The historical proof ring-fencing will not work

By Elisa Barwick

Advocates of separating commercial and investment banking functions within a bank—ring-fencing—are either ignorant of history, or are deliberately obscuring it. The irrefutable evidence that ring-fencing will not work, is that it is the exact equivalent of the regulatory system prior to the 1933 introduction of Glass-Steagall banking separation, which allowed the excesses leading to the 1929 crash and Great Depression.

Last week's *Australian Alert Service* reviewed the 1932-33 Pecora Commission, an investigation into the causes of the 1929 market crash, named for the indefatigable prosecutor Ferdinand Pecora. A detailed account of those hearings was provided by author Michael Perino in his 2010 book, *The Hellhound of Wall Street: How Ferdinand Pecora's investigation of the Great Crash forever changed American finance*.

One case study provided by the hearings, described by a journalist of the time as "a vast class in economics", is that of National City Bank and its securities affiliate National City Company. This story reveals exactly how banks will assuredly get around any regulation which falls short of full Glass-Steagall laws.

Affiliates: how banks split hairs

The *National Banking Act* of 1863 prohibited banks from trading their own shares or securities. Nationally chartered banks, or "national banks" as they were known, were not allowed to engage in anything other than commercial banking. National City Bank got around this by establishing an *affiliated* investment house to which it referred its depositors for investment advice, which usually involved flogging them City Bank shares, securities, or shares of companies the bank had invested in, including troubled or collapsing investments. In one case, their affiliate National City Company sold investors property in Cuba which National City Bank was foreclosing on and to which it was heavily exposed. It was also not uncommon for National City Company to short City Bank's stocks at the same time it was recommending and selling them to its customers. The bank even lent money to other firms in order for them to buy City Bank stock, including when the markets began to crash in October 1929.

National City Bank was not the only one to establish a securities affiliate, which it did in 1917. By that time there were a couple of hundred bank affiliates, their purpose to underwrite securities issues and broker stocks—previously the domain of private investment banks and trust companies. Perino writes: "The key to business success was to ensure that the executives of the bank completely controlled the affiliate without actually owning it, which would violate federal law. National banks turned to their Wall Street lawyers, who came up with an ingenious solution. The shareholders of the bank formed a separate corporation … Legally, the affiliate was a separate corporation in which the bank had no ownership interest. In reality, however, because the bank and the affiliate had precisely the same management, this structure was the functional equivalent of the bank forming a wholly owned subsidiary to pursue these business ventures. Indeed, City Bank was literally inseparable from the company—National City's stock was printed on the reverse side of the stock certificate for the bank."

Pecora, who was aware of this history, concluded that this action nullified the *National Banking Act*. He described it as a "hair-splitting triumph". Ripping into City Bank chairman Charles "Sunshine Charlie" Mitchell during the hearings, Pecora described the setup as "one body with two heads … the same body, the same blood, meaning the capital derived from the sale of the capital stock of the bank … but instead of having one head it has two heads". In the personality of Mitchell, however, as Chairman of both institutions, the two heads were really one. Pecora made clear, as Perino put it, that "any real separation between City Bank and the National City Company was illusory—a mere legal fiction—because Mitchell was the driving force behind both companies."

The Hellhound of Wall Street, Ferdinand Pecora. Photo: National Archives/Senate.gov

City Bank officials admitted in testimony that the names of the bank's depositors interested in investments were handed over to the Company, which immediately contacted them. City Bank had pioneered a completely new approach to savings in order to collect such contacts—allowing bank accounts to be set up with as little as one dollar and issuing loans of as little as fifty dollars. Pecora was able to draw out the conflict of interest apparent in this set-up. Details of incentives received by salesmen when they sold the bank's stock emerged. To encourage sales of its own stock, or securities the company sponsored, premium commissions were introduced, up to a third higher than standard commissions, and sales competitions were held. City's team included door-to-door salesmen, and used techniques of large-scale sales organisations including ads in popular magazines and billboards.

Government acquiescence

In 1911 as banking affiliates began to proliferate, President William Taft had requested an opinion on the legality of what banks and their affiliates were doing. Solicitor General Frederick Lehmann concluded after a thorough investigation that such activities were in violation of the law. He pointed out that the affiliate had "no independence of action" and was completely controlled by the bank's board. "The temptation to the speculative use of the funds of the banks", he said, "will prove to be irresistible". City Bank was singled out in this opinion because in addition its affiliate had effectively become the nation's first bank holding company, meaning it held the stocks of a number of banks—giving it a degree of control over those institutions. City Bank shareholders had transferred large holdings of shares they held in other banks into the company. This was also held to be in contravention of federal law.

Concerned about sparking a new banking crisis like the Panic of 1907, Taft equivocated and failed to act on the Lehmann opinion. Hence National City Company and other banks' affiliates received the tacit approval of the federal government.

The creation of National City Company also spurred an investigation which came to be known as the Pujo Committee. The Committee presented evidence of severe conflicts of interests when nationally chartered banks underwrote and sold securities through their affiliates, and recommended they be prohibited from doing so. But the

government again failed to act, and Congress never passed legislation to reflect the Committee's recommendation. In fact, over the next decade, despite warnings that the securities affiliates were a "menace", the government acquiesced even further, loosening restrictions on national banks. The 1927 *McFadden Act* formally recognised securities affiliates, and they quickly doubled their activities, becoming the main players in investment banking.

While investment banks did the same thing as the affiliates, they did not do it under a pretence. The good reputation and government approval of "national banks" had been used to push ordinary depositors into shares and securities, drawing a large section of the middle class into a category of speculation of which they knew nothing.

As documented by Perino, after just a week of Pecora's hearings, even the *New York Times* recognised that systemic problems would have to be addressed:

"The sensational disclosures at Washington, not yet complete, show what happens when vast banking resources are made available for excesses of speculation. Through their subordinate companies, the so-called 'affiliates', too many banks were infected by the mania of the time and became more like agencies for the flotation of securities than organisations for the regular supply of loans and discounts in ordinary business. But there is now reason to believe that the lesson of that folly has been learned and that at least for a long time to come the principles of conservative banking will be recognised and lived up to. The abuses of recent years, some of which the Glass banking bill [Glass-Steagall] would remove or correct, will certainly have fewer defenders after the wholesome publicity which has now set them in so vivid and startling a light."

It was Senator Carter Glass who, after the crash, dug up Solicitor General Lehmann's 1911 legal opinion, which according to Pecora had been "buried" after its release twenty years earlier, with only a single carbon copy remaining. Glass charged in a May 1932 speech on the Senate floor that affiliates had been one of the biggest causes of the Depression, and urged they be separated from national banks. In the aftermath of the Pecora hearings Glass would seize the opportunity to again put up his banking regulation bill, which had previously been blocked.

During the Pecora hearings, debate about regulating the banks grew. "The entire country seemed to be talking about the banks", Perino wrote. Perino reports that the president of the American Bankers Association argued against any new laws, especially if they would strip commercial banks of their affiliates. The "honesty and efficiency" of the nation's bankers, he contended, was enough. Joseph Kennedy, chairman of the newly created Securities and Exchange Commission, spoke what everyone was thinking in the wake of the crisis: "The belief that those in control of the corporate life of America were motivated by honesty and ideals of honourable conduct was completely shattered." Letters flooded into Congress from American citizens demanding federal legislation to address the abuses.

Meanwhile, "Pecora gave them proof", Perino wrote; "Proof that the honesty and integrity of the financial establishment was inadequate—proof that *laissez-faire* didn't work. If Wall Street could not or would not regulate itself, Washington would have to regulate for them."

During the 2013 debate in the UK Parliament over whether to regulate banks with full Glass-Steagall or ring-fencing, a number of peers of both parties expressed concerns that we *do not know* if ring-fencing will work, or that we would not know until "donkey's years" into the process. We *do* know definitively that Glass-Steagall works, however, and if you are reading this now, you also know ring-fencing does not.

A victim of City Bank tells his story

Here is the story of one of National City Bank's victims and one of Pecora's witnesses, Edgar D. Brown of Pottsville, Pennsylvania. At just forty he had tuberculosis and was nearly deaf, though he had had a successful career as a theatre owner. He had sold up, clearing $100,000 as well as some government bonds, in order to move to California because of his poor health. Coming across a City Bank ad, which urged, "Heading out on a long trip?" Contact City Bank, which could help when you were away from "the advice of your local banker".

"The close working relationship between City Bank and its securities affiliate was never better demonstrated", Perino wrote in *The Hellhound of Wall Street*. "Brown was sure that he wrote to City Bank, but he received a reply from a salesman in the National City Company's Philadelphia office named Fred Rummel. Rummel told Brown that his bonds 'were all wrong'. He should sell the United States government bonds, borrow two or three times the $100,000 he had, and then invest in a wide variety of securities the company recommended.

"Brown took the company's advice, insisting only that he wanted bonds instead of stock. Other than that Brown trusted the company implicitly. … 'After all', Pecora wrote, 'he was not dealing with some fly by night bucket shop or itinerant gold-mining stock peddler, but with the greatest and soundest bank in the world.' …

"Over the next year a welter of bonds came in and out of Brown's portfolio. … They seemed to have only one thing in common—they all went down in value.

"When Brown complained at the end of 1928, Rummel told him, 'Well, that is your fault for insisting upon bonds. Why don't you let me sell you some stock?' Brown, like most everyone else, thought the stock market was 'continuously moving up. So then I took hook, line and sinker…'

"In early 1929, Brown went all the way to 55 Wall Street to complain yet again. Despite the rising stock market, his portfolio had gone down in value. … The manager in New York recommended … Brown should sell everything he had and put all his money in City Bank stock, Anaconda Copper, and a few other stock offerings the company was sponsoring."

When Brown tried to sell his stocks in September 1929, he was "'surrounded at once by all of the salesmen in the place, and made to know that that was a very, very foolish thing to do.' … Brown was advised to 'sit tight'…. When the crash came a month later, the company sold out all of Brown's stock. He had lost nearly everything. 'I am now 40 years of age', he wrote the company, 'tubercular—almost totally deaf—my wife and family are depending on me solely and alone and because of my abiding faith in the advice of your company I am today a pauper.'"

–Chapter 14, "Day Eight: Shorn Lamb", The Hellhound of Wall Street