A Coming Showdown Over Restoring Glass-Steagall

by Paul Gallagher

Nov. 25—The intermittent Congress may appear obsessed now with the suicidal "fiscal cliff" austerity drill assigned it by Obama and Wall Street's various "debt commissions." Yet Wall Street spokesmen are giving clear signals that they are worried about the sudden emergence of a showdown over restoration of the Glass-Steagall Act, the real key to turning around the economic collapse, which was supposed to be dodged by passing the Dodd-Frank "Wall Street Reform" Act in 2010.

The impossibly, deliberately complicated Dodd-Frank Act is not really being implemented; is showing no sign of either breaking up or reforming the behavior of the dozen or so huge banks which control two-thirds of U.S. bank assets; and is being sabotaged by Treasury Secretary Tim Geithner, as in his recent move to exempt entire foreign-exchange and credit-derivatives markets from regulation.

And Dodd-Frank, along with Helicopter Ben Bernanke's zero-interest-rate policy and the looming global capital rules known as "Basel III," is now threatening the nation's community banking sector, still the deepest in the world, and a lifeline for many businesses during the crash years. Some 60 smaller commercial banks have failed through October of this year, after 92 failures in 2011, thus continuing the rate of failure at two-thirds that of the worst rates of 2009-10.

There is no sign of the credit in the economy—certainly not coming through the global monster banks—which could turn around mass unemployment, rescue agriculture from drought and disasters, or fill the large and desperate needs for new economic infrastructure. That's true not only for the United States, but for the entire trans-Atlantic economic-financial system, now in its death throes.

In this situation, any move for introduction in the U.S. Senate of legislation to restore Glass-Steagall—matching H.R. 1489, the bill with 85 sponsors in the House—will set off a showdown over potential fast passage, with widespread support from both parties in both Houses.

Obama Said 'No'

President Obama personally reflected the financial powers' fear of this potential when he brought up Glass-Steagall, unsolicited, in order to oppose it, in an interview with *Rolling Stone* magazine Oct. 25. The "arguments" Obama gave against Glass-Steagall were so transparently false that the interviewers debunked the President in a blog post the next day. On Nov. 14, *Business Week* reported the remarks of Commodity Futures Trading Commission member Bart Chilton under the wishful headline, "Volcker Rule Should Prevent Glass-Steagall Return." Chilton reportedly said, "I don't know if we need to go back to Glass-Steagall," and hoped to get "enough" bank reform from the so-called Volcker Rule—not to be implemented until 2014, at best!—to hold off Glass-Steagall reenactment. Indeed, the panel of the Bloomberg News foreign-exchange conference Chilton spoke at, was entitled, "Banking Under Fire: A look at the on-going debate about, whether or not, it is time to reinstate Glass-Steagall and break up Wall Street's biggest banks. Which banks should be broken up and how? What are the risks?"

A growing number of community bank representatives are publicly calling for Glass-Steagall to be restored, as for example Connecticut Banking Association chairman Martin J. Geitz on Oct. 29. So are former bank overseers like Neil Barofsky, and current FDIC vice chairman Thomas Hoenig. Others, such as Federal Reserve governors Daniel Tarullo and Richard Fisher, are advocating that large banks be "broken up" by other forms of regulation.

It is notable that three newly elected U.S. Senators advocated Glass-Steagall during their campaigns: Democrats Tammy Baldwin (Wisc.) and Elizabeth Warren (Mass.), and Republican Dean Heller (Nev.). But the fight to restore Glass-Steagall could break out even during the remaining month of the lame duck 111th Congress.

American Banker, in reporting the pace of bank failures Nov. 6, said that, aside from the years-long zero-interest-rate policy of Bernanke's Federal Reserve—which makes both the banks' lending business less profitable and their customers' savings accounts and CDs much less desirable—the Dodd-Frank law was written to regulate, but also to protect and preserve, the big banks. With the implicit guarantees of the Act that no big banks will fail, the "cost of capital" differential between big banks and small, has grown to double (0.78% average for institutions of less than $1 billion in assets, vs. 0.34% average for those with over $1 billion, and 0.30% average for banks of over $50 billion assets). Prior to the 2007-08 crash, the differential went in the opposite direction, because the big banks' activities to acquire capital and assets were more costly than the straightforward deposit-taking of the community banks.

Congressional offices are now taking heat from agitated community bankers, and some of that heat is focussed: Restore Glass-Steagall now.

'Shadow Banking' Dominates Again

A clear signal of the continuing speculative sickness of the big "universal bank" sector is the rapid ballooning, once again, of the so-called shadow-banking sector. The European Commission's Financial Services Board (FSB) reported on Nov. 19 its estimate that the global "shadow banking sector" has ballooned back up to $67 trillion in assets as of Dec. 31, 2011, a bigger speculative asset bubble than in mid-2007, just before the world financial blowout. The Nov. 18 report, while admittedly just an estimate of unregulated debt, gives an indication of what the trans-Atlantic financial institutions have been doing with the tens of trillions in bail-out money-printing by central banks—they have clearly not been lending any of it into the real economy.

"Shadow banking sector" is a general term referring, as the fellow who invented it said, to "the whole alphabet soup of levered-up non-bank investment conduits, vehicles and structures," such as hedge funds, private-equity funds, mutual and money-market funds, and the banks' special investment vehicles whose sudden illiquidity collapse helped trigger the financial crisis. It first became clear what this shadow sector could do to regulated banking 25-30 years ago, when the U.S. savings-and-loan banking sector was wiped out, after money-market and other mutual funds seized the savings banks' mortgage-lending market with an earlier real estate bubble, which then collapsed by 1989, and triggered a deep recession. But in the 1990s, with Alan Greenspan's gradual destruction of Glass-Steagall, the commercial banks themselves were tempted to lend their deposit bases to feed "shadow banking" operations, until the "shadow sector" was larger than the banking sector itself just before the crash began in 2007.

A recent New York Federal Reserve Bank study, "Peeling the Onion: The Structure of Large Bank Holding Companies," showed that the Glass-Steagall destruction-and-repeal period, 1994-99, started a massive proliferation of non-bank, speculative securities-dealing structures *by the big commercial banks themselves*. This reached the point that a full one-third of Citigroup's $2 trillion-plus assets, for example, migrated from commercial banking into securities operations during that period to 2011.

Now "shadow banking" has ballooned back larger than banking again. In the past four years the Federal Reserve has printed $2.5 trillion to buy overvalued securities from big banks which refuse to deleverage or recognize losses, and continues to print $40-80 billion/month. Other major central banks have done the same thing—a total of nearly $9 trillion in money-printing in four years. During that entire period, net lending by those banks into the real U.S. economy has declined.

The shadow banking system in the United States was back up to $23 trillion in assets at end-2011, FSB estimated, the euro area at $22 trillion, the U.K. alone at $9 trillion.

Sixty years' enforcement of Glass-Steagall prohibited precisely this. The ballooning of money-market mutual funds is new, and they were wrongly given commercial bank-like FDIC insurance in late 2008. But the House Glass-Steagall bill H.R. 1489 cracks down on them, as does Hoenig's proposed restoration.

The so-called Volcker Rule section of the Dodd-

Frank Act, which may prevent some kinds of bank securities dealing when implemented, is fading further into the future distance and becoming more irrelevant to the ongoing bank crisis. The Volcker Rule was put in Dodd-Frank, in the first place, to keep Congress from re-enacting the Glass-Steagall Act, but is unworkable as written. Even the writing of the "final" Volcker Rule is now being further delayed by a dispute among the bank regulators, and may not be completed this year; July 1 was the most recently hoped-for date. So the implementation of the rule, which supposedly will bar banks from owning in-house securities-dealing operations, will be kicked at least into 2015—long after the banking crisis will have exploded again.

The huge gaps in this regulation—being industriously widened by Wall Street's boy Geithner—were highlighted by the JPMorgan Chase "London Whale" case, where Morgan's London traders were able to manipulate the global credit derivatives market, and also lose $6-7 billion, while technically in compliance with the theoretical Volcker Rule. Former FDIC Chairman Sheila Bair calls it "a 320-page Rube Goldberg contraption."

The regulators' latest inability to formulate the Volcker Rule drew a letter of strong criticism Oct. 25 from Democratic Senators Carl Levin (Mich.) and Jeff Merkely (Ore.), who are afraid the chances of ever enforcing an effective Volcker Rule are slipping away. Despite Levin's and Merkely's protests, the idea that "something else is needed, different from Dodd-Frank," to save the economy from Wall Street, is spreading.

Meanwhile, the severe lack of credit in the economy is about to get worse. While facing a true "physical-economic cliff" crumbling underneath them, the nation's elected officials are debating what shape of "fiscal cliff" to dive off. Obama's verison, the Simpson-Bowles Commission's, the Supercommittee's—all will bring mass layoffs, economic austerity, at least a 2% contraction even in the phony GDP measure. This, when the United States desperately needs food-production support, drought relief, new water-management "great projects," and flood protection; not to mention investing trillions in replacing other crumbling infrastructure platforms.

A new national-banking credit system is immediately needed; but for five years, all "credit" being issued in the name of the United States, whether by Fed or Treasury or FDIC guarantee, has been going straight into the financial sector's black holes of speculation. Restoring Glass-Steagall ends that. It's the essential first step.