Bank Secrecy Should Be Ended—This Would Make the Financial System Safer

By Raymond B. Vickers

"The time is coming when all businesses will have to be done with glass pockets."
J.P. Morgan, 1913

I.

During the recent speculative mania, America's leading banks funded yet another cycle of greed, corruption, and insider abuse. Not since the Great Depression did so many individuals suffer such significant losses. But depositors did not have to feel the pain caused by the savings and loan debacle of the 1980s: their deposits were insured by the federal government, and Congress bailed out the S&L industry. So the impetus for sweeping reform that would have opened the system to public scrutiny never gained momentum. *And the absence of such scrutiny—the secrecy which instead prevailed—was what made possible the investor losses of more billions of dollars caused by recent corporate misconduct.* Sadly—because this need not still be happening—these losses parallel all too closely the losses sustained by investors and depositors in the 1930s, when the markets collapsed and the banking system was decimated by an epidemic number of failures.[1]

As investors struggle to recover today, the public has once again been left in the dark about the complete breakdown of the bank regulatory system. This is the still untold story of Enron. Where were all the regulators when Citigroup and J.P. Morgan Chase & Co. were financing Enron's special purpose entities with billions of dollars in elaborately disguised loans? They had front row seats from which to witness the bizarre schemes, along with the power to stop them. They also had the clear mandate to remove the unscrupulous bankers who promoted the loans and, further, to ban them from the industry—all of which they should have done, and none of which they did. However, their inaction should not come as a surprise, especially after the spectacular regulatory lapses involving S&L promoters such as David Paul and Charles Keating during the 1980s, and the regulatory failures of the 1930s.

Although a 1932 federal appeals court complained that regulatory powers at the time were "too sweeping and imperialistic," it nonetheless upheld those powers, conceding that in bestowing them, "unquestionably Congress contemplated the upheaval and cataclysm to which the financial structure is subject, the importance of its stability, and the

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necessity which exists for action unhampered by technicality in emergency." Subsequently, Franklin Roosevelt's New Deal reforms expanded these powers, and soon after the S&L crisis, Congress reorganized the regulators and greatly increased their powers, to the extent that by the 1990s, America had in place the most far-reaching regulatory system in the world. This, despite the Gramm-Leach-Bliley Act of 1999, which repealed one of the most significant of the New Deal reforms, the Glass-Steagall Act's separation of most aspects of commercial and investment banking. *But Congress failed to provide for public accountability, with the result that today the supervision of the banking system still depends exclusively on regulators who operate in secret, behind closed doors.*[2]

As we now know, this supervision failed miserably in reining in the participants in the Enron fiasco. After Enron's bankruptcy, Senator Carl M. Levin (D-Michigan) accurately described the company's deals as "sham contrivances . . . to make Enron look more financially healthy than it really was, violating accounting standards." He declared that "by concocting elaborate schemes of so-called structured finance with no legitimate business purpose other than tax and accounting manipulation, Citigroup and J.P. Morgan Chase helped Enron deceive the investing public as well as Enron employees and stockholders." Indeed, Enron's court-appointed examiner, Neal Batson, concluded that both banks "had actual knowledge of the wrongful conduct" and that they "aided and abetted certain Enron officers in breaching their fiduciary duties." But Batson's report was too little, and way too late. Had the details of these transactions been disclosed in the early 1990s by the regulators who were examining the banks at that time, stock analysts and credit-rating agencies would have been compelled to issue timely investor alerts about their riskiness, and the disaster could have been avoided.[3]

In agreeing recently to a settlement of some $300 million as penance—certainly not as fair recompense—for the misdeeds of Citigroup and J.P. Morgan Chase, *the regulators and prosecutors spared Enron's bankers the ordeal of a public trial. Such a criminal prosecution would have spotlighted the bankers' complicity in devising fraudulent schemes to hide $8.3 billion in loans* by falsely reporting the debt as cash flow from operations. And settling, instead of seeking jail time for the bankers, also saved the jobs of all the regulators who failed to stop the madness.

Although refusing to cooperate with the authorities, J. P. Morgan Chase nevertheless issued an apology to Manhattan District Attorney Robert M. Morgenthau: "We have made mistakes. We cannot undo what has been done, but we can express genuine regret and learn from the past." An e-mail written by a Chase senior officer clearly reveals the bank's culpability: "WE ARE MAKING DISGUISED LOANS, USUALLY BURIED IN COMMODITIES OR EQUITIES DERIVATIVES (AND I'M SURE IN OTHER AREAS). WITH A FEW EXCEPTIONS, THEY ARE UNDERSTOOD TO BE DISGUISED LOANS AND APPROVED AS SUCH." Other e-mail exchanges between Citigroup's bankers described in explicit detail how they were "manipulating cash flows" with financing schemes at Enron.[4]

Morgenthau agreed that his office would not prosecute the banks or their officials for their willful misconduct, but added that "there is no place in free and fair markets for players who think they can continue to conduct risky business under a cloud of deception and secrecy." Jacob H. Zamansky, a New York lawyer representing investors, protested the deal: "The message being sent by the regulators is 'write a big enough check and you can get away with anything.'"[5]

There is no doubt that full disclosure of the bank regulators' examination reports, corre-

spondence, and other regulatory records of Enron's two lead banks would have had a chilling effect on their officers when the loans were being made, or that this disclosure would have proved to be an effective deterrent to similar misconduct in the future. But not only was there no disclosure at the time, but under current law, these regulatory records are sealed—and will continue to be sealed—from public view. In fact, for as long as a bank continues to operate, its regulatory records, which have been prepared by government employees at taxpayers' expense, remain confidential. And since both Citicorp, a subsidiary of Citigroup, the nation's largest financial institution ranked by assets, and Chase Manhattan Bank, a subsidiary of J.P. Morgan Chase, the second largest financial institution, are too big to fail, their records will never be released.[6]

As opposed to bank regulatory records, the annual reports and other SEC filings of financial institutions typically contain nothing more than bland general discussions and analyses of the status of their commercial and investment banking operations, along with statistical information about their aggregate loan portfolios. No specific details about questionable transactions are disclosed, including the identities of the bankers and their borrowers who are under investigation. Throughout the last decade, the public SEC filings of Citigroup and J.P. Morgan Chase failed to reveal the controversial Enron transactions and the scant information provided *after* the company's bankruptcy, pursuant to current securities laws, was woefully inadequate and failed, even then, to disclose the details of the financing schemes.

In stark contrast to these uninformative SEC filings, bank examiners' reports contain detailed and candid narratives criticizing insider deals, bad loans, and other questionable transactions, such as the ones conducted by Enron and its banks. Also revealed in these reports are the names of specific troubled borrowers and those of their entities who are engaged in high-risk activities, and the ventures in which the banks have concentrated their loans. Even the correspondence between the regulators and the banking institutions contains information that can be illuminating and should be available to the public, but isn't.[7]

Indeed, secrecy is maintained even *after* the failure of a bank. The public continues to be prohibited from examining the federal government's regulatory and liquidation records of a defunct bank for 50 years after it closes its doors.

II.

Despite all this, bank secrecy has had its advocates for many decades. One of the most ardent was Herbert Hoover, who charged, incorrectly, that during the banking crisis of 1933, "the publication by Democratic leaders of the House of the Reconstruction [Finance] Corporation loans has caused runs on hundreds of banks, failures of many of them," in order to justify instigating a stringent policy of secrecy. Since then, the policy of secrecy has become so embedded in our bank regulatory system that it can reasonably be regarded as Hoover's most enduring legacy.

Indeed, secrecy is maintained even *after* the failure of a bank. The public continues to be prohibited from examining the federal government's regulatory and liquidation records of a defunct bank *for 50 years after it closes its doors*. Thus, the federal records of any

institution that fails in 2003 will be sealed until the year 2053, long after anyone can be held accountable. And, as we have seen, the records of a bank that doesn't fail will be sealed permanently.[8]

Years before the Great Depression, the call to eliminate bank secrecy was made by Louis D. Brandeis, whom historian Thomas McCraw described as a "prophet of regulation." Brandeis's 1914 book, *Other People's Money and How the Bankers Use It*, became a national sensation by sharply criticizing insider abuses in the banking and securities industries, saying that public disclosure was the "best of disinfectants . . . and the most efficient policeman" *for the financial system.* Still, Congress ignored Brandeis's recomendation of disclosure for nearly 20 years until forced to take action at the height of the Depression by revelations of financial manipulations by some of the nation's leading businessmen and bankers involving Samuel Insull's bankrupt utilities empire, along with the chicanery of Charles E. Mitchell, chairman of National City Bank of New York, and Albert H. Wiggin, president of Chase National Bank.[9]

The lobbying power of bankers in Washington and in state capitals has—then and now—succeeded in keeping their activities hidden under a shroud of secrecy. The cost of that secrecy has been staggering.

Finally, on March 29, 1933, three weeks after having to proclaim a national bank holiday, President Roosevelt recommended that Congress pass the Securities Act of 1933, which would open the investment banking industry to public scrutiny. In making his argument, he told Congress that since the public had suffered significant losses "through practices neither ethical nor honest," consequently the federal government had to mandate that the sale of securities be "accompanied by full publicity and information, and that no essentially important element attending the issue shall be concealed from the buying public." The legislation he proposed would, he said, put "the burden of telling the whole truth on the seller. It should give impetus to honest dealing in securities and thereby bring back public confidence."

Roosevelt went on to emphasize that the law's purpose would be "to protect the public with the least possible interference with honest business." Adopting the Brandeis "money trust" argument, Roosevelt said: *"What we seek is a return to a clearer understanding of the ancient truth that those who manage banks, corporations, and other agencies handling or using other people's money are trustees acting for others."* (Emphasis added.)[10]

The President had asked his close friend Felix Frankfurter, a professor at Harvard Law School, for help in drafting the securities legislation, which Congress subsequently passed. A few months later, Frankfurter wrote that *the new law was intended to operate "on the principle that when a corporation seeks funds from the public, it becomes in every true sense a public corporation. Its affairs cease to be the private perquisite of its bankers and managers; its bankers and managers themselves become public functionaries."* (Emphasis added.)

As much as that principle applied to investment banking, it should have applied to depository institutions all the more, given federal deposit insurance and taxpayer bailouts. Nevertheless, commercial bankers managed to escape disclosure during the New Deal by

convincing Congress that revealing the precarious condition of the nation's banks would cause depositor runs and more bank failures, many of which they had conveniently blamed on the publicity surrounding the RFC loans to banks. *But because of federal deposit insurance and taxpayer bailouts, when the names of insolvent but insured S&Ls were published, there, in fact, were no Depression-style runs on them or the banks.*[11]

Brandeis argued that any regulatory system would fail if it denied public access to financial information and instead relied solely on the government. He thought that "real disclosure," revealing banking activities to the public, would create the kind of informed consent that was brought about by the labeling requirements of the Pure Food Law. But the lobbying power of bankers in Washington and in state capitals has—then and now—succeeded in keeping their activities hidden under a shroud of secrecy. The cost of that secrecy has been staggering.[12]

After reviewing examination reports and other regulatory records of 26 failed S&Ls, but without releasing the specifics—once again, because of bank secrecy laws—the U.S. General Accounting Office (GAO) reported to the House Banking Committee in January of 1989 that:

> . . . *extensive, repeated and blatant violations of laws and regulations characterized the failed thrifts that we reviewed in each and every case. Virtually every one of the thrifts was operating in an unsafe and unsound manner and was exposed to risks far beyond what was prudent. Under the Bank Board's definitions alone, fraud or insider abuse existed at each and every one of the failed thrifts and allegations of criminal misconduct abounded.* Economic downturns in some sectors of the economy were beyond management's controls and affected all of the thrifts. The failed thrifts, with their illegal and unsafe practices coupled with high-risk investments, were unable to withstand the downturns. On the other hand, many thrifts which were operated prudently withstood the same economic conditions in the same areas. Lastly, despite the fact that examination reports revealed critical problems at the failed thrifts, federal regulators did not always obtain agreements for corrective action. When they obtained them, they were in many cases violated, ignored, and in many cases it was years before resolutions were taken. The failed thrifts were not responsive to the concerns of the regulators. (Emphasis added.)

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Henry Gonzalez, then chairman of the House Banking Committee, had it right when he said: *"The savings and loan scandals grew in the dark basements of official government secrecy."* (Emphasis added.)[13] Secrecy had struck again.

Without full disclosure, the sorry saga of Enron will be repeated again and again. How can investors be expected to regain confidence in the financial system when they still have no way of knowing what goes on inside the Park Avenue offices of the very same bankers who financed Enron and other such schemes? *Antiquated bank secrecy laws have*

covered up today's wrongdoing and regulatory failures, just as effectively as they did during the S&L scandals.

Throughout the American experience, landmark banking reform has only occurred in the wake of a national financial calamity. Will it take still another such calamity to get bank examination reports and other regulatory records released to the public as soon as they are compiled? They should, in fact, be available to the public through the Internet, so that a depositor or investor could merely type in the name of a bank and have immediate access to its records.

Such a banking-in-the-sunshine law would go far beyond reforming the banking industry, in that it would also purge the system of the bankers and corporate executives responsible for Enron and the other business failures of the 1990s. The disclosure of reckless financing schemes as soon as questionable loans are criticized by regulators would expose irresponsible officials, who rose through the ranks during the decade of greed and insider abuse and who are to this day more interested in personal enrichment than in fulfilling their fiduciary obligations to their stockholders.

Put simply, the bank regulatory system needs a drastic overhaul with disclosure, rather than secrecy, as its basis. ◆

Endnotes

[1] Vincent P. Carosso, *Investment Banking in America*, 155. The bailout of the S&L industry will cost taxpayers between $325 and $500 billion, according to the U.S. General Accounting Office (GAO). Henry N. Pontell and Kitty Calavita, "The Savings and Loan Industry," in *Beyond the Law: Crime in Complex Organizations*, edited by Michael Tonry and Albert J. Reiss, Jr. Chicago: University of Chicago Press, 1993, 203-04, 212-13.

[2] *U.S.N.B. of LaGrande v. Pole*, 2 F. Supp. 153, 157. In 1927, the U.S. Fourth Circuit Court of Appeals ruled that the comptroller of the currency had "almost imperialistic powers" (*Liberty National Bank of South Carolina at Columbia v. McIntosh*, 16 F.2d 906); James J. White, *Teaching Materials on Banking Law* (St. Paul, Minn.: West, 1976), 65-67, 868-73. For a discussion of the Gramm-Leach-Bliley Act, see Form 10-K of J.P. Morgan Chase and Company, December 31, 2001.

[3] Appendix D, Role of Citigroup and its Affiliates, 2; Appendix E, Role of J.P. Morgan Chase and its Affiliates, 2, Third Interim Report of Neal Batson, Court-Appointed Examiner, In re: Enron Corp., et al., Debtors, Chapter 11, Case No. 01-16034 (AJG), United States Bankruptcy Court, Southern District of New York; *Houston Chronicle*, December 9, 11, 2002; *Los Angeles Times*, July 28, 2003; *New York Times*, August 1, 2003.

[4] The capitalization was in the original e-mail. News Release, District Attorney, New York County, July 28, 2003; United States Securities and Exchange Commission, Plaintiff, vs. J.P. Morgan Chase & Co., Defendant, U.S. District Court, Southern District of Texas, Houston Division, July 2003; United States of America before the Securities and Exchange Commission, In the Matter of Citigroup, Inc., Respondent, Order Instituting a Public Administrative Proceeding Pursuant to Section 21C of the Securities Exchange Act of 1934, Making Findings, and Imposing a Cease-and-Desist Order and Other Relief, July 2003.

[5] News Release, District Attorney, New York County, July 28, 2003; "Enron's Bankers: A Great Prison Escape: As Citi and J.P. Morgan settled up, new evidence underscored their roles in the dirty dealing. So why isn't jail time an option?" *Business Week Online*, July 31, 2003.

[6] *Guide to the National Archives of the United States*, Washington, D. C.: National Archives and Records Administration, 1987, 161.

[7] See the Form 10-K and 2001 Annual Report of J. P. Morgan Chase & Co.; and the J. P. Morgan Chase's Form 10-Q for the third quarter ending September 30, 2002; and its SEC Form 8-K, January 2, 2003. "List of Creditors Holding 20 Largest Unsecured Claims," United States Bankruptcy Court Southern District of New York, In re Enron Corp. Debtor, December 2, 2001; See the Form 10-K and 2001 Annual Report of Citigroup Inc. and its subsidiaries; Testimony of Robert Roach, Chief Investigator, Permanent Subcommittee on Investigations, "The Role of the Financial Institutions in Enron's Collapse," July 23, 2002.

[8] *Guide to the National Archives of the United States*, 161; Herbert Hoover to Simeon D. Fess, February 21, 1933, Box 155, Herbert Hoover Papers, Herbert Hoover Presidential Library, West Branch, Iowa.

[9] Louis D. Brandeis, *Other People's Money and How the Bankers Use It*, New York: Frederick A. Stokes Company, 1932, 92-108; Samuel Rosenman, ed., *The Public Papers and Addresses of Franklin D. Roosevelt*, vol. 2, New York: Random House, 1938, 24-29, 48, 93-94; Vincent P. Carosso, *Investment Banking in America: A History*, Boston: Harvard University Press, 1970, 110, 137, 180, 182-83, 322-354, 356; Helen M. Burns, *The American Banking Community and New Deal Banking Reforms 1933-1935*, Westport, Conn.: Greenwood Press, 1974, 78.

[10] Rosenman, *The Public Papers and Addresses of Franklin D. Roosevelt*, 24-29, 48, 93-94.

[11] Carosso, *Investment Banking in America*, 353.

[12] Brandeis, *Other People's Money and How the Bankers Use It*, New York: Frederick A. Stokes Company, 1932, 92-108; Thomas K. McCraw, *The Prophets of Regulation*, Cambridge, Mass.: Harvard University Press, 1984, 1-25; Carosso, *The Morgans: Private International Bankers, 1854-1913*, Cambridge, Mass.: Harvard University Press, 1987, 639-40; Charles H. Hession and Hyman Sardy, *Ascent To Affluence*, Boston: Allyn and Bacon, Inc., 1969, 717; White, *Banking Law*, 80-82; James Ring Adams, *The Big Fix*, New York: John Wiley & Sons, Inc., 1990, 6, 135.

[13] "Failed Financial Institutions: Reasons, Costs, Remedies and Unresolved Issues," Statement of Frederick D. Wolf before the U. S. House Committee on Banking, Finance and Urban Affairs, United States General Accounting Office Testimony, January 13, 1989, 9, 10, 11, 13, 21, 22, 40; Teresa Simons, "Banking On Secrecy," *The Washington Monthly*, December 1990, 31.