APRA – RESPONSE TO PROPOSED REDEFINING THE CAPITAL BUFFER FRAMEWORK FOR AUTHORISED DEPOSIT-TAKING (ADIs) FINANCIAL INSTITUTIONS

WHERE IS THE WIDER CONTEXT?

APRA has argued that Australia's ADIs are highly capitalized and 'unquestionably strong' and there is a need to make them 'resilient' by redefining the capital buffer framework. Omitted is any explanation for the meaning in and reasoning for a mind-set change from 'unquestionably strong' to 'resilient'! Omitted also in the Discussion and Response Papers is the relationship between the wider context in which these proposed changes fit[1]. Nor is there any explanation what assets have made ADIs 'unquestionably strong', how this has come about and under what conditions would this be sustainable when the wider context is factored in ?[2] The ADI's asset base must have a strong bearing on how the proposed redefinition of the capital buffer is related to the international landscape and the instruments at play in it. Given the repetitive phrasing, 'global financial stability' used by financial institutions, such as the Bank of International Settlement (BIS), Reserve Bank of Australia, Treasury , APRA and the media, the public is aware that Australia's ADIs have an international context. Therefore, any redefinition of capital buffers to enhance 'loss absorbing capacity in times of financial stress' needs to have credibility within that wider financial context[3].

When the repetitive parenthood statements, such as 'financial stability' are put aside, the underpinning agenda for why these changes are proposed remains obfuscated, other than an unquestioned adherence to Basel III. It is concerning that phrasing such as 'agreed capital framework', risk-weighed assets', 'frameworks for credit risk, credit valuation risk and operational risk' etc permeate the papers when none of the reasons for why Basel III exists are made explicit, challenged or indeed reformed. What is needed is transparency about some of the background variables that make up the wider context, particularly in relation to what variables pose the greatest financial stress and who benefits from the proposed changes and do they affect sovereignty over monetary policy? In both the aforementioned papers the nexus between the national and international financial system as a whole is omitted, including how the technical changes in the capital buffers are related to the wider context in which they must show 'resilience'.

WHAT HAS BEEN LEARNED FROM THE GLOBAL FINANCIAL CRISIS – THE DERIVATIVES MARKET?

The GFC was brought about, in large part by greed and dishonesty in the derivatives market and bad management of leveraging. e.g. Collaterised Debt Obligations. The derivatives market has grown exponentially since the GFC so the problem has not been solved. Instead, it has accelerated since

[11] Discussion Paper – A more flexible and resilient capital framework for ADIs APRA 8.12.20 and Response to Submissions – A more flexible and resilient capital framework for ADIs APRA 8.12.20

[2] The IMF has recognized the business model concentrating on dwelling stock that puts Australia's ADIs at variance with the rest of the world with over 60% of assets concentrated in the residential mortgage market.

[3] Littrell Charles 'APRA's Basel III Implementation and Rationale 23 November 2011 omitted reference to derivates yet this was a workshop on explaining to the participants the agreed Basel III reforms.

2007/08 to-date. There doesn't appear to be any political will, either globally or nationally, to address the root cause of the risk these bring to the global economy and financial instability[4]. Central banks have shown no incentive or intention to address the fundamental issue of the derivatives markets.[5] To do so would appear to be at variance with the interests of the central banks and their lobbyists.[6]

Shareholders in Australia's banks, particularly the 'Big Four' are pushing institutions into higher risk undertakings. This has been aided and abetted by aggressive injections of liquidity, manipulation of the yield curve on bonds and pushing interest rates to historically low levels Growth in exposure in the derivatives market in Australia has grown from $14n at the time of the GFC to $54Bn by March 2020. Banks have been increasingly reliant on derivatives since then.

The derivatives trade has become more complex with few people understanding how it works and in what traders are trading.[7] They can be high risk instruments where trade can be disconnected from the value of the underlying asset as the market continues its addiction to leveraging, most often in the exchange traded derivatives. They are largely off the balance sheet and questions arise about returns being properly taxed, if taxed at all.

Not all derivatives are 'bad' and indeed necessary to minimize risk. However, the GFC showed how leveraging can destroy financial stability and indeed continue to threaten it. [8] Perhaps only 20% of derivatives justify as legitimate insurance. There remains 80% of 'paper derivatives' that are no better than casino gambling and described by Warren Buffet as 'weapons of mass destruction'. Traders working inside the global banks will either long or short the bond markets and then leverage the derivative to maximize potential profits. They are depending on massive liquidity injections into the financial market because they are operating on very low percentages. Volume is the basis on which profits on low interest rates are earned. The central banks are responding by pumping massive QE into the banking system. The central banks are justifying the QE by asserting they are fulfilling their statutory role of supporting global financial stability. It is more probable they are creating financial harm in their keenness to maximize profits in the derivatives' markets!

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[4] The recent squeeze in GameStop gives an excellent insight with only one stock on how the derivatives market is played!

[5] Reference to the derivatives market also include its volatility. Not only is there no reporting on its volume there is nothing about its volatility yet both have a profound influence on financial stability – the root cause which is ignored in the BIS pushing for sovereign states to redefine their capital buffer frameworks as per Basel III

[6] Jamie Dimon CEO of J P Morgan Chase could be expected to actively oppose any intervention in the derivatives market to stablise the global financial system given the profits made from his active trading in them. It is more than reasonable his attitude would be supported by other CEOs of the major international financial institutions who operate at a supra national level.

[7] Derivatives traders in Australia have been considered so dumb by their USA counterparts they could be sold anything! This comment was made directly to me by a derivates trader, ex Goldman Sacs and now working as a sought after trader in the financial sector in Australia. Today, his specialised role is to 'handle' difficult derivatives, which decoded means off loading bad derivatives his employer a major ADI doesn't want to hold.

[8] Global derivates exposure is estimated at one quadrillion (YouTube David Hunter Peak Prosperity 8.1.21) Valuing in notional value, gross value and gross credit will give different values. March 2020 bank swamp lines had to be BAILED OUT giving evidence of the risk derivatives pose to financial stability!

The 2013 created Trade Repository Data on Over the Counter derivatives has not allayed concerns about their risk to financial stability[9]. That depository is simply data collecting with the Reserve Bank taking the position it will use the data to research its implications on financial stability.[10] Even in its 21 June 2018 Bulletin it had only abstracted from the Singaporean repository, data on Australia OTC interest rate derivatives which gave a well researched descriptive perspective on the trade. It is questionable the Reserve Bank could use that description to generate credible comment on the risk OTC derivatives mean to financial stability either nationally or internationally. It has had that research bulletin for over two years to act on it!

Given the exponential growth in derivatives since the GFC; the fact that exposure to Over-the-Counter derivatives between banks in particular remains unresolved, compounded by the fact that the notional value of exposure to derivatives is deliberately withheld by the ADIs, questions the credibility of any stress testing of ADIs for 'strength' or intended 'resilience'. Derivatives have first claim on an ADI's assets, so what is happening in that market is where the real risk to financial stability lies.[11] Redefining the capital buffer framework to allegedly enhance 'resilience' against financial instability is fiddling with the capital buffers against an unknown scale of potential instability brought about by the domino effect of counter-party settlements in the derivatives market be they OTC or exchange-traded.

Deregulation of the financial sector has brought about undesirable and dangerous consequences to the financial stability of ADIs. Yet, rather than focusing on the fundamental threats, particularly the derivatives to financial stability , APRA's is focusing on fiddling with 'redefining ' the capital framework in a manner that presents as 'regulating' the ADIs with more of a bark than a needed bite. Deconstructed it is reduced to a non-public skirmish between the banks and the regulator. What is proposed is too little but creates the impression of 'doing something' rather than taking on the needed structural reform to give strength and resilience to the financial institutions with a focused agenda on national stability and confidence. This would be consistent with the Reserve Bank and APRA's statutory aims. Instead, APRA is redefining the capital framework of Australia's ADI's in part, to adjust to internationally harmonized definitions of capital and risk weighted assets. It is alleged this will improve "transparency, comparability and flexibility of the capital framework"[12] It brings ADIs into more intimate alignment with the central banks. The Federal Reserve is privately owned and so are others in part. Their agendas may be at variance with the respective national interests. What is concerning is lack of transparency about the context for these proposed changes. Rather, there appears to be a deliberate

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[9] Basel agreement on a Trade Repository Data collection

[10] Duke Cole and Daniel Ji The Australian OTC Derivatives Market – Insights from New Trade Repository Data' Reserve Bank Bulletin 21 June 2018 gave insights into the Australian OTC interest rate derivates but could only conclude that "Reserve Bank intends to use these data (from the then recently created Trade Repository Data) for further research into financial stability risk and financial conditions, and CCP supervision."

[11] Stability is endeavoured to be legislated in the Financial Sector Legislation Amendment (Crisis Resolution Powers and Other Measures) Act 2018 see section dealing with Conversion and Write Off and the Explanatory Memorandum s5.12 and s5.15. The latter provides for conversion of instruments that would otherwise not be considered capital! This opens the loophole for deposits to be converted into equity. The Financial Claim Scheme is only activated in the event of a qualifying ADI becoming insolvent and not whilst it is in the process of being deemed insolvent.

[12] APRA Response Paper 2.1

obfuscation about what central banks are doing and the consequences of it. Aligning the ADIs with Basel III, the Bank of International Settlement and pressure from the International Monetary Fund's (IMF) allows unelected international bodies to bypass Australia's Treasury and Parliament in directing monetary policy in Australia. In the absence of effective political oversight it is complicit in making the central banks more powerful than the state and giving more power to secretive bank lobbyists.

LIQUIDITY INJECTIONS AND ASSET INFLATION

Currency has poured into the equities and realty markets and not economic growth. This trend was in place well before COVID-19. As at January 2021, global debt was reportedly standing at $250Tr[13] and malinvestment is being generated by virtually free credit as a result. The equities market is characterized by its disassociation from economic growth and excessive debt has enabled market multiples to distort to unsustainably excessive heights on an unprecedented level. It's called inflation and brings into question credibility in the fiat currency. Australia's ADIs function in this wider context where leading questions have to be, 'who owns this debt' and 'who benefits from this debt'?

This trend shows no sign of abatement with Quantitative Easing (QC) now embraced by the Australian Government and the Reserve Bank using contentious "unconventional monetary policy" to justify injections of massive liquidity into the system. The notion of the 'Deficit Myth' and Modern Monetary Theory has been fully embraced by the government, creating debt to unsustainable and unpayable levels. However, there has been no acknowledgement that:

(a) It is not modern and has failed over several times in the past,
(b) It is not a theory because it is in practice
(c) It is a currency issue as distinct from real (fiat) money issue because it lacks durability, does not function as a store of value and is not interchangeable across borders.

The leading questions have to be, 'who owns this debt' and 'who benefits from this debt'? These are foremost questions no one is prepared to talk about! Yet, historically, governments can only spend money either raised via taxation or borrowing which is a way of postponing taxation. Now the mantra is to shift the focus from debt to GDP to interest-expense to GDP. This can only work if the bond yield is continually manipulated by the central banks and currency is continually injected into the system.

Australia's ADIs function in this wider, uncertain and risky context

The IBS, APRA and CEOs of financial institutions would be well aware of the aforementioned as is the general public.

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[13] David Hunter Peak Prosperity Stock Crash 65%-80% YouTube 8.1.21. It is predicted by Hunter to be US$375Tr by the end of the decade.

SUBMISSIONS TO PROPOSED CHANGES AND LACK OF DISCLOSURE TO THE GENERAL PUBLIC

Non-confidential submissions from the Australian Bankers Association and HSBC, 2018 clearly indicate their determination to be global players in a landscape that is increasingly dissociated from growth in GDP. APRA is supportive and has recognized this by differentiating the proposed Countercyclical Capital Buffer required by ADIs that are international players such as the 'Big Four'.

Sadly, only a small number of non confidential submissions have been made, albeit by associations representing bodies within in the financial industry, to what is a national issue affecting every person and/or business that has any dealings with an ADI. APRA did not respond to the suggestion of describing and explaining in a comprehensive manner, what is proposed to a targeted public audience[14]. Consequently, the implication of tying Australia's ADIs to the agenda of the global central bankers by 'harmonising' monetary policy at a scale and in a direction to disengage the sovereign state threatens to go unchallenged. Failure to inform the public about the global context for these proposed changes begs the question, why?

Unless Treasury asserts more determined authority over APRA to safeguard the loss of control over monetary policy then politicians' addiction to bank lobbyists will dominate. Given that Treasury is political party based, it is unlikely to do this thus serving lobbyists well.

Given the interconnectedness between the Reserve Bank and the BIS, including its committees, it is unlikely the Reserve Bank can be seen to give 'independent' advice to government or the Council of Financial Regulators. This is compounded by concerns about the revolving doors for key officials and committees sustaining a 'group-think' mentality. Yet, the need for more bite than bark over the banking system is warranted given the lack of public confidence in institutions such as ADIs and in politicians, a distrust that has been growing world wide. However, in Australia that distrust in ADIs has been grounded in the Banking Royal Commission and how it was opposed so vehemently by selected politicians.

Evidence strongly shows that little has been learned from the continuing fallout of the GFC. In fact, the derivatives market has increased as indeed has its sophistication and risk to global financial stability. There is no evidence to show that the central banks are altruistic in business. There is evidence they expect and are confident that governments will protect them as shown in the March 2020 Bail Out of bank swap lines and indeed the bail out of the hedge fund that was against the wall with GameStop.

The BIS, APRA and decision makers in the ADIs would be well aware of the aforementioned!

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[14] Obviously, the targeted audience will determine the language used.

HOUSEHOLD INDEBTEDNESS AND THE BANKS' ASSET BASE RE DO THIS SECTION BECAUSE ASSET BASE IS COMMON EQUITY….NEED TO RESEARCH THIS BETTER.

Australian households are now the highest privately indebted households in the world relative to GDP as ADIs continue to follow a business model that puts over 60% of loan assets on the balance sheet in residential mortgages. This makes the banks the highest in the world in terms of their concentration in one type of asset base, a fact that the IMF has criticized.

Rather than diversify their asset base, banks have increasingly concentrated their lending in realty as opposed to small and medium businesses linked to growth in GDP. Thus, the ADIs must be weighting the asset base of their balance sheets in residential mortgages to argue they are 'unquestionably strong'. In turn this must be seen as heavily dependent on government 'subsidies' through tax incentives such as negative gearing, capital gains tax and sundry grants and concessions to different sectors of the population to make it easy to enter and/or speculate in the housing market. No consideration is given to a collapse in the mortgage market and foreclosures[15].

There are clear warnings signs that injections of liquidity and cheap credit lending will lead to increasing inequality and poverty in Australia. Property prices are now well above 2016 level, fuelled by cheap credit. The consequence is to make property unaffordable for an increasing numbers of households. This is aggravated by changes in the workplace to the precariousness of intermittent work, casual, part time and contract work all of which affect households' ability to service mortgage debt. However, it provides the ADIs with a realty asset on the balance sheet to represent 'unquestionable strong' capital.

ADIs are reluctant to do market to book valuations which must reflect movements in loan to value ratios. This brings into question the credibility of their risk-weighted assets which in turn must bring into question the credibility of any stress-testing of the ADIs.

The IMF is raising questions about increasing inequities brought about by quantitative easing and monetary policies albeit not making explicit the massive transfer of wealth and its concentration that has been and continues to be a consequence of it.[16] In contrast, the Reserve Bank's manta and behaviour is to stimulate asset prices in the housing market in particular, increase the asset value on ADI's balance sheets, particularly by encouraging/ stimulating household debt. Nothing in the proposed redefinition addresses the growing inequities[17]. Nothing in the proposed redefinitions address the need for structural reform in the ADIs that would be more in keeping with the needs of households and small to medium businesses.

BIS, the IMF, APRA and decision-makers in ADIs would be well aware of the aforementioned!

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[15] In the USA it is reported that thousands upon thousands of mortgages continue to go unpaid since 2007/08 but will still sit on the balance sheets IF the mortgage can be directly linked to a property. Trading in CDO has made that connection extremely difficult. Research in Australia is indicating that First Home Buyers default within the first 3 years – data source YouTube Digital Finance Analytics "It's a Mad, Mad, Mad Mad World 20.2.21

[16] IMF Working Paper WP/20/196 'Should Inequality Factor into Central Bank Decisions'

[17] I am reminded here of a former Y11 student over 20 years ago stating, "Miss, you don't understand' the rich are frightened of the poor because there are so many of them." The stratospheric wealth of his house was based on dealing in the global real estate market.

ASSET PRICES AND INJECTIONS OF LIQUIDITY

The current economic situation is one where asset prices in equities and realty are inflated. The relationship between what is happening in the former is removed from growth in GDP and 'forbearance' is allowing insolvent companies to trade thus compounding the situation. Injections of credit by ADIs has fuelled the disconnect from the physical world as corporations engage in 'buy-backs' to manipulate the stock market. This was well in place before COVID-19 and has merely intensified.

Currently, the ADI's are swilling in deposits[18]. In all probability depositors are in fear of the uncertainties that started well before COVID-19 virus only to be intensified because of it. Interest rates are low and can be expected to be kept low for the foreseeable future. This was also in train well before COVID-19. . Fiscal policy has injected an historic liquidity expansion into the economy through Job Seeker/Job Keeper. Given the correlated increase in household savings and the reported use of government stimulus to pay down mortgages, this could as readily be re-branded as Bank Keeper and have greater credibility[19].

The Reserve Bank, Term Lending Facility has extended $200Bn in credit to the ADI's. Credit is being pumped into the market paralleling what happened in the history of the former Commonwealth Bank before it was renamed the Reserve Bank and the Commonwealth Banking Corporation was created in 1959 as a separate entity. It begs the question why is the Reserve Bank providing credit when bank deposits are so high other than to provide it at lower interest rates[20] than what ADI's would otherwise pay on deposits. This keeps the cost of servicing the ADI's liabilities particularly that on bank deposits artificially low. It also sends a clear message to ADIs that in times of financial stress they can depend on the Reserve Bank to provide credit. In recent times, the readiness of the Reserve Bank to manipulate control of the bond yield curve similarly signals they can expect it to mitigate financial stress.

In spite of liquidity injections, the divergence between the growth in broad money and credit, with latter being higher in pursuit of assets and equities, means that credit growth isn't stimulating growth. Business investment continues to be sluggish.

APRA and ADIs' decision-makers would be well aware of the aforementioned!

EFFECTIVENESS OF THE COUNTERCYCLICAL CAPITAL BUFFER

Given the wider financial context in which these proposals are being put, it brings into question the effectiveness of the Countercyclical Capital Buffer (CCyB) the ADIs exposure in jurisdictions other than

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[18] ABC Radio reported that the banks have $200Bn in deposits as a result of savings paralleling in large part JobKeeper/Seeker 2020

[19] Given the banks reported $200Bn in savings January to November 2020 then even moreso is the fiscal injection a Bank Keeper

[20] The Reserve Bank's interest rate undercuts what would otherwise be the market rate on deposits.

mortgages and in particular the derivatives market. It can only be interpreted that the increase in basis points for institutions doing business in the international markets, including Australia's Big Four, primarily because of their exposure to the derivatives market? Yet that market is ignored in APRA's redefining the capital buffer framework and the banks would not be disclosing how exposed they are to it. On what substantive grounds does APRA justify the quantum increase in the basis points that differentiates those ADIs? Alternatively, does this mean the increase in basis points is based on guesswork? No want wants to report on either the derivatives market or its volatility yet these are critical to the financial market in which the central banks are pretending they know what is happening and what to do! It brings into question whose agenda is driving the redefinition of the capital buffer frameworks for ADIs not only in Australia but globally?

APRA proposed increased in the CCyB has concentrated on justifying consideration of core indicators aligned principally with the realty market.[21] The core indicators are ethnocentric and ignore the implications of the risks in the derivates market.

It is also concerning that the CCyB is conceptually, taking out the normal market peaks and troughs in business cycles. Instead, these changes can easily be interpreted as replacing the free market with mechanisms that 'nothing can fail'.

BIS, APRA and ADI decision makers would be well aware of the aforementioned!

STRUCTURAL REFORM – THE WAY FORWARD

It is concerning the aforementioned would be well known by the BIS, APRA and decision-makers in the ADIs. Yet, not one paper seems to have the will to address the relationship between what is happening in the global financial industry, including the derivatives market, and any notion of how this relates to regulatory changes in the capital buffers for alleged 'resilience' in the ADIs.

Fiddling with redefining the capital framework is skirting around the need for structural reform. That reform must:

(a) *Separate retail and investment banking*: The two systems could readily function with retail focusing on residential mortgages and small to medium businesses. A firewall is needed between the two types of ADIs which would allow those involved in the international markets to continue to function. It would give individuals and corporations a choice as to where they would want to deposit funds, invest in bonds etc. It is suggested the beginnings of this separation could be abstracted from APRA's redefinition of the capital buffer framework hedging on interest rates, have higher basis points than those that don't. ADI's that transact in the international market need to be identified on the stock exchange. ADIs focusing on the

[21] Countercyclical Capital Buffer APRA Information Paper December 2020 page 9. That information paper is best described as an interim report on the banks during COVID-19 only.

national market have explicit in the Banking Act 1959 that their deposits are excluded from BAIL IN and the Financial Claims Scheme only applies to these and not those transacting in the international market. A subsidiary of an internationally trading ADI is excluded from the Financial Claims Scheme and can be listed on the stock market.

(b) *Establish a national bank* as per the purpose and intent of the original Commonwealth Bank 1911. Capital into the bank, particularly that of superannuation funds could be channeled into renewing infrastructure and construction the new infrastructure for the Fourth Industrial Revolution.

APRA would be well aware of why there should be structural reform. Why hasn't it argued in support of structural reform as opposed to aligning ADIs with Basel III and the Bank of International Settlement?