# Call for Glass-Steagall to end 'regulatory alchemy'

*By Elisa Barwick*

Amid many more warnings of the oncoming financial Armageddon accumulating in major press outlets, Glass-Steagall is again becoming a major topic of debate in the USA. In the 24 June London *Telegraph*, Ambrose Evans-Pritchard reviewed the Bank for International Settlements' latest annual report which warned of the impact of increasing interest rates given the increased global debt load, especially that denominated in US dollars, and that carried by emerging markets (which has doubled since the last crash); the growing corporate debt bubble; the risk of a GFC-style crash in countries that avoided it last time around, including Australia and Canada; and a "snapback" of global bond yields caused by sharply increasing inflation.

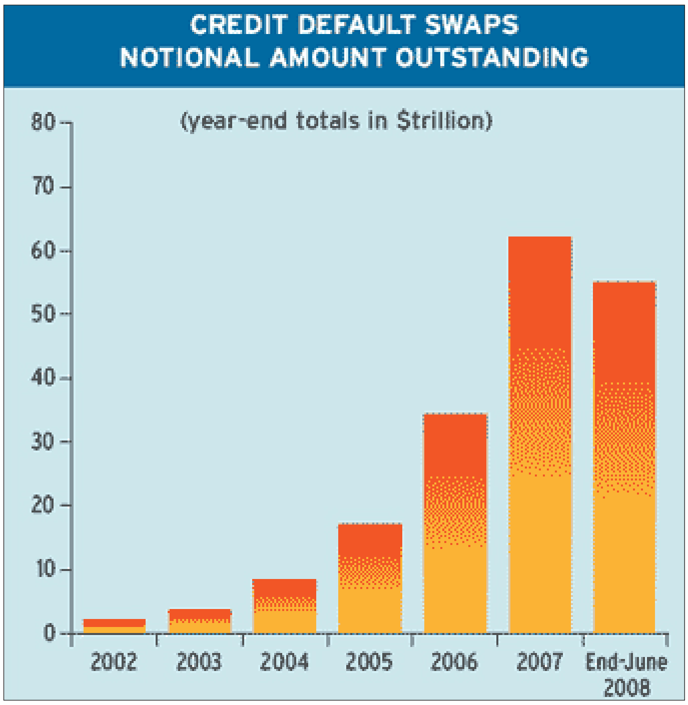
Under the headline "Wild trading day at Deutsche Bank raises questions on risk—Deutsche could sink the system!" Bloomberg reported 21 June on a major first quarter one-day loss at one of the world's largest derivatives traders; "Risks Pile Up Quietly in the US Corporate Bond Market", from Wolf Street on 24 June, revealed that triple-A rated bonds are "dying out", with 60 per cent of US companies given a "junk" credit rating by Moody's, which has implications for bond investments; and "Why a US-Style Housing Bust & Mortgage Crisis Can Happen in Canada, Australia, and Other Bubble Markets", in Wolf Street on 20 June 2018, showed why markets that remained relatively unscathed after the GFC are not immune to a full-blown crisis this time around.

Had the USA reinstated Glass-Steagall legislation instead of passing the woeful substitute known as the *Dodd-Frank Act*, such worries would be a memory of the past. As former City of London banker, Lord Forsyth of Drumlean, succinctly pointed out in the UK Parliament's Glass-Steagall debate in 2013—which came very close to amending the British "ring-fence" by turning it into full-blown Glass-Steagall rules—this new crisis proves that "investment bankers are extremely adept at getting between the wallpaper and the wall".

A report by former Director, Division of Trading and Markets at the US Commodity Futures Trading Commission (CFTC), Michael Greenberger, published by the Institute for New Economic Thinking, reveals that a loophole contained in a footnote in the *Dodd-Frank Act* has allowed America's biggest banks to continue the exact form of gambling which brought on that crisis.

The June 2018 paper is titled, "Too Big to Fail US banks' regulatory alchemy: Converting an obscure agency footnote into an 'at will' nullification of Dodd-Frank's regulation of the multi-trillion dollar financial swaps market". Credit Default Swaps, an especially risky derivative, was one of the main instruments that triggered the 2008 global financial crisis. The *Dodd-Frank Act* was supposed to make the swaps market completely transparent to US regulators, but a guidance issued by the CFTC stating that banks could get around these regulations by placing their swaps with their foreign subsidiaries meant they were not bound by Dodd-Frank.

All that was required to take advantage of the loophole was for banks to "de-guarantee" their foreign affiliates—which was as easy as checking a box on a form. If a foreign affiliate is guaranteed by a US parent it is subject to Dodd-Frank rules even if a trade is executed abroad. So although US banks were "arranging, negotiating, and executing" these swaps in the United States with US bank personnel, they got away with it by formally "assigning" them to their foreign subsidiaries. CFTC has been aware of this for at least three years, Greenberger says.




Credit default swaps (CDS) are derivatives that "insure" against debt defaults. Their use grew massively in the years leading up to the 2008 crash, which turned the bankruptcy of Lehman Brothers into a chain-reaction global financial meltdown. Source: Global Finance Magazine/International Swaps and Derivatives Association

The CFTC proposed a rule to close the loophole in October 2016 but it has not been pursued by regulators or lawmakers. Consequently, if US banks fail due to the poorly regulated derivatives held by their foreign branches, the US government will be obliged to rescue them to prevent contagion, just as it did in 2008.

### It's not too late ... yet

In his paper Greenberger says that those pushing deregulation today, including to further water down Dodd-Frank, are, revealingly, *not* pushing to roll back the swaps regulations in Dodd-Frank. This is because its "extraterritorial loopholes" are adequate for the banks to gamble in derivatives, and the banks are aware that any attempt to seek more latitude might invite a push for what should have been implemented originally—Glass-Steagall: "any legislation advanced to repeal Dodd-Frank swaps regulation for those huge banks might also be the target of a legislative rider to reinstate a 'modern day' Glass-Steagall in a format which would cause these US swaps dealer banks to separate some or all of their commercial banking efforts with federally-insured commercial deposits to separate bank structures, thereby stopping completely or cutting substantially their speculative swaps trading".

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Greenberger explains the threat this represents to big banks with a big money mindset: "Under a new Glass-Steagall-like scenario, US bank holding company swaps dealers almost certainly would not be fully able to engage in swaps trading as they do today. Much of that trading, even under the most lenient pending Glass-Steagall proposals, would mostly be removed from a commercial bank with federally insured deposits, and the bulk of that trading would be left, inter alia, to investment banks and hedge funds ring fenced from commercial banking. ... The failure of these ring-fenced banks self-evidently would also not threaten customer deposits, because they would have so little or even none."

Greenberger reviews the variations of Glass-Steagall and ring-fencing being proposed, noting that "Wall Street certainly would not cheer even a modest 'third-way' compromise" such as the UK ring-fencing option.

As reported by US National Public Radio on 19 June, the International Swaps and Derivatives Association, which represents the derivatives industry, dismissed the issue saying it had already been discussed extensively, and "is designed to rehash old criticisms and ignore the very real progress that has been made in increasing the resilience, transparency and safety of global and US derivatives markets".

On the 85th anniversary of Glass-Steagall, on 16 June, retired US Army intelligence officer Col. Pat Lang's blog, *Sic Semper Tyrannis*, weighed into the matter with an important piece titled, "Happy anniversary Glass-Steagall—we miss you, come back". The article reports the campaign launched by JPMorgan in 1984 to repeal Glass-Steagall. A study prepared by the banks, titled "Rethinking Glass-Steagall", "proposed a war of attrition against the principle of complete bank separation", the article said. "The war was launched in 1987, with the appointment of Alan Greenspan as the new Chairman of the Federal Reserve. Greenspan had been a partner at JPMorgan.... By the mid-1990s, enforcement of Glass-Steagall had eroded."

The piece goes on to point out that "The IMF, the Bank for International Settlements, the Federal Reserve and Bloomberg News are all warning that we are headed for another major financial 'correction' sometime soon. ... Wouldn't it be wise to move to insulate the commercial banking sector from another fiasco before the next crisis? Are the White House and Congress ready to act or are we heading blindly to a replay of 2008?"

# Jim Rickards: Repeal of Glass-Steagall caused the GFC

*An audience member at the 3 November 2017 "Perfect Wealth Transfer Storm" conference in Adelaide, South Australia asked US author, financial lawyer and 35-year Wall Street veteran James G. Rickards for his views on Glass-Steagall. This was his response:*

For those who don't know, Glass-Steagall was a law passed in 1933, so you've got to go back to the 1920s. So what happened in the 1920s? Commercial banking, which is deposits and lending; and investment banking, which is underwriting and sale of securities, were all done in the same institutions—first, National City Bank, then Morgan, and Goldman, and the rest. So the banks said, "Aha! Why don't we create some really garbage securities, and sell them to the customers? Isn't that a good business model?" And that's exactly what they did: They made a lot of bad loans, wrapped them up in securities, and sold them to the customers. So then we had the collapse, the crash of the stock market, and the Great Depression. And Congress had hearings, it was called the Pecora Commission. It reported, and the Congress passed a law that said, "Here's the deal: From now on, you can take deposits and make loans; or you can underwrite and sell securities; but you *cannot do both*. You have to separate commercial banking and investment banking. You cannot do both, because there is an inherent conflict of interest—the temptation always is to create lousy securities and sell them to the customers. So take deposits and make loans, or underwrite and sell securities, but not both". That was Glass-Steagall.

That was the law in the United States for almost 70 years; it was the law until 1999. And then the Congress, in 1999—on a bipartisan basis, led by Phil Gramm, a Republican Senator—and Bill Clinton, a Democratic President, they thought they were smarter than the people in 1933. They thought they knew better. They said, "Oh, well, we've got all this modern financial technology, and 'value at risk', and risk management, and computers. We're not going to make those mistakes, we've got this figured out." And then [Travelers Insurance boss] Sandy Weill, and the lobbyists go ahead and they get Glass-Steagall repealed.

What happened? The banks went out, organised garbage securities, and sold them to the customers! They did the same thing they did in the 1920s! What a surprise! It was just a replay. And ten years later the world collapses, we had another collapse—*completely* predictable. So, you know, the Congress in 1999 were actually idiots; the Congress in 1933 knew what they were doing. You have a law, it solves a problem, it works perfectly for eighty [*sic*] years, and then you think you're smarter than that and you tear it up. And within ten years, right on time, you get the Global Financial Crisis.

So Glass-Steagall was a big part of it. There are a lot of people say it wasn't; sorry, I spent way too long in—I worked at commercial banks, investment banks, hedge funds, and I ran a stock exchange. So there aren't too many people who've seen as many facets of this as I have, and I can tell you: The Global Financial Crisis *was the predictable result of the repeal of Glass-Steagall*. So what's the answer? Bring it back! Separate commercial and investment banking.

*Jim Rickards then expressed pessimism that Glass-Steagall would ever be restored, putting its chances at "near-zero", due to Washington's control by Wall Street. "You're not going to see Glass-Steagall", he said, adding "what you should expect, in the fullness of time, is another catastrophe."*

*However, the CEC does not share his pessimism about getting it passed, for a number of reasons—not least of which is the fact that, as he demonstrated with his brilliant explanation, Glass-Steagall is actually impossible to argue against. It isn't necessary to win an argument, but to inform so many people that the demand for Glass-Steagall becomes overwhelming. On that score, the fact that a random attendee of a conference in Adelaide is able to ask a question about Glass-Steagall shows that the CEC's efforts to educate Australians on this issue are working.*