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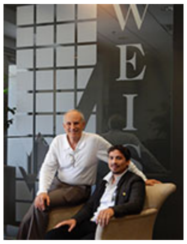
Volcker Rule Change: Savers Now Have New Reason to Move to Cryptocurrencies

By Martin D. Weiss, PhD and Juan M. Villaverde on May 22, 2018



The Federal Reserve and other U.S. banking regulators are getting ready to water down the Volcker Rule.

Reason: They want to make it easier for megabanks to take big risks with other people's money — our money. They want to give banks the green light to trade more of the same kinds of assets that helped cause the 2008 debt crisis.

Bad timing! The new rule changes come precisely at a time when risk-taking has reached a peak and key risk assets threaten to cause severe losses.

According to the JPMorgan Chase index, debt of American companies just posted one of their worst 100-day returns since 2000. And Fitch Ratings says massive global debt levels have made emerging markets especially vulnerable as U.S. interest rates move higher.

They're right.

Just this month, citizens of Argentina have suffered massive losses in their life savings, as their pesos have plunged in value. And they're relatively fortunate when compared to Iranian citizens, whose **rials have plunged to 42,000 to the dollar (https://weisscryptocurrencyratings.com/news/iran-crisis-real-consequences-no-ones-talking-787)** and even lower on the black market.

Are U.S. bankers and their regulators suffering from collective amnesia? Have they forgotten what happened in 2008 and WHY it happened?

Have they forgotten how the global financial system almost ground to a halt? How credit markets froze? How panic was the order of the day?

Back then, the Fed and the U.S. Treasury decided they had no choice: Either bail out the banks or let the world melt down. It was The Big Fix, sustained by nearly a decade of quantitative easing.

They THINK it worked. But did it really? The fact is the experience also unmasked fundamental weaknesses in the global financial system:

Weakness #1. There was, and still is, an over-reliance on megabanks — not only as depository institutions and custodians, but also as a major source of liquidity for global capital markets. (They provide this liquidity not just with ordinary lending, but also with high-risk speculation in instruments called "derivatives," which we'll review in just a moment.)

Weakness #2. There were, and still are, rich rewards for excessive risk-taking — not only by commercial banks but also investment banks, nonbank banks, insurance companies, and even government-sponsored agencies.

In the mid-2000s, these financial institutions helped create a historic speculative bubble in real estate, mortgages and mortgage-backed securities.

In the current cycle, they've retained the will and the means to do the same in other sectors, such as speculative-grade corporate debt or even sovereign debts.

These potentially toxic assets are not simply investments and speculations banks make with their own capital. No. Despite the Volcker Rule, they continued to do it with *your* deposits — sometimes in quantities and with risk levels sufficient to wipe out their capital.

In the event of a meltdown, trillions of dollars in savings are at risk. Thousands of businesses, big and small, would have to cease operations.

Weakness #3. Derivatives. These are highly leveraged, often risky, side bets — the main ones that banks want more freedom to trade . Why so risky? Actually, there are at least four factors that contribute to their riskiness:

- *The amounts are huge.* According to the **fourth-quarter 2017 report (https://www.occ.gov/topics/capital-markets/financial-markets/derivatives/dq318.pdf)** by the Office of Comptroller of the Currency (OCC), although down from their peaks, the notional (face) value of derivatives held by U.S. banks at year-end was still a massive **$172 trillion.** Foreign banks hold even more.
- *The ownership of derivatives is extremely concentrated and centralized.* The OCC reports that, although a total of 1,364 U.S.-insured institutions reported derivatives activities, 89.4% of the derivatives are held by only FOUR large commercial banks: JPMorgan Chase, Citigroup, Bank of America and Goldman Sachs.
- *Unlike most stocks and bonds, 62% of derivatives are still not cleared in central exchanges,* according to the OCC. So even if a bank wins a bet, it can still lose money if its trading partner fails to pay up. To avoid this risk, fortunes are spent on counterparty due diligence. But the 2008 experience demonstrates conclusively that all it would take is one failure, like a Lehman Bros., to cause a chain reaction of defaults on derivatives and sink the financial system.
- *Portfolio diversification is very weak.* The OCC reports that 75.8% of derivatives contracts are bets on interest rates. If we see some big interest-rate surprises down the road, their losses could be so devastating that no amount of hedging would protect them.

All this helps explain why these institutions had to be bailed out in 2008.

We can debate till we're blue in the face about the ethics or specifics of bailout policies. But the bottom line is *this wasn't just crony capitalism at its finest*. It was also a pragmatic emergency response to a very real problem: The banks were doing precisely what they want to do again; they were buying all these speculative assets with other people's money.

Most of the Public Still in the Dark

Average savers and small business owners don't care much about "the benefits of fractional reserve banking."

Nor do they get warm and fuzzy when you tell them banks are "the lifeblood of the credit markets that enable commerce and world trade." They use banks because they're a convenient place for their money. That's it.

The fact that, once deposited, their money is removed from their direct control, loaned out and no longer held by their bank is an uncomfortable truth. One that most are unaware of.

This is a problem — not only because it's poorly communicated and the public is misinformed, but also because banks fail in their most fundamental of functions: *to provide the population simple, safe and unencumbered storage for savings*.

In most developed nations, this failure comes into question only during extreme crises — like during the thousands of bank and S&L failures of the 1980s or the megabank failures of 2008.

But in Third World countries, it is the unspoken reason many people, even among the financially literate, often shun bank accounts. They do so because of firsthand experience with policymakers that abused their power by printing money wildly, swapping their money for cheaper currency, freezing assets, confiscating retirement accounts to bail out governments and worse.

The informed citizen's response is a rational one: No money in the bank. No savings in the national currency. Better to park your money "under the mattress" or some equivalent.

Cryptocurrencies do such a fundamentally better job as a safe depository, it's difficult to envision a world in which this technology does not become a game-changer for money and banking.

Bitcoin was invented in 2009 as a direct response to the government bailouts that were being announced across the world.

This is why Satoshi Nakamoto, the inventor of Bitcoin, wrote on the very first Bitcoin block: "The time is 03/Jan/2009. Chancellor on brink of second bailout for banks."

It was a not-so-subtle shot across the bow of the monetary system — a time-capsule message declaring the intent behind the creation of this revolutionary technology.

At the very core of its design stands this one guiding principle: Everyone should own their money directly. Everyone should trade directly with whomever they please. No third party, no custody, no trust in a central authority.

And unlike derivatives, all are automatically enforced by the code and the community. No need to spend fortunes on due diligence.

No institutions gambling and speculating on global markets in a scheme that gives them the quick profits but gives you the ultimate risks.

That's a scheme that, in the final analysis, does not work. It lacks the fundamental feature that cryptocurrencies restore: You and only you can be the true owner of your assets. Only you can control them. Only you decide your financial destiny.

Why Banks May Not Survive Unless They Adapt to the Coming Cryptocurrency Revolution

Right now, there are two key reasons the majority has not yet switched to cryptocurrency platforms:

- *Too much volatility:* Prices need to stabilize. But that will happen naturally over time as adoption grows and liquidity improves.
- *Lack of information:* Few people know what cryptocurrencies are or how they work. Fewer still understand the advantages of cryptocurrencies in a wallet over money in a bank.

As soon as they learn the difference, they almost invariably express extreme interest — especially in parts of the world that have a history of financial instability.

That's where adoption is accelerating now and where it will continue to grow. Just look at Argentina, Venezuela, Iran or Zimbabwe. Despite lower-than-average financial literacy, people in these countries are often demonstrating higher-than-average adoption or interest in cryptocurrencies.

Still, the lack of reliable information remains the most significant barrier of entry today. We laugh when the so-called "experts" say widespread adoption can't happen because "it requires technical knowledge beyond the expertise of the average individual."

Have you tried sending a bank wire recently? We'd argue that trading in crypto is orders of magnitude easier. And cheaper!

Moreover, there's abundant evidence that cryptocurrencies are going to become much more user-friendly very quickly. New, easy-to-use mobile apps are being launched globally. The technology is already here to simply whip out your phone and scan a code. All with robust security.

So what happens when these interfaces are streamlined and when the public learns more about the inherent risks of traditional banking and starts to gain more confidence in cryptocurrencies?

Unless they adapt to the cryptocurrency revolution, it's hard to imagine a world in which banks in their current form retain custody of people's assets. And it's easy to imagine one in which crypto platforms disrupt banks like Uber or Lyft disrupt taxis.

If there is one thing we can state with certainty it's that the simplest application of Distributed Ledger Technology — digital money — is one that makes banks as we now know them redundant and obsolete.

So will banks survive the crypto revolution? It all depends on how well and how quickly they can adapt.

There will still be a need to invest the assets that people own. There will still be a need for credit. But the structure and process will change. Today, banking institutions have a virtual monopoly on money. Savers and investors have few other practical options. So they are virtually forced into the banking system, and this forced adoption is the main source of liquidity for credit and investment.

Now that we have better technology for safe storage of savings, credit markets will have to reinvent themselves. The future financial system is likely to be very different from what we take for granted today.

What might they look like? We'll save that question for a future post.

Best,

Juan and Martin

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