Submission to the Financial System Inquiry

Stability—addressing too-big-to-fail

"The study of money, above all other fields in economics, is one in which complexity is used to disguise truth or to evade truth, not to reveal it. The process by which banks create money is so simple the mind is repelled. With something so important, a deeper mystery seems only decent."

John Kenneth Galbraith

Submission by Anthony Allison

This financial inquiry is now considering the question of Systemic Risk and "Too Big To Fail" banks.

The 1933 Pecora Commission, in seeking to uncover the causes of the 1929 financial collapse, found that irresponsible bank behaviour was the main cause of the Great Depression of the 1930s. Chief Counsel Ferdinand Pecora revealed that bankers could not be trusted to regulate their own behaviour in the face of the great temptation to abuse the tremendous power that banks are granted via their banking licence.

The GFC was brought on by similarly irresponsible behaviour by banks.

Now we are faced with the question: what to do about banks that are "too big to fail"?

The obvious answer is to separate the banking functions (as the Glass-Steagall law did in the United States) to ensure that banks in Australia are not "too big to fail". Under Glass-Steagall, TBTF banks are broken into two totally separate entities:

Commercial banks which take deposits, are regulated and whose depositors' funds guaranteed.

Investment banks speculate at their own risk with money that their own customers knowingly "invest" in the investment bank in expectation of speculative profits.

To maintain the health of a "Systemically Important Financial Institution", the solution is not to underwrite the bank's total debt (which is inflated by speculation) but to reduce the size of the institution by breaking it into two parts:

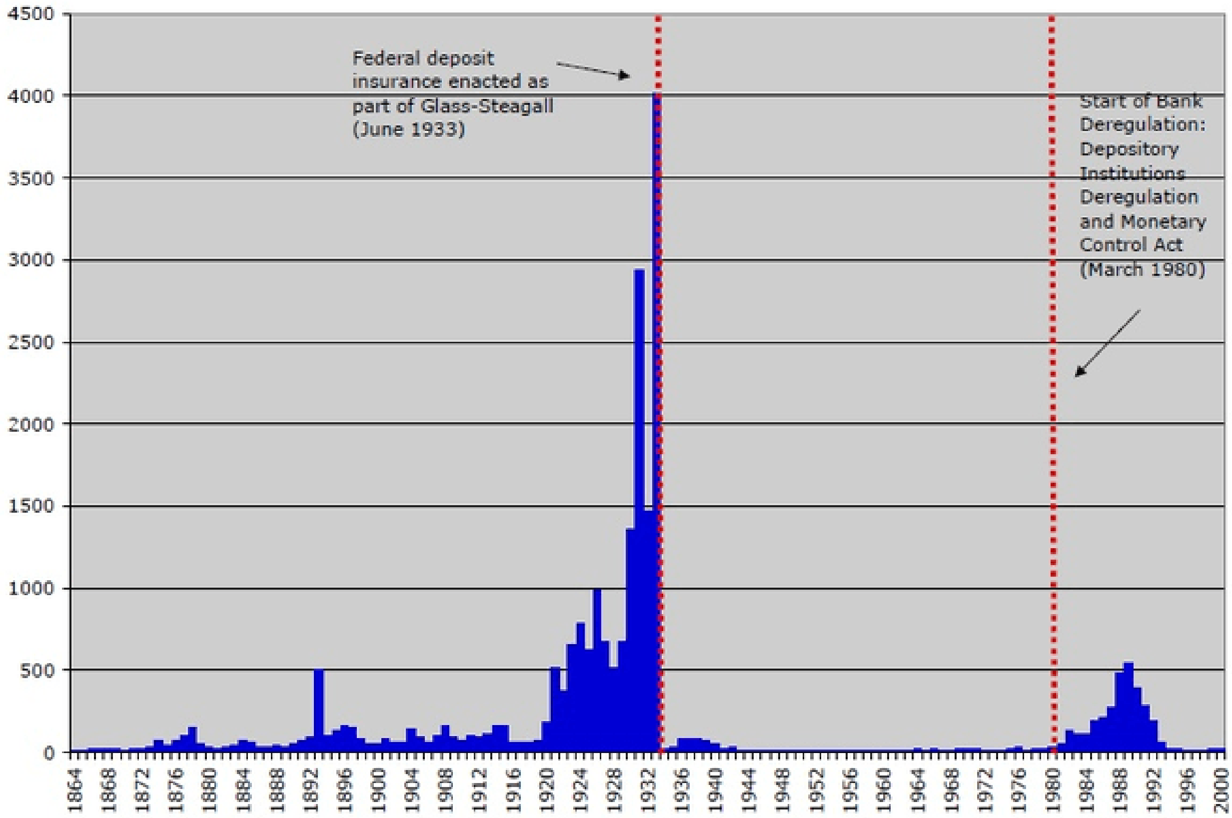
1. The commercial bank with depositors' funds guaranteed by the Australian government

2. The investment bank free to speculate with the funds of its investors but without the safety net of a government guarantee.

This is the underlying philosophy of Glass-Steagall and Australia should implement such a law in order to protect depositors' funds and relieve government of the responsibility for debts arising from speculation.

As was demonstrated during the Pecora Commission of enquiry into the behaviour of banks leading to the Great Depression of the 1930s, banks cannot be trusted to regulate themselves. The temptation to put personal financial gain above the interest of the community is just too great.

The American Glass-Steagall law effectively separated the speculative investment banks from the productive commercial banks and heralded a period of great stability for over eighty years in the American banking system as demonstrated by the graph below which shows US Financial Institution Failures in blue. The period shown is 1864 to 2000.



Sources: Historical statistics of the United States: colonial times to 1970 (Washington CD Government printing office, 1975). Series X-741 (p 1038); Failures and Assistance Transactions". Table BF02, FDIC website.

Glass-Steagall was progressively undermined and finally repealed under the enormous and unrelenting pressure of the banking lobby. The graph tellingly illustrates the consequences of the repeal of Glass-Steagall in terms of the stability of the banking industry.

A Glass-Steagall separation of the TBTF banks in Australia is needed to protect the deposits of ordinary Australians from the self-serving behaviour of bankers which, sadly, history has shown to be the inevitable outcome of an unregulated banking system.

I appeal to this enquiry to heed the words of John Kenneth Galbraith and not be deceived by the bankers' claim that a bank can be “Too Big To Fail”. This is just banker-speak for: “leave us alone – we are too important to be meddled with!”

The five Australian banks can no longer be saved from failure by government guarantee of deposits because the financial losses of a failure would exceed Government's capacity to pay.

This is why the Bank for International Settlements is pushing for Australia to introduce “bail-in” legislation to protect systemically important banks.

However "bail-in" threatens depositors' funds because in bail-in, depositors are regarded as "unsecured creditors" and their funds (deposits) are regarded by banks as a legitimate source of funds for a bail-in of an insolvent bank.

Against the sophistry that tax-payers should be spared the cost of bail-out, bail-in seeks to confiscate depositors' (aka "unsecured creditors") funds to counter a bank deficit on the scurrilous assertion that depositors place their funds in the bank knowing and accepting the risk associated with the "investment of their savings" in order to gain profit by way of interest earned.

This assertion is scurrilous because the interest paid on customers' deposits is invariably minimal and much less than the rate of inflation. Depositors are taxpayers and so asserting that bail-in will save the taxpayer is a disingenuous assertion because the depositor whose savings are confiscated by bail-in is, after all, also a taxpayer.

Since the GFC, the western world has stagnated. Economies have stalled, business complains that banks are not lending to business ventures and productive industries like automotive and manufacturing are shutting down. In the case of Argentina, a US court is attempting to force a sovereign nation to submit to the claims of a "Vulture Fund" seeking profit to the detriment of the welfare of the people.

Billions of dollars have been injected via Quantitative Easing yet the outcome appears to be increasing financial derivatives speculation while public assets are being sold off to fund government deficits. This is not a healthy condition for the physical economy or for the people of Australia.

It is past time to rein in the arrogant power of the banks. In determining what to do about Too Big To Fail, the only legitimate course in terms of the general welfare of the Australian nation is to reduce the size of Systemically Important Financial Institutions. The proven way to do this effectively is to implement a Glass-Steagall separation of the commercial and investment arms of the bank so that there is a total disconnect of both parts.

I hope that this will be a key recommendation in the final report of this Financial System Inquiry.

Anthony Allison

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