The great bail-in fail

By Elisa Barwick

If Europe's embrace of "bail-in" was genuinely intended to replace bailouts for troubled too-big-to-fail banks, it is proving a huge failure. New warnings by the former chair of the UK's 2011 Independent Commission on Banking, Sir John Vickers, that regulators have fallen short of what is required to shore up banks for a new financial crisis, come in the wake of several indications that bail-in mechanisms are not working as planned.

The *Economist* admitted on 21 April, under the headline "Coco bonds have not lived up to their promise", that "contingent convertible" or bail-in bonds, which convert into equity when a bank's equity falls below a certain percentage of its assets, have not succeeded in better capitalising banks. Investment in the bonds is a tiny fraction of bank debt issued. Described by the *Economist* as "a way to satisfy both regulators ... and bankers", the notion of recapitalising banks by selling investors bonds that become worthless in a crisis was a blatant attempt to protect the existing system rather than change it, and as such was always doomed to fail.

Bank resolution through bail-in involves writing off or converting bank liabilities to unsecured creditors, including depositor funds above the level guaranteed by governments, to recapitalise collapsing banks. Coco bonds were added to subordinated debt and some senior debt that was earmarked for this purpose. So ineffective is the approach that some European countries have recently created an entirely new tier of bank debt, "senior non-preferred bonds", inserted into the bail-in hierarchy above junior debt but below senior debt, to try to entice new investors. Borrowing features from both bond categories, which only confuses investors, it is a hybrid of a hybrid bond. Where will it end?

The crisis in Italy's banks has led to more exemptions for Italy from Europe's resolution regime, the Bank Recovery and Resolution Directive (BRRD), in addition to others made in recent years. In April the European Commission approved a plan by Italian authorities to liquidate small banks with assets less than €3 billion. According to Wolf Street on 19 April, a collapsing small bank would be swallowed up by a larger bank under normal insolvency procedures. If liabilities exceed assets, a joint bail-in/bail-out would take place first. The plan to allow such "orderly exit of small failing banks" could be used Europe-wide, and fits in with comments of European Central Bank (ECB) representatives about reducing the number of smaller banks to cut competition for bigger lenders. The ECB is also considering bending the BRRD rules to allow financial support to banks undergoing resolution, with a new lending facility called the Eurosystem Resolution Liquidity.

Bailouts using taxpayer funds still need to be accessed in addition to bail-in because deposit guarantee schemes, which back up insured deposits, are critically underfunded. Some European countries have set aside as little as 0.1 per cent of the value of deposits covered by their deposit-guarantee schemes. Under EU rules member states are supposed to hold at least 0.8 per cent.

Spain is especially farcical. As even small companies often have deposits over the guaranteed level of €100,000, the EU's bail-in policy means that as soon as a bank goes wobbly, small to large companies immediately withdraw their money to avoid being bailed in, but of course this can crash the bank in the process. (It proves the absurdity of bail-in as a serious policy, and exposes it for what it actually is: an extreme austerity measure.) The Spanish government is therefore expanding its deposit guarantee to cover unlimited deposits of institutions and small to large companies so they don't withdraw their money. For the same reason of averting pre-emptive withdrawals, the ECB is taking the opposite approach and is pushing a proposal to amend the BRRD to include a "pre-resolution moratorium tool" which would allow deposits in banks that are considered "failing or likely to fail" to be frozen for five days, repeatedly if necessary. Bizarrely, all this is touted as a way of convincing customers the banking system is "safe". Yet in a 15 March lecture at the Florence School of Banking and Finance, ECB board member Sabine Lautenschläger admitted that, in theory, "everything" can be bailed in.

The architect of ring-fencing in the UK, Sir John Vickers, is not so sure it will suffice in a new crisis. Photo: Screenshot

Another complication created by Europe's "solution" is the creation of derivatives clearing houses, which are supposed to safeguard both parties to a derivatives trade by conduiting the trade through an intermediary that can hold both sides' collateral. Such facilities are now broadly acknowledged to have themselves become dangerous, too-big-to-fail institutions, in which the extreme risks of derivatives have become concentrated.

Ring-fencing

Vickers, who has also worked as Chief Economist for the Bank of England, drew up the rules for ring-fencing—a watered down version of Glass-Steagall banking separation legislated in 2013 that allows the ostensibly separated banking divisions to remain under the same roof—after chairing Britain's banking commission, but in the last couple of years he has repeatedly stated that nothing fundamental has changed. Speaking at a *Financial Times*/Fitch global banking conference in London on 2 May, Vickers warned that British banks are still undercapitalised and vulnerable to the impact of a new financial crisis. He said that leverage in the British banking system was "dangerously high" as regulators "fell short" of what was required to crisis-proof the system. Vickers commented on the bail-in regime: "The amount of bail-inable debt is a substantial add-on, but I don't think we can rely on it in a crisis and if we had another systemic crisis anything like the last one, goodness knows what would happen."

Vickers' remarks betray the fact that any measure short of full Glass-Steagall regulations will not suffice. British banks are in the process of enacting the ring-fence he recommended at the conclusion of his inquiry, which must be in place by the start of 2019. Barclays bank actually completed the shift over the Easter weekend, yet it is in a world of trouble. In the last couple of years various indicators put Barclays at the bottom rung of performance among European banks, surpassed only in some areas by the crisis-riddled Deutsche Bank. Barclays is currently the first British bank facing criminal trial for its conduct during the global financial crisis.

Ring-fencing is in fact exactly what existed prior to the implementation of Glass-Steagall regulations in America in 1933. It allowed National City Bank to create a securities "affiliate", kept at arms length, National City Company, to get around laws that prohibited banks from trading their own shares or securities. In this way trusted deposit-taking banks flogged off troubled or collapsing investments and shorted stocks sold to their customers, creating the basis for the 1929 financial crisis. Such "separation" is a mere legal fiction. ("The historical proof ring-fencing will not work", *AAS* 17 May 2017.)

US Senator Carter Glass charged in a May 1932 speech on the Senate floor that affiliates had been one of the biggest causes of the Great Depression, and urged they be separated from retail banks. In the aftermath of the Pecora hearings, the Senate Committee inquiry which exposed the banks' criminal activity; and with Franklin Roosevelt coming into office with an agenda to reform the financial system, the banking regulation bill of which Glass and Representative Harry Steagall were co-sponsors became law.

Even at the time Vickers' ring fence was legislated in 2013, it was recognised as inadequate. Andrew Tyrie, chairman of the UK House of Commons Treasury Committee, recommended "electrification" of the ring-fence—essentially, touch it once and you die, i.e. any bank that breaches it once would be subject to a complete Glass-Steagall separation. Any way you cut it the only effective solution always converges on Glass-Steagall. British economist John Kay wrote in his 2015 book *Other People's Money* that an effective ring-fence would actually result in a full separation, because the *only* benefit banking conglomerates derive from holding deposits is being able to use them to collateralise their gambling. He predicts that if applied effectively, ring-fencing would see banks sell off their retail divisions, because managing them would become a net cost.

Pundits in Australia who claim full Glass-Steagall is not necessary, and split hairs between "vertical" and so-called "horizontal" integration to claim that only vertical integration should end, are making the same mistake as those in the UK. While most big Australian banks are already voluntarily divesting themselves of different divisions, they don't want to be forced, which means they want the option to keep whatever integration is profitable and to go back into some other businesses in the future. This cannot be allowed—it all has to go. The 29 April *Sydney Morning Herald* cited Vickers' 2011 report saying ring-fencing was a better solution than structural separation—they might need to check back with him for an update.

To protect depositors from the oncoming new financial crisis banks must return to boring banking—taking deposits and commercial lending. The other activity can continue, but without any material connection to retail banking or government support. See the CEC's Glass-Steagall legislation for the fine details (Banking System Reform [Separation of Banks] Bill 2018).

Prins presents 'Collusion' book in DC

By Nancy Spannaus

3 May—A crowd filled up all the available seats at the Politics and Prose bookstore in Washington, DC last night, eager to hear Wall Street whistleblower and renowned author Nomi Prins discuss her latest book. The author, once a Wall Street insider at Goldman Sachs, Bear Stearns, and Lehman Brothers, did not disappoint.

In her new book, entitled *Collusion: How Central Bankers Rigged the World*, Prins documents her personal investigation of how the bailout of the world's major bankers by the Federal Reserve, European Central Bank (ECB), and Bank of Japan (BoJ) after the 2008 crash, not only ensured that the super-banks would be the winners, but also have set the world up for a new financial fall, this one from an even greater height of speculative bubble than the last.

With humour, down-to-earth analogies, and many personal anecdotes about her own interactions with leading players in the financial game, Prins explained the phenomenon of Quantitative Easing (QE). QE is the way in which the world's central banks have fed trillions into the world's super-banks, thus creating a new bubble. The result has been the creation of US$15 trillion in QE among the Fed, ECB, and BoJ alone.

None of this money has gone to "Main Street", she said. This situation is "not going to turn out well", no matter how careful the central banks are in trying to deflate the bubble gradually with incrementally higher interest rates.

Nomi Prins presents her book *Collusion* on 2 May in Washington, DC.

The banking system remains unhealthy, she said, and when a crisis of confidence hits, this time it won't be mortgages, but corporate bonds which explode, since corporate debt has replaced mortgages as the risky securities to be bundled and passed on at higher and higher prices.

Prins briefly touched on what she would recommend as remedies to the current situation, which she said has scared the central bankers. First, some of the US$4.5 trillion created by the Fed for QE could be collateralised for the purpose of investment in the real economy—meeting the USA's infrastructure needs, for example. Second, some of the debt could simply be cancelled or restructured. And third, regulations separating speculation from investment in the real economy could be re-enacted, specifically Glass-Steagall protections.

The event concluded with a lively question and answer session, and book-signing.

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Australia's bank inquiry sends shockwaves through global financial system

Australia's banking royal commission could be the shot heard round the world in the global battle for nations to take back control of their financial systems from predatory speculators. There are signs the inquiry is starting to cause concern among the elite bankers of the City of London and Wall Street. Since the 2008 crash the banking cartel has been able to maintain its corrupt political influence and block any meaningful government action to reform the financial system, especially the push to restore the Glass-Steagall separation of traditional banking from speculation. With Australia's banks, which were previously held up as exemplars of sound management and regulation, now being exposed as criminal enterprises, there is obvious fear in London and Wall Street that it might inspire similar scrutiny and a similar political backlash that would fuel renewed calls for Glass-Steagall to end their too-big-to-fail extortion of the economy and political system.

On 2 May Rupert Murdoch's London *Times* expressed this fear in "UK lenders should scent danger from Australian banking's dirty secrets". Murdoch has spent four decades as a propagandist for the neoliberal policies of deregulation and privatisation that transformed the banks into criminal financial predators. Judging by his media reports, he and the financial oligarchs he speaks for are now nervous the jig could be up.

Times reporter Katherine Griffiths wrote of the shocking findings of the royal commission so far: "The affair has sent shockwaves as far as Britain, where Australia has been hailed for coming through the financial crisis relatively unscathed and where its bankers and regulators were seen as holding the secret to doing business profitably but sensibly." She noted, however, that with the end of the mining boom, which had papered over Australia's financial problems during the 2008 global financial crisis, "Its banks are having a tougher time *and they have lost some of the dominant hold they used to have over politicians*, opening the door to the Royal Commission." (Emphasis added.)

Griffiths then claimed, falsely, that the UK has already had investigations of the banks which led to reforms, presumably meaning the 2011 Vickers inquiry, which recommended not Glass-Steagall, as many MPs supported, but so-called ring-fencing of retail banking operations with deposits from other financial services that are allowed to remain within the same bank. Having dodged the Glass-Steagall bullet in 2013, London is nervous that Australia's royal commission is fuelling a renewed push to break up the banks, which might spread globally. Griffiths wrote, "In Australia, it is possible that the commission will take things one step further, by demanding a break-up of the country's big banks in an attempt to enforce better behaviour and improve competition. *That would be something for the UK's large lenders to worry about, because even though the reputation of Australia's financial system has been tarnished, it is a precedent that could capture the imagination of banking critics the world over*." (Emphasis added.)

The City of London-Wall Street financial elite are panicked that Australia's banking royal commission might lead to the break up of banks worldwide.

Rather than wait for the royal commission, the Citizens Electoral Council is expediting the break-up of the banks, with the Australian Glass-Steagall bill that Bob Katter is moving to introduce into Parliament. Doubtless this is being observed in London, with great consternation.

Other nations are also monitoring the Australian inquiry. The 29 April *Washington Post* reported that the shocking revelations from the royal commission include "deception, practices driven by greed and possible fraud", but noted nervously that even this is "not on the scale of banking scandals experienced in the United States over the past decade". Meanwhile in New Zealand, where the major banks are all owned by Australia's big banks, the union for finance sector employees has called for a similar royal commission into banking.

Keep this international dimension in mind as we fight for the Glass-Steagall bill. The opposition won't just come from Australia's banks, but the entire international financial system. Achieving Glass-Steagall here can light the flame internationally.

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