IFSA
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24 July 2009

Mr John Hawkins
Committee Secretary
Senate Standing Committee on Economics
Parliament House
CANBERRA ACT 2600

Email: economics.sen@aph.gov.au

Dear Mr Hawkins

Re: IFSA submission on the Senate's inquiry into the bank funding guarantees

Thank you for the invitation to provide input on the Senate Economics Committee's current inquiry into the Government's current bank funding guarantees.

IFSA is a national not-for-profit organisation which represents the retail and wholesale funds management, superannuation and life insurance industries. IFSA has over 145 members who are responsible for investing over $1 trillion on behalf of more than ten million Australians. Members' compliance with IFSA Standards and Guidance Notes ensures the promotion of industry best practice.

In reference to the Federal Government's guarantee of wholesale funding and bank deposits, we acknowledge that the measure was implemented in Australia and other countries to act as a circuit breaker in the midst of a potential banking crisis. While the financial crisis extended for much of the fourth quarter of 2008 and first quarter of 2009, market conditions are beginning to stabilise. In this regard we note that ASIC's prohibition on covered short selling was lifted in May 2009 and many financial sector firms in Australia have recently raised large sums in debt and equity.

However IFSA is concerned that the current guarantee arrangements have led to a number of significant market distortions. The main areas for our concern in the financial services industry are:

Liquidity issues in the mortgage fund industry

Conservatively managed mortgage funds serve a very similar function to bank deposits for investors looking for a regular and stable income stream (typically monthly). Mortgage funds are also an important source of funding for the commercial sector, primarily commercial property, and have played a critical role in creating competition in this market. The sector lends approximately $8 billion per annum to small businesses (including commercial property investors and developers) and has provided funding for many businesses which has not been competitively available from the banking sector.

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On 12 October 2008 the Australian Government announced guarantee arrangements for deposits and wholesale funding of eligible authorised deposit-taking institutions (ADIs). Following the announcement, IFSA's mortgage fund providers experienced a massive increase in redemptions and a cessation of new investment monies/applications flowing into the mortgage fund market. As a result, the overwhelming majority of these funds were placed in freeze mode.

Mortgage funds continue to face liquidity constraints whereby they were unable to provide funding for new commercial loan arrangements, roll-over their maturing book of loans and to meet (in full) redemption calls from investors.

Given that banks are also rationing mortgage funding, the cost and availability of mortgages, particularly for small-medium commercial development, may become a larger problem as existing mortgages mature. This development will continue to adversely impact competition in the commercial lending market.

- Mortgage fund and IFSA activities

While all of IFSA's mortgage fund providers continue to pay monthly distributions, the industry partly meets redemption requests from underlying investors (directly and indirectly via financial advisers) on a quarterly basis. The underlying redemption policy for funds is to base redemptions on investor equity and the level of cash (liquidity) available at the end of each quarter.

IFSA members regularly communicate with underlying investors and advisers with regards to the status and transaction/redemption processes for their mortgage funds. This information is also made publicly available.

In July 2008 IFSA released a new Standard No. 18 ('Best Practice Guidance for Disclosure in the Mortgage Trust Sector') promoting uniform disclosure and the efficient operation of mortgage funds. IFSA liaised extensively with ASIC on developing the Standard and compliance is mandatory for IFSA members. IFSA also produced a working guide in November 2008 to assist the industry on the administration and communication of varied redemption arrangements for managed funds, including mortgage funds.

Furthermore, IFSA continues to monitor market liquidity and the operation of the industry via an industry working group and our Board of Directors.

Ongoing impact on Cash Management Trusts and other income funds

Bank Deposit Alternatives (such as cash management trusts and, to a lesser extent, other money market funds and other income funds) are highly diversified and act as a key liquidity mechanism on the capital market. Whilst they are legally different to bank deposits, they are almost indistinguishable by investors from traditional bank accounts.

To varying degrees, IFSA members initially reported an increase in outflows from cash management trusts and a large number of investor inquiries following introduction of the guarantee. In response to investor concerns, many cash management trusts have repositioned their portfolios into 100% of securities that qualify for the guarantee.

By establishing a new "protected" cash fund, where securities will be invested in the banks' new guaranteed product (for assets over $1 million), there has been a commensurate reduction in expected returns. The net effect may reduce returns to investors and impose establishment and higher administration costs on fund managers.

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Additionally, as investors move from Bank Deposit Alternatives to Authorised Deposit Institutions (ADIs) and as fund managers reposition their Bank Deposit Alternative portfolios to eligible guaranteed securities, there is also less demand for corporate securities. Typically, the assets most impacted are securitised (RMBS, CMBS), Bank Term debt (bank subordinated paper) and Corporate Bonds.

Given the impact on the semi government and asset backed market, the potential effect is to push non bank corporates into higher cost bank financing and, for high grade assets such as AAA prime RMBS pools, trade at distressed levels.

Additional costs for superannuation funds and investment platforms

An ongoing practical issue for investors through investment platforms (including a life policy), managed funds and superannuation funds with cash or term deposit investment options, or cash funds/accounts, is that they are denied the benefit of the fee-free deposit guarantee threshold because the aggregated ADI deposit held collectively on their behalf is greater than $1 million.

Because the account holder with the ADI will be a custodian or trustee, and the account balance will be an aggregate of total member entitlements that will exceed the $1 million threshold, individual investors with funds less than $1 million in the ADI through a custodial arrangement will be subject to the guarantee levy if the aggregate sum deposited is to be guaranteed.

In response, some superannuation funds are developing dual cash products to offer members – with and without the government guarantee. This may impose additional costs borne by investors in collective investment schemes (including superannuation funds) and continue to influence market distortions.

Further, within the retirement savings sector itself the deposit guarantee applies inequitably, encouraging flows into products which can accommodate the 'free guarantee' more easily than others, often as a result of the inherent structure or typical size of such products. This trend has distorted the market, creating an uneven playing field which has in turn impacted investor decision making. We strongly believe competitive neutrality should be restored across the sector in order to promote market stability.

IFSA believes that these issues could be resolved by modifying the Deposit Guarantee Parameters to include an interim "look-through" provision to the underlying investors, unitholders and superannuation fund members with investments that are held in deposit accounts or certificates of deposit with ADIs. Ideally the guarantee fee for deposits with ADIs in excess of $1 million should therefore be waived where:

- the deposit account is held by an entity on behalf of underlying investors and that holds an Australian Financial Services Licence and is registered as the responsible entity of a managed investment scheme, or licensed to operate an IDPS, or is an Approved Trustee or Life Company; and
- the balance of the underlying individual account holder is less than the fee-free deposit guarantee threshold.

Risk and return imbalances

Within the guaranteed sector, distortions are arising because of the lack of linkage between risk and return. Lower rated non bank ADIs may attract deposits away from AA rated banks and from the non ADI sector. Some non bank ADIs are offering significantly higher deposit rates than the banks under the same guarantee structure. The longer this persists, the greater the adjustment for lower rated ADIs when the guarantee is removed or reduced. While financial market stability is the top priority at this stage, the guarantee could delay necessary structural change in the second tier ADIs.

Overview of the United States guarantee programs

- U.S. Treasury Guaranty Program for Money Market Funds

On 19 September 2008, the U.S. Treasury Department announced the establishment of a temporary guarantee program for the U.S. money market mutual fund industry. The program provides a guarantee based on the number of shares held at the close of business on September 19, 2008. As a consequence we note that the US money market fund sector experienced significant net inflows during the fourth quarter of 2008.

Under the government's guarantee program, coverage will kick in if a participating fund's unit price falls below $0.995 (these funds target a constant value of $1).

While the program protects the shares of all money market fund investors as of September 19, 2008, each money market fund makes the decision to pay an upfront fee and sign up for the program. Investors cannot sign up for the program individually.

The program has been extended until 18 September 2009.

- U.S. Federal Deposit Insurance Corporation

The Federal Deposit Insurance Corporation (FDIC) provides insurance which covers funds in deposit accounts, including checking and savings accounts, money market deposit accounts and certificates of deposit.

The standard insurance amount currently is US$250,000 per depositor. While the US$250,000 limit is permanent for certain retirement accounts, the threshold is temporary for all other deposit accounts through to 13 December 2013. The FDIC has indicated that from 1 January 2014 the standard insurance amount will return to US$100,000 per depositor for all account categories except certain retirement accounts, which will remain at US$250,000 per depositor.

US deposit taking institutions are required to pay insurance premiums to the FDIC in exchange for the guarantee on applicable retail deposits. The premium varies according to the institution and has been temporarily higher during the current volatility.

IFSA's preferred solutions

IFSA has presented various submissions to Government, including the Senate's inquiry into the *Australian Business Investment Partnership Bill 2009*, on our preferred approach (interim and permanent) to address the market distortions discussed above. We believe that our recommendations are necessary in order to:

- Provide greater funding which will stimulate the economy by assisting and promoting business investment;
- Ensure financial market stability through avoiding contagion to non-guaranteed products and financial institutions (including superannuation funds and wealth management platforms);
- Restore a stronger linkage between risk and return within the guaranteed sector;

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- Improve liquidity in the broader debt markets, particularly for the semi-government, (non bank) corporate and asset backed sectors; and
- Balance the financial costs and benefits of the guarantee's impact on the federal budget and industry.

The following IFSA recommendations are focussed on a permanent solution to be implemented over the medium term and a number of interim relief measures while the bank guarantee remains in place.

Permanent response: Narrow the existing bank deposit guarantee

IFSA strongly supports a gradual reduction of the $1 million threshold to $50,000 over the next 12 to 18 months (and in line with market conditions) with that level being retained for a further 12 months before being closed.

Progressively lowering the threshold would reduce (but not eliminate) the incentive to transfer funds from Bank Deposit Alternatives to ADIs. Certainty with regards to a phase-down of the cap is consistent with the approach in the United States and would further promote market confidence and stability.

As the threshold is reduced, we envisage that investors with deposits above the revised threshold could still ensure they received the guarantee and would be required to pay a fee for the guarantee.

It is important that this change be made in conjunction with limiting the fee-free guarantee to individuals with total deposits below the cap across all ADIs. This would prevent depositors circumventing the lower cap by splitting their deposits across a number of ADIs.

We submit that the wholesale arrangements would remain – although the government could underline its intention that, subject to market conditions "normalising" and consistent with international developments (as per the original conditions for removal), the funding guarantee would be removed within 12 months of inception – that is, at the same time that the deposit guarantee was reduced.

In the event that the Government does not pursue a gradual reduction of the bank deposit guarantee, further consideration should be given to applying a charge to cover costs. The effect of this charge would be as follows:

a. Compensate public revenue to cover potential major risks to the economy; and
b. Provide a clear price signal to the market by balancing risk and return.

Interim measure: Permit look-through for individual investors in investment platforms and superannuation funds

See comments above.

Interim measure: Government temporarily invest directly in eligible mortgage funds

In order to support the mortgage fund industry in recommencing and renegotiating commercial lending arrangements and to ease liquidity pressures to facilitate redemptions (and assist investors), we propose that the Government purchase units in eligible mortgage funds (subject to the establishment of an appropriate eligibility criteria).

Under this proposal mortgage funds would apply directly to Government to invest (via, for example, the Australian Office of Financial Management, Reserve Bank of Australia or Special

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Purpose Vehicle) in existing funds or new funds presented by an existing mortgage fund provider. Consistent with previous initiatives, the eligibility criteria should be fair, transparent and open to all mortgage funds to apply.

This investment action would immediately provide a source of capital facilitating the refinancing of maturing commercial loans from existing mortgage funds and facilitate the funding of new commercial loan arrangements in either existing or new mortgage funds.

Direct investment in existing mortgage funds would similarly provide a source of liquidity to support these funds in meeting redemption calls from investors.

We note that there will continue to be circumstances where redemption requests exceed available liquidity and the legal requirements of a responsible entity in an existing fund would restrict the ability to facilitate new commercial loan arrangements via the new funding. For that reason we have also proposed that the investments in these circumstances may need to be made in eligible new funds (presented by an existing mortgage fund provider).

In order to promote ongoing stability in the mortgage fund and commercial lending markets, the Government's investment should be on at least a medium term basis and reviewed in line with market conditions and the operation of the Government's guarantee.

As markets stabilise and investors return to the mortgage fund sector we expect that the Government would seek to redeem its units. Appropriate redemption arrangements, however, would need to be agreed so as to avoid a recurrence of the type of liquidity problems currently being experienced. For example, a fixed term investment structure or securitisation model may be appropriate. For the same reason, we would expect that the new funds presented by an existing mortgage fund provider would have redemption arrangements for retail investors which would reflect the medium to long term nature of these investments.

Monthly distributions will be made to the Government in line with the returns on these funds.

In summary, IFSA is supportive of the government's ongoing commitment to stabilise financial markets, restore the flow of market liquidity and support domestic economic growth. We believe that the recommendations outlined above will alleviate the current market distortions while also promoting market stability and confidence.

Thank you for the opportunity to provide additional supporting information on IFSA's position regarding the Government's bank funding guarantee. We welcome the opportunity to provide further information as required.

Please feel free to contact me on (02) 9299 3022 if you have any questions with regards to the information provided above.

Yours sincerely

Joseph Sorby
Senior Policy Manager