

Banks to stay - not go!

Written by The Conversation

It is such a shame that the story of lemmings rushing pell-mell over a cliff to their deaths is just a [myth](#) created by Walt Disney because it describes really well the panic that sometimes grips financial markets.

One such panic was (can we ever forget) when Lehman Brothers filed for bankruptcy and all hell broke out in the financial markets, especially as regards termination of the financial contracts to which Lehman was a counter-party.

Completely within their legal rights at the time, some banks on the other side of Lehman's contracts immediately pulled the plug and Lehman went down the gurgler. Some banks were a bit too quick in bailing out and [disputes](#) are to this day still working their way through the US justice system. Lawyers win on the way up and on the way down.

The Lehman derivatives fiasco pointed up the fact, if it were needed, that derivative securities pose 'systemic risk'. A beggar my neighbour attitude by one bank can create problems for other banks with a knock on impact on the financial systems as whole.

The systemic risk of derivatives contracts has been highlighted this week in the G20 forum in Turkey when the G20 leaders [signed off on a proposal](#) to temporarily 'stay' the termination of derivative contracts in a crisis. This is like regulators calling a 'time out' with only seconds on the clock.

The G20 summit also signed off on a number of other measures to head off a future GFC, not least requiring Too Big To Fail (TBTF) banks to issue unsecured debt that will increase what is called a bank's Total Loss-Absorbing Capital, or TLAC. The [concept](#) is that TBTF banks will be required to issue unsecured debt of up to 22% of their capital that will hopefully cover losses if a bank was to fail.

This has been termed 'bail in' to denote that, unlike the GFC, bond-holders (mainly large banks) will be in the line of fire in the event of a future bank failure.

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Recently Wayne Byres, the head of APRA, addressed the need for TLAC but put the problem off [until after the summer holidays](#). In this instance, no need to rush he said as “it makes good sense that we hasten slowly”. And since these new regulations are not coming in fully until 2022, he may have a point or he may just be hoping it will all go away until after his watch.

Technically, as the [RBA points out](#), the Big Four Australian banks are not G-SIBs (Global-Systemically Important Banks) but as the RBA notes you cannot have it both ways. The rest of the world is watching how local regulators respond to the Murray Inquiry's [recommendation](#) that Australian banks are perceived to be ‘unquestionably strong’. And if they are not strong their precious credit ratings may be revised.

On the matter of forced termination of derivatives contracts, however, Australian banks will have little option but to join in as they will be on the other side of many of these particular contracts. In other words, the termination of such contracts will be ‘stayed’ or delayed by overseas regulators.

Little or no impact on Australia you might think? But a last minute addition was the inclusion of so-called securities financing transactions in the ‘[protocol](#)’. This is not chickenfeed, about half a trillion dollars worldwide according to the Financial Stability Board (FSB).

As a result of the extension of the Protocol to securities financing transactions and its adoption by G - SIBs, it is estimated that more than \$560bn of cross - border securities financing activity that could previously have been terminated at the point of resolution will be subject to the stay regimes of relevant G- SIB home jurisdictions

You may have thought that when your super fund buys a share for your super it is locked away somewhere with your name on it – it is, sort of. But in a nice little sideline, your fund may [lend out the share for a short time](#) for a fraction of the share's value - cents rather than dollars but it's pretty safe income. You remain the ‘beneficial owner’ but like loaning your car to a teenager, someone else is enjoying the benefits of using it. But what if the borrower (often a short seller) prangs the car?

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Are you insured? Probably. But from today you will, if the security has been loaned to an overseas bank that goes belly up, have to wait for some time to get your claim processed, and you will be back of the queue.

This, of course, creates what is called 'moral hazard' since a borrowing bank does not have to worry so much what happens if they are teetering on the edge of bankruptcy, and will just keep playing with borrowed money, since they have a little bit of extra time up their sleeves.

On the other hand, if the market has any inkling that a bank may fold, securities lenders may just exit the market prematurely, as they did just before the GFC, and stop lending securities, thus potentially starting a bank run. In other words, reducing systemic risk in one place may actually increase systemic risk in another.

In the great scheme of things. this is definitely a 'first world' issue - only a problem if you have enough money to worry about it. But it is now part of the global financial system and if history has taught us anything it is to tie up the loose ends.

We await an [update](#) by ASIC as to how the legal issues in securities lending in the new regime are to be covered.

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