Summary

In response to the global financial crisis, and following calls for action by the Opposition, the Government introduced in October 2008 two guarantee schemes for authorised deposit-taking institutions (ADIs); one for deposits and one for wholesale funding.

The Opposition had called on the Government to lift the cap on its proposed Financial Claims Scheme from $20,000 to $100,000. The Government instead went much further, introducing an unlimited deposit guarantee. This led to a large impact on financial institutions not covered by the guarantee, which then faced difficulties in raising both wholesale and retail funding.

A fee is charged for the wholesale funding guarantee, and for deposits of over $1 million. The fee is tiered, with ADIs with credit ratings of AAA to AA- paying 70 basis points per annum; those with credit ratings of A+ to A- paying 100 basis points and others paying 150 basis points.

Despite the government guarantee, markets are still requiring higher interest rates to provide funds to lower-rated ADIs. This means the lower rated ADIs are in a sense 'paying twice', which may be putting them at a significant competitive disadvantage relative to the major banks.

While Treasury are coy about the extent to which the market was anticipated to 'look through' the guarantees in this way, the lack of clear explanations for this behaviour suggest it was probably not expected. The Committee therefore regards it as a reason to review the extent of tiering of the premia to ensure that lower-rated ADIs are not 'paying twice'.

Recommendation 1

The Committee recommends that, in view of the experience of markets not pricing all guaranteed debt identically, the Government review the need to apply differential premia for ADIs with different ratings for the wholesale funding guarantee (and hence also that applying to deposits over $1 million).

The global financial crisis has had a severe impact on securitisation markets, and those lenders who relied on them to raise funds.

The Committee believes that the securitisation model of financing should be supported through its current difficulties, as well as the ADI lending model. It therefore supports calls for some form of guarantee for residential mortgage-backed securities. However, there will need to be care taken in the design of such a scheme to avoid any further unintended consequences.

Recommendation 2

The Committee recommends that the Government introduce an appropriately designed guarantee scheme for residential mortgage-backed securities.

There is always a tension between solvency and competition. To take an extreme case, a monopoly bank would be very profitable, and therefore robust in a crisis, but would be unlikely to provide low-cost or innovative products to its customers.

During financial crises, the balance of concern tends to move from competition towards solvency. One manifestation of this is that the authorities tend to be more likely to allow mergers. The Committee regards it is appropriate for greater weight to be given to solvency concerns in a crisis. But a fine judgment is required as to how much the emphasis should shift, as it may be hard to revive competition once the crisis has passed.

In the medium term, there are real concerns that a diminution in competition can lead to borrowers facing higher interest rates and depositors receiving lower rates. The Committee notes that the four major banks now account for around 80 per cent of new home loans, and that bank interest margins, which had been narrowing for a long while, have recently widened again. With less competition, there is more scope for banks to raise loan interest rates even without any increase in official interest rates by the Reserve Bank.

Once the global financial crisis eases, there should be a prompt transition to a more limited, permanent, scheme of depositor protection and a complete withdrawal of support for wholesale fundraising. The Government has done little to indicate how or when this might occur. The removal of the wholesale funding guarantee may need to involve a degree of international coordination to avoid disadvantaging Australian institutions in global markets.