Citizens Electoral Council of Australia

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Independent Political Party

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Don't be fooled: bank 'ring-fencing' is NOT Glass-Steagall

Financial System Inquiry chairman David Murray suggested 4 August that Australia should consider imposing a "legal separation" between the investment and retail parts of banks, which is called "ring-fencing".

He was echoed a day later by visiting former Bank of England Governor Mervyn King, who recommended that to avoid the "terrible moral hazard" of taxpayers bailing out too-big-to-fail banks Australia should look at the ring-fencing law enacted last year in England, based on the recommendation of an inquiry into the British financial system conducted by Sir John Vickers, the author of ring-fencing.

Australians who have followed the CEC's campaign for separating investment banking from retail banking should be aware: ring-fencing is NOT the same as the banking separation imposed by the Glass-Steagall Act, which was a total separation of the retail and investment banking sectors—no cross ownership, no shared directors, no contact whatsoever.

By contrast, the Vickers ring-fencing is the old "Chinese walls" separation, in which investment banking and retail banking still operate in the one bank, under the one board of directors, but supposedly kept legally separate.

When Vickers' proposal was debated in the British Parliament last year, experienced City of London bankers slammed it as unworkable, and warned that investment bankers would always look for ways around the separation.

In the House of Lords debate 26-27 November 2013, Labour Party peer Lord Barnett warned, "We are told by others that the professionals do not think that the new [Vickers' ring-fencing] system will work. We have heard that a firm of private consultants called Kinetic Partners surveyed 300 people [financial professionals], of whom 35 thought that it would work; the rest did not, and they are the people who know what it is all about. The noble Lord, Lord Forsyth of Drumlean, who spent seven or nine years as an investment banker, told us that '*bankers are extremely adept at getting between the wallpaper and the wall. If they can find a way to get around something, they will.*' We have seen that succeed. The financial crisis has been too big for us now to experiment. Now is the time for action, otherwise the lobbyists will have won yet again… However, if we managed to introduce a UK form of Glass-Steagall, strengthened to prevent lobbyists succeeding, we will have achieved something that has never been achieved before. We cannot wait for another big financial crisis. We must do it now…" [Emphasis added.]

Conservative Lord Lawson, former Chancellor of the Exchequer, declared, "I have always been in favour of full separation—I came out publicly in favour of it long before the Vickers commission was even set up. We know that this works. It worked in the United States for many, many years under the Glass-Steagall arrangements, and it is no accident that serious problems emerged after the *Glass-Steagall Act* had been repealed… Another of the things that the Vickers commission did not consider is the problem of governance. The ring-fence is a curious system, because there is one company with two subsidiaries—the retail bank and the investment bank—and we are told that they are completely separate, but they are together. There is a real question whether that model of governance is workable…"

Conservative Lord Hamilton of Epsom said, "My noble friend the Minister described the ring-fencing as robust. I do not know how he can speak with such confidence… I do know that many people in the City today are, as we speak, *working on ways to get around the ring-fence and to make sure that money held in clearing banks can be used in investment banks*. The problem is there is an enormous financial incentive to get around this ring-fence…" [Emphasis addeed.]

The attempt by these members of the Lords to amend the ring-fencing law so that it transitioned into full Glass-Steagall was narrowly defeated by just nine votes, but months later, the 5 April 2014 London *Telegraph* reported Lord Lawson's continued opposition to ring-fencing:

"Lord Lawson, the former Chancellor, has delivered a stinging attack on the Government's banking reforms, warning that they will not ensure the safety of the financial system. 'I don't believe our problems can be solved by a ring-fence between investment banking and commercial banking,' he told a conference… 'The Vickers model of corporate governance is one that has never worked anywhere in the world, and I don't believe it is workable. And I don't know any senior banker who believes privately that this model is workable'. Lord Lawson has been a long-time advocate of the full break-up of large universal banks…"

The *Glass-Steagall Act* was enacted in the U.S. in 1933 after it became evidence that the Wall Street banks which caused the Great Depression had repeatedly side-stepped the existing restrictions on contact between investment banking and commercial banking, which were similar to ring-fencing. Only the full Glass-Steagall separation stopped investment bankers from preying on the savings of the customers of commercial banks.

Tell the FSI: we will not be fooled—full Glass-Steagall now

The CEC is encouraging all Australians to get in now and have their say on this issue, by making a personal submission to David Murray's Financial System Inquiry to deliver the message: No to Australia enacting a bail-in law[1], yes to a *full* Glass-Steagall banking separation, with emphasis on the *full* separation—not a sham ring-fence.

Please go online for details on how to make a submission to the FSI[2]. Please note that the deadline for submissions is 26 August.

Footnotes
1) http://cecaust.com.au/releases/2014_07_17_Murray_Inquiry.html
2) http://www.cecaust.com.au/fsi/

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Murray inquiry sets stage for Australian bail-in law

The interim report of David Murray's Financial System Inquiry, released 15 July, pushes the case for supposedly solving the problem of too-big-to-fail (TBTF) by implementing "bail-in"—the system which includes confiscating customer deposits to prop up failing banks, Cyprus-style.

Furthermore, Murray recommends the Abbott-Hockey government continue the process commenced under the Gillard-Rudd-Swan governments, of aligning Australia's regulations with the Financial Stability Board's (FSB) Key Attributes of Effective Resolution Regimes, the financial measures to which G20 member countries are committed to comply, including bail-in.

Murray's interim report perpetuates the fraud that bail-in is a solution to TBTF banks, even though bail-in does nothing to reduce the size of the banks such that if they fail they won't damage the rest of the economy. Bail-in is presented as a way to ensure governments won't need to bail out a failing bank, because the cost will be borne by the bank's creditors instead.

(A bank fails when its losses are greater than its capital. In a normal bankruptcy, the bank's assets would be sold up and the proceeds distributed among its creditors, with depositors having a priority claim. In a bail-in, the TBTF bank is kept going, by forcing the creditors, including depositors which are "unsecured creditors", to take a drastic cut on what they are owed, sufficient to reduce the bank's liabilities below its assets, to pretend it is again solvent. In Cyprus in 2013, all depositors lost money, some more than 40 per cent of their total deposit.)

Murray effectively says that failing TBTF banks must be able to be resolved internally, so that there is no need for governments to bail them out. However, it cautions, this means that a bank's creditors (to whom it owes money) will have to accept losses, and the problem is that creditors are often other banks. If one bank's problems causes losses in other banks, it could trigger a wider banking crisis, which bankers call contagion. Therefore, Murray asks, which creditors are best able to absorb losses, in a way that doesn't risk financial instability?

This reasoning pushes the argument to one conclusion: shareholders and depositors.

The report highlights in blue the questions for further discussion: "Is it possible to reduce the perceptions of an implicit guarantee for systemic financial institutions by imposing losses on particular classes of creditors during a crisis, without causing greater systemic disruption? If so, *what types of creditors are most likely to be able to bear losses?*"

What is left unsaid in this argument, is that the specific area where defaulting banks are in danger of damaging other banks, is in their multi-trillion dollar derivatives gambling. When Lehman Brothers' bankruptcy in September 2008 caused it to default on its obligations to its derivatives counterparties in other banks, it blew a massive hole in the global derivatives bubble which triggered the global financial crisis that is still ongoing today. Murray is effectively making the case that a bank's derivatives gambling bets must be honoured above its depositors. (In the past 12 months, derivative gambling globally grew by 20 per cent, to around $2 quadrillion [thousand trillion] by some estimates, setting the world up for a new round of financial meltdown that will be worse than 2008.)

The interim report mentions bail-in four times, as a possible solution to TBTF. It also notes the gaps between Australia's current financial laws, and the FSB's "Key Attributes":

"The gaps identified include: powers to address a distressed foreign bank branch in Australia; the ability to require restructuring of a regulated entity to facilitate resolution; deficiencies in powers to resolve group distress; *a lack of statutory 'bail-in' powers to impose losses on particular creditors*…"

Murray explicitly recommends that the Hockey government continue the Gillard-Rudd-Swan government's process of working with the FSB to close the gaps, which can only mean one thing: finalise the legislation for bail-in powers that the FSB noted in its 15 April 2013 report was "in train in Australia".

Glass-Steagall

There is only one genuine solution to TBTF banks, which protects both the economy and bank deposits: a full, Glass-Steagall separation of investment banking from commercial banking, as mandated in America's 1933 *Glass-Steagall Act*. Under Glass-Steagall, the Big Four banks and Macquarie would be split up into completely separate new institutions: commercial banks that hold deposits and perform the so-called "boring", but safe, banking functions that service the community; and investment banks that engage in risky financial speculation. The two types of banking would have no contact whatsoever: no cross-ownership, no shared directors, no joint ventures. The commercial banks will be super-safe, and the investment banks will know that if their financial gambling goes bad, they are on their own, and will not be bailed out.

Murray's interim report noted that Glass-Steagall is an option, but argued the bankers' case, that a separation would be "expensive", to discourage any moves in that direction. A Glass-Steagall separation would indeed be expensive—to the financial gamblers who are currently able to gamble with depositors' funds, *not* to the depositors.

Make your own submission

All Australians who oppose bail-in and support Glass-Steagall should make that clear to the Murray inquiry, by making a personal submission to the second round of consultations before the deadline of 26 August.

Go to http://fsi.gov.au/consultation/submissions/ and under the section "Which Interim Report observations or question are you responding to?" click on "Stability—addressing too-big-to-fail", and then write your message in the area provided under "Submission summary".

Please reply to the CEC to indicate you made a submission, email to: cec@cecaust.com.au