Australia did *not* avoid the GFC! The Australian banking crisis of 2008

By Robert Barwick

In the movie *The Big Short*, Brad Pitt's character helps two young investors strike a deal with Wall Street's biggest banks to bet against the sub-prime mortgage market. In the book on which the movie is based, *The Big Short: Inside the Doomsday Machine*, author Michael Lewis tells how the two investors, Charlie Ledley and Jamie Mai, couldn't believe that it was possible to make such one-sided bets in their favour. It was October 2006, and the US housing market had been falling since June. Lewis recounts:

The underlying mortgage loans were already going sour, and yet the prices of the bonds backed by the loans hadn't budged. "That was the part that was so weird", said Charlie. "They'd already started going bad. We just kept asking, 'Who the hell is taking the other side of this trade?' And the answer that kept coming back to us was, 'It's the CDOs.'"

Or, in other words, sucker investors all over the world which had invested in derivatives called CDOs—collateralised debt obligations—on US sub-prime mortgages. Among these suckers were dozens of local government councils and charities in Australia, including Wingecarribee Council, Parkes Council, and the City of Swan, which had purchased AAA-rated CDOs from Grange Securities, the Australian subsidiary of the giant Wall Street investment bank Lehman Brothers. When Lehman Brothers collapsed on 15 September 2008, ten years ago this week, those three councils and 69 other councils, charities, churches and schools, lost $200 million on their supposedly AAA-rated investments.

It is loudly proclaimed that Australia avoided the 2008 global financial crisis (GFC), as Australia's banks were "sound" due to the prudential regulation of bank supervisor APRA, and the Rudd government's emergency measures. This well-worn claim was repeated recently by the Labor Party's shadow Treasurer Chris Bowen, in a 12 February 2018 Parliamentary speech in support of the government's bill giving crisis resolution powers to APRA. "Thanks to the response of the Labor government, Australia again avoided recession [in 2008]", he said. "And of course it is the case that the institutional frameworks that were put in place prior to the crisis served Australia well, most particularly the prudential regulation regime overseen by APRA."

That is not the true story, however. The 72 councils and charities which lost heavily on CDOs is just one example of the GFC hitting Australia hard. The true story is that, like their Wall Street counterparts, Australia's banks were also facing collapse, and for the same reason—a housing market meltdown. Only the combination of a fluke of timing, the US bank bailout, and a disguised government rescue saved the banks, and only China's massive infrastructure investment program saved the Australian economy.

GFC losses

The GFC took a heavy toll on the finances of retirees and people preparing to retire, usually through their superannuation funds. Over a period of 16 months preceding and following the banking crash, the Australian Securities Exchange lost 54 per cent of its value. Nest eggs that many retirees had accumulated from decades of work were smashed, damaging retirement living standards.

Another group who suffered were the more than 60,000 investors in managed funds, many of them mortgage funds operated by large financial institutions, which were frozen during the GFC, and remained frozen for years. The fund managers, large blue-chip companies such as AXA, Perpetual and CBA, froze withdrawals because worried investors were rushing to put their money in banks to take advantage of the government's new deposit guarantee. The funds continued to make pension payments, but as well as freezing funds, they suspended daily withdrawals, affecting investors' lifestyles. Despite freezing their customers' funds, Adele Ferguson reported in the 10 November 2014 *Sydney Morning Herald,* CBA and other institutions continued to charge management fees, and financial planners continued to receive trailing commissions.

Mortgage crisis

The centre of the crisis in Australia, however, wasn't the widespread investment losses. It was the mortgage market and the banks—just like in the USA and Europe. The seriousness of the crisis was effectively covered up, by the government, the regulators, and the media.

From 2000 to 2008, a bubble had inflated in Australia's housing market, with similarities to the US bubble. In some respects Australia lagged behind—whereas the US rate of mortgage securitisation was 50 per cent by the time of the crash, the Australian rate was 25 per cent, but growing fast. Many aspects were similar, however. The subprime lending that caused the crisis reached 20 per cent of all US mortgage originations at their peak in 2006; Australia had its own version of subprime mortgages, called low-doc and no-doc loans, which had grown from 1 per cent of all mortgages in 2000, to the same rate as US sub-prime lending by 2008—20 per cent.

Also like the US, fraud was endemic in Australian mortgage lending. Australia's Financial Services Royal Commission touched on more recent instances of mortgage fraud in its first round of hearings in March 2018, but Denise Brailey of the Banking and Finance Consumers Support Association (BFCSA) has shown that mortgage control fraud by banks started well before the GFC. This was reflected in the rapid growth of low-doc and no-doc loans, which enabled the banks to write mortgage loans on very little verifiable information.

It is now known that APRA was aware in 2007 of the growing risks in the mortgage market from poor lending standards, but chose to ignore them. A March 2007 internal APRA report revealed that the lowering of mortgage lending standards, which APRA had approved, had produced a bubble in mortgage lending. The report revealed that the amount of housing debt outstanding was three and a half times greater than it would have been under the older, more conservative, lending standard. Moreover, it predicted that mortgage delinquencies would rise from 1 per cent to more than 7 per cent within three years, which would likely panic overseas investors in the housing market, leading to a credit crunch and a housing crash that would trigger a recession. According to a 4 April 2016 ABC report by Stephen Long, not only did APRA ignore the report, but then-APRA chairman John Laker refused to allow it to be published "because it would panic investors and could undermine the banks", Long wrote.

Before the September 2008 crash, the scenario warned of in the secret APRA report had started playing out. On the back of steadily rising interest rates, which drove a cost of living crisis that cost John Howard the November 2007 election, mortgage defaults were rising and house prices had started falling. The banks were staring at a disaster.

Crunch time

Ironically what intervened to save the Australian banks was the collapse of Lehman Brothers in New York. The global shock snapped governments out of their denial and into emergency action, including Australia's Rudd Labor government. Crunch time in Australia came on the weekend of 11-12 October 2008.

While the government and media were loudly reassuring the public that Australia's banks were sound, real panic had broken out in official circles. Australia's banks owed $440 billion overseas in very short-term, 90-day debt, which left them stranded when interbank lending ground to a halt in the global credit crunch. According to the 2010 book *Shitstorm* by Lenore Taylor and David Uren, international investors refused to roll over their loans to Australia's banks, and had called in $50 billion in short term debt.

The panic had started the moment Lehman Brothers went under. In July 2010, *The Age* reported the revelations of Freedom of Information requests, showing that the senior management of Australia's fifth biggest bank, Macquarie, immediately started making frantic calls to Canberra to get into contact with Kevin Rudd and his senior ministers, begging for protection. (In 2014, a former Macquarie executive who had been present that day gave the CEC a firsthand account of the panic. Noting Macquarie's notorious neoliberal ideology, he said, "I never thought I'd see Macquarie in favour of government intervention.") The following day, 17 September in Australia, Macquarie sent a flurry of emails to securities regulator ASIC, which shared the same Sydney office building, and two days later ASIC intervened to rescue Macquarie's plummeting share price by banning short selling of financial stocks.

In *Shitstorm*—so named for PM Kevin Rudd's description of the crisis in a TV discussion—Taylor and Uren also revealed:

• one of the architects of Australia's regulatory structure, Professor Ian Harper, reassured everyone who asked in early October 2008 that Australia's banks were safe, but personally withdrew a sizeable sum of money from an ATM on the weekend of 11-12 October because he feared there might be a run on the banks the following Monday;

• the Reserve Bank printed around $10 billion in $100 and $50 notes in early October 2008, almost doubling their strategic cash reserve, for the first time since their preparation for the Y2K crisis in December 1999;

• among the wave of panicked withdrawals by depositors, $1 billion was withdrawn from Suncorp, and $2 billion from Bankwest.

The former senior economics advisor to Prime Minister Bob Hawke, Professor Ross Garnaut, revealed in his 2009 book *The Great Crash of 2008*, co-authored with David Llewellyn-Smith, that in early 2008 the major banks all met with Kevin Rudd to beg for guarantees for their overseas borrowing. "The banks told [Rudd] that, if the Government did not guarantee their foreign debts, they would not be able to roll over the debt as it became due", Garnaut and Llewellyn-Smith recounted. "Some was due immediately, so they would have to begin withdrawing credit from Australian borrowers. *They would be insolvent sooner rather than later* … The process of adjustment would be enormously disruptive and costly."

Bank rescue

The crisis reached a crescendo on the weekend of 11-12 October. Kevin Rudd and his Strategic Priorities and Budgetary Committee (SPBC), known as the "gang of four"—Rudd, Treasurer Wayne Swan, Finance Minister Lindsay Tanner and deputy PM Julia Gillard—met with Treasury Secretary Ken Henry and Reserve Bank governor Glenn Stevens with one objective: rescue the banks. All the while they continued to proclaim Australia's banks were "sound".

The Rudd government's Gang of Four—(clockwise from left) Tanner, Swan, Gillard and (back to camera) Rudd—assured the public the banks were sound, but scrambled frantically behind the scenes to rescue them.

This meeting agreed to three emergency measures: 1) a guarantee on deposits to avert bank runs; 2) a guarantee on the banks' overseas borrowings, so they could roll over their short-term debt; and 3) a tripling of the First Home Owner Grant to $21,000, to help first-time buyers afford a home. To continue to cover up the actual crisis in the banks, Rudd announced the latter as a housing "affordability" measure, but that was a lie. The government was desperate to stop house prices falling, which would trigger the same mortgage market meltdown in Australia that was under way in the USA, and the bank crash and recession warned of in the 2007 secret APRA report. Taylor and Uren quoted Treasury Secretary Ken Henry stating explicitly that they tripled the grant not to make housing affordable, as was claimed, but because "it gets house prices up and that was the point".

Without these emergency measures, Australia's banks were goners. Even then, Kevin Rudd had to lobby US President George W. Bush to bail out AIG, to which Australia's insurance companies were heavily exposed as the reinsurer of a third of Australian insurance policies. And Australian banks were direct recipients of the US bank bailout. In a 2014 paper, "Implications of the Global Financial Crisis", published in *The EBE Journal*, former APRA Principal Researcher Dr Wilson Sy noted, "Secrecy was maintained in Australia during the GFC when Westpac and NAB came close to failure. Insolvency was forestalled during 2008 and 2009 through a combined emergency loan of US$5.5 billion from the Term Auction Facility provided by the US Federal Reserve."

The timing of the Lehman Brothers collapse triggered the Australian government's guarantees and the US bank bailout which averted an Australian banking collapse and housing market crash—temporarily. The real rescue came from China's massive infrastructure investment program, which revived the iron ore and coal exports on which Australia's economy depended. But instead of taking the crisis as an opportunity to clean up the unpayable mortgage debt and related derivatives in the banks, the government and APRA allowed the banks to go even harder into the reckless activities that got them into trouble in 2008. Consequently, bank derivatives have almost tripled, from $14 trillion to $40 trillion, and there is more than double the mortgage debt today than when the secret APRA report warned of the mortgage risks in 2007.