440 Black Mountain Road
Black Mountain, Old. 4563
21 September 2014.

The Chairman
Financial System Inquiry
GPO Box 89
Sydney, NSW 2000

Dear Sir

**Submission to the Financial System Inquiry**

Please accept this late Submission.

The critical problem in the Financial System is the result of the inappropriate interpretation of the International Accounting Standards and Practices in relation to Derivative Products which has allowed the cost of derivatives to be accounted for on the maturity date of the underlying transactions and not the date the derivatives were entered into.

**Example;**

1. 1. A Bank makes a 10 year term borrowing at a fixed interest rate and invests the borrowing in variable interest rate products to make a profit for the Bank.

1. 2. Variable interest rates fall resulting in this 10-year term fixed interest rate borrowing making a loss for the Bank.

1. 3. The Bank enters into a Derivate SWAP to replace the 10 year term fixed interest rate borrowing with a similar borrowing at a lower fixed rate of interest and invests the proceeds, net of the payment of the cost of the Derivative SWAP, in variable interest rate products to make a profit for the Bank.

1. 4. The Bank and its Auditors inappropriately interpret the International Accounting Standards and Practices and defer the accounting and financial reporting of the payment of the cost of the Derivate SWAP until the maturity date of the original 10 year borrowing.

1. 5. The Bank and its Tax Agent claim, in its current financial year Taxation Return and Financial Statements, a deduction for the cost of the Derivate SWAP, of which payment has been made i.e. the transaction has crystalised.

1. 6. As a consequence of (4) the Bank's Financial Statements for the current Financial Year do not disclose the cost of the Derivate SWAP.

1. 7. As a consequence of (5) the Bank's Financial Statements for the current Financial Year disclose a tax deduction for the cost of the Derivate SWAP.

1. 8. As a consequence of (6) and (7), the Bank's Financial Statements for the current Financial Year disclosing a profit, including a tax deduction for the cost of the Derivative SWAP, is OVERSTATED by the cost of the Derivate SWAP which will not be accounted for and disclosed in the Financial Statements until up to 10 years into the future.

The Bank, its Chairman and Board of Directors and Executives now have a magic formula for unbridled speculative borrowings, overstated profits and overstated remuneration based on these overstated profits. This puts depositors' monies at grave risk.

The appropriate interpretation of the International Accounting Standards and Practices of the Financial System is to account for the cost of a Derivative on the date the payment is made and to disclose this cost against the results of the Financial Statements of the period.

My understanding is that outstanding Derivatives, with unaccounted and unreported paid costs, amount to $Trillions and many times the GDP of Australia.

**The SOLUTION to this critical financial problem is-**

**To immediately-**

1. 1. replace APRA, which in my opinion has proven itself to be incompetent as the Regulator of the Financial System;
2. 2. appoint a new Regulator, with representation from the Accounting Profession, Depositors and Borrowers, with two divisions (1) responsible for Regulation and (2) responsible for Compliance.

**The first duty of the new Regulator being to determine -**

1. 1. as above, the appropriate interpretation of the International Accounting Standards and Practices in respect of Derivatives;
2. 2. the unaccounted and unreported paid costs of outstanding Derivatives;
3. 3. the financial impact on the Financial System of accounting for and reporting in the current financial year of the paid costs as in (2);
4. 4. the face value of outstanding Derivatives, which are unlikely to be paid when they fall due and payable. Note the obligation to pay then goes to the next counter-party and can ultimately fall upon the originating party of the Derivate.

**The Government via the Reserve Bank to take over the**

1. 1. paid costs as in (3) which if accounted for and reported in the current financial year would destabilize the Financial System; and
2. 2. Derivatives as in (4).

**Until the above is put into effect it is unrealistic to consider the separation of the Financial System to protect depositors and home loan mortgage borrowers. The total Financial System must be placed on a viable basis.**

**It is an ethical and moral imperative that depositors' monies be treated as sacrosanct and not exposed to speculation. No consideration of "bank bail in".**

**Also home loan mortgage borrowers unable to meet their repayment obligations after a reasonable period of grace must have any equity in their property protected by the following arrangements.**

1. The property to be appropriately advertised on the open market without any reference to

Mortgagee in Possession. The property to sell on its own merits.



2. 2. The Financier to pay the cost of this advertising (1) to be recovered from the proceeds
3. of sale after settlement of the outstanding home loan mortgage borrowing including

4. outstanding interest.
5. 3. The Financier, on the settlement of (2) to pay to the borrower the property sale proceeds
6. less the cost of advertising and the outstanding home loan mortgage borrowing.
7. 4. In the event that the proceeds of sale as in (1) do not fully cover the payments in (3) the
8. Financier to bear the cost of any shortfall on the basis of bad lending and account
9. management practices.

I trust the above will receive due and proper consideration.

Yours sincerely

Derek Smith CA

**The above is based on: -**

1. 1) My personal experience as a Chief Financial Officer, responsible with the Chairman, for signing the Financial Statement of the Bank for lodgment with the Regulators;
1. 2) Court proceedings, which I took to protect my professional reputation as a Chartered Accountant. The proceedings involved the Institute of Chartered Accountants;
3) Subsequent correspondence and discussions with – the RBA, Institute of Chartered Accountants and Federal Treasury. Note the post De-regulation, Regulator the Australian Prudential Regulation Authority (APRA) did not acknowledge and respond to my correspondence; and
1. 3) The uninformed reporting by the Media as to the cause of the GFC and of the status of the financial affairs of the Financial System.

**The GFC was not caused by the De-regulation of the Banking/Finance/Insurance Industry but by the mismanagement of the De-regulation**.