Failing to Break Up the Big Banks is Destroying America

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The Size of the Big Banks Is – Literally – Destroying the Rule of Law

Pulitzer prize-winning journalist Ron Suskind quotes Treasury Secretary Timothy Geithner as saying:

> The confidence in the system is so fragile still… a disclosure of a fraud… could result in a run, just like Lehman.

In other words, Geithner said that the big bankers are "too big to jail", because disclosing any portion of their massive fraud would cause bank runs.

Former IMF economist Simon Johnson notes:

> The main motivation behind the administration's indulgence of serious criminality evidently is fear of the consequences of taking tough action on individual bankers.
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> The message to bank executives today is simple: build your bank to be as big as possible – and then keep growing. If you manage to become big enough, you and your employees are not just too big to fail, but also too big to jail.

Glenn Greenwald notes:

> To justify this lack of accountability for the nation's wealthiest lawbreakers, the all-too-familiar excuses long used to shield the politically powerful are trotted out on cue. Once again, we are told that prosecutions are too disruptive; that it's more important to fix the system than to seek retribution for the past; that because the wrongdoers' reputation is in tatters, they have already suffered enough; that we need the goodwill of financial titans to ensure our common prosperity; and so on.

Indeed, the Obama administration has made it official policy *not to prosecute fraud*.

Top economists, on the other hand, completely contradict Geithner and the rest of the administration … saying that fraud caused the Great Depression and the current financial crisis, and that the economy will*never recover until fraud is prosecuted*.

Top economists and experts on fraud say that fraud is not only widespread, it is actually the business model adopted by the giant banks. See this, this, this, this, this and this.

Therefore, unless the big banks are broken up, financial fraud will grow exponentially like cancer, and the economy will be destroyed.

Their Size Allows Them to Rig the Market

The "father of free market economics" – Adam Smith – knew that monopolies hurt the economy.

As the Libor scandal shows, the size and concentration of the biggest banks allows them to commitmassive manipulation in the world's biggest markets, and to engage in insider trading on a scale never before seen in history.

In addition, Richard Alford – former New York Fed economist, trading floor economist and strategist –showed that banks that get too big benefit from "information asymmetry" which disrupts the free market.

Nobel prize winning economist Joseph Stiglitz noted in September that giants like Goldman are using their size to manipulate the market:

> "The main problem that Goldman raises is a question of size: 'too big to fail.' In some markets, they have a significant fraction of trades. Why is that important? They trade both on their proprietary desk and on behalf of customers. When you do that and you have a significant fraction of all trades, you have a lot of information."
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> Further, he says, "That raises the potential of conflicts of interest, problems of front-running, using that inside information for your proprietary desk. And that's why the Volcker report came out and said that we need to restrict the kinds of activity that these large institutions have. If you're going to trade on behalf of others, if you're going to be a commercial bank, you can't engage in certain kinds of risk-taking behavior."

The giants (especially Goldman Sachs) have also used high-frequency program trading which not onlydistorted the markets – making up more than 70% of stock trades – but which also let the program trading giants take a sneak peak at what the real (aka "human") traders are buying and selling, and then trade on the insider information. See this, this, this, this and this. (This is frontrunning, which is illegal; but it is a lot bigger than garden variety frontrunning, because the program traders are not only trading based on inside knowledge of what their own clients are doing, they are also trading based on knowledge of what all other traders are doing).

Goldman also admitted that its proprietary trading program can "manipulate the markets in unfair ways". The giant banks have also allegedly used their Counterparty Risk Management Policy Group(CRMPG) to exchange secret information and formulate coordinated mutually beneficial actions, all with the government's blessings.

In other words, a handful of giants doing it, it can manipulate the entire economy in ways which are not good for the American citizen.

And the political system. No wonder Nobel prize-winning economist Paul Krugman thinks that we have to break up the big banks to stop their domination of the political process.

If We Break Up the Giants, Smaller Banks Will Thrive … And Loan More to Main Street

Do we need to keep the TBTFs to make sure that loans are made?

Nope.

USA Today points out:

> Banks that received federal assistance during the financial crisis reduced lending more aggressively and gave bigger pay raises to employees than institutions that didn't get aid, a USA TODAY/American University review found.
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> The amount of loans outstanding to businesses and individuals fell 9.1% for the 12 months ending Sept. 30, 2009, at banks that participated in TARP compared with a 6.2% drop at banks that didn't.

Dennis Santiago – CEO and Managing Director of Institutional Risk Analytics (Chris Whalen's company) – notes:

> The really shocking numbers are in the unused line of credit commitments of banks to U.S. business. This is the canary number I like to look at because it is a direct expression of banking and finance confidence in Main Street industry. It's gone from $92 billion in Dec -2007 to just $24 billion as of Sep-2010. More importantly, the vast majority of this contraction of credit availability to American industry has been by the larger banks, C&I LOC from $87B down to $18.8B by the institutions with assets over $10B. Poof!

Fortune reports that smaller banks are stepping in to fill the lending void left by the giant banks' current hesitancy to make loans. Indeed, the article points out that the only reason that smaller banks haven't been able to expand and thrive is that the too-big-to-fails have decreased competition:

> Growth for the nation's smaller banks represents a reversal of trends from the last twenty years, when the biggest banks got much bigger and many of the smallest players were gobbled up or driven under…
>
> As big banks struggle to find a way forward and rising loan losses threaten to punish poorly run banks of all sizes, smaller but well capitalized institutions have a long-awaited chance to expand.

BusinessWeek notes:

> As big banks struggle, community banks are stepping in to offer loans and lines of credit to small business owners…
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> At a congressional hearing on small business and the economic recovery earlier this month, economist Paul Merski, of the Independent Community

> Bankers of America, a Washington (D.C.) trade group, told lawmakers that community banks make 20% of all small-business loans, even though they represent only about 12% of all bank assets. Furthermore, he said that about 50% of all small-business loans under $100,000 are made by community banks…
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> Indeed, for the past two years, small-business lending among community banks has grown at a faster rate than from larger institutions, according to Aite Group, a Boston banking consultancy. "Community banks are quickly taking on more market share not only from the top five banks but from some of the regional banks," says Christine Barry, Aite's research director. "They are focusing more attention on small businesses than before. They are seeing revenue opportunities and deploying the right solutions in place to serve these customers."

Fed Governor Daniel K. Tarullo said:

> The importance of traditional financial intermediation services, and hence of the smaller banks that typically specialize in providing those services, tends to increase during times of financial stress. Indeed, the crisis has highlighted the important continuing role of community banks…
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> For example, while the number of credit unions has declined by 42 percent since 1989, credit union deposits have more than quadrupled, and credit unions have increased their share of national deposits from 4.7 percent to 8.5 percent. In addition, some credit unions have shifted from the traditional membership based on a common interest to membership that encompasses anyone who lives or works within one or more local banking markets. In the last few years, some credit unions have also moved beyond their traditional focus on consumer services to provide services to small businesses, increasing the extent to which they compete with community banks.

Thomas M. Hoenig pointed out in a speech at a U.S. Chamber of Commerce summit in Washington:

> During the recent financial crisis, losses quickly depleted the capital of these large, over-leveraged companies. As expected, these firms were rescued using government funds from the Troubled Asset Relief Program (TARP). The result was an immediate reduction in lending to Main Street, as the financial institutions tried to rebuild their capital. Although these institutions have raised substantial amounts of new capital, much of it has been used to repay the TARP funds instead of supporting new lending.

On the other hand, Hoenig pointed out:

> In 2009, 45 percent of banks with assets under $1 billion increased their business lending.

45% is about *45% morethan the amount of increased lending by the too big to fails.*

Indeed, some very smart people say that the big banks aren't really focusing as much on the lending business as smaller banks.

Specifically since Glass-Steagall was repealed in 1999, the giant banks have made much of their money in trading assets, securities, derivatives and other speculative bets, the banks' own paper and securities, and in other money-making activities which have nothing to do with traditional depository functions.

Now that the economy has crashed, the big banks are making very few loans to consumers or small businesses because they still have trillions in bad derivatives gambling debts to pay off, and so they are only loaning to the biggest players and those who don't really need credit in the first place. See this andthis.

So we don't really need these giant gamblers. We don't really need JP Morgan, Citi, Bank of America, Goldman Sachs or Morgan Stanley. What we need are dedicated lenders.

The Fortune article discussed above points out that the banking giants are not necessarily more efficient than smaller banks:

> The largest banks often don't show the greatest efficiency. This now seems unsurprising given the deep problems that the biggest institutions have faced over the past year.
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> "They actually experience diseconomies of scale," Narter wrote of the biggest banks. "There are so many large autonomous divisions of the bank that the complexity of connecting them overwhelms the advantage of size."

And Governor Tarullo points out some of the benefits of small community banks over the giant banks:

> Many community banks have thrived, in large part because their local presence and personal interactions give them an advantage in meeting the financial needs of many households, small businesses, and agricultural firms. Their business model is based on an important economic explanation of the role of financial intermediaries–to develop and apply expertise that allows a lender to make better judgments about the creditworthiness of potential borrowers than could be made by a potential lender with less information about the borrowers.
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> A small, but growing, body of research suggests that the financial services provided by large banks are less-than-perfect substitutes for those provided by community banks.

It is simply not true that we need the mega-banks. In fact, as many top economists and financial analysts have said, the "too big to fails" are actually stifling competition from smaller lenders and credit unions, and dragging the entire economy down into a black hole.

We Do NOT Need the Big Banks to Help the Economy Recover

Do we need the Too Big to Fails to help the economy recover?

No.

The following top economists and financial experts believe that the economy cannot recover unless the big, insolvent banks are broken up in an orderly fashion:

- Nobel prize-winning economist, Joseph Stiglitz
- Nobel prize-winning economist, Ed Prescott
- Former chairman of the Federal Reserve, Alan Greenspan
- Former chairman of the Federal Reserve, Paul Volcker
- Former Secretary of Labor Robert Reich
- Dean and professor of finance and economics at Columbia Business School, and chairman of the Council of Economic Advisers under President George W. Bush, R. Glenn Hubbard
- Simon Johnson (and see this)
- Former 20-year President of the Federal Reserve Bank of Kansas City, who was today nominated to be FDIC Vice Chair Thomas Hoenig (and see this)
- President of the Federal Reserve Bank of Dallas, Richard Fisher (and see this)
- President of the Federal Reserve Bank of St. Louis, Thomas Bullard
- Deputy Treasury Secretary, Neal S. Wolin
- The President of the Independent Community Bankers of America, a Washington-based trade group with about 5,000 members, Camden R. Fine
- The Congressional panel overseeing the bailout (and see this)
- The head of the FDIC, Sheila Bair
- The head of the Bank of England, Mervyn King
- The leading monetary economist and co-author with Milton Friedman of the leading treatise on the Great Depression, Anna Schwartz
- Economics professor and senior regulator during the S & L crisis, William K. Black
- Leading British economist, John Kay
- Economics professor, Nouriel Roubini
- Economist, Marc Faber
- Professor of entrepreneurship and finance at the Chicago Booth School of

Business, Luigi Zingales

- Economics professor, Thomas F. Cooley
- Economist Dean Baker
- Economist Arnold Kling
- Former investment banker, Philip Augar
- Chairman of the Commons Treasury, John McFall

In addition, many top economists and financial experts, including Bank of Israel Governor Stanley Fischer – who was Ben Bernanke's thesis adviser at MIT – say that – at the very least – the size of the financial giants should be limited.

Even the Bank of International Settlements – the "Central Banks' Central Bank" – has slammed too big to fail. As summarized by the Financial Times:

> The report was particularly scathing in its assessment of governments' attempts to clean up their banks. "The reluctance of officials to quickly clean up the banks, many of which are now owned in large part by governments, may well delay recovery," it said, adding that government interventions had ingrained the belief that some banks were too big or too interconnected to fail.
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> This was dangerous because it reinforced the risks of moral hazard which might lead to an even bigger financial crisis in future.

And as I noted in December 2008, the big banks are the major reason why sovereign debt has become a crisis:

> BIS points out in a new report that the bank rescue packages have transferred significant risks onto government balance sheets, which is reflected in the corresponding widening of sovereign credit default swaps:
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> > The scope and magnitude of the bank rescue packages also meant that significant risks had been transferred onto government balance sheets. This was particularly apparent in the market for CDS referencing sovereigns involved either in large individual bank rescues or in broad-based support packages for the financial sector, including the United States. While such CDS were thinly traded prior to the announced rescue packages, spreads widened suddenly on increased demand for credit protection, while corresponding financial sector spreads tightened.
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> In other words, by assuming huge portions of the risk from banks trading in toxic derivatives, and by spending trillions that they don't have, central banks have put their countries at risk from default.

Similarly, a study of 124 banking crises by the International Monetary Fund found that propping banks which are only pretending to be solvent hurts the economy:

> Existing empirical research has shown that providing assistance to banks and their borrowers can be counterproductive, resulting in increased losses to banks, which often abuse forbearance to take unproductive risks at government expense. The typical result of forbearance is a deeper hole in the net worth of banks, crippling tax burdens to finance bank bailouts, and even more severe credit supply contraction and economic decline than would have occurred in the absence of forbearance.
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> Cross-country analysis to date also shows that accommodative policy measures (such as substantial liquidity support, explicit government guarantee on financial institutions' liabilities and forbearance from prudential regulations) tend to be fiscally costly and that these particular policies do not necessarily accelerate the speed of economic recovery.
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> All too often, central banks privilege stability over cost in the heat of the containment phase: if so, they may too liberally extend loans to an illiquid bank which is almost certain to prove insolvent anyway. Also, closure of a nonviable bank is often delayed for too long, even when there are clear signs of insolvency (Lindgren, 2003). Since bank closures face many obstacles, there is a tendency to rely instead on blanket government guarantees which, if the government's fiscal and political position makes them credible, can work albeit at the cost of placing the burden on the budget, typically squeezing future provision of needed public services.

The big banks have been bailed out to the tune of many trillions, dragging the economy down a bottomless pit from which we can't escape. See this, this, this and this. Unless we break them up, we will never escape.

The Failure to Break Up the Big Banks Is Dooming Us to Depression

All independent experts agree that unless we rein in derivatives, will have another – bigger – financial crisis.

But the big banks are preventing derivatives from being tamed.

We have also pointed out that derivatives are still very dangerous for the economy, that the derivatives "reform" legislation previously passed has probably actually weakened existing regulations, and the legislation was "probably written by JP Morgan and Goldman Sachs".

We've noted:

> Harold Bradley – who oversees almost $2 billion in assets as chief investment officer at the Kauffman Foundation – told the Reuters Global Exchanges and Trading Summit in New York that a cabal is preventing swap derivatives from being forced onto clearing exchanges:
>
> > There is no incentive from the moneyed interests in either Washington or New York to change it…

> I believe we are in a cabal. There are five or six players only who are engaged and dominant in this marketplace and apparently they own the regulatory apparatus. Everybody is afraid to regulate them.

That's bad enough.

But Bob Litan of the Brookings Institute wrote a paper (here's a summary) showing that – even if real derivatives legislation is ever passed – the 5 big derivatives players will still prevent any real change. James Kwak notes that Litan is no radical, but has previously written in defense in financial "innovation".

Here's a good summary from Rortybomb, showing that this is yet another reason to break up the too big to fails:

> Litan is worried about the "Dealer's Club" of the major derivatives players. I particularly like this paper as the best introduction to the current oligarchy that takes place in the very profitable over-the-counter derivatives trading market and credit default swap market. [Litton says]:
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> > I have written this essay primarily to call attention to the main impediments to meaningful reform: the private actors who now control the trading of derivatives and all key elements of the infrastructure of derivatives trading, the major dealer banks. The importance of this "Derivatives Dealers' Club" cannot be overstated. All end-users who want derivatives products, CDS in particular, must transact with dealer banks…I will argue that the major dealer banks have strong financial incentives and the ability to delay or impede changes from the status quo — even if the legislative reforms that are now being widely discussed are adopted — that would make the CDS and eventually other derivatives markets safer and more transparent for all concerned…
> >
> > Here, of course, I refer to the major derivatives dealers – the top 5 dealer-banks that control virtually all of the dealer-to-dealer trades in CDS, together with a few others that participate with the top 5 in other institutions important to the derivatives market. Collectively, these institutions have the ability and incentive, if not counteracted by policy intervention, to delay, distort or impede clearing, exchange trading and transparency…
> >
> > Market-makers make the most profit, however, as long as they can operate as much in the dark as is possible – so that customers don't know the true going prices, only the dealers do. This opacity allows the dealers to keep spreads high…
> >
> > In combination, these various market institutions – relating to standardization, clearing and pricing – have incentives not to rock the boat, and not to accelerate the kinds of changes that would make the derivatives market safer and more transparent. The common element among all of these institutions is strong participation, if not significant ownership, by the major dealers.
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> So Bob Litan is waving a giant red flag that the top dealer-banks that control the CDS market can more or less, through a variety of means he lays out

convincingly in the paper, derail or significantly slow down CDS reform after the fact if it passes.

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If you thought we'd at least get our arms around credit default swap reform from a financial reform bill, you should read this report from Litan as a giant warning flag. In case you weren't sure if you've heard anyone directly lay out the case on how the market and political concentration in the United States banking sector hurts consumers and increases systemic risk through both political pressures and anticompetitive levels of control of the institutions of the market, now you have. It's not Matt Taibbi, but it's much further away from a "everything is actually fine and the Treasury is in control of reform" reassurance. Which should scare you, and give you yet another good reason for size caps for the major banks.

Moreover, the big banks are still dumping huge amounts of their toxic derivatives on the taxpayer. And see this.

And the extreme concentration of power and control over the entire global economy of a handful of large banks means that the entire system is extremely vulnerable.

Why Aren't They Be Broken Up?

So what is the real reason that the TBTFs aren't being broken up (and why are they 30% *bigger* now than before the financial "reform" law was was passed)?

Certainly, there is regulatory capture, cowardice and corruption:

- Joseph Stiglitz (the Nobel prize winning economist) said recently that the U.S. government is wary of challenging the financial industry because it is politically difficult, and that he hopes the Group of 20 leaders will cajole the U.S. into tougher action

- Economic historian Niall Ferguson asks:

> Guess which institutions are among the biggest lobbyists and campaign-finance contributors? Surprise! None other than the TBTFs [too big to fails].

- Manhattan Institute senior fellow Nicole Gelinas agrees:

> The too-big-to-fail financial industry has been good to elected officials and former elected officials of both parties over its 25-year life span

- Investment analyst and financial writer Yves Smith says:

> Major financial players [have gained] control over the

> all-important over-the-counter debt markets…It is pretty hard to regulate someone who has a knife at your throat.

- William K. Black says:

> There has been no honest examination of the crisis because it would embarrass C.E.O.s and politicians . . .Instead, the Treasury and the Fed are urging us not to examine the crisis and to believe that all will soon be well. There have been no prosecutions of the chief executives of the large nonprime lenders that would expose the "epidemic" of fraudulent mortgage lending that drove the crisis. There has been no accountability…
>
> The Obama administration and Fed Chairman Ben Bernanke have refused to investigate the nature and causes of the crisis. And the administration selected Timothy Geithner, who with then Treasury Secretary Paulson bungled the bailout of A.I.G. and other favored "too big to fail" institutions, to head up Treasury.
>
> Now Lawrence Summers, head of the White House National Economic Council, and Mr. Geithner argue that no fundamental change in finance is needed. They want to recreate a secondary market in the subprime mortgages that caused trillions of dollars of losses.
>
> Traditional neo-classical economic theory, particularly "modern finance theory," has been proven false but economists have failed to replace it. No fundamental reform can be passed when the proponents are pretending that there really is no crisis or need for change.

- Harvard professor of government Jeffry A. Frieden says:

> Regulatory agencies are often sympathetic to the industries they regulate. This pattern is so well known among scholars that it has a name: "regulatory capture." This effect can be due to the political influence of the industry on its regulators; or to the fact that the regulators spend so much time with their charges that they come to accept their world view; or to the prospect of lucrative private-sector jobs when regulators retire or resign.

- Economic consultant Edward Harrison agrees:Regulating Wall Street has become difficult in large part because of regulatory capture.

But there is an even more interesting reason . . .

The number one reason the TBTF's aren't being broken up is [drumroll] . . . the 'ole 80′s playbook is being used.

As the New York Times reports:

> In the 1980s, during the height of the Latin American debt crisis, the total risk to the nine money-center banks in New York was estimated at more than three times the capital of those banks. The regulators, analysts say, did not force the banks to value those loans at the fire-sale prices of the moment, helping to avert a disaster in the banking system.

In other words, the nine biggest banks were all insolvent in the 1980s.

Indeed, Richard C. Koo – former economist at the Federal Reserve Bank of New York and doctoral fellow with the Fed's Board of Governors, and now chief economist for Nomura – confirmed this fact last year in a speech to the Center for Strategic & International Studies. Specifically, Koo said that -after the Latin American crisis hit in 1982 – the New York Fed concluded that 7 out of 8 money center banks were actually "underwater" and "bankrupt", but that the Fed hid that fact from the American people.

So the government's failure to break up the insolvent giants – even though virtually all independent experts say that is the only way to save the economy, and even though there is no good reason not to break them up – is nothing new.

William K. Black's statement that the government's entire strategy now – as in the S&L crisis – is to cover up how bad things are ("the entire strategy is to keep people from getting the facts") makes a lot more sense.

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