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SUBMISSION TO THE FINANCIAL SYSTEM INQUIRY

Stability and Appropriateness of the Australian Banking System

I am an informed citizen who has serious concerns about

1. the probability of a major bank collapse of Australian banks that may devastate the Australian economy and public finances;
2. the measures being proposed to protect against this possibility, - namely, 'bail-in' and 'ring-fencing' as being very destructive or inadequate; and
3. lack of support for productive investment, infrastructure projects and innovation in preference for housing investment and speculative activity (eg. derivatives) provided by Australia's 'too-big-to-fail banks'.

The risk of another major financial crisis. I am informed that since the progressive deregulation of the banking industry in Australia, our 'too-big-to-fail banks' have invested heavily in highly-leveraged and unsafe investments such as derivatives and sub-prime mortgages (prior to and since the 2008 GFC). The extent of derivative exposure of each of our four major banks is in excess of Au\$3 trillion, built on a deposit base of some Au\$400 per bank. (See graph below). Whilst investment in derivatives may be highly profitable in good times, market reversals could lead to massive losses for our major banks, so large that even bail-out by the Australian Government may not be sufficient to save these banks. 'Bail-out' would also devastate our public finances, and given the high level of indebtedness of world-wide economies may be unaffordable in many countries so afflicted.

It concerns the writer that the current FSI does not appear to have addressed the potential or actual magnitude of risky investment exposures of our major banks to turn toxic and deliver financial disaster to this country. Are the derivatives exposures of our banks really in the order of trillions of \$\$s? Could bank collapse really devastate the modern Australian economy? If the answer to these questions is YES, then our community and our government deserves more appropriate advice from the FSI.

The likelihood of another global financial crisis. In this scenario of such a high level of indebtedness, both of government and non-government sectors internationally, and the numerous hot-spots of military conflicts around the world that could erupt into warfare, it is deemed by responsible analysts that the likelihood of a major international financial crash happening is very high, and 'sooner rather than later'.

Bail-in. In such a climate of nervousness about another imminent GFC, it is not surprising that banking interests have been lobbying governments around the world to legislate to permit 'bail-in', as happened in Cypress in 2013, when their banks would have defaulted but were legally permitted to steal deposits of their customers. Such an option, though clearly favoured by banks that gamble in risky investments, would certainly not be acceptable to bank depositors. These depositors include not just individuals, but also businesses, investment funds and superannuation funds. Bail-in would create a huge credit crunch to the extent that multi-billions of dollars of depositors money would be lost to the economy, in the attempt to rescue our 'too-big-to-fail banks' from their propensity to gamble in highly risky investments. Bail-in would also be deemed as a betrayal by governments of its citizens and businesses, many of whom do not appreciate that as bank depositors they are regarded as 'unsecured depositors'. Governments would have to introduce bail-in legislation secretly, without any notion of informed consent being allowed for the public. There is also the distinct possibility of corrupt inducements being directed at politicians to vote in favour of bail-in. Few people in Australia appreciate that government guarantees for bank deposits are limited to about 20% of current levels of bank deposits. Bail-in, of course would extinguish such guarantees.

Ring-fencing. The proposal to somehow separate the low risk commercial activities of banks from their high risk investment exposures, sounds of merit at first consideration. But there are doubts that it could

protect economies and depositors from full-blown bank collapse. The recent collapse of Portugal's Espirito Santo Bank showed that 'ring-fencing' did not work. That bank's collapse required not just 'bail-in' but also 'bail-out' by a government already highly indebted itself, pushing Portugal closer to sovereign collapse. Ring-fencing in this instance neither protected depositors nor taxpayers. Ring-fencing may help to provide assurances that something is being done to protect against bank collapse, helping to prevent rapid withdrawal of deposits from unsafe banks. However, such assurances are likely to be illusory. In addition, ring-fencing does nothing to correct the innate instability and distortions of the banking system.

Investment Distortions of Australia's Banking System. Currently our banks invest in order to maximise their profits, as would be expected of all privately owned businesses. Their investment decisions, underpinned by depositor's money, have favoured investment in the housing mortgage market, so creating a housing bubble and inflation of property prices. Like all financial bubbles, this property market bubble is likely to burst, with destructive consequences to mortgage holders and their lenders. In addition, the banks have opted to invest in high-yielding derivatives and other risky investment products that unfortunately carry a high risk of reversal to significant losses, in adverse market situations. Under our banking system, funding for farming, small businesses, venture capital and infrastructure projects is restricted and difficult to obtain. This diverts funding away from productive and infrastructure investments that are essential for the future wealth-creation of this country.

Australia needs safe banks. It is undoubted that there is clear concern that our financial system is built on institutions that have thrived in a less regulated environment, but which have become liable to over-indebtedness and more prone to default. Should a bank collapse occur, the economic consequences for this country could be dire at best, but at worst, catastrophic, comparable in degree to that of the 1930's depression. It is imperative that Australia commences the transition to a predominantly safe banking system, in which depositors know that their money is safe in the financial institutions, and in which the government can confidently guarantee deposits, knowing that they will never have to bail-out depositors funds, because safe banks will be regulated so that they will never fail. We also need a banking system that will support infrastructure projects, business investment, venture and innovation projects better than our current banking system provides.

It concerns the writer that the chairman of the FSI when questioned at the Melbourne Forum on 14 August, admitted he knew of no 'safe' bank in Australia, suggesting that the issue of safe banks has received little attention from the FSI.

The instability now inherent in the world's 'too-big-to-fail banks', seems to have developed historically since the end of the Glass-Steagall banking legislation in the USA in 1999. In Australia a sequence of legislative changes allowing significant deregulation of the banking system had similar effects in the Australian financial system. The Glass-Steagall banking structure provided for safe banks, and infrastructure banks in which depositors funds were absolutely safe. It assisted in providing a stable financial banking system in the period following the 1930's depression.

It concerns the writer that the current FSI in Australia seems to have given no priority to the option of safe banks, particularly based on the previously successful model of Glass-Steagall.

Recommendations

1. The FSI should advise the Australian Government and the community of the exposure of our 'too-big-to-fail banks' to highly risky investments such as derivatives, which have the potential in adverse market conditions, to cause financial collapse of these banks and of our economy.
2. The FSI should add to its list of recommendations that the Australian Government facilitate the urgent establishment of 'safe banks' in which depositors funds are safe and can be fully guaranteed.
3. That the Australian Government should seriously consider a major reform of the Australian financial system along Glass Steagall lines into government-guaranteed 'safe banks' that invest in the economy, and speculative investment banks that are allowed to gamble but which have no taxpayer protection.

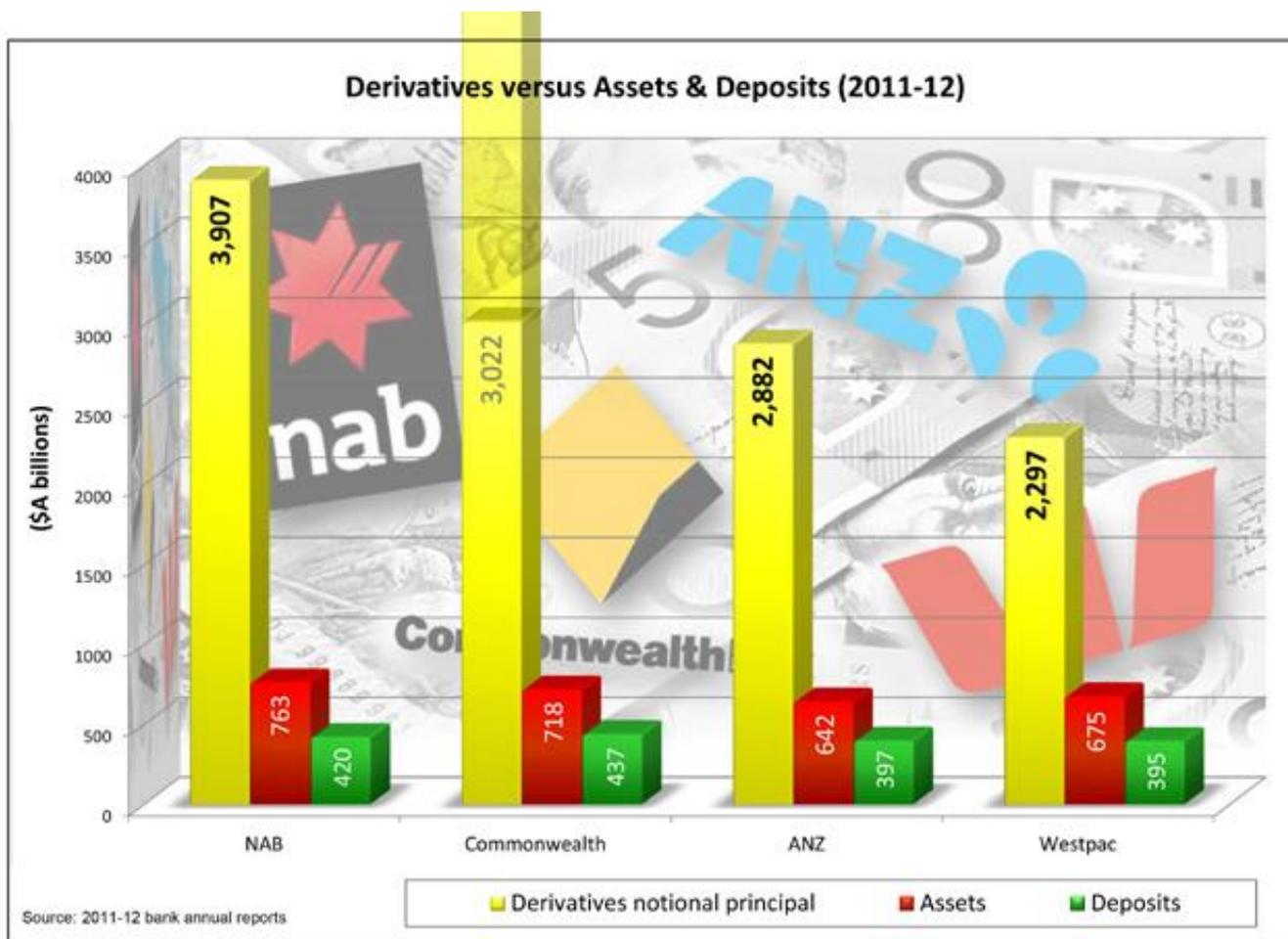
There would be an element of scandal should a major bank crash occur if this FSI had not given the warning about risk of bank collapse and included safe banks in its recommendations.

In summary, until convinced otherwise, on the best available evidence it appears to this writer that the priority of a responsible FSI should be –

- to help protect Australia from the irresponsible investment practices of our ‘Too-Big-To-Fail Banks’ rather than
- to help rescue these banks from consequences of their high-risk and speculative investment activities.

Yours sincerely,

DR. JOHN PIESSE



* The CBA does not currently release figures of its derivative exposures as do other major banks.