

Citizens Electoral Council of Australia

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31 March 2014

Mr David Murray
Chairman
Financial System Inquiry
Commonwealth of Australia

Citizens Electoral Council submission to the Financial System Inquiry

Dear Mr Murray and panel,

The Inquiry you are charged to conduct will be incomplete, unless it includes the threat currently facing the Australian people of a total collapse of the financial system, as a consequence of the reckless speculation by Australia's banks in financial derivatives that are based on Australia's property bubble.

Furthermore, your Inquiry should investigate the solution that the CEC supports, and which has broad support around the world: that of a complete separation of all retail banking from all investment and related banking, as mandated in the successful United States law which lasted from 1933-1999, the *Glass-Steagall Act*.

Both issues cited above come under Point 2 of your Inquiry's Terms of Reference.

The following points summarise the systemic risks confronting the Australian financial system, and why a full Glass-Steagall banking separation is the only solution:

- * Australia's financial system is concentrated in just four banking conglomerates, which are by definition too-big-to-fail (TBTF);
- * all four of these banking conglomerates are heavily exposed to the real estate market, which accounts for about 60 per cent of their combined business;
- * this exposure to real estate is far higher than the banks in most other countries;
- * the median value of Australia's residential real estate has soared in a little over a decade, to more than 7 times median annual household income, and in some pockets even higher, which is well above the historical house price to annual income ratio of 3-3.5 times—this, by any definition, constitutes a "bubble";
- * the major banks in that time borrowed hundreds of billions of dollars from overseas to lend into the domestic property market, which borrowings caught them out in the October 2008 credit crunch, such that they were only kept solvent by the Rudd government's emergency guarantee (the banks have reduced this exposure since then, but it is still in the hundreds of billions);

* the major banks have entered into many trillions of dollars' worth of derivatives contracts that are related to their exposure to the real estate market, such as interest rate swaps and currency swaps on their hefty overseas borrowings;

* even more alarming than the volume of the banks' derivatives exposure, is the accelerating rate of growth in their use of derivatives, and the decision by Australia's largest bank, CBA, in 2012 to no longer disclose the full face value, aka notional principal, of its rapidly growing derivatives obligation.

Therefore, in the event of an inevitable collapse in property prices, Australia's banks will be wiped out. Moreover, the impact will flow through to their derivatives counterparties, which has implications for the global financial system.

How will the Australian government and Australia's banking authorities—RBA, APRA and ASIC—respond to such an event?

Presently, there are two possible responses on the agenda:

1. Bail-out/bail-in;
2. Glass-Steagall

Bail-out/bail-in

It is not possible for the Australian government to bail out all four major banks. Indeed, Australia's Council of Financial Regulators acknowledged in 2009 that the government couldn't even honour its deposit guarantee, the Financial Claims Scheme, if just one of the major banks collapsed.

That leaves bail-in, which the Australian Treasury is presently preparing legislation for enactment in Australia. It is officially denied that bail-in will apply to bank deposits, as was the case in Cyprus in March 2013. Purportedly the Australian bail-in legislation will only apply to a certain kind of bail-in-able bank bond. However, the legislation is not yet public. Given the European experience, and the fact that the IMF has deemed Australia's financial system collectively to be globally systemically important, it is more likely than not that if the failure of Australia's big four banks threatened a global chain reaction, and that failure could only be averted by bailing in depositors a la Cyprus, that is what would happen.

Glass-Steagall

The alternative to bail-in is Glass-Steagall, which I can attest is the only solution. Bail-in will in fact destroy the banking system it is trying to save, by completely destroying the confidence that depositors have in the banks. Glass-Steagall will save the banking system.

As demonstrated in the U.S. between 1933 and 1999, completely separating all commercial (retail) banking from investment banking dramatically decreases the risks to which bank deposits are exposed. Testifying to the effectiveness of the *Glass-Steagall Act* is a) its longevity of 66 years; and b) the disaster that befell the U.S. banking system after its repeal, caused by excessive financial speculation of a volume that was not possible under the *Glass-Steagall Act*.

For Australia, Glass-Steagall would mean splitting up the Big Four banks into completely separate retail banks, and investment banks/insurers/brokers. Any government guarantees would only apply to the retail banks, but bolstering the guarantees would be the reality that the retail banks are at far

less risk. The derivatives exposure would be worn by the investment banks, which would require unwinding the securitisation derivatives and others that are based on the mortgages which originated from the deposits in the retail banks.

If implemented before another major financial meltdown, a Glass-Steagall separation could be imposed in an orderly fashion, over a number of years. The government could use capital controls to minimise any speculative disruptions.

Presently, there are four bills before the U.S. Congress to fully reinstate Glass-Steagall, over a five-year period. There are bills before a number of European parliaments, and there is widespread support in Europe generally for Glass-Steagall, especially in the U.K. Parliament, such that if it passed in the U.S. it would be quickly copied in other jurisdictions.

Conclusion

Included in this submission are four reports that the CEC has recently produced, which bear out all of the claims made in this submission:

1. *Memo: The Great Australian Mortgage Bubble*
2. *How safe is your super?* The CEC's response to State Super Financial Services Australia's 27 August 2013 "Investment Viewpoint".
3. *Glass-Steagall Now!*, a comprehensive explanation of Glass-Steagall, why it is necessary for Australia, its global support, and the U.S. legislation to restore it in that country.
4. *Commonwealth National Credit Bank Bill*, the CEC's draft legislation for a new National Bank, owned and controlled by the elected government, which can harness and direct the credit of the nation into developing the infrastructure Australia needs for a prosperous future.

Yours sincerely,



Craig Isherwood
National Secretary
Citizens Electoral Council of Australia