RESPONSE TO TREASURY'S ABIP SUBMISSION

HENRY ERGAS, CHAIRMAN, CONCEPT ECONOMICS

1. INTRODUCTION

The submission by Treasury to the Senate inquiry into the ABIP Bill 2009 contains a number of inconsistencies and seeming errors of logic and analysis.

No direct evidence is presented of the need for this particular piece of legislation. The submission does not set out any general principles that could be used to guide the government's use of taxpayer funds to prevent price fluctuations in this or any other instance. The document's explanation of ABIP's role contains several internal inconsistencies. Treasury fails to identify or quantify risks to the taxpayer and the Commonwealth's financial position that could occur as a result of this Bill. Finally, the treatment of issues relating to the Trade Practices is cursory and unsatisfactory.

2. LACK OF EVIDENCE AND LACK OF GENERAL GUIDING PRINCIPLES

Treasury has not presented any compelling economic evidence of the need for the interventions that are contemplated in this Bill. Taxpayers have been provided with no guidance as to exactly which foreign banks are contemplating exit from Australia, how much money is actually involved, which assets might actually be affected, which syndicates and domestic banks are actually affected, the actual commercial terms under which these agreements have been made, or the precise nature and size of the economic effects that would ensue should withdrawals occur.

The legislation therefore seems to be purely precautionary in nature. But Treasury has developed no general set of principles that would seek to limit the earmarking of taxpayer funds for "precautionary" reasons in this or other instances where similar precautions could be justified if the government's economic arguments were taken seriously and applied more widely.

For example, there have been significant declines in world commodity prices recently. These will undoubtedly affect macroeconomic conditions in Australia. Global commodity price movements affect Australia's terms of trade, exchange rate, gross national income, gross domestic product, and employment. Would Treasury also favour "precautionary" government measures against such movements – a return to taxpayer funded commodity price stabilisation schemes for agricultural commodities, for example?

3. INTERNAL CONTRADICTIONS

Treasury says that ABIP's "lending criteria will be consistent with the lending criteria of the four major banks and will ensure that ABIP only provides funding for commercial property where the underlying assets, and the income streams from those assets, are financially viable."

This undermines the case for ABIP. If consistent with means “similar to”, and ABIP’s lending criteria are in this sense consistent with the criteria of the four major banks, it is unclear why ABIP’s lending decisions would be any different from the decisions that the banks would take in the absence of ABIP. In turn, if ABIP’s decisions are based on the same criteria as the decisions that would be taken by market participants, how is ABIP “correcting” a market failure? If lending will only occur under these circumstances, why would ABIP be required?

Treasury then only makes matters worse when it notes at the bottom of page 2 in footnote 2 that:

> *“The ABIP Board will need to determine on a case-by-case basis if finance relating to the relevant assets is/is not available from commercial providers. In considering whether such finance is/is not available, the ABIP Board will need to have regard to the terms and conditions applying to any alternative finance for the assets, which may be offered by other commercial providers. It will need to form a view as to whether or not these terms and conditions are such as to impose an onerous and commercially unrealistic burden on the loan recipient so as as [sic] to significantly impact on the financial viability of the project. This involves the exercise of some judgment by the ABIP Board. However, the intention is that generally speaking, ABIP would operate as a lender of last recourse.”*

How the finance available from the banks could be “onerous and commercially unrealistic”, yet ABIP’s, applying the same criteria, not be, is unexplained.

However, compounding the problem, Treasury also says that “neither the four major banks nor the Government will support ABIP extending lending beyond commercial property on less than fully commercial terms” and that “ABIP’s loans will be priced at a small premium above the prevailing market.”

If this means what it says – that ABIP would price its loans at a premium above the market – then would it not be the case that ABIP’s own lending criteria impose “onerous” terms and conditions, since that is exactly what ABIP proposes? If, on the other hand, “pricing at a small premium” does not mean pricing above the commercial rates, whatever does it mean?

However that may be, it is difficult to see how ABIP would improve matters by vetoing agreements with certain market-determined terms and conditions because that may threaten the financial viability of projects, and then substitute its own terms and conditions which consist of a premium in excess of prevailing market rates.

The inability of ABIP to improve matters is all the more likely once adverse selection risk is taken into account. Adverse selection risk occurs when one party to a transaction faces a more informed trader on the other side of the transaction. ABIP, like other lenders, will not have complete information about borrowers in the market. A borrower that cannot obtain private financing at commercial rates - ABIP’s likely customer - is more likely to be a far riskier proposition than the average borrower in the market. Charging these borrowers a high premium risks exacerbating the adverse selection problem, because it narrows the pool of willing borrowers even further and makes the remaining pool even riskier and less commercially viable on average.

Additionally, there is the issue of ABIP’s discretionary powers. Borrowing and lending terms and conditions vary from agreement to agreement. Thus, the process of determining whether finance is available “on a case by case basis” could require the ABIP Board to

investigate each and every commercial lending agreement that comes under the auspices of this Bill.

In effect, in the process of determining whether "the market has failed", ABIP will be required to substitute its own judgement for the business judgement of other commercial lenders – lenders with which the shareholders of ABIP compete in the marketplace on a daily basis. How else will ABIP determine whether the "terms and conditions" offered by those other lenders are "onerous and commercially unrealistic"?

However, this process will be unusual in two respects:

- First, the parties responsible for the alleged market failure (i.e. the major banks) will be participating in this process of second guessing their own decisions. This will provide ample opportunity for gaming, including through shifting poor quality assets from their own balance sheets on to a balance sheet in which they have merely a minority interest (and hence only need to take a small share of the ultimate value loss). All of the competitors stand to gain at the expense of the taxpayer if they agree for each other's poor loans to be socialised in this way[1]; and
- Second, the process will inevitably result in the disclosure by market participants to their major competitors of information about their lending criteria and commercial decisions. This ongoing disclosure of information and coordinated decision-making cannot but create a risk of lessening competition.

To add insult to injury, it seems that ABIP will then impose a premium above what the market would otherwise charge in the absence of ABIP.

Thus, as Treasury describes it, the Bill gives the ABIP Board a considerable amount of discretion. The Bill places a significant amount of power into the hands of ABIP's shareholders and potentially allows them to exercise a veto over a large proportion of commercial property refinancing decisions taken by their domestic and foreign competitors. This puts ABIP's shareholders in a position to use the vehicle of ABIP - and taxpayer funds - to gradually weaken the position of their competitors, at very little risk to themselves.

4. UNFORSEEN EVENTS AND UNINTENDED CONSEQUENCES

Treasury admits that "financial market conditions can change quickly and unpredictably" and that "the global credit contraction may evolve in ways that are unforeseen".

Treasury also concede that "In the current global financial environment, market conditions can evolve rapidly, and market participants can quickly change their positions and intentions."

Yet Treasury fails to even entertain events that are completely foreseeable in relation to this Bill, let alone analyse and assess them in a rigorous fashion.

[1] Suppose that Banks A, B, C and D - all shareholders of ABIP - agree to refinance each other's loans on assets for 100 cents in the dollar. Suppose that the agreed value of each of the four assets is $1, but the actual market value of each asset is only 50 cents. Each bank, together with the Commonwealth, would contribute 80 cents to refinance the $4 in loans. Since the market value is only 50 per cent of the agreed value, each shareholder makes a loss of 40 cents on this transaction. But the alternative for each bank was to lose 50 cents. Thus, each bank has effectively made a profit of 10 cents from this transaction. The profit – 40 cents in total – comes at the expense of the fifth shareholder – the Commonwealth (i.e. the taxpayer).

In particular, what would be the financial and economic consequences for taxpayers and Australia's sovereign credit rating if the decisions of the ABIP Board turned out to be poor and the assets which they refinance do not, in fact, turn out to be financially viable?

If, as Treasury claims, "market conditions can evolve rapidly, and market participants can quickly change their positions and intentions", how will ABIP be able to guard against this possibility and protect the taxpayer against what Treasury says would be "unforeseen" and "unpredictable" events? Where is Treasury's rigorous assessment of these very real risks to the taxpayer and their possible costs? What hedging strategies have been adopted to manage these risks to taxpayers?

The point here - which Treasury fails to acknowledge, let alone assess - is that transferring an asset from the private sector to the taxpayer in no way alters the risk characteristics of that asset. It merely transfers risk to taxpayers and forces them to bear that risk which they would otherwise be unwilling to bear.

In other words, if, as Treasury says, falling asset values will have deleterious macroeconomic effects, then those do not become any less deleterious if they are borne by taxpayers rather than the parties that voluntarily agreed to expose themselves to those effects when they originally signed loan agreements.

5. TRADE PRACTICES ISSUES

Finally, there is Treasury's observation that "It is difficult to definitively determine whether ABIP would contravene any provisions of the Trade Practices Act 1974, including if the parties avail themselves of the joint venture defence under sections 76C and 76D. To remove any uncertainty about the operations of ABIP, the Bill specifically authorises the activities undertaken by ABIP, its shareholders, directors, officers, agents and employees in furtherance of ABIP's objects to be exempt from the competition provisions of the Trade Practices Act 1974."

If, as Treasury says, the need for this legislation is purely precautionary, it must not be the case that there is an urgent and pressing need for ABIP to hold meetings and make decisions in the very near future. Hence there is no reason why ABIP could not go through the ordinary authorisation process, as provided for in the Trade Practices Act, in relation to potentially anticompetitive conduct. Treasury seems to be arguing here that the mere fact that it is "difficult to definitively determine" whether conduct contravenes the Trade Practices Act constitutes a sufficient reason for that conduct to be given a blanket exemption at law from the competition provisions of the Trade Practices Act.

In making this argument, there can be little doubt that Treasury has created a new principle, and an extremely dangerous precedent, for the application and development of competition law in Australia. Instead of requiring authorisation of conduct under the authorisation provisions of the Trade Practices Act (which mandate a public process in which the claimed public benefits of the conduct are tested relative to its potential competitive detriments), Treasury seems content to exempt entities from the competition provisions of the Trade Practices Act altogether. Authorisations no longer seem relevant; all that is required for a full exemption is that it must be "difficult to definitively determine" whether conduct contravenes the TPA.

Given the government's vocal commitment to competition, it will be interesting to see the extent to which the government applies this new principle to other areas of policy.