Memorandum

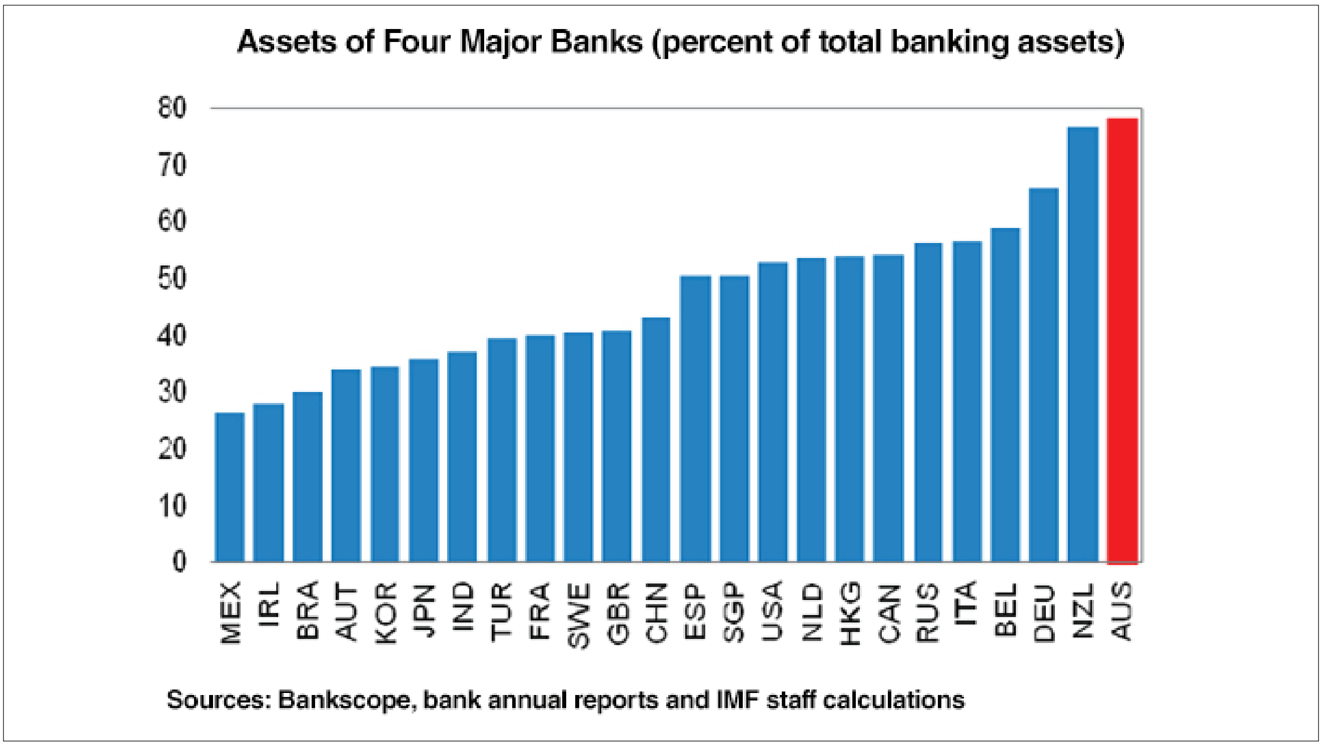
Re: The Great Australian Mortgage Bubble

By Robert Barwick and Allen Douglas
Citizens Electoral Council of Australia
1 March 2014

Australia's "Big Four" banks are intimately tied into the world's London and Wall Street-centred financial system through their combined holdings of $A23 trillion in derivatives. Thus the Australian financial system could blow at any moment that the inevitable chain reaction starts from London or Wall Street. But, putting that defining reality aside for the moment, even in its own, more narrow terms, Australia's financial system could also explode at any moment because it is built upon arguably the largest mortgage bubble in the world, one which is presently expanding exponentially. Australian legislators have a responsibility to act to save the nation from this otherwise inevitable explosion, and thus must understand, first, that it is a Dutch tulip bulb-style bubble, and second, how to defuse this keg of mortgage dynamite upon which the nation is sitting, through Glass-Steagall and the establishment of a National Bank. The purpose of this memo is to sketch merely some of the parameters of this bubble.

The Overview

Though Australia is indeed inexorably linked with the London/Wall Street globalist speculative-centred monetary system, for historical reasons it has certain unique characteristics of its own, which date from the way in which the financial deregulation process was carried out here following the end of the Bretton Woods fixed exchange rate system on 15 August 1971. In brief, it is probably the world's single most concentrated financial system, which itself sits on top of the worst mortgage bubble in the world, centred in our "Big Four" banks: Commonwealth Bank of Australia, the ANZ Bank, Westpac, and National Australia Bank.



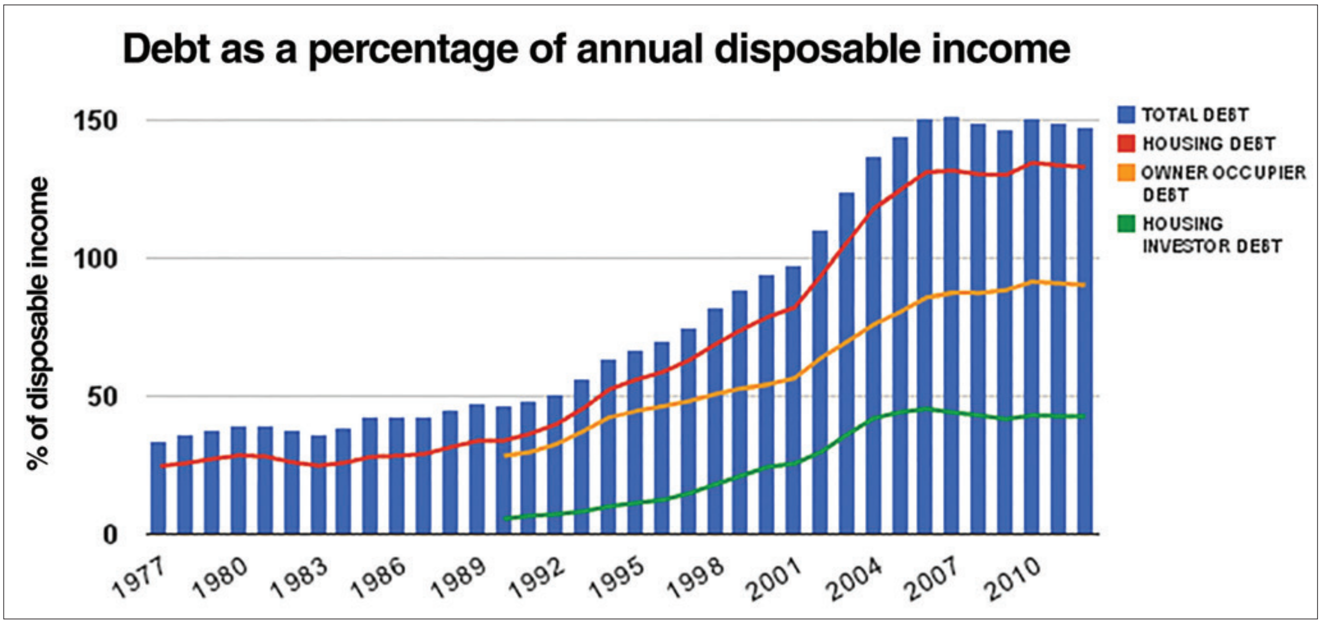
http:www.whocrashedtheeconomy.com.au/blog/

Australian financial and political figures proclaim the Big Four to be "some of the safest banks in the world". Many of them actually believe that, also because that same line is frequently echoed elsewhere in the world. Most of this reputation of "safest" arises from the supposed fact that the Big Four were ostensibly in no danger of melting down during the 2007-08 Global Financial Collapse, unlike banks everywhere else in the world. That is utter nonsense. In fact, they would certainly have collapsed had not the government stepped in over the weekend of 11-12 October 2008 to provide them (and their sister Macquarie Bank) government guarantees for all of their deposits and for their huge foreign borrowings, which latter they were otherwise not able to roll over when the international credit markets seized up in the wake of the Lehman Brothers collapse in September 2008.

Each of these Big Four ranks among the world's top fifty largest banks, and have been named Globally Systemically Important by the Bank for International Settlements (BIS). As for the CBA, "In May, analysts at UBS said the Commonwealth Bank of Australia was the most expensive large bank in the world by nearly every standard valuation measure. The bank's shares closed at $73.82 on Friday." [Kehoe, *Australian Financial Review* article, see reference below]. The CBA also happens to be the most heavily invested of the Big Four in the mortgage bubble. In 2012 it suddenly stopped disclosing its skyrocketing derivatives exposure. The twin realities of heavy mortgage, and heavy derivatives exposure are not surprising: the overwhelming amount of the Big Four's $A23 trillion in derivatives are in currency and interest rate swaps, taken out to "insure" their heavy overseas borrowing for the purpose of pouring those funds into the domestic mortgage market, as noted below. Thus, were the Australian mortgage bubble to pop, that by itself could easily blow out the entire world's financial system. Note that "the market capitalisation of the Australian banks has swelled from 2 per cent of the global banking index to 14 per cent over the past decade." ["Wall St's latest worry: Australian banks", *Australian Financial Review*, 16 September 2013, John Kehoe.]

Reflecting the growth of this mortgage bubble over the past three decades, Australians now have either the highest or second highest ratio of household indebtedness to disposable income in the world, depending on whose figures one looks at. A paper by Reserve Bank of Australia economist Michael Davies ("Household debt in Australia") observed a staggering rise already before 2007, and it has worsened since:

"During the 1980s, the ratio of debt to disposable income for Australian households was fairly stable at around 45%. But since 1990, this ratio has risen rapidly, reaching 157% in December 2007. Housing debt accounts for the bulk of the increase, with the ratio of housing debt to disposable income rising from 31% to 134% over the period. … Many advanced economies have witnessed a large rise in household indebtedness over the past two decades. However, the increase in Australia has been particularly pronounced. The ratio of household debt to income in Australia went from being one of the lowest in the advanced economies in the late 1980s to one of the highest in December 2007."



Source: "Fretting about mortgage debt?" 12 April 2013 Author: Jodi Bird
http://www.choice.com.au/reviews-and-tests/money/borrowing/your-mortgage/mortgage-debt.aspx

Unlike Americans, Australians cannot merely walk away from mortgages they can no longer pay, because the banks are allowed to garnishee their salaries/wages until the full mortgage is paid. We are, truly, debt slaves. Only declaring bankruptcy discharges Australians of their mortgage obligation.

Moreover, with the sharp collapse in the "mining boom", and the recent closure of major manufacturing industries, including oil refineries, food processors, aluminium smelters and the announced shutdown of Australia's entire car manufacturing industry by 2016, an estimated 100,000 people or more will be thrown out of work, many perhaps even most of whom, presumably, will no longer be able to meet their mortgage payments. The Abbott government has ostentatiously chosen not to extend help to these industries, even as they pour assistance into the "finance sector", with much more planned via the FSI.

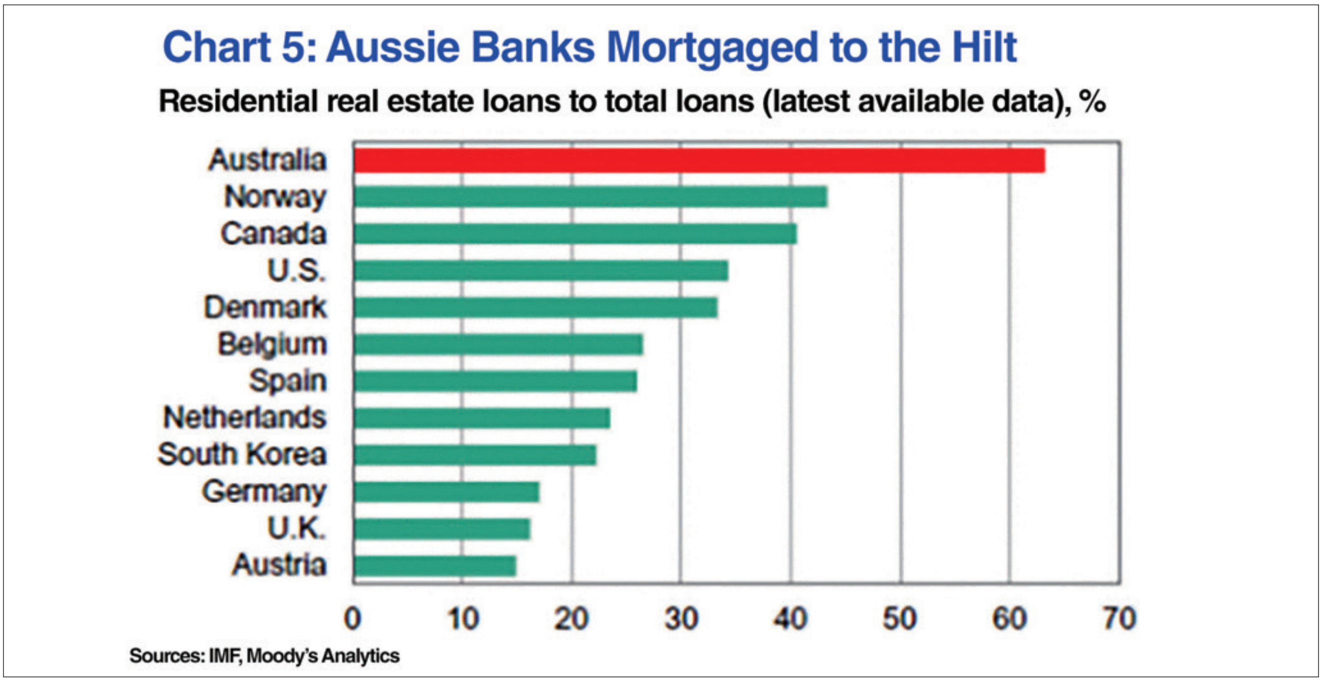
For many years now, the Big Four have borrowed massively from overseas; some 30-40 per cent of all their liabilities derive from the overseas wholesale funds market. As is almost universally acknowledged, they borrowed so heavily from that market, close to $900 billion at the peak prior to 2008, for only one reason—to pour the funds into the domestic home mortgage bubble. Australia has a $5 trillion residential property market. The Big Four hold some 83 per cent of all mortgage loans in that market, and these loans constitute the majority of their entire loan book. Australia's financial regulator, the British-modelled Australian Prudential Regulatory Authority (APRA), allows the banks to hold a mere 2 per cent of reserves against these mortgages, compared with much higher reserves it demands from loans to agriculture or to industry, through the ruse of "risk-weighting" capital. (In fact, the more that property prices inflate, the less capital APRA demands that they set aside against those mortgages.) That of course, provides a built-in motivation for them to lend for mortgages at the expense of the real economy—but such APRA regulations were constructed in the first place to support an already existing property bubble.

Additionally, the Reserve Bank of Australia has now set its base interest rate at 2.5 per cent—the lowest in sixty years—precisely in order to facilitate this mortgage process, to encourage more people to pour into that market. Lawfully, the Big Four's lending into the property market has taken on such steam in the past year or two, that there is even an ongoing public debate in the news media on whether Australia now has a "property bubble". The Australian government, notably through Treasurer Joe Hockey, has loudly proclaimed that "there is no such bubble, Australian houses are the largest in the world, they have unique characteristics", etc. etc. But the very fact that such an intense debate is under way, is itself clear evidence that such a bubble does exist and is gathering speed by the moment.

The bubble accelerates

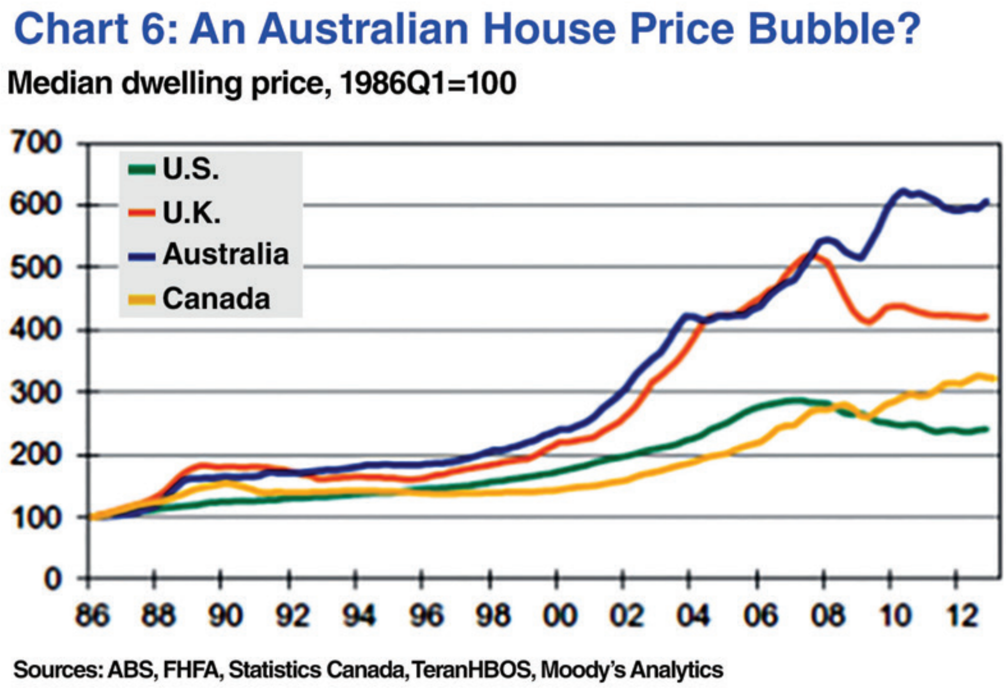
Over the past 12 months, for instance, Sydney has seen an 8.5 per cent rise in property prices, Perth with 7.5 per cent and Melbourne with 6 per cent. An 18 January 2014 article in *The Australian* titled "Low-doc loans back in play" provided clear evidence of the bubble taking off:

"High-risk, no-deposit home loans and low-doc loans—so-called 'liar's loans' are re-emerging in the heated property market, raising concerns over lending standards. With first-home owners and aspiring investors locked out of the market due to soaring prices, lenders are again offering loans covering up to 99 per cent of a property's purchase price, while others are spruiking loans where borrowers 'self-certify' their own income. … Several lenders are offering loans requiring 1 per cent deposits or less, while some are advertising loans which cover 106



per cent of a property's purchase price. The major lenders have loosened lending standards in recent years, with most offering loans providing 95 per cent of a property's purchase price, with a number of providers, such as RAMS, offering 97 per cent, after including lender's mortgage insurance. However, other lenders are avoiding the requirement for a deposit almost altogether, by coupling home loans with large-balance credit cards."

Already on 18 May 2011 Moody's had downgraded the credit ratings of the Big Four, noting that the decade prior to 2008 had seen a 150 per cent rise in property prices, which had pushed Australia's household debt to annual income to 159 per cent by mid-2010—a higher level than the U.S., U.K. and Spain at the peak of their housing cycles.



In 2013, $26 billion of Australian Residential Mortgage-Backed Securities (RMBS) were issued, more than double that of 2012. ["Japan enters Aussie mortgage market", which notes that Bank of Tokyo-Mitsubishi "has launched the first major salvo by a Japanese bank into the Australian mortgage market, extending a $500 million one-year mortgage-backed facility to AMP Ltd." —Source: www.macrobusiness.com.au, 26 November 2013.]

Let us look briefly at the history of the creation of this bubble, in order to further appreciate how the entire Australian financial system has been constructed upon it over the past three decades or more, and why ever more desperate and blatant measures have been taken in recent years to keep pumping air into it, under the clear recognition that it will otherwise most certainly pop. In fact, a chief proclaimed rationale for the Financial System Inquiry (FSI) established last year and now under way is to conduct a "once every several decades root-and-branch review of Australia's financial system", to figure out ways to "increase funding to the banks", in order to decrease their dependency on borrowing overseas. The FSI is dominated by private bankers, beginning with chairman David Murray, former chairman of the Commonwealth Bank from 1992 to 2005 when its derivatives holdings exploded, and one of its leading members, Ken Henry, a former Treasury Secretary and private banker, who played a decisive role in propping up the bubble as Treasury Secretary from 2001-11. A second major rationale for the FSI is to revamp state and federal regulations of all sorts, including such minimal regulation of Australia's financial system as still exists, in order to finance a speculative boom in infrastructure construction.[1]

1. "Infrastructure, infrastructure" is the mantra chanted every day by Australia's present Liberal Party/National Party government. Prime Minister Tony Abbott has said that he wants to be known as "the Infrastructure Prime Minister", while Treasurer Joe Hockey has taken the point as chairman of the G20 Finance Ministers this year, to lead a crusade for an internationally-agreed series of regulatory changes to facilitate new infrastructure, one which mirrors completely the efforts of Europe's Long Term Investors Club (LTIC) over the past several years. The line is "Governments don't have money, they can't finance infrastructure anymore, so we have to change any and all existing regulations, risk evaluations, etc. in order to allow the private sector to take the lead in building this infrastructure, with the necessary backup by governments", notably on the "Public-Private Partnership" model trumpeted by the LTIC. In practice, Abbott and Hockey intend to privatise whatever has not been already privatised of federal government assets, and to force the states to also privatise everything which has not already been sold off. The funds from those forced sales are then to be reinvested in "new infrastructure", with massive fees flowing to the investment banks arranging these deals, and the returns guaranteed by "user-pays"—slapping tolls on all new roads, or any other kind of infrastructure.

Another unique facet of the Australian financial system which is important to understanding its mortgage bubble is the "superannuation industry" established by Australian Labor Party (ALP) Prime Minister Paul Keating in the 1990s. Thanks to "Super", Australia now boasts the second or third single largest pool of liquidity in the world, some $1.7 - $1.9 trillion.[2] All of that money has to be invested somewhere, and much of it is invested in the stocks of the Big Four banks, which comprise an astonishing one-third of the entire Australian stock market (one-half trillion dollars in all—*Australian Financial Review*, 15 November 2013, George Liondis), the same Big Four whose record-setting profits this year are based upon the mortgage bubble.

In November 2013, a UBS report concluded that the high amount invested by Australians—mainly through their super—in banks, shares, bonds and other securities was a potential "concentration risk". "We believe that the concentration risk to bank securities is more significant in Australia than other areas of the developed markets", UBS analysts Jonathan Mott and Chris Williams wrote in the report. UBS said investments in shares and other securities linked to the Big Four banks accounted for 21 per cent of all household wealth in Australia outside housing and deposits and that Australians had a further $762 billion in deposits at the Big Four. They asked, "Is it appropriate that 21 per cent of their net worth outside housing deposits is invested in four highly correlated banks? Will this become an increasing concern for fund trustees and financial planners? Further, given the Australian banks are highly leveraged to the property market, on a look-through basis this further increases the concentration of household net worth to residential and commercial property."

An increasing share of Super is also being pumped into the domestic mortgage market, especially though Self-Managed Super Funds (SMSF), of which there are 439,000 holding $421 billion, or about one-third of the entire superannuation pool. [News.com.au 21 March 2011, Anthony Keane] (Aside from their own funds, these SMSF's have been allowed since 2007 to borrow heavily to invest in property (typically 65-70 per cent of the property value), and in the past two years the percentage of property held in such SMSF's has typically risen from 50 to 80 per cent.) The rest of that pool outside of the SMSF's is managed by "professional fund managers", invariably former investment bankers for JPMorgan Chase, Deutsche Bank, and their cohorts from the other London/Wall Street TBTF banks. It would appear that the ongoing FSI intends to loosen present regulations on "Super", to allow much more of it to be channelled into RMBS. That would certainly be one tried-and-true way of "ensuring more funding to the banks."

Australia's mortgage bubble, and the role of that bubble as the base upon which the entire Australian financial system rests, was initiated in the late 1970s by the Australian arms of the elite, London-centred Hill Samuel Bank and the even more elite Schroders Bank, through Schroder's Australian subsidiary Darling & Co. But unlike what happened in the rest of the world during 2007-08 when some of the air was temporarily let out of the mortgage bubble in the U.S. and elsewhere through the "subprime crisis", that never really happened in Australia. In fact, the Australian government and financial authorities took measures to expand the bubble even more rapidly, while conspiring to cover up the reality of mass defaults on mortgages by simply holding onto the vacant houses and pretending they didn't exist, even as many thousands of Australians were forced onto the streets. The bubble was so central to the entire Australian financial system even then, that if any air were let out of it, the whole system would have blown to smithereens. Bespeaking the growing hysteria over the past couple of years that this mortgage bubble could pop, note just a couple of the desperate measures that governments, both the preceding Labor government (2007-13) and the present Coalition government have taken, again keeping in mind that additional, perhaps even more dramatic such measures will result from the present FSI.

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2. As federal Shadow Treasurer in the late 1970s and early 1980s before becoming Federal Treasurer under PM Bob Hawke in 1983, Keating became the protégé of the top names in the British Crown-centred international minerals cartel around Rio Tinto, BHP Billiton, etc. Early on, and then during his own stint as Prime Minister from 1991-96, he openly proclaimed that he intended to let agriculture or industry live or die on their own (after pulling down most protective tariffs) and instead to turn Australia into a giant raw materials quarry. He also proclaimed his intent to create an "Antipodean Venice" in Australia—a world leading "financial industry", to replace agriculture and industry. (See pp. 67-72 of the CEC's *Glass-Steagall Now!* pamphlet for Keating's intentions, and for the history of the disastrous financial deregulation since the 1970s, of which the present Financial System Inquiry is the next phase.) Now that Australia's China-centred "mining boom" is slowing down, and under the new Liberal/National Coalition government, there is more of an emphasis than ever on expanding the "finance sector" as the lynchpin of Australia's economy.

1) The overall suite of measures was summarised in 2010 by then Opposition Treasurer, now Treasurer, Joe Hockey. The CEC reported his summary in a 29 November 2010 press release headlined, “Joe knows the banks are stuffed, but only the CEC will act”:

> Mr Isherwood referenced Hockey’s fairly dramatic 22 November Canberra press conference, when the Opposition Treasurer very soberly stressed, “I think 2011 is going to be a very challenging year in global markets and I think, as I’ve said in Parliament, you will see a tsunami of government debt hitting the markets over the next 12 months. Australian financial institutions are amongst the biggest borrowing banks in the world for their size. *I say again, Australian banks are amongst the biggest borrowing banks in the world for their size, and Australia is a massive importer of money.* Now, if there is a huge demand for money offshore, with all these governments rolling over their paper and the private sector rolling over its paper, it’s going to create real challenges for the cost of funds in Australia, and it may mean higher interest rates again. So let’s prepare now.” [emphasis added]
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> In an *Australian Financial Review* column that day, Hockey also highlighted the extent to which Australia’s private banks were dependent upon government support:
>
> - Australian taxpayers are guarantor for more than $850 billion worth of the banks’ liabilities—$690 billion in deposit guarantees and $163 billion in overseas borrowings guarantees;
> - The Reserve Bank of Australia has pumped in $43 billion in very favourable loans;
> - $16 billion worth of mortgage-backed securities has been purchased by the Commonwealth Treasury, to prop up smaller lenders, using the excuse of promoting “competition”.
> - His conclusion? “… we have world-class banks and a very good financial system.” !!!!!!
>
> [end CEC press release]

2) On 12 December 2010, ALP Federal Treasurer Wayne Swan announced that he was introducing legislation to allow the Big Four for the first time ever to sell “covered bonds”, and legislation to do so was duly passed in 2011. Covered bonds have long been used in Europe, but never before in Australia. The bonds are basically residential mortgage backed securities, but even though they are sold, the underlying mortgages are kept on the Big Four’s books. Thus, in the event of a default on the bonds, the buyer has access not only to the underlying mortgages, but to any and all other assets of the bank—the definition of “covered”. In other words, covered bonds are ranked above all other bank creditors, including individual depositors—a gross violation of the cornerstone *Banking Act 1959* upon which Australia’s present financial system still basically rests.

The covered bond legislation allowed for the Big Four to sell up to 8 per cent of their total assets in such bonds, a total estimated by the government to be $130 billion. Swan pledged that the government would buy $4 billion of those bonds immediately. In 2012 Australia’s Big Four collectively dominated the world in covered bond sales with CBA selling the second largest total in the world.

3) The government through the Reserve Bank is now creating a $380 billion Committed Liquidity Facility (CLF), an institution which Australian financial specialists report to be unique on the planet. Its purpose is to allow the Big Four to dump their RMBS into the CLF in return for liquidity at dirt-cheap rates, to satisfy Basel III capital requirements, but actually to keep pumping air into the bubble lest it pop. In addition, the chief vehicle used by the Big Four in the Reserve Bank of Australia’s repo market, are of course RMBS.

Aside from these measures, Australia has long had a tax incentive for property investors, called “negative gearing”. Individual property investors can claim any ongoing losses from an investment property off their income tax. This is such an incentive to buy investment properties, that out of 23 million Australians, as of 2011 nearly two million owned investment properties, and that year they claimed losses off their tax of $13 billion—a large amount by Australian standards.

The history, briefly

The following is a summary chronology of merely some of the highlights of the expansion of Australia's mortgage industry, to demonstrate the almost uninterrupted expansion of that bubble since its original creation, into today.

1999: Treasurer Peter Costello introduced a 50 per cent discount on capital gains tax. At the time the welfare lobby group, the Australian Council of Social Service, warned it would create a property bubble. Within a short time they were proven right.

2000: Howard-Costello government announced a $7,000 grant for first home buyers. The same year, Australian banks and mortgage brokers started issuing so-called "low-doc" and even "no-doc" loans, for people without normal credit histories. These loans were only 1 per cent of the total in 2000, but by 2008 such lending had increased to 20 per cent—Australia's version of sub-prime lending.

2003: The Age newspaper's economics writer Tim Colebatch reported on 8 July that the implications of the rapidly-growing housing bubble were understood at the highest levels. In an article called, "Why Costello should scrap negative gearing", Colebatch wrote, "As Reserve Bank governor Ian Macfarlane told the parliamentary economics committee last month, the main threat to the economy is the unsustainable growth in home lending and house prices. In six years, our after-tax income per head has risen 27 per cent. But average house prices have risen 85 per cent, and our housing debt has doubled to almost $400 billion. … But the biggest risk is that a bust in home prices will bring down the economy."

2006: Treasurer Peter Costello allowed self-managed superannuation funds to invest in property, and to borrow to invest in property.

2007: Banks started foreclosing on home owners in large numbers, throwing a lot of families onto the street. But house prices only declined marginally. It was later demonstrated that the banks sat on an enormous number of empty properties, refusing to sell, knowing such large-scale selling would crash prices.

2008: In the global shock following the collapse of Lehman Brothers, the Australian government sprang into action to avert a collapse of the property bubble, knowing it would cause the banks to crash. They guaranteed the banks' overseas borrowings, which they needed to keep lending into the local market, and on 14 October 2008 the government boosted the first home buyers grant. The First Home Owner Boost (FHOB) was announced, one month after Lehman Brothers filed for bankruptcy. For first home buyers purchasing an existing dwelling, the FHOB was a $7,000 boost to the existing $7,000 first home buyers grant introduced on 1 July 2000. An estimated 200,000 buyers took up the offer within the next year. Additionally, the government changed the requirements by the Foreign Investment Review Board, to allow temporary residents to purchase real estate in Australia without having to first gain approval from the FIRB. This boost was plainly not to make housing more affordable for home buyers, but to push up prices, which the CEC exposed in this press release:

CEC press release, 27 September 2010:

> **Rudd-Gillard increased home owners grant to make housing more expensive.**
>
> First home buyers of the past two years have been bled—by their own government.
>
> When the First Home Owners Grant was increased by the Rudd-Gillard government in October 2008, the public was told it was to support construction, and make housing more "affordable". …
>
> As revealed—but only in passing—in the June 2010 book *Shitstorm* by *The Australian*'s Lenore Taylor and David Uren, on the weekend of October 11-12, 2008, when Australia's financial system was on the brink, an emergency meeting of the Rudd government's Strategic Priorities and Budgetary Committee (SPBC)—Rudd, Julia Gillard, Wayne Swan and Lindsay Tanner—which included Treasury Secretary Ken Henry and Reserve Bank Governor Glenn Stevens, decided as one of their courses of emergency action to support the housing market, *to reverse the slight fall in house prices and get them rising again.*

How? *By increasing the First Home Owners Grant.* Use public funds to induce buyers to overcome their natural prudence and rush into the market, to drive up prices—which it did, by around triple the size of the increased grant. In other words, the worsening affordability of housing that occurred as a result of the increased grant wasn't an unintended consequence, *it was the aim.*

Taylor and Uren report, "Treasury's analysis had shown that, far from helping first home buyers get into the market, most of the benefit went to the people selling them their first homes, as the additional few thousand dollars was added to the price. 'One of the risks in the Australian economy—and we saw it playing out in the U.S. and elsewhere—was the risk of house prices falling sharply. One of our concerns about the option of the first home buyers scheme is that *it gets house prices up and that was the point.* In that week, we found ourselves quite comfortable with it for that reason. You're in a situation where bidding up house prices is not a negative,' [Ken] Henry says." [Emphasis added.]

It was that same weekend that the government propped up the banks with the twin guarantees—of deposits and of foreign borrowings—because the banks pleaded if they didn't, "they would be insolvent sooner rather than later" (*The Great Crash of 2008*, by Ross Garnaut and David Llewellyn-Smith).
But equally crucial to propping up the banks, was supporting their loans into the property bubble, for which most of the enormous foreign debt of Australia's banks—over $800 billion, of which over $400 billion was on 90-day-terms—was incurred. …

Summation

With such massive government aid to the residential housing markets, why so little aid to manufacturing and agriculture, which have been in dire crisis for at least a couple of decades? Because the entire financial system does not rest upon them, as it does upon the Big Four's dealing in RMBS.

How safe is your super?

Published 12 August 2013 in The New Citizen*, Vol. 7 No. 10 Reprint Edition*

Shortly after the CEC began its campaign in June 2013 to stop secretive plans by the Swiss-based Bank for International Settlements (BIS) to ram bail-in legislation through the Australian parliament, State Super Financial Services Australia (SSFSA) issued the following "Investment Viewpoint". Given the document's timing, as well as its obvious intent to reassure SSFSA's clients and perhaps others as to the stability of the Australian and global financial system—in which case bail-in would presumably never be needed—we reply, sequentially, to each of the SSFSA's assertions.

The purpose of "bail-in" legislation is to save those Too Big To Fail banks (including Australia's Big Four), whose unbridled speculation caused the 2008 GFC in the first place, and is now plunging the world into a far worse crisis. One of these TBTF banks, JPMorgan Chase & Co., is the Custodian for the SSFSA. The bank is one of the world's largest traders in derivatives, with over $75 trillion in current deals, and has just agreed to pay the US government an unprecedented $13 billion in fines for multiple crimes including rigging bond markets, betting against its own customers, mortgage fraud, and fixing electricity and commodity prices. In Italy, meanwhile, prosecutors seek its indictment for fraud in collusion with Italy's third largest bank, the scandal-ridden Monte dei Paschi in Siena in which JPMorgan Chase owns extensive shares (and in which the SSFSA has also invested). To protect such ill-gotten gains, JPMorgan Chase is leading the crusade in the United States against the reintroduction of the Glass-Steagall law to split normal commercial banking from the speculative activities typical of investment banks.

We have italicised certain words or phrases in the SSFSA document for emphasis, and explain their actual meaning in our accompanying commentaries.

Craig Isherwood
National Secretary
Citizens Electoral Council

What is the SSFSA?

Its public documents state that the SSFSA "provides past and present NSW and Commonwealth public sector employees and their family members with financial planning and funds management services". Managing more than $12 billion, the SSFSA was established by the SAS Trustee Corporation, itself 100 per cent owned by the SAS Trustee Corporation Pooled Fund. The present and former managers of the SAS Trustee companies, like many super fund managers, have been drawn from the ranks of former executives of such speculative giants as Deutsche Bank, National Australia Bank, Macquarie Group Limited, ABN AMRO, Royal Bank of Scotland, and Lazard, among others.


Investment Viewpoint

State Super Financial Services Australia

27 August 2013

What is the risk of a bank failure for Australian depositors?

The SSFA document "Investment Viewpoint"

The focus of global banking regulatory activity since the Global Financial Crisis (GFC) has been to reduce the probability and the severity of a repeat of the banking crisis that occurred in 2008. Regulators have approached this task by targeting the regulatory and operating environment within which banks operate.

The CEC responds: Notice that the "focus of global banking regulatory activity", is *not* to ensure the expansion of the world's *actual physical economy* nor the full employment and well-being of its citizens in all nations, but to ensure the safety of the banks. Ironically, if the former were ensured, then the latter obviously would be also. At present, however, according to those regulators' own figures, the banks are lending but a small fraction of their deposits into the real economy while the bulk of their funds are tied up in speculation on the financial markets.

In essence, the business of a commercial bank, one focused on accepting deposits and providing loans, revolves around using deposits to advance loans. They make a margin on the loan that is above the cost of the funds they have lent, delivering a profit to shareholders.

CEC: That is indeed the function of a "commercial bank" under the Glass-Steagall-style separation of commercial and investment banks which prevailed in the United States, for instance, from 1933 until the 1980s and in many other countries as well, but not the way banking functions at present, either in the U.S. or most of the world. The "margin" which the banks now make is drawn overwhelmingly from speculation, notably in the international derivatives trade now estimated at $1.4 quadrillion, 20 times the GDP of the entire world. Banking in the service of speculation rather than of the physical economy inevitably leads to a financial crash.

Prior to the GFC, the relatively lax global regulatory oversight of banks meant they could increase their leverage and maintain a very low level of capital to underpin those borrowings. A high level of leverage leads to strong profitability in a positive credit growth environment but also increases the sensitivity of the system to negative impacts from systemic shocks. In the GFC, we saw the equity of global banks being significantly reduced or extinguished entirely. In addition, if it was not for Governments providing guarantees for bank deposits and supporting the debt of banks, more banks would have defaulted.

CEC: That last sentence is the understatement of the year: in fact it is almost universally acknowledged that without such government guarantees *the entire world banking system would have collapsed*. And had the government of Australia not provided open-ended guarantees to all of the Big Four banks, those banks by their own admission would have certainly failed.

The negative impact of the GFC on banks was exacerbated by two contributing factors. One was the interconnected nature of the global banking system. In effect, banks conducted business with each other, whether that was in holding the debt of another bank or as a counterparty to a derivative transaction.

CEC: This is precisely what we said above: the banks were (and still are) mainly conducting speculative transactions with each other, not lending to the real economy.

The second issue was the increased size of investment banking operations. With these activities came greater exposure to increasingly complex derivative transactions. In the heat of the crisis, without clarity on the size and types of exposures to these transactions for individual banks, banks did not want to lend to each other, as they were not aware of the exact level of derivative exposure of the other bank. As a result, inter-bank activity froze and without this activity, the liquidity (the ability of a bank to pay back cash in the short-term) was significantly reduced.For some banks, this saw them default on their liabilities (i.e. Lehman Brothers) or get very close to such a situation. Indeed, without the significant injection of liquidity to capital markets provided by government agencies, the GFC would have caused even greater damage.

CEC: The above constitutes a straightforward admission that derivatives speculation *caused* the GFC. And the derivatives exposures of what the BIS terms Global Systemically Important Banks (G-SIBs), have soared since then. So have those of a second tier known as the Domestic Systemically Important Banks (D-SIBs), which include Australia's Big Four, each of which ranks among the top fifty largest banks in the world. Thus the BIS demands that each G20 nation enact bail-in legislation to prepare for the coming inevitable collapse, which has been temporarily forestalled by the "significant injection of liquidity by governments" to save the banks, estimated to be $23 trillion from the US Federal Reserve alone.

It is worth noting that the vast majority of derivative positions for commercial banking operations are for the management of interest rate risk within their assets and liabilities. This is quite distinct from the more exotic derivatives that were seen at the centre of the GFC. However, as noted above, the interconnectedness of the system meant that banks stopped wanting to deal with other banks because they were worried about potential insolvency and potential derivative exposures.

CEC: Following the passage of Glass-Steagall legislation in 1933, the world got along just fine for almost six decades without derivatives to "manage interest rate risk". In fact, such "plain vanilla" derivatives as "interest rate swaps" have helped bankrupt hundreds of U.S. cities, hospitals, school boards, etc., which were pressured or forced into buying them before the banks would agree to float their bonds.

In fact, most interest rates worldwide are pegged to the London Interbank Offered Rate (LIBOR), which a London-centred cartel of major banks has illegally run up and down like a yoyo for the past two decades for their own profit, thus ensuring "interest rate volatility". Most of those same banks are now under investigation by U.S., British, and Swiss authorities for also rigging the ISDAfix, a benchmark number used worldwide to calculate the price of interest rate swaps. In fact, the New Jersey-based firm ICAP, the world's largest broker of interest rate swaps, admitted on 25 September 2013, that it, too, had been involved in LIBOR rigging.

But even assuming that the "vast majority of derivative positions" are indeed contracted for banks' "management of interest rate risk", why has the Commonwealth Bank taken to *hiding* its actual derivatives exposure? And has there been so much "interest rate risk" that the derivatives holdings of all of Australia's Big Four have soared since 2008?

Regulatory Response

Regulators have responded to those issues by seeking to moderate the ability for banks to leverage their asset base and to operate across a broad spectrum of activities. The regulators are seeking to reduce the banks' risk profiles and moderate the interconnectedness of the global banking system. …

CEC: If that be true, then why in Australia, for instance, do the Big Four boast an astoundingly high average leverage rate (the ratio of loans to capital) of 26.5 to 1? By comparison, the leverage rate of the Long-Term Capital Management (LTCM) hedge fund shortly before its collapse in 1998 almost blew out the world's entire financial system, was 27 to 1.

The updated regulatory environment will mean commercial banks have a lower risk profile. *However, we would not suggest that the new measures mean a future banking crisis will not occur because in reality a banking crisis largely reflects a crisis of confidence. Given the current scenario of elevated indebtedness of banks and governments globally, confidence could be easily affected*. We have seen this happen when European debt concerns surfaced a number of times in recent years.

CEC: This constitutes a virtual admission that we are heading for a new GFC.

Depositor Positioning

[The SSFSA document here touts the importance of the $250,000 per depositor "guaranteed" by the Financial Claims Scheme.]

CEC: The FCS is worthless, as APRA and the FSB themselves have acknowledged. (See Fig. 2, p. 3 of this *New Citizen*.) Compare, for instance, the FCS "guarantee" of $20 billion per bank with the actual deposits of the Big Four as of 2012: ANZ, $397 billion; CBA, $428 billion; NAB, $420 billion; Westpac: $395 billion.

The importance of depositors to the banking system is also recognised by the Financial Stability Board (FSB), which has defined the "Key Attributes" for a resolution strategy to maintain a functioning system in the face of systemic stresses. …

CEC: One could drown in the hypocrisy here: the same FSB which is pushing full-steam ahead to bail-in depositors, claim to have those same depositors' best interests at heart, as amplified in the following paragraph.

[P]rotecting depositors is a key part of the FSB's resolution requirements in the face of a banking crisis. This focus on depositors helps bolster confidence in the banking system. The prioritisation of depositors can also be seen in the fact that depositors have a priority claim on the assets of a failed Approved Deposit-taking Institution (ADI), ahead of *other unsecured creditors*. APRA is charged with the prudential regulation and supervision of Approved Deposit-taking Institutions and has a mandate to ensure that, *under all reasonable circumstances*, they meet their financial promises to depositors, within a stable, efficient and competitive financial system. …

CEC: Note the admission here that depositors are in fact "unsecured creditors". Presuming they are not bailed-in, they supposedly rank first for payouts from a failed bank. In fact, then-Treasurer Wayne Swan ushered the *Banking Amendment (Covered Bonds) Act 2011* through Parliament which created a new, "secured" form of financial instrument which is guaranteed *ahead of depositors*, notwithstanding the *1959 Banking Act* which did prioritise depositors.

Meanwhile, the phrase "under all reasonable circumstances", is an escape hatch so big you could drive a semi-trailer through it. Will a global financial crash be regarded as a "reasonable circumstance"? If not, then any "prioritisation of depositors" goes out the window.

The Risk to Australian Bank Depositors

Overall, the Reserve Bank of Australia views the Australian banking system as well capitalised and strongly regulated. However, the system's reliance on some proportion of funding from overseas does mean we cannot be totally insulated in the event of global financial stress. Since the GFC, Australian banks have sought to moderate their reliance on funding their operations from overseas borrowing and this has been effective, with typical levels of overseas borrowing moderating from over 60% to around 30%. Importantly, on average, this borrowing has also been extended in maturity to reduce the shorter-term sensitivity to stress events in global financial markets.

CEC: Overseas borrowing is indeed a vulnerability, especially when such borrowing is used to make more mortgage loans to feed the Australian housing bubble. But a much greater vulnerability is the $23 trillion in derivatives held by Australian banks. That is the elephant in the room.

Overall, we would agree that the Australian banking system appears to be robust when compared to other banking systems. This view is underpinned by the broad support from credit rating agencies, who believe Australia's major banks are amongst the highest rated banks globally. The asset profile of Australian banks is typically more skewed towards the domestic housing market than for some of their global counterparts and this drives the strong focus of the RBA and credit rating agencies upon the health of the Australian residential housing market.

CEC: The exposure of Australia's banks to the domestic housing market is a terminal vulnerability, because the housing market is just one big bubble waiting to explode. The present debate as to whether the recent 5.5 per cent growth in house prices constitutes a bubble is a fraud—the Australian housing market has been a bubble for the best part of the last decade. Historically, house prices stay at a multiple of around 3 times annual income, i.e. around $150,000 for a household income of $50,000. In Australia it has been around 7 times annual income for a decade—the highest in the world. Already in April 2010 *The Economist* magazine calculated that Australian house prices were the most overpriced in the world, while a recent UBS report observed that "Australia may have the world's most leveraged landlords, making the nation more vulnerable to a property market collapse than regulators, banks and investors expect."

As noted above, there is a Government guarantee in place for depositors up to a level of $250,000. The question of whether this guarantee could be taken away in the case of a banking crisis is extremely difficult to answer but the FCS and depositor preference is enshrined in legislation. The example of Cyprus suggests that it could not be completely ruled out; however, we would underline the significant difference in the position of Australian banks to those in the periphery of Europe. …

CEC: Do you feel safer now? Without quite saying it outright, this whole paragraph basically admits what the CEC has been saying all along – that "depositor preference" *will* be taken away, "enshrined in legislation" or not. As for the "significant difference" in Australian banks, remember that they almost collapsed in 2008 and are in much worse shape today, with far higher derivatives and a loan base tied up in the world's worst property bubble.