Submission to the Senate Committee on Economics: Inquiry into the Bank Funding Guarantees

Fariborz Moshirian[1]

Professor of Finance and an Editor of the Journal of Banking and Finance, The Australian School of Business, the University of New South Wales

There have been a number of papers, including the earlier submissions to this inquiry that articulate well the causes of the current global financial crisis and/or the rational behind the introduction of the guarantee schemes (deposits and wholesale funding) and how the schemes could be modified/changed over time. However, I feel that there has not been enough emphasis on the importance of a globally coordinated approach to the gradual removal of these guarantees schemes. I intend to refer to the work of the IMF and others in this respect. Furthermore, I will highlight some of the related developments in the US and Europe for the purpose of a more coordinated approach to removing or modifying these schemes. I would also like to highlight the risk of more regulatory arbitrage that could potentially disadvantage the Australian financial institutions, in the absence of a globally coordinated approach to these schemes.

In the meantime, similar to a number of other people and organisations who have submitted their views to this Committee, I agree that we should try to find an exit strategy as quickly as possible and in the meantime, find ways to reduce/modify the level of guarantees and/or increase charges in some areas associated with these schemes, particularly if other

[1] f.moshirian@unsw.edu.au

governments are demanding more fees for a similar level of support or guarantees from their financial institutions or their depositors[2].

In a recent research work conducted in collaboration with the IMF and the World, Demirgüç-Kunt, Claessens and Moshirian (2009)[3] identified a number of financial challenges facing governments around the world, including issues with respect to bank funding guarantees. They have discussed/acknowledged/considered/analysed why governments had to take some extraordinary measures in their response to the current global financial crisis. However, as a matter of principle they also referred to a work by Demirgüç-Kunt and Serven[4] (2009) who explained that the goal of financial regulation and supervision is not to reduce financial institutions' risk-taking, but to manage the safety net so that private risk-taking is neither taxed nor subsidized. This implies that supervisors have a duty to ensure that risks are fully understood and fairly priced by investors.

The recent remarks by the Governor of the Reserve Bank, Mr Glenn Stevens regarding the government's backed debt scheme for financial institutions, has further stimulated discussion on the time frame for an exit strategy from this scheme in Australia.

In an international context, the Australian government backed debt scheme was initially more generous than other countries. The maximum maturity date beyond which the debt

---

[2] I should state that part of this submission to the Senate Committee was published in the Australian Financial Review on Monday 10 August Mixed blessing of government backing

[3] Claessens is the Assistant Director of the Research Department at the IMF and Demirguc-Kunt is the Head of the Research Department at the World Bank.

Stijn Claessens, Aslı Demirgüç-Kunt and Fariborz Moshirian, Global Financial Crisis, Financial Risk and Financial Management, The Journal of Banking and Finance, November, 2009.

[4] Demirgüç-Kunt, A., Serven L., 2009., Are all the sacred cows dead? Implications of the financial crisis for macro and financial policies, Policy Research Working Paper, 4807, the World Bank.

issued by financial institutions is no longer covered by government, is 5 years in Australia. Most other advanced countries such as Germany, the UK and the US initially offered such a guarantee until the end of 2012. However, these countries, except the US, extended the guarantee until the end of 2014. The key issue here is that Australia and New Zealand are the only two OECD countries that did not specify the final date for the government backed debt scheme to be terminated, whereas other key OECD countries have specified the end of December 2009 as the final date for this scheme. This could explain why Mr Stevens raised his concerns recently. With respect to the deposit guarantee policy in Australia compared to other OECD countries, the current termination date for this scheme in Australia is October 2011 compared to December 2013 in the US, while the UK and Germany have not specified a date.

However, it should be noted that in the US, the deposit guarantee is US$250,000 per account. In other words, it is possible to have a number of accounts in the US under single or joint names and extend the current level of guarantee well beyond US$250,000. At the same time, apart from Australia's current deposit guarantee scheme, there are also unlimited guarantees in some other countries.

Some of the statistics provided by the Wall Street Journal about the US government guarantee on new debt issued by financial firms since November 2008 are noteworthy. For instance, due to this guarantee scheme, major banks in the US were able to easily raise funds that, in turn, assisted them in the resurgence of business activities. Due to access to low cost FDIC-backed debt, Citigroup saved around $US600 million in its latest quarterly debt issued. Indeed, 14 percent of Citigroup's overall profits of $US4.28 billion in the second quarter was due to access to such a low cost debt scheme. Similarly, other major players such as Goldman Sachs and JP Morgan Chase have been saving millions of dollars due to a significant cut in their cost of funds. To better understand the extent of cost savings by financial firms in the US, one should note that in November 2008, there was more than 5 percent difference in yields for debt issued by Goldman Sachs with or without the government backed debt scheme. Goldman's government backed debt guarantee with a maturity of June 2012 had an annual interest rate of 3.25 percent, whereas Goldman's outstanding debt, without a government backed debt scheme, maturing in September 2012 was yielding 8.51.

For J.P Morgan Chase & Co, the total reduction in financing cost is expected to be around $US3.1 billion according to the Wall Street Journal. It is also estimated that 10 percent of the recent profit announced by JB Morgan Chase was attributed to a reduction in cost of funding due to the government backed debt scheme. Some commentators have also argued that such a scheme in the US assisted the faster recovery of the US banks which were able to report positive profitability in the second quarter, which in turn has contributed to the recent stock market rally. However, the US government, who has collected about $US6.9 billion in fees from this scheme is going to terminate it by the end of October 2009, earlier than the UK and Germany that intend to complete this program in December 2009. In Australia there is no deadline for a similar scheme to be terminated.

While there are signs that Australian banks have less challenges accessing the wholesale funding market without Federal government support, European banks are still finding it difficult to access it. This is because of less confidence in the pace of economic recovery in Europe and the fear of more loan defaults. Recent data released by the ECB indicate that banks in the Euro-zone have scaled back their lending activities further, due to fear of loan defaults. This is despite the ECB's injection of $626 billion in June, in one -year funds, into the banking system. Central banks in Germany, France, Italy and Spain are become more frustrated with commercial banks who slowed their lending activities down more, according to data released on Wednesday. Indeed, the German government threatened banks with unspecified action, if banks lending does not increase, while the ECB President Jean-Claude Trichet appealed to banks to use the liquidity injection for lending.

In the UK, data recently released indicate that June consumer lending grew at the smallest pace since 1993. In the UK, banks are complaining that wholesale funding is harder to access and competition for customer deposits has intensified. This may also indicate the way the wholesale funding market is considering the UK's economic health in the medium term.

While Australian banks are in a much stronger position to access the wholesale funding market, it is also important to ensure that some kind of coordination exists amongst countries for terminating the government backed debt program. The National Bank chief executive, Cameron Clyne, stated that the G20 summit in September could be a good time to ensure some kind of coordination amongst the key countries for terminating such a scheme. Some observers, as reported in the Australian Financial Review, are also indicating that despite the willingness of the Macquarie Group to wind down the government backed debt scheme, due to a number of uncertain factors, there is no guarantee that the Macquarie Group will be able to raise funds on its own over the next six months or so.

While, there is no question that government intervention in the financial markets have distorted effective allocation resources and reduced fair competition, an ineffective coordinated approach, in the presence of continuous global financial uncertainty and the risk of further deterioration in the global financial market, to remove the guarantee schemes may not be in the best interests of financial stability in Australia or elsewhere. However, this does not mean that we should not consider increasing some of the fees associated with this program or create a mechanism so that we could modify and/or in some instances accelerate the phasing out of such schemes.

It is noteworthy that in May this year the Head of the IMF called for a "new global framework". This was after the G20 Summit in London where national regulators were entrusted to fix their financial system, where applicable, and at the same time, ensure less regulatory arbitrage associated with their national financial policies. In this context, Stauss Kahn[5] (2009) identified coordination in depositor and investor protection as area that could be part of the emergence of " a new global framework". He stated that "*The framework should bring some consistency to the amount of protection given to depositors and investors, and should feature explicit coordination principles.*

With respect to coordination of regulations, Straus Kahn (2009) argued that *One of the lessons of the crisis is that we must avoid regulatory arbitrage. Key aspects of prudential regulations must be applied consistently across countries and across financial activities. This is especially important today, as the road to a safer future involves strengthened financial regulation and supervision, not only of cross-border institutions but also of cross-border*

---

[5] Strauss-Kahn, D., Crisis Management and Policy Coordination: Do We Need a New Global Framework?

markets. This will only work if all countries sign on and take ownership of the initiative, and resist the temptation to offer loopholes.

Since the global financial market appears to have stabilized, it is important that the programs related to guarantee schemes be discussed at the upcoming G20 Summit in September to ensure that we are not only able to have a coordinated approach to these schemes, but also ensure that new developments or changes in national regulatory policies do not lead to more regulatory arbitrage which in turn could disadvantage the Australian financial system and its participants.