Fed authors don't make the point as such, but that was the origin of the huge growth of the so-called "shadow banking sector" in the ten years up to 2007's start of the financial crash.

As for the pure gamblers, Goldman Sachs and Morgan Stanley, which were allowed in 2008 to have bank holding company licenses and set up commercial banking units—they have 89% and 90%, respectively, of their assets in securities, derivatives—casino banking generally.

Bloomberg's coverage, again citing FDIC's Hoenig, also took up the implications for the Dodd-Frank Act's so-called "power to resolve" (wind up) such huge banks failing in a crisis. "It's harder for regulators to use such powers to scale back the largest financial firms, rather than specific laws that would disassemble them, such as Glass-Steagall, Hoenig said. 'In good times, it's very hard to break them up. Anything but very bad times, it's very hard to justify the breakup, because it requires the presumption that they will bring the system down.'"

With a new explosion of the financial system about to be detonated in the Eurozone banks, we either put Glass-Steagall back to work right now, breaking up and regulating those commercial banks, or we'll see new bailouts printing trillions of dollars, with hyperinflationary effects like Germany in 1923.