**Citizens Electoral Council of Australia**

# Proposal for a Glass-Steagall separation of Australia's banking system

*For depositor protection, financial security and stability, and a banking system that meets the credit needs of the real economy, Australia must separate commercial banking from investment banking and other financial services.*

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## Introduction

The Australian banking system in its present regulatory form is a threat to Australians and a systemic risk to the Australian economy. Unless the Commonwealth government steps in and reorganises the banks, through a Glass-Steagall separation of commercial banking from all other financial services, Australia will suffer a devastating financial collapse.

Four very large, and one smaller, Too-Big-To-Fail banks dominate Australia's banking system: CBA, NAB, ANZ, Westpac and Macquarie Bank. They materially benefit from an implicit guarantee that the government could not, and would not, allow them to fail in the event of a crisis.[1]

The TBTF banks hold more than 80 per cent of Australian deposits. These are ostensibly guaranteed by the government up to $250,000 per person per Authorised Deposit-taking Institution (ADI). However, Australia's Council of Financial Regulators and the Financial Stability Board (FSB) at the Bank for International Settlements have already noted that the government would not have the funds to honour its deposit guarantee in the event of a failure of any of the Big Four.[2]

The TBTF banks are considered "sound". The government, banks and media repeatedly described them as such during the 2008 global financial crisis, claiming they were largely unaffected by the crisis, which was credited to Australia's effective prudential regulation. This was false. On the weekend of 11-12 November 2008 all five TBTF banks were forced to beg the Commonwealth government for guarantees to keep them solvent,[3] which Prime Minister Kevin Rudd provided: on their overseas borrowings, on deposits, and effectively on their exposure to the inflated housing market through a tripling of the First Home Owner Grant, resulting in even further increases in house prices.[4]

Today, the TBTF banks are even more at risk than in 2008. They have increased their exposure to the housing market, with mortgages now accounting for more than 60 per cent of the assets of each of the Big Four. Already in 2007 a confidential report[5] by banking regulator APRA (Australian Prudential Regulation Authority) had warned that lax bank lending standards had created a property bubble that presented a threat to the banks. Since then, mortgage debt has more than doubled, and to keep fuelling the market the banks have increasingly resorted to interest-only loans, which comprised 40 per cent of all housing loans in 2016. This is especially alarming when compared with the USA, where 25 per cent of all home loans in 2005 were interest only, which the USA's 2011 Financial Crisis Inquiry Report blamed for the wave of defaults in 2007-08 that triggered the 2008 financial crash. While APRA boasts that it has overseen a major increase in the banks' capital since 2008, it is so-called "risk-weighted capital", which translates to between four and five per cent total capital.[6] All of these factors force the conclusion that a property crash that triggers a banking crisis is inevitable in the near term.

The Republic of Ireland demonstrates what happens when a government guarantees banks that are exposed to a property bubble. The implosion of the Irish property bubble in late 2008 collapsed

[1] The guarantee is Australia's worst kept secret, only belatedly acknowledged by government ministers in relation to the 2017 bank levy, but long assumed by domestic and international financial markets.

[2] Minutes of 27th meeting of CFR, 19 June 2009; FSB Peer Review of Australia 21 September 2011.

[3] Ross Garnaut and David Llewellyn-Smith, *The Great Crash of 2008* (Carlton: Melbourne University Press, 2009).

[4] The tripled First Home Owner Grant was announced as a housing affordability measure, but the Rudd government's actual intention was to push up house prices—thus making housing *less* affordable—in order to prop up the market and save the banks from the same fate as those in the USA, UK, Ireland, Spain and other nations then suffering a property crash. Lenore Taylor and David Uren, *Shitstorm* (Carlton: Melbourne University Press, 2010), pp. 78-79.

[5] "Secret APRA report warned lax lending standards could lead to banking crisis and recession", ABC 7.30 4 April 2016.

[6] As mortgages account for more than 60 per cent of assets of the Big Four banks, and mortgages are risk weighted at 25 per cent, the around 10 per cent capital the banks hold against 25 per cent of the value of their mortgages translates into less than two per cent total capital; the higher risk weighting for the banks' other asset types brings total capital up to 4-5 per cent.

Ireland's banks, forcing the government to honour its guarantee of the banks' huge liabilities, which led to national bankruptcy, an IMF/EU bailout, and years of crippling austerity.

The other major point of alarm about Australia's banks is their massive exposure to derivatives, the risky financial instruments that were at the centre of the 2008 financial crisis. The banks claim their derivatives trades are normal hedging, but their exposure to derivatives is around eight times their assets, and has grown rapidly since 2008, from slightly less than $14 trillion to around $35 trillion. It is this incredible growth in derivatives that especially contradicts the claim of normal hedging (see Appendix A). Three of the five TBTF banks—CBA, NAB and Macquarie—have stopped disclosing their true derivatives exposure. They claim that the much smaller "net" figure they disclose, called "fair value", is a true statement of their exposure and risk, but accounting experts who refute this method of accounting were proven correct in the 2008 financial crisis.[7]

The present condition of Australia's TBTF banks, combined with emerging threats in the domestic and international economy, including the sharp increase in global debt, the US corporate debt bubble, and the intensifying European banking crisis, raises the need for the government to prepare for the likely failure of one or more of the TBTF banks.[8] The only effective measure to protect Australians against a financial crisis would be to implement a full Glass-Steagall separation of the TBTF banks.

## Glass-Steagall

The USA enacted the *Glass-Steagall Act of 1933* following an explosive Senate inquiry into the 1929 stock market crash and ensuing depression. The legal counsel who conducted the inquiry, Ferdinand Pecora, exposed a predatory banking culture in which banks employed aggressive salesmen to sell risky securities to their unsuspecting depositors. (The practices exposed by Pecora resemble the wealth management scandals that have wracked Australia's banks over the past decade or more.)

Glass-Steagall forbade commercial banks with deposits from owning an affiliate that traded securities, from sharing directors with an investment bank, and from evading these provisions by having any financial dealings with affiliates except in the most stringently regulated and controlled circumstances; it also established the Federal Deposit Insurance Corporation to insure bank deposits. Its purpose, stated in the Act's preamble, was: "To provide for the safer and more effective use of the assets of banks, to regulate interbank control, to prevent the undue diversion of funds into speculative operations, and for other purposes." The Act's banking separation provisions were in force for 66 years until they were watered down in the 1980s[9] and then repealed by the 1999 *Gramm-Leach-Bliley Act*.

The record demonstrates that Glass-Steagall worked. In the three years between the 1929 stock market crash and the passage of the *Glass-Steagall Act*, more than 6,000 US banks had failed. Under Glass-Steagall however, from 1933 to 1999 there were no systemic banking failures in the United States (the Savings and Loan crisis in the late 1980s was due to the watering down of Glass-Steagall, S&L's having been granted explicit exemptions to the *Glass-Steagall Act*). Yet within nine years of its repeal, the collapse of Lehman Brothers triggered a chain-reaction meltdown of the global banking system, which forced governments to intervene with massive taxpayer bailouts.

Following the 2008 crisis, many notable experts called for the restoration of Glass-Steagall, including:

• Former CEO Sandy Weill and former Chairman John Reed of Citigroup, the universal bank formed by the 1999 merger of Citibank with Travelers Insurance and its investment bank subsidiary Salomon Smith Barney, which provided the impetus for the repeal of Glass-Steagall; Weill's colleagues had

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[7] David Hirst and Andrew Linden, "Banks face challenge on billions of dollars of off-balance-sheet exposure", *Sydney Morning Herald* 4 November 2008.

[8] Due to their similar structures, a crisis in one of Australia's TBTF banks would likely be a crisis in all.

[9] In one instance, the Office of Comptroller of the Currency (OCC) in 1987 allowed commercial banks to ignore the *Glass-Steagall Act*'s ban on trading securities by ruling they could sell the new financial products called mortgage-backed securities (MBS); two decades later, these MBS products sparked the global financial crisis.

awarded him a plaque proclaiming him "The Shatterer of Glass-Steagall". In the 2008 crisis Citigroup required the largest government bailout of any bank in the world. By 2012 both men admitted the repeal of Glass-Steagall had been a grave mistake, and called for its return. Reed emphasised that the two types of banking are completely different, and must remain separate.

• Lord Nigel Lawson, former UK Chancellor of the Exchequer under Margaret Thatcher, who oversaw the 1986 "Big Bang" deregulation of the City of London which ended the separation of commercial and investment banking in the UK, and became a source of pressure for the repeal of Glass-Steagall in the USA. Lawson regards the ending of banking separation as a mistake, and also emphasises the differences in the nature of the two types of banking. In 2013 he led a push in the UK House of Lords to amend the *Financial Services (Banking Reform) Act* to legislate a full-blown Glass-Steagall separation in the UK; the amendment fell short by just nine votes.

• Don Argus, former CEO of National Australia Bank and former Chairman of BHP, said in *The Australian* of 17 September 2011: "People are lashing out and creating all sorts of regulation, but the issue is whether they're creating the right regulation…. What has to be done is to separate commercial banking from investment banking."

And many more, including:

• Bankers: Sir Martin Taylor, former CEO of Barclays; Peter Hambro of Hambros Bank family; Philip Purcell, former Chairman and CEO of Morgan Stanley; David Komansky, former CEO of Merrill Lynch.

• Regulators: Thomas Hoenig, Vice President Federal Deposit Insurance Corporation; Richard Fisher, President and CEO of Dallas Federal Reserve; Sheila Bair, former Chair FDIC; Andrew Haldane, Bank of England Executive Director for Financial Stability; Daisuke Kotegawa, former Deputy Director of the Ministry of Finance, Japan, and former Executive Director for Japan at the IMF; David Stockman, former US Director of the Office of Management and Budget.

• And a bipartisan cross-section of politicians have called for a Glass-Steagall banking separation: US President Donald Trump; Republican US Senator John McCain; Democratic Senators Elizabeth Warren, Maria Cantwell, and Bernie Sanders; Independent Senator Angus King; the 2016 platforms of US Democratic Party and Republican Party; Jeremy Corbyn, UK Leader of the Opposition; John McDonnell, UK Shadow Chancellor of the Exchequer; Andrea Leadsom, British Conservative MP and former City Minister, and former senior banker at Barclays; Lord Paul Myners, former British Labour MP and City Minister; Sir Peter Tapsell, former Minister and Conservative Father of the House of Commons; the late Malcolm Fraser, former Prime Minister of Australia.

## The USA's *21st Century Glass-Steagall Act*

In the United States Senate, Senators John McCain, Elizabeth Warren, Angus King and Maria Cantwell have introduced the *21st Century Glass-Steagall Act* (Appendix B): "To reduce risks to the financial system by limiting banks' ability to engage in certain risky activities and limiting conflicts of interest; to reinstate certain *Glass-Steagall Act* protections that were repealed by the *Gramm-Leach-Bliley Act*, and for other purposes." Under Section 2, subsection (b) Purpose, the bill stipulates:

"The purposes of this Act are—

> (1) to reduce risks to the financial system by limiting banks' ability to engage in activities other than socially valuable core banking activities;
>
> (2) to protect taxpayers and reduce moral hazard by removing explicit and implicit government guarantees for high-risk activities outside of the core business of banking; and
>
> (3) to eliminate conflicts of interest that arise from banks engaging in activities from which their profits are earned at the expense of their customers or clients."

Neither the USA's extremely complex, 848-page *Dodd-Frank Act 2010*, the UK's *Financial Services (Banking Reform) Act 2013* (with its fake separation called "ring-fencing"), nor the BIS-FSB's bail-in policy of increasing the Total Loss-Absorbing Capacity (TLAC) of globally systemically important banks (G-SIBs) have succeeded in solving the problem of TBTF banks, which are in fact bigger and more TBTF than in 2008. The *21st Century Glass-Steagall Act* would solve TBTF by restoring the Glass-Steagall firewall, under which no failing bank was able to threaten the entire banking system.

## Glass-Steagall for Australia

While Australia has previously not enacted specific Glass-Steagall legislation, regulations in place until the deregulation of banks commenced in the 1970s and 1980s effectively imposed many similar restrictions.

The Commonwealth Parliament has constitutional authority over banking (other than state banking). The 1937 Royal Commission on Banking found that the Commonwealth government is the supreme authority in the Australian financial system. It is therefore the responsibility of the Commonwealth government to protect the Australian people and economy from a banking crash.

The Commonwealth government must not outsource this responsibility to the so-called "independent" Reserve Bank or APRA. Like their international counterparts, these agencies have overseen the regulatory failings that have enabled the banks to ruthlessly exploit their customers and inflate massive speculative bubbles in the housing market and derivatives trading. Instead of rectifying these failings, they have applied in Australia the failed policies of the BIS, such as "bail-in" bonds for TLAC, which have put more Australians at financial risk.

The core business of banking—taking deposits and providing credit—is a socially-indispensable public function; in this respect, various experts have likened banking to utilities that provide power and water etc., which the public expect to be government-owned, or at least heavily government-regulated.[10] As the present condition of Australia's TBTF banks demonstrates, the deregulation of banking, and resulting farce of self-regulation, have fatally undermined this public function. The purpose of the strict regulations that the government imposed on the banks prior to deregulation was to ensure a stable banking system that functioned in the national interest.[11] Today it is in the national interest to avert a banking crash and to reorganise the banking system to serve the economy; therefore, the Commonwealth government must again assert its regulatory authority. Ironically, the most effective regulation is also the most efficient and least complex—Glass-Steagall.

The model that Australia should emulate to enact a Glass-Steagall separation of the banking system is provided in the 21st Century Glass-Steagall bill currently before the US Congress (Appendix B). Applied to Australia's banking system, it would involve the government legislating to direct all so-called universal banks (aka vertically-integrated banks or banking groups) to establish their retail divisions as separate, stand-alone commercial banking companies. The legislation would mandate a date by which the separation must be complete, encompassing a transition period of one or two years. Either the directors of banks would implement the separation under strict government supervision, or the government would step in and do it for them. In this period, the banks would operate under explicit

[10] Ben Chifley, Australia's wartime treasurer and later prime minister, likened banks to utilities in his dissenting report on the 1937 Banking Royal Commission; more recently, Minneapolis Federal Reserve President Neel Kashkari, the former Goldman Sachs executive who managed the Troubled Asset Relief Program (TARP) bailout of the US banks in 2008-09, also concluded that banks should be regarded as utilities.

[11] Following the 1892 financial crash, which wiped out most of the colonial banks, Australia's governments imposed strict capital requirements on banks, which successfully guarded against a repeat of the crisis. During the national emergency of WWII, Prime Minister John Curtin and Treasurer Ben Chifley directed the government-owned Commonwealth Bank to heavily regulate the private banks, in order to ensure that the national banking system provided the credit necessary for the war effort. Such regulations were an accepted responsibility of governments until the deregulation ideology took hold in the 1980s, with disastrous consequences—the USA's 2011 *Financial Crisis Inquiry Report* placed the blame for the 2008 crash squarely on deregulation and the weakening of bank supervision.

government protection, and the government should implement security measures such as capital controls, to guard against speculation and capital flight.

While the mechanics of a Glass-Steagall separation would vary slightly depending on the structure of the bank, the outcome would be uniform. Australia's predominantly commercial (retail) banks, including the Big Four and Bendigo etc., would split off their various other divisions—be they investment banking, insurance, wealth management, superannuation or stock broking—into one or more separate businesses, under different ownership and management from the retail division. For the predominantly investment banks, such as Macquarie Bank, it would be the retail divisions that are split off. The separation must also apply to foreign banks, which are predominantly investment banks, but some such as HSBC and Citibank operate as universal banks, and would be required to divest themselves of their Australian retail banking divisions. Foreign universal banks must not be allowed to offer retail banking services in Australia that would potentially expose Australian depositors to the risks of the foreign universal bank's other financial activities. (The two mentioned are particularly notorious: as noted, Citigroup required the biggest taxpayer bailout of all banks in the 2008 crisis, while HSBC in 2011 was caught laundering money for drug cartels and terrorists.)

The separation process would be straightforward, with the exception of the banks' over-the-counter (OTC) derivatives obligations, which are a complicated mess. Significant quantities of those trades are effectively underwritten by the banks' deposits. British banking economist John Kay, the author of *Other People's Money* and an advocate of Glass-Steagall, notes that separating deposits from all trading in securities and derivatives would remove the subsidy that deposits provide to such trading, which would also remove most, if not all, of the risks to deposits: "The subsidy to trading activities arising from the availability of the deposit base as collateral should be removed; the likelihood that the taxpayers' guarantee of routine deposits will be called will therefore be limited, if not altogether eliminated", Kay writes.[12]

To clear the retail banks of the derivatives obligations that their deposits have been used to underwrite, the derivatives would have to be "netted" out and cancelled. Daisuke Kotegawa, formerly the deputy director of Japan's Ministry of Finance and an expert at successfully resolving banking derivatives crises, advises announcing a date on which the banks' derivatives would be cancelled, to give their counterparties time to unwind their contracts, and then cancelling them on that date.[13] It is not the government's responsibility to honour the claims of counterparties.

At the end of this process Australia's financial system would be safer, less concentrated, and more productive. While CBA, NAB, ANZ and Westpac would still be large commercial banks, they would be smaller institutions, and no longer giant, vertically-integrated conglomerates of investment banking, insurance, wealth management, superannuation and stock broking. The government would still guarantee deposits as an ultimate safety net, but the real security for deposits, and the real strength of the banks, would come not from the size of the banks, but from being strictly separated from securities and derivatives trading. With the banks not being able to use their deposits to subsidise other, non-bank businesses, there would be more credit available for lending into the real economy.

## Conclusion

The Australian government will have to address a systemic banking crisis; its only choice will be whether to act before or after the crisis. The *21st Century Glass-Steagall Act* currently before the US Congress (Appendix B), which applies the lessons painfully learned from the 2008 banking collapse, provides an invaluable blueprint for pre-emptive action the Australian government can take to avert a similar, or likely worse, banking crisis in Australia. The time to act pre-emptively, however, is a luxury that is fast running out.

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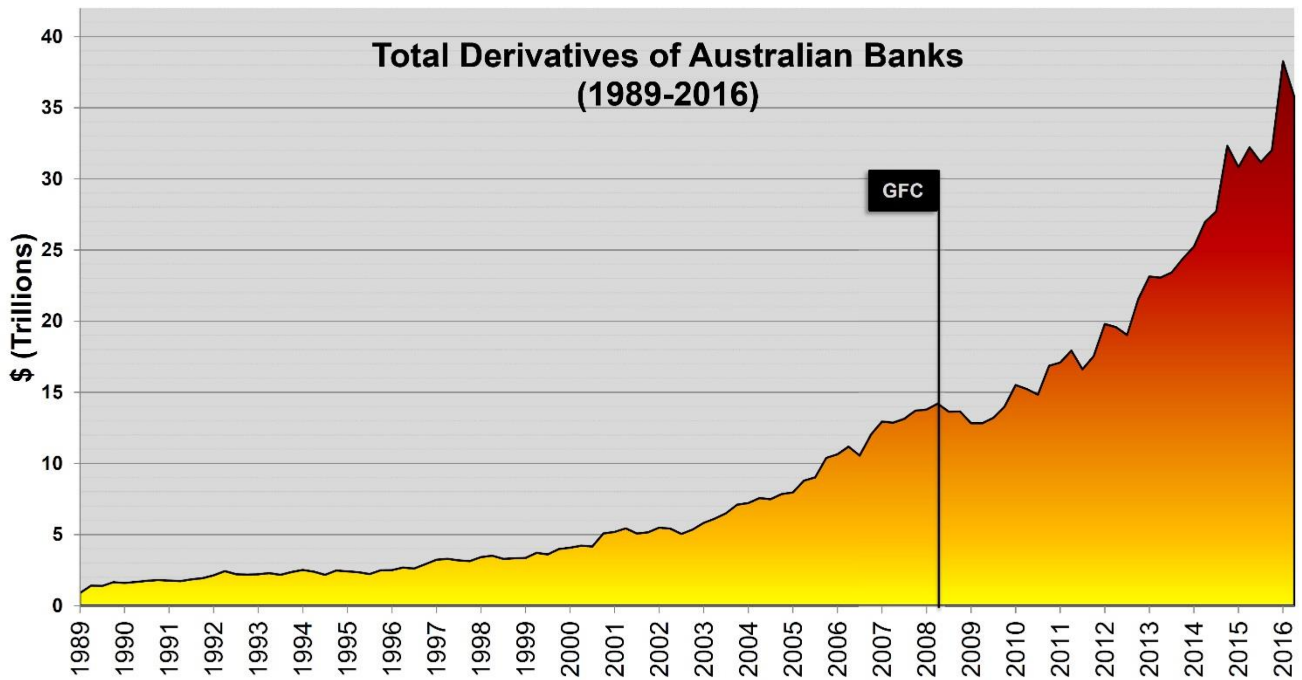
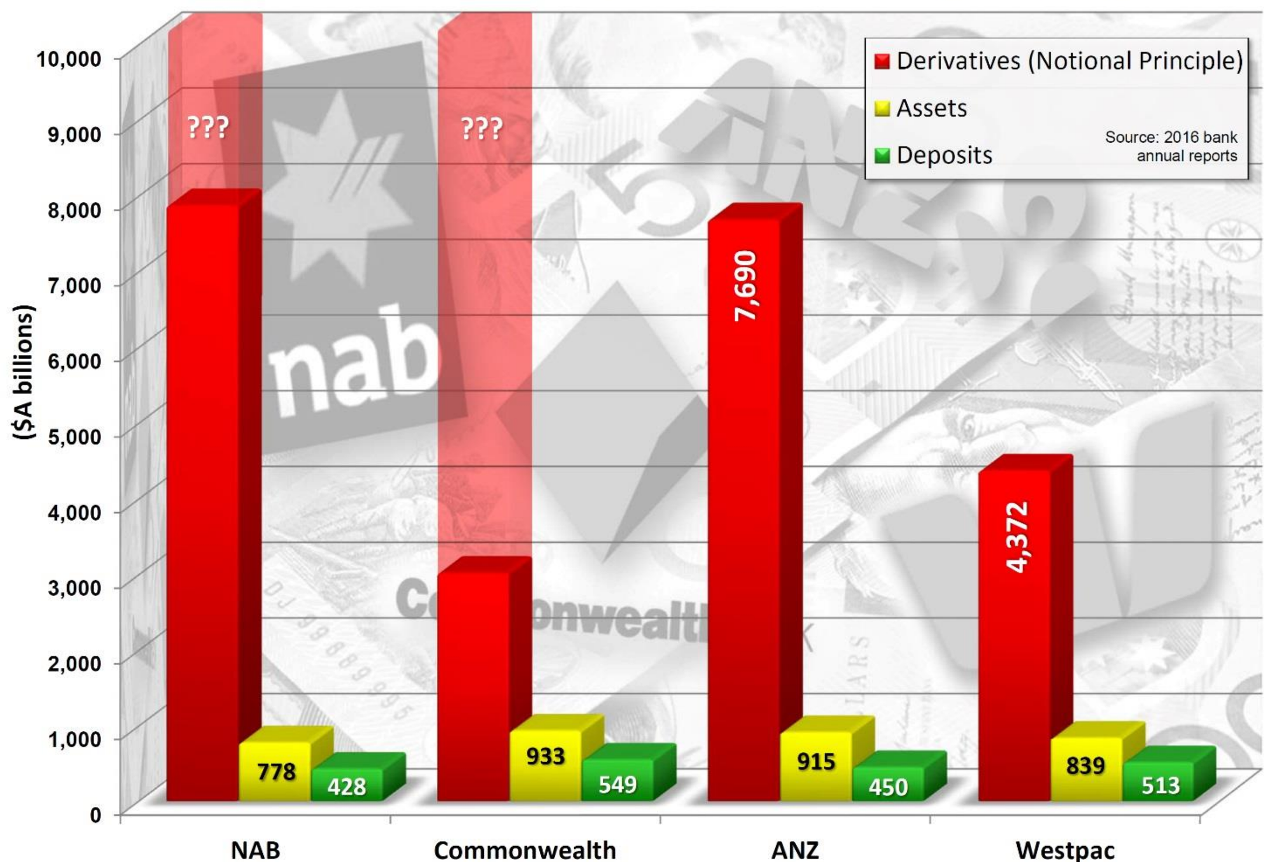
[12] John Kay, *Other People's Money* (London: Profile Books, 2015), Chapter 10: The Reform of Structure.

[13] "Japanese expert's solution for banks: Glass-Steagall, jail bankers, cancel derivatives", CEC media release 13 October 2016. Mr Kotegawa visited Australia in March 2014 and met with senior staff of the Commonwealth Treasurer (Joe Hockey) to recommend Australia implement Glass-Steagall.

# APPENDIX A – FINANCIAL DERIVATIVES GROWTH




In 2016, the NAB stopped disclosing the notional principal value of its over-the-counter derivatives contracts. The CBA stopped disclosing these same figures in 2012.

## Big 4 Derivatives (notional principle), Assets and Deposits (2012)

($A billions)

| | NAB | Commonwealth | ANZ | Westpac |
|---|---|---|---|---|
| Derivatives (Notional Principle) | 3,907 | ??? | 2,882 | 2,297 |
| Assets | 763 | 718 | 642 | 675 |
| Deposits | 420 | 437 | 397 | 395 |

Source: 2012 bank annual reports

## Big 4 Derivatives (notional principle), Assets and Deposits (2008)

($A billions)

| | NAB | Commonwealth | ANZ | Westpac |
|---|---|---|---|---|
| Derivatives (Notional Principle) | 3,362 | 1,426 | 1,911 | 1,682 |
| Assets | 657 | 488 | 471 | 440 |
| Deposits | 327 | 264 | 284 | 234 |

Source: 2008 bank annual reports

## APPENDIX B – The 21st Century Glass-Steagall Act of 2017

# S. 881

To reduce risks to the financial system by limiting banks' ability to engage in certain risky activities and limiting conflicts of interest, to reinstate certain Glass-Steagall Act protections that were repealed by the Gramm-Leach-Bliley Act, and for other purposes.

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IN THE SENATE OF THE UNITED STATES
April 6 (legislative day, April 4), 2017

Ms. Warren (for herself, Mr. McCain, Ms. Cantwell, and Mr. King) introduced the following bill; which was read twice and referred to the Committee on Banking, Housing, and Urban Affairs

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# A BILL

To reduce risks to the financial system by limiting banks' ability to engage in certain risky activities and limiting conflicts of interest, to reinstate certain Glass-Steagall Act protections that were repealed by the Gramm-Leach-Bliley Act, and for other purposes.

*Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,*

**SECTION 1. SHORT TITLE.**

This Act may be cited as the "21st Century Glass-Steagall Act of 2017".

**SEC. 2. FINDINGS AND PURPOSE.**

(a) FINDINGS.—Congress finds that—

(1) in response to a financial crisis and the ensuing Great Depression, Congress enacted the Banking Act of 1933, known as the "Glass-Steagall Act", to prohibit commercial banks from offering investment banking and insurance services;

(2) a series of deregulatory decisions by the Board of Governors of the Federal Reserve System and the Office of the Comptroller of the Currency, in addition to decisions by Federal courts, permitted commercial banks to engage in an increasing number of risky financial activities that had previously been restricted under the Glass-Steagall Act, and also vastly expanded the meaning of the "business of banking" and "closely related activities" in banking law;

(3) in 1999, Congress enacted the "Gramm-Leach-Bliley Act", which repealed the Glass-Steagall Act separation between commercial and investment banking and allowed for complex cross-subsidies and interconnections between commercial and investment banks;

(4) former Kansas City Federal Reserve President Thomas Hoenig observed that "with the elimination of Glass-Steagall, the largest institutions with the greatest ability to leverage their balance sheets increased their risk profile by getting into trading, market making, and hedge fund activities, adding ever greater complexity to their balance sheets.";

(5) the Financial Crisis Inquiry Report issued by the Financial Crisis Inquiry Commission concluded that, in the years between the passage of the Gramm-Leach Bliley

Act and the global financial crisis, “regulation and supervision of traditional banking had been weakened significantly, allowing commercial banks and thrifts to operate with fewer constraints and to engage in a wider range of financial activities, including activities in the shadow banking system.”. The Commission also concluded that “[t]his deregulation made the financial system especially vulnerable to the financial crisis and exacerbated its effects.”;

(6) a report by the Financial Stability Oversight Council pursuant to section 123 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (12 U.S.C. 5333) states that increased complexity and diversity of financial activities at financial institutions may “shift institutions towards more risk-taking, increase the level of interconnectedness among financial firms, and therefore may increase systemic default risk. These potential costs may be exacerbated in cases where the market perceives diverse and complex financial institutions as ‘too big to fail,’ which may lead to excessive risk taking and concerns about moral hazard.”;

(7) the Senate Permanent Subcommittee on Investigations report, “Wall Street and the Financial Crisis: Anatomy of a Financial Collapse”, states that repeal of the Glass-Steagall Act “made it more difficult for regulators to distinguish between activities intended to benefit customers versus the financial institution itself. The expanded set of financial services investment banks were allowed to offer also contributed to the multiple and significant conflicts of interest that arose between some investment banks and their clients during the financial crisis.”;

(8) the Senate Permanent Subcommittee on Investigations report, “JPMorgan Chase Whale Trades: A Case History of Derivatives Risks and Abuses”, describes how traders at JPMorgan Chase made risky bets using excess deposits that were partly insured by the Federal Government;

(9) in Europe, the Vickers Independent Commission on Banking (for the United Kingdom) and the Liikanen Report (for the Euro area) have both found that there is no inherent reason to bundle “retail banking” with “investment banking” or other forms of relatively high risk securities trading, and European countries are set on a path of separating various activities that are currently bundled together in the business of banking;

(10) private sector actors prefer having access to underpriced public sector insurance, whether explicit (for insured deposits) or implicit (for “too big to fail” financial institutions), to subsidize dangerous levels of risk-taking, which, from a broader social perspective, is not an advantageous arrangement; and

the financial crisis, and the regulatory response to the crisis, has led to more mergers between financial institutions, creating greater financial sector consolidation and increasing the dominance of a few large, complex financial institutions that are generally considered to be “too big to fail”, and therefore are perceived by the markets as having an implicit guarantee from the Federal Government to bail them out in the event of their failure.

(b) PURPOSES.—The purposes of this Act are—

(1) to reduce risks to the financial system by limiting the ability of banks to engage in activities other than socially valuable core banking activities;

(2) to protect taxpayers and reduce moral hazard by removing explicit and implicit government guarantees for high-risk activities outside of the core business of banking; and

(3) to eliminate any conflict of interest that arises from banks engaging in activities from which their profits are earned at the expense of their customers or clients.

**The complete *21st Century Glass-Steagall Act of 2017* can be read here:**
**https://www.congress.gov/bill/115th-congress/senate-bill/881/text**