AUSTRALIAN BANKERS' ASSOCIATION INC.

Response to Senate Economics References Committee Inquiry into Bank Funding Guarantees

Australian Bankers' Association

August 2009

Introduction

The Australian Bankers' Association (ABA) welcomes the opportunity of providing a submission to the Senate Economics References Committee inquiry into the bank funding guarantee. We see this inquiry as a good opportunity to put forward information and arguments that will better explain the issues surrounding these guarantees. The submission is structured around the Inquiry's terms-of-reference.

The main theme of the ABA's submission is that the Australian banking system is very sound and has performed well throughout the financial crisis. We also acknowledge the bank funding guarantees were important in reducing the probability that Australia could have faced a more significant crisis.

In terms of recommendations, the main issue we think that the Government needs to deal with is setting the deposit guarantee cap when the current timeframe runs its course, scheduled for October 2011. We see this as a priority because it will take all banks considerable time to properly prepare for the new arrangements.

The ABA recommends that the new deposit insurance limit be based on an international benchmark. The ABA also recommends a flattening in the insurance premiums charged by the Federal Government for the wholesale funding guarantee, although ABA member banks differ in view on the extent of this flattening.

Response to the terms-of-reference

(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;

The ABA was not privy to the discussions leading to the deposit and wholesale funding guarantees, so we cannot comment specifically. However, at the time, it was obvious that there was rising uncertainty in the community over the economic and financial outlook.

Our understanding is that one reason to limit the deposit guarantee to $1million was a concern that the unlimited deposit guarantee was distorting the wholesale funding markets. The unlimited deposit guarantee created an incentive for those with cash to invest in deposits rather than other savings instruments like commercial paper.

(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;

The ABA's understanding is that the wholesale funding guarantee was introduced as a protection against potential credit rationing.

Australia runs a current account deficit (CAD) – which is simply the difference between how much money households and companies want to spend on consumptions and investment minus the amount of domestic savings available. Given there is a gap, it must be filled, and it is primarily done so through the local banking system.

Australian banks borrow on global money markets in their own name and then pass this money onto Australian households and businesses who want it – in the form of loans. Banks therefore perform a very important role in helping to fund Australia's CAD.

The global credit crisis put this process under stress. Those overseas investors with money became extremely risk averse and therefore very careful about whom they lent their money. Because our banks are amongst the strongest in the world[1], they continued to access global money markets through most of the crisis.

The crunch came after the Lehman Brothers (USA) collapse. Not only did investors become even more risk averse, but Governments around the world started to guarantee the credit worthiness of their own bank's funding, starting with the Irish Government. At this point, the Australian government had to choose either:

(a) Follow the international precedents and guarantee Australian banks funding; or

(b) Resist the pressure to issue guarantees, but risk credit rationing i.e. some business and households who want loans being restricted in accessing those loans.

It is often alleged that the Government's wholesale funding guarantee 'bailed out' the Australian banks. This is false. No bank would have collapsed if the guarantee had <u>not</u> been put in place; it simply would have meant that <u>if</u> the local banks were unable to secure funding from overseas, then domestic credit would have been rationed. Australia would have gone through a painful internal adjustment to close the CAD.

(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);

The deposit guarantee had the effect of maintaining depositor confidence in the prudentially-regulated deposit-taking institutions. There was a growing unease amongst depositors emerging, although there was no evidence that any of our deposit-taking institutions were about to default.

The main impact of the deposit guarantee was to create an incentive for those households and businesses with savings to deposit their money in government guaranteed products. So, investment products that could not offer a guarantee faced increased withdrawals. This led to widespread freezes on redemptions in non-deposit savings products.

(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;

The wholesale bank funding guarantee increased the probability that the domestic banks would continue to access overseas funding to support domestic lending. It is possible that Australian banks – due to their strong credit ratings – could have continued to access funding, but the guarantee was an additional safeguard, especially once other Governments started issuing guarantees (e.g. the Irish, German and UK governments).

It is hard to assess the impact of the wholesale funding guarantee on non-APRA regulated entities. Well before the wholesale funding guarantee was introduced, it was widely argued by academics and commentators that the global financial crisis had made defunct the business model of non-bank housing lenders. In response to this concern over the competition implications, the Federal Government announced $8 billion in direct funding to purchase securitized assets of institutions other than the major four banks.

[1] Australia now has 4 of the 8 strongest banks in the world.

It is argued that the wholesale funding guarantee reduced the potential leverage of this $8 billion government expenditure by encouraging private sector investors to buy “guaranteed” products rather than these RMBS assets. Another view is that investors are still concerned over the securitization product given its central role in the US sub-prime lending crisis.

The ABA has not attempted to assess the validity or otherwise of these two arguments, but we note that Australian RMBS have performed considerably better than US RMBS.

(e) the estimated effect of the bank deposit and wholesale funding guarantees on interest rates in Australia;

It is unclear as to the effect of the deposit guarantee on deposit interest rates, particularly given the guarantee for deposits under $1m is not priced. The main influence on deposit rates (which are currently high relative to the cash rate) is driven by a desire of banks to reduce their dependence on wholesale funding, particularly offshore funding.

The impact of the wholesale guarantee is likely to be negligible. While the government guarantee has the effect of reducing the risk-premium of lending to Australian banks, the government has imposed high premiums for this benefit. The premiums range between 70-150 basis points, depending on the institution’s credit rating. These premiums obviously feed into the retail interest rates of housing and business lending products.

Competition between lenders has had the effect of keeping interest rates in close alignment, so the effect of differential premiums for the wholesale guarantee will be to disadvantage those institutions that have to pay the higher premiums. However, these same institutions are probably also the relatively higher beneficiaries of the non-priced deposit guarantee.

(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;

This is well documented in the Reserve Bank’s / APRA submission to this inquiry.

(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;

Once the credit crisis commenced in August 2007, considerable strain came onto the business models of lenders that were either heavily or fully dependent upon securitization markets to fund their lending.

This strain led to calls for the Government to prop up the non-bank lending sector in order to provide competition against the major banks. It was claimed that without these actions, then mortgage lending margins would increase dramatically (a claim that has so far proven wrong – margins actually fell).

In order to promote competition in housing lending, the Government announced a $4 billion program to buy RMBS assets and then doubled this amount to $8 billion. The idea was that with the Government purchasing RMBS this would give confidence to other private sector investors to also buy these assets.

However, there is little evidence of private sector investor appetite for RMBS assets. One reason cited is that the Government’s deposit and wholesale guarantees have drawn investors away from the RMBS market. Another possibility is that the private sector investors are still concerned about the nature of the RMBS product because it was this product that was at the core of the US sub-prime crisis.

The ABA does not have a view on which one of these arguments is more correct.

(h) the nature of the financial and economic distortions that the unlimited deposit guarantee scheme has created vis-à-vis savings products that are not covered by the guarantee scheme;

It is hard to assess the degree of distortion that the deposit guarantee caused because its effects were mitigated by fund manager actions to stop redemptions.

Probably the main impact has been to slow the growth in the funds under management market, particularly for funds that do not tap the compulsory superannuation funds inflow.

(i) the optimal cap, if any, for the deposit guarantee in the light of international experience;

The ABA does not have a formal $ dollar number to recommend as the optimal cap. Instead we recommend that the cap be based on an international benchmark.

We are doing further work on this, but a methodology based on an average of the deposit insurance limits used in a selection of relevant countries, such as the USA, UK, Canada, Hong Kong, and Singapore. It could be defined as a multiple of average weekly earnings.

By using an international benchmark to set a deposit guarantee limit, the Government can minimize the incentive for depositors to seek out countries with the most generous deposit insurance arrangements.

(j) recommendations for ameliorating the moral hazard associated with the deposit guarantee and wholesale funding guarantees;

The academic literature (mostly written before the current financial crisis) cites the following deposit insurance design features as useful in minimizing moral hazard:

- Low limits – this gives those with large deposits additional incentive to monitor the health of the deposit-taker.
- Co-insurance – this is where depositors bear some of the loss if their institution fails and its assets are insufficient to cover depositors, e.g. customers lose 10% of their deposit, regardless of where the limit is set.
- Risk-based premiums – this is where the riskier institutions are required to pay higher premiums into the insurance pool. This is normally associated with pre-funded schemes.
- Requirement to issue debt instruments – this is where the Government requires all institutions to issue debt instruments so the institution's performance is monitored closely by the bond holders. This is really relevant only to institution's that are heavily funded through deposits.
- Separate insurance pools – this is where classes of institutions have their own insurance pool. The ABA has long advocated that banks should have a different insurance pool from those institutions with a mutual structure, i.e. credit unions and building societies.

The ABA recommends that moral hazard is reduced by having separate insurance pools – one for banks, and one for mutual's. Our reasoning is that all of our domestic banks are listed on the ASX which makes them subject to the continuing disclosure regime and more intensive reporting obligations. Also, most listed banks are active in wholesale markets which provides greater scrutiny than institutions raising most money through retail deposits. These features of banks provide a level of scrutiny beyond that of credit unions and building societies.

Also, the credit unions and building societies have argued that their business model is particularly strong in the current climate because they have a high degree of deposit funding plus strong capital levels. Given this, they should welcome having a separate insurance pool as it implies they will face lower insurance premiums.

In terms of the wholesale funding guarantee, we don't see moral hazard as a long-term issue because this guarantee is temporary and institutions are keen to avoid the government insurance premiums, so will move away from using the guarantee as soon as practicable.

(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;

The current timeframes are well known (October 2011) and seem appropriate. However, the ABA advocates that the earlier a new deposit guarantee limit is determined, the better. Banks will need to plan well ahead if there is to be a reduction in the limit of $1million.

(l) the effects of the bank deposit guarantee and wholesale funding guarantee on competition within the financial sector;

The bank deposit guarantee benefitted all prudentially supervised institutions either directly or indirectly. When the deposit guarantee was first instituted, some banks viewed it as unnecessary to sustain their net deposit inflows. However, all banks benefited from the overall confidence it maintained in the sector.

The deposit guarantee has no premiums attached for deposits of less than $1 million and the scheme is underwritten by the banks collectively (not by the Government as is so often alleged), so in a theoretical sense it benefits riskier institutions over that of less risky institutions, but in a real world sense, given there is virtually no possibility of depositor losses[2], there are no obvious competition implications.

In respect of the wholesale guarantee, the Government has imposed differential premiums. We are unaware of the methodology used by the Government to set these premiums, so we cannot comment on whether they embody true risk premiums or not[3]. However, the reality is that those banks that cannot access the lower premiums are disadvantaged over those institutions that can.

While lower rated banks have access to the government guarantee, in practice it is almost uneconomic for them to use it. This is because they need to pay both (a) a higher government insurance premium, and (b) a higher margin to the investors.

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[2] Unlike in most countries, depositors in Australia have priority status in the event of insolvency.

[3] Anecdotally we think the 150 basis point premium for a BBB rated institution is excessive – more than double that paid by AA rated institutions. This concern is strengthened by the fact that risk of default is mitigated by an intensive level of prudential regulation and the practical and most realistic option of minimising any potential losses through a trade sale of a failing institution to another bank.

The term used to describe this is that investors are 'looking through' the government guarantee and charging the lower rated banks a premium - ignoring the credit enhancement provided by the government. One contributory reason for this is that the current design of the guarantee does not give investors confidence that, in the event of default, the government will make good on the guarantee within an acceptable timeframe. The ABA has raised this issue with the Federal Treasury and we are waiting on a resolution. (However, this should not be seen as a full answer to the problem.)

To address this issue, the ABA recommends that the current gap between the premium levels is reduced. The ABA member banks have differing views on the extent to which the gap should be reduced. Some banks, including at least one major bank, believe a complete flattening of the premiums is justified.

(m) the effects of the announcement of the unlimited bank deposit guarantee and unlimited wholesale funding guarantee on consumer and business confidence;

The guarantees are likely to have improved confidence as the Lehman Brothers (USA) collapse led to a steep decline in people's confidence in the economic outlook.

(n) the broader economic and social consequences of these distortions;

Australia's financial system has performed well compared to other countries. This is mainly due to our strong banking system but the government guarantees helped instil some confidence after the Lehman Brothers (USA) collapse.

(o) the size and nature of the contingent liability that the unlimited deposit guarantee has created for Australian taxpayers; and

Of the $820 billion of deposit and wholesale liabilities subject to guarantee, the taxpayer is on paper at risk for the $110 billion component of this.

The rest of the money - $700 billion – is underwritten by the banking industry, so there is no taxpayer risk.

This reality is contrary to many claims that the Government has underwritten the banks. In reality, taxpayers have guaranteed a relatively small proportion of the total liability and it is our expectation that this will not be used.

(p) other matters relevant to the bank deposit guarantee and wholesale funding guarantee that the committee considers appropriate.

- Politicians need to understand and acknowledge the linkage between bank bashing and competition. By relentless attacks on major bank's housing interest rate movements, politicians have created an incentive for banks to keep housing rates artificially low and have this offset by other interest rates. This negatively impacts other housing lenders, particularly those that do not have as diversified loan portfolios and cannot therefore offset the artificially low housing rates.

Conclusion

In conclusion, we believe the actions of the Federal Government to issue deposit and funding guarantees were beneficial moves that lowered the probability of a more serious crisis impacting Australia.

The main challenge now is moving to a new, stable regime. The ABA is, of course, available to provide additional information and appear to give oral evidence if necessary.