

Dangerous derivatives—why are Australia’s banks hiding their gambling?

The least understood threat to the financial system is from derivatives, the complex financial gambling instruments designed by advanced mathematicians that

Fig. 1

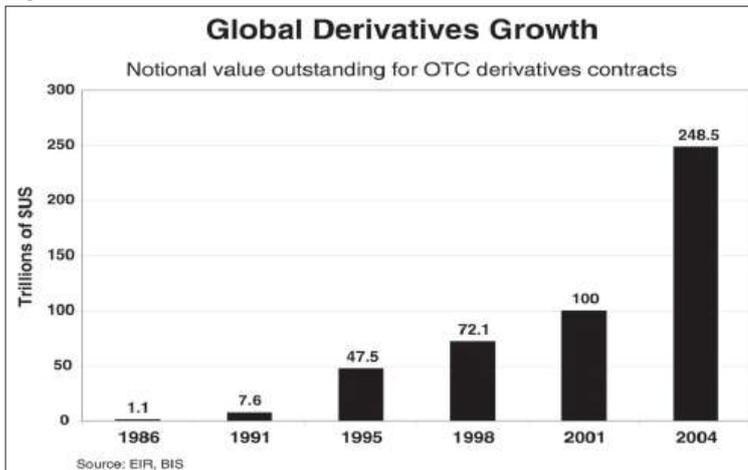


Fig. 2

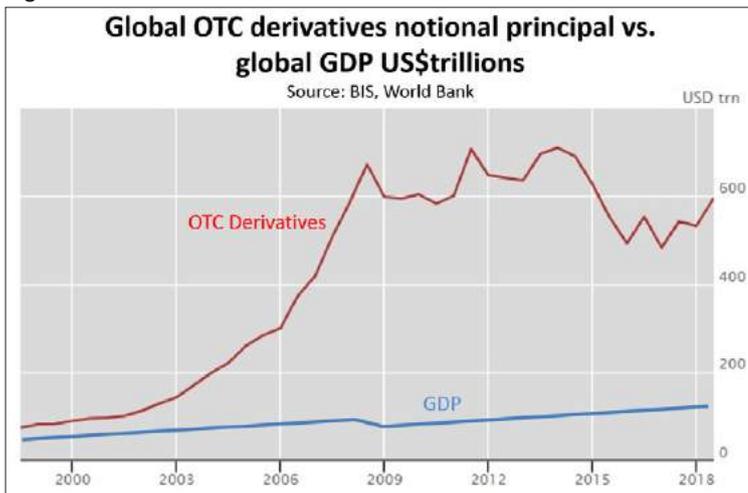
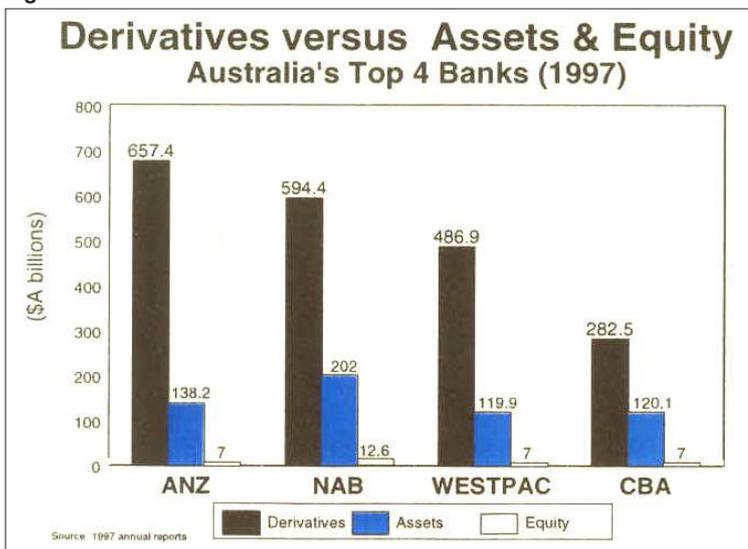


Fig. 3



investor Warren Buffett called “financial weapons of mass destruction”. While the average bank customer won’t know how derivatives work, they can recognise how dangerous they are, from the numerous derivatives disasters that have caused massive bankruptcies in recent decades, including Orange County in 1994, Barings Bank in 1995, Long-Term Capital Management in 1998, Enron in 2001, and—the big one—the global financial crisis in 2008, triggered by the derivatives meltdown of Lehman Brothers and AIG. Today, Deutsche Bank is like a ticking time-bomb sitting on nearly US\$50 trillion in bad derivatives bets, which the IMF has warned have the potential of setting off another global banking meltdown.

Like their international counterparts, Australia’s banks are also heavily involved in derivatives trading. The following charts were created by the Citizens Electoral Council over more than 20 years of monitoring the derivatives exposure of Australia’s banks, and they reveal how Australia has become a casino economy. CEC Research Director Robert Barwick presented these charts in a 3 May 2019 interview with banking expert Martin North on his Digital Finance Analytics YouTube channel, called “Dangerous Derivatives and Why Our Banks Are Hiding Them”.

Fig. 1: The global growth in over-the-counter (OTC) derivatives speculation between banks started in the mid-1980s. By 1998 the derivatives bubble had overtaken global GDP, and grew exponentially following the repeal of the US *Glass-Steagall Act* in 1999.

Fig. 2: The hyperbolic growth in OTC derivatives trading following the repeal of Glass-Steagall saw the bubble grow to around US\$700 trillion in 2008, before it started melting down in the global financial crisis. The 2008 bank bailout, followed by central banks injecting trillions of dollars and equivalent in Quantitative Easing (QE) money-printing, went to shoring up this derivatives bubble. This chart is of the official Bank for International Settlements figures, which rely on the banks accurately disclosing their exposure. It is more likely that global derivatives are over a quadrillion dollars—US\$1.2 quadrillion according to British mathematician and quantitative financial analyst Paul Wilmott.

Fig. 3: This is the first graph the CEC made of the derivatives exposure of Australia’s big four banks, in 1997. It is notable for two features: 1) all of the banks’ exposures were less than a trillion dollars; 2) CBA’s exposure was much smaller than the other three, reflecting in part that it had been publicly owned until the year before, when the third and final tranche of its privatisation was finalised. The figures in this chart were sourced from the banks’ annual reports.

Fig. 4

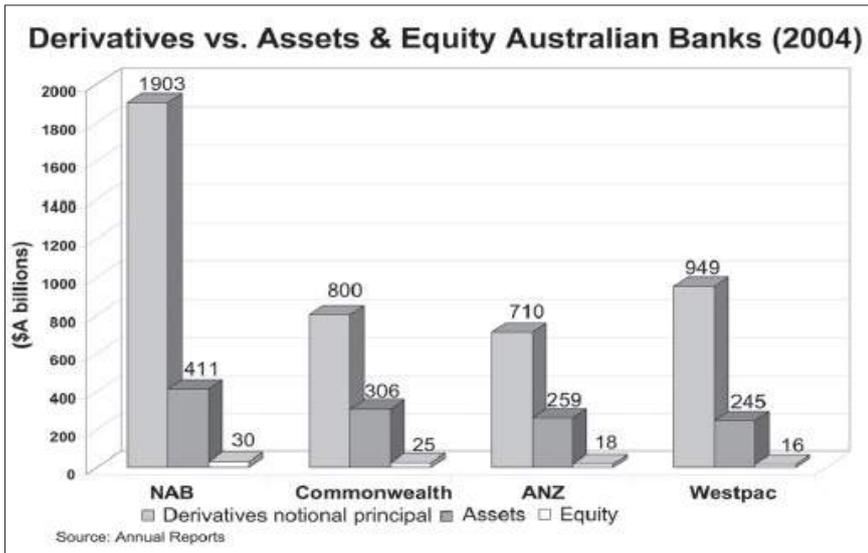


Fig. 4: This 2004 chart of the derivatives of the big four banks, seven years after the CEC's original 1997 chart, revealed massive growth in the exposure of NAB, Westpac and CBA, but very little growth in ANZ. The CEC published this chart in a 2005 issue of its *New Citizen* newspaper, warning that derivatives were the "mother of all bubbles" and would cause a global financial crisis when the bubble burst. In response, the securities regulator ASIC sent threatening letters to the CEC's directors, warning against giving financial advice without a licence. Three years later, derivatives speculation caused the global financial crisis—ASIC didn't apologise.

Fig. 5

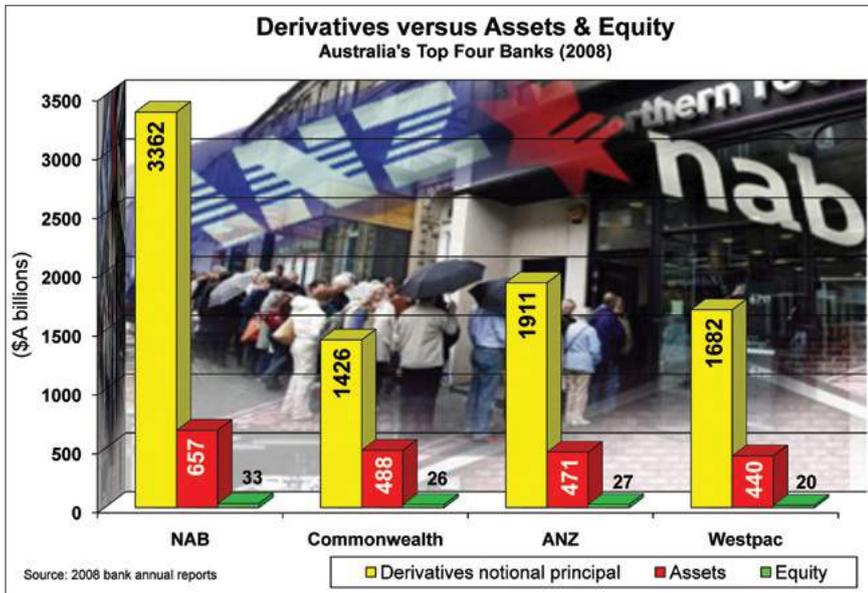


Fig. 5: The big four's derivatives at the time of the global financial crisis, all in the trillions. NAB's exposure was still far greater than the other banks, but ANZ had become aggressive, almost tripling its exposure compared with 2004. This was the state of the banks when they required emergency government guarantees of their foreign borrowings; otherwise, they desperately warned then-PM Kevin Rudd, they would be insolvent "sooner rather than later". Any insolvency would have caused the banks to default on their derivatives, adding to the global meltdown of the derivatives bubble then under way. At this time, Westpac and ANZ were also recipients of bailout funds from the US government's massive bank bailout.

Fig. 6

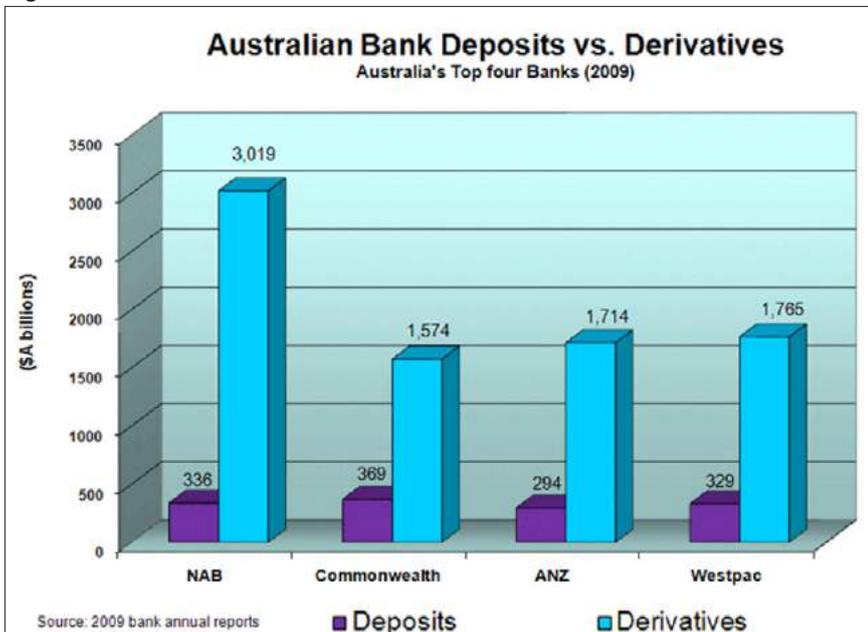


Fig. 6: Trading water during the GFC. By 2009, the derivatives of the banks had either fallen (NAB, ANZ), or slowed right down. The CEC produced this graph comparing derivatives with deposits, to show that the new deposit guarantee had no hope of saving banks in a derivatives meltdown. (Bail-in was unknown at the time, but it also shows that even if all deposits are bailed in, they couldn't cover serious losses in derivatives.)

Bail-in and derivatives

It is derivatives that have the most potential to cause a banking crisis and trigger a bail-in to prop up failing banks, but derivatives liabilities are exempt from being bailed in. That is because the purpose of bail-in is to stop a crisis in one bank setting off a domino collapse, which defaulting on derivatives obligations could do. So bail-in steals the savings of innocent bank customers to pay gambling debts, but it won't work—potential derivatives losses are far greater than bank deposits. It would be far safer to stop banks from gambling in derivatives in the first place.

Dangerous derivatives

Fig. 7

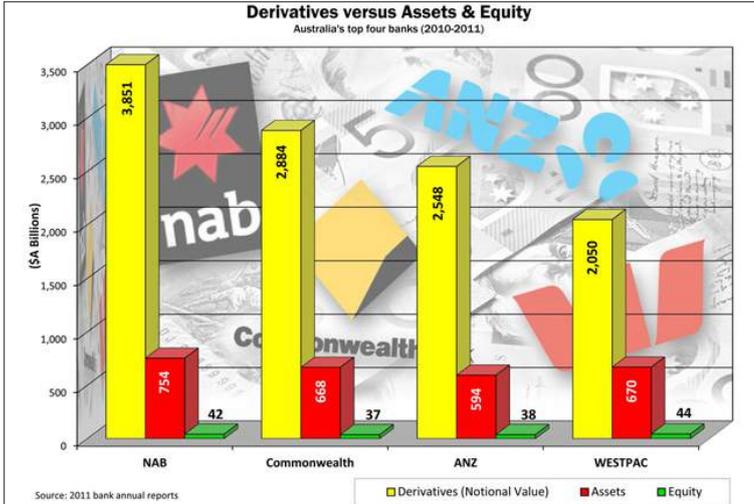


Fig. 7: The start of the post-GFC rise. This chart from 2011 revealed a curious development: while global growth in derivatives speculation had levelled off (Fig. 2), Australia's banks, now government-guaranteed, were experiencing a new growth spurt. This coincided with the return of mega-profits. CBA in particular, the biggest and most profitable bank, went on a derivatives binge, racing from having the lowest exposure in 2009, to overtaking both ANZ and Westpac.

Fig. 8

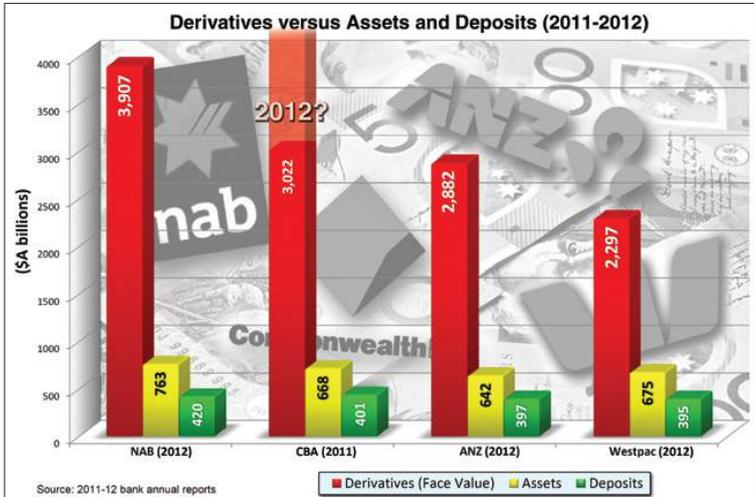


Fig 8: What is CBA hiding? A year after CBA disclosed massive growth in derivatives, far outstripping its competitors, it suddenly stopped disclosing the notional principal value, also known as face value, of its derivatives in its annual report. This was a standard figure that had been included in its annual reports for two decades, but suddenly CBA claimed it wasn't relevant. When asked why this was appropriate in the wake of the GFC, which proved how dangerous derivatives are, CBA executives told a CEC researcher that their derivatives weren't dangerous like the credit derivatives that had caused the GFC, but were "plain vanilla" derivatives. However, this claim was contradicted by the extraordinary growth rate in CBA's derivatives trading—plain vanilla "hedging" derivatives would not have grown so fast.

Fig. 9

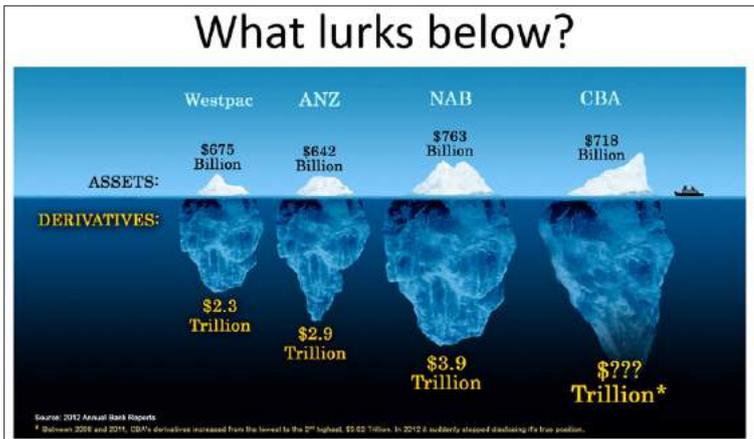


Fig. 9: What lurks below? This 2014 poster illustrated the magnitude of the danger that derivatives posed to Australia's ship of state, pictured as the submerged section of icebergs because they are allowed to be held "off-balance sheet", and even not disclosed, as per CBA. This "off-balance sheet" accounting is a scandal, especially following the GFC which proved that they are capable of wiping out banks' balance sheets. In the middle of the GFC, Bloomberg quoted Pauline Wallace, a partner at PricewaterhouseCoopers and team leader in London for financial instruments, who said of off-balance sheet accounting: "I've always regarded it as a bit of a magic trick. Magicians come to parties, and they make things seem to disappear. The risk is somewhere, but you never knew where."

Fig. 10

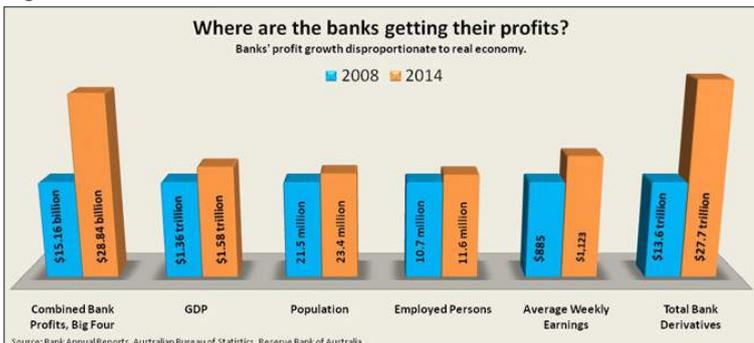


Fig 10: Derivatives and bank profits. This chart compared the incredible growth in Australian bank profits with standard metrics of economic growth, to show that profits were growing much faster than the economy they were being extracted from. The only area that matched the growth in profits was the banks' derivatives speculation. One element that could have been included in this chart was bank mortgage lending, the growth of which would also have matched derivatives, and indeed was related, as mortgages are the basis of most of the banks' derivatives gambling.

What are derivatives?

Short answer: financial side-bets. Derivatives are literally bets between banks, and were illegal in Germany until 1989 under anti-gaming laws. The bets are typically made on interest rates, exchange rates, and market indices, and often complex combinations of all three.

Dangerous derivatives

Fig. 11: The exponential growth of big four bank derivatives post-GFC. This chart captures the incredible growth in derivatives trading following the GFC, up until CBA in 2012, and then NAB in 2016, started hiding their notional principal exposure. The grey lines are the CEC's guesstimates of what the exposure may have increased to, based on the previous rate of growth, and on the RBA's figures of total Australian derivatives, which also showed incredible growth, but not broken down for each bank.

Fig. 11

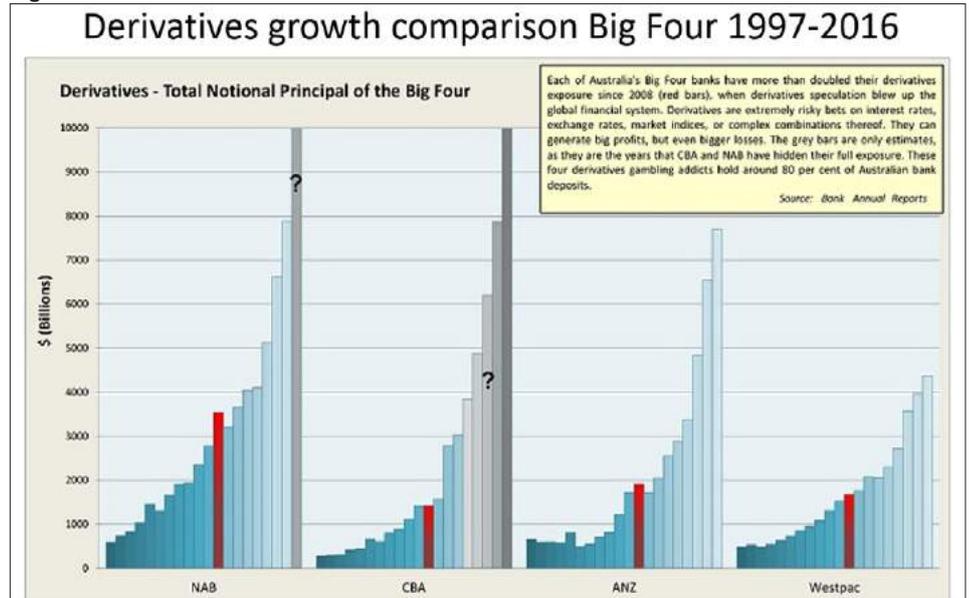


Fig. 12: Hidden figures. By 2018, all of the big four except Westpac were hiding their notional principal exposure to derivatives. This was the year that the government snuck through its preliminary bail-in law, to seize savings, including deposits, to prop up these same banks. It was also the year of the banking royal commission, which proved the banks are vast criminal enterprises, but, constrained by the bank-approved terms of reference, recommended no serious actions to reform them. Despite the CEC's best efforts, this derivatives speculation, and the banks' determination to hide it, was not examined by the royal commission. It is unacceptable that the banks have been allowed to hide this activity given that it represents the greatest risk to Australia's financial system and economy, so the CEC has drafted legislation directing the Auditor-General to conduct a thorough audit of the banks' books, both on- and off-balance sheet, drilling down into hidden areas such as derivatives, so the government can know well in advance the risks confronting the economy.

Fig. 12

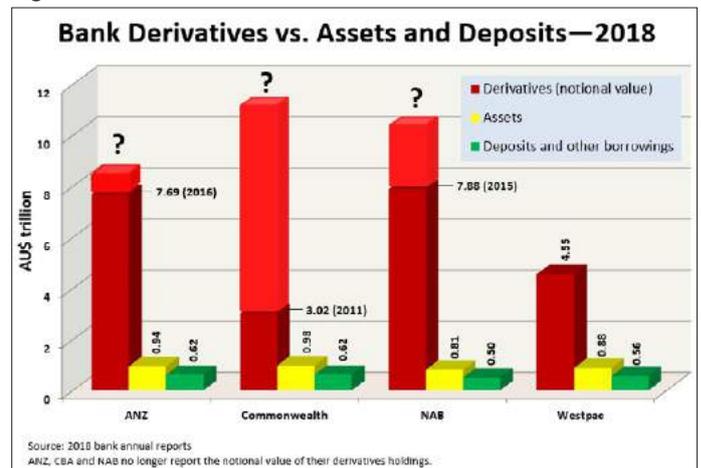
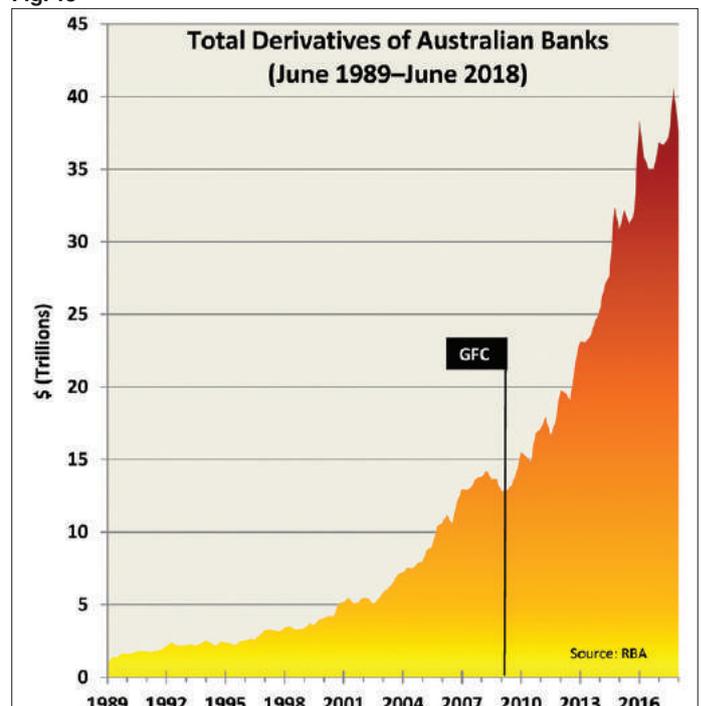


Fig. 13: \$38 trillion disaster waiting to happen. This chart shows the Reserve Bank's aggregate figures of total off-balance sheet business for all Australian banks. At \$38 trillion-\$40 trillion, Australia's derivatives bubble is almost 20 times Australian GDP. At this size, it is a potential risk not just to Australia, but to the entire global financial system, if an Australian banking crisis causes the banks to default on their derivatives obligations to their international counterparties, which could set off a chain reaction of defaults. In February 2018 London-based Absolute Strategy Research called Australia's banks a "global systemic threat".

Fig. 13



Get derivatives away from deposits—Glass-Steagall

While it would be good to ban derivatives, it's virtually impossible, as investment bankers would simply come up with more exotic varieties that regulators wouldn't understand. What can be done is stop banks with deposits from trading in them, by restoring the Glass-Steagall separation of deposit-taking banks from the high-risk securities-trading world of investment banking. This will ensure that deposits are kept safely away from derivatives risks, but also reduce the volume and riskiness of derivatives trading, given most of it is currently underwritten by deposits, which encourages the traders to take greater risks, as it is with "other people's money"—yours!