Bank Officials Fear Bail-In Scheme

by Stuart Rosenblatt

Nov. 4—The deepening crisis in the trans-Atlantic banking system was exposed this past Summer when Federal Reserve Board chairman Ben Bernanke backed away from the vaunted "tapering" of the $85 billion bailout for fear of totally destabilizing the system. Even the mere whisper of a proposal to cut the bailout by $10 billion sent bond markets on both sides of the Atlantic reeling. Only when Bernanke announced that the full bailout would go on for months or longer did the markets finally calm down.

Further draconian budget cuts this Fall are being rushed into place to prop up the system. The Obama Administration has put Social Security, Medicare, Medicaid, and other Federal programs on the table in the killer budget negotiations. Cities such as Detroit are cutting health-care benefits for municipal workers, and Congress is putting forward legislation to steal multi-employer pensions, which have been previously paid for by the workers themselves.

Calls To Tread Softly on Bail-Ins

None of this is succeeding. Over the past month, the vaunted "bail-in" scheme, first proposed by the Nazi-connected Bank for International Settlements, and known as Title II of the Dodd-Frank Act, is triggering second thoughts among its top proponents, for fear of provoking "bondholders' runs" on major banks. European Central Bank president Mario Draghi and New York Federal Reserve president William Dudley both recently called for treading softly before moving for bail-ins of SIFI banks (systemically important financial institutions).

Unlike its bail-out counterpart, bail-ins, which are now embedded in much U.S. and European legislation, allows governments to unilaterally seize unsecured debt, secured debt, bank deposits, and other financial holdings to provide fast "orderly resolution" of failing banks, by recapitalizing them internally. It has already been used in Cyprus, Spain, and other locations, further destroying these near-ruined nations.

On Oct. 19, a letter dated July 30, from Draghi to European Union competition commissioner Joaquin Almunia, was leaked to the Italian daily *La Repubblica*, and eventually to Bloomberg and other media. Draghi wrote that imposing bail-in losses on junior creditors could hurt subordinated bank bonds. Draghi is now asking the EU Commission to freeze bail-in procedures for the moment, because bail-in of bondholders as a condition for government aid to banks could provoke a run on the banks.

Draghi's letter was written when Commissioner Almunia was ordering Monte dei Paschi di Siena bank (MPS), Italy's oldest, and third-largest, to bail in (i.e., expropriate) bondholders as a condition to approve the EU4.1 billion government loan issued by the Monti government. MPS did default on interest rates on three subordinated bonds. In his letter, Draghi stated, "An improperly strict interpretation of the state aid rules may well destroy the very confidence in the euro area banks which we all intend to restore."

In the *Repubblica* article, Draghi called for "precautionary recapitalization" and for government "backstops." "It is essential that member states commit credible public backstops to ensure that resources are available in case private sources of capital are insufficient in the face of capital shortfalls. The absence of a public commitment would undermine the credibility of the exercise from the outset."

In other words, before acting to "bail in" creditors and depositors of a big bank, have a big government bailout ready—just what it is claimed bail-ins would do away with!

"According to several people with direct knowledge," *Repubblica* noted, "Draghi's letter to Brussels contains a basic message: We must avoid forcing losses on those who have invested in bank bonds, at least for the moment, lest this should destabilize the financial system in Europe. The ECB president is not against imposing losses on bank creditors once the European banking union is operating at full speed. Draghi fears that imposing losses on bondholders now, potentially for dozens of European lenders at once, can destabilize the markets."

New York Fed Chief Echoes Draghi

On Oct. 18, New York Fed President Dudley gave an 18-minute speech to the Richmond Federal Reserve conference dedicated to "explaining" Title II of Dodd

Frank, the notorious section that sanctions bail-ins of U.S. bank depostors. In the speech, he promoted bail-in as a useful tool in resolving TBTF (too big to fail) bank failures, but at the same time, exposed several of the Achilles' heels contained in the policy.

First, Dudley said, "even assuming resolution is successful," "over-the-counter derivatives will be outside the reach of resolution," i.e., they won't be bailed in, if located outside U.S. borders. Given that London is the origin of 50% of all OTC derivative contracts worldwide, including U.S. bank derivatives, the counterparties to the derivatives "and other qualified financial contracts" will likely declare the FDIC's notice of intent to "resolve" the bank under Dodd-Frank Title II, as a default event. They will then move to seize their collateral, ignore any roadblocks from Dodd-Frank, and potentially set off a panic. Said Dudley, "this would also propagate stress more broadly throughout the financial system."

Second, given the distrust by most derivatives dealers in the bail-in process, Dudley said that "the FDIC will have a sufficient credit line from the Treasury to ensure a smooth resolution"; i.e., the taxpayer bailout will be there to facilitate the bail-in.

Third, Dudley admitted that the mere announcement that a TBTF bank will be put into conservatorship or Title II resolution may cause "unsecured creditors' runs" on those banks, dumping their capital and provoking the bank's failure. This is precisely the same warning given by Draghi at the same time.

Dudley also said that the uncertainty of a global bank run might lead European regulators to attempt pre-emptive ring-fencing, or even bank separation!

The Solution: Glass-Steagall on Both Continents

While panicked bank officials were back-pedalling from bail-in and other elixirs, the LaRouche movement was intervening with others to spell out the only solution: Restore Glass-Steagall legislation in the United States, and implement it in Europe as well. At a well-attended forum in Nicosia, Cyprus on Oct. 17, two representatives of the LaRouche movement were among four speakers at a conference called to bring the murderous Cyprus bail-in before the European Court of Justice. The conference was organized by the Anglo-Cypriot Law Association and its president, Dr. Katherine Alexander-Theodotou (see *EIR*, Nov. 1).

After two prominent British barristers presented the legal grounds on which the bail-in should be nullified, Dean Andromidas and Elke Fimmen of the LaRouche movement in Europe laid bare the utter bankruptcy of the derivatives-based international banking system. They attacked both bailouts and bail-ins, and the massive program of Nazi-style killer austerity being implemented on both sides of the Atlantic. They stressed that if the human race is to survive, Glass-Steagall and a credit system should be immediately implemented in each sovereign nation-state.

In the United States, the Michigan State Senate became the latest state legislature to have a Glass-Steagall resolution introduced. And in a surprise announcement, Costco, the giant warehouse store chain, announced the results of its national poll on bank separation, Glass-Steagall. The *Costco Connection*, mailed to 8 million households in October, posed the question: Should the United States implement a bank separation along the lines of Roosevelt's 1933 Glass-Steagall Act? In November, Costco published the results in its magazine: 90% of respondents resoundingly supported the restoration of Glass-Steagall in the U.S.!