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Official Committee Hansard

SENATE

ECONOMICS REFERENCES COMMITTEE

Reference: Bank funding guarantees

TUESDAY, 18 AUGUST 2009

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**SENATE ECONOMICS
REFERENCES COMMITTEE**

Tuesday, 18 August 2009

Members: Senator Eggleston (*Chair*), Senator Hurley (*Deputy Chair*), Senators Bushby, Joyce, Pratt and Xenophon

Participating members: Senators Abetz, Adams, Back, Barnett, Bernardi, Bilyk, Birmingham, Bishop, Boswell, Boyce, Brandis, Bob Brown, Carol Brown, Cameron, Cash, Colbeck, Jacinta Collins, Coonan, Cormann, Crossin, Farrell, Feeney, Ferguson, Fielding, Fierravanti-Wells, Fifield, Fisher, Forshaw, Furner, Hanson-Young, Heffernan, Humphries, Hutchins, Johnston, Kroger, Ludlam, Lundy, Macdonald, McEwen, McGauran, McLucas, Marshall, Mason, Milne, Minchin, Moore, Nash, O'Brien, Parry, Payne, Polley, Ronaldson, Ryan, Scullion, Siewert, Sterle, Troeth, Trood, Williams and Wortley

Senators in attendance: Senators Bushby, Eggleston, Hurley and Pratt

Terms of reference for the inquiry:

To inquire into and report on:

- (a) the circumstances and basis of the decision to introduce an unlimited bank deposit guarantee and of subsequent decisions to change or define the guarantee;
- (b) the circumstances and basis of the decision to introduce an unlimited wholesale bank funding guarantee and of subsequent decisions to change or define the guarantee;
- (c) the effect that the initial announcement of, and subsequent changes to, an unlimited bank deposit guarantee had on operations of the Australian financial sector, including for entities not regulated by the Australian Prudential Regulation Authority (APRA);
- (d) the effect that the initial announcement of, and subsequent changes to, an unlimited wholesale bank funding guarantee had on the operations of the Australian financial sector, including for entities not regulated by APRA;
- (e) the estimated effect of the bank deposit and wholesale funding guarantees on interest rates in Australia;
- (f) how Australia's deposit guarantee and wholesale funding guarantee schemes compare with guarantees offered in other countries and the way in which these schemes were introduced and changed in major overseas countries;
- (g) the interaction between the deposit guarantee scheme and other recent measures implemented by the Government since September 2008, including the wholesale funding guarantee and the purchases of residential mortgage backed securities;
- (h) the nature of the financial and economic distortions that the unlimited deposit guarantee scheme has created vis-a-vis savings products that are not covered by the guarantee scheme;
- (i) the optimal cap, if any, for the deposit guarantee in the light of international experience;
- (j) recommendations for ameliorating the moral hazard associated with the deposit guarantee and wholesale funding guarantees;
- (k) recommendations for timelines and for policies to credibly remove the wholesale funding guarantee and to reduce the deposit guarantee to any recommended optimal cap;
- (l) the effects of the bank deposit guarantee and wholesale funding guarantee on competition within the financial sector;
- (m) the effects of the announcement of the unlimited bank deposit guarantee and unlimited wholesale funding guarantee on consumer and business confidence;
- (n) the broader economic and social consequences of these distortions;
- (o) the size and nature of the contingent liability that the unlimited deposit guarantee has created for Australian taxpayers; and
- (p) other matters relevant to the bank deposit guarantee and wholesale funding guarantee that the committee considers appropriate.

WITNESSES

BATH, Mr Michael Paul, Director, Financial Risk, Australian Office of Financial Management 2
HYDEN, Mr Neil Francis, Chief Executive Officer, Australian Office of Financial Management 2
MARTINE, Mr David, General Manager, Financial Systems, Treasury 2
MURPHY, Mr Jim, Executive Director, Markets Group, Treasury..... 2
WIJEYEWARDINE, Ms Kerstin, Manager, Banking Unit, Treasury 2

Committee met at 7.32 pm

CHAIR (Senator Eggleston)—I declare open this third public hearing of the Senate Economics References Committee for its inquiry into bank funding guarantees. On 23 June 2009, the Senate referred this matter to the committee for report by 15 September 2009.

These are public proceedings, although the committee may agree to a request to have evidence heard in camera or may determine that certain evidence should be heard in camera. I remind the witnesses that in giving evidence to the committee they are protected by parliamentary privilege. It is unlawful for anyone to threaten or disadvantage a witness on account of evidence given to a committee, and such action may be treated by the Senate as a contempt. It is also a contempt to give false or misleading evidence to the committee. If a witness objects to answering a question, the witness should state the ground upon which the objection is taken, and the committee will determine whether it will insist on an answer, having regard to the ground which is claimed. If the committee determines to insist on an answer, a witness may request that the answer be given in camera. Such a request may also be made at any other time.

I remind members of the committee that the Senate has resolved that departmental officers shall not be asked to give opinions on matters of policy and shall be given reasonable opportunity to refer questions to superior officers or to a minister. This resolution prohibits only asking for opinions on matters of policy and does not preclude questions asking for explanations of policies or factual questions about when and how policies were adopted.

[7.34 pm]

BATH, Mr Michael Paul, Director, Financial Risk, Australian Office of Financial Management

HYDEN, Mr Neil Francis, Chief Executive Officer, Australian Office of Financial Management

MARTINE, Mr David, General Manager, Financial Systems, Treasury

MURPHY, Mr Jim, Executive Director, Markets Group, Treasury

WIJEYEWARDINE, Ms Kerstin, Manager, Banking Unit, Treasury

CHAIR—I now welcome officers from Treasury and the Australian Office of Financial Management. Do you wish to make an opening statement?

Mr Murphy—Treasury thanks the Senate Economics References Committee for the invitation to appear before it. I note that Treasury has already provided a substantial submission for the committee's consideration. As outlined in our submission, the Australian government's deposit and wholesale-funding guarantees were introduced following the serious deterioration in global financial markets, which escalated in late 2008 with the collapse of Lehman Brothers. Australia's financial system was relatively well placed to withstand these developments. Nonetheless, the freezing of global credit flows, the revaluing of risk and the introduction of financial sector guarantees internationally impacted on the ability of Australian financial institutions to access funding. This potentially had serious implications for liquidity and lending activity within Australia.

It was in this climate of heightened uncertainty and extreme market dislocation that the government announced the introduction of a guarantee of deposits and wholesale funding as part of a broader package of measures aimed at protecting and supporting confidence in the Australian economy. Treasury believes the guarantees have been effective. They have made an important contribution to the stability and strength of the Australian financial system; maintained depositor confidence in Australian ADIs, thus securing a large portion of ADIs' funding; and enabled Australian financial institutions to continue to access wholesale funding markets, which has ensured that households and businesses have been able to secure credit through the economic downturn.

The Treasury submission describes the operation and usage of the scheme in considerable detail, so I do not propose to comment on that. However, I would like to say a few words in relation to two matters that have been raised in a number of submissions to the committee: the impact of the guarantees on competition in the banking sector and the withdrawal of the guarantees. In relation to competition, the deposit and wholesale-funding guarantees are available to over 180 eligible Australian ADIs. This broad coverage benefits a significant number of financial institutions that collectively represent the bulk of the banking services industry, thus supporting competition among a wide range of participants. While Australia's four major banks have been the largest issuers of government guaranteed long-term funding, this is

consistent with their size and historic reliance on wholesale markets for a larger share of their total funding relative to smaller institutions.

Smaller institutions have also benefited significantly from the guarantees. The introduction of the Financial Claims Scheme stemmed an outflow of deposits from some small institutions to larger institutions. According to APRA data, smaller institutions' deposits have grown at a faster rate than those of the large banks since the introduction of the guarantee schemes. A larger proportion of smaller institutions' funding is guaranteed automatically and for free under the Financial Claims Scheme relative to that of the four major banks. Lastly, a number of small institutions have actually increased their share of total wholesale term funding—that is, government guaranteed and non-guaranteed—since the guarantees were introduced. Arguably, this demonstrates that the guarantees have not disproportionately benefited any particular group of ADIs.

In relation to the withdrawal of the guarantees, the government has indicated that it is in the long-term interests of individual institutions and the financial sector for ADIs to cease using the guarantees as market conditions normalise. To this end, we are beginning to see some positive signs in the Australian financial sector. In particular, the recent increase in non-guaranteed issuances at prices approaching those of guaranteed issuances has been encouraging. The removal of guarantee arrangements in Australia will need to take into account the timing of the removal of similar arrangements overseas. Jurisdictions are working towards reaching multilateral agreement to unwind emergency interventions in a timely, well-sequenced and coordinated manner. As you would be aware, this is an issue which is being addressed by the G20.

This concludes my opening statement. We are happy to answer your questions, Senators.

CHAIR—Thank you, Mr Murphy. We have received evidence during the course of this inquiry that the minor players in the market, the smaller banks and other institutions, have found it difficult to get funding either directly or through securitisation, which means in turn that they cannot make the loans they want to. I wonder what would happen to these institutions when the guarantee is removed. It may be that investor preferences fundamentally altered as a result of the global financial crisis. What would you say about that?

Mr Murphy—I have got to look at this in the context of events that have occurred prior to the global financial crisis, during the crisis and even in this transition out of the more difficult market conditions. It seemed that prior to the GFC smaller banks, and in particular non-ADIs, were able to access funding sources which enabled them to be a competitive force within the banking and financial services industry. If we look at each one of them, the smaller banks were largely relying for a lot of their funding from, firstly, deposits and the securitisation markets. In terms of where we are now, the smaller banks have benefited significantly, in my view, and not disproportionately but fairly, from the government's free guarantee on deposits. There would be no reason for anyone, on the grounds of safety of deposits, to choose a major bank from a smaller bank. Everything is guaranteed and it is free. So they have benefited from that. I think some smaller banks institutions have had difficulties replacing the securitisation source of funding. However, I would say that they are adapting to the market conditions that they find themselves in and, given that we are just starting to see the emergence again of the securitisation market, that may well come back on stream and return the banks to the position they were in

previously. I think that may be more expensive funding than it was pre-GFC but it still will be a source of funding.

In terms of the non-ADIs, they were a competitive force but they were not deposit taking institutions so they were very dependent on either the wholesale markets or the securitisation markets. We saw competitive pressures impacting on them prior to the global financial crisis. A number of institutions withdrew from especially the mortgage market prior to the global financial crisis because I think largely funding was starting to be priced up and it was not as cheap which enabled the non-ADIs to be quite competitive.

What happens when there is a withdrawal of the guarantee? One would hope that we would to some extent return to a market whereby there was a diversity of players, that people could complete and provide a competitive environment. It is important that there is not a premature withdrawal of the guarantee in relation to wholesale funding. In relation to deposit taking, the government is committed to a three-year period from October 2008. Coming with that withdrawal, this government has already introduced the financial claims scheme, which gives confidence to depositors. So I think there is a range of matters which need to be taken into account when the government reaches a conclusion that it is timely to withdraw the guarantee arrangements.

CHAIR—Some of the minor banks have told us that it has been more expensive for them to obtain money because they have had to pay higher fees and that has adversely impacted on their competitive situation with the larger banks. Would you like to comment on that? Do you see that being rectified?

Mr Murphy—I think all financial institutions have had to pay higher fees for their borrowings and their issuances of debt. To some extent I think those comments are directed at the fee schedule which is imposed in terms of wholesale funding guarantee. That fee schedule represents the recommendations of the Council of Financial Regulators in terms of the need to maintain a risk spectrum and to protect the Commonwealth in terms of the risks it was taking by guaranteeing the fundraising by a wide range of institutions. We cannot escape the fact that a BBB-rated institution will have to pay more for its funding than an AA-rated institution. That was always the case. I suppose the issue that the smaller banks raise is the fact that the divergence between what the AA banks are paying for their fundraising vis-a-vis the BBB or the A-rated banks has widened. I think you will find that that will come back in time and narrow, but it will always be the case that when borrowing the size of the institution and its credit rating is a major factor in the cost of funds.

CHAIR—Is the excess premium being charged on lower rated banks in Australia greater than is being charged in similar schemes in other countries?

Mr Murphy—No, I do not think so. Each country has come to its own conclusion on that. We are probably at the lower end of the fee charges.

Senator BUSHBY—Could you give us a table which shows comparatively OECD countries, what the fees charged are for the guarantee?

Mr Martine—Page 14 of our submission provides some information on the guarantee schemes in a range of countries. As Mr Murphy indicated, our fee schedule is probably at the lower end of the scale. However, one also needs to factor in swap costs, which generally could be around 50 basis points. When you take it into account the fact that our institutions need to swap back into Australian dollars, it is not that inconsistent. There is some information provided on page 14 on the fee schedules for a range of countries.

CHAIR—Thank you. Do you think that there will be any permanent anti-competitive effects on the smaller banking institutions and non-banking institutions as a result of the consequences of the guarantee and the fact that it has been more expensive for the smaller banks to obtain money from other sources?

Mr Murphy—It is hard to forecast or predict that. I do not think so, and the reason I come to this view is that a lot of the smaller players are involved in the mortgage market. The Australian mortgage market is a gold plated market to some extent. We have the lowest default rates on mortgages. It is in the Australian psyche that people want to be homeowners, and probably the last thing that they would give up would be their own home. That means that there is going to be a vibrant and dynamic housing market and mortgage market out there. It seems to me that, as in the past, anyone who wants to provide competition to the major banks can be quite profitable if they provide better service and seek to get a niche in or a share of that mortgage market. I think that we will see competition return in that market, and competition will come from the smaller players. That is not unusual in markets; it will be the smaller players. Some of them are still there; we have the smaller institutions. I do not see the guarantees as having a long-term distorting impact on the markets. I think that they will respond and innovation and ingenuity from people providing financial services will come to the fore. As well as that, I can see that there may be foreign institutions which will want to come in and compete in the Australian market because it is a very profitable market.

Senator HURLEY—In response to questions you were talking about the big four banks and smaller banks, but there are a number of other institutions out there in the market which are having some difficulty in accessing funding. You were saying that the deposit funding assisted the smaller banks, which I think they freely acknowledge. It is the issue of wholesale funding, I think, that we have had most submissions on—and the freeing-up of the securitisation market. There have been some specific suggestions, particularly from the Australian Securitisation Forum submission, about RMBS. They acknowledge the assistance that AOFM's activity in that area has caused—but also covered bonds and I think they mentioned one other. They are talking about improving the securitisation market. Do you think there is any scope to assist not only the smaller banks but the other organisations that are in there whose funds have been frozen or where there is still a limited redeemability of those funds? That has disadvantaged a number of people who have their funds invested in those kinds of organisations.

Mr Murphy—There has been an \$8 billion program by the AOFM on RMBS. We think that that has sought to assist the smaller players, either the banks or the non-ADIs, to retain their market share. From the government's point of view, it is quite a successful program so far. The government has had representations from the securitisation groups and from various players about reporting back on what they consider to be the success of the program and making representations to the government that there should be another program or a continuation of that program. All I can say at the present time is that the government has that under consideration.

Senator HURLEY—Okay.

Mr Murphy—In terms of covered bonds, we have consulted extensively with interest groups on covered bonds. They are a part of the funding in overseas markets, such as the UK. They are not at the moment available in Australia, as there is an impact on prudential regulation issues there. Again, all I can say on that is that government is listening to the representations and has that one under consideration. Treasury is discussing the covered bonds issue with APRA and the Reserve Bank.

Senator HURLEY—I think you said that the smaller banks are adapting. In what way are they adapting?

Mr Murphy—I think they have increased their funding, their share of the deposit market. They have also raised some money in the wholesale market.

Senator HURLEY—Have they used the government guarantee to do that?

Mr Murphy—Yes.

Senator HURLEY—To what extent have they used the government guarantee?

Mr Murphy—We can give you some figures, but they have used it. They have never been great participants in wholesale markets, but they have used the government guarantee to raise funds.

Mr Martine—On page 28 of our submission, we give a few statistics in relation to the use of the wholesale guarantee. The point we note there is A-rated institutions have increased their share of term funding from six per cent to 18 per cent and the triple-Bs have remained broadly constant. So as Mr Murphy indicated, the lower rated institutions, such as the triple-Bs, were never great users of the wholesale funding markets. They generally funded their operations through deposits. They have raised some wholesale funding under the guarantee, and for triple-Bs that has remained broadly constant pre-guarantee to post guarantee.

Senator BUSHBY—Isn't that increase though because of the lack of availability of funds from other traditional methods, like securitisation? They had no choice, basically.

Mr Martine—We have sort of touched on this a little bit through the course of the questioning. On page 15 we try to represent, through a series of pie charts, the share of funding from the major banks through to the regional banks, building societies. What you can see there is that the regional banks, credit unions for example, certainly rely a lot more on deposits. But you are quite right. In terms of comparing them with the major banks, they are the institutions that are a lot more reliant on the securitisation markets, which started very much drying up in the early part of 2008.

Senator BUSHBY—I would like to see those pie charts with a comparison of what it looked like 12 months earlier in terms of the sources of funding.

Mr Murphy—For instance the triple-B Bank of Queensland, I think it was about 26 per cent of its funding was coming from the securitisation markets. That is a huge gap to fill. When we talk about the triple-Bs, we talk about credit unions and largely they are deposit based institutions.

Mr Martine—Pre-guarantee there was a flight of deposits to the majors because depositors were a bit concerned about risk. One of the consequences we saw with the guarantee was a shift back to some of these second-tier institutions and credit unions because everyone was getting that guarantee. So we have actually seen those deposits grow. There is no question that securitisation has been quite a big issue for those lower rated institutions, including the credit unions.

Mr Murphy—I think that the guarantee in deposits, especially the free nature of it, has sort of normalised the deposit market. I do not think people are making choices for majors because it has taken away the issue of insecurity. That is okay. There is an issue in the pricing of the guarantee, but I think, fundamentally, the drying up of the securitisation market is the thing that has really affected people outside the top four.

Senator HURLEY—And in terms of that, you have also said that the spread of the wholesale funding guarantee fee will narrow.

Mr Murphy—No. The guarantee fee—the 70, 100, 140 basis points—is set by the government, and its operations are monitored and regularly reviewed by the Council of Financial Regulators as to whether it is appropriate for the circumstances. What I said I thought would gradually narrow is the fee that is charged for borrowings, taking that and putting it to one side, in terms of double-A versus triple-B in the market. I think that is what is going to happen. Even putting the government's guarantee to one side, the assessment of risk in the market is still pertinent and affecting the pricing. If issuances are by, say, Australia's four banks, given that we have four of the top 10 banks in the world, they are obviously going to be able to raise funds at a pretty competitive rate. That assessment enables them to raise funds at a certain price, whereas at the present time, because people are reassessing the price of risk, it makes it much harder for the double-As and triple-Bs to raise funds. So the market is imposing a premium.

Senator HURLEY—It is precisely the issue that has been raised with this committee. There are great concerns about the competitiveness of anyone outside of the major four banks.

Mr Martine—We have seen the spreads over the bank bill swap rates come down from perhaps the height of the crisis towards the end of 2008, more so for A-rated institutions. They have probably fallen roughly about 100 basis points versus the double-As, which have fallen perhaps half that. The numbers are a little bit rough and ready, but we have certainly seen those spreads drop as the institutions are issuing more into the markets. That is separate to the fee on the actual guarantee.

Mr Murphy—So we would argue that it is getting better. From the height of the GFC, where without the government's wholesale guarantee program they probably would not have been able to raise any funds, it is now getting cheaper. It really is a matter for the institutions as to whether they want to access that source of funds or go elsewhere.

Senator HURLEY—I do think it is about the relative competitiveness of the organisations though. As fees get cheaper, it also gets cheaper for the major banks.

Mr Martine—In a way, that has always been the case.

Senator HURLEY—Yes, but without the securitisation market and the other—

Mr Murphy—Yes, and that is why we would suggest that the government's program in relation the government's program from the AOFM in relation to the RMBS, the \$8 billion program, was very important in trying to maintain a securitisation market in Australia. As I have said, we have heard the representations coming from that sector.

Senator HURLEY—I would like to ask Mr Hyden about the appetite and the confidence in RMBS. I think we went over this at estimates, but if we could rehash it a bit. Is the market good for those residential mortgage type securities?

Mr Hyden—The market has been difficult since the onset of the financial crisis. I think we have seen some improvement over recent weeks, but that is a relative improvement from a lower base. The big issue is the confidence of investors and bringing them back into the market. The program has been designed to encourage investors to return. In recent months, investors who have come into the market have been doing so in issues that we have been a cornerstone investor for and their focus has been on the shorter maturity tranches. So there is still a way to go before they are investing in the longer term tranches with confidence.

Senator HURLEY—That is the issue that has been highlighted to us and the reason why some organisations are calling for a government guarantee in that area. I am trying to frame this without referring to policy. Clearly, if there were a government guarantee, the confidence in that market would be greatly improved.

Mr Hyden—I cannot comment on the policy issue or what should be done. But what we have done so far through the program has at least kept a number of existing institutions functioning or helped them to continue functioning with some funds through securitisation so that they have not had to stop lending; they are still taking customers and generating mortgages.

Senator HURLEY—But, of course, that is for existing securities, is it not? New security instruments are not being developed.

Mr Hyden—With mortgages that back securities when they are issued, of course the mortgages have to already exist, so they are existing mortgages, but in the program we have made it one of our selection criteria that we ask the proposers to indicate to us how they will be applying the funds that they raise through the issue and to what extent they will be applying them to the issuance of new mortgages.

Senator HURLEY—The Australian Securitisation Forum say that callable RMBS are preferred by investors. They say that, if the call is not exercised, the holder has to wait longer to be repaid their principal and the delay results in the value of the MBS falling. Primary deals are marketed to the first available call date and secondary trade has followed from this, so a

government guarantee could mitigate this risk. They point to that as one of the areas where a government guarantee is particularly important.

Mr Hyden—There have been instances where issuers have chosen not to call securities in. These are not RMBS that we have been involved in; they are existing RMBS. A normal RMBS arrangement will provide for the issuer to be able to call on the remaining securities just because as a security ages it gets paid back progressively as people pay off the underlying mortgages, so it tends to reach a point either in time or in terms of the volume of mortgages and securities remaining where it is sensible to call them. Investors do tend to have expectations that those securities will be called. So, in the instances that have occurred where they have not been called, there has been some adverse impact on the market. In terms of what can be done about it, I think that is a policy issue, so I will not comment on that.

Senator BUSHBY—Thank you very much for coming out this evening to assist us with the inquiry. I am sure there are other places you would rather be tonight. Going back to the opening statement by Mr Murphy, I have a couple of things to raise. In the context of competition, you mentioned that the guarantees are available to over 180 ADIs. But they have access to it, as we have already heard tonight, at varying prices. We have also had discussions tonight about how the market also prices in higher costs for lower rated institutions. Although that spread may be coming down, there is still a differential. Effectively, the fee that is placed on the guarantees provides a double whammy in terms of the additional cost of funds for those institutions that are not AA rated. That clearly would have an effect on competition, in the sense that the smaller institutions have much higher borrowing costs before they go out and compete in the retail banking market. That does not appear to be acknowledged in your submission when you talk about competition.

Mr Murphy—We do not resile from the fact that the GFC has had a significant impact in our financial system and, in some ways, on competition within the Australian financial system, especially in relation to the mortgage market. But we see the guarantees very much, especially the wholesale-funding guarantees, as a temporary measure.

Senator BUSHBY—But in that temporary period when they exist the structure of those fees is placing lesser rated institutions at a comparative disadvantage to the AA rated institutions because it imposes additional costs that would not otherwise be there. Acknowledging the fact that the guarantee has provided benefits for all, the differential in the fee itself places them at a comparative disadvantage compared to the AA rated banks, and we will come to the reasons for that in a minute. Regardless of the reasons for it, it does introduce a comparative disadvantage.

Mr Murphy—There is a comparative disadvantage, but whether that is a disadvantage which is a bad thing is another issue. When the Council of Financial Regulators recommended to the government this fee schedule, the concerns were that you were trying (1) to enable the institutions to raise wholesale funds, because we thought they would not be able to raise funds without a government guarantee; (2) to put them in the position they would be in if markets were open and there was no guarantee; and (3) to take account of the fact that it is the government who is underwriting the system, so the government should be able to charge a risk premium based on the ratings of those institutions. That is the thinking behind it.

Senator BUSHBY—I will come to (3) in a minute, but (2) illuminates it to an extent. Was it the case that they thought by providing the government guarantee that the market would then treat them equally and not actually price differentially? Was it deliberately put in to maintain what was there beforehand?

Mr Murphy—There were wide-ranging discussions about the fee schedule and what the appropriate schedule was. It was a dramatic and quite innovative approach which, as has been demonstrated, was necessary. At the time we were trying to get to a position where all institutions would have access to wholesale funding at an appropriate price. I know certain institutions feel that they are paying—

Senator BUSHBY—Twice.

Mr Murphy—an impost. I question whether it should be seen as an impost. Maybe that should just be seen as the price of having access to wholesale funding with a government guarantee.

Senator BUSHBY—But I do not think any institution would argue against the fact that they have to pay a price for it. What those who are making submissions to us are raising is the fact that some have to pay more than others.

Senator HURLEY—Yet they are all APRA regulated.

Senator BUSHBY—Exactly; they are all APRA regulated.

Mr Martine—One can debate the quanta of the differentials, but I do not think it is an unreasonable position on different rates for institutions. All the ADIs are getting a service from government—they are getting the guarantee backed up by the government and the taxpayer—so it is not an unreasonable proposition to say that the riskier institutions pay a bit more.

Senator BUSHBY—We are going to come to the risk; you are raising that. In your submission itself you say that you consider that the risk being underwritten by the government is very low. You do not, in your submission, highlight the difference that it is very low for AA, not quite as low for A and maybe a little—

Mr Martine—That is right. So we are saying—

Senator BUSHBY—You do not say that; you say it is very low. Are you saying that the Treasury has considered that there is a higher risk in respect of A-rated and BBB-rated banks?

Mr Murphy—That is just the rating system. I think there is, just by nature, all things being equal.

Senator BUSHBY—I am not talking about whether they have been rated differently. We had evidence on Monday or earlier this week—sorry; it was last week, on Friday—from one of the banks; I think it was the Bank of Queensland. They consider that, because of the risk profile of the activities that they actually undertake, which does not involve as much speculative overseas investment and other aspects like that—they invest, basically, in very well-backed mortgages—

they essentially are in reality probably a safer option than the four big banks. That is not reflected in the ratings, because it is not the way the ratings look at it, but arguably the risk to the taxpayers from underwriting their activities is pretty low.

Mr Murphy—If they are such a good risk, that means that, putting the guarantee to one side, they would be able to borrow at a less costly rate—at a price lower than the AAs.

Senator BUSHBY—But that is not how the market works, and you know that.

Mr Murphy—No, because—

Senator BUSHBY—The government is not the market; the government is intervening in this particular industry because it is trying to deliver particular policy outcomes which revolve around stability and solvency of the institutions.

Mr Murphy—That is right.

Senator BUSHBY—You are not in it to make a dollar; you are in it to actually deliver those outcomes. That comes back to my question. If the Council of Financial Regulators actually looked at it and thought, ‘If the Commonwealth provides a guarantee to all the ADIs, which means that the market is probably likely to look at and assess or provide funds to them based on a AAA rating that has been provided by the Commonwealth government, the government needs to put in that differential so that the differential that existed before still does,’ that is one thing. But if the Council of Financial Regulators decided deliberately to put a differential on, knowing full well that the market would still differentially price the cost of funds, then that is another thing altogether. I would like an indication of whether there was a consideration of that before the decision was made.

Mr Murphy—Those issues were discussed, but at the time no-one really knew.

Senator BUSHBY—So it was based on an assessment of what they thought might happen?

Mr Murphy—Yes.

Senator BUSHBY—Was the assessment that they thought that the market would price the risk in the same way given that there was Commonwealth backing for all institutions?

Mr Murphy—There was some uncertainty about that. You could look at it in two ways. What has eventuated is that the market, in effect, looks through the government guarantee and makes its assessment.

Senator BUSHBY—Yes, and that is what has happened. But what I am interested in is whether the decision they made initially was in the expectation that the market would not look through the government guarantee.

Mr Murphy—From recollection, the matters were discussed, and realistically we did not know.

Senator BUSHBY—So the decision on the differential fees was made in an environment where you were not sure what the outcome was going to be in terms of how the market would treat the institutions afterwards. Was there any consideration given to adjusting those fees once you knew how the market would treat those institutions?

Mr Murphy—As you have quite rightly said, the purpose of the guarantees was to in effect ensure that Australian institutions could get access to wholesale markets. Secondly, a policy imperative was to try, to the greatest extent possible, to retain the competitive position or the structure of the market as such. Thirdly, the guarantees were always seen as a temporary measure. Fourthly, I suppose you could say it was thought that the operation of the guarantees would be monitored and adjustments made if it were felt desirable.

Senator BUSHBY—Would that include potentially adjustments to the fee structure?

Mr Murphy—Yes, it could.

Senator BUSHBY—You also mentioned in your opening statement that the securitisation market was returning to normal or was improving—I did not write down exactly what you said.

Mr Murphy—We have seen the signs that it is coming back, but it is an international market and, as Mr Hyden said, it relies on the appetite of investors. We have confidence that it may come back strongly in Australia, given that the underlying mortgages that our securitisation market relies on are in effect such good investments in Australia.

Senator BUSHBY—It has been a very strong market with no problems in Australia.

Mr Murphy—Yes, but our problem is that the securitisation market internationally has been damned by the subprime crisis. To some extent international markets are not as well informed as one would hope and there has been discrimination against securitisation. The Australian securitisation market still has to overcome that view—and I think the Securitisation Forum has made the point that people are still very wary of securitisation as a vehicle.

Senator BUSHBY—How important is securitisation in our finance system? How important for returning the banking system to normality is it that it does recover?

Mr Murphy—It is not the principal source of funding, but it has been a source of funding that has contributed to a competitive and diverse financial system. If we want to get back to a diverse, competitive and profitable range of institutions and players out there, securitisation will be an important factor.

Senator BUSHBY—And that was effectively acknowledged by the \$8 billion that the AOFM has been asked to spend in it to try to foster confidence.

Mr Murphy—Yes. If you look back at when that was announced, the Treasurer told us, as Mr Hyden has said, the industry needed some support to maintain the infrastructure there to tide them over while the international markets started to pick up, and that is what the initial program has done.

Senator BUSHBY—Do you think it has been entirely successful in achieving those aims? I am not trying to score any political points on this.

Mr Murphy—I think it has.

Senator BUSHBY—Do you think it needs to be extended, or there is potential for that?

Mr Murphy—I think it has been successful. It was a modest measure, which still has not been fully completed. It is a matter for consideration of the government whether it wishes to continue down that path—I think that is the best way to put it.

Senator BUSHBY—That is fair—it is a matter for government consideration. If the government decided to expand the program, would that be of benefit to the finance system in terms of making additional funds available, particularly to the smaller institutions?

Mr Murphy—In all of these things there is no straightforward black-and-white answer. If funding were funnelled to small- and medium-sized businesses that may be of more advantage than if the money were going into the mortgage market.

Senator BUSHBY—And Mr Hyden did mention that they do take an interest in where the money is going.

Mr Murphy—Yes. From our assessment, the mortgage market seems to be well serviced at the moment—

Senator BUSHBY—But there are issues with small- and medium-sized businesses accessing funds.

Mr Murphy—It is the constraining of credit. We monitor this on behalf of the government. It seems that people say that, with mortgages, prices have never been as low. There is plenty of access to mortgage finance. What is an issue for the government is to ensure there is credit available to small- and medium-sized enterprises.

Senator BUSHBY—So what tools might be available to the government to actually increase credit availability in that area?

Mr Murphy—One, the government is continually talking, through Treasury and ministers, to the institutions to encourage them to ensure that credit is available. The Governor of the Reserve Bank has made various comments about the economy. Credit will become available as the economy picks up. Also, the securitisation market would assist.

Senator BUSHBY—A proposition that has been put to me—and I think it may have been in some of the submissions—is that the introduction of the bank guarantees obviously favoured the ADIs against those who fell outside the bank guarantee area. I understand and acknowledge that in exceptional circumstances you have to shift the balance towards stability and solvency of institutions, but that has to be carefully monitored and the balance has to be shifted back as soon as you can, in my opinion. As a result, a lot of those institutions that were sources of funding for small business in particular have dried up.

I note what you say about the trends heading that way already, but we have had evidence from IFSA that their members had a 2,500 per cent increase in redemptions in the two to three months following the introduction of the bank guarantee. There may well have been a trend towards it, but 2,500 per cent is fairly extreme. What tools could be employed to open up the non-ADI and non-guaranteed market, which traditionally did provide funds to a lot of small business, particularly for projects that the banks viewed as too high a risk, so that small business again has to access funds?

Mr Murphy—The government has been monitoring and is concerned about where mortgage funds were frozen and finance companies had to freeze redemptions. Those players always were going to offer more competitive rates to attract deposits and yes, they were lenders to small business. What can the government do about it? No investor has lost funds in these institutions.

Senator BUSHBY—Generally they are quite sound, despite the lack of investor appetite these days.

Mr Murphy—Yes, and I think that is a very important point. I know people have had their money tied up. We have to take into account the fact that a lot of people who invest in those types of funds—whether they are property trusts or finance companies—are retirees and pensioners. It is important that, one, they do not lose their investment and, two, they get an income. What the government has done through ASIC is ensure that people in hardship circumstances can get access to their funds. Also we have seen over time some of these institutions start to flow out the redemptions.

Senator BUSHBY—In a partial sense.

Mr Murphy—In a partial sense; that is right. One would hope that, when markets return to normality these institutions would be able to come back to where they can run a normal business—

Senator BUSHBY—The evidence suggested they are winding down. New investors are not coming in and they are allowing redemptions as they wind down—

Mr Murphy—They have always been competitive because they have offered a better rate of return. They will still be able to offer a better rate of return because, coming out of a global financial crisis—and that is what has put us in this position—they have largely kept their head above water and sought to retain their market position.

The government has made an offer, for instance, to finance companies, saying, ‘If you want access to the government guarantee you can become prudentially regulated.’ That has not been attractive to finance companies. They feel that prudential regulation would impose considerable costs on their operations and I think they have decided to just ride out the storm and wait for when markets become normal and the government guarantee is removed from wholesale funding and then possibly the guarantee in relation to deposits is adjusted and they will be able to compete.

If you contrast us with New Zealand, they have had a stream of finance company failures. Our finance companies—and I know it has been difficult for them, but you have to give them

credit—have been able to remain in the game. Other than that, I do not think that there are any deliberative actions which the government can take to assist those companies. I think that it is a difficult time and they have to manage it.

Senator BUSHBY—I would like to ask lots more questions and I would like to ask AOFM some questions too, but I think we running out of time, so thank you very much.

Senator PRATT—I want to ask about unrated institutions that are regulated in the same way that banks are. You would be aware that we are also doing an inquiry into bank mergers currently. The picture that is emerging for me is that we have got our big four pillars and we have got all these competitive pressures within the banking sector. I am quite worried about the coalescence of the competitive pressures, a lack of competitive access to securities finance for some of the institutions that have not been able to access the guarantee and how that is going to flow into the competitiveness of the banking sector overall in terms of where people can get their borrowings from and ultimately the kinds of services that consumers will have access to because the competitiveness of credit unions and other banking institutions could be undermined. What can we do to mitigate those risks?

Mr Murphy—I think your starting point should be that we are just getting out of a global financial crisis—

Senator PRATT—Stakeholders said that they needed the guarantee and to not have it would have been a disaster.

Mr Murphy—Having four major strong institutions has stood us in remarkably good stead. Also having a diversity of providers has also stood us in good stead. I think that you will find that when markets return to some normality more competition will return. I go back to my previous comments: the Australian financial services industry, or that market, is a very attractive market and I think that you will find that more competition will return. I think that there is competition there now. The four major banks will say that competition is extremely tough among them, and there are also individuals, say, from the credit union movement as well. A lot of people prefer to do their banking with smaller institutions. The credit union movement has not lost in terms of deposits nor have small institutions. I do not know whether you were around when I said that I think there are a number of factors which will come into play and make the Australian market a very attractive place for institutions to compete in.

Senator PRATT—All of those things may be true in the long term, but we are also getting other people saying to us that they are worried about their long-term competitiveness if these pressures remain in place and that they are losing market share. What do we need to watch for to make sure, if by chance they are right, that we are in a position to adjust our current policy settings to mitigate those problems?

Mr Murphy—I think that the government is monitoring it. The number 1 issue, other than the stability of the system, that the Treasurer is concerned about is competition within the system. We have looked at a number of issues on his behalf and I think that we are in a transition stage at the present time. If you asked me what we would be concerned about, it would be that once we moved out of this transition and remove the guarantees is just seeing how the market develops. I have confidence that we will return to a highly competitive market.

Senator PRATT—Would you envisage that the current circumstances and the influence of the guarantees should be taken into account in any future proposals for bank mergers?

Mr Murphy—I think that you saw with the two latest bank mergers, St George and Westpac, that there was a very thorough analysis done by the ACCC. As you would know, they looked at all the different markets and they felt that there would not be a lessening of competition by having that merger. The Commonwealth Bank and Bankwest issue was, to some extent, more difficult given the withdrawal of funding by the parent. We have the ACCC, the regulator, and Mr Samuels who has made comments that he sees that as a particular market and he thinks that competition is very important. So I think that the Australian community is in good stead there in that the competition regulator is apprised of issues on competition in relation to financial services.

Senator PRATT—In that sense, the fact that some institutions have access to a guarantee and others do not, despite the fact that a lot of them are regulated and have to uphold the same standards ultimately, if you are a credit union—

Mr Murphy—They do not—

Senator PRATT—They are not rated? They are still regulated the same way.

Mr Murphy—All the ADIs—and the credit unions would be ADIs—have access to the guarantee. The people who do not have access to the guarantee would be, say, finance companies, non-bank financial institutions, and it is these other issues of wholesale funding or securitisation markets that are affecting their ability to continue with their competitive edge. But notwithstanding that, none of them, largely—and I think there is just one small finance company—have gone into insolvency, which is very important in relation to their investors.

Senator PRATT—Thank you. But you would acknowledge that the fact that some players and some institutions have access to the guarantee and others do not would be a factor—

Mr Murphy—The guarantee comes at a very heavy price. You have access to the guarantee if you are prudentially regulated, and prudential regulation largely means that the government stands behind it. You are regulated by APRA. The institutions that do not have access to the guarantee are not regulated by the prudential regulator; they are regulated by the Australian Securities and Investments Commission. There is a clear distinction between prudentially regulated institutions and non-prudentially regulated institutions. Largely, for prudentially regulated institutions there is in effect an implicit guarantee from the government that they will be closely regulated and ensure that people's money is protected, whereas non-prudentially regulated institutions have much less costs of regulation imposed upon them and are able to operate much more freely. They can offer greater rates of return, but people investing in them—and this is an issue—should realise that they are not prudentially regulated. There are more risks investing in non-prudentially regulated institutions than there are in investing in a bank.

Senator PRATT—I understand that, but I have had credit unions and the like complain that they are subject to a lot of the same regulation—

Mr Murphy—They are prudentially regulated.

Senator PRATT—Yes, that is right—but that they have to access a lot of their credit through the securities markets and are disadvantaged in the current—

Mr Murphy—They are, but we are all a little bit disadvantaged in a global financial crisis.

Senator PRATT—Yes. And, frankly, the credit unions said, ‘Yes, we needed the guarantees because we needed the stability and we didn’t want the flight of deposits,’ and they accepted that. But what I am asking is whether you would acknowledge that the existence of these guarantees is a factor that will need to be considered in any potential applications for mergers of institutions?

Mr Murphy—I cannot speak for the competition regulator but I think what you would have to take account of goes back to some of the issues discussed previously with Senator Bushby. We are all flying a little bit blind in that, if you are looking at competition and at proposed mergers, I think you would be trying to say, ‘In a non-guaranteed world, what would be the impact on competition?’ If there were mergers put up at the present time I think you are correct, Senator, in saying that you would have to look at it in terms of the impacts of the guarantee and then think to yourself: ‘If we removed the guarantees, what would be the impact of this merger on competition? Would there be a lessening of competition in the market for that particular product or service?’ It is a little bit difficult at the present time with the guarantees, and that is why I think, underlying all this, the government is keen—and all governments would be—to remove the guarantees on wholesale funding as soon as possible.

Senator PRATT—Great. Thank you.

CHAIR—Senator Bushby just wants to ask a question for the committee about the ending of the guarantee.

Senator BUSHBY—If you could just indulge me for another couple of minutes, one of the things we have not really touched on tonight is the withdrawal or the exit strategy from both guarantees. I am interested in what conditions would need to be met in terms of the market before that would be considered for both guarantees and whether there is any case—noting that there were discussions about it beforehand—for a permanent guarantee of some type remaining in the deposit market in particular, but I am also interested in your views on an ongoing availability of such in the wholesale market.

Mr Murphy—In the wholesale market I think we have really got to have an eye for what is happening in international markets. Exit strategies from various actions that governments have taken are matters that are being discussed in the G20, the Financial Stability Board and other international meetings on these issues. From Australia’s point of view we have to make sure that withdrawal would not be detrimental to the availability of funding for the Australian community, and that is why the guarantees are there—

Senator BUSHBY—In wholesale funding what are the options for withdrawal? How would you approach it in a progressive manner? Would it be progressively increasing the fee to such a point as it becomes uneconomical for—

Mr Murphy—Some of the major bank CEOs have said they would like to be in a world where, even if there was a guaranteed there, they could raise funds with non-guaranteed—

Senator BUSHBY—Which to some extent is happening now.

Mr Murphy—That is right. We are pleased that that is happening, and you will see that the Reserve Bank is seeking to encourage that. So you may be able to get to a position where the price, the cost of raising funds, non-guaranteed—

Senator BUSHBY—Where the appetite for return overtakes the appetite for safety; for minimal risk.

Mr Murphy—Exactly. The complication is that we have to make sure that the second tier and the third tier have access to funds whether they are guaranteed or non-guaranteed. That is a complicating factor, but I think what you will find is that governments worldwide would like to get out of the guarantee business. In terms of deposits the Prime Minister announced on that weekend in October that there would be a deposit guarantee for three years. The legislation was also introduced for the Financial Claims Scheme. That is the government's policy position.

Senator BUSHBY—Forgive me for not knowing this, but was the government's policy position that the deposit guarantee would be at the level that it currently is for that period or just that there would be a deposit guarantee.

Mr Martine—It was set at a million dollar cap. You effectively have the Financial Claims Scheme which has the million dollar cap and then you have the large deposit guarantee. The government's announcement was that the large deposit and wholesale funding guarantee would continue until markets normalise. Then the Financial Claims Scheme with the million dollar cap was set until October 2011.

Senator BUSHBY—In the format that it currently is?

Mr Martine—Yes.

Senator BUSHBY—So at this stage, short of the government changing its policy, there is no indication that that may be varied or wound down progressively.

Mr Martine—It would be a policy change from what was announced.

Mr Murphy—Work was done on this over an extended period of time. In Australia there was never any deposit insurance. There was deposit preference.

Senator BUSHBY—Like they have in the US?

Mr Murphy—Thirty-one out of 32 countries in the OECD have deposit insurance and governments worked on a number of years. Our Financial Claims Scheme is deposit insurance like. It is a minimum scheme. I think the view of government now is that there will always be some form of deposit insurance scheme. It may be that the Financial Claims Scheme will continue on or it may be that we will see. There will always be deposit insurance.

Senator BUSHBY—Thank you very much.

CHAIR—Thank you all very much indeed. I thank Hansard and the secretariat.

Committee adjourned at 8.47 pm
