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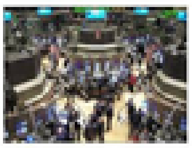
Congress Is Facilitating "Catastrophic Risk" by Allowing Federally-Insured Banks to Be Owned by Wall Street's Trading Houses

By Pam Martens and Russ Martens: November 17, 2021 ~



We recently read the report conducted by the Special Committee of the Board of Directors of Credit Suisse into how the bank had lost $5.5 billion when the Archegos family office hedge fund that was being financed by Credit Suisse and other Wall Street firms blew itself up this past March. One paragraph in particular caught our attention:

> "The Archegos-related losses sustained by CS are the result of a fundamental failure of management and controls in CS's Investment Bank and, specifically, in its Prime Services business. The business was focused on maximizing short-term profits and failed to rein in and, indeed, enabled Archegos's voracious risk-taking. There were numerous warning signals—including large, persistent limit breaches—indicating that Archegos's concentrated, volatile, and severely under-margined swap positions posed potentially catastrophic risk to CS. Yet the business, from the in-business risk managers to the Global Head of Equities, as well as the risk function, failed to heed these signs, despite evidence that some individuals did raise concerns appropriately."

(For a more succinct look at the Archegos blowup, see our report: Archegos: Wall Street Was Effectively Giving 85 Percent Margin Loans on Concentrated Stock Positions – Thwarting the Fed's Reg T and Its Own Margin Rules.)

What grabbed our attention in that paragraph from the Credit Suisse report is that the Board of Directors is actually acknowledging that trading positions posed "catastrophic risk" to the bank. What also grabbed our attention is that banking regulators in the United States have been reading this same kind of assessment of catastrophic risk within the mega banks on Wall Street since the financial crisis of 2008, while doing absolutely nothing meaningful to rein it in.

Even more striking, banking regulators and Congress continue to allow the majority of the largest trading houses on Wall Street to continue to own federally-insured deposit-taking banks where the taxpayer would be on the hook for bailouts if they blow themselves up.

Consider these three paragraphs from the report prepared by the Senate's Permanent Subcommittee on Investigations after JPMorgan Chase lost at least $6.2 billion gambling in derivatives in London using deposits from its federally-insured bank:

> "The bank's reli[redacted]sk within the CIO

"The bank's reliance on Ms. Drew to police risk within the CIO [Chief Investment Office] was so excessive that some senior risk personnel first became aware of the CIO's outsized synthetic credit positions from the media. John Hogan, the bank's Chief Risk Officer, for example, told the Subcommittee that the articles about the 'London Whale,' which first appeared on April 6, 2012, surprised him. Mr. Hogan said that the Synthetic Credit Portfolio was not on his radar in an 'alarming way' prior to that date. It speaks volumes that the financial press became aware of the CIO's risk problems before JPMorgan Chase's Chief Risk Officer.

"While the bank's Chief Risk Officer was apparently left in the dark, by April 2012, senior CIO management was well aware that the Synthetic Credit Portfolio had lost money on most days during the first quarter of the year, had cumulative losses of at least $719 million, and had massively increased the portfolio size with tens of billions of dollars of new synthetic credit positions threatening additional losses. Ms. Drew was so concerned that on March 23, she had ordered the traders to stop trading. Yet in the week following publication of the 'London Whale' articles, Mr. Dimon, Mr. Hogan, Chief Financial Officer Douglas Braunstein, and others, gave the impression that the press reports were overblown. On the bank's April 13 quarterly earnings call, Mr. Dimon referred to the press accounts as a 'complete tempest in a teapot,' and Mr. Braunstein stated that the bank was 'very comfortable with our positions.' Those statements did not reflect the magnitude of the problems in the Synthetic Credit Portfolio. Mr. Dimon publicly withdrew his comment a month later.

"Prudent regulation of the U.S. financial system depends in part on understanding how a small group of traders in the London office of a global bank renowned for stringent risk management were able to purchase such a large volume of synthetic credit derivatives that they eventually led to losses of more than $6 billion. This case study elucidates the tension between traders and risk managers. Traders are incentivized to be aggressive and take on significant risk. Risk managers are supposed to be a voice of caution, limiting and reigning in that risk. Just because trading strategies sometimes succeed does not mean they are prudent. Bad bets sometimes pay off, and it is easy to confound profits with successful trading strategies. At the CIO, initial success in high risk credit derivative trading contributed to complacent risk management, followed by massive losses."

JPMorgan Chase is the largest deposit-taking bank in the United States. According to the Federal Deposit Insurance Corporation (FDIC), it has 5,135 branch bank offices across the United States accepting insured deposits from moms and pops, small businesses, pension funds and the like. The vast majority of these depositors have no idea that the bank is allowed by Congress and its regulators to make wild gambles in derivatives.

The three paragraphs abo [redacted] gan Chase are

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but Michael Lewis, who wrote the book on which the movie is based, told the public a good deal about Hubler within its pages.

Lewis describes Hubler as a star bond trader at Morgan Stanley, making $25 million in one year prior to the collapse of the subprime mortgage market. Hubler was one of those who made early bets that the lower-rated subprime bonds would fail. He used credit default swaps (derivatives) to make his bets. But because he had to pay out premiums on these bets until the collapse came, he placed $16 billion in other bets on higher-rated portions of the subprime market, according to Lewis. When those bets failed, Morgan Stanley lost at least $9 billion.

According to a government audit of the Fed's secret loans to the trading houses on Wall Street during and after the 2008 Wall Street implosion, Morgan Stanley was the second largest recipient (after Citigroup) of the Fed's secret loans that were funneled from December 1, 2007 to at least July 21, 2010 to bail out the lack of risk controls on Wall Street. Morgan Stanley received a total of $2.04 *trillion* in cumulative loans from the Fed.

If you care about the financial stability of the United States; if you care about the kind of future you are leaving to your children and grandchildren, pick up the phone today and call your U.S. Senators and members of Congress and demand that they restore the Glass-Steagall Act, which would ban federally-insured banks from being part of Wall Street's trading casino.

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The three paragraphs above from the report on JPMorgan Chase are bad enough, but here's what else you need to know. The "Ms. Drew" that was supposed to be policing trading risk for the bank and was supposed to be policing the derivative traders in London didn't even possess a trading license herself. That's illegal at trading houses known as broker-dealers on Wall Street. At broker-dealers, a supervisor must have the proper licenses to oversee traders.

The Senate's Permanent Subcommittee on Investigations held hearings as part of its explosive London Whale investigation. Ina Drew (the "Ms. Drew" referred to above) told the Subcommittee that the investment securities portfolio exceeded $500 billion during 2008 and 2009 and as of the first quarter of 2012 was $350 billion. But we learned from the industry's self-regulator, FINRA, that during the 13 years that Drew supervised stunning amounts of securities trading, she had neither a securities license nor a principal's license to supervise others who were trading securities.

At the time, we asked numerous Wall Street regulators to explain how Drew could have been overseeing traders without the proper trading licenses. One regulator who spoke on background only told us that Drew could not hold a securities license because she worked for the federally-insured commercial bank, not its broker-dealer. Only employees of broker-dealers are allowed to hold securities licenses. But apparently, not having a securities license does not stop one from supervising a $500 billion portfolio of securities trading at a federally-insured bank.

Welcome to the insane world of Wall Street today.

Was JPMorgan Chase chastened by its humiliation in the press and before the U.S. Senate, which also called Jamie Dimon, the bank's Chairman and CEO, to testify in the matter? Not in the least. Last year, Wall Street On Parade published the following articles, showing the wild cowboy culture was alive and well at JPMorgan Chase:

> Using Bank Deposits, JPMorgan Chase Lost $3.2 Billion Trading Stocks and Credit Derivatives in First Quarter

> JPMorgan Chase and Citibank Have $2.96 Trillion in Exposure to Credit Default Swaps

Morgan Stanley is another blowup waiting to happen on Wall Street. It also owns federally-insured banks, although their size pales in comparison to the $2 trillion in deposits held by JPMorgan Chase's domestic branches.

Morgan Stanley was another Wall Street bank that had exposure to Archegos when it blew up in March. It acknowledged almost $1 billion in losses from Archegos. Morgan Stanley has had far larger losses from trading blowups in the past. During the 2007-2008 subprime mortgage crisis, one of Morgan Stanley's traders, Howie Hubler, lost $9 billion of the firm's capital betting on subprime debt. Hubler didn't get a character to play his role in "The Big Short" movie but Michael Lewis, who [redacted] movie is based,