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SENATE

ECONOMICS REFERENCES COMMITTEE

Reference: Bank funding guarantees

FRIDAY, 14 AUGUST 2009

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**SENATE ECONOMICS
REFERENCES COMMITTEE**

Friday, 14 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, Mark 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, Ian 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, Joyce 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.

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Committee met at 9.08 am

CHAIR (Senator Eggleston)—I declare open this second public hearing of the Senate Economics References Committee 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 hearings, 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 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 a Senate 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. A witness called to answer a question for the first time should state their full name and the capacity in which they appear and witnesses should speak clearly and into the microphones to assist Hansard to record proceedings.

[9.10 am]

SWAN, Professor Peter, Private capacity

CHAIR—Welcome, Professor Swan. Would you like to make an opening statement?

Prof. Swan—No, other than simply to repeat what was said in my written evidence: that in current circumstances I do not see any need to subsidise and guarantee wholesale borrowing by Australian banks, and the sooner this scheme is phased out the better, in my opinion.

CHAIR—Thank you. We will go to questions.

Senator BUSHBY—Thank you, Professor Swan, for your submission and the issues you have raised. You suggest that Treasury's argument for the guarantees is a disingenuous argument in the sense that it suggests that Australian banks need to be protected from low-cost competition from foreign banks. Would you care to expand upon that?

Prof. Swan—Yes. Australian banks are perhaps the most concentrated and most profitable in the world, and in the present climate where major global banks have sustained huge losses—Citibank and many other banks—and many of the major US banks are ripping up subsidy funding and are not in the position to be effectively competing in markets like Australia, it does not make any sense to argue that Australian banks need to be protected from loans from companies of major banks. These banks are not in a position to put Australian banks out of business by providing very cheap, economic or low-cost loans to Australian businesses, and even if they were I think we should applaud such unlikely behaviour because it would benefit Australia. I think the more international competition there is in banking the better, and we certainly do not need to subsidise Australian banks to be able to compete with the parents of the majors operating globally.

Senator BUSHBY—Thank you. Given that you suggest that that is one of the reasons why Treasury backed the need for the guarantees, do you think there are other reasons that justify the guarantees being introduced?

Prof. Swan—I was simply stating the case to Treasury. They say that at time this decision was made last year, global debt markets were in disarray and that this would make it difficult for Australian banks to source capital from overseas; this therefore would help to justify the subsidy, along with this I think very disingenuous argument about the need to protect Australian banks from foreign competition. So I suspect that they probably relied more on the former argument than the latter, because the latter obviously always was and always will be a very weak sort of argument. Even on that basis I do not see any need to go on providing subsidies.

I think it is very discriminatory because it is based on bank ratings. With very big differences between the subsidy rate to more highly rated banks and that to more lowly rated banks, it further biases the banking system towards the larger banks. I think in the longer term, if this continues, it will tend to further reduce competition in the Australian market. So there are a whole variety of reasons why this scheme should be phased out. I do not think these banks need

guarantees anymore. Many of them are now operating without the need for guarantees. They are able to raise both debt and equity capital in Australia or in global markets without the need for continuing subsidies. So I do not really see that they have any case to maintain the continuation of these subsidies.

Senator BUSHBY—There are a couple of questions that come out of those comments. The first is on the differential between the ratings for the wholesale guarantee. On the first day of our hearings, it was explained to us that the differential was placed upon it because that is how the market prices risk when you are looking at the different banks. Given the stated reason for the need for the wholesale guarantee, do you think that pricing the fee charged on a market basis is the appropriate way? Given that it was an intervention in a market to try to achieve a policy outcome or avoid an outcome they did not want from a policy perspective, do you think that market pricing is the pure and only way to price of fee, or should they have looked at how that may have played out and what consequences it may have had on competition?

Prof. Swan—I think the subsequent developments have shown that it is not purely a market based system. While it is true that a market based system relies to some extent on the ratings of agencies, the differential between different classes of debt changes over time. Perhaps at the time this guarantee was introduced the lower ranked banks had to borrow with a higher risk premium. But with the passage of time and fears of global recessions moving away, I suspect that that differential, and the market differential, has lowered yet Treasury have not adjusted their relative rates; they have stuck by the relative rates that they first announced last year.

Senator BUSHBY—Given that official interest rates have come down significantly since they were first introduced as well, talking about relativities in terms of the size of the fee compared to what the official rate is, that has probably increased the relativity in a broader sense. Do you think that that should also have been considered in that context?

Prof. Swan—Yes. It is a bit silly to talk about using a market based system when the whole purpose of Treasury's intervention was to bypass the market. But insofar as it make sense to unnecessarily depart from markets then they should have been finetuning the level and the relative rates for different classifications of banks over time. That would have meant, with the lowering of risk premiums and the lowering of global rates, that they would have considerably reduced the subsidy to the prime bank borrowers and perhaps kept it for some of the weaker banks. They should have narrowed that differential and lowered the subsidy for both groups of borrowers, in my opinion.

Senator BUSHBY—You mentioned that it should be withdrawn.

Prof. Swan—That is correct.

Senator BUSHBY—How do you think we should go about achieving that? Should it just be a blanket withdrawal or a phased one, or should we be withdrawing it by increasing the fee until it becomes irrelevant? What are your thoughts on how the government should proceed in that respect?

Prof. Swan—In my submission I suggested that it not be done instantaneously because there is no need to introduce artificial large shocks into the system when expectations have been raised

that the scheme will continue for a bit longer, although these schemes are being phased out around the world. I would suggest, particularly for the larger banks, to the point where it is no longer worth their while to rely on the guarantee, that a similar process be used for the lower rated banks. Here one has to keep in mind that the prudential authorities would need to keep a very close eye on the financials particularly of the weaker borrowers because it is well known that only very weak borrowers who are likely to fail are willing to pay very high fees. The scheme would need to be phased out with reducing the subsidies but keeping an eye on the solvency of the weaker borrowers.

Senator BUSHBY—It has been suggested by other witnesses that we do not need to take specific action to phase out the wholesale guarantee because, as the appetite of investors returns to higher returns rather than security, the bonds sold will tend to be ones that are not sold with the guarantee. Do you think that is a phenomenon that is likely to occur?

Prof. Swan—I think that particularly the weaker banks who have trouble borrowing will want to go on relying on the guarantees as much as possible. In fact, so far as the rates are kept at the wrong levels, as they currently are, I think all banks will want to avail themselves of it. I think you pointed to further risks for the Australian taxpayer. The banks' appetite for risk is I think increasing. We might well see these funds deployed for much riskier purposes. The last thing we want is the Australian taxpayer underwriting very risky investments.

Senator BUSHBY—Over recent months a lot of the bonds that have been issued by the banks have been issued unguaranteed because they have been able to do that without having to pay the fee.

Prof. Swan—That is correct and that is good.

Senator BUSHBY—Do you think that that trend will continue to the point where the wholesale guarantee basically becomes irrelevant, it just gets priced out of the market, or do we need to take steps to deliberately price it out of the market by progressively increasing the fee?

Prof. Swan—I think it is the latter but there will be self-selection of the weakest and riskiest borrowers. These people are almost out of the market. So it is necessary to give them a nudge along by raising the fees and penalties to discourage this source of funding.

Senator BUSHBY—What are your thoughts on where the committee needs to go on the bank deposit guarantee?

Prof. Swan—For Australian—are we talking about the depositors now?

Senator BUSHBY—Yes, the depositors.

Prof. Swan—I did not really comment on that in the initial—

Senator BUSHBY—I am interested if you had thoughts on that as well.

Prof. Swan—It is having disastrous—it is locking up a lot of capital in slightly riskier investments which are not covered by the guarantee. So a lot are trapped in funds which lack

liquidity because of the guarantee to regular bank deposits. So funds that miss out on these guarantees are adversely affected by it. We have gone from one extreme to the other, from no official guarantees at all to one of the most guaranteed systems in the world with virtually no limitation except some fees that come in above the \$1 million deposit level. I just do not think it is sustainable or required.

We could go back to the system we had before, with no formal guarantees but some implication that failing banks will be encouraged to be purchased by stronger banks, which is the policy we have had for many, many decades. I hope we will gradually move back to that situation and phase down the point at which the guarantee phases out to either very low levels or altogether.

Senator HURLEY—Professor Swan, I think most of your submission deals mostly with the problems of the overseas banks and the situation there but you talked initially about why the Treasury put in place the guarantee and you quote the Treasury saying:

“To address these pressures, the guarantees are designed to assist Australian banks, credit unions and building societies to continue to access funding in domestic and international credit markets—

which, as you stated was the principal reason. Your quote from Treasury also went on to say:

The guarantees are also designed to ensure that Australian institutions are not placed at a commercial disadvantage vis-a-vis their international competitors that have received similar government guarantees on their bank debt.”

Prof. Swan—Yes, that is correct. That is their argument, and I think it is a very weak argument.

Senator HURLEY—The second part is very weak, you are saying. Does that apply to the first part? Do you think that the guarantee should never have been put in place to help Australian ADIs access funding internationally?

Prof. Swan—I am a great believer in letting markets work their way through problems and, while it is always tempting to intervene and I am willing to concede that there can be some short-term benefits to the economy from such intervention, I am more concerned about the firmer implications. For example, banks may in future make very risky decisions, thinking that they will be bailed out as have the very poorly performing US banks to the tune of billions of dollars. So we want to try not to give bank executives the feeling that they will be bailed out in one form or another in future. The way to do this is either to not intervene at all or to intervene in a very light-handed way on a very short-term basis so that we will be spared the disorder that has befallen both the UK and the US where, in my opinion, very poor supervisory and public policies have been pursued for many years to promote low cost housing and they have had the inevitable consequence of the subprime loan crisis.

Senator HURLEY—But, of course, that was not due to any government intervention. That was purely due to the market.

Prof. Swan—No, it was not; not at all. I have written an article about this and published it recently. I am certainly willing to provide a copy for you.

CHAIR—The committee would be grateful. Thank you.

Prof. Swan—The subprime crisis was primarily due to the policies initiated by the US government over many years: Freddie and Fannie and the requirement that banks make loans to disadvantaged people at less than commercial rates. It was certainly exacerbated by other factors and by reducing interest rates down to one and 1½ per cent below any sort of commercial level following the collapse of the high-tech bubble around 2001 and 2002, but it certainly was not the private sector alone that caused the problem.

Senator HURLEY—Okay. You go on in your submission to say:

While the smaller banks have lobbied the Government to change the system from guaranteeing wholesale funds to guaranteeing individual mortgages to remove the discrimination against banks with lower credit rankings, I am strongly opposed to this idea.

I appreciate that, and you give your reasons. My understanding is that the lobbying has not been to guarantee individual mortgages but to free up the market with residential mortgage bonds. Do you also oppose that?

Prof. Swan—Some of the reports I have read have claimed that Canada has moved at least in the direction of individual—

Senator HURLEY—I am referring to the Australian situation. That is what we are looking at here.

Prof. Swan—I would much rather see the implicit subsidies of the larger banks being taken away than have government guarantees for these mortgages provided by banks.

Senator HURLEY—So you would selectively remove the guarantee for the larger banks—by which I assume you mean the big four or AA rated banks—and leave it in place for the smaller banks? Is that what you are saying?

Prof. Swan—It could be phased out for both kinds of banks. As weaker banks get into a better borrowing position, the relative rates of the two can be adjusted so that both are phased out at roughly equal rates. I am looking for a non-discriminatory form of subsidy that is phased out as rapidly as possible.

Senator HURLEY—Phased out from the current level—because the smaller banks are already saying that the current level is too high?

Prof. Swan—They are saying that they are still having more trouble than the larger banks in accessing international credit, I should imagine. They are arguing that.

Senator HURLEY—Would you reduce the fee for them or leave it as it is?

Prof. Swan—No, I would not reduce it. I would raise the fees for all forms of borrowing to the point that none of the borrowers would want to avail themselves of it.

Senator HURLEY—Even though the smaller banks say—and I think we are all concerned about the concentration in the banking sector—that they are already struggling with the current situation?

Prof. Swan—I am sure the smaller banks are, to some extent. Maybe it is because their model, which relies much heavily on external borrowing than the major banks', is a much weaker model in a period of very tight credit where interest rates are going to continue to be fairly high for some time. That does not mean that government policy should deliberately favour them; nor does it mean that government policy should deliberately favour the larger banks. I think the government has been quite happy to see the smaller banks absorbed by the large banks. I do not think that is in the best interests of competition in the banking system in the longer term.

Senator HURLEY—I would certainly agree with that. It is not in the best interests for the smaller banks to be swallowed up.

Prof. Swan—That is right.

Senator HURLEY—If we are not going to produce the guarantee fee and we are going to phase out the guarantee in any case, what would you do to assist the smaller banks?

Prof. Swan—I would probably phase out the subsidies for the larger banks a little bit more rapidly. It may be the case that it is very hard to do anything. The business model of the smaller banks is not very good in the current environment and all the smaller banks with a market presence—like St George, BankWest and so on—have already been absorbed, which I think was unfortunate outcome. It is not clear that the government can or should do a great deal.

Senator JOYCE—Couldn't we just have a sliding scale for the guarantee where, for instance—let's pick a nominal figure, because I know there is \$780 billion, which we cannot possibly underwrite, but we have underwritten it nonetheless—for the first half a billion the bank pay a lower rate, for the next half a billion they pay a higher rate, on an ever-increasing scale until, at the top rate, it is obviously unaffordable and they are priced out of the market? This would both look after the smaller banks and also give encouragement to the bigger banks to move out.

Prof. Swan—Yes, if one now wants to reverse the direction of public policy, which I think has been to subsidise the big banks at the expense of the small banks, having a sliding scale along those lines could be beneficial. One downside is that you are micromanaging the loans scheme, and it may therefore become more a permanent part of the landscape, which would be the last thing—

Senator JOYCE—But then over time, once it became evident that there was an abundance of finance, the government would be happy to withdraw. The government is earning about half a billion dollars worth of revenue out of this per year, for something it cannot really underwrite. So obviously they would just put the scale up for everybody, right across the board. But it still leaves an avenue for smaller banks to be covered at an affordable rate and for there to be parity because the bigger banks also have access to that same amount of money. But for the bigger banks, with their much bigger books, there are a larger proportion that are on a higher rate, which obviously encourages them to reduce their access to the guarantee overall.

Prof. Swan—I agree that a sliding scale would have some of the consequences that you are describing, with the proviso that the prudential authorities look and make sure that the scheme is not just attracting the most risky borrowers at the small end who are unrated and have no wish to invest in a very risky undertaking. So that was the proviso I had in mind. The scheme that you are proposing would certainly help move the balance away from the big four and the big borrowers to some of the smaller banks.

Senator JOYCE—We are a very dynamic economics committee.

Senator PRATT—Professor Swan, at the end of your submission you raise the prospect of moral hazards and Australian banks. You just hint at it. How real is that prospect, in your mind?

Prof. Swan—Unfortunately, I think it is a real prospect. No-one anticipated the hundreds of billions of dollars that were lost by the big US banks. It came as an enormous shock to the bank officials and executives as well as to the government and the regulators. These things are very hard to predict, and the guaranteed borrowing is currently over \$100 billion. I imagine the regulators cannot really keep track of where that money is going or how risky the investments that are being made are. It is better to play safe and to phase out this scheme.

While we have a reasonably efficient and accountable system, I think one of the reasons the global crisis has had so little impact in Australia, relative to the US, is that we had a much better system without all these kinds of interventions. So, once again, the sooner these interventions are phased out and we can return to a system where executives are responsible, essentially, for the decisions that they make rather than the taxpayer, who has no choice in the matter, being the ultimate shareholder, the better.

CHAIR—Thank you, Professor Swan. We are very pleased you were able to appear.

Prof. Swan—Thank you very much.

[9.39 am]

SATHYE, Professor Milind, Private capacity

CHAIR—Welcome. We invite you to make an opening statement.

Prof. Sathye—Thank you for the opportunity. The decision of the government to give a guarantee, in my opinion, has adversely affected the small financial institutions, in particular in the context of the loss of market share, the profit decline and the high funding costs for them. In my submission, I have given statistical data to demonstrate that. The businesses have also been affected because of the reduced issue of securities in the market—the bank securities have a guarantee; their securities do not have a guarantee—and the rise in the funding costs for the businesses.

The consumers have been affected. There is a low return on the deposit for them. There is also an anxiety for some of the clients of institutions like Colonial. This has created an imbalance in the liquidity scenario as the liquidity has started flowing more towards the bigger banks. That is probably one of the things which led to the problems that Colonial was facing. The major banks have benefited, as a group. I have tried to estimate the amount of profit which they would be making over a three-year period, and my estimates show that they will be making a profit of something like \$1.34 billion.

Senator BUSHBY—An additional \$1.34 billion?

Prof. Sathye—Yes, an additional \$1.34 billion arising out of this guarantee. I consider this to be a taxpayer funded subsidy. This has exacerbated the moral hazard problem in the economy. What has happened is that the government has revealed its hand, and the consumers, the businesses, the banks, everyone, now know that—whether you say it or not—a 100 per cent guarantee is available. So, when things go difficult in the economy, there will be public pressure, with people saying, ‘Why don’t you go back to that system where we had a 100 per cent guarantee?’ That is likely to happen.

One of the rationales for this announcement was the confidence problem in the economy. However, the data does not support that there was any confidence problem as such. This is supported by the statement made by the Governor of the Reserve Bank that there is no evidence that there was any widespread confidence problem.

There are a couple of things that came to my mind just yesterday morning, and I thought I would present them to you as well. One is that the whole idea of the guarantee was to help the institutions to raise funds to maintain liquidity and to on-lend to businesses. The idea was to help the institutions. This was to help all the institutions. All are APRA-regulated institutions, so on that footing they are ranked the same. However, while pricing the guarantee, we had a sliding scale depending upon the risk rating of these institutions. I would agree with a risk based sliding scale in normal situations, but we were not dealing with a normal situation; it was an abnormal situation, where we wanted banks to raise money in order to be able to fund businesses and

others. The sliding scale is actually acting something like a double whammy for the smaller financial institutions.

Take the case of deposits. If a bank has a rating of A-minus and somebody has a deposit of \$1 million with that bank, it pays a fee of 100 basis points as per the scheme. Now, there is another bank that has an AA rating, which pays 70 basis points. We assume here that the banks will ultimately be passing on that burden to the customers in one way or another, so that means that there is an incentive for me, if I am a depositor, to move my funds from a bank that is AA-minus to a bank that is AA-plus or AA. So the decision is then leading to movement of funds from one institution to another at a time when we really want all institutions to survive. That is what the intention is.

I would also like to say that my wife contributed one thought on this, because I was discussing this with her in the morning. She said that, in the case of tax, we impose a lower rate of tax on people depending upon their income and the higher earners pay a higher tax. Here, it is the reverse, because we are going from the risk perspective, which, in my opinion, is not appropriate in a situation where we are dealing with an abnormality.

I would probably suggest that it is high time that we phase out the funding guarantee now. The banks have already shown in recent months that they can stand on their own and raise funds in the market. So far as the rolling back of the deposit guarantee is concerned, I would certainly advise caution so that we have a soft landing in the market. There are different opinions about how it needs to be phased out. I have suggested in my submission that we can phase it out in a particular manner.

CHAIR—Professor, I will just ask you a question. Given that there were guarantees in many other countries around the world—or notwithstanding the fact that other countries, and many of them, did have guarantees—are you of the opinion that the guarantees were not really necessary in the Australian situation? The wholesale guarantee, say, had some justification when announced, but do you think Australia could have got along altogether without these guarantees?

Prof. Sathye—I would probably say that Australia need not have gone from a situation of no guarantee at all to a wholesale guarantee. That was going right to the other end of the continuum. We were having a provision for having up to \$20,000 guaranteed, following from the report of the Davis committee, so that guarantee was enough, in my view. At the most, if you wanted, if you felt that you had information that there was some confidence problem—and of course I say that there was no confidence problem, and the governor supports that there was no confidence problem, but if the government had some information that, yes, there was a confidence problem out there—then you could have increased that limit maybe from \$20,000 to \$60,000, as I wrote in the op-ed in the *Australian*, and that would have still covered nearly 80 per cent of the households in Australia. The situation in Australia was not that dire, as it was in countries like the US or the UK. In spite of that, they were cautious in increasing their limits. We are in a very solid situation. I wonder why we had a need to go from a no guarantee situation to a 100 per cent guarantee situation. That is what I am a bit unable to understand, really.

CHAIR—Some people argue that the guarantee settings were in fact designed to cause an exit to quality, so-called, and shore up the Australian major banking system, the top four. What would your comment on that be? Do you think that is a possible rationale?

Prof. Sathye—That is actually the impact of the decision. In fact, it has really helped the major banks in several ways. It may not be wrong to say that the smaller institutions have really been discriminated against in this game. As deposits were flowing anyway, the contention is that, ‘Oh, well, deposits were flowing even before the guarantee, so what big difference is there if they flow after the guarantee?’ Well, there is a difference. The difference is that your intention was to stabilise the system, to create confidence, and you wanted to create confidence in everyone, including confidence in the depositors of credit unions or building societies. But obviously, if after the guarantee as well the funds kept on flowing, it meant that confidence was probably not created. So the objective of the guarantee, to create confidence in all Australians, was probably not achieved.

Senator PRATT—We have had representatives of small institutions give evidence saying, ‘We needed to act quickly and in order to do something quickly the guarantee was probably necessary, despite the fact that it discriminated against us, and now is the point for it to change.’ They have not necessarily contested that. Clearly they have argued they would like to have been included and that it is now creating some distortions, but they have very strongly argued that we needed to do something quickly in order to prevent those mass withdrawals. Would you agree with that contention?

Prof. Sathye—It is true and I do agree with that. That is the reason I said that as \$20,000 was coming in, we could have increased this to \$60,000. However, the thing I am not comfortable with is having the 100 per cent thing. That is the problem I am finding difficult to reconcile with. Also, when the initial announcement was made, there was no limit prescribed. Subsequently the government said that it is going to be the one million and below one million band. Obviously that was not directed at the small financial institutions at all. We will not be expecting the small financial institutions to have individual deposits of a million dollars or so. So I do support that with a limit of \$60,000.

Senator BUSHBY—You were talking about the decision to have differential fees on the wholesale funding guarantee and the fact that they have obviously chosen risk as the appropriate way of dealing with that. We heard from APRA, I think it was, who were saying that is how the market prices these things and therefore that is what they did. From a policy perspective of making deliberate intervention in a market that was potentially at risk of having a failure, is looking at what the market does in terms of pricing an appropriate way or should they be looking at what they are trying to achieve, what the consequences might be of their intervention and how to set up what they are going to do and the best way to avoid consequences they did not want?

Prof. Sathye—You are correct. As a matter of fact, the objective was to help banks to raise funds so that they can on-lend, and this was a very abnormal situation. In that situation, you really cannot use, in my opinion, the rules that we use in normal situations of risk based pricing. So in my opinion, given the situation and given the objective that we want to stabilise institutions and we do not want any institutions to fail, and all institutions are APRA regulated, so on that front they are all equal, and if they are all equal, then why is there a discrimination on the risk basis at a time when risk was pretty high?

Senator BUSHBY—The risk was very high at that time and if you are looking at the institutions that are able to avail themselves of the wholesale guarantee, if the policy intention is

to stop or to limit the risk of institutions failing, does it make sense to you to put a higher cost on the fee to those who probably have the higher risk of failing?

Prof. Sathye—It does not. What often happens is that you are furthering their going into financial problems because they are now finding it harder to raise money in the international market.

Senator BUSHBY—So not only do they have an inherent market disadvantage because they are a higher risk and therefore in the market that is priced in, but the government has imposed a higher fee on them as well.

Prof. Sathye—Yes.

Senator BUSHBY—I think earlier you used the term ‘double dipping’.

Prof. Sathye—Yes, double whammy.

Senator BUSHBY—Yes, double something. So they may in the overall sense have helped the market to access funds but in doing so they have made it harder for those more at risk to remain viable—in a relative sense, anyway.

Prof. Sathye—Very correct. I do not mind the market making a decision about which institutions are more risky or less risky. That information adds balance to the market because it is important for everything to have a level for everyone. So let the investor make that decision. However, by sliding fees here, we are also sort of supporting giving extra rating to these banks, which is probably not what government policy should be doing.

Senator BUSHBY—Would that have been reasonably foreseeable prior to the decision to introduce the wholesale guarantee?

Prof. Sathye—Why not? It was certainly possible to foresee that. That is the reason why the US government had one fixed line for all banks. There it was based on the duration of the instrument acquisition in the market rather than on the riskiness of the institution itself. That makes some sense. If you have risk for a longer period you pay more. That is fine as it is not institution risk based.

Senator BUSHBY—As to the bank deposit guarantee itself, I think you mentioned that it has had the impact of putting at a competitive disadvantage those who are not able to take advantage of it. In respect of what you were saying about having a lower guarantee or a fixed amount rather than what is effectively an unlimited guarantee if you are prepared to pay the fee of over \$1 million, do you think a limited guaranteed amount—\$20,000 or \$60,000; I think Malcolm Turnbull suggested \$100,000 at the time—would have reduced the impact on those institutions that were not guaranteed?

Prof. Sathye—I am looking at the limited guarantee from a moral hazard perspective. From a moral hazard perspective, having a blanket unlimited guarantee is not really desirable.

Senator BUSHBY—Because, essentially, people can undertake highly risky activities—

Prof. Sathye—Yes. There is a signalling effect to the market that, yes, it is available. So in the course of time, even if you pull back from the situation, actors in the financial system know that as it is institutionalised they can always fall back on it; it is available. They know that it was implemented at one point in time, so they can think, ‘Why not at this point in time?’ These kinds of moral hazard problems will arise. As to the blanket guarantee and a \$60,000 guarantee, as I was saying, \$60,000 was meant to protect the small depositors, and that is still about 80 per cent of households in Australia. As far as the larger, wholesale depositors are concerned, in my opinion there was not any risk of them moving their funds out of the country. Moving funds out of the country has several implications. The first is that they exchange risk that they are going to take. The second is that the interest here could be better than the interest from the other banks overseas. The third is that a lot of the banks in overseas countries were already in trouble. Why would one move their wholesale funds from here to somewhere else? There was less probability of the wholesale funds taken out of the country, so why not limit the guarantee to \$50,000 or \$60,000 or whatever. That could have been negotiated. I would have said \$60,000 because that would still cover people in 80 per cent of households.

Senator BUSHBY—In terms of moving forward, a phased approach is what you recommend so that we do not have a major shock to it.

Prof. Sathye—Yes.

Senator BUSHBY—And then moving back over a period of time. Would you recommend that you retain some form of guarantee in the longer term at a much lower cap?

Prof. Sathye—Yes. I would recommend a guarantee at a much lower cap, and \$20,000 was what it was.

Senator BUSHBY—Do you think it should be a guarantee or an insurance scheme like they have in the US?

Prof. Sathye—I prefer the insurance scheme; it is deposit insurance. I feel that the wholesale guarantee should be scrapped as soon as possible.

Senator JOYCE—It seems that bigger banks do not really need it; smaller banks do. It has also become apparent we do not have the capacity to cover the amount of the guarantee—\$780 billion—if it were ever called on, nor do we have the capacity to cover even some of it, if one major bank went wrong. I think we would find that over time we would have to phase this guarantee out. So I run the same idea that we gave to the last witness. Is it possible for us to say that the price of the guarantee for a bank for the first \$500 million will be a certain price, the next half a billion will be at an increased price and the next a further increased price, so that we are scaling up for the more the institution avails itself of that guarantee? Quite obviously at the top end the banks will be saying that once they get past whatever it is—let’s say \$10 billion or \$20 billion or something—they are costed out of the market. Yet this would allow the smaller banks to stay in the market, and over time you take the whole scale of the fees up so as to encourage everybody to get out of it. Can you give us some feedback on that?

Prof. Sathye—There could be several ways of looking at it and that is one of the ways. What would probably happen is, again, we would continue to interfere with the market. I am in favour

of a market mechanism to work. That was why I said that charging a sliding scale of the guarantee fee itself militates with that market mechanism, letting the investor decide what the risk rating of the banks is and accordingly decide whether to invest or not. We need not be a party to that. Coming from that perspective, in order to ensure a soft landing, we could consider different options. The option that you have suggested could also be tried, though I am not particularly in favour of it; I would still like a level playing field in the market for everyone.

Senator JOYCE—Everybody would be able to access the first tranche—say X dollars—at a certain price and then, regardless of what institution you are, we start moving our nation away from covering an extensive amount of money, which, even though it is highly unlikely it would ever be called on, it is still something we want to get off the books. It also allows the smaller banks to not be compromised. We do not want to lose any more regional banks if we can help it because we start to overcentralise our market beyond it already being overcentralised. And obviously, if the big banks start saying that the top end of the volume of money costs them too much to guarantee and they are not going to get the guarantee, then quite obviously the market will start perceiving that they probably do not need the guarantee at all and they will no doubt have a very attuned cost accountant who will say, ‘Get rid of the guarantee; we do not need it as a product; we can move without it.’

Professor Sathye—I am not in favour of that because, in my opinion, if you bring down the limit of the guarantee to, say, \$100,000—and I have given it a ceiling in my submission of \$100,000 by the end of this year, \$60,000 by June next year and \$20,000 by December next year—then we still give the assurance to the depositors of the small institutions that they need. For the major banks, we really do not need to have that kind of tapering system of pricing and then still say that the guarantee is available—that is, the price is different but the guarantee is available. I am not in support of that. I would say that it is better to bring down the scale itself.

Senator JOYCE—There is \$780 billion out there that we are guaranteeing. Let us just say there is one institution—call it institution X—that has \$200 billion of that. To make it easy for this conversation, for the first \$50 billion you are only going to pay half of a per cent; for the next \$50 billion you are going to pay one per cent; for the next \$50 billion you are going to pay 1½ per cent; and for the next \$50 billion you will pay two per cent. It is all available to you but the call is yours as to how much of the guarantee you want. Quite obviously, any guarantee is a product. You go to the market place and you determine how much you want to buy of a guarantee. Therefore, it is not working on the size of the deposit. It is on the bank’s decision of how much overall cover they want to pay for.

Professor Sathye—But still it says that the guarantee is available. You may be charging a different fee for that. What I am not comfortable with is having the guarantee itself there.

Senator JOYCE—You do not want any guarantee at all?

Professor Sathye—That is what I am in favour of reducing—the guarantee itself.

Senator JOYCE—But this is the mechanism which obviously starts to walk people out of the guarantee in any case. Surely, if we remove the guarantee tomorrow then all there will be is a rush of money away from the regional banks, which will collapse, and then the big banks—which do not really need the guarantee—will use that imposition in the market to just increase

their play in the market. Then the Australian people will be left with a terribly overcentralised banking system.

Professor Sathye—The thing that I have proposed is on a tapering basis bringing this ceiling down. The assumption is that the Australian economy is stabilising—well, there was no problem with the Australian economy. The overseas economies are stabilising, and that is reflected in the unemployment data in the US and also the stock market indices. I am assuming that over a period of a year or so we will have a definite indication about the state of the overseas economies and the state of the world economy as such. That should help us to decide the lowering of the limit and the limit that we could put. If the economies are looking okay, then it is really a question of public confidence. If the economies are looking good, people are then not going to move out their money from one institution to another—that is, out of something that they are already used to. They would like to keep their money with that institution if the general confidence in the economy is good. I am looking at it more from a confidence perspective. From that perspective I feel that if confidence goes up then it should be possible for us to reduce the deposit insurance limit. That is not likely to vitiate the financial flows, in my opinion.

Senator JOYCE—I suppose we are all trying to place the trainer wheels back on the banks to walk them out of the guarantee. There would be a lot of people who would say, ‘You are only guaranteeing \$60,000 deposits and I have got a \$1 million deposit.’ Unfortunately, if I have a \$1 million deposit, I am probably going to be a lot more attuned to moving money at a rate of knots. This could in itself—if we start talking about the size of the deposit—put the onus back on the myriad deposit holders who have knowledge of the market. In the proposition I put forward, the onus is really on the banks. I think that is a fairer proposition.

Prof. Sathye—There could be several ways of looking at it. Your perspective could be one way of looking at it. Personally, I am not much comfortable with it.

Senator JOYCE—Thank you very much for that.

CHAIR—Thank you for appearing today, Professor. The committee will now suspend to have a short private meeting.

Proceedings suspended from 10.11 am to 10.29 am

BELL, Mr David Peter, Chief Executive Officer, Australian Bankers Association

HOSSACK, Mr Nicholas, Director, Prudential, Payments and Competition Policy, Australian Bankers Association

CHAIR—We welcome representatives of the Australian Bankers Association. Gentlemen, would you like to make an opening statement?

Mr Bell—Yes, we would. Thank you for this opportunity to the committee. We welcome the opportunity to provide evidence today but we need to establish upfront that ABA is an industry association that represents the broad interests of its members. There are many aspects to the guarantee issue that the ABA cannot represent all its members on, because there are differences of opinion amongst our member banks. Having said that, our submission sought to identify areas of common agreement.

In brief, our submission argues the following points. Firstly, Australia's banking system has performed well through the financial crisis. Secondly, this performance is primarily the result of the sound banking practices of Australian banks. Thirdly, the government's policy announcements in relation to the deposit guarantee helped maintain confidence in deposit-taking institutions. Fourthly, the government's wholesale guarantee was a prudent measure, because of the actions of foreign governments to guarantee the funding of their banks. Fifthly, our submission argues that the deposit guarantee limit should revert to an international benchmark in time. Sixthly, the insurance premiums on the wholesale funding guarantee should narrow, but there are differences of opinion amongst our banks on the extent of this narrowing. Finally, the ABA encourages the bank to reach an international agreement to wind back the wholesale guarantees. We are very happy to take your questions now.

Senator HURLEY—I think it is that international aspect that I want to explore more. We have heard a bit of evidence in this inquiry that the guarantee was not needed in the first place, secondly that it certainly is no longer needed and thirdly that Australian banks were not in the same position as the international banks and so needed less of a deposit guarantee or the guarantee on wholesale funding. Can you comment a bit more on that and, in particular, on that international connection and why that is important?

Mr Bell—I think the first thing to do is clearly identify the difference between the deposit guarantee and the wholesale funding guarantee. Our view, which we have stated in our submission, is that, at the time of those announcements in October last year, we thought that the announcement for the deposit guarantee was an appropriate measure to ensure that there was consumer confidence in the financial system here in Australia. Having said that, we have also stated in our submission that there was no suggestion that any financial institution in Australia—not one we represent anyway—was in any form of trouble. In terms of the wholesale guarantee, it was clear that, because of the actions of other governments, particularly led by Ireland and others quickly following, it was important that the government did what it did to ensure that Australian banks were able to access funds from overseas. Australian banks source only half of their funding from Australian depositors. The other half comes from the wholesale markets, and, depending on what bank you are talking about, roughly half again comes from the international

markets. So it was critical that our banks be able to access funds from overseas. The alternative, which again we have stated in our submission, was that there would have been credit rationing. I invite my colleague to add anything further.

Mr Hossack—No; I think that is fine.

Senator HURLEY—What about this idea that Australian banks did not need that guarantee from the government, that in fact it was a moral hazard to have the guarantee, that it invited risky behaviour?

Mr Bell—Are you referring to the deposit guarantee the wholesale guarantee?

Senator HURLEY—The wholesale guarantee.

Mr Bell—Again, I think the facts speak for themselves. Depending on which bank you are talking about, banks did need to access funds from overseas markets. It is a fact that we do not, here in Australia, save enough to pass on to our lenders. The actions of foreign governments meant that the Australian government really had to move, because, otherwise, banks would not have had access to a source of funds—

Senator HURLEY—Even though our banks are highly rated in international terms?

Mr Bell—Absolutely. We are talking here about unprecedented circumstances. Again the fact is that the markets froze. The alternative would have been literally a credit squeeze here in Australia. Banks would not have had access to a line of credit which they had before.

Senator HURLEY—You have suggested that it seems things are stabilising and improving in some senses. But the committee has heard again and again that the banking market in Australia has, particularly during the global economic crisis, worked to benefit the big four banks in Australia, particularly in terms of retail depositors and their share of particularly home loans but loans generally. There have been suggestions that both the deposit guarantee and the wholesale funding guarantee have exacerbated that greatly. In terms of what it was worth to the banks, we had one figure of \$1.34 billion. That embodies two questions. One is: how do you think we can increase competition in the banking sector? Secondly: do you think that we should unwind the guarantee provisions more quickly or more slowly?

Mr Bell—If you do not mind, I will let my colleague answer the second question but I will start with the first question, which is competition in the banking sector. Our view is, and we think the facts demonstrate this, that the Australian banking sector is competitive. It was competitive prior to the global financial crisis and we believe it is now. I will add to that in just a moment. The evidence is in the number of products available and in the price of those products. You only have to look at home loan rates, which are at 44-year lows, or 45-year lows, and at the evidence that interest margins for banks are on a long-term trend downwards. This has been a recent uptick, but there are always upticks and downticks. So, we think, on the basis of that evidence that, generally speaking, the competitive position—

Senator HURLEY—I am sorry, Mr Bell, but isn't the interest rate downturn not so much a matter of competition but of the general downturn in interest rates around the globe?

Mr Bell—That is certainly a fact. But I am simply pointing out all these contributing factors, which indicate that we do have a competitive banking sector. The other aspect, of course, of competition—and we have said this in our submission—is that, clearly, the cost of money is an important business input for banks, and one of the aspects of the wholesale guarantee scheme was that those institutions which had a lower rating than the bigger banks had to pay more for their money. So that would have increased one of their business input costs.

Mr Hossack—I think the striking feature of the global financial crisis was the closure of the securitisation market or the effective closure of the securitisation market. That meant that those institutions that were dependent upon those markets to fund their asset growth, their loans, were going to do it tougher than institutions that were not as dependent on the securitisation market. So the most dependent institutions were the nonbank lenders, the loan securitisers. Amongst the banks, the regional banks had higher proportions of their assets securitised, so they were relatively disadvantaged. The building societies and credit unions had that to a much lesser extent, because they have a very high of proportion of deposits. The major banks were impacted but they are relatively smaller users of securitisation products, so they were less affected. So the global financial crisis itself had those sorts of distributional effects, essentially because of the disruption to the securitisation market.

Mr Bell—If I may just add to that, Ms Hurley. It was not one of your questions, but in your introductory remarks you reflected upon the relative market shares of big banks versus other institutions. There is no doubt there is clear evidence that big banks have increased their market share. One of the big contributing reasons for that is that the securitisation lenders and other lenders who had different business models which did not rely on deposits effectively had to shut up shop. There was a gap in the market, and that gap in the market had to be filled by someone. Thankfully, we have strong banks here in Australia and we were able to fill that gap.

Senator HURLEY—I understand that, but, now that we are looking towards coming out into recovery, how do we set things up so that there are at least the conditions for an increased amount of competition in the financial sector? Does the guarantee affect that? Does how quickly it has taken off or the way it has taken off affect that?

Mr Bell—I will lead off and ask my colleague to finish. I think implicit in your question is that we do not have a competitive banking system here in Australia.

Senator HURLEY—Perhaps I should rephrase it, but where you have the big four banks taking up about 80 to 90 per cent of the home loan market, for example, that is not a big range of competitors.

Mr Bell—It depends how you measure competition. I would measure competition on price and availability of product. Based on both of those things, we would argue that there is a competitive market here. Having said that, you are quite right to identify that how we exit the guarantee schemes is important, and, in particular, how we deal with the fact that there is a gap between those higher rated institutions and those lower rated institutions. In our submission we have said that gap should be narrowed.

Senator HURLEY—And in terms of how quickly that should happen?

Mr Hossack—What we have said is in terms of the wholesale guarantee. We would like to see that as part of an international agreement, through the G20—that is probably the most obvious body. I understand there is a meeting in the next couple of months, so we can assess then, but I think that most people—and the banks have certainly expressed strong views on this—would say that the sooner they can wean themselves off, or the sooner there can be an agreement to remove the wholesale guarantees, the better. They are trying to issue more non-guaranteed debt. There just needs to be a sensible approach. Adding to some of the points that David made, in terms of some practical things which we think the government could do to support, if you like, the non-major banks—or those that were more dependent upon the securitisation market than what the major banks were—firstly, as we said in our submission, a narrowing of the differential fee paid would help those banks. It would mean they would not have to pay as much to secure funding which they may have previously got from the securitisation market and now have to get through other wholesale means. So that would assist. Also, there is a proposal around to guarantee our MBS securities, to try and get more liquidity in that market. The ABA would support that. The one qualification we have there is that in an RMBS security you have a number of loans which are issued not just by regulated institutions—which are banks, credit unions and building societies, regional banks, larger banks—but you can also have loans originated by non-bank lenders, and they are not prudentially regulated. So there is a risk issue there for the government. While we would support the proposal to have a guarantee, that is just something they would have to deal with.

CHAIR—I might just ask you one quick question. You talk about some of the issues to be considered surrounding the guarantees. Is there any case to be made for some form of guarantee to be made permanent?

Mr Hossack—My understanding, in terms of the deposit guarantee, the wholesale funding guarantee, I think it is clearly in everyone's interest that that ultimately be removed. The question is what is the future of the deposit guarantee; and, incorporated in that is whereabouts ultimately you are going to set the limit on that if it is to be a permanent feature. It is called the Financial Claims Scheme. As part of the Financial Claims Scheme there is an explicit deposit guarantee. It was always the intention—at least that was my understanding—that that scheme is going to be in perpetuity and the only question now is what the limit is. Certainly in the design of it, up until it was actually legislated, it was being viewed as a permanent feature in the regulatory framework. So we do not think that there is any strong recommendation from anywhere that that be removed and we go back to a situation where deposits are guaranteed. That is certainly our understanding. So the main question now is where the limit should be set. What we have suggested in our submission is that we have not come up with a specific number, but we have said that it is probably sensible to look at some sort of international benchmark and to set Australia's deposit guarantee consistent with a range of international countries.

Senator BUSHBY—I thank the ABA for appearing. Mr Hossack, you were talking about some of the challenges facing those institutions that relied on securitisation. You mentioned some things that you thought the government could do to assist certainly the ADI guaranteed side of that, but what needs to happen generally to entice private sector investors to purchase asset backed securities and to again build a viable securitisation industry in Australia? What is private industry doing to rebuild private sector interest in securitisation?

Mr Hossack—I think you are right: it is in everyone's interest that we have a good, strong, viable securitisation industry in Australia. It has proven to be a robust industry. If you look at the defaults on the underlying assets on the securities it is pretty low, so the Australian RMBS market has actually performed well. The problem is that, given the very extensive increase in risk aversion and also the problems associated with these types of securities in the US through the subprime loan problems, there has been a risk aversion which has really impacted this market.

At the core of it, ultimately investors will probably become more comfortable with the risk/return of the product, particularly the Australian product, but maybe there are still some questions such as: is there more that can be done by the industry to ensure that investors are confident and fully understand the risks involved in these securities? I think the industry is doing work on that. Ultimately, if the risk can be better identified and investors are a bit more comfortable with the product, I think it will come back.

Senator BUSHBY—As you say, it was basically a sound industry in Australia, but there was a confidence issue that really led to the risk aversion because of those factors you mentioned. Do you think that the securitisation industry can be viable in Australia in the long term without government intervention?

Mr Hossack—In the long term I am confident that it can because I think, theoretically, it makes sense. I think it is a good product. The defaults are relatively low and, on that basis, I think it is going to be here for the future.

Senator BUSHBY—I will move to a different area. Mr Bell, in your opening remarks you mentioned the deposit guarantee and the wholesale guarantee both being appropriate at the time for various reasons. On the deposit guarantee, do you think that when it was introduced it needed to be an unlimited guarantee, which effectively it was provided you paid a fee for deposits over \$1 million?

Mr Bell—That is a good question. At the time the ABA was not consulted on that. The government had to make a decision in a very short space of time and under a great deal of pressure given what was happening with the financial markets. I guess they had to pick a number. It is unlimited in the sense that any deposit can be guaranteed, but it is not unlimited in the sense that for deposits over \$1 million you have to pay a fee. I guess the government, based on all the information that was to hand at the time and the timing of their decision, made an appropriate decision.

Senator BUSHBY—I understand that, but do you think that, if the government had said, 'We're going to provide a full guarantee up to \$250,000,' that would have been sufficient to deal with the challenges the industry was facing at the time? Perhaps it could have been \$500,000 or another figure below \$1 million. Do you think that could have addressed most of the issues?

Mr Hossack—I suppose that is a speculative question; however, I will make one point about the unlimited guarantee: it is simpler to announce an unlimited guarantee than it is to announce a guarantee that has a limit on it. A limit invokes a whole lot of complications of design. What does the limit mean? Is it a limit relating to an individual depositor or individual products and that sort of thing? If you are under time pressure, which I believe the government certainly

believed it was, announcing an unlimited guarantee would make some sense. I do note that quite a few countries around the world did that and, in fact, still have unlimited guarantees.

Senator BUSHBY—Not most of our major comparable countries like the US and the UK. They all had—

Mr Hossack—I think Singapore has an unlimited guarantee.

Senator BUSHBY—Certainly some have, but most of the comparable nations do not.

Mr Bell—I think the other aspect is: what was the government's objective?—and I am making an assumption here. It was not to prop up an institution that was about to fall over; it was to send a very clear signal to the community that it was there to stand by.

Senator BUSHBY—Sure. I guess what I am trying to say, at the risk of being judgemental, is that the vast majority of people who are likely to cause a run on a bank are the less financially informed, in a lot of ways. They are people who do not understand that the securitisation market is basically sound in Australia. People who have deposits of half a million dollars in the bank probably are pretty aware of what is going on. If you went out there and said that you were guaranteeing all deposits up to \$250,000, the vast majority of Australians would think that sounded pretty and would be pretty well covered. You note in your submission that the deposit guarantee did ultimately lead to widespread freezes on redemption in non-deposit savings products. The decision which they, quoting you, 'had to make quickly' did have consequences which may well have been unintended but could well have been foreseen. We have had evidence that suggests that a guarantee with a cap on it may well have averted some of the run that occurred on those that were not guaranteed.

Mr Hossack—I think there was a movement out of many of those funds anyway. The announcement of the guarantee may have increased the raid but I think that certainly a trend had been established. In addressing the other question, there was an unlimited announcement, but it a couple of weeks after that, of course, there was a limitation put on it. So the government's own actions suggested that they saw that there could be a better way to go forward. That is not unusual. There were countries around the world whose initial announcements were in the heat of the moment and they needed to restore confidence. But once they had done that then they sat down to think a little bit more about design issues and then amended them where appropriate, which is what happened here. The question, I suppose, is: is the million dollars too high? I think everyone agrees two things: (1) it had a stabilising effect; and (2) it probably is too high, and the debate now is about where you bring it down to for the future.

Senator BUSHBY—Nobody argued about the need for action. I guess it was the implementation of the guarantee itself that raises questions, particularly since there were consequences that flowed out of its implementation and whether a little bit more forethought may well have minimised some of those impacts. Changing now to the wholesale guarantee because we only have limited time, I have the same question on that. Given your comments that the primary need for it was to avoid an outcome that ultimately would have led to credit rationing, from a policy perspective of government, do you think that needed to have a variation in fees according to the rating of the banks? Could they have just put in an offer of the wholesale guarantee on one set fee and achieved the outcome, which you noted it was designed to achieve?

Mr Bell—Firstly, we literally were not consulted about that at the time. Secondly, in our submission we stated that we think that gap should narrow, and that is an amalgam of views. We have spoken to our banks and that is what we have arrived at. As to why we have arrived at that point or why they have arrived at that point, we have not surveyed them about that. At this point that is their view.

Senator BUSHBY—I understand that you as the member organisation have issues because you have members who might have varying views on where we go from there. But you as an organisation have said that it was a necessary thing to avoid an outcome that could have led to credit rationing. Could that outcome have been avoided if the guarantee had been offered on one set fee?

Mr Hossack—Hindsight is a wonderful thing. One of the arguments that we have looked at is that we think it is valid as to why the gap should close on the premiums. Of course smaller institutions, or maybe lesser rated institutions is more accurate, have always paid more for wholesale debt when they have gone out to get it because investors that see an A or a BBB charge more when they see a AA.

Senator BUSHBY—But that is still being productive, despite the guarantee.

Mr Hossack—That is right, and that is the real development which has made it into a more serious issue. That is that investors are looking through the AAA of the Commonwealth government and are still charging a premium to the institutions on a rating, and that seems to us, from a practical point, as not a good situation. Because you would expect if it was government guaranteed then they would look through that credit rating issue. On that basis alone we think a narrowing is warranted, and then there is the separate question about whether it was just too wide to start with. We note and agree with others who have looked at this that it looks as though the gap in Australia is wider than the international average. That is another basis upon which you could argue that it should be narrowed.

Senator BUSHBY—When I asked APRA about this in a previous hearing they indicated the main reason for having the differential was that is how the market prices risk. We are talking here about a government measure, a proposal that is designed to avert an outcome that is considered undesirable for Australians generally but also for the Australian banking market. Just because that is how the market would price risk, surely that is not sufficient justification for government to do something when what they are trying to achieve does not require it.

Mr Bell—As my colleague mentioned, at the time of that announcement perhaps no-one could have anticipated this looking-through issue.

Senator BUSHBY—Are you suggesting it was a fully unintended and unpredictable consequence?

Mr Bell—Yes, possibly. Now with the effluxion of time we have seen from an international point of view that the gaps in Australia are wider than elsewhere, as well as this looking-through effect. That is why we have arrived at the conclusion that the gap needs to narrow.

Senator BUSHBY—You suggested in the case of both guarantees that we need to look at an international situation and work out on that basis where we go in the wholesale guarantees with a benchmark, with the bank deposit and with setting an appropriate cap. I can see the sense in the bank deposit. As money is transferable, it is probably a reasonable thing to ensure that what we do is consistent with what they would do elsewhere. You mentioned yourself that banks are trying to issue more bonds without the guarantee. I have heard evidence on the wholesale guarantee that, as the appetite for return increases and the risk averseness decreases, the market itself will take care of it and will not be able to issue bonds with a guarantee because they are too expensive. Do you think that is likely to occur?

Mr Hossack—I think the incentive is that the banks do not want to have to pay a premium to the government.

Mr Bell—Exactly.

Mr Hossack—They prefer not to pay it. The government says if you are a AA rated bank it is \$70. As we know, it is \$100 or \$150 depending on your rating. Nobody wants to pay that so there is an incentive already built in.

Senator BUSHBY—But if nobody is buying it without the guarantee—

Mr Hossack—That is why you need an international agreement. We think that our banking system is strong enough to be a magnet for funds so long as they do not have to compete against other banks which have government guarantees. That is why the international agreement to remove them all is important for us. Remember that we are quite dependent upon bank customers, housing borrowers and small businesses. Even large corporates now are quite dependent on banks getting this money in, so we need to be careful that we do not do something which disadvantages our industry.

Senator BUSHBY—So you do not think that in recent months we have seen significant increases in the amount of unguaranteed money that has been out there. You think that it is a trend that will not continue, because we have strong banks, and that the people who are looking for higher returns will come to us anyway without the international agreement.

Mr Hossack—That is certainly how the banks would like it to happen. They can start issuing everything unguaranteed because, as I said, they do not pay the fee to the government. But while that incentive is there it is another step altogether to say that from this point on, regardless of what the world is doing, we are not going to have a guarantee, because circumstances could change quite quickly and it may be difficult for the banks to raise the amount of money at the price that they want.

Mr Bell—But if you are an investor and you have the choice to invest in an Australian bank with an A rating or with a bank overseas within an A rating and their government has a guarantee scheme in place and ours does not, which way would you go?

Senator BUSHBY—To some extent it depends on the return you can get.

Mr Bell—But, again, you are going to take the safest option.

Senator BUSHBY—Certainly in the immediate aftermath of the global financial crisis people were going for the safer option, but there is evidence that people are beginning to look for returns. There is obviously always a balance between return and risk, and that balance might be shifting a little bit more towards return at the moment.

Senator PRATT—I have a couple of brief questions. Earlier in our discussion you talked about the changes in market share that have been occurring as a result of the guarantee. Can you elaborate on those shifts within the sector?

Mr Bell—You mean the actual quantum of the shifts?

Senator PRATT—Yes.

Mr Bell—I could not actually produce the numbers off the top of my head, but it is a fact that, because of the exit of non-bank lenders—or non-APRA regulated lenders—from the market, there has been a gap in the market. I am not sure precisely what that gap is—maybe my colleague can help me. That gap has had to be filled and that gap is being filled by a mixture of banks, building societies and credit unions, but particularly banks.

Senator PRATT—What do we need to do? That is part of why we need to exit out of this so we do not continue to distort the market further. Your submission on page 4 talked about mortgage interest margins of banks falling. But I have noted that overall bank margins have actually increased. The *RBA Bulletin* in June this year highlighted that fact. Could you comment on that?

Mr Bell—Yes, certainly. Over the past 15 years, the trend of interest rate margins is that they have fallen from roughly four per cent to roughly two per cent. If you look at the curve and you look at that particular Reserve Bank graph, which you have had a look at, you will see that in that long run fall it goes up, it goes down, it goes up and it goes down. Yes, we have had a recent uptick, but we have had upticks and downticks. The long-term trend has been down and there is long-term pressure on bank interest margins.

Senator PRATT—When we are talking about margins, as highlighted by the RBA, does that pertain to interest margins?

Mr Bell—Yes, that is in relation to interest margins. That is basically the difference between what banks borrow money for from a range of people—including depositors, wholesale markets et cetera—and what they lend it for. Again, the rough figures are from down from four per cent 15 years ago to two per cent, which has been a clear benefit to the Australian community.

Senator PRATT—Okay. Thank you.

CHAIR—That is all the questions we have for you. These half-hour segments are very short. Thank you very much for appearing this morning.

Mr Bell—Thank you.

Mr Hossack—Thank you.

[11.03 am]

KANGATHARAN, Mr Ram, Group Executive and Chief Financial Officer, Bank of Queensland

CHAIR—The committee welcomes Mr Kangatharan from the Bank of Queensland. I invite you to make an opening statement.

Mr Kangatharan—We welcome this opportunity to provide the following submission in relation to the government's bank funding guarantee for this committee's consideration. We have made a submission, so I will keep my comments brief. I would just like to reference, if you like, the key points from our submission. BoQ was very supportive of the government's decision to introduce both the deposit guarantee and the wholesale funding guarantee. Our key concern has been what we believe are the unintended consequences of the tiered pricing structure, which has resulted in a very anticompetitive playing field. Since the introduction of the scheme several banks have issued debt under this program, which provides a basis to examine the impact of that tiered pricing.

What we have seen is that the market is looking through the AAA rating of the guarantee and pricing the risk on the basis of the underlying issuer, not the government guarantee. However, the government guarantee acts as almost a ticket to the dance, so without the guarantee access is not available, especially for smaller, lesser rated banks. If you look at the numbers, 98 per cent of the issues under the government guarantee had been made by the majors, so they have been the major beneficiaries of the government guarantee. And it has been needed as the majors have had to go into offshore markets to issue their term debt, which has meant that without the government guarantee they would not have been able to fund their balance sheets. Most of the regional banks, as in some of the comments made earlier today, have been more domestically focused and have actually relied on securitisation to overcome the disadvantages of a lesser credit rating with respect to term funding.

To explain the impact of that tiered pricing on the cost of the guarantee, prior to the economic crisis, if you consider the period pre-August 2007, the difference in a three-year term funding spread between a AA rated bank, which is all the majors, and a BBB rated bank, which is most of the regionals, was a 30 to 40 basis point difference. That is a 0.3 to 0.4 per cent difference. A review of the guaranteed issues since late January 2009 would indicate that the spread between the majors and the smaller banks, again on a three-year term funding basis, remains at 30 to 40 basis points. This highlights that we are paying an additional spread on our guaranteed issues in addition to the 80 basis points difference which we pay to the government for renting, if you like, that AAA rating. So this effectively widens our spread differential or spread disadvantage to 110 to 120 basis points, or 1.1 to 1.2 per cent. Clearly it is very difficult to offer a competitive product to our customers with that sort of a differential cost of funding. Effectively if you think about an average margin on a mortgage that a regional bank makes, it is roughly 1.4 per cent. So when you have a 1.2 per cent cost disadvantage against the majors, it becomes almost impossible to compete effectively.

As I mentioned earlier, the securitisation markets which previously acted as a leveller of the playing field have remained closed and increased reliance on other funding sources, such as the guarantee on our retail deposit base, has become much more important. So the retail deposit guarantee has been critical for the regional banks as an alternative source of funding. Whilst we are supportive of the assistance offered by the AOFM in the securitisation markets, we believe that the amounts of funding available in those markets have been minuscule compared to the government guaranteed issues the majors have been allowed to make. It is an \$8 billion program in terms of the AOFM securitisation initiative compared to government guaranteed issues by the majors, which is a factor of 10 to 15 times that amount. So clearly in terms of the competitive dynamics of the assistance offered it has very much gone to the majors in terms of both volume and also cost of those programs.

From a retail deposit perspective, we believe the tiered structure created a perception in the public domain that lower rated banks are not as safe as the majors. This does not take into account a number of factors, such as the conservative lending portfolios of the smaller institutions and the international experience, which suggests it is larger institutions that take greater risks and actually have required assistance along the way. I think it is true to say that if you look at most of our regional banks in Australia the bad debts as a percentage of their total portfolios are actually a fraction of the losses being experienced by the majors. That is a function of both the larger capital bases available to the majors and also the risk appetite and the ability to absorb losses. So I think it is fair to say that the regional banks in Australia are actually safer institutions and the credit rating that they have is more a function of size than true risk. The Australian public has recognised that in the past, but with the tiered cost of the government guarantee cost I think that perception has been reversed, and that has disadvantaged the regionals.

If you look at the market share moves on retail deposits since the introduction of the government guarantee, you see a consistent flow of funds to the majors in the retail deposit markets, which has advantaged them on the competitive front because they have not had to price those deposits as aggressively as the regionals to defend our share of deposits.

In summary, we recommend that the government guarantee should remain in place until the cost of issuing non-guaranteed funding equates to the cost of issuing under the guarantee. Right now we are in a situation where for the majors that statement is true: the cost of issuing unguaranteed and guaranteed has equalised. That statement is not true with respect to the regionals. In terms of the timing and the fashion in which that guarantee could be withdrawn, we agree that it has to be by agreement via a body like the G20. It needs to be coordinated, otherwise the majors would be significantly disadvantaged in their offshore borrowing programs and they would aggressively focus on the domestic market, thereby creating considerable dislocation for the smaller players like us.

The second recommendation is the cost of the guarantee. We believe it should be a flat fee across all credit ratings. Seventy basis points across all rated institutions would basically not disadvantage anyone, including the majors. In other words, their fee stays at 70 basis points, but the regionals would then be able to access the markets on the same basis as the majors and still pay an additional cost for the fact that we are BBB rated compared to the AAs, because the market demands it.

The third recommendation is that this alignment should be implemented retrospectively as well as being applied to future issues. This would remove a historic unfair tax on the smaller players. In fact, from a revenue perspective for the government, should there be an equal fee across all banks there would actually be greater issues of government guaranteed debt from the smaller banks, so it would probably be revenue neutral.

The last recommendation is that the AOFM mandate on securitisation should be increased. We would recommend a number somewhere between \$30 billion and \$40 billion to really reopen the securitisation market. Whilst the initiative has been good, the \$8 billion currently in place is not sufficient to reopen those markets. In that context, a government guarantee for the securitisation issues supported by the AOFM would be welcome and would serve to equalise the playing field to precrisis levels.

CHAIR—Thank you.

Senator BUSHBY—Given that you finished up there on securitisation, the financial crisis is easing around the globe and hopefully it is over and on its way back, but time will tell. But credit markets are beginning to function better around the world. What are the current obstacles to the securitisation industry repairing itself, effectively?

Mr Kangatharan—As a practical matter, most of the investors in securitised products have been burnt through the US experience. So a lot of the mandates and decision-makers in terms of those investment houses that invest in securitisation products, the decisions are made out of jurisdictions where there is risk averseness. That is going to take time to unwind.

What we are experiencing in Australia is a transmission of that risk averseness which will take time to unwind. That is where the government intervention becomes quite important. If the government were to, for instance, expand the AOFM program to a size of—let us call it this—\$30 billion or \$40 billion compared to the current \$8 billion, that would then attract the attention of some of those investors in terms of changing their view about the Australian market and the opportunities available in the local securitisation market. I think it has already been mentioned that the default rates on Australian RMBS have been extremely low. It is a matter of attracting, if you like, attention to that and actually communicating to those investors that there are sizeable volumes available, to move the needle for them. These are large investors with considerable funds at their disposal. To get their attention and make the Australian context an exception to the rule would be the way that the unfreezing process can start.

I would like to refer to the previous comments around unregulated and regulated issuers in terms of securitisation. The true mechanics of a securitisation issue are dependent on two things. One is obviously your historical track record on default because investors assess that before they will buy your securities. But a second and often ignored element is the loan mortgage insurance that is required—and it is usually provided by a third party into the deal—that gives investors confidence to rate those securities as AA, AAA et cetera. One of the effects of the global financial crisis has been that the availability of mortgage insurance was under threat because two of the largest players in our local market had their own problems due to losses in the US. This is where the government guaranteeing the securitisation issue acts as a clear circuit-breaker should that concern re-emerge at any point in time.

Senator BUSHBY—With the government guarantee, are you talking about it in terms of their playing in the market and going up to 30 or 40 or are you talking about the actual guarantee.

Mr Kangatharan—The guarantee would be a second initiative.

Senator BUSHBY—Okay. I was going to actually ask you about that. There have been some suggestions that the government should look to guarantee in this area. Do you think that would be a worthy thing that would actually assist the recovery of the securitisation market?

Mr Kangatharan—Absolutely. If you look at the pre-crisis spreads on securitisation issues they were truly trading at levels that represented the higher rated paper, up to AAA. If you look at the current trading ranges for securitised issues, they are trading at BBB levels, which is a reflection of that risk averseness as well as probably concerns around the mortgage insurance providers.

Senator BUSHBY—What do you think the future is for the securitisation market if neither of those initiatives are implemented? Can it recover on its own? Can the private industry actually address it?

Mr Kangatharan—I think the road to recovery will take a very prolonged period of time without that intervention and that is simply because the returns currently being experienced through government guaranteed paper et cetera would be far more attractive in the current circumstances. For instance, with a major bank issuing unguaranteed paper for a three-year term, which is roughly the same maturity as a securitisation issue, you could buy that paper for about a 1.15 or 1.2 per cent level. It is very difficult to pass that up and to pay 1.2 or 1.3 per cent for a securitisation deal. Because the alternatives available in the marketplace today with the government guarantee have attractive yields, it is going to take a very long time for the investors to move up the risk curve for the sorts of returns available on the securitisation markets.

Senator BUSHBY—Do you see any potential unintended consequences from introducing a guarantee into the securitisation industry?

Mr Kangatharan—If a guarantee were introduced into the securitisation market the piece that the government would need to monitor carefully is that the LMI providers providing insurance for the portions of the loan book that are riskier do not become risk seeking.

Senator BUSHBY—So it is a moral hazard.

Mr Kangatharan—There is a moral hazard involved there, knowing that the government is ultimately guaranteeing the paper. There is a way to execute that, and part of that would be monitoring the default rates and you can have caps where the government would have recourse to the LMI provider. So there are mechanisms that the government could employ to make sure that the moral hazard does not translate into greater losses on those securities going forward.

Senator BUSHBY—You mentioned briefly that in a lot of ways the regional banks' activities are less risk averse than those of the major banks, and in that sense they are a safer proposition than the major banks. But you did touch on the ratings, that they get rated higher because they are big. Would you like to expand on that a little bit? If the banks are indeed safer in terms of

their actual finances, can't it be argued that they should be rated at a higher rating? Or is it a fault in the rating system?

Mr Kangatharan—Look, this is an argument that we run with the rating agencies every time we meet them. If you take the Bank of Queensland, we have a bad debt to gross loans outstanding ratio of roughly 0.2 per cent. The average for the majors is about 0.8. So our loss rates are roughly a quarter of the majors. That is a function of the fact that we do not engage in corporate lending. We focus exclusively in housing and small to medium enterprise lending. In fact, we are on the smaller end of that SME segment. So the losses that we incur are far smaller, and we also focus on secured lending, which means that usually we have an asset against which we have a claim. We do not engage in large proprietary trading, derivatives trading et cetera simply because our balance sheet is not large enough to support those activities.

So the risks that we take are both a function of the size of our balance sheet, but also our business aim given the resources available to us. The majors will argue they have larger balance sheets, the ability to absorb greater losses and therefore they should be rated higher. I think the two things go hand in hand. If you realise your limitations and you act within your boundaries, you are a safer institution for the risks that you take. So while we understand why the larger banks are rated higher, we have an alternative view—that is, if consistently through the credit cycles you have a better or safer profile, you are in fact a safer bank because you are not subject to the same volatility as the majors.

Senator BUSHBY—Do you think the government should have taken that into account when looking at the fees for the wholesale funding guarantee?

Mr Kangatharan—Absolutely. Our view is that the government, especially on the deposit guarantee, has created a situation where in the public's mind the first time there is a differentiation about the safety of different sized—

Senator BUSHBY—This is for the fees above \$1 million?

Mr Kangatharan—Exactly. Also, if you look at the press and the advertising by the majors during the time when the guarantee was introduced, there was definitely a desire to create that anxiousness in the public's mind because they had the benefit of that in the flight to safety. So if you look at the deposit market share, there was a massive increase for the majors off the back of that time period when they all ran ads about their safety and their size.

Senator BUSHBY—You mentioned that you are supportive of the bank guarantee for all sorts of reasons. Do you think that it needed to be effectively unlimited when it was originally announced, effectively unlimited if you are prepared to pay a fee? Or could the policy outcomes being sought to be delivered by the government be achieved with a cap that was somewhat lower?

Mr Kangatharan—We felt that in terms of the government's response time, if it had acted earlier, it could have announced a program with a limit. It could have been \$100,000; it could have been \$½ million or \$1 million. It would not have mattered and it would have had the desired effect of calming the public and providing a safety net that would have avoided some of the speculation immediately.

Senator BUSHBY—Malcolm Turnbull called for a \$100,000 cap some time earlier, before this.

Mr Kangatharan—Right. But given the acceleration in the public fear and the overseas events that accompanied the eventual announcement of an unlimited guarantee, it acted as a circuit breaker. There was public fear starting to build up with some of the overseas banks effectively going into government stewardship because they could not support the withdrawals.

Senator BUSHBY—There is certainly a need for it, I would agree with that. In the US they bumped theirs up—I might get the numbers wrong—from US\$100,000 to US\$250,000. The UK knocked theirs up to I think £50,000. In Australia, we did not have one at all, and introducing one at \$100,000 or \$250,000 would surely have sent that signal to the community?

Mr Kangatharan—Done earlier and with proper communication, that would have been a more effective solution. Equally, we believe the regulatory authority should have also been monitoring the large banks and their advertising in the press et cetera to not play the situation up. We have contemplated—

Senator BUSHBY—Which regulatory authority do you think should have had responsibility for that?

Mr Kangatharan—We believe it should be the RBA and the APRA. Both APRA and RBA should be monitoring that sort of disruptive behaviour, which is predatory in times of concern.

Senator BUSHBY—It is the last thing you need when you have people who have real concerns to then play up ones that are not necessarily as real.

Mr Kangatharan—Absolutely. If we were to take out full-page ads noting that most of the banks that have required rescue or support from governments were rated AA six months prior, I am sure that would have caused some disruption in the marketplace too.

Senator BUSHBY—I might leave it there to allow some other questions. Thank you very much.

Senator PRATT—You might be aware that we have also got an inquiry underway into certain aspects of bank mergers and have a terms of reference for that.

Mr Kangatharan—I have appeared before it.

Senator PRATT—Yes, that is right. The intersection between this issue and that one in terms of competition in the sector and in terms of emerging issues in the future as we unpick our way out of this situation currently in terms of trying to re-level the playing field, in terms of the kinds of distortions that we have created, probably necessarily so, but that we now need to try to get out from underneath, do you have any comment on this in terms of maintaining competition within the sector as to the interrelationship of those two issues?

Mr Kangatharan—We are certainly of the view that there has been a very large shift in the competitiveness in the Australian banking scene. Both St George and BankWest have been taken

out of the independent roles that they played in competition, and we think that has diminished competition. We have heard submissions about the number of products available as a proxy for the competitiveness of the system, and it could be quite misleading. In fact, there is an ad in the *Fin Review* today. It is for a BankWest product that claims to keep the rates 0.9 per cent below the majors and it says 'Small is better'. BankWest is owned by the Commonwealth Bank and having multiple channels to market and having a different way to address each of those segments to win market share does not improve competition in the long run. Banking is a long game. You get your customers in today and they will very rarely move. They really do not have choice in the marketplace. That will be the time when you will see even greater rates and fees being introduced to really milk that customer acquisition strategy that is currently in train.

Senator PRATT—What does that mean from a regulatory point of view in terms of the new things that we need to be watching?

Mr Kangatharan—Here is our view on the market share shift that you are seeing. In housing—I may get this number wrong—I think the four majors have gone from nearly a 68 per cent share to close to 82 per cent over the last three years. That effectively needs to be watched, because once you acquire such a large, dominant position in terms of market share, if some of the funding avenues that allowed non-bank lenders and smaller banks to compete effectively do not reappear—you have, if you like, effectively a global situation that will affect those avenues for the next two or three years—the competitive landscape will be locked for the next 10 to 15 years. It has been noted that bank margins have been declining for the last 10 years. That has largely been a function of the competitiveness of the Australian banking market.

Senator PRATT—Allowing a bank merger like the one that happened between BankWest and the Commonwealth might have been quite necessary at the time because of the vulnerabilities of BankWest, which are interconnected with the kinds of reasons why we needed the bank guarantee, but in the future we are going to really need to work out how to prevent that kind of concentration further.

Mr Kangatharan—I would dispute the assertion that BankWest needed to be rescued by the Commonwealth Bank in the sense that if that deal had been available to the Bank of Queensland on the same terms, with the funding support and implied support from the regulatory authorities, then we would have been quite happy to take on that business; in fact it had a lot of synergies with us. I think that in the name of stability there were deals done behind closed doors that, in the light of the concerns around competition today, I do not think would stack up in terms of the merits for those take-outs.

CHAIR—Were you offered that opportunity?

Mr Kangatharan—No.

CHAIR—Did you know it was going on at the time?

Mr Kangatharan—No.

CHAIR—Very interesting.

Mr Kangatharan—Good.

Senator PRATT—I found that little ad and, yes, it says, ‘The smaller you are, the happier people are.’ I have noted BankWest’s little advertising campaign along those lines, but I suppose they are not really that small anymore, are they?

Senator JOYCE—One of the issues that are twirling around is that there seems to be a desire to move ultimately out of the guarantees—I mean, ultimately we have to. But how do we actually do the pricing matrix that moves it? Bank of Queensland seems like a good one to try this out on. Instead of the guarantee being attributed to the level of the deposits, what if the pricing matrix were actually at the bank level? I do not know how much you have covered by the guarantee; I am just going to pick a figure to make it easy. Let us say you have \$100 so we can go through the science of it. So for the first \$20 you pay a certain percentage, for the next \$20 you pay another percentage and it scales up to \$100; the top end is more expensive. In actual fact, it might really be that for the first \$50 billion that you are covered for the government charge you whatever it is—the 0.5 per cent fee—for the next \$50 billion they charge you up to a one per cent fee, for the next \$50 billion it is 1½ per cent and for the final \$50 billion it is a two per cent fee. That in itself would have the bank making the price decision as to what extent they want the guarantee to go to for them. Can you make any comments on that?

Mr Kangatharan—If I understand you correctly, Senator Joyce, you are saying that, based on the bank’s total balance sheet—

Senator JOYCE—Based on the extent to which the bank wishes to access the guarantee. If they choose not to, they can say, ‘I don’t want any of that,’ and so they do not have to pay anything. But if they say, ‘I have an interest in funds up to \$50 billion, so I will be paying the fee up to \$50 billion and I will be acknowledging and pricing in how I sell myself in the marketplace to collect deposits,’ then this is the extent to which they will be covered.

Mr Kangatharan—In some respects, in terms of the current construct, that sort of offering is possible. For instance, a bank can choose to offer the guarantee on a particular product for, say, over \$1 million up to \$10 million and either pass the cost on to the customer or price that in the rate of return for that product. Is that what you mean in terms of how to construct that so that the banks choose when they use the guarantee and when they do not for deposits?

Senator JOYCE—Yes. It basically gives the motivation. Basically, the first \$50 billion is the cheapest, the next \$50 billion is dearer and the next \$50 billion is dearer again. This will give smaller regional banks some sense of cover. It will also give the motivation for the majors—who, to be honest, probably could do without the guarantee; it is becoming less essential to them—to not utilise it to the extent that the government has offered it to them, which is unlimited, and to start scaling back. It sort of puts the training wheels back on the banks to start moving away from the guarantee, while not scaring the regionals and having a flight of funds away from them by basically making the scheme so it is concentrating at the bank level rather than at the deposit level and let the bank do the managing and marketing and informing the client base of how much they are actually covered for. I imagine that big deposit holders have far better market knowledge than small deposit holders in that case as well.

Mr Kangatharan—Yes. That would certainly reverse, if you like, the disadvantage today where, despite the government guarantee, there is a continuing flight to safety on the back of the perceived safety of the larger banks. What that sort of construct would do is make explicit the cost of the guarantee, in which case the majors would lose the advantage of the large deposit bases and the advertising capabilities et cetera that they have. I think that would effectively level the playing field of the large and small banks.

Senator JOYCE—Even though you have a guarantee, the market still prices in a risk margin on you. Why does the market do that?

Mr Kangatharan—The practical answer to that is: because it can. Right now, because of that risk averseness, the investor base are looking at their rates of return and treating the government guarantee as a ticket to the dance. In other words, it is a free guarantee as far as the investor is concerned, and they are pricing that debt issue on the basis they would have without a guarantee, which is why the cost of the guarantee is almost a double-dip for us. The cost differential between us and the majors is unchanged pre-crisis and post-crisis—which, as I said, on a three-year debt is roughly 30 to 40 basis points. But the 80 basis points difference that the government has introduced under the cost of the guarantee basically makes the disadvantage three times what the market difference would have been.

Senator JOYCE—The staging of the fee to the extent to which you utilise it would sort of level the playing field in that instance because the marketplace is charging you a premium for something it should not be charging you a premium for in any case. This is another mechanism to level the playing field, so to speak.

Mr Kangatharan—Absolutely. If the cost of the guarantee was flat at 70 basis points across all of the banks, effectively I think you will start to see the regionals being more competitive and issuing more government guaranteed paper, because, as I mentioned, to date 98 per cent of the issues have been by the majors.

Senator JOYCE—Yes, and this would also, to be honest, this would give the capacity to the Treasury to be more comparably covered, paid for. We have a \$780 billion risk that the government is underwriting and we have to give the major banks the motivation to stop requiring that coverage, because, to be honest, if one of the big ones fell over I do not know whether we would be able to pay it. This gives the motivation at the top end to start moving out. Thank you very much for that.

CHAIR—Thank you very much.

[11.43 am]

HARPER, Professor Ian Ross, Director, Access Economics Pty Ltd

Evidence was taken via teleconference—

CHAIR—Welcome to this inquiry. Would you like to make an opening statement?

Prof. Harper—I am happy to take it where you would like to take it, Senator.

CHAIR—Would you like to proceed to make an opening statement?

Prof. Harper—I have been asked to appear to offer whatever views I have on this matter in response to your questions, and I am happy to take them.

Senator PRATT—We have had some discussion this morning about the smaller banks having to offer higher yields than major banks on deposits and bonds which have the government guarantee when in is more difficult for those smaller banks to do that. Can you comment on that, please?

Prof. Harper—Are you talking about the deposit guarantee, as opposed to the wholesale funding guarantee?

Senator PRATT—You can comment on both if you like.

Prof. Harper—I will just wind back a bit and say that the purpose of the intervention was essentially to secure the core of the banking system from the worst that the GFC might have done. A line, therefore, has to be drawn somewhere to isolate the core of the system from other elements that might be regarded as non-core. Whenever that line is drawn there are going to be arguments in both directions that it has been drawn at the right place or the wrong place. It is inevitable that on the inside of that cordon there will be greater support given than on the outside. That is the whole point. These types of interventions are clearly undesirable in normal working circumstances. But the whole point of financial regulation is to achieve an appropriate balance between competitive efficiency and system stability. Something like the GFC obviously upsets that balance and raises the premium which a government should place on system stability at the expense of competitive efficiency, at least until things return to normal.

In my personal view the government did exactly the right thing in stabilising the system and I think the results of that are quite clear. I think senators should be very clear that, had there been no intervention at all, circumstances could have been a good deal worse than they actually were. Having said that, it is also true that these sorts of interventions should be unwound at an appropriate pace. Once we get a sense that the system really has stabilised again then I would be in favour of having those restrictions wound back and listening much more carefully to the concerns of those who are outside the cordon that to continue to have these restrictions in place will upset the competitive balance in the system. They are quite right to say that. It is just a question of judgment about how we balance system stability against competitive efficiency.

Senator PRATT—I agree with you. I want to ask about what kinds of distortions in competitive balance we might continue to expect if we do not start to come to grips with how we exit from here.

Prof. Harper—If you leave these things in place, you unduly strengthen the institutions that are inside the cordon, relative to their competitors on the outside of the cordon. The longer you leave it there, the more competitive strength they gather, which is really drawn on the strength of the guarantee rather than on competitive performance. In the worst case, you debilitate the system by making life so difficult for those outside the cordon that they eventually begin to fail or are absorbed by those inside the cordon and you create for yourself an inner core in the system which becomes certainly very stable but really too profitable for the long-term good of the efficiency of the system.

Senator PRATT—So in that sense everyone has benefited up until this point—some more than others—because stability has been provided, but that has been at the expense of some other players, relatively speaking, and that will continue to distort now unless we find a way of exiting.

Prof. Harper—That is correct. In fact it gets worse. Obviously, as the system becomes more stable the capacity of the core internally to use this guarantee or benefit to its competitive advantage just increases.

Senator PRATT—We are not inquiring into this matter today, but this committee is also currently doing an inquiry on bank mergers. What are the implications of what we are looking for—maintaining a competitive sector that is stable and suits consumers—in terms of watching this space into the future?

Prof. Harper—Clearly, as far as the details of the circumstances within the banking industry at present are concerned, the ACCC is charged under the act to keep a watching brief on this. But, broadly speaking, you end up with the same trade-off. If you have a larger number of banks, you can benefit from competitive pressure at the margin, but you can also forego some of the advantages that come with scale. I think it would be fair to say that the views that mainstream economists might have had about this, and I would include myself in that, were challenged by the GFC. I am on the public record, not the least reason being that the Wallis committee made a similar statement to which I was a signatory, that the four pillars policy should be removed and that the major banks in our country should be able to put a case to the ACCC in the usual way.

I am well aware that others, and particularly distinguished people like the former Governor of the Reserve Bank, Mr Macfarlane, had made public statements to the effect that the four pillars policy prevented us experiencing some of the worst aspects of the crisis that was experienced overseas. That is a valid argument to make. It comes to precisely the same point that things like the four pillars policy are at some level anticompetitive or they stand in the way of competitive adjustments that can be realised through scale and merger but they also purchase a measure of stability. Same trade-off. It is very difficult, without the evidence in front of you, to actually uniformly declare that allowing bank mergers would be anticompetitive, but neither would it be obvious straight up to say that we should be preventing bank mergers because that would be something that is going to simply empower the banks further.

Senator PRATT—In the 1990s regional banks were emphasised within the Trade Practices Commission in terms of maintaining competition in the sector. Now the emphasis seems to be on the competition between the four pillars. To some extent, as we just heard from our previous witness, smaller regional banks have not benefited as much from the guarantees as well as other smaller banking institutions. What is the connection between the banking guarantees and the discrimination and the fact that that has benefited the four pillars and our policy about competition and mergers within the sector?

Prof. Harper—If I understand your question correctly the connection I think is that, in circumstances like we have just experienced, you have to keep the core of the financial system—that essentially in our country is the major banks—as profitable and as stable as you can. For years, before we embarked on remaking regulations following the Campbell inquiry's report in the 1980s, the maintained view was that you should keep major banks at the core of the centre profitable and, if necessary, earning excess profits in order to secure the stability of the system.

We have moved away from that view and switched the trade-off a bit more in the direction of competition at the expense of stability, although we then introduced a much more rigorous system of prudential supervision because we recognised that, in going too far in that direction, we paid a penalty in terms of the efficiency of the system, particularly its capacity to deliver services to a wide range of Australian businesses at a competitive cost. But, as you just intimated, in the 1990s the fact that these heavily regulated banks then were deregulated and became very competitive contributed to the breakdown in the financial system in the early 1990s. The lever or the dial was turned back in the other direction and the Wallis committee came along and recommended that there be some tougher regulations here and there to try and bring the balance back the other way.

We are always dealing with the balance. The connection is that the regional banks, the fringes of competition to the major banks, are very important for driving innovation and competition in the system, most especially through the advent of mortgage securitisation, for example, in recent times. That is a plus but it comes at the expense of making the major banks less profitable and riskier at the margins. We try to control that through prudential supervision by APRA and ultimately the intervention of the Reserve Bank—that is, if you like, the insurance against that happening. In that way we try to balance it all up.

Where do mergers fit in? The more competitive pressure you place on the big banks, the more they look for opportunities to reduce their costs through consolidation. There is an argument that consolidation will not reduce costs and there is an argument that it will. In the end, people like the ACCC have to make a judgment as to whether these mergers are in the public interest or not, but that is the connection. If you do not submit the banks to much competition then they really have no particular incentive to merge. The more competition you put on them, the more they want to merge. If they were to continue to be protected from competitive pressure from the fringe, or if competition were diminished as a result of these protections being kept on too long, you would not necessarily see increased pressure for the banks to merge because, almost by definition, they would be facing less competitive pressure.

CHAIR—I am quite interested in the issue of competition and the way it perhaps relates to the guarantees. The smaller banks have said the cost of money is higher for them because of the higher price they have to pay for the guarantees. We saw the Commonwealth Bank recently not

pass on cuts in interest rates by the Reserve Bank. To what degree is that an example of an anti-competitive outcome with a guarantee? The Commonwealth Bank obviously has access to cheaper money, and the smaller institutions which offer finance for mortgages are no longer with us as a result of the GFC.

Prof. Harper—In a sense, we cannot have it both ways. There are concerns that the banks were cutting corners with their lending criteria and taking on too much risk. I am not suggesting that our banks fell into that trap anywhere near as seriously as happened overseas. But if you stand back and have a look at the big picture, the key reason why the GFC emerged was that risk was under pressure globally, and that included Australia. What that means is that banks are taking on too much risk relative to the capital base. Again, I am not picking on individuals; I am saying that as a general rule. It happened much worse overseas than it did in Australia. If you think that is true and that, as a result of the GFC, the price of money is going to go back up again—it has been adjusted upwards in light of this experience—that means that banks everywhere, including Australia, both in the core and at the margin, are going to have to operate on wider interest rate margins in order to restore an appropriate margin for the risk they are actually taking on their capital bases. Whether that means individual banks will not pass on particular interest rate reductions that the central bank is making is very much a matter for the individual bank to decide relative to its own financial circumstances and what its balance sheet looks like. But as to the general principle that, in the light of this experience, you would expect to see the banks seeking to find opportunities to widen their interest rate margins in order to restore an appropriate relationship to the capital risk they are taking on, all of that ought to be expected.

Your question is: is this being made easier for them by having the guarantee in place? The answer has to be yes. The point of having the government involved in this is that, for a time at least, we are going to allow the Commonwealth's balance sheet to reduce the cost of risk bearing on the private banks so that they can sustain themselves through this process, make the necessary adjustments and eventually be back on their own two feet. The public policy case for that is, I think, fairly clear: if any of the major banks fail, the Commonwealth would essentially be obliged to take them over anyway in the interests of stability in the system. So I think the Commonwealth doing what it is doing is the most efficient way in which it can, if you like, 'sew a stitch in time to save nine'.

But does this make it easier for the major banks or those who are in receipt of a subsidy to compete against their competitors and make an adjustment to their interest rate margin more easily? The answer is, obviously, yes. How long do you let that situation stay in place? No longer than a reasonable judgment would have it that the system has returned to stability.

CHAIR—We have just heard from the Bank of Queensland, who thought that the combination of factors at play now would mean that there would be decreased competition in the money market for smaller consumers for many years as a result. They quoted the fact that the market share of the big four banks in housing lending had increased from 68 per cent to 80 per cent plus in the current market. Do you see that as a good public policy outcome?

Prof. Harper—It is certainly a public policy outcome on the same logic as I have been describing. It is the core case that the government deliberately sought to protect and shore up the poor of the banking system in the face of the crisis, which was unknown at the outset. The fact

that it looks like it is going to be a bit less malignant than we feared is no reason to go back on the government and say, 'You made the wrong decision.' We did not know. What they did was entirely appropriate. So, yes, that is a deliberate outcome of public policy. I point out that the people themselves have rushed back to the major banks, in part because the Commonwealth government, in their wisdom, underpinned the major banks deposits. But, even before that when the process was coming to a head, it was already true that the people were running back to the banks.

This might sound a bit dramatic but, compared to previous experiences of the same type, this time we can be very thankful that people in general ran to the banks and did not run to cash. The great depressions of the 1890s and 1930s were so destructive. The 1890s depression, particularly, was an appalling debacle where one-third of Australia's banks were destroyed through that process and people ran to currency and gold. In the 1930s, they ran to cash. In the 1990s, there were runs on the State Bank of Victoria. As it turned out, the state bank's deposits were guaranteed by the state of Victoria, but that did not stop people rushing to branches of the State Bank of Victoria and demanding currency.

One of the things to come out of our experience is that people did not do that this time. They ran to the major banks. That has clearly caused difficulties for the non-major banks, and the Commonwealth guarantee has made that more difficult again. But the really positive dimension of this is that people did not abandon the banking system when the crisis reached its peak because there is enough confidence in the way our banks are regulated and the way in which banks have behaved. That is a plus but it does not make life any easier for those who are outside this cordon. People like the Bank of Queensland saying to you that there has been what is technically known as a re-intermediation of business back onto the balance sheets of the major banks reflects not only those two things we have just been talking about but also something a little more fundamental.

The other clear outcome of this crisis is that the process of securitisation or mortgage origination—using capital markets to finance mortgages—has been severely called into question. It was an alternative technology to old-style fully drawn bank advances, where people on the one side of the bank's balance sheet would put deposits in and on the other side the bank would make a loan. That loan would stay on its books until it eventually matured.

That system was challenged by securitisation and mortgage origination because it was argued, with some justification, that the old system was too expensive of capital and too rigid. In particular it did not allow the banks to do as much business as they could otherwise have done. Competitors entered in to vie with the major banks offering deals which were cheaper, importantly, because they were off balance-sheet deals and therefore did not require as much capital as the banks required. Through one set of eyes, through the eyes of the new entrants and obviously some mortgage holders, this looked like a technological advance which was to be utterly welcomed and was one in the eye for the traditional banks. I would have to say that for the bulk of the 1990s I think most people would have said exactly that. They would have hailed the advent of competition, hailed the impact of that on the banks' margins—that is, on narrowing those margins—and would have said, 'This is competition doing its best.'

In light of the GFC what we have discovered is that securitisation actually may have looked like a new dawn. Perhaps not totally, but there was the idea that you could actually get away

with having less capital, that you were doing the same thing but on a narrow capital base and therefore more efficiently. That may turn out to have been a false economy because it looks like those sorts of processes, clearly in the United States, can come very horribly adrift. In the end it was revealed that the amount of risk that was being carried was simply not properly priced. Looked at through that lens of good old-fashioned balance sheet banking with its heavy layers of capital and its thick interest margins does not look as anti-competitive or uncompetitive as it otherwise might have looked.

What you have here is a reassessment on the part of borrowers and lenders as to the relative security, longevity and sustainability of these two models of doing business between borrowers and lenders. My final point about that is that, yes, the Commonwealth interventions have tilted the playing field back in favour of the major banks—that is clear. That was done for an obvious and defensible reason which was to restore the stability of the system in the face of a crisis—understood. However, the GFC has also called into question whether the alternative to fully drawn advances on banks was the technological revolution that it had been hailed to be. Even if it were a technological revolution, it actually had hidden costs in terms of systemic risk which we did not appreciate.

I think that both lenders and borrowers have gravitated back to the major banks and would have done so anyway even absent the Commonwealth interventions because of the dawning realisation that life outside the old system may not be all that it has been cracked up to be. When the Commonwealth takes its guarantees away, I do not expect to see a restoration of the status quo ante. Even without the Commonwealth guarantees and interventions, I expect to see that the market will have redrawn the boundary between traditional intermediation and securitised instruments.

CHAIR—Thank you. Dr Harper, you referred to loans where the security was not as good or where the evaluation of the risk was not as well done as it should have been. Was not a key factor in the United States the fact that the ratings agencies actually misled the banks over the risks involved in many of these mortgages and that was one of the key factors involved in the subprime mortgage scandal? Therefore, were risks to be properly evaluated, would you have a different view on the securitisation system?

Prof. Harper—Indeed, I do not think that securitisation as an idea or a notion is inherently flawed but it was built on the proposition that the market is essentially efficient—that is to say, it generates its own information about the securities and it can see through these securities albeit aided and abetted or assisted by credit rating agencies.

The whole idea was that using the capital markets you could build on the back of the efficient markets theory in order to substitute for the old technology which required, as I say, layers of capital and departments of credit risk managers to suss all this out. But that old technology is expensive. The lessons we have learnt, however, is that the capital markets are not as efficient as the people assumed they would be. One of the most shocking things that emerged from this crisis is that the market simply closed for certain instruments—particularly sophisticated ones, there was no market. That is not something which the efficient markets theory ever predicts. It would predict that the price might be very low, it would predict that the price might be very unstable, but the idea that the market would simply disappear is, if you like, off the theoretical radar screen. Once you understand that capital markets are nowhere near as efficient at solving

information asymmetries—resolving these information problems—as people thought they were, then suddenly of course you are looking again at the old technology and thinking, ‘Well, maybe these guys knew a bit more than we gave them credit for, or maybe this model—which, of course, is much older than securitised instruments, had more going for it than we really thought.’

If the information cannot be extracted by the market through buying and selling, then the old ideas, which of course involved tyre kicking and credit risk management and all of the techniques that bankers have used probably since the 16th century—capital and all that sort of stuff—that starts to look as if it is much more efficient relative to securitisation in securing the underlying risks than we might have given it credit for. We know it is expensive, but it actually does a better job maybe.

CHAIR—Thank you very much for those views, Dr Harper.

Senator BUSHBY—Thank you, Dr Harper. On securitisation, about which you had a few words to say with Senator Eggleston, we had some discussions this morning with some of the other witnesses about that. I do not think any of them actually suggested that it may well have proven to be a false economy and that it does not have a future. On the contrary, we actually had one witness suggesting that what we needed to do is to try to stimulate the securitisation industry and made suggestions of both a government guarantee in an area and also increasing the \$8 billion that the AOFM is managing and turning it into \$30 billion or \$40 billion. What are your thoughts on it?

Prof. Harper—I should declare straight away that I was part of a team at Access Economics which advised the Australia Securitisation Forum on precisely that. So, in a sense, through my company I am a signatory to views which would say yes, elements of securitisation deserve to be given an even access, if you like, to what public support is available. I am carefully distinguishing between access to emergency provisions for the sake of keeping the system stable and what might happen absent those emergency conditions and a return to normal circumstances. I want to keep those two views quite clear.

People from the securitisation industry are saying, ‘Look it is not reasonable that the Commonwealth would make available access to its balance sheet, effectively, to AA rated Australian banks when AAA rated securities are offered no support.’ This indeed is something that is unfair. It also in some respects denies the government an opportunity to make a bit of money out of the irrationality of the market. I think those arguments are valid and I would stand by the proposal that the ASF has put forward that if these guarantees are to continue it needs to be evened up between the two alternative ways of doing business. Another way to think about that is to say, ‘Look, securitisation is carrying a cross anyway as a result of what has been happening. Some of the cross that it has been carrying is unjustified. It is staggering through a break-out of irrational fear.’

Senator BUSHBY—Particularly in Australia, where we have actually had quite sound securitisation markets.

Prof. Harper—Exactly. So I am not going to stand before you, senators, and say that securitisation is broken and therefore it should be allowed to die. I am not going to say that, because I do not think it is true. I think that securitisation will be reassessed in the light of the

experience. I think it was Senator Eggleston who was asking about credit rating agencies. Well, indeed, I would argue that credit rating agencies need to be supervised to ensure that the sorts of statements that they are making are much more easily verified and grounded than what would appear to be the case. I would also be wanting to tighten up any other aspects of the securitisation process where it would appear that the information which people assumed was easily accessed turns out not to be as easily accessed.

Senator BUSHBY—Has that been a problem, though, in Australia or is it a transposition of people's observations in other jurisdictions into Australia?

Prof. Harper—I think it is the latter, but inasmuch as that is true, if people were so sophisticated that they could say, 'Oh, yes, but that's just a US based problem . The situation here in Australia is completely different.' If they were sophisticated enough to do that, there would be no issue, but there is an issue, because they are not that sophisticated.

Senator BUSHBY—I am not arguing against the need to examine the issue, but in terms of outcomes, are you suggesting that we should actually introduce a new regulatory regime that covers this, even though here it has actually worked, purely to ensure that the perception of the regulation of our industry is sufficient to actually attract investors?

Prof. Harper—I am. Access Economics will be releasing a report a little later this year in company with the Financial Services Institute of Australasia, where a number of these proposals will be made public at that time. I am not talking about a massive overhaul of our system—on the contrary. But I am talking about some tightening up and tweaking to overcome what have been difficulties.

We have been regulating banks, for instance, for more than a century, as you would appreciate. Part of the reason for intervening and regulating banks is because of bank runs, the equivalent of which we have seen in capital markets. We have lived with bank runs for a long time. We know that bank runs have their root often in simply irrational behaviour: fear, lack of information. No amount of megaphoning in a street outside a bank on which people are running will do any good at all. It is irrational. We regulated banks to ensure some system stability in the face of these sorts of events.

Now what we have learnt from the GFC is, contrary to the predictions of the efficient market hypothesis, the same sort of thing affects capital markets. So we are going to have to draw up a set of supervisory arrangements or regulations which are appropriate for that method of doing financial business that also recognise that capital markets can behave irrationally as well. You have given the example. All of this stuff afflicted the United States much, much worse than it did in Australia and people ran on capital market instruments in Australia. There is the irrationality. That is also the basis for evening up any government support that is offered to both ways of doing business. There is no need for the Commonwealth to put its oar in and distort the choice between these two ways of doing business. The market [inaudible]. We do need to think about how both should be regulated, but there are no grounds in my view for walking away from securitisation.

Senator BUSHBY—That is good to hear, because I think securitisation does actually assist greatly in promoting the competition side of the equation that you were talking about before.

Prof. Harper—Indeed. I am sure you are right about that. However, before the GFC the Wallis committee, I confess, had this view that traditional intermediaries needed to be prudentially regulated and anything outside of that could essentially rely upon the efficiency of the market to do the job for you, with a bit of [inaudible]. That is what has to be reassessed, because it now looks like the capital markets are also subject to irrational waves of sentiment and they may need to be regulated, if not prudentially then certainly some sort of supervisory arrangements need to be dreamt up which is appropriate to their circumstances to prevent what is a very viable of doing financial business—and, as you point out, a very good source of competition—but we have got to prevent it from becoming a source of systemic risk. Otherwise, whatever we gain on one front we more than lose on the other.

Senator BUSHBY—I am comforted to some extent by the fact that you are saying that you are not asking for wholesale change or wholesale regulation but just what is necessary to provide the confidence, which I do not think anybody could argue against. I have one final question on that. The securitisation industry covers both institutions that are prudentially regulated and an awful lot that are not—

Prof. Harper—That is right.

Senator BUSHBY—Would you be suggesting that those that are not be brought under prudential regulation?

Prof. Harper—No, not necessarily. It is more the types of instruments that are being securitised and the process itself that I think needs oversight. For instance, when the markets for some of these more complex instruments simply closed and people would not buy the stock, when asked they basically said, ‘I’m not going to touch that stuff, because I have no idea what is inside.’ [inaudible] your jaw drops, and you say, ‘Excuse me?’ The whole process of securitisation was supposed to be transparent. ‘What is inside there is mortgages. What do you mean you do not know what is inside? Make me a price.’ I am not saying to make me a price that is higher than what I paid, I’m just saying, ‘Make me a price.’ [inaudible] ‘I have no idea what’s inside.’ When people are saying that, you realise that we have not travelled very far at all from the banking system. That is what they used to say about banks. That is what they do say about banks, and with good reason. Banks are opaque. The whole point of securitisation was to escape from that [inaudible] gather together bundles of securities, which everybody understood, which are easily sliced, diced, measured and rated and all the rest, and then to sell securities against that. It is a brilliant idea. But if people turn around and say, ‘I’m not going to buy this because I have no idea what’s inside,’ it’s just like a bank.

Many of these vehicles turned out, after the fact, to be quasi banks. And one way of thinking about the GFC is this: we have known for at least 200 years that unregulated banks fail. Now what we have discovered is that these securitisation vehicles that we thought were [inaudible] because they were transparent and they were rated and all the rest of it, it turns out that a lot of them are the next best thing to banks. They are almost banks and, therefore, unregulated they do exactly what banks do. They get themselves into strife, they are subject to waves of adverse sentiment and they become a source of instability. So inasmuch as we never dumped banking, our answer to unstable banks was appropriate regulation, and it has taken us more than 100 years backwards and forwards to try and get that mix right, the fact that people ran to the banks this time is a very good sign that we are very close to a good mix there—at least in our case. We

need to go through the same exercise with securitisation. You do not dump the idea. What you do is go back and think carefully about how you would regulate it, what mix of prudential regulation and disclosure regulation would be appropriate for these types of instruments, given that they are much closer to balance sheet banking than perhaps we thought they were before.

Senator BUSHBY—Thank you for that. I will move on from there to some other issues. Earlier you indicated that you were very supportive of the interventions by the government in terms of both guarantees—

Prof. Harper—Yes.

Senator BUSHBY—and that you thought they were what was needed at the time. I think your quote was that government did exactly the right thing. I want to explore the ‘exactly’ aspect of that. I do not think that anybody argues that, at the time, there was a need for both measures to some extent. The only argument that I am aware of is in terms of the details around their implementation. Starting with the deposit guarantee, do you think that the deposit guarantee could have achieved the desired outcome, which was obviously confidence in the banks and people’s money that they have in the banks, without being an unlimited guarantee, in effect, with the over \$1 million fee?

Prof. Harper—I will put it this way. With hindsight it is easy to answer that. At the time, I was receiving telephone calls in late September, early October last year. I was receiving telephone calls from the media asking me about Australia’s deposit protection system. Media people were saying to me, ‘Can you assure Australian people that their deposits are safe?’ I said, ‘I can’t do that.’ They said, ‘Why not? They’re guaranteed, aren’t they?’ ‘No, they’re not guaranteed.’ ‘They’re not guaranteed?’ ‘No, they’re not.’ ‘Well, how does our system—’ I said, ‘Hang on, let’s be careful. Depositor protection, depositor preference.’

I was taking more and more of these calls and getting increasingly concerned that there was panic beginning to break out within our community about exactly what all this would mean. I have been doing this sort of thing for long enough now to know that a widespread banking panic is a calamity and we want to stay right away from that. The only way that you can deal with that sort of thing, in my experience, is with a short, sharp shock. You have to do something which stops the herd from stampeding. If I was sitting around the table on that day with the Prime Minister, the Treasurer and the Secretary to the Treasury, I do not know whether it would have been \$1 million or \$500,000. What I do know is this: the government had to do something to allay—to stop in its tracks—what I began to sense was a growing unease, leading at its edges to panic, among ordinary people about what might happen if the banking system collapsed. In those circumstances, the government had to say, ‘Folks, it’s all okay. It’s guaranteed—bang—up to this limit and you’re all covered. You can all go home.’ They did that.

The question you are asking me is: could they have done that with a guarantee of \$250,000 or \$500,000 or \$100,000? I do not know the answer to that. In a sense, what I am saying is that I would far rather that the government erred on the side of too big a hit than too small a hit, because you only get one chance to do that in those circumstances. Fortunately, the government’s intervention worked and I do not know if it would have worked at \$500,000 or \$250,000. If it had not worked, the chances of a second round working would have been much lower and we would have been in a much more difficult situation.

Senator BUSHBY—The UK had a couple of bites at it, but they did get there with a much lower limit than our \$1 million and without the ability to guarantee amounts above that. In the US they moved from \$100,000 to \$250,000 and that seemed to work. In both the UK and the US the banks were in far more trouble than any of our banks were, even though there was, as you correctly point out, concern by depositors. The point that I really want to make is that the vast majority of depositors who were less likely to participate in the rational debate about the safety of their deposits are probably those with less than hundreds of thousands of dollars in the bank.

Prof. Harper—I would contest that point. These things start in the wholesale markets. The irrationality that you are talking about was amongst wholesale investment funds. Frankly, the banks, including our major banks, stopped lending to each other. The Reserve Bank went to the major banks and said, ‘You’re all related to banks. I’m here—the central bank.’ The banks said, ‘No, we’re not lending to each other.’ When you are dealing with that, you are not talking about ordinary *Herald Sun*-reading folk on the train. No, in many cases the opposite is true. Those folk had no idea this was going on. The ones who ought to have known better were frightened to the point of closing their balance sheets, not lending and hoarding cash—the whole lot. That is why, in my view, the best thing to do was to convince people who had a lot of money that it was all safe rather than the mums and dads with not that much.

Senator BUSHBY—That says a lot about the people in that part of the industry. I have to move on because we are about to run out of time. In respect of the wholesale guarantee and the policy outcomes that the government was seeking to achieve by introducing that guarantee, could those outcomes have been achieved without putting differential fees on the cost of taking out the guarantee?

Prof. Harper—They could have, but not without exposing the Commonwealth to greater risk.

Senator BUSHBY—But how real is that exposure to risk? When you are talking about regional banks and building societies—

Prof. Harper—There is a risk spectrum in the financial system. The reality is, I would have argued, that those on the margin, those further out, have a higher probability of succumbing than those further in. That is why there is a risk spectrum; that is why the market charges some of the nonbanks and other institutions and regional banks a higher rate than it charges the majors and it charges the Commonwealth.

Senator BUSHBY—The Bank of Queensland presented before us this morning. Their argument was that, on the basis of bad loans and on any objective sense looking at their bottom line and their balance sheet and activities they are involved in, they are a safer proposition in reality than most of the big banks, who operate in overseas markets and put their fingers into all sorts of risky things. Sure, they have the ability to absorb their losses, but on the whole they are a riskier proposition in terms of their activities than the Bank of Queensland is. The bank’s view is that, apart from the fact of where it is a relevant thing for the government to consider risk when they are trying to achieve a policy outcome of stability, even if they do consider the issue of risk then they should actually look beyond the ratings and look at the reality.

Prof. Harper—That is a reasonable point for them to put. The ratings agencies often differentiate amongst institutions on a basis that leaves the institutions scratching their heads.

Given the timing of this, given the urgency of action, for the Commonwealth to have gone through and tried to tailor-make ratings or premiums for individual institutions or groups of institutions would have really been difficult in the circumstances. So I cannot say that the actual premiums the Commonwealth came up with are the right premiums. What I do know is that as the market recovers these different institutions will walk away from the Commonwealth guarantee at the appropriate rate. That is really what matters.

Senator BUSHBY—The other thing the Bank of Queensland raises was the differentials in the fees for the over a million dollar deposit guarantees. That is where it really hurt them, apparently.

Prof. Harper—Okay.

Senator BUSHBY—The chairman is winding me up. Thank you, Professor Harper.

CHAIR—Thank you for appearing this morning. This afternoon, interestingly enough, we have the Australian Securitisation Forum as such.

Prof. Harper—Good. Thank you, Senator Eggleston and other senators.

Proceedings suspended from 12.32 pm to 1.30 pm

DALTON, Mr Chris, Chief Executive, Australian Securitisation Forum**TUTTLE, Mr Patrick, Deputy Chairman, Australian Securitisation Forum**

CHAIR—We welcome representatives of the Australian Securitisation Forum and thank you for your comprehensive submission. We invite you to make an opening statement.

Mr Dalton—Good afternoon. On behalf of the Australian Securitisation Forum I would like to introduce the forum. The forum represents those participants in the securitisation market in Australia. It is a forum that came together in 1989 and the membership constitutes the major banks, smaller regional banks, smaller ADIs, building societies and credit unions, as well as the non-bank mortgage lenders. Additionally, it includes amongst its membership service providers such as accountants, legal firms, trustee companies, rating agencies and institutional fixed-income investors. So it is a fairly broad constituency that the ASF represents, but specifically our interest is in the securitisation sector of the financial markets. We are appreciative of your time this afternoon and the opportunity to make comments and submit the submission that we have with respect to the changes and the impacts of the bank funding guarantees in the markets, which have had an impact upon securitisation in terms of its attractiveness in the present market conditions.

Securitisation is a financing technique which allows consumer assets to be funded by the way of an issue of asset backed securities. The cash flows from those consumer receivables—such as residential mortgage loans, credit card receivables, auto or lease receivables—are used to repay the principle and also pay interest on the asset backed securities. The Australian market developed through the nineties but really found its feet around the middle of the nineties—1995, 1996.

The major class of consumer receivables that have been securitised have been residential mortgage loans. And as a result of more competition coming into the home loan sector from non-bank lenders and smaller ADIs, Australian consumers were able to benefit by a reduction in the margin charged on home loans by in excess of 200 basis points. The advent of more competition provided more choice to Australian borrowers for home finance and there were new features introduced to home loans that were not previously available in the market. So securitisation has brought additional competition and innovation to particularly the residential home loan market.

Whilst the global financial crisis has had a substantial impact upon securitisation, to the extent of causing the market to freeze in terms of new issuance, the performance of outstanding residential mortgage backed securities over the last couple of years has continued to be stellar. It is in contrast to problems that were witnessed and have been experienced in overseas markets, particularly the United States and the United Kingdom, as well as some European countries. This reflects the all-moneys mortgage that is the common form of finance provided to home loan borrowers here in Australia. It reflects the lending standards that have been applied in this country. It reflects the rather unique lenders mortgage insurance which is provided and is typically included in securitisation of residential mortgages.

The global financial crisis meant that the closure of debt capital markets and the aversion to risk and the repricing of risk cut off the funding opportunities for many organisations that were securitising—particularly the nonbanks but also some of the regional banks. Adelaide Bank and Bendigo Bank were quite significant securitisers of their residential home loans. In the absence of funding from the debt capital markets, the wholesale markets, the people who had been using securitisation were forced to turn to alternatives. In some cases that meant they had to rely, if they were an ADI, on deposits or other wholesale funding. The non-bank sector were relying upon some finance that was being provided through warehouse facilities by financial institutions, including some of the foreign banks. But it has really been the program which the government put in place in September last year, the \$8 billion program administered by the Australian Office of Financial Management, to purchase highly rated, highly creditworthy residential mortgage backed securities that has kept the non-bank lending sector and the smaller ADIs continuing to be active in the lending market.

As a response to this, the Australian Securitisation Forum has put forward proposals to the government to continue support to the sector. Whilst conditions in the credit markets have improved through the course of this year, the primary market for the issuance of asset backed securities and mortgage backed securities in Australia still remains very difficult. It is our proposition to the government that continuing support needs to be provided. That could be provided by way of a number of sources, including an extension of the AOFM program. But we have proposed the attractions of a guarantee on Australian residential mortgage backed securities. We are talking about this in terms of a guarantee on new issues, not those outstanding in the market. We are proposing this as a temporary measure, possibly to coincide with the sunset on the retail guarantee of bank deposits for a period of, say, up to 18 months as a way in which to provide support to bring investors back into the market to kick-start the primary market to allow finance to be directly funded through to specific areas of the economy—that is, residential mortgage finance.

One of the major benefits that securitisation provided to the Australian economy was a way in which the small business and self-employed sector were able to gain finance by using low-doc loans to raise funds secured by primary residences. So it is a way in which finance can be specifically directed to these areas of the economy. It could also be expanded to commercial finance and be opened up to a guarantee of commercial mortgage backed securities.

We are proposing this as a temporary measure. We believe that the Australian financial system needs, and will benefit from having, a sustainable and competitive securitisation sector which will continue to provide a way to finance our needs as an economy and a country outside of the major banking institutions. At the height of the market, in terms of a source of funds, 50 per cent of residential mortgage backed securities were sold to overseas global investors, particularly the European investors, and the other 50 per cent were taken by the local fixed income institutions. So there has been continuing interest in what is happening here in Australia. Overseas investors have told the forum that they have been encouraged by the actions of the government to date to implement the AOFM program. They see it as being a unique market that has not had the credit problems that some of the other markets have had.

The Access Economics report goes into some detail about the state of the market and the options that we have spoken to government about, but we took the opportunity to appear before you to highlight in particular the merits as we see them for a residential mortgage backed

guarantee to be considered. It would be a guarantee that could be used by all issuers of mortgage backed securities and that could include the major banks, who have been issuers of mortgage backed securities in the past; the regional banks; the smaller ADIs; credit unions and building societies; as well as the non-bank sector. It would also have the advantage of providing access to funding based on a flat fee. We would suggest that a fee should be levied based on the credit quality of the securities so that, whether you are a small ADI, a large bank or a nonbank, you would pay the same fee based on the credit quality of the debt securities. It would be a guarantee of the issuer's obligations to pay principal and interest under the securities, so it is not a guarantee of the organisation but a guarantee of the debt securities specifically.

The second matter that we have put before the committee is a proposal that we developed through one of our working groups and put to the Treasurer that highlights the case to consider changes to legislation to allow a new form of debt security to be issued by Australian banks—that is, covered bonds. This is a form of debt financing that is quite common in many developed banking systems, and there is quite a large global investor base that is attracted to and invests in covered bonds. In our view it would be suited if it were brought in by way of a legislative framework, so the Australian Securitisation Forum is proposing a new covered bond act and consideration of changes to the Banking Act to put this in place.

We have put this forward based on the experience of the global financial crisis, which demonstrated and probably shattered a few assumptions that funding was always available and that there would be funding at reasonable prices. We think it is good from the point of view of financial stability that Australian banks have as many options and bases of investor pools of money to fund themselves as possible, and we think that there is a case for covered bonds to be considered. We are suggesting that it should be subject to the continued prudential supervision of APRA and would allow banks to have a wider array of options to fund and potentially diversify the sources of funding. I will pause at this point so our deputy chairman can make some comments.

Mr Tuttle—The only other comment that I would add is that the reason we took up the offer to appear before the committee was to advocate securitisation as a means of creating a more level playing field and maybe an alternative to the wholesale bank guarantee, in that it provides access to funding institutions other than the four major banks and is arguably a cheaper form of wholesale funding for the small ADIs, regionals and non-bank lenders, who clearly do not have access to the wholesale funding guarantee.

CHAIR—I have looked through your submission and it is a very interesting subject. You included a report you commissioned from Access Economics, which we have in our briefing pack, and you said at the time that it was confidential. Do you wish that report to remain confidential or can we use it and refer to it?

Mr Dalton—We would be happy for the committee to use it and refer to it. We would prefer that it was not publicly available simply because our members paid for the report and we would like them to have the primary benefit of it.

CHAIR—No, it is just to clarify that point. You are talking about a residential mortgage backed guarantee—do you see that would really stimulate the residential mortgage market at the moment? It seems to be picking up anyway, from what we gather—more people are getting into

houses. What sort of additional stimulus do you think this kind of financial vehicle would provide?

Mr Dalton—I guess we are primarily advocating the merits of a guarantee to ensure that the Australian economy continues to have the benefit of the infrastructure that has been built up over the last 18 years or so in terms of having a form of lending that is available outside the traditional main banking system. People have built businesses, set up shops, invested in technology and employed brokers to compete and provide services and products in the residential home loan space.

To the extent that funding continues to be unavailable, or very expensive, in the primary debt capital markets this section of the financial system is likely to wither and die over the next 12 months. In the absence of more reasonable pricing being available in the wholesale debt capital markets for asset backed and mortgage backed securities, these firms will have no option but to reconsider their business model and either change what they are doing or gradually wind down the business.

Part of our proposition is to ensure that the infrastructure remains part of the Australian financial sector through this period of crisis, until some level of normality returns.

Mr Tuttle—One of the direct benefits of the guarantee on RMBS is to try and stimulate investor confidence in those securities. As Chris mentioned, the performance of RMBS in Australia has been stellar; so we are not actually advocating the guarantee because it is needed from a credit perspective. But we are advocating that it would provide additional confidence having that sovereign guarantee to back those securities and hopefully, we would think, it would encourage investors back into the RMBS market because, if you look at the Access Economics report, one of the issues they bring out is that the existence of the wholesale banking guarantee has actually created a desire for many investors to only invest in sovereign backed securities. It obviously was not an intended consequence, but as a result it has probably discouraged those same investors who may have participated in RMBS transactions in the past from actually doing so now that they can access wholesale guaranteed bank debt versus RMBS, which does not carry the guarantee. We think it has created a differential, albeit unintended.

CHAIR—The nonbank housing finance sector has withered considerably during the course of this crisis and so this would be a stimulus to that sector with a great deal of potential. Do you want to enlarge on that—the withering of the nonbank sector?

Mr Tuttle—Perhaps I could answer—as well as being the deputy chair of the ASF, I am also the managing director of the Pepper Homeloans group, who are a nonbank lender and whose traditional source of funding is the securitisation markets. We are not an ADI, so we are not a deposit-taking institution.

The stimulus that we are talking about there is by virtue of a guarantee. We would hope that would encourage new issuance in the mortgage backed market, which clearly provides our primary source of funding. It would enable us to refinance what are called ‘warehouse facilities’, which we obtain from major commercial banks to initially fund our loans. We then refinance those facilities by issuing mortgage backed securities in the capital markets, and therefore that enables us to recycle that funding and make new lending. It would enable us to compete again in

the mortgage space up against the sorts of guaranteed banks that have access to wholesale funding and also deposit sources.

In that sense we are really talking about enabling the nonbank lenders, the smaller ADIs and, to some extent, the regional banks, who have really rationed credit in terms of the volume they are putting out into, say, residential mortgages over the past 18 months.

CHAIR—Have these smaller regional banks traditionally been large users of securities?

Mr Dalton—It depends, for example, if we look at what is now Bendigo and Adelaide Bank, Adelaide Bank in its previous form was funding itself probably about 30 per cent from securitisation into the debt capital markets. With that sort of cut-off at the present time, they have had to access whatever wholesale funding they can obtain and compete with other banks for deposits. But, as Pat has mentioned, they have been prudently scaling back their lending activity based on their view of funding availability to meet the commitments that they give to borrowers.

Mr Tuttle—Bank of Queensland and Suncorp would be at similar levels, historically, of securitisation being a material source of home loan funding. Members Equity Bank is another one that probably relied even more heavily on mortgage backed securities as opposed to deposit gathering to fund their mortgage lending operations. It does vary for many of those banks. Taking that further, for credit unions and some of the larger building societies, securitisation would have been a material source of funding but not the only source because, obviously, they can also rely on deposit taking and access to wholesale markets as well.

Senator HURLEY—I have not had a lot of time to go through your submission. The AOFM has been buying existing RMBS. You are asking for stimulation of new securities in that area. Could that not be addressed by AOFM continuing to stand in the market, or do you need the government guarantee?

Mr Dalton—You are correct. They could continue and if the government provided an increase in the facility they have provided, they could continue to buy issues. That has been very valuable for many of the players to at least know that they could obtain funding and recycle and re-lend, as Pat has explained. We believe the guarantee is primarily to bring more investors and the institutional fixed-income investors back into the market to get the primary market back to the state that it should have in terms of the buyers and sellers.

Senator HURLEY—That is what I want to explore, because there has been some criticism of the existing guarantees, as you would be aware. If AOFM continues to be in the market, will that not stimulate other investors, knowing that there is a sound buyer in the market, to come in and invest themselves, or are you saying that it requires more than that?

Mr Dalton—The situation has been and is improving, but AOFM has been buying issues at around 130-140 basis points over the relevant benchmark interest rate. The market is indicating that for other institutional fixed-income investors to come back in they would want, as of today, something like 200 basis points. Until the primary market bridges that gap, the institutional investors say they do not see value in buying at the same rate that AOFM is buying. AOFM is buying at a rate that allows the institutions to fund themselves at an economic level that they can lend the money out and the business model works. To do an issue of mortgage backed securities

and pay 200 basis points over the benchmark does not allow the institution, the small ADI or the non-bank to economically lend and make a profit and continue in business.

By having a guarantee, what we are suggesting is that that will bring the margins back in because it is not just a well structured Australian mortgage backed security but now has a sovereign guarantee to it. So it has that attraction. It will be differentiated but it should then go into the same basket of guaranteed bank paper and government bonds as well.

Mr Tuttle—The only thing I would add is that your assertion is right. When the AOFM program came in, the intent was they would be cornerstone investor and would attract others. Unfortunately, while it has been incredibly helpful to the sector, it has not actually attracted the other investors that we thought would come to the party. We believe that by adding the guarantee to the investment it will encourage more investment and, as Chris mentioned, hopefully bring that pricing into a more economic level.

Senator HURLEY—Good. I think I have got commercial mortgage backed securities along similar lines. I am not sure I understand entirely what you mean by covered bonds.

Mr Dalton—A covered bond is a debt security issued by a bank which is actually benefiting from the security of a designated pool of mortgages which remain on the bank's balance sheet, but are segregated and identified, for the benefit—potentially, in the event of a default by the institution—of the holders of the covered bond. Typically, they are over-collateralised, so if a bank issues a \$100 bond there may be \$103 worth of mortgages that are allocated as security for that. As you would appreciate, at the present time banks borrow on an unsecured basis, so this is a secured type of borrowing. It is a common feature in many other banking systems—and that is not necessarily a reason to follow it—but the ASF argues that it would be prudent as a result of the experience of the global financial crisis to allow banks to have as many avenues to fund themselves and, potentially, to tap into a new investor class which typically only buys AAA highly rated securities. Covered bonds typically can have a rating of AAA even though the bank itself, and in Australia's case, is rated AA.

Senator HURLEY—That answers my question about risk. Going back to RMBS in particular, and the government guarantee, how much do you think we are talking about the government guaranteeing?

Mr Dalton—To give you some figures, in the 2007 calendar year there was issuance in Australia of around \$57 billion. If you look at the prima facie figure for 2008, that was \$56 billion, but \$42 billion of that represented the residential mortgage backed securities that were created by the big four banks to repo—or enter into repurchase agreements—with the Reserve Bank to access liquidity. If you take the \$42 billion, last year in real issuance into the net capital markets was \$14 billion, and year-to-date the estimate is \$6.1 billion. That is primarily the programs that have been supported and largely bought by the AOFM. In the absence of the AOFM being in the market, the figure for 2009 might be something around zero.

Mr Tuttle—But I guess if you allow for the potential of a AAA guarantee on RMBS—we speculated about what kind of volume we might be talking about in terms of guarantee—if you got the market up and running from a standing start, we think the maximum you could originate in, say, a given year would be about \$20 billion of paper being guaranteed. That might grow,

potentially, to \$30 billion the following year, if it was successful. You would also argue that maybe banks would not be necessarily as big, as issuers in the RMBS market, if they had other avenues of funding, other than RMBS.

Mr Dalton—The expectation is that the market will probably not come back to the levels of the height of 2007. We would estimate a sustainable level something around \$30 billion to \$40 billion going forward.

Senator HURLEY—Just a last question: you made some comment about putting some measure on while the existing guarantee was being wound back. Is that right?

Mr Dalton—At the present time there is the wholesale guarantee that the banks can take advantage of. If the government was inclined to put in place a guarantee on residential mortgage backed securities, that would be something that could take away the current guarantee but still allow banks to have access to guaranteed funding by way of doing an RMBS issue. So it could be seen as a stepping stone, or a halfway house—if that is the correct term—to moving away from the current arrangement.

Senator HURLEY—That is interesting because we have been talking about how to phase it out, and the RMBS, I take it from what you are saying, would benefit those regional and smaller banks. So as the guarantee was being phased out the securities guarantee would assist them, perhaps more than the existing one because of the spread.

Mr Dalton—Absolutely. And because we are suggesting a guarantee that applies to residential mortgage backed, it still could be used if there was a hiccup or some event in the market by the major banks. It would still allow anyone that could put together a residential mortgage backed issue to take a government guarantee, subject to the terms of the government and the administration of the guarantee, to then access the markets with the benefit of the guarantee.

Senator HURLEY—So you might get a feeling that it had players coming into the market.

Mr Tuttle—The only thing I would add, and you touched on this at the beginning, is if the government decided to bring it in it could still be phased out along a similar timeline to what was envisaged with the existing guarantees.

Mr Dalton—Yes.

Mr Tuttle—We are not suggesting that it carry on beyond that. It is meant to be a short-term solution.

Senator BUSHBY—So you are not suggesting that you wait until there is a wholesale guarantee, you would like to see it in now because that is the whole point of it?

Mr Tuttle—Ideally. For the smaller players, if we wait too long some of them will have stopped lending and their infrastructure will wither away and therefore they will be out of the market altogether. To wait too long would see those players exit.

Mr Dalton—I think we are at a critical junction. The AOFM has spent and committed all of its funds for issues by ADIs and has a small amount of money left under the facility that was put in place for the non-banks. By the end of September, I think there will be a continuing hiatus in the market. Both local and international investors are looking for some sort of signal as to the government's intention but will also be looking to see if the market is going to survive in Australia.

Senator BUSHBY—Given what you are saying about the current state of securitisation, I will take the advantages and benefits of having a healthy securitisation market as a given. I think that has been well enunciated by you and others. You are asking for significant ongoing government intervention to help correct—probably a reasonable term to use, from your perspective—the market and help it get back on its feet. Given that the financial crisis is easing around the globe and credit markets are beginning to function well again—they are certainly a lot better than they were 12 months ago—is there any potential for the market to recover itself and to develop without further intervention by the government?

Mr Dalton—I think that is a possibility and that the challenge is time. It is probably up to others that are involved with market pricing and trading to indicate where they would see margins moving to. But we still have this fundamental problem that, for residential mortgage backed securities to be economic and to help small ADIs and the non-banks, they probably need to be able to issue RMBS at something under 150 basis points to break even. It is a question of when the market moves to that point. I think we are in a situation where there is going to be a lot of issuance of government guaranteed bank debt and government debt; so the attraction, or interest, in residential mortgage backed securities is likely to continue to be under a cloud.

Senator BUSHBY—Essentially, I think the point you are making is that there are decisions of government in place, or government policy, that will actually hinder the securitisation market from recovering on its own?

Mr Tuttle—I think a potential crowding-out effect of government bond issuance is a factor.

Senator BUSHBY—Crowding out is one aspect of it because there is only so much money available for investing, but there is also the question of where to put your investment. If the market has been performing in a stellar fashion but does not have government backing against an option to invest money where you have government guarantees, it does put you at a competitive disadvantage at least in that respect.

Mr Tuttle—Exactly.

Mr Dalton—Yes, it does. And the difficulty we also see is that superannuation trustees and investors are looking at their asset allocations. They are looking at what lessons they can take out of the global financial crisis. In many cases they are changing the way in which they have been investing in fixed income. With the availability of solvent debt and government guaranteed debt there are greater allocations going to that.

So there is the risk that, even though the market may come back, the investors, through their mandates and the advice of asset consultants, find that there is not the same appetite to buy these securities because they have changed their investment strategies as a result of the GFC and what

has been going on this year. We are conscious of both ends of the equation in terms of the time the primary market, in terms of margins, corrects itself, and also not leaving this hiatus in the investment world, where they turn their attention to global credit. That would be to the detriment of the Australian bond market, because this asset class could potentially disappear and the opportunities for Australian fixed income managers to compete to provide a product against managers in San Francisco, Boston and Tokyo, who provide global credit and fixed income options, becomes a harder proposition for them to advance to their customers because there are less securities and there is less diversification available to be found in the Australian domestic corporate bond market.

Mr Tuttle—And whilst I accept that there is a strong argument to do nothing, we are still seeing AAA RMBS trade in the secondary market at levels, whilst they have come in, still well north of 200 basis points. At those levels, none of the funders could economically go to the RMBS market to obtain funding. So our view is that, if you can provide this short-term stimulus of sovereign guarantee, it will bring that pricing right in, hopefully bring investors back to the market and then naturally bring that pricing down to a level that we can issue, unaided by guarantees, some period there after.

Senator BUSHBY—Looking at the guarantee specifically, I think Senator Hurley mentioned that there has been some criticism of some of the largely unintended consequences of the other two guarantees. What potential impact would such a guarantee have on other participants in the financial market overall and what other consequences could flow from introducing such a guarantee that the government should be aware of and try to avert before it takes any action in this regard?

Mr Dalton—I think the government would need to take into consideration the state of the residential property markets in Australia and the availability of finance at any point in time. I think the guarantee would have to be administered from a government perspective on the basis of frequency of use by an institution, the size of the issue and, potentially, maybe some consideration of where the funding might be directed. It may make sense based on information to support a Bank of Queensland or a mock building society issue because those funds will be going into specific geographic areas where finance may be constrained for whatever reason. Not to be critical or negative of the major banks, but I would expect they would not be utilising the guarantee initially or for large amounts necessarily. I think they are fortunately finding that they can finance themselves in a variety of ways. From my conversations with the treasurer of the four banks, they do not see a need to use RMBS at the present time because there are other avenues that they have. So I think it would be a case of oversight so that there was not excess finance going into the residential property market that could inflate prices by excess credit being available.

One of the areas where we believe securitisation has been very beneficial has been through small business and the self-employed accessing finance through low-documentation loans. Again, through government administration of such a guarantee, you could attempt to direct more funds to that sector if they were finding difficulty in the current environment obtaining finance for their businesses where they were not able to utilise the asset that they may have in their residential property.

Senator BUSHBY—So you are suggesting that there should be a fair degree of discretion in terms of the control and oversight of how such a guarantee is applied?

Mr Tuttle—We have not obviously documented the minutia of how we saw the guarantee operating, but I think that is a fair assumption—that the government would have the ability to determine which issuers get the benefit of the guarantee—

Senator BUSHBY—Should it be the government or should it be a regulator?

Mr Dalton—It is probably not an informed response, but possibly someone like the AOFM. They are currently making decisions on which issues they buy.

Senator BUSHBY—But I do not know that they would necessarily be that keen to actually make decisions about where and—

Mr Tuttle—Possibly not; they might prefer to be directed.

Senator BUSHBY—That is right. I think they like to focus on issues of return and security of investments and things like that rather than trying to actually achieve or stimulate policy outcomes.

Mr Dalton—To be honest, the ASF has not considered which arm of government may be best placed or equipped to do this.

Senator BUSHBY—If the government does decide to look seriously at something like this then it is going to have to work through that. It would constitute a major intervention in the financial markets, and when you do intervene in the financial markets you need to think about what the ripple effect and the consequences will be and make sure that you minimise those to the best extent possible.

Mr Tuttle—I think the government would also want to have confidence that, to the issuers that it gives the benefit of the guarantee, it has some assurances and confidence that they will continue to write new mortgages. Because it cannot just be that they get the benefit of a guarantee, refinance their existing facilities and then stop lending. It has to have a social benefit that they will continue to provide funding to whatever segment of the market they are servicing. We see that as another criterion for being a recipient for the guarantee.

Senator BUSHBY—In terms of your covered bonds suggestion, you are talking here about banks or ADIs issuing bonds that would actually have a degree of priority or guaranteed priority in the event there was a run on a bank or problems with a bank, so presumably they would get that ahead of depositors.

Mr Dalton—That is correct. By giving the security they effectively have priority, in the event of a bankruptcy or liquidation of the bank, to the call on those specific assets that are identified as part of what is called the covered pool.

Senator BUSHBY—To make that work would you need an ongoing deposit guarantee?

Mr Dalton—We think it is timely to consider covered bonds in the context of the retail deposit guarantee having a finite life. What we would also say is that we believe APRA has a key role, if this were to be introduced, to oversee, again, the amount, the timing and the institutions that were issuing covered bonds. If you look at overseas markets where these have been quite common, banks typically fund themselves to the extent of, say, around five to seven per cent of their liabilities through covered bonds, so it is not a major part of their funding strategy.

Senator BUSHBY—What is the advantage for banks? Why would they choose to do it?

Mr Dalton—Because they can achieve through the overcollateralisation effect a higher rating than the rating of the institution. To use an example, today Westpac issues bonds based on its own rating of AA. If it were able to issue covered bonds it could potentially be issuing covered bonds with a rating of AAA. So that gives them a pricing advantage based on that rating differential and it also allows them to tap into what is called a global investor base. They reference them as being rates investors, where they effectively see no credit risk and they are just interested in the rate and the time, the term of the issue, so it allows the banks to diversify into a new investor base.

Mr Tuttle—From an investor perspective a covered bond pays interest as you go but it does not pay the capital. It is a bullet security; you get your principal back at the end. So it is a different class of security that would enable the banks to diversify to another source of funding—

Senator BUSHBY—Basically make the cake bigger in terms of where they might get funding from and thereby provide another guaranteed source of—

Mr Tuttle—Yes, give them another link to their armoury.

Senator BUSHBY—An additional source of liquidity, which may well help in the circumstances like we face.

Mr Tuttle—Yes.

Mr Dalton—And in the current situation, Westpac is able to issue either AAA rated government guaranteed bonds or unguaranteed AA bonds. If the guarantee were to be removed they could still potentially issue AAA rated bonds by issuing covered bonds. But you are right in your primary point that there is a claim on those assets and—

Senator BUSHBY—Yes, I was going to come back to that.

Mr Dalton—depositors need to be protected. So I think it would need to be put in place in the context of APRA judging the amount of free assets that still protected depositors so that in the extreme a bank was not entirely funding itself outside of deposits through covered bonds, because clearly depositors would be in a worse position than they were before the guarantee or where you may expect them to be afterwards.

Senator BUSHBY—Quite apart from the reality of ensuring that APRA makes sure that depositors are protected in respect to funds that they have in those institutions, there is also the perception, which would need to be addressed. I do not know that a lot of depositors out there would be that happy that they were going to come second in the event that the bank became insolvent.

Mr Dalton—That probably then comes back to what the government's intentions are in terms of deposit—

Senator BUSHBY—It would need to be sold well, and maybe a guarantee of some sort might be needed to give that degree of confidence.

Mr Tuttle—A retail deposit scheme will probably have to be brought in, potentially at the same time, to address that concern.

Mr Dalton—And as you know, in many other jurisdictions there is deposit insurance protection and that may be the quid pro quo of covered bonds, but also—

Senator BUSHBY—And banks pay a premium towards covering that.

Mr Tuttle—Yes. And it would require rewrites to the Banking Act as well.

Senator HURLEY—Will increasing the range of securities available help organisations which currently have frozen or severely limited funds with their investors to free up those funds?

Mr Tuttle—I can answer that as an issuer. If I were able to do a securitisation with the benefit of the guarantee, yes, it would. It would enable me to sell effectively the loans that I have in what I have mentioned as being my warehouse facilities into mortgaged backed issues, and that would free up my limit again for new lending, so it enables us to recycle our money.

Senator PRATT—I want to ask about these issues that we have canvassed, but from a consumer point of view—that is, people's access to credit and the cost of that credit. Some of those issues have been implicit in what you have said about the biases towards different sectors, but I wonder if you could talk about those issues from a consumer point of view.

Mr Tuttle—I certainly think, with the current state of the market, what you have is—because of the lack of competition from the smaller players in that they do not have access to funding, they are clearly not able to be as sharply priced as they were pre global financial crisis. To that extent, where the smaller players were acting as a sort of price leader—for example, in our market, residential mortgages—that pressure has come off somewhat. The fact that they do not have access to funding means that their pricing is not as sharp as it could be because their costs of funds are much higher.

Senator PRATT—But what is that doing to margins? I would have thought that lots of those players would be forced to offer more competitive rates, but probably offer fewer products because they just do not have access in order to make—

Mr Tuttle—I agree with you. The actual headline rate on mortgages is probably higher as a result, but for the non-banks—for example, where we rely on these warehouse facilities, those margins have gone up three- or fourfold in terms of the margins we pay for that money. Our margins are squeezed so that we cannot pass that on to the consumer because our cost of funding has gone up exponentially in terms of warehouse funding.

Senator PRATT—In that sense, do consumers need to choose more expensive providers?

Mr Tuttle—It probably limits their choice. I suspect it means there is now more concentration of pricing in retail mortgages. Where you might have seen a range of pricing of residential mortgages two years ago—where you would have had some very low-cost providers that perhaps did not have bells and whistles with their mortgage in terms of credit cards, but it was a very low-cost mortgage—now you could probably throw a blanket over the standard variable rate of all the providers and it is pretty close, so you are not getting perhaps the pricing divergence that we saw as a result of that.

Senator PRATT—Frankly there is a danger to consumers on that basis in not fixing this problem, isn't there?

Mr Tuttle—The advocates of securitisation clearly see the benefits of historically pricing, so it has helped sharpen pricing, it has helped create product innovation because the non-bank lenders and smaller players have created arguably more sophisticated mortgages and therefore it has created competition generally. So just that lack of competition means there is less potential choice, although I would say I still believe the Australian market has a fairly good choice of residential mortgages given the strength of our banking system. One of the key differences in the UK market was that even the major banks had to ration credit because they lost access to funding.

Mr Dalton—The other thing I would throw in from a consumer point of view is that securitisation and competition and innovation improve service levels. Now home loan lenders will come to the potential borrower, whereas when I took my first mortgage, I went to the bank, introduced by my father. At the present time we are hearing, in terms of getting responses from banks because a lot of it is being channelled through before, that people are waiting up to two-plus weeks for a response when they are probably trying to make a decision on whether to go to auction or to buy something. There is a service element to competition as well, so I think securitisation is certainly—

Senator PRATT—I have had recent experience in that, so I can appreciate that.

Mr Tuttle—To be fair to the banks, it is probably because they are inundated with volume because the other guys are not there to provide the product.

CHAIR—Thank you very much. We thank you for appearing today.

Mr Tuttle—Thank you.

[2.21 pm]

DEGOTARDI, Mr Mark, Head of Public Affairs, Abacus-Australian Mutuals Ltd

LAWLER, Mr Luke, Senior Adviser, Abacus-Australian Mutuals Ltd

CHAIR—Welcome. I invite you to make an opening statement if you so desire.

Mr Degotardi—Thank you for the opportunity to appear before the committee today. While this inquiry is into bank funding guarantees, of course the guarantees apply to all authorised deposit-taking institutions in Australia, including credit unions and mutual building societies. Abacus represents 124 mutual ADIs and collectively those credit unions and building societies serve more than four million Australians. Mutual ADIs are subject to exactly the same regulatory framework as banks and meet the same high prudential standards as those banks. But where we differ is that we are entirely focused on our customers, whereas banks are driven to maximise returns to shareholders. Our sector holds just under 12 per cent of household deposit market and around seven per cent of the home loan market.

There is little doubt that the competitive landscape in retail banking has changed as a result of the GFC. The competitive role of mutual ADIs in the banking market has become even more important as non-ADIs have exited that market and some of the regional banks, as we well know, have been taken over by the majors. Only the mutual ADIs and a few remaining regional banks compete with the major banks across the full range of consumer banking products and services, such as transaction accounts, deposits, home and personal loans, debit and credit cards and branches and ATM networks.

In our view, the government's response in the form of the deposit and wholesale funding guarantee to the global financial crisis has delivered on its aim—that is, the creation of stability and confidence to the core of the Australian financial system, the ADO sector. Our banking sector, including mutual ADIs, has performed very strongly by international standards. The economy and, more generally, Australians are better off as a result.

While we had little warning of its introduction, Abacus has always supported the decisive introduction of the deposit guarantee for deposits of up to \$1 million. Our sector was not experiencing deposit outflows before the government announcement in October 2008, but it was clear to us that Australians were concerned about the safety of the Australian banking market in light of overseas events. As noted in our submission, we support continuation of the guarantee in its current form. We do not believe that consumer confidence has returned to a sufficient extent to allow for the normal operation of investment markets. We do, however, acknowledge that it is appropriate that the government and industry carefully monitor consumer behaviour and international events and develop a well communicated longer term plan for changes to the existing guarantee arrangements.

The deposit guarantee has played an important stabilising role and has certainly brought peace of mind and certainty to Australian depositors. The Guarantee Scheme for Large Deposits and

Wholesale Funding has also played an important stabilising role and has enabled those ADIs using the scheme to maintain the flow of credit to the Australian economy.

Stability in the banking market has been achieved but we now believe it is critical that the government turn its mind to the competitive structure of the retail banking industry and look at ways to both remove competitive barriers and stimulate competition in a market now dominated by the four major banks.

As noted in our submission, we are critical of the fee structure of the Guarantee Scheme for Large Deposits and Wholesale Funding. That fee structure is anticompetitive and has had the unintended effect of further strengthening the competitive position of the four major banks relative to other ADIs.

Abacus and its members seek refinements to that fee structure to better balance stability and competition objectives. We believe the fee structure should be flattened or, at the very least, considerably narrowed. Mutual ADIs have found it extremely difficult or expensive to compete for guaranteed deposits over \$1 million, and only one institution has managed to obtain guaranteed wholesale funding. Pricing of the guarantee is a key issue in this competitive imbalance. APRA and the RBA have advised this inquiry that the fee structure's differential is relatively large compared to other countries. Other countries have altered their guarantee arrangements when required, and we at Abacus and our members believe that our government should do the same. This will boost competition in the lending market and send a strong signal about the government's confidence in the strength of Australia's prudential regulation regime for ADIs.

The deposit guarantee and the Guarantee Scheme for Large Deposits and Wholesale Funding were introduced in the context of a global crisis. The Treasurer commented in his statement to parliament just last Tuesday:

The most striking feature of this downturn ... has been the blinding speed with which it has unfolded.

The Treasurer noted that:

... conditions in the global economy are still very difficult.

The Reserve Bank's monetary policy statement last week said that credit conditions are still difficult in many countries and more unexpected bad news in the financial sector could again have an unsettling effect on confidence. For these reasons we support the position that any exit from the Guarantee Scheme for Large Deposits and Wholesale Funding should be gradual and implemented in a coordinated way, with other countries, in an atmosphere of international cooperation. In our view, it is simply too soon to dismantle the guarantee schemes. Thank you. I am very happy to answer questions.

CHAIR—Thank you very much indeed. Could I open by asking whether your members were losing market share in retail deposits to the big four banks after the global financial crisis began?

Mr Degotardi—Certainly in terms of our retail deposits which, as you would well know, are a major feature of our funding base. We have lost market share in retail deposits since the advent

of the global financial crisis. It is important to understand that that does not mean we have been losing deposits. We have in fact been growing our deposit base but, as a proportional measure, as market share, we have been losing market share in a very minimal way to the major banks, yes.

CHAIR—Only in a minimal way?

Mr Degotardi—Our market share was around 12 per cent in the middle of last year and it is about 11.5 per cent now.

CHAIR—That is interesting. Before the crisis, what was the typical difference between the interest rate that a large building society paid to raise wholesale funds and that paid by major banks?

Mr Degotardi—I cannot answer that question. I do not have that information with me. I am happy to find that information out and provide it to the committee in due course.

CHAIR—Are your members paying more now than the major banks for wholesale funds do you think?

Mr Degotardi—Typically, of course, most of our member institutions are actually unrated institutions, but there are a small number who are rated institutions. Of the unrated institutions, most of them have participated in the wholesale market through securitisation rather than participating directly. However, some of those rated institutions did, before the global financial crisis—and some of them still do now—participate in that wholesale market, and they pay a risk premium that has always been determined in that market based on ratings, whether you agree with that prospect or not, I guess. The difficulty that those members have faced is that not only do they face the market differentiating between them on the basis of rating, but also they face the differential fee for the guaranteed deposit as well, which means, effectively, that they are unable to participate in that market.

Mr Lawler—Only one of our members has ventured into the wholesale market using the government guarantee, and has had to pay the full 150 basis points compared to the 70 for its competitor major banks.

CHAIR—Your group has come through this reasonably well—would that be a fair comment?

Mr Degotardi—We would absolutely endorse that view. There are a lot of reasons for that, including the fact that we have always been prudent and cautious lenders in the first place. The fact that we are APRA regulated has some responsibility for that as well. The fact that we were about 85 per cent funded by retail deposits meant that when that initial shock to the wholesale funding system or wholesale market occurred, we were in some respects less affected initially by those initial shocks. Of course, as those institutions have sought other sources of funding than wholesale funding, predominantly through retail deposits, that has made that market particularly competitive and we are wearing the pain as a result of that.

CHAIR—In a way you are not so much concerned about the guarantee, are you?

Mr Degotardi—Which form of guarantee, I guess, is the question.

CHAIR—The deposit.

Mr Degotardi—Are we worried about the guarantee? As I mentioned in my opening statement, we were not losing deposits prior to the guarantee coming in place, but there is no question that our switchboards were lighting up—as were the switchboards of many financial institutions across the country in the wake of Lehman Brothers and other collapses that were occurring—by people who were concerned about their superannuation savings and their other household savings. They just wanted to know that those savings were going to be safe. I do not have a crystal ball so I do not know what would have happened had the guarantee not been put in place, but I can tell you what did happen as a result of that guarantee is that consumer confidence was almost automatically returned. We are certainly not of the view that the market, or indeed the economy, has normalised—whatever normalised might mean in the current environment—to the extent that it is time, right now, to remove that guarantee.

CHAIR—It is time to remove it?

Mr Degotardi—It is not time to remove it, for us particularly, and when those conditions do get to that point it is also very important that our institutions are given sufficient lead time to adapt to those changes. I think it is also important for consumers for those changes to be really well communicated.

Senator PRATT—I note your submission highlights some findings from KPMG about the capacity of credit unions and building societies and, I suppose, smaller banks to compete with the major banks. I want to ask about the long-term implications if we do not fix that imbalance, particularly in relation to eroding competition in the banking market.

Mr Degotardi—I think there is little question that in any market, whether it is retail banking or any other service provision market, if there are only a handful of players and those players are dominant, then over time consumers are going to fare worse as a result of that. There is no question about that. We have now gone from a market 12 months ago where there was a range of competitive regional banks, a range of competitive credit unions and mutual building societies and a range of competitive non-ADI lenders, particularly in that home loan space, and of course the major banks, to one now where the well-publicised and well-worn figure is that about 90 per cent of new home loans are being written by those major banks. In the longer term that is not going to be a good outcome for consumers.

Senator PRATT—In that context, I note that credit unions and building societies generally fare well in terms of customer satisfaction. If it is those institutions that are marginalised in the long term, what does that do to consumers in terms of competition in the sector to satisfy consumers and of making consumer satisfaction a priority within the banking sector as a whole?

Mr Degotardi—If I may, the other aspect to your question that I would like to address is the fact of where some of our institutions are as well. We think of the retail banking market as some sort of homogenous market with an even spread across all regions and communities, but that is just not the case. The impact of the disappearance of competition will have uneven impacts on different communities. For us, certainly, we have always been very strong in regional and rural communities and continue to be so. The banks have at various times come in and out of those

communities and, happily, in recent decades they have responded to community concerns and come back to those communities.

But certainly, from our point of view, in the absence of vibrant competition all of those communities suffer. To turn to the question that I think you are asking, Senator Pratt, here is the real issue that we as small institutions face. You have had evidence before this committee that suggested that when the non-ADIs vacated the space because of funding the major banks simply did the right thing and took up that space. I would have a slightly different spin on that particular view. We would have liked, and still would like now, to take up that space. But in some respects you need to look at what banking business is, and there need to be two sides to the banking business: you need to have funds in and you need to be able to provide funds out. We cannot have significant growth aspirations unless we have some sort of diverse and reliable source of funding. For us that has always been mostly deposits, with a bit of securitisation and wholesale funding. But without that diversity and reliability we cannot prudently say that we want to expand into those markets and guarantee competition. I think that, contrary to some earlier discussion, consumers in Australia are relatively savvy. If a credit union or building society cannot get to them the products that they want, they will choose other providers. We have been constrained about being competitive on both pricing and availability of funding.

Senator BUSHBY—You were saying that there are two sides of the equation: you have to have the money in to be able to take up that space and to be able to offer the products that people want to take up when they are moving from non-ADIs into the ADI sector. You mentioned that most of your money came from deposits, some from securitisation and some from the wholesale market. But when this was all happening and the guarantees were introduced, people were moving from the non-ADIs primarily to the big banks. Were there any decisions of government that made it harder for you to get that funding that you needed so that you could actually try and capitalise and take up some of that extra space? I am not asking you to criticise the government, but could things have been done differently? I am asking so that we can learn from it, essentially.

Mr Degotardi—Before the guarantee came into place those securitisation markets were disappearing. That was a global economic event, not any decision of this government or any other one.

Senator BUSHBY—But it accelerated that?

Mr Degotardi—That certainly impacted our ability to compete. Whilst I would not characterise it as a decision of government, certainly the role of APRA is important here. APRA has, as you well know, a role to protect depositors of ADIs, and rightly so. One of their constraints and one of the things they have said clearly—not just to our sector but certainly to our sector—is that your growth aspirations need to be matched by your funding aspirations. If you cannot match those two things you cannot pursue growth. That, again, was not a decision of government but certainly has had an impact on our decision making for risk.

Senator BUSHBY—It was part of the solvency charter that they have with respect to the ADIs?

Mr Degotardi—That is absolutely right. Here is what we would have liked, and what we still would have liked once the guarantee scheme was in place. The fee structure, we argued from day

one, was anticompetitive in our view. As it turned out, that has probably proven to be the case in terms of both what has happened to the competitive space in that market and the way that the figures have panned out on who has been able to access those wholesale funds.

To be clear, to a large extent our sector has never, before this crisis, accessed wholesale funding. Our mechanism was more in the securitisation space. I guess that 10 months on, with the benefit of hindsight, and now that stability has been achieved so that we have the luxury of considering of these things, we would like to see now—and would probably liked to have seen earlier—some sort of ability for small institutions, through securitisation or similar vehicles, to access another source of funding.

Senator BUSHBY—So if the government, say, at the same time as the wholesale funding guarantee had introduced some form of guarantee for securities or RMBS, that may have assisted you to be able to capitalise on the drift towards ADIs?

Mr Degotardi—I think that is probably a fair—

Senator BUSHBY—Better able to match up the funding with the idea you are putting out?

Mr Degotardi—I think that is a fair assessment. Certainly the AOFM proposal has been accessed by some of our members.

Senator BUSHBY—The \$8 billion?

Mr Degotardi—Yes. But clearly that is a limited pool and not necessarily a pool that has been able to be accessed by all our members. One of the difficulties of our sector is that we have institutions ranging from very small local institutions to quite sophisticated large institutions with around \$7½ billion in assets. Whilst the larger ones can access AOFM and issue hundreds of millions of dollars of securities, of course our smaller ones cannot.

Senator BUSHBY—Yes.

Mr Degotardi—Another mechanism that allows those institutions to group together and issue some sort of aggregated security through a scheme would also be welcome.

Senator BUSHBY—All of this happened post October last year, and you are reliant on deposits primarily for your funding so quite clearly I can understand your strong support for the deposit guarantee because without that that could have caused your members a huge problem. But even given that, did your members as a whole, or any particular sector of them, have any problems obtaining finance after the guarantee was brought in.? Did you face a credit crunch at all?

Mr Degotardi—In the immediate lead up to the announcement by the government on 12 October none of our institutions were experiencing a run of any kind.

Senator BUSHBY—No, I am not so much interested in the runs. The point of the wholesale funding guarantee was to ensure that we had liquidity in the system and our banks could borrow money. You do not make use of that as a general rule, so that is not something that assisted you

greatly, but obviously the deposit guarantee has. Did you find that there were liquidity issues either in the lead up to or post the decision to put the guarantees?

Mr Degotardi—There were certainly no actual liquidity issues in our sector. Our liquidity was quite high then.

Senator BUSHBY—I might be terming it wrongly. I am not talking about solvency challenges, I am talking about the ability to get as much money as you need and you could place.

Mr Degotardi—If the question is, ‘Were some of our institutions wanting to access more money so they could grow?’—

Senator BUSHBY—Yes.

Mr Degotardi—And could they, then the answer was probably ‘no’.

Senator BUSHBY—Yes, that is more what I am coming at, rather than whether any of them were on shaky legs.

Mr Degotardi—Sure. There would have been some of our institutions who are quite strong and who would have been well placed to have taken advantage of the conditions.

Senator BUSHBY—And 12 months before that, maybe, they might have been able to access that through the securitisation market?

Mr Degotardi—Yes, that is true.

Senator BUSHBY—Okay. As I mentioned, and as you have certainly stated quite clearly, you are very strong supporters of the deposit guarantee. The words you used are that you have always supported the deposit guarantee for up to \$1 million. Is the \$1 million aspect of it key to your support? If they come in with an \$800,000 or a \$500,000 or a \$250,000 would it have had the same effect in your opinion?

Mr Degotardi—Again, I do not have a crystal ball so it is very difficult for us to make that sensible analysis. I guess our comments reflect the fact that that is what it is and what it became. Our comments reflect the fact that we support it in its current form.

Senator BUSHBY—They won’t have to worry about it!

Mr Degotardi—I think it is important to understand that it is not just about the number of consumers that are under that limit but about the amount of funds—comparatively speaking—that the institution raises over and under that limit. There is the question of what stability you need to create. There has been some interesting activity in the over \$1 million deposit mark since the guarantee. Some of that has been—

Senator BUSHBY—With your members?

Mr Degotardi—Yes, amongst our members and amongst other institutions as well. Some of the activity above the \$1 million threshold has seen investors chasing the guarantee. For instance, if you had \$5 million, you would place that with five different institutions rather than one. The corollary of that is that, if the threshold had been lower, would you have seen that same activity at a much more damaging level? I guess I cannot answer that question with any clarity.

Senator BUSHBY—If you look at the UK and the US markets, they have capped guarantees at a much lower level than we have. Effectively, ours are uncapped if you are willing to pay a fee. They do not have that option at all. From memory, the UK has it capped at £50,000 and the US at about US\$250,000. That seems to have worked in markets where they had real runs on banks and there was a much greater reason for people to be concerned about their deposits. In Australia everything was fairly sound, even though there was a bit of concern and switchboards were lighting up. It raises issues of why we needed to go to the extent we did. In places where there were real threats, they did not have to go anywhere near as far.

Mr Lawler—The announcement of the deposit guarantee was, I would say, extremely well timed. In the lead-up to that, as APRA and the RBA have commented, there was definitely some fragility of confidence. Frankly, there was a lot of misinformation about the way the regulatory system works being peddled by people who were supposedly well informed about this sort of thing. The timing of the government's announcements made all those problems go away. If the government had not announced it at that time, the general level of public confidence a week later might have been a completely different story. Conceivably, it could have got quite a lot worse quite quickly given the relentless amount of bad news rolling in from off shore. Global banks were falling over. There were huge government interventions on an incredible scale in overseas countries. On the level of public knowledge—and even so-called expert knowledge—about how our system works and why our banking system was sound and safe, there was probably a lack of good information. There was an atmosphere that was creating a certain amount of hysteria. The government's intervention, I think, was extremely well-timed. That is important to keep in mind.

Senator BUSHBY—Malcolm Turnbull was calling for it a week earlier than it was actually announced. So there are no issues that it was needed. To quote a previous witness—was it Ian Harper?—when it happened it needed to be a shock. It needed to actually be something that hit people so that they thought, 'Good,' and understood that things were guaranteed. One previous witness said that if it had been done earlier then a higher limit or even an unlimited cap may not have been as necessary. I raise this because you raised the issue of timing. Another week later, it might have been too late. A week earlier, you possibly could have come with a lower cap to give that degree of confidence to people, to quote an earlier witness. Do you think that is a reasonable proposition?

Mr Lawler—The cap that was proposed when the financial claim scheme was being developed to a point where it could be drafted into legislation was \$20,000. That was seen by the people designing it—the policymakers at Treasury, APRA and the Reserve Bank—without a crisis atmosphere, as a reasonable limit. Clearly there was a debate to be had about that. In a crisis everything changes. Everything has changed so we are facing a different situation now. We have had a crisis where there have been unprecedented outcomes. We have seen AAA rated organisations fall over. There has been a real shock to confidence. It is a completely different story now. To speculate about if you had come in a bit earlier or a bit later—

Senator BUSHBY—The only reason I speculated was that you speculated about coming in a bit later.

Mr Lawler—I just wanted to make the point that our institutions were performing well, even though there was this—if I dare to use the term—rising level of hysteria, which in part reflects the close relationships with the members and the trust that is there. The level of public confidence was clearly under threat and the announcement made all that go away.

Senator BUSHBY—I accept all of that. In terms of the fee for the guarantee over \$1 million—that obviously concerns you?

Mr Degotardi—Yes.

Senator BUSHBY—I presume that would concern you far more than the variability of the fee for the wholesale funding, given that your members do not make too much use of it?

Mr Degotardi—Even in the wholesale funding space it is still important. One of the reasons our members do not use wholesale funding in its current structure is because of the fee.

Senator BUSHBY—Yes.

Mr Degotardi—But certainly in the deposit space it is also very critical. I think in some respects, it is even more anticompetitive in the deposit space. We are all regulated the same way as ADIs, and APRA's remit, as I said earlier, is to protect depositors. Presumably all depositors and all ADIs are protected the same way, and yet we have got a different risk differential premium applied to us for deposits with us.

Senator BUSHBY—I actually asked APRA about the differential risk at the previous hearing on this. Their comment was, 'Well, that is how the market prices risk.' That is fine if you are in the market and you are out there in normal circumstances looking at it, but when you are in a crisis situation and you are trying to introduce the confidence that you need with depositors, you are trying to achieve policy outcomes for the good of the country. You are not in there as a participant in the market. In particular, playing as a participant in the market and adding a premium for risk because that is what the market does is actually going to have consequences in the competition context. It just does not seem to look at the whole picture and the purpose of why you are actually intervening.

Mr Degotardi—I agree. Particularly in the light of deposits, APRA requires us to hold certain levels of liquidity, and we exceed those certain levels of capital—we well exceed those. There is risk management, governance fit and proper and a whole raft of requirements for us, as well as other ADIs, and we meet that same level of regulation. That capital and that liquidity are there to meet the demands of depositors. We would certainly argue that what the market might do for pricing for risk in the wholesale space has absolutely no relevance to the question of whether a deposit with an ADI is safer in one ADI than another. That is one of the reasons we are—

Senator BUSHBY—There are two issues, I think, in terms of that. One is what the actual real risk is to the government in terms of guaranteeing it, which is what you have just addressed. The other is from a policy perspective: what is the outcome that the government is trying to achieve?

If it is confidence with depositors in the ADIs then does it need to price for risk? It is trying to achieve an outcome, why price for risk—particularly if it actually has other outcomes?

Mr Degotardi—We can say for certain that, in our view, the pricing structure has created in the minds of consumers different levels of ADIs. That perception should never have existed and does not exist in reality.

Senator BUSHBY—Just on the securitisation: you are in favour of guarantee for the RMBSs? Does that assist your members to ensure they can access funds on a competitive basis?

Mr Degotardi—We are very supportive of investigating any sort of scheme that allows better access to wholesale markets, whether that be directly or indirectly through a mortgage backed security type arrangement. Certainly, some of the proposals that have been put up are worthy of consideration, in our view. One of the benefits of securitisation for smaller ADIs is that it allows participation indirectly in the wholesale market. That is not ordinarily available to us, and it is in an important source of alternative funding for us.

Senator BUSHBY—What about a greater level of intervention through the AOFM and the RMBS market?

Mr Degotardi—We are concerned that the \$8 billion is effectively being issued and we would support government backing an RMBS market either directly through a guarantee or through some other mechanism. The one rider that we would put on that is that, if we are going to ask the government to take on a risk, then the government rightly has to be concerned about what the risk is that they are taking on.

Senator BUSHBY—Absolutely.

Mr Degotardi—We think that the best of those securitisation schemes that have worked are the ones that have the right sorts of criteria for participation both in terms of the institution and the underlying assets. Any sort of system would need to make sure that those two things are critically right. From our point of view, we would not make it just for ADIs, but if it is going to be participated in by non-ADIs then they should also meet certain levels of regulation or criteria that we already meet.

Senator BUSHBY—Prudential types of obligations?

Mr Degotardi—Sure.

Senator BUSHBY—Thank you.

Senator PRATT—You have touched on the fact that credit unions here have weathered the storm quite well. Is that the same for credit unions overseas? How is Australia positioned in terms of the sector as a whole?

Mr Degotardi—The Australian credit union and mutual building society sector is probably leading the world, without waving too strong a flag on that, in terms of our performance in the way in which we have weathered the GFC. I think it is attributable to our own performance but

also to the regulatory system that we have in Australia. It is probably stronger than other systems. Regional credit unions elsewhere are also holding up quite strongly. Interestingly, in times of crisis in some overseas jurisdictions when people refer to a 'flock to quality' that actually means a flock to ethical, responsible institutions such as credit unions. That is an interesting dynamic that occurs in some other areas. Clearly, in markets such as the US there are pockets where the residential lending books, in Florida for instance, are very difficult and so credit unions lending in those areas will be facing the same sorts of pressures as others. Generally speaking, we have done a little bit better but across the world the credit union sector is quite strong.

Senator PRATT—The guarantee has clearly stabilised the sector for everybody and despite you not having access to it you are still benefiting because of the strong reputation of credit unions as responsible institutions in the current climate.

Mr Degotardi—I think that is true. I would also guess we benefit from having been responsible in the first instance. We have never had the risk appetite. We have never engaged in some of the securities and other loans that have led to some of these issues—no-doc lending and complex securities markets. That is also one of the reasons.

Senator PRATT—You would benefit from that now on the basis that people are likely to be a bit more risk averse in the current climate.

Mr Degotardi—Investors are risk averse, but people still want to buy cars, sofas and TVs and have a home loan and that is completely reasonable. What we want to do is to make sure they get the opportunity to get one from us.

CHAIR—Thank you very much for appearing today.

Committee adjourned at 2.59 pm