Greed and Global Financial Crisis: Reflections on the Repeal of Glass-Steagall Act

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Abstract

One of the main causes of the economic crisis is the "greed" manifested at the different levels of society. From a moral point of view, in all religions of the world greed is repulsive and evil. In this paper, we'll look at how the degree of greed displayed by bank directors and the unscrupulous tactics significantly contributed to the collapse of the financial system and we will focus on the consequences of repealing the Glass Steagall Act.

Though, over time, both philosophers, scientists, politicians, church have tried, through their works, to influence human behavior in order to be more selfless, these actions are not enough. It requires government intervention, through strict regulations applied to institutions and individuals that lead to extreme greed and affect the population through their actions.

We have to launch a strident call for a new kind of humanism to confront a world seemingly out of control!

Key words: greed, economic crisis, Glass Steagall Act
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1. Introduction

The first objective of this paper is to delimit the concept of "greed" and then let's see what influence this feature has over the human behavior and the economy. Greed can be defined as the selfish desire to possess wealth, objects, humans, power, status, appreciation or attention, far beyond what is required for a basic human comfort (Robertson, 2001). To fill the feeling of void and dissatisfaction, the greedy individual acts in such a way that often costs the happiness of others. Doctor Fromm said that: "Greed is a bottomless pit that exhausts the person in an endless effort to satisfy the need, without ever getting satisfaction" (Fromm, 1939, p. 507-523).

This concern regarding the human's tendency to be greedy exists since over 2000 years ago – the Latin poet Plautus used the expression "Homo homini lupus" ("A man is a wolf to another man," or more tersely "Man is wolf to man") in his comedy Asinaria (Plautus, 195BC, verce 495), referring to the wild, insatiable greed which transforms some people into beasts towards their peers. In the same direction are the claims of philosopher Thomas Hobbes, who wrote that "the natural state of men is a war of all against all" (Lloyd et al, 2014, p. 2-4), or of philosopher John Locke who considered "amor sceleratus habendi (accursed love of possessing), evil concupiscence" being a cause of corruption, referring to the sinful greed of selfish people and their desire to have more than meeting everyday needs (Locke, 2003, p. 25).

From a moral point of view, in all religions of the world greed is repulsive and evil. The Bible claims that "love of money is the root of all evil" (Bible, Timothy 6:10). In Quran (C64, v16) it's written that "whoever is saved (from the) greediness (of) his soul, then those [they] (are) the successful ones".

Pope Benedict in his 2008 Christmas message said: "If people look only to meet their own interests, our world will surely fall apart." In the same sense was the answer of Dalai Lama when asked: "what is the real cause of this sort of economic crisis?" at which he replied: "Too much speculation and ultimately greed" (Suranovic, 2010, p. 2)

2. Greed and the global economic crisis

In the specialized economic literature, there are numerous papers and books that have highlighted the fact that the underlying cause of the economic crisis is the "greed" manifested at the different levels of society. In this regard, we would like to mention a few steps: Suranovic S. "Greed, Capitalism and the Financial Crisis", Lo A.W. "Hedge Funds, Systemic Risk, and the Financial Crisis of 2007-2008", Mason P. "Meltdown: The End of the Age of Greed".

Globally, greed and intemperance can lead to many issues that can include wars, invasions, massacres, extreme poverty, social instability, over-populations, climate change and, last but not least, economic crises.

The seeds of the current crisis were created during a long period of prosperity, in which we all became more tolerant of risk. In other words, "we" have become greedy. As Lo wrote, this greed has been driven by "profit-seeking, intoxicating and anesthetic effects of success" (Lo, 2008, p.14) As a result of the crisis, when everything began to collapse, our greed was then transformed into fear.

Piff et al. (2012, p. 4086–4091), investigating the relationship between socio-economic class and behavior came to these conclusions:

1) individuals in the upper class (the rich) behave unethically compared to the lower class
2) individuals in the upper class are more likely to lack ethics in making decisions, in taking valuable goods from others, lying when negotiating, deceiving to increase their chances to win a prize or to approve unethical behavior at work. Researchers believe that this behavior can be explained by a more lenient attitude towards greed.

One example of a greedy investor is Bernard Madoff, investigated for engaging in fraudulent financial activities, including securities fraud, mail fraud, money laundering and perjury, for which he got a 150-year sentence (Frank, R. et al, 2009).

In this regard, asked about the causes of the current economic crisis, the chairman of the Federal Deposit Insurance Corporation answered: "greed and myopia" (Bair, 2013)

Indeed, the situation at the beginning of the crisis was a classic example of human greed and selfishness:

- financial institution managers' greed, which facilitated the acquirement of credits and loans
- owners' greed to buy houses they could not afford
- the greed on the Wall Street that led to the creation of new financial instruments such as mortgage-backed securities
- Director-Generals' greed which led to extravagant and very large compensation packages
- customers' greed which led to excessive use of credit cards to buy things immediately

3. Repealing of the Glass Steagall Act – one of the causes of the crisis

Moving forward, we'll look at how the degree of greed displayed by bank directors and the unscrupulous tactics significantly contributed to the collapse of the financial system.

Immediately after the 1929 crisis, investigations were opened to determine the causes of its occurrence. If in the first phase their results were very weak, the hearings changed dramatically in January 1933 under the guidance of Ferdinand Pecora (former Sicilian immigrant, later deputy prosecutor). One of the witnesses investigated was Charles Mitchell, head of the National City Bank, known for promoting new risky securities. He acknowledged that the National City Bank granted bonuses to employees based on their turnovers: the riskier the titles were, the higher the bonuses. During the hearings, Mitchell also revealed that National City Bank has provided non-performing loans to Latin American countries. Six days after Pecora opened the investigation, Mitchell resigned. At the same hearing, J. P. Morgan Jr., executive director of Chase Bank, admitted that he also enriched himself through the transactions made during the crisis.

The Pecora Commision report explained:

"A prolific source of evil has been the affiliated investment companies of large commercial banks. These affiliates have been employed as instrumentalities by commercial banks to speculate in their own stock, to participate in market operations designed to manipulate the price of securities, and to conduct other operations in which commercial banks are forbidden by law to engage. Commercial banks did not hesitate to violate their fiduciary duty to depositors seeking disinterested investment counsel by referring such inquiries to their affiliates. The affiliates unloaded securities owned by them on unsuspecting investors and depositors. The activities of investment affiliates encouraged speculation by officers and directors of commercial banks and resulted in the payment of excessive compensation and profits to these officials" (Pecora Commission Report, p. 113-114)

The Congress has been alarmed that commercial bank operations support losses from unstable capital markets. Consequently, the aim pursued by the Congress was to limit bank credits used for risky speculation and to redirect funds towards a more productive use, such as commerce or agriculture. Politicians had no choice but to establish and enforce strict banking regulations.

As a result, Senator Carter Glass and Congressman Henry Steagall, members of the Democratic Party, proposed a law that reformed the foundations of the US financial system, with the main purpose of preventing unjustified misappropriation of funds in speculative operations. With this law it was aimed to separate commercial banks' business from investment, as well as securing client deposits with banks, limiting interest paid by banks to customers, and reforming the Federal Reserve.

Glass initially introduced the law project for the banking reform in January 1932. He received extensive criticism and comments from bankers, economists and from the Federal Reserve. Steagall, chairman of House Banking and Currency Committee at that moment, agreed to support the project after a change was added to allow deposits to be secured. On June 16, 1933, President Roosevelt signed, transforming the project into actual law.

The four sections (16, 20, 21, 32) that referred to this law and occupied a remarkably small number of pages, are to be included and adopted in the "Banking Act" and will remain known in history under the name of "Glass Steagall Act ":

- Section 16, which although amended over the years is still in effect, confers a limited authority to banks; They are only authorized to engage in "banking" and not in underwriting or trading in securities (bonds and shares) activity.
- Section 20 prohibits Federal Reserve System member banks from affiliating with companies that are "principally engaged" in securities trading.
- Section 21, still in effect today in a modified form, makes it illegal for a firm to engage in both deposit and investment operations at the same time.
- Section 32 prohibits affiliation between member banks and securities firms.

Thus, the most important measure proposed by Senator Glass was the separation of commercial banks from investment banks. By delimiting commercial banks as deposit and lending banks, and investment banks as banks that subscribe and trade securities (bonds and shares), the Glass-Steagall Act has established that commercial banks are not allowed to carry out transactions with Securities, and investment banks are not allowed to own their own commercial banks or close links with them. As an exception, commercial banks are allowed to subscribe bonds issued by the government, as well as the possibility of obtaining a maximum of 10% of their income from the securities.

Commercial banks face certain risks because depositors have the right to withdraw their short-term funds, and external events can cause loans to not be reimbursed, even if these loans were granted in a prudent manner. Securities markets (stocks and bonds) are inherently risky because stock prices are volatile. However, exposure of a securities firm to price volatility depends primarily on the degree to which the securities company traded on its own or served as an intermediary for its clients (whether they are buyers or issuers of securities). By separating the activity of commercial banks from the investment ones, the risks in the banking system declined because financial institutions could no longer use their liabilities (money collected from customer deposits) for financial operations with a high risk to depositors and shareholders.

The Glass-Steagall Law restored public confidence in the US financial system. It also set a new foundation of integrity and stability for US banks. Even though some small banks continued to fail occasionally, depositors escaped, mostly, untouched. Together, confidence in stocks and bonds has increased. For the investors around the world, the US financial system meant a high standard of transparency and reliability.

Basically, since the day it became and actual law, banks have begun lobbying towards the repeal of the Glass Steagall law. These endeavors increased especially in the 1970s and 1980s.

Furthermore, European banks were not subject to Glass-Steagall stipulations and could form divisions of investment banking: Credit Suisse creates a joint venture with First Boston's American investment bank, which Credit Suisse later buys in 1996; Deutsche Bank buys the British investment bank Morgan Greenfel & Co in 1990; Dresdner Bank buys British bank Kleinwort Dresdner.

Since 1987, the Federal Reserve Board has interpreted the law by the fact that a member bank could be affiliated to a brokerage firm, as long as the latter was not "mainly engaged" in activities with securities forbidden for a bank (thus in 1998 it was approved to Citigroup, as owner of the Citibank, to acquire one of the largest securities firms in the world - Salomon Smith Barney). Because this merger was a violation of the Glass-Steagall Act, the Federal Reserve granted Citigroup a temporary exemption until 1999, when the adoption of the Gramm-Leach-Bliley Act GLBA provided a free path for mergers in financial services. It was thus possible to make a mix between commercial banking, investment banking, insurance and brokerage (Bank of America, Chase Manhattan, JPMorgan, Citigroup and First Union are among the first US banks to receive Federal Reserve’s approval to form financial holdings).

Thereby, the Glass-Steagall Law remained in effect until 1999, when the Congress abrogated it by passing the Gramm-Leach-Bliley Law proposed by Sen. Phil Gramm, constituting the culmination of a lobby valued at $300 million, made by representatives of the banking and financial system (the Senate passed the law with 90 votes to 8 against).

Among the senators who resisted, we mention Byron Dorgan who said:

“I think we will look back in 10 years` time and say we shouldn`t have done this, but we did because we forgot the lessons of the past and that what was true in the 1930`s is true in 2010. I wasnt around during the 1930s or the debate over Glass-Steagall... We have now decided in the name of modernization to forget the lessons of the past of safety and soundness” (Labaton, 1999).

In the same direction was Senator Paul Wellstone's statement:

“This is the wrong kind of modernization because it fails to put in place adequate regulatory safeguards for these new financial giants, the failure of which could jeopardize the entire economy. “It’s the wrong kind of modernization because taxpayers could be stuck with the bill if these conglomerates become too big to fail” (Financial Services Modernization Act Of 1999, p. S13871)

One of the largest economists, Joseph Stiglitz, opposed the abolition of the Glass-Steagall Act because the banks that were previously carefully managed were carefully focused towards on acquisitions and mergers with other financial institutions (insurance, brokerage, etc.), namely riskier investments to raise their income:

“Commercial banks are not supposed to be high-risk ventures; they are supposed to manage other people’s money very conservatively…It is with this understanding that the government agrees to pick up the tab should they fail. Investment banks, on the other hand, have traditionally managed rich people’s money — people who can take bigger risks in order to get bigger returns. When repeal of Glass-Steagall brought investment and commercial banks together, the investment-bank culture came out on top. There was a demand for the kind of high returns that could be obtained only through high leverage and big risk-taking” (Roosevelt Institute, 2009)

What has happened then after the abolition of Glass Steagall Act? Greed has expanded from financial elites to most consumers. Mortgage lenders have convinced millions of people to buy exotic mortgage bonds, many of whom do not know what they are doing. But these companies have been aided by the complicity of banks and rating agencies. Banks bought mortgages and reorganized them, selling them to credulous investors. They had created some products that, although praised as risk management tools, were so dangerous that they threatened to bring down the US financial system. The rating agencies, which ought to have checked the expansion of these instruments, hurried to give them a certificate of good quality, which encouraged many to buy them

- including pension funds looking for a safe place where to keep the money that the laborers had set aside for retirement.

Commercial banks have played an essential role in the process of buying and selling mortgage-backed securities and in granting default swaps CDS (allow credit risk transfer: in exchange for a premium, the institution selling a CDS undertakes that when the debtor is unable to pay to cover the customer's losses. At sovereign level, CDSs reflect the price of country risk). Without the abolition of Glass-Steagall, banks would've been excluded from most of these activities.

Low interest rates and lax regulations fueled the real estate bubble. Breaking the bubble mainly affected the weakest mortgages (substandard loans, granted to low-income people), but soon came to affect all that belonged to the residential real estate. When the bubble burst, the effects were boosted because the banks had built up complex financial products that relied on mortgages at the base. This complexity, combined with the rapid pace in which the situation deteriorated and the high degree of bank over-indebtedness (just like households, banks had funded their investments by borrowing massively) caused the banks not to know if the amounts owed by them to depositors and bond holders exceeded their assets. Banks refused to borrow each other - or demanded higher interest rates to compensate for the risk. Global credit markets have begun to disintegrate. It was the moment the financial crisis triggered, followed by the economic crisis.

In the US, the lawmakers then unsuccessfully tried to restore Glass-Steagall sections 20 and 32 as part of the Dodd-Frank Wall Street Reform and Consumer Protection Act in 2010. The law, signed by Barack Obama, was designed to prevent such excessive risk-taking that would contribute to financial crisis, and to completely remodel the US regulatory system on the following issues: consumer protection, trading restrictions, credit ratings, financial product regulation, corporate governance and transparency.

4. Conclusions

The solution for greed is to invoke his opposite, altruism. All over the world, in churches, synagogues, and mosques, people find that the right and proper way of living is not be selfish and greedy, but to be altruistic; to give others. Indeed, for each of the seven sins of death there is a virtue, and for greed the opposite is charity.

Praise for charity is prominent in the comments often quoted by authors, politicians and scientists. For example, Winston Churchill said: "We make a living by what we get, but we make a life by what we give." And John F. Kennedy said: "Ask what your country can do for you, but what you can do for your country."

But how can we influence people in a way that they are no longer led in their actions by such greed and selfishness but rather by altruism? Religion has been trying for a long time to bring individuals on the right track. Various nongovernmental organizations, from all over the world, carry out charitable activities. Culture people and writers have tried through their works to influence human behavior. But these actions are not enough. It requires government intervention, through strict regulations applied to institutions and individuals that lead to extreme greed and affect the population through their actions. Although limited greed, regarded as a wish for success, could provide a pulse for the economy, recent history has shown us that uncontrolled greed can lead us to a deep and long-lasting economic recession.

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