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The Secretary
Senate Economics Legislation Committee
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Parliament House
CANBERRA ACT 2600 Email: economics.sen@aph.gov.au

AFC SUBMISSION TO THE
INQUIRY INTO THE BANK FUNDING GUARANTEES

Introduction

The Australian Finance Conference (AFC) appreciates the opportunity to make a submission to the Inquiry. By way of background, the AFC (membership list attached) was formed in 1958 and has evolved to become a non-institutionally based financial services association. Our membership includes participants actively involved in both the banking and non-banking sectors. AFC caters for members' needs in relation to their consumer and commercial activities across Australia, including consumer credit and housing finance, equipment leasing and finance, wholesale and receivables finance, deposit-taking and other fundraising activities.

Impact of Financial Crisis on Funding

In line with the growth in the Australian economy, the industry had been very buoyant for a good number of years with a strong demand for finance. This demand required financiers to seek a variety of funding sources including from local retail markets, domestic and overseas banks and commercial/wholesale markets, parent lines and via securitisation. The finance industry had been anticipating a cyclical slowdown in the market and had been preparing for it in recent years. However, what was not anticipated was the extent of the global liquidity crisis which has led to a reduction in wholesale funds far in excess of the reduction in demand by customers. This of course means the available wholesale funds are at a significantly higher price (interest rate).

The impact of the global financial crisis on the Australian financial system has been well documented by government agencies and analysts. The ability of many financiers to access sufficient funds to provide for their customers' needs although a little improved, continues to be adversely impacted. The market and the regulators in Australia recognise that the current funding difficulties are not due to poor balance sheets or prudential mismanagement. The asset quality has been good and the institutions have been well managed. It is well recognised that the crisis is a result of international problems and confidence in the international market. Australian financiers, to varying degrees, have been frozen out of markets due to no fault of their own or a fundamental lack of demand.

Financial System Stability and Guarantees

The enormous loss of investor confidence overseas contributed significantly to reduction in available wholesale funds. The Australian public then started to raise questions about the financial soundness of Australian financial institutions despite their strength and the robust prudential supervision of ADIs. Understandably, depositors and investors were becoming nervous as bad news on the international financial scene continued. In early October 2008, AFC had reports from various members that an increasing number of depositors and investors had been enquiring about the soundness of the institution and the safety of their deposit/investment. Money was starting to be withdrawn and notice given that term investments would not be renewed by the customers. Some AFC members were becoming very concerned about the public's wavering confidence just prior to the late October announcement of the guarantee of ADI retail deposits. The enquiries and withdrawals from ADIs stopped once the announcement was made and confidence in the ADI sector returned. However, wavering confidence in the non-ADI sector was not addressed and the guarantee compounded this. In addition, the gap in the relative risks and therefore pricing on investments in non-ADIs, for example by way of debentures, had widened.

Guarantees and Non-ADI Retail Funding

On the morning following the announcement of the ADI retail guarantee, AFC members which raised funds via debenture and note prospectus were subject to considerable retail investor questioning as to their status within the guarantee (clearly they weren't). As a consequence, investments at call were withdrawn, those for a term were flagged for withdrawal at term and new investments dried up. Debenture funders do not have the ability under their Trust Deeds to suspend redemptions and in the event one member breached their Deed and was placed into receivership while another ceased offering debentures (after 40 plus years) and began funding directly via its parent bank.

In recent months the fortuitous absence of bad news and the settling of ADI competition for deposit funds, has seen non-ADI retail prospectus funding normalise somewhat. This presently benign condition is however precarious.

Guarantees and Commercial Funding

Once the wholesale funding guarantee was put in place for ADIs (late November) there was an increase in the availability of funds for ADIs. However, the *variable* fee charged by the government which was applied on the basis of credit ratings added to the *variable* premium that continued to be charged by the market. Essentially this meant double fees, both of which were higher for lower rated institutions. A number of smaller ADIs have indicated that this has made wholesale funding very expensive and has limited their use of such funds. Some ADIs have avoided such funding altogether because it is not commercial.

Again, the wholesale funds guarantee only applied to ADIs. Other financiers had, and continue to have, great difficulty raising funds due to the lack of investor interest in Commercial Paper and Medium Term Notes. Many finance companies have not been able to borrow funds in Australia at competitive rates. Some have sought funding through offshore loans that are more expensive due to the added foreign exchange hedging cost. This has lead to these financiers increasing rather than decreasing the interest rates they can offer to customers sometimes up to 2% to 3.5% (200 bps to 350 bps) higher than those offered by the major banks for similar finance products. Prior to the crisis, the gap was much narrower (between 25 bps to 50 bps).

Some financiers with ratings of investment grade or better have traditionally raised competitive AUD funds through Commercial Paper and Medium Term Notes issuance and this has been their main source of funding. However, the tight credit market has severely restricted these markets and has severely affected their ability to offer competitive and affordable loans and leases to customers. Many members have significantly lost market share and continue to reduce new business. Some members have withdrawn from particular sectors of their market and some have withdrawn from financing altogether – not due to weak balance sheets but lack of access to, or the prohibitive cost of, funding.

In relation to the broader economic implications, consumers, industry and commerce are less able to access competitive finance for housing, consumer items or commercial equipment. In turn this impacts on employment - in the finance sector, as well as industry and commerce.

In summary, financiers in Australia have been affected across a broad range of funding sources. Wholesale funding generally has become less available and more expensive. Some financiers have been more severely affected than others. The general economic implications of this shortage in funding are significant and recovery will be severely inhibited until the funding problems are overcome.

The Risk Spectrum

Financial intermediaries (ADI and non-ADI) raise their funds from markets along a risk spectrum and pay the appropriate price as assessed by the entity providing the funding. A similar risk spectrum and assessment applies to intermediaries when they lend. In the pre-crisis market, this resulted in the better-rated financial institutions lending to the better-assessed borrowing applicants, and vice versa along a relatively smooth if rising curve.

Given the major sectoral dislocation, particularly since October 2008, several phases of the risk spectrum have become inoperable due to a lack of funding availability or a pricing that is prohibitive relative to the viability of passing it on to borrowers. This has resulted in discontinuities in the spectrum which are compounded by those intermediaries in funds taking into account a recessionary credit outlook. Unless and until the spectrum is restored this translates into otherwise creditworthy demand for finance not being able to be met.

Securitisation

Securitisation is another area that has been particularly hit. Many financial institutions that have provided competition in Australia have been very reliant on securitisation of loans to fund their business expansion. Many smaller institutions which are unrated have had to rely on securitisation because other wholesale funds are more expensive. The securitisation market has enabled financial institutions to compete on more equal terms because the pricing in the securitisation market has reflected the quality of the underlying assets in the pools. However, the securitisation market has effectively not been operating in Australia since August 2007. Some securitisation deals have occurred recently, but are limited and at very high cost. Other funding markets have been less accessible and more costly.

For this reason the AFC welcomed the Government's initiative in late 2008 for the Australian Office of Financial Management (AOFM) to purchase Australian residential mortgage-backed securities (RMBS) as a measure to assist liquidity in the Australian mortgage market. We have been hopeful that the Government's initiative will go at least some way towards maintaining liquidity, efficiency, competition and diversity in the market.

As recently stated by Dr Debelle, Assistant Governor, RBA[1], securitisation is improving but is significantly less than two years ago. He stated: "No one's actually lost any money on mortgage backed securities in this country unlike the US ... the quality of Australian mortgage backed securities is considerably higher ... Investor mentality has got to change back again to recognising the quality of Australian mortgage backed securities...". It is the AFC's view that this will require continued government intervention by way of purchases of MBS and other quality securities.

Beyond RMBS there is a need to support funding of other secured asset classes such as for portfolios secured over motor vehicles, equipment, other real property and consumer credit. Both the United States (Term Asset-backed securities Loan Facility - TALF) and Canada (Secured Credit Facility - CSCF) have Government supported programs to fill this gap.

Covered Bonds

The Report of the inquiry into competition in the banking and non-banking sectors By the House of Representatives Standing Committee on Economics (November 2008) recommended that "the Treasury examine the appropriateness and feasibility of allowing Australian authorised deposit-taking institutions to issue covered bonds." These are bonds issued directly by the financial institution which remain on the institution's balance sheet. Bonds are covered by a group, or 'pool', of mortgage loans. If the issuing institution collapses, the bonds are 'covered' by the pool and are separated from the institution's other assets to pay back the bond holder. AFC agrees that an examination of covered bonds should be undertaken taking into account APRA's concerns. Adding ADIs would add to the depth of this nascent market and should be expanded beyond RMBS.

Recommendations

Because of the potential impact particularly on smaller ADIs we do not believe now is the time to withdraw the guarantee on retail deposits. However, AFC recommends that the Government consider measures that would restore investor confidence in a broad range of funding sources and where necessary directly assist financiers to acquire funds. This may include:

- Increasing the AOFM program of purchasing residential mortgage backed securities and expanding this to include other quality asset-backed securities issued by financiers who meet a certain standard.

- Consideration be given to the proposal for Government to guarantee the issue of RMBS to reinvigorate the market and promote additional and alternative sources of wholesale funding..

- Introduction of other policies to generate short to mid-term liquidity for non-ADI's.

[1] Guy Debelle, Assistant Governor (Financial Markets) – at the Mortgage Finance Industry Association, Industry Leaders – Panel Forum 22 July 2009

- Reduction of the fee for the wholesale guarantee for lesser rated ADIs in recognition of market premium already payable for risk.

- Convening a whole-of-market forum to canvass the full extent of current market funding imbalances, the means of addressing these and the processes and likely consequences of the wholesale and then retail guarantee phase-outs.

AFC would be pleased to provide further details or elaboration as required.

Yours truly,

Ron Hardaker
Executive Director

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(*As at July 2009