How safe is your super?

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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.

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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 Euro-

pean 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.