31 July 2009

Committee Secretary
Senate Standing Committee on Economics
PO Box 6100
Parliament House
CANBERRA ACT 2600

By email: economics.sen@aph.gov.au

Dear Sir/Madam

Inquiry into Bank Funding Guarantees

The Australian Financial Markets Association (AFMA) appreciates the opportunity to make a submission to the Committee's Inquiry into the Bank Funding Guarantees. AFMA represents the interests of participants in Australia's wholesale banking and financial markets. Our members include domestic and foreign owned banks, stockbrokers, state treasury corporations, fund managers, traders in specialised products and industry service providers. The Deposit and Wholesale Funding Guarantee Scheme has had a significant impact on the financial institutions and markets that AFMA represents.

One of the more significant policy questions to be resolved now is the timing and manner of the withdrawal of the Guarantee Scheme. We believe the removal of bank guarantee arrangements should be coordinated with similar actions in key overseas jurisdictions to ensure this is achieved in a smooth and non-disruptive manner. The rationale for this approach is outlined in the following sections.

1. The circumstances and basis of the decision to introduce the banking funding Guarantee Scheme

The Government's decision to introduce the bank guarantee arrangements on 12 October 2008 was an exceptional measure but one that was justified by the issues confronting the banking system and potentially the Australian economy, as global market conditions deteriorated at that point in time.

A number of overseas jurisdictions had taken action to introduce bank guarantee arrangements which, together with the significant reliance on external borrowings by banks operating in Australia, meant it was necessary

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for the Government to introduce the deposit and wholesale funding Guarantee Scheme.

Even though the major Australian banks are accorded high credit ratings in global terms, it would have been difficult and expensive for them to secure funding on the international capital markets given the uncertainty that prevailed across the global markets at that time. In effect, the guarantees being given by overseas governments eliminated the natural funding advantage that the Australian banks should have benefitted from in the international markets.

In this context, it was also necessary for the Government to introduce the guarantee arrangements for deposits to avoid the risk that funds may have been redirected from the Australian banking system to banks in jurisdictions for which a deposit guarantee was in place. The decision to extend the Guarantee Scheme to domestic deposits also helped to ameliorate any retail investor concerns about the potential effect of the volatile and uncertain international financial markets climate on deposit savings. Notwithstanding the prudentially sound foundation of the Australian banks, retail investors were at that time faced with considerable uncertainty as the global financial crisis unfolded with speed and intensity.

2. The effect that the initial announcement of, and subsequent changes to, the bank guarantee arrangement had on operations of the Australian wholesale banking and financial markets

2.1 Wholesale Money Market

The Government's decision on 12 October 2008 to introduce the Guarantee Scheme generated concern in the wholesale money market. As the industry body through which participants manage the operation of the wholesale money, debt and OTC derivatives markets, AFMA made an assessment of the situation and raised two key matters with the Government, Treasury, Reserve Bank and APRA.

The first concern related to the likely adverse impact of the differentiation between certificates of deposits (CDs) and deposit accounts, for the purposes of the Scheme, on the efficiency of the short term money market. All deposits were initially guaranteed at no cost, whereas it was decided that CDs would be treated as wholesale funding and, thus, would attract a charge. Left unaddressed this situation would have diverted funds from tradeable wholesale money market securities to deposit accounts.

The problem was resolved by the Government on 24 October 2008 when the Treasurer announced a $1 million limit on the amount covered by the free deposit guarantee, with a fee charged for the guarantee on amounts above this limit. This substantially restored neutrality to wholesale short term cash investments within the framework of the Guarantee Scheme.

The second concern was the exclusion of foreign bank branches from the Guarantee Scheme which could, in effect, have led to a tiering of the wholesale money market. This would have impacted the operation of the market generally, as some banks would have had access to the Guarantee

Scheme but others not. Foreign bank branches had issued $95 billion in CDs, almost 29% of the total bank outstanding, at that time.

In addition, the exclusion of foreign bank branches could potentially have disturbed the process for establishing the benchmark 'BBSW' short term interest rate. The BBSW rate is used in the bank bill market and is referenced in a wide variety of financial contracts and it relies on the concept of 'Prime Bank'. AFMA Prime Bank paper is considered to be of the highest quality with regard to liquidity, credit and consistency of yield, trading as a homogenous group of liquid securities. This promotes greater market liquidity and assists investors who seek to diversify and manage their investments within this framework. In October 2008, there were eight AFMA Prime Banks; the four majors and four foreign bank branches.

The issue was resolved when the Government announced on 24 October 2008 that foreign bank branches would be given access to the bank Guarantee Scheme on a limited basis.

On 27/28 October 2008, AFMA's relevant market committees unanimously agreed that the wholesale bank bill/CD market would operate by trading non-guaranteed paper. The demand for guaranteed short term paper was considered to be low and the market has since operated continuously on this basis. This further helped to avoid a split in the money market into guaranteed and unguaranteed security segments which would have reduced liquidity and impaired market efficiency.

2.2 Foreign Bank Branches

Foreign bank branches were the only Authorised Deposit-taking Institutions (ADIs) in Australia not covered by the deposit and wholesale funding guarantee arrangements announced on 12 October 2008. This had a serious impact on their business, as major foreign bank branches began to experience outflows as cash management trusts and other investors sought government guaranteed facilities. Foreign bank branches are typically self-funded through both the Australian and international debt markets. They were unable to draw on their parent bank guarantee to refinance their business. Further, they could not fund on competitive terms by borrowing from their parent (where funds were available), due to the penal effect of interest withholding tax and a cap on interest deductibility at the LIBOR rate. Foreign bank branches had assets on their domestic book of almost $300 billion at that time, so there was a risk that the growth and stability of credit available to Australian business would have been impaired.

On 24 October 2008 the Treasurer announced that the Government was extending the deposit and wholesale funding guarantee in a limited manner to foreign bank branches. If the Government had not taken this action, foreign bank branches collectively would have had to curtail their business in the Australian wholesale banking market with adverse consequences for borrowers, for competition in the Australian market and for our aspiration to be a regional financial services centre.

New Zealand, Hong Kong and Singapore, amongst others, also moved at that time to address the problems encountered by foreign banks in their jurisdictions by guaranteeing deposits of foreign branches.

The extension of the Guarantee Scheme to foreign bank branches initially only covered short term funding issued up until the end of 2009. This condition of access was subsequently altered to permit foreign bank branches to issue short-term guaranteed debt instruments with maturities of up to fifteen months for the period of the Guarantee Scheme. This development was welcomed by the industry, as a necessary measure to provide a more certain and broader basis upon which to fund foreign bank branch business in Australia.

Foreign bank branches as a group have been moderate users of the Guarantee Scheme, when compared with local ADIs. However, their ability to access the Scheme for short term funding is widely regarded as being very important by the foreign bank branches, because it provides comfort to the market about the ongoing availability of funds in the event of further market disruption. Some of the foreign bank branches with relatively larger amounts of domestic assets have been the bigger users of the Guarantee Scheme in order to support their local funding requirements, which stands to reason.

2.3 The Semi Government Bond Market

The semi government market is well established and has a broad investor base, both domestic and international, built up over the period since the late 1980's. The bank Guarantee Scheme had a significant impact on the semi government market by causing a significant shift in investor preference away from the sector. Investors sought to take advantage of guaranteed bank security issues that had a similar credit rating but were priced at a yield significantly higher than comparable semi government bonds (depending upon the term and issuer, at least 70 basis points above) but had a similar credit rating. As a consequence the margin paid by the semi government borrowers above the commonwealth curve widened significantly (from historical 10 year spreads of between 25 to 35 basis points to around 140 basis points) and liquidity in the market deteriorated.

The risk of a potential contraction in the semi government investor base and a significantly increased cost of funds for the States occurred at a time where their funding requirements were increasing in line with the need to undertake infrastructure investment. Though the effect of the establishment of the bank guarantee market on the semi government market was unavoidable; the inability to access markets for the required volume of funding was a significant concern for the States. This issue was resolved in March 2009 when the Commonwealth announced its intention to provide the States access to the guarantee facility.

Whilst on a stand-alone basis the States have a high credit standing, for the larger States, the option of accessing the guarantee facility provides the flexibility of being able to access the broadest range of potential investors, particularly from offshore given the significantly increased competition from bank guaranteed issuers globally. The announcement of the intention for the States to borrow under the guarantee was received positively by the market,

as reflected in the semi government bond spread contracting significantly over the following months as the various policy steps to enable the States to issue under a Commonwealth guarantee were confirmed.

2.4 Outstanding Issues

There are a number of issues identified by member banks in relation to the bank guarantee arrangements that are unresolved.

- Some member banks have voiced concern about the relatively high cost of the bank funding guarantee for banks that are rated below AA and feel this has placed them at a competitive disadvantage in the funding market, as they cannot extract full value from the guarantee. In part, this is because investors have 'looked through' the guarantee, thus increasing the relative funding cost for banks rated lower than AA. The banks affected by this outcome generally favour a flattening of the fee structure so all banks at least may obtain the guarantee at the same rate, with the market still providing pricing differentiation.

- Foreign bank branches cannot use guaranteed funds to support related party operations in Australia. This represents a significant practical limitation for some foreign banks that operate through a group structure, with the branch being used as a funding vehicle for related financial services companies, like stockbrokers and finance companies. Foreign banks have a particularly large business presence in the Australian capital markets, facilitating trading and capital raising, and much of this business is conducted in subsidiaries for regulatory reasons, amongst other things.

- In addition, foreign bank branches cannot access the wholesale funding guarantee for medium term security issues. In contrast, domestic ADIs may issue eligible securities under the guarantee with a term of up to 60 months. Data on use of the Guarantee Scheme by all ADIs show that the medium term wholesale funding component is easily the most heavily used part of the Scheme. A number of foreign bank branches have expressed concern about the difficulty of maintaining a balanced funding book in the absence of access to the medium term funding guarantee and the competitive disadvantage this position places on them. The short duration of the Guarantee Scheme for foreign bank branches significantly limits the universe of investors who can theoretically buy their guaranteed paper. This is an important reason as to why the Guarantee Scheme was not heavily utilised by foreign bank branches.

3. The effect of the bank funding guarantee on the operations of the Australian financial sector, including for entities not regulated by APRA

The ADIs who have full access to the bank funding Guarantee Scheme have been placed in a more advantageous position than financial institutions that do have not access to the Scheme, or receive only partial access.

The global financial crisis creates special difficulty for financial entities that are not authorised to accept deposits in Australia (ie not ADIs) and, hence, cannot avail of the government funding guarantee. These entities are unable to compete by offering guaranteed funds in an environment where investors remain cautious about credit risk. In the case of foreign owned subsidiaries, they must borrow from their parent in order to maintain their business presence in Australia at a normal level. Where these subsidiaries are able to replace local funding with borrowing from their parent, the cost of funds is increased by the imposition of a 10% withholding tax on the associated interest payments.

4. The estimated effect of the bank deposit and wholesale funding guarantees on interest rates in Australia

Interest rates in Australia would most likely have been significantly higher in the absence of the bank funding Guarantee Scheme. Australian banks would almost certainly have experienced difficulty in raising funds internationally and a sharp increase in their (unguaranteed) funding costs, which they would have had to pass on to business and consumers through higher interest rates. We are not in a position to put a number on the actual size of the higher interest rate cost that might have been experienced.

5. Ameliorating the moral hazard associated with the deposit guarantee and wholesale funding guarantees

When the opportunity presents itself, the free guarantee threshold for deposits of $1 million should be reduced to minimise the impact of this form of intervention on our banking system. Reducing the threshold for the free deposit guarantee would reduce the deposit base that is not subject to the discipline of a direct cost for protection. This would promote further market scrutiny of banks – though we note this is already intensive in the wholesale debt market where substantial unguaranteed debt issues take place.

The monetary cap on deposit protection under the permanent financial claims scheme should be set at a level well below $1 million. The $20,000 threshold that was originally proposed is low relative to the international standard. We recommend that Treasury should undertake further work and consultation on the appropriate level of protection that should be afforded to depositors under this mechanism.

6. Timelines and policies to credibly remove the wholesale funding guarantee and to reduce the deposit guarantee to any recommended optimal cap

As outlined above, the decision by jurisdictions overseas to introduce bank guarantee arrangements in the face of the global financial crisis was a critical factor in the need for an Australian bank funding Guarantee Scheme.

The corollary of this is that the removal of the Guarantee Scheme should be coordinated with the removal of bank guarantee arrangements in key overseas jurisdictions to ensure this is achieved in a smooth manner that avoids generating capital flows between jurisdictions that are driven by access to government bank guarantees. The significant reliance which the Australian

banks have had, and will continue to have, on international capital markets for their wholesale funding means that the removal of the guarantee needs to be done in a way to cause minimal disruption to this access to offshore capital.

Removal of the Australian guarantee should also be contingent on the ability of the banks to access funding without the guarantee on reasonable terms. However, the relative strength of Australian banks in global terms suggests that the international timetable is the most relevant timing factor.

It is desirable that the bank funding guarantee is removed as soon as is practically feasible, as the longer it exists, then the longer it may take the banking system to return to complete normality. It is widely accepted that it is not appropriate to close the Guarantee Scheme at this time. For example, one member bank has commented that international markets have demonstrated significant repair over the last few months, with liquidity returning to the senior unsecured (unguaranteed) market. However, they still cannot envisage an immediate return to "normal" functioning in markets where international investors will completely dispense with a requirement for some form/level of government support of bank issuance in bond markets.

Finally, from a practical perspective, members feel that information about the removal of the bank funding guarantee should be clearly communicated to the market well in advance of its scheduled implementation.

7. Concluding Comments

Our experience with the Guarantee Scheme reinforces the important message that governments should be cautious about intervening in the market place, though at times it is necessary. The effect of the bank funding guarantee demonstrates that the impact of disturbing the normal competitive balance struck by the market in one area can extend well beyond the immediacy of the intervention target, sometimes creating a range of undesirable (if sometimes unavoidable) secondary effects. These issues need to be actively managed through effective consultation and timely action to resolve problems throughout the implementation period.

Thank you for considering this submission and we hope that the Committee finds the information provided herein useful to it in its deliberations. Please contact me if you have any queries.

Yours sincerely

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