FED OFFICIALS WARN:

'Bernankecare' Heads for Bust

by Paul Gallagher and Stuart Rosenblatt

Dec. 2—The trans-Atlantic financial system, whose 20 huge bank holding companies have swallowed $3.5 trillion in Federal Reserve money-printing and a trillion more by other central banks since 2009, is heading for a new blowout of the speculative debt bubbles, which those giant banks have reinflated by speculating with this continuous bailout.

While $2.5 trillion of the Fed-printed liquidity has become "excess reserves" of big banks—reserves growing at a faster rate in 2013 than even post-crash 2009—and their deposits are more than $2 trillion greater than in 2008, their lending into the economy is distinctly lower, by nearly $1 trillion. No longer primarily deposit-and-lending banks at all, they are each conducting securities and derivatives speculation through thousands of units. JPMorgan Chase's London Chief Involvement Office alone had invested $450 billion of the bank's deposit base in credit derivatives through "shadow" subsidiaries, before the "London Whale" trades went bad in 2012.

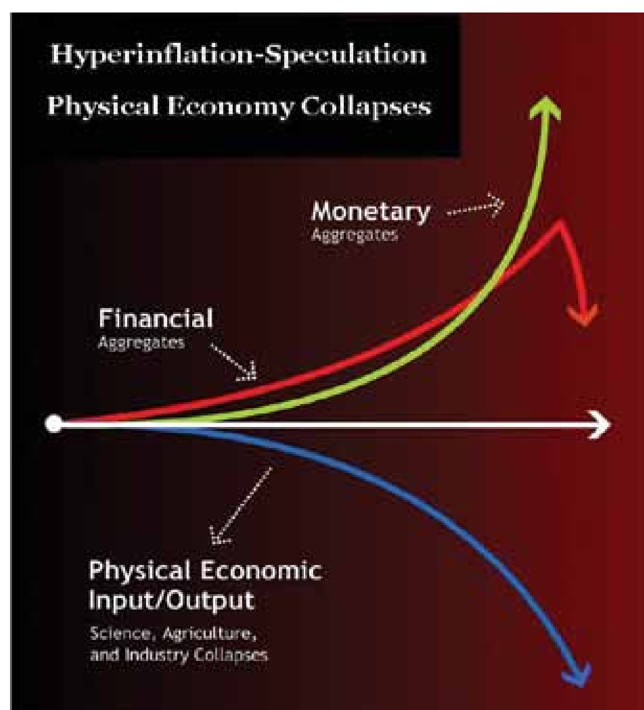
Hence the urgency of both enacting Glass-Steagall in the United States and Europe—compelling this immense speculation by commercial banking institutions to stop—and hastening the departure of President Obama and company from power in the United States.

At several conferences held in Washington, D.C., in November, Federal Reserve officials, and current and former IMF and Treasury Department officials, warned, in typically complex "bank-speak," that the result of endless central bank quantitative easing (QE) is the emergence of interconnected financial bubbles all over the economy. As Lyndon LaRouche warned over the past several years, QE has been generating hyperinflation, and this is how it is appearing. The totally foreseeable result of the $3.5 trillion poured by the Federal Reserve into the Too Big To Fail (TBTF) banks and their various subsidiaries, coupled with five years of 0% interest rates, has brought the trans-Atlantic financial system to the tipping point.

As per LaRouche's "Triple Curve Function" (**Figure 1**), these financial bubbles are "unsupported" by the rapidly vanishing real physical economy. The collapse of the real economy has been regularly reported by this publication, and can be identified by the rapid rise of real unemployment, youth unemployment, pockets of starvation, increase of death rates, and declines in life-expectancy and/or population, shutdowns of hospitals and other medical facilities in the name of Obamacare, bankruptcy of cities such as Detroit, collapse of the productive output of Michigan, Pennsylvania, Ohio, and other rust-belt states, etc. The trans-Atlantic system is not in recovery; but as LaRouche has emphasized, it is in a breakdown crisis. The issue of a new financial collapse is only a matter of how soon, not whether.

The only reason for this cancerous metastasizing of

FIGURE 1
LaRouche's 'Typical Collapse Function'



EIRNS

financial bubbles is the failure to enact Glass-Steagall legislation in 2010, and the resulting bailouts of a financial system that was hopelessly bankrupt from 2008 onward. There is no Brand X substitute for enacting Glass-Steagall now.

Bubbles Proliferate

On the financial side, bubbles abound. The most obvious, as a result of the Fed's non-stop emission of currency, is the hyperbolic rise in the **equities markets**. The Dow Jones and Nasdaq averages are achieving new high marks daily. When Fed Chairman Ben Bernanke even hints at "tapering," these markets immediately rattle and come apart. No sane analyst dares call these anything but enormous, malignant bubbles that can burst on a moment's notice; as witness Nobel economist Robert Shiller's Dec. 1 *Der Spiegel* interview: "I am most worried about the boom in the U.S. stock market. Also because our economy is still weak and vulnerable,"

Another marker is the $1.2 trillion **student-loan bubble**, of which 30% is delinquent or in default. On Nov. 18, Anit Chopra of the Consumer Financial Protection Board (CFPB), warned that the student-loan market is in danger of a meltdown. In an interview with the *American Banker*, Chopra characterized the market as "full of deficiencies" and similar to the housing bubble before its demise. Forty million Americans share this $1.2 trillion debt burden, an average of $30,000 each. A large percentage of the holders of the debt are unemployed members of the workforce who went back to school, and their ability to repay this debt has fallen over the years. According to the Census, real wages for young college graduates have fallen 5.4% over the past six years.

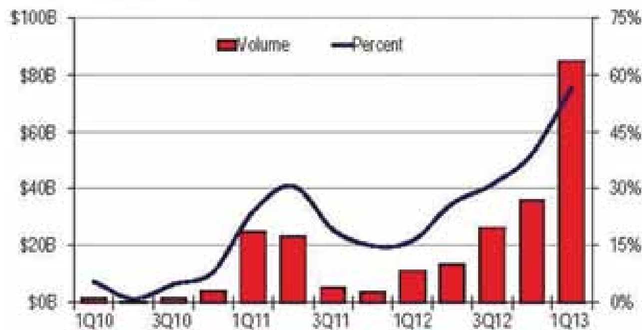
Equally ominous has been the rapid rise in **leveraged loans** of all types. These financial products are similar to the junk bonds that abounded in the 1980s (remember Michael Milken!). They mimic the worst aspects of the subprime lending fiascos of the last decade, which precipitated the mortgage-backed security (MBS) debacle. As a recent New York Times Dealbook article said, these are below-investment-grade debt that go to companies already awash in debts, and are considered in the investing community to be highly speculative.

Leveraged lending fell off after the 2008 meltdown, but has returned with a vengeance recently. This year alone, over $585 billion of such debt has been created, which surpasses the $535 billion in 2007, on the eve of the crash. These loans are used to bankroll purchases of other companies, to refinance debt, or to engage in other private equity deals. The financing is "covenant-lite" (cov-lite), meaning there is no real repayment schedule—just a high interest rate, and few protections for members of the investing public to alert them to approaching catastrophe. The company involved does not need to keep its debt below a certain level, or even to report its financial results in a timely fashion, according to the *Times*. Covenant-lite loans are secured by the company's assets, and give lenders priority over bondholders and stockholders if the company goes belly-up, not unlike the "superiority" status of derivatives holders in the case of a bankrupted bank.

In an exemplary leveraged loan, one media company, Learfield Communications of Jefferson City, Mo., borrowed eight times its annual earnings (!) at an interest rate of 8.75%. In September, Dell Co. garnered a $9.1 billion cov-lite loan to help finance a $25 billion buyout by its founder, Michael Dell.

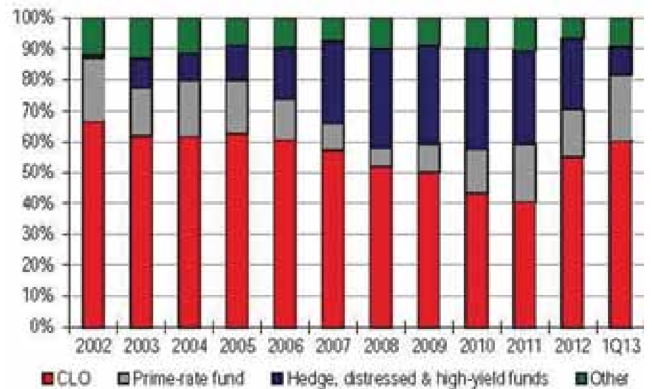
In March, the FDIC, Federal Reserve, and the Office of the Comptroller of the Currency issued a statement saying that "prudent lending practices have deterio-

FIGURE 2
Covenant-Lite Volume



Source: S&P Capital IQ LCD

FIGURE 3
Share of New-Isuse Institutional Loan Allocations by Investor Type



Source: S&P Capital IQ LCD

rated" and urged lenders to tighten their standards. They cited cov-lite loans in particular. Sixty percent of the cov-lite loans are coming from the highly unregulated "shadow banking sector" of private equity firms and investment funds. According to a recent speech by Adam Ashcraft, Senior Vice-President and Head of Credit Risk Management at the New York Federal Reserve, the covenant-lite loans are now $80 billion and have risen exponentially in the past 18 months. (**Figures 2 and 3**.

Last week, the *Wall Street Journal* reported that these "leveraged business loans" have been bundled and securitized into collateralized debt obligations (CDOs) and synthetic collateralized loan obligation (CLO) derivatives—the same vehicles that popped in 2008.

Along this same line, the **junk bond bubble** has tripled in the past 18 months to $180 billion. Bonds rated CCC or lower—that is, eight steps below investment grade—have gained 11% this year, and debt rated BB, two grades below investment, are trading above their normal price. According to James Serhant, head of high-yield investments at Hartford Investment Management Co. in Connecticut, the $516 billion of notes in the top tier of junk are trading at an average price of more than 104 cents on the dollar. Normally they sell in the mid-80s.

Simultaneously, the subprime market for **auto loans** has skyrocketed. These are loans made to purchasers with the shakiest credit scores, 650 and lower, and bundled into bonds to be sold to the most unscrupulous speculators. Approximately half of the $300 billion in subprime auto loans has been securitized by the banks.

'Bernankecare' in Action

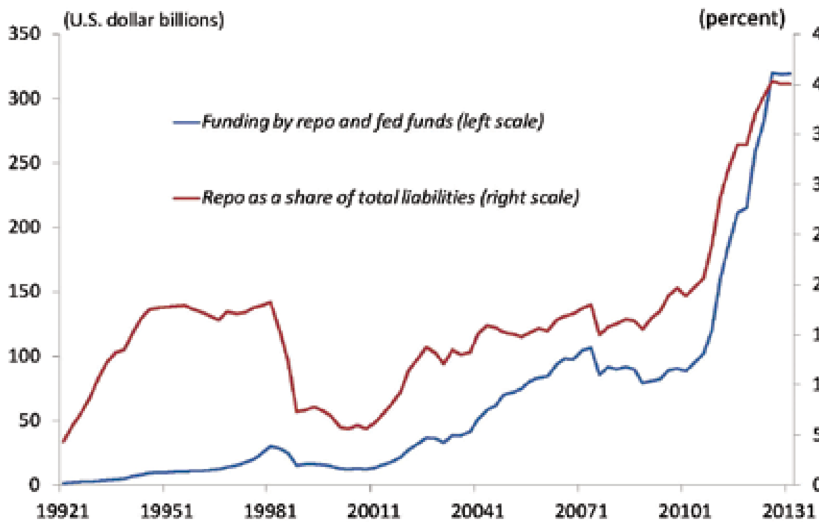
Commenting in bewilderment on the effects of now five years of 0% lending and nearly $4 trillion in asset purchases by the Fed, Joshua Brown, CEO of Ritholtz Wealth Management in New York, said, "It adds up to Bernankecare, and it's causing parts of the market to behave strangely. Stocks of companies with weak balance sheets are rising twice as fast as stronger ones; junk borrowers get rates lower than their investment-grade counterparts did before the credit crisis; and initial public offerings are doubling on their first day of trading."

Equally ominous are the growth of the Agency Real Estate Investment Trust bubble and the reinsurance bubble. **Agency Real Investment Trusts** are investment vehicles that primarily invest in mortgage-related assets. Agency REITs invest in mortgage backed securities issued by U.S. government-sponsored agencies (GSE), especially Fannie Mae and Freddie Mac. Agency REITs are publicly traded, but virtually unregulated, and have engaged in higher leverage than other REITs. The sector holds over $350 billion of agency MBSs, 7% of the total agency MBS market.

This bubble has quadrupled in less than two years, to nearly $400 billion in debt, and according to IMF official Dr. Laura Kodres, the role of unregulated "shadow banking" funding of the agency mortgage REITs has increased from 12% to 45% in the same period.

The returns have been worth it to them. According to a recent Fed study, *Shadow Bank Monitoring*, the

FIGURE 4
Real Estate Investment Trust (REIT) Dependence on Short-Term Funding



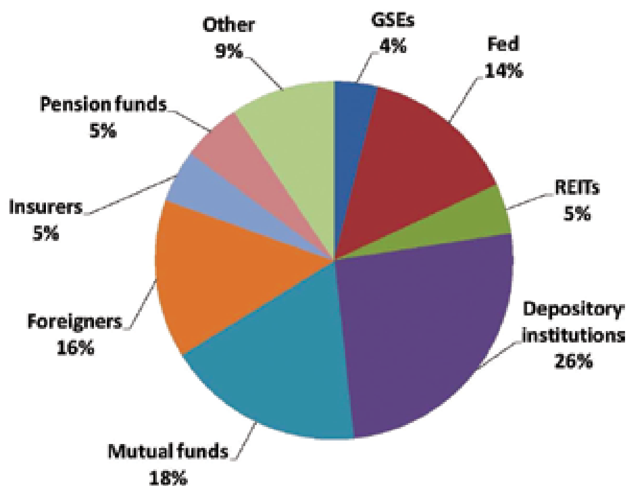
Source: Federal Reserve; and IMF staff estimates.

high degree of leverage of agency REITs allows them to generate dividend yields that are among the highest for all traded stocks. The largest agency REITs have achieved dividend yields around 20% in recent years, despite general long-term interest rates that are only around 2%. They also get special tax treatment; earnings are not taxed at the corporate level, except in special circumstances. The report does admit though, that in a rising rate environment, there could be a massive sell-off of agency REITs. The REITs might fire-sale their MBS portfolio; their liquidity might become "impaired"; and this might spill over into other related institutions. But for now, enjoy the ride (**Figures 4, 5, and 6**).

Another bubble near the bursting point is the **reinsurance bubble**. The same report, of which Adam Ashcraft was a co-author, warned of the buildup of speculative paper in this area. Reinsurance is the sale of risk from an insurance company to a reinsurance company. The report delineates all the attending risk and puts up a red flag demanding resolution. Reinsurance has grown from $250 billion in 2006 to over $550 billion currently (**Figure 7**).

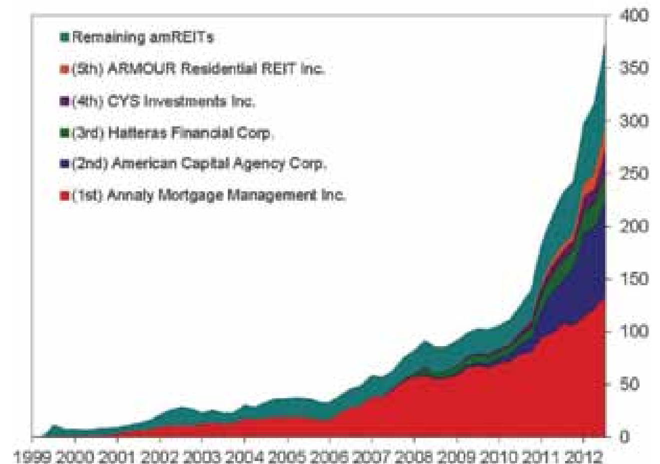
Add in the nearly $250 trillion of derivatives on the books of just the FDIC-insured TBTF banks, the example of the London Whale debacle of last year, and

FIGURE 5
Holdings of Agency Mortgage-Backed Securities



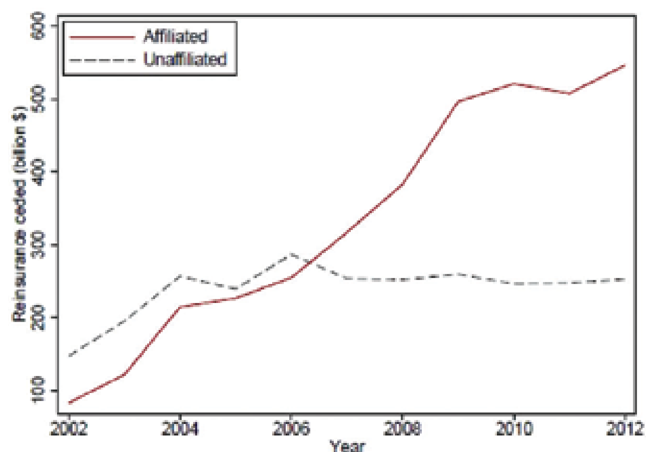
Source: Federal Reserve; and IMF staff estimates.

FIGURE 6
Agency Mortgage REITs
$ Billions



Adam Ashcraft, "The Dark Side of Shadow Credit Intermediation," Federal Reserve Bank of New York, Nov. 23, 2013.

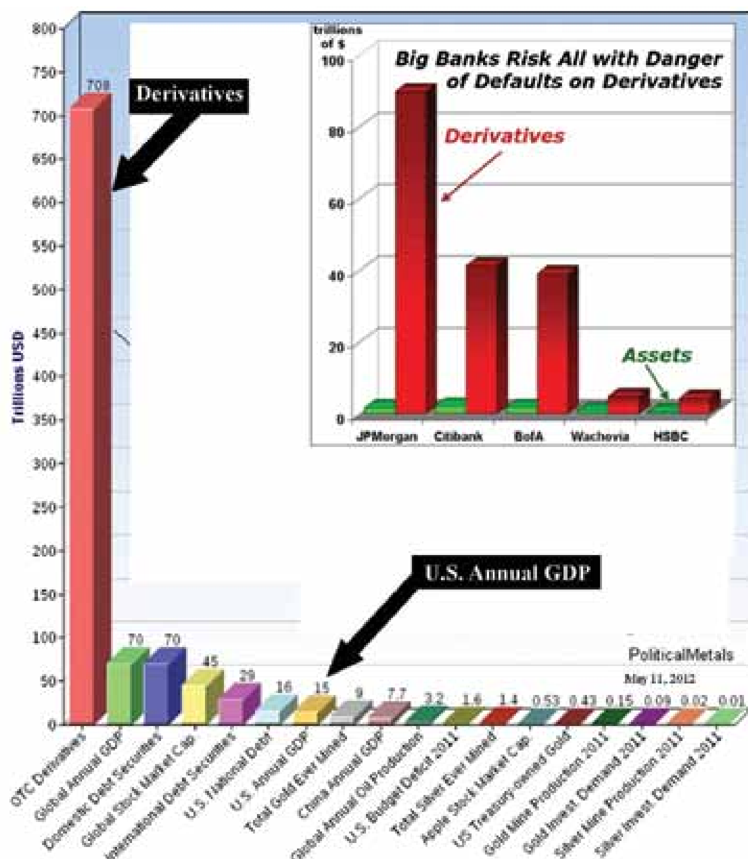
FIGURE 7
Reinsurance



Adam Ashcraft, "The Dark Side of Shadow Credit Intermediation," Federal Reserve Bank of New York, Nov. 23, 2013.

Figure 7 reports life and annuity reinsurance ceded by U.S. life insurers to affiliated and unaffiliated reinsurers. Reinsurance ceded is the sum of reserve credit taken and modified coinsurance reserve ceded.

FIGURE 8
Derivatives



Source: Bank of International Settlements—The Future Tense, June 15, 2012.

the over $700 trillion of over-the-counter derivatives in the trans-Atlantic economy, and you have nearly a full picture of looming financial blowout, which will rival the impact of a gigantic asteroid on the planet (**Figure 8**).

Shadow Banking: Myth and Reality

One causal feature of this crisis has been the meteoric rise of the "shadow banking" system. Much has been written and uttered about this concatenation of hedge funds, money-market funds, repurchase operations, and sundry other "non-bank" sources of seemingly limitless credit being fed into the financial side of the economy.

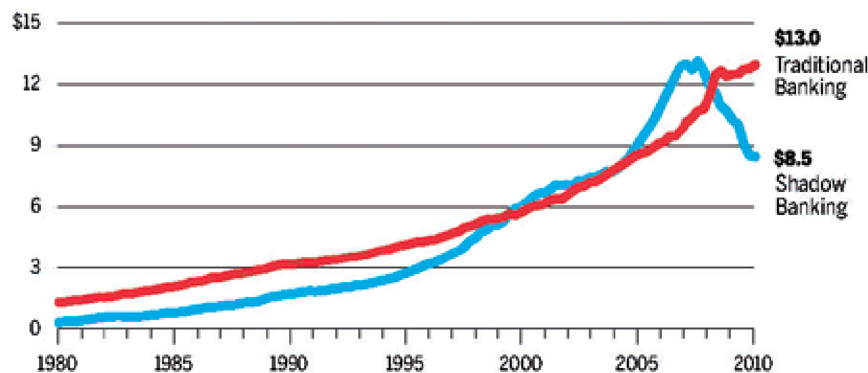
There is a conglomerate of "shadow bank" institutions that have been central to pumping up this enormous bubble. It is nothing more than an organized crime gambling syndicate. Shadow banking is a set of vehicles whose purpose is to create new "house money" for the insane gamblers on Wall Street. These entities are creatures of, and to a large extent controlled by, the same oligarchical regime of TBTF banks (including JPMorgan Chase, Wells Fargo, Citibank, Morgan Stanley, Goldman Sachs, and Bank of America) that have dominated and repeatedly destroyed the U.S. economy since no later than the murder of John F. Kennedy.

The elaboration of the shadow banking network and the risks it poses to the system, were spelled out at the Roosevelt Institute conference on Nov. 12 in the Senate Russell Office Building. Speakers included Marcus Stanley, the Policy Director of the Americans for Financial Reform; Saule Omarova, a law professor and former special advisor to the Treasury Department; Wallace Turbeville, an adjunct law professor at the University of Maryland and senior fellow at Demos; and many others. This was followed by the Nov. 22 conference at the Economic Policy Institute (EPI), which focused on "monitoring" shadow banking, and featured Ashcraft; Nicola Cetorelli, assistant vice-president of the Research Department of the New York Fed; Dr. Laura Kodres, assistant director of the Monetary and Capital Markets Department of the IMF; Simon Johnson, former chief economist of the IMF; Daniel Tarullo, a

FIGURE 9

Traditional and Shadow Banking Systems

($ Trillions)



Financial Crisis Inquiry Commission Report, 2010

The funding available through the shadow banking system grew sharply in the 200s, exceeding the traditional banking system in the years before the crisis. Note: Shadow banking funding includes commercial paper and other short-term borrowing (bankers acceptances), repo, net securities loaned, liabilities of asset-backed securities issuers, and money-market mutual fund assets.

member of the Board of Governors of the Fed; and many others.

Shadow banking has become a preferred operation of Wall Street to sidestep Glass-Steagall and gamble with other people's money. This witches' brew of investment banks, broker-dealers, mortgage originators, and others was documented in the explosive report by the Financial Crisis Inquiry Commission (FCIC) in 2010. This report was the result of extensive hearings by the FCIC, which was created by the Congress. (See **Figure 9**.)

Shadow banking has grown to equal the size of the regular commercial banking system over the past decade, with nearly $70 trillion in assets. It had previously been limited to investment banking, and kept largely in check under Glass-Steagall. It began to expand in the 1970s, with the watering down of the Glass-Steagall legislation. In 1971, the Federal Reserve promulgated Regulation Q, and put a ceiling on interest rates that banks and thrifts could offer to depositors. Seizing an opening, the investment banks created money-market funds, and other mutual funds arose independently to take deposits and offer a higher rate of return than the banks. From there, shadow banking took off.

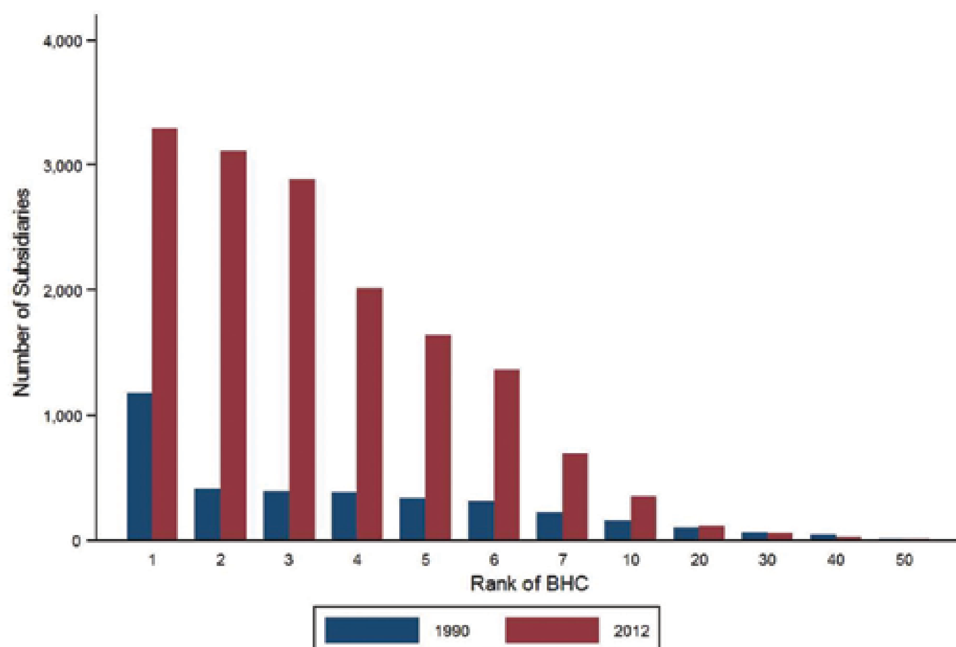
In regular commercial banking, the bank is the intermediary between the depositor and the recipient of bank loans. Shadow banking unleashed a grouping of new intermediaries to grease the skids of finance, increasingly outside the bounds of the regulated Glass-Steagall system. These included: the expanded role of investment banks (Morgan Stanley, Goldman Sachs; as well as Merrill Lynch, Lehman Brothers, and Bear Sterns, all of which went bankrupt in 2008). The first three were saved by then-Treasury Secretary Henry Paulson and given bank holding company (BHC) status to continue their derivatives and related gambling operations. The investment banks sponsored many of the money-market mutual funds, which competed with the regular banks for "deposits," and moved their depositors' money into an assortment of "investments," such as the schemes listed in the previous section.

Other components of shadow banking included the proliferation of repurchase agreements (repos, tri-party repos, etc.), which trade securities for the cash of money-market funds (for example), and then pour that cash into speculation; and commercial paper issued by companies and banks to fuel their own speculation. Commercial paper was a favorite purchase of money-market mutual funds.

With the erosion of Glass-Steagall in the 1990s and its repeal in 1999 came a host of new vultures to cash in on the bonanza: independent mortgage brokers initiate mortgages; finance companies finance them, then sell them to a "warehouse" company; from warehouses, the mortgages and mortgage-backed securities are placed onto the financial markets; broker-dealer subsidiaries of major banks create special purpose vehicles to market the loans, which are given guarantees by the underwriting banks, *ad infinitum*. The two biggest sources of funds for shadow banking are money-market funds, which total over $3 trillion, and real estate investment trusts, which are over $1.5 trillion—but all sorts of instruments have been created to further this ludicrous process. Credit intermediation and other operations are done outside the "regular" banking system, at least on the surface.

However, even in the 1990s shadow-banking opera-

FIGURE 10
Top U.S. Bank Holding Companies, Number of Subsidiaries, 1990 vs. 2012



Tobias Adrian, Adam B. Ashcraft, Nicola Cetorelli, "Shadow Bank Monitoring," Federal Reserve Bank of New York Staff Report No. 638, September 2013

tions, the big commercial banks were front and center. They sponsored the thousands of hedge funds and other entities whose sole purpose was to circumvent Glass-Steagall prohibitions against securities speculation and other practices. The poster child for this operation was the 1993 creation of Long Term Capital Management (LTCM) by Merrill Lynch. Prior to its near demise in 1998, the company had lines of credit from over 50 FDIC-insured banks, investment banks, and foreign banks, which had given it 100:1 leverage! Had Glass-Steagall been enforced at that time, this never would have occurred.

At its height, LTCM had $4.5 billion in capital, $125 billion in lines of credit from the banks, and issued over $1 trillion in derivatives. It came within an inch of bankrupting the entire world economy in 1998, when its resident "geniuses" bet wrong on Russian bonds. Russia defaulted on its bonds, an event never predicted in the mathematical models of LTCM, and that "ingenious" bet had been mimicked by other hedge funds. The world economy was nearly destroyed by shadow banking, done with loans from the biggest commercial banks.

LTCM Redux: TBTF Banks Control Shadow Banking

The major paper presented at the Nov. 22 conference sponsored by Americans for Financial Reform and held at the Economic Policy Institute, was the *Shadow Bank Monitoring* document written by Ashcraft, Nicola Cetorelli, and Tobias Adrian of the New York Fed. On pages 9-10 is a description of the role of the regulated banks in this operation. They cite a report in 2012 by Vitaly M. Bord and João A.C. Santos of the New York Fed, where the "authors document that more than 75 percent of syndicated credit lines are bought by syndicate participant [commercial] banks."

Ashcraft et al. show that "as of 2011, bank holding companies controlled about 38% of the assets of the largest insurance companies, 41% of total money-market mutual fund assets, and 93% of the assets of the largest brokers and dealers. Moreover, very little securities lending and related cash collateral reinvestments take place without . . . the main custodian banks." This measures how "shadow banking" reached behemoth proportions after the takedown of Glass-Steagall.

The authors admit that bank holding companies (BHCs) (e.g., JPMorgan Chase, Citibank) are changing with the advent of shadow credit intermediations. A chart details the massive growth of shadow-banking subsidiaries of the TBTF banks; they admit that each of the five biggest BHCs in the United States had over 1,500 subsidiaries in 2012, with JPMorgan Chase owning over 3,500 units around the world, all dealing in derivatives, structured vehicles, funds, which are identical to the entities that comprise the shadow banking apparatus. (See **Figure 10**.)

The report further details "the extent to which banks have been buying non-bank targets, such as asset man-

agers, insurance underwriters, insurance brokers, and the extent to which these entities engaged in similar organizational changes.

"The largest non-bank BHC subsidiaries consist of finance companies, broker-dealers, wealth management units, including mutual, hedge, money-market mutual funds. While the two decades in the run-up to the financial crisis saw the emergence of a shadow banking system that was partially independent from BHCs, the financial crisis led, perhaps paradoxically [!], to a migration of independent shadow banking activity into BHCs."

As in the case of LTCM, it is the Too Big To Fail Banks that control the entire process of financial speculation, dreaming up new schemes with which to gamble with the public's deposits. Their insanity has brought us to the brink of yet another catastrophe. Larry Summers, who as Treasury Secretary in 1998, was a slayer of Glass-Steagall, and *New York Times* columnist Paul Krugman, have been peddling the line that we will be in an endless economic depression, which will limp along, killing people as it goes. They are wrong. This system is doomed and will soon disintegrate, on both sides of the Atlantic.

Return to the Glass-Steagall Principle

These recent conferences charted out the dead end toward which the authors were manipulating policymakers. Rather than demand a return to the original Glass-Steagall legislation, they argued for a more aggressive implementation of the Dodd-Frank regulations, which are mired in endless battles with the army of Wall Street lobbyists. Many, including former FDIC chair Sheila Bair, who addressed the Economic Policy Institute conference, argued for a strong Volcker Rule. The background discussions the authors held with participants, including high-level Congressional banking staffers, featured the constant refrain: Strengthen the Volcker Rule, implement it, and let us see how it works.

The Volcker Rule, a section of Dodd-Frank meant to sucker Glass-Steagall supporters in Congress, aims to curb only proprietary trading by federally insured banks. It has already been watered down by former Treasury Secretary Tim Geithner to exclude foreign exchange swap derivatives, a $4 trillion daily market, whose collapse in 2008 was a major event in the meltdown. It has been further eroded by conflicting definitions of what constitutes "hedging" by the insured bank. JPMorgan Chase CEO Jamie Dimon, who should be locked up in a Federal penitentiary, made clear its worthlessness when he said that "portfolio hedging" is permitted under the Volcker Rule and hence would allow the London Whale derivatives trading that cost JPMorgan over $6 billion in losses, and more in fines.

Dodd-Frank is a joke; 60% of the regulations remain unwritten, three years after its passage; even a strong Volcker Rule is like putting a bandaid on Stage V cancer. The hopelessly bankrupt financial system itself must be replaced, not "regulated."

The most adamant spokesman for "more regulations" was Federal Reserve Governor Dan Tarullo, the darling of the so-called reformers inside the financial establishment. His speech at the Economic Policy Institute (EPI) conference was a detailed rundown of the evolution of the shadow banking apparatus. In elaborating the problem, he convincingly proved how current regulations are woefully inadequate to deal with the current and potential crises. At every turn, he proposed yet more regulations, including the now-discredited use of increased capital and liquidity requirements for each and every category of new financial chicanery.

His conclusions were delusional. First, he praised the Dodd-Frank Act for addressing "Non-bank Systemically Important Financial Institutions" (i.e., shadow banks), with more regulations. Second, he praised the SEC for addressing new regulations of money-market mutual funds. Finally, he warned that new cash-rich entities are a source of funding for shadow banks, and remain "outside the perimeter"; hence we need yet more regulations!

The actual solution to the crisis did appear, like the Chorus in Greek tragedy and Shakespeare, at each conference, and in the Congress. The solution, which worked for 66 years, is the return to Franklin Roosevelt's Glass-Steagall principle: bankrupting Wall Street and its attendant "shadow banks," followed by a program for real Roosevelt-style credit to expand the physical economy, infrastructure, and sponsor high-technology-driver projects. At the EPI conference, LaRouchePAC and *EIR* participants Alicia Cerretani and Stuart Rosenblatt intervened to pose the Glass-Steagall legislation now gaining support before Congress, and demanded that participants address this alternative.

Federal Reserve representative Cetorelli tried to respond. While initially conceding that it was "important," he proceeded to "question" the utility of Glass-Steagall. But privately, one prominent banking panelist agreed with Glass-Steagall: "The Volcker Rule is a joke; it will never address the problem. I agree with you, only structural reform has a chance."

At the Roosevelt Institute conference, *EIR*'s Paul Gallagher challenged one panel on the need for Glass-Steagall. After exposing the role of Wall Street in creating LTCM as the model for its sponsorship of shadow banking, he posed the Glass-Steagall alternative. Only one panelist answered directly: "You asked, do we support the restoration of Glass-Steagall? My answer is 'Yes.'" With that, reality began to creep into the meeting.

After another panel, Rosenblatt posed the same question, prefacing his challenge with a rundown of the pending congressional legislation in both houses of Congress, the growing institutional support in state legislatures and other institutions outside the Congress, and the role of Sen. Elizabeth Warren (D-Mass.), in championing the issue with her legislation. Even though they had invited her to be their keynote speaker, they assiduously avoided her initiative! One panelist again took up the issue, and said that in fact Glass-Steagall worked, was a good idea, and in general she was sympathetic. Others nervously demurred.

The timing was appropriate. Thirty minutes later, in walked Senator Warren, who delivered an aggressive 20-minute address in which she exposed the fallacies of Dodd-Frank, though defending the Consumer Financial Protection Board, her creation. She denounced the inability of the regulators to draft 60% of the rules of the rest of Dodd-Frank. Then she "damned with faint praise" Treasury Secretary Jack Lew, who had promised in the Spring that if the regulations were not completed by year's end, maybe another approach should be investigated. Warren simply stated, "We are about at the end of the year."

She then laid out the 21st Century Glass-Steagall bill (S. 1282) introduced by herself, John McCain (R-Ariz.), Angus King (I-Me.), and Maria Cantwell (D-Wash.). She said that the Wall Street bankers would fight this tooth and nail, that the fight would be rough, but in the conflict between David and Goliath, David won. It was time for the audience to pick up their slingshots.

Nuclear NAWAPA XXI | Gateway to the Fusion Economy

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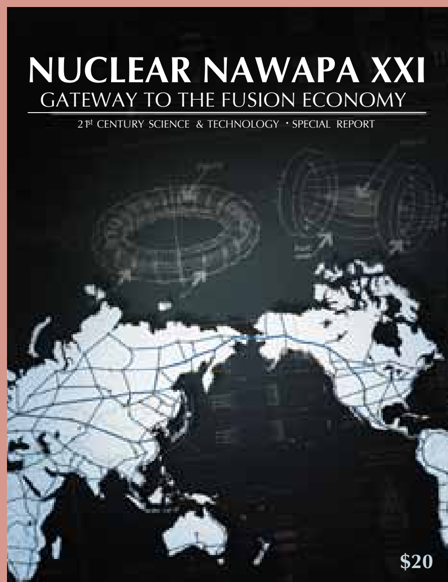

From the Introduction:

This planet can no longer tolerate environmentalists. The time has come to make a tremendous step forward in our relationship to nature, by making the development of a fusion-based economy—bringing the power of the stars under our control—our primary long-term physical economic goal.

Articles include:

- A Call for an International Crash Program: Creating the Fusion Economy
- Increasing the Productivity of the North American Water Cycle
- Nuclear NAWAPA XXI and the New Economy
- Nuclear Agro-Industrial Complexes for NAWAPA XXI
- The Pacific Development Corridor: Maglev Through the Bering Strait
- The 'Common Aims of Mankind': A Strategic Defense of Earth