The ABC of Economics, Derivatives in the 2020s, and the Glass-Steagall

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Burried for years inside Treaury Internal documents is the potential format for a log supporting a clearing mechanism for derivatives.

An interactive government reporting mechanism including mandatory electronic logging of all trading with derivatives that cannot escape scrutiny from law enforcement agencies and the tax office is needed coordinated with current " Derivative Clearing " parties.

A long time ago Alan Kohler wrote an excellent article : "Throw the Gaming Act at derivatives bookies"

More recently in his acceptance speech, at the Republican Convention, the Republican Candidate Donald Trump (Bachelor of Economics, Option Banking) clearly stated:

"My first mandate will be to re-introduce the Glass-Steagall"

...Since then, in the last couple of year or so, a fierce debate has taken place around the world regarding this matter and what it will mean for the largest banks and their investments including super.

So who are the actors and what is at stake behind derivatives and the Glass-Steagall given that the current Royal Commission in Australia avoided to investigate these toxic financial transactions! Today it seems that a real clearing mechanism with logs accessible to law enforcement agencies that would be implemented incrementally is a better option than re regulating with an old out of date Glass-Steagall, **specially as it would enable governments to colect a levy while just chnging rules with reporting but without interactive logging and clearing would not enable collecting a levy.**

A Derivative is a contract between two parties sometime in different countries with a notional amount to be paid in the contract after the occurrence of a specific type of event, duration and some collateral clauses can be added to the contract, assets can be involved concerning agriculture mining equities interests rates etc etc this financial instrument is either used for hedging or speculation or interpreting the value of assets.

For each $1 of the world trade($120trillion) there is about 10$ gambled mainly on exotic financial products at Canary Wharf(60%) and Wall St(30%), $1Quadrillion, gambled on the performance of some aspects of the trade itself including currencies and other aspects totally unrelated to the stock exchange, instead of real trading investments shares/ equities etc...purchased on the trading floor!
There is nothing beneficiary to local jobs, local investment and trading and local equities when some rogue investors in Wall St threaten the entire banking system and gamble on Greece defaulting with an amount of gambling hundred time bigger then the debt of Greece itself, or when banks mix good and bad loans together in the banking system for the sole purpose of more gambling benefits...
... and yet   => more than 80% of derivatives are legitimate hedging by business on currencies, rates, commodities, to smooth trading and limit trade / business peaks and through caused by excessive variations in currencies rates and or commodities that impact business inputs and/ or outputs.

What actors should tackle the problem caused by derivatives.
Between 2015 and 2020 a different direction to the one envisaged initially by the US congress has emerged.

Until 2016, BIS the Bureau of International Settlements which looks after banking regulations neglected to put in place equivalent rules or a renewal/ adaptation and enforcement of the Glass Steagall regarding exotic financial transactions, the stock exchange and the banking industry since the Glass-Steagall was abandoned, instead BIS preferred letting the banks "report" and regulate themselves with the consequences that we know, GFC 1.0 and GFC 2.0 is at the corner if nothing is done.
Between 2016 and 2018 the US congress and   BIS recommended a new reporting by the Banks ie capturing and reporting information about Derivatives but not any real world wide formal clearing mechanism with both logging and clearing accessible by law enforcement agencies also world wide such a mechanism which would have helped ultimately to collect a levy.

Various forms of reporting have been produced pleasing public servants who like typical post evaluation 19th century techniques but not interactive or pro-active 21st century tech who could compromised their jobs.
The result has been an increasing technology gap between Governments agencies and trading floors around the world. Few Banks have been investigated for malpractice if any and the sacrosanct word Derivative has been removed from the vocabulary despite banks being investigated and punished for malpractice in other sectors to make some appeasing noise such as recently downunder in Australia with the Royal Commission on Banking.

Germany did implement a tax on derivatives.

The result of this tax implementation was a cynical move to Canary Wharf of part of the Derivative Business by traders to avoid business scrutiny and tax, with the Deutsche Bank unintended exposure and the US Fed weekly intervention of $315Billion(**) and talks at the bilderberg meeting (*) on this matter certainly took place in 2019.
(*)"Since its inaugural Meeting in 1954, the Bilderberg Meeting has been an annual forum for informal discussions, designed to foster dialogue between Europe and North America. Every year, approx. 130 political leaders and experts from industry, finance, labour, academia and the media are invited to take part in the Meeting. About two thirds of the participants come from Europe and the rest from North America; one third from politics and government and the rest from other fields. The Meeting is a forum for informal discussions about major issues. The Meetings are held under the Chatham House Rule, which states that participants are free to use the information received, but neither the identity nor the affiliation of the speaker(s) nor of any other participant may be revealed"... from the Bilderberg web site.

With an Australian daily transaction turnover varying between $100b and $200billion or half the Australian Budget and weekly turnover bigger than our GDP(Y),   some questions may be asked on how safely do we control our derivatives and their process and how safe is our four major banks $13trillion exposure to derivatives.
For example could a 0.1% levy on transactions safely reach the tax office(X) and if not, when would our law enforcement agencies be able to make such levy operational given that in the current context it would nearly double or triple our budget revenue!!! So may be we only need a 0.05% transaction levy or even less!

Z($1.7trillion) is the amount of exposure to Australian commodity based derivatives, can it affects our trade?

Derivatives internally resemble programming object classes(investments) with properties which may be inherited from other derivatives (embedded hybrid derivatives) such as duration, collateral links....

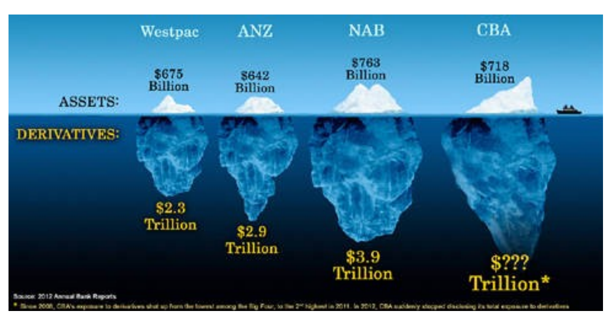
Events happening during the life of the derivative such as the rise and fall of some equities or events such as Greece defaulting, the $US falling, the $US rising, the name of the new French President or the death of a well known person affect the outcome of the punt, and once again the programmer's analogy...if this AND this OR this happen and if the outcome is not favorable then collaterals protection to hedge the derivative against other debts can be implemented etc etc...

To make an analogy on the size of derivatives visible in the diagrams below, it is a bit like gambling on the race just before the Grand Liverpool Steeple Chase with a prize for the winner of 100 000£ and betting on the race above 500 000 000£. While everything looks OK even so it is not the Grand National but the race before, until the number 4 attached to the saddle of the horse 'show me the money' is suddenly swapped with the number 7 attached to the saddle of 'Mr Ponzi' simply by returning the number tag and only to satisfy gambling by some punters on derivatives for the remaining of the race, while it is not as simple, the final outcome is the same.

Hidden behind convoluted software and sometime javavuvavascript classes this whole trading floor whizzbang creates a smokescreen without the same type of logs supporting traditional banking transactions,   inherently supplying both the identification and traceability of financial transactions including locking rejecting and rollback, some flaw and risks in the system was demonstrated with high speed trading after a Trading Session crashed at Wall St.

To continue the analogy with the racing industry, a dubious practice such as this one put at risk the entire industry of breeders trainers jockeys owners etc...transferred to the finance and banking sector, it means a controversial practice such as this put at risk the entire banking industry and stock exchange as well as the economy.
Bookies and Betting agencies are ruled by a code of conduct with specific rules to follow in order to protect the racing industry from fraud etc...these rules it is the Glass Steagall in the banking industry.

Today an investor can become a gambler using bitcoins or other crypto-currencies (see article on Virtual Currencies/ VCs) in the Bahamas betting on the Stock exchange and the value of currencies as well as using multiple conditions related to the death of some personalities without visiting a casino or a racing ground, this investor may not be even aware of it, further more savings and money from retirements can be channeled into schemes / financial systems corrupted and uncontrolled through the Internet and sophisticated software hiding the trail, given computer logs are not always kept on some of these large transactions anymore (see recent Wall St interruption/ halt in trading and losses by traders).
Before the abolition of the Glass-Steagall and the nineteen sixty-seventy years financial institutions able to market these exotic financial products such as collateral debt obligations derivatives etc... operated outside traditional banks used by the mass of mum and dad investors representing by analogy the racing industry above.



The Diagram above from the CEC Report shows the four main Australian Banks and their Derivatives exposure, though 85 to 90% of Banks Exposure to Derivatives is mostly made of over-the-counter(OTC) harmless Interest Rate and Currency Derivatives.

The term Glass Steagall Act usually refers to four provisions of the U.S. Banking Act of 1933 that limited commercial bank securities activities and affiliations within commercial banks and securities firms. The progressive removal of part of the Glass Steagall since 2000 may have play a part in the GFC and derivatives saga.

With the Glass-Steagall the entire banking industry was protected from clever and corrupted 'bookies' who today manipulate amount of investments so large that the entire banking industry could be placed at risk, as Lehman Bros collapse like a game of cards triggered GFC 1.0. If GFC 1.0 was cushioned by the too big to fall protection, there is no guarantee next time that the damage will not be much worst.

What we have learned from GFC 1.0 is that no auditor who advised to use some of these OVNIs(Elephant juice in the racing industries) was ever taken to court, and neither rating agencies who rated Lehman Bros triple A.

In 2017 the magnitude of Derivative gambling as well as risks behind manipulations linked with PRIVATE EQUITY FUNDS(this subject will be developed later) .... could even be more devastating than it was in 2008, if nothing is done an explosion of the Eurozone(*) or a sudden downturn in the stock exchange could trigger, the next GFC as mentioned by Joseph Stiglitz, the nobel prize of Economics. In a GFC 2.0 context the local collateral damage with real equities and local real jobs already put at risk by crypto-currencies will be huge. Banks have already a MONEY MULTIPLIER equivalent to Printing 17 times the amount of deposits, it should be used to prop up the real economy, not gamblers/ dubious rent seekers. A heavy tax on these UFOs would help to discourage the practice, Germany is showing the way. A **1% levy on the Banks exposure to derivatives (between $12t and $24trillion) would force our major banks out of this toxic derivative practice even before a new Glass-Steagall is implemented!**

This article does not target the vast majority of hedging over-the-counter(OTC) Derivatives including hybrid derivatives sometime on the border line, most are more or less harmless regarding our $13t+ Australian Banks Exposure, see previous diagram, or most of the $ quadrillion exposure world wide. However there are at least 10% of non-OTC complex and mostly speculative derivatives which are not arm less at all and look more like WMD escaping scrutiny (apart from the obvious ones concerning Greece defaulting). These may or may not have connections with Australian Banks, but with the current system we dont know!

An interactive government reporting mechanism including mandatory electronic logging of all trading with derivatives that cannot escape scrutiny from law enforcement agencies and the tax office is needed coordinated with current " Derivative Clearing " parties.

This paragraph by the author was written and discussed on social medias almost 10 years ago in the context of Derivatives enabling a lower GST or a flat lower rate, to reduce pressure and means testing on pensions., reduce corporate tax, or replace it by a tax on turnover.

Changes to Derivatives taxation could also be the first step to tackle new tech based Virtual Currencies and payment methods and adapt the ATO to a modern 21st Century interactive tax system

(see this link for tax and technology)

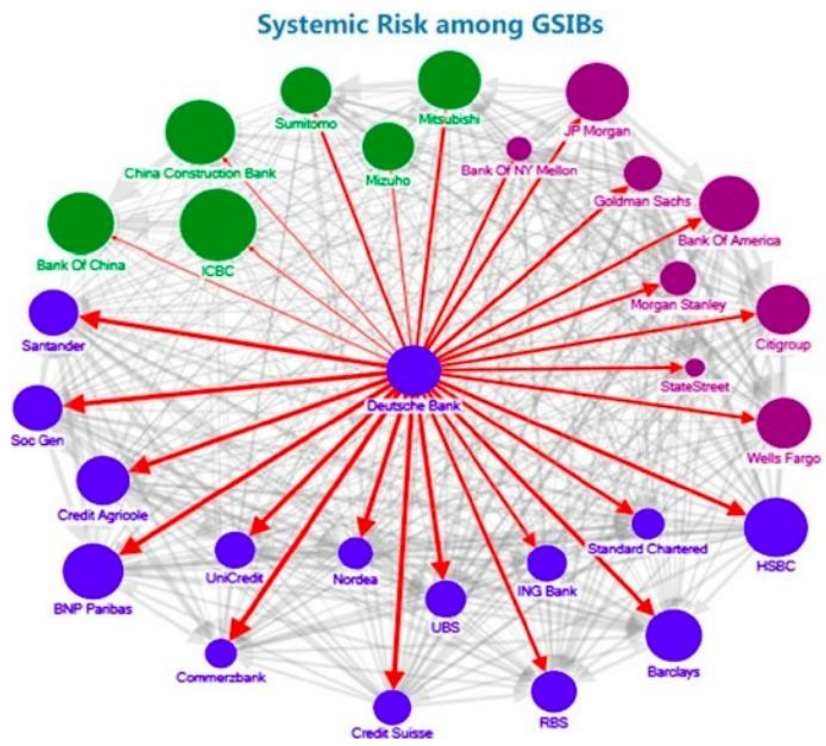
(see this link for virtual currencies and Libra)

Derivatives we cannot scrutinize and specially avoiding any taxation/ levy should not be there at all, anything else is very suspicious!

Note: the concept of the Euro is supported by Collateral Debt Obligations between France Germany and Italy but all are now in debt albeit Germany a bit less than the other.

One critical question, does BIS understand the risks and consequences of our new technological world for bank transactions and payments or is just interested by collecting data which may or may not be accurate to produce surveys/ reports?

The diagram on the right from the IMF shows entities related to Deutsche Bank and the domino effect potential risk.



Derivatives Trading Mechanism, the technical side:

1 - From an internal viewpoint Derivatives are just like Java/ javascript Classes, they have some properties and may inherit some properties from other Derivatives (embedded hybrid derivatives), and collaterals, this is almost identical to an Object model, but the real issue are the absence of mandatory formatted logs containing the identification of punt and punters, albeit there are mandatory reporting requirenents for some type of OTC that can be enforced by Goverment agencies but all this is assuming that all trading platforms overseas are committed to identical trading rules and this is ignoring non-OTC Derivatives!

2 - Traders mainly in Wall St(30%) and Canary Wharf(60%) dealing with Derivatives are communicating with clients from the banks and bank accounts which are traceable, that is, for the one dealing with the "normal" Banking system or have electronic reporting requirement obligations.

3 - Trading floors themselves in places such as Wall St and Canary Wharf have sophisticated computer systems, with "mirroring", which duplicates data and processes so that if one processor fails another takes over simultaneously protecting from trading halt, logs enable to track all transactions from the beginning of the trading floor session and are restored when a new session starts and can be analysed by law enforcement agencies.

4 - The clients from the Banks benefit from a reliable and safe transaction system which also stores all transactions on a log, that is credit card and ATM transactions are stored on a log with mirroring for 24h, at the end of which, the mnemopost file is purged just after the Bank ledger update 5, hence there is a check and balance mechanism or is there if derivatives have escaped the radar through non-OTC or rogue traders overseas?

5-6 **– A process similar to the former clearing house control and clear the transactions between Banks but government agencies around the world are still discussing derivatives clearing**, and existing clearing mechanisms for derivatives are as much distributed as block chains around the world, in private hands and not necessary linked with major banks through a formal mechanism that law enforcement agencies can supervise!

Note: Tensions relating to "Repos" , loans inter banks, with special rates are an indication of stress in many areas.

7- The central Bank overviewed and supervised the process during the old days when cheques where issued between customers of different banks, the bar-codes at the bottom of the cheque were used to sort them before they were recorded on a file to be processed by the clearing house, today with the internet the mechanism is more straight forward albeit contracts between parties in derivatives often in different countries have no mandatory electronic formal formatted log available to law enforcement agencies to evaluate automatically the clearing process from any trading platform if any were to exist, replacing or complementing current reporting!

From a banking point of view all transactions balanced to "THE" ledger before update and, most importantly, are traceable(apart from some derivatives) as to who issued what financial transaction/ payment.

8- But what's happen when Traders instead of dealing with the Traditional Banking System are involved with **Blockchains** with or without Crypto currencies(9) which are functioning with a different mechanism to flat currencies that central banks(7) issue and multiply ad- aeternam, the only limit being the sky and the number of new hands available created by demographics or developing countries to absorb the potential inflation.

The trading system has now two sides(see also Money supply and Virtual Currencies)

I - Where one deals with data logs scrutinized by law enforcement agencies and agencies fighting fraud and money laundering in the traditional Banking system, but with limited supervision/ control on Derivatives.

II - Where the control is kept at arm length from law enforcement agencies, either for technical reasons beyond the level of skills developed by BIS and Government agencies, or because these are facing blockchains with a different level of scrutiny, because they are dispersed in a peer to peer system of ledgers have multiple dispersed logs or no log at all depending on the situation.

Ultimately the ATO and other Tax Offices around the world will have to bite the bullet and move to a more interactive taxation adapted to modern technologies and their new methods of payment, and will need some control over VC(virtual currencies see article on this web site and IMF SDN 1603 internal discussion document) and blockchains, specially in the context of Derivatives, so is the ATO and the MIBs at the RBA and APRA doing their job or are they living in a world that is quickly vanishing?

The OECD has been speaking for the last ten years of the shrinking of Government Revenue Base in many OECD Countries and the IMF has been warning OECD Governments of the importance to be aware of change in Payment Methods. Hopefully the Australian Tax Office will adapt more quickly to interatcive taxation than it did for the GST and the internet/ eSales, it took 20 years, possibly $500billion of uncollected revenue not mentioning the loss of many local jobs!!, though I am curious to see how it will unfold without looking beyond the GST and looking at having the whole or at least most of the interactive if not pro active taxation being based on the internet coupled with the latest POS Technology and cyber capture of all transactions between banks, trading floors, and businesses, inclusing new Vcs. Will we see more of the clever ads on TV with subliminal meta constructs to capture the mind of voters without doing anything! As said before, does collecting data which may or may not be accurate to produce surveys/ reports help in anyway even to collect a small levy!

(**)

From Wall Street on Parade, A citizen guide to Wall Street :After a $354 Billion U.S. Bailout, Germany's Deutsche Bank Still Has $49 Trillion in Derivatives By Pam Martens and Russ Martens: April 17, 2019

~ Why did the U.S. Fed throw $364 billion at one German bank when its country of origin has only reached in its pocket to the tune of $79 billion for all of its troubled banks? During 2018, the serially troubled Deutsche Bank – which still has a vast derivatives footprint in the U.S. as counterparty to some of the largest banks on Wall Street – trimmed its exposure to derivatives from a notional €48.266 trillion to a notional €43.459 trillion (49 trillion U.S. dollars) according to its 2018 annual report. A derivatives book of $49 trillion notional puts Deutsche Bank in the same league as the bank holding companies of U.S. juggernauts JPMorgan Chase, Citigroup and Goldman Sachs, which logged in at $48 trillion, $47 trillion and $42 trillion, respectively, at the end of December 2018...