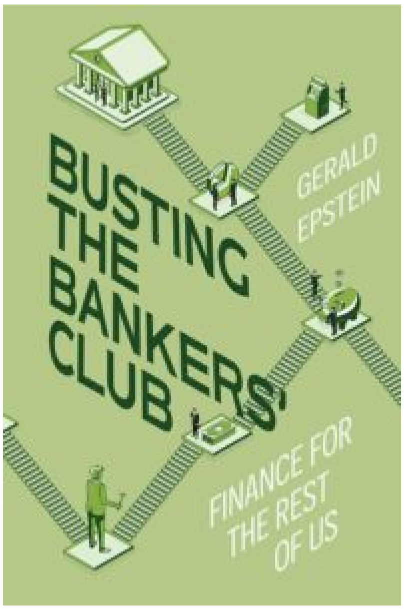
How To Bust The Bankers' Club



03-01-2024 ~ *C. J. Polychroniou speaks with progressive economist Gerald Epstein about why alternative banking is possible and urgently needed.*

It's been almost a year since the banking crisis kicked off last March. On Friday, March 10, 2023, Silicon Valley Bank, or SVB, or SVB, a state-chartered commercial bank based in Santa Clara, California, collapsed after facing a sudden bank run and capital crisis. SVB's collapse was the second largest bank failure in U.S. history since Washington Mutual in 2008. Two days later, New York-based Signature Bank also collapsed due to yet another bank run. But that was not the end of bank failures in 2023. On May 1, the San Francisco-based First Republic Bank, plagued by many of the same problems as those that doomed SVB and Signature Bank, also went under and was seized in turn by regulators who promptly sold all of its deposits and most assets to JP Morgan Chase. Two more banks would go on to declare insolvency later in the year, bringing the number of failed banks to a total of five.

Indeed, 2023 was the worst year for U.S. banks since 2008. But why do U.S. banks continue to fail after the reforms that were implemented in the aftermath of the 2008 global financial crisis? Why does the business model of commercial banks remain so fragile? World renowned progressive economist Gerald Epstein, author of the recently published book *Busting the Bankers' Club: Finance for the Rest of Us*, tackles these questions in the interview that follows. Epstein is professor of economics and co-director of the Political Economy Research Institute (PERI) at the University of Massachusetts Amherst.

C. J. Polychroniou: Jerry, in your new book *Busting the Bankers' Club,*you describe the business model of commercial banks in the age of neoliberalism as "roaring banking" and you juxtapose it with that of "boring banking," which prevailed from the New Deal era right through the Reagan era. Under "boring banking," banks were prohibited from many of today's financial engineering practices and financial shenanigans. The result was relative financial stability and economic growth. Obviously, bankers hated this business model, but what factors made possible the transition from "boring banking" to "roaring banking?" Was it simply because of the "logic" of the free-enterprise system at work, or did it happen because of actual intervention in the realm of policymaking?

Gerald Epstein: Like much historical change, the evolution from "boring banking" to "roaring banking" was the outcome of the underlying dynamics and pressures of the economic system and specific historical conjunctures, all with plenty of involvement of actual human beings and classes.

The major Wall Street bankers were never happy with the New Deal financial regulatory rules that made it harder for them to charge excessively high interest rates, make highly leveraged bets, or engineer fraudulent Ponzi or "pump and dump" frauds against customers. The numbers on Wall Street bankers' incomes show why. As *The Bankers' Club* reports, prior to 1929, bankers scarfed down incomes almost twice as high as the average wage in the economy; but after the Depression and up until the late 1970s, their incomes were about average for the whole economy. As my colleague James Crotty put it, these bankers wanted to break out of their New Deal cages to restore their superior incomes and power.

So, starting in the 1960s the major Wall Street banks organized "the Bankers' Club," an army of politicians, lawyers, economists, regulators, and fellow business associates to incrementally poke holes, then ditches and finally massive canals through the wall of New Deal financial regulations. According to Robert Weissman, now president of Public Citizen, these financial firms spent over $5 billion, just counting from the early 80s, on the club and its activities. This effort led, most famously, to the repeal of the Glass-Steagall Act in 1999 under the Clinton administration, which then officially ended the separation of commercial from investment banking.

These efforts, carried out by real (mostly) men, were aided by underlying dynamic changes in the U.S. and world economies. The U.S. experienced phenomenal economic growth in the aftermath of World War II, and the world also witnessed the resurrection of the European and Asian economies. In due time, competition facing the U.S. in trade and finance intensified, leading to the demise of the Bretton Woods system of fixed exchange rates and relatively stable interest rates. Massive military spending by the U.S. government on the war in Vietnam from 1964 to 1973 combined with the effects of the geopolitics of energy driven by the formation of OPEC led in the 1970s to large increases in commodity prices and inflation, again putting upward pressure on interest rates to keep up with inflation. Then-Fed Chair Paul Volcker jacked up interest rates in an attempt to break the inflationary pressure, once again destabilizing the interest rate structure in banking. All of these forces put enormous pressure on the New Deal framework, partly because the system depended on relatively stable interest rates. The New Deal model chose to stabilize interest rates in order to try to stabilize bank profits and promote borrowing and investment in non-speculative activities.

Thus, something had to give. In principle, the government could have reformed the system. But the Bankers' Club had a different idea: Tear down the New Deal model and usher in a new era in banking, the "roaring banking" system of mega financial institutions and high-risk banking strategies.

CJP: The neoliberal era is replete with financial crises and bank failures. In 2008, the world experienced the worst economic disaster since the Great Depression because of a financial crisis that originated in the U.S. There was a sharp decline in economic activity which led to a loss of more than $2 trillion from the global economy while millions of people lost their homes and unemployment skyrocketed. Yet, the regulations that followed in the aftermath of the 2008 global financial crisis were essentially cosmetic, as evidenced by the collapse of five major banks in 2023. What were the reasons that SVB, Signature Bank, and First Republic Bank failed, especially since the Board of Governors of the Federal Reserve System insisted at the time that the banking system was "sound and resilient"?

GE: It is good that you bring up the collapse of SVB and the failures of Signature Bank and First Republic, since we are about to reach the one-year anniversary of these important events which occurred in early March 2023.

The Dodd-Frank Act, signed into law by then-President Barack Obama in 2010, was supposed to bring about the end of the “too-big-to-fail” (TBTF) banks and government bailouts. But a year ago when these banks got into trouble, the turmoil threatened to spread panic into the broader U.S. financial markets, signaling a possible series of bank runs in *It’s a Wonderful Life* style throughout the system. The Dodd-Frank Act had tried to forestall these types of events by making larger banks (those with assets of at least $50 billion) be subject to more careful monitoring by the Federal Reserve, requiring them to hold more capital of their own so that they could withstand larger shocks, and have greater liquidity (cash or cash-like assets) in order to help forestall bank runs. But during the Trump administration, these “medium-sized banks” lobbied to be exempt from the tougher rules. A major player in the fight was Silicon Valley Bank.

But on March 10, 2023, after a major bank run hit Silicon Valley Bank, it was forced to close. The Fed did not bail out the bank’s executives, but guaranteed the deposits of its remaining depositors even when these were far above the $250,000 amount covered by Federal Deposit Insurance Corporation insurance. When contagion spread to other banks in the U.S., the Fed guaranteed all deposits, no matter how big.

In April, the Federal Reserve published a major exercise of “self-crit” in its handling of SVB, prior to and after the crisis. It’s pretty accurate assessment included the following four problems:

1. SVB’s board of directors and management failed to manage their risks.
2. Federal Reserve supervisors did not understand SVB’s vulnerabilities.
3. When the Fed supervisors did understand risks, they did not take sufficient steps to prevent a crisis.
4. The Fed should not have allowed SVB to fly under the radar even though Congress had raised the threshold bank size in order to strictly monitor and regulate banks.

Though accurate as far as they go, these criticisms miss a crucial point: These are essentially the same problems that allowed bigger banks to instigate the Great Financial Crisis in 2008-2009. The Fed itself had done much to block more fundamental reforms during the Dodd-Frank negotiations and afterward as the rules were finalized. And the Fed under Jerome Powell supported the weakening of rules for the medium-sized banks.

In other words, the Fed was still acting as chairman of the Bankers’ Club rather than steward of the public interest. This, the Fed's post-mortem would not admit.

CJP: Speaking of the Federal Reserve, in your book you do label it as the "chairman" of the Bankers' Club. Briefly explain what you mean by that, and does the Fed actually have any input in regulatory reforms proposed by lawmakers?

GE: The Federal Reserve, the central bank of the United States, has two main functions. It is in charge of U.S. monetary policy, which includes trying to manage short-term interest rates and the overall supply of money and credit in the economy. And it also has a major role to play in regulating and supervising banks, including the mega banks or what I call the "roaring banks." The Federal Reserve has been delegated these powers by the U.S. Congress, which, along with the president, establishes the mandates, or major goals, which the Federal Reserve is supposed to try to achieve. The question of the Fed's mandates or goals has been a subject of long-term political fights in the United States, which explains why the Federal Reserve is a "contested terrain." I say that the Fed is the "chairman" of the Bankers' Club because history shows that, for most of the time, the big banks and the capitalist class at large win the contest for dominance of the Fed, both with respect to its monetary policy and regulatory policy. For example, after a long political battle, the Federal Reserve was given by Congress a dual mandate: to achieve high employment and stable prices (steady and low inflation). In addition, more recently, the Federal Reserve was given a mandate to maintain financial stability. But if one studies the Fed's record, we find that when there is a conflict between keeping inflation very low (which finance normally prefers) and achieving full employment (which workers tend to prefer) the Fed almost always chooses low inflation. And when it comes to regulating banks tightly in order to maintain financial stability, or bailing them out after they get into trouble, the Fed has preferred to simply bail them out. More generally, the Fed offers significant favors to the banks, and in return expects the banks to protect its operations from the intrusive hands of Congress and the president.

To answer your question more directly, the Fed has a big influence on the regulations that Congress eventually passes, as one can see from the inordinate influence that Alan Greenspan had in the legislation to gut Glass-Steagall, and the inordinate role that Ben Bernanke and the Fed had in ensuring that Dodd-Frank regulations were riddled with loopholes.

CJP: The Dodd-Frank Wall Street Reform and Consumer Protection Act has been treated as one of the most significant U.S. regulatory reforms since the Great Depression. But it does remain a highly flawed regulatory framework, and even plugging all the holes in it won't do the job, you argue in your book. What are the strategic shortcomings of the Dodd-Frank approach to financial regulation?

GE: To identify the flaws in Dodd-Frank, one can start by identifying the causes of the major financial crises we have experienced as well as the rocks and hard places the regulators found themselves between in responding to these crises. These causes are:

- Financial institutions that were allowed to become too big to fail, to manage, to regulate, and to jail.
- Lack of accountability for bad actors who took on excessive risk, even engaged in fraudulent activities, and were left free after the crash to take the money and run and hit the restart button on their next gig.
- Insufficient limits on the debt that these financial institutions could take on and the interconnectedness they could create between themselves and other financial institutions so that when one financial institution got into trouble it could threaten to bring down others like a house of cards.
- Insufficient controls on the short-term financing of long-term or excessively risky financial investments.
- Leaving dark holes in the financial system, that is, institutions and markets that are subject to little or no monitoring, much less regulation. These include hedge funds, private equity firms, and others. Post-crisis problems often emerged from these dark corners of the financial markets.
- Lack of precaution in the implementation of new financial products, so that dangerous products could infect the financial system before sufficient controls could be fashioned.
- No quid pro quos for government support: for example, bailouts with no strings attached.

Dodd-Frank did not really address these problems, and the Trump administration weakened the Dodd-Frank rules even further. As such, these problems are still very much with us.
CJP: What measures do you propose for improving financial regulation, so we won't have bank failures and severe recessions triggered by financial crises?

GE: At a minimum, we must address these "causes" of the problems that I identified above:

- Cut down the size of the mega banks. For example, implement a modern Glass-Steagall Act that would reduce the maximum size of these banks and separate core banking functions from riskier, more speculative ones.
- Make traders and CEOs responsible for the steps and missteps they take. For example, implement "clawbacks" so that the incomes they are promised to receive from trades or decisions are held in escrow and only paid out when the investment pays off, without the need for government support. These bankers also need stricter legal consequences for breaking the law, including jail time for egregious offenses.
- Strict capital, leverage, and liquidity requirements for all banks that have significance for the overall economy, including "medium-sized banks" on the order of Silicon Valley Bank.
- Comprehensive monitoring and regulation of all financial institutions, markets, and products; no dark holes in the financial system.
- A precautionary principle for new financial innovations, such as Artificial Intelligence (AI) cryptocurrencies. Rules should ensure that these are safe and effective before they are allowed to be introduced into the core financial system. If anything, they should first be tested on the fringes where they cannot do significant harm.
- Support from the Federal Reserve or the U.S. Department of the Treasury in the case of a crisis should only be forthcoming as a last resort and should only come with strict strings (and quid pro quos) attached: Those responsible should be held accountable; the bank should have to change its business model to a safer form; the bank should engage in social services for the community, much like an individual legal offender, at least until it has paid back its bailout funds in full. A more reasonable quid pro quo is that the bank should always have to engage in more socially responsible behaviors simply by virtue of benefiting from this implicit insurance policy from the Federal Reserve or the U.S. government.

This last point touches on an important and more general issue. Financial regulation, at least since the New Deal, has been a negative screen: a list of things banks should NOT do. However, we have many crucial societal problems that the financial system should be taking a more proactive role to help solve. These include, for example, helping to build a green energy economy and ending our reliance on fossil fuels. Also, and this is equally important, contributing to the

economic development of marginalized communities. Financial institutions that get government support—and that means ALL of them—should not only avoid crashing our economy but also contribute to our society's important needs.
CJP: In *Busting the Bankers' Club,* you advocate the establishment of banks without bankers because financial regulation alone will not be sufficient to address the plethora of problems (poverty, inequality, discrimination, climate change) facing the contemporary United States. How far can public banking go in addressing these problems, and how do we overcome the resistance of the political system to radical proposals that aim toward the making of a democratic economy?

GE: Yes. Private banks, no matter how regulated, or how incentivized to do socially useful activities, will not be sufficiently motivated to provide many of the key long-term social goods that we need: green energy, healthy communities for all, sufficient financial resources for the development of our rural areas. The reason is that these banks focus on maximizing profits in the short to medium term. Many of these other activities are socially profitable but might not be sufficiently privately profitable, at least in the short to medium term. As a result, we need more publicly oriented financial institutions, such as public banks that are dedicated to broader social goals.

There are activist groups in more than 20 states across the U.S. who are pushing for public banks of various kinds. The most successful ones so far are located in California, but New Jersey is also moving closer to establishing a public bank and there is a strong public bank campaign underway in Massachusetts.

Still, there are several general obstacles to implementing an ecosystem of public banks adequate to face the problems we have. One is the intense opposition of the Bankers' Club even though most of these public bank initiatives are structured to minimize competition with the private banks. For example, they do not take deposits; they do not lend directly to customers but rather to other banks who then lend to final customers, etc. Apparently, the Bankers' Club simply does not want to legitimize any competitive sources of finance that could undercut their power.

Moreover, even if you add up all the public banking initiatives, they would still not be large enough or widespread enough to make a huge dent in the problems we are facing. What we need are national public banking institutions. For example, the Inflation Reduction Act (IRA) created a small Green Development Bank that, with support, could grow and thrive. A more activist and socially oriented Federal Reserve could play an important role here. The Federal Reserve should give the same level of support to public banking organizations as it has to private banks. And it should broaden its tools to promote key social goals: For example, the Fed could buy Green Bonds. It has already bought asset backed securities to bailout the banks.

How do we overcome resistance from the Bankers' Club and right-wingers to these kinds of reforms? Two things: Join the Club Busters, those activists who are trying to block the Bankers' Club and promote more socially useful institutions; and protect democracy by helping to get money out of the financial system (eg. repeal *Citizen's United*), expand voting rights, and fight against fascism.

In the last chapter of my book, I suggest that we all bite off what we can chew. Look around and join others who are fighting one of more of these battles. Join them and pitch in. As our forces gather, we will have impacts that build on each other. If some of our initiatives get blocked, other initiatives will move forward.

There are many Club Busters around the country, and indeed the world. In the U.S. we have public banking organizations, Americans for Financial Reform, Better Markets, Rainforest Action Network, and many others. Support politicians who fight for these issues, including Elizabeth Warren, Sherrod Brown, Jeff Merkley, and Alexandria Ocasio-Cortez.

There are plenty of places to join others and take a stand. That's how we fight the Bankers' Club.

Source: https://www.commondreams.org/opinion/bust-the-bankers-club

C.J. Polychroniou is a political economist/political scientist who has taught and worked in numerous universities and research centers in Europe and the United States. His latest books are The Precipice: Neoliberalism, the Pandemic and the Urgent Need for Social Change (A collection of interviews with Noam Chomsky; Haymarket Books, 2021), and Economics and the Left: Interviews with Progressive Economists (Verso, 2021).