Chapter 1
Introduction

The referral

1.1 The Senate has referred the matter of the government guarantees provided to authorised deposit-taking institutions to the Economics References Committee. The referral on 23 June 2009 required the Committee to report by 15 September 2009, but this was later extended to 17 September.

Summary of the guarantees

1.2 In response to the global financial crisis, the Government introduced in October 2008 two guarantee schemes for authorised deposit-taking institutions[1] (ADIs i.e. banks including Australian subsidiaries of foreign banks, building societies and credit unions):

(i) an unlimited deposit guarantee, which will operate until October 2011. The first million dollars are guaranteed free of charge under an expanded Financial Claims Scheme (FCS). Larger deposits can be insured for a fee, as can deposits of foreign bank branches;

(ii) an unlimited wholesale bank funding guarantee which will last 'until conditions normalise'. The guarantee is available for short-term liabilities such as bank bills, certificates of deposit, commercial paper and certain debentures with initial maturities of up to 15 months and to long-term liabilities such as bonds, notes and certain debentures with terms of maturity of 15 to 60 months. A fee is charged for this guarantee, of 70 basis points per annum for credit ratings of AAA to AA-; 100 basis points for ratings of A+ to A- and 150 basis points for lower or unrated securities.

1.3 The guarantees cover over 16 million deposit accounts and over 99 per cent of depositors.[2] Treasury described the scale of the scheme:

> Around $650 billion of deposits are guaranteed under the FCS. A further $21 billion in large deposits, $15 billion in short-term wholesale funding and $91 billion in long-term wholesale funding are guaranteed under the Guarantee Scheme. The total stock of guaranteed liabilities continues to grow, reflecting growth in deposits and long-term wholesale issuance.[3]

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1 While they cover more than just banks and do not cover all external liabilities, the guarantees are commonly referred to as 'bank funding guarantees'.

2 Treasury, *Submission 22*, p 15.

3 Treasury, *Submission 22*, p 2.

Background

1.4 The Reserve Bank of Australia (RBA) and the Australian Prudential Regulation Authority (APRA) characterise the economic background to the introduction of the guarantees as follows:

> In the latter part of 2008, heightened risk aversion led to pressure on the availability and cost of funding for banks around the world. In September 2008, the collapse of Lehman Brothers triggered extreme uncertainty about the stability of the global financial system, and a virtual closure of parts of global capital markets. Despite their ongoing good performance, Australian ADIs were affected by these developments with increasing reluctance among investors to buy long-term bank debt, and signs of nervousness among some depositors.[4]

1.5 By comparison with other countries, the Australian guarantees had a very broad coverage:

> The duration announced was three years (longer than that announced by several other countries), amount of coverage was without limit and 100 percent (several countries had put limits on amount and percentage insured), and it included both retail and wholesale deposits at all banks (several countries restricted it to retail deposits and certain institutions only) and was fee free (several countries had fee in place).[5]

1.6 However, Australia did not go as far with other extraordinary actions such as capital injections (or even nationalisation) to stabilise the financial systems as a number of other countries (Table 1.1).[6] This reflected the fact that our system was far more stable and better regulated than those in most other nations because of prudential arrangements put in place by the Coalition. As such, Australian institutions have not engaged to the same extent in the types of risky practices which occurred elsewhere.

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4 RBA & APRA, *Submission 7*, p 1. A broadly similar account is given by Treasury, *Submission 22*, p 6.

5 Professor Milind Sathye, *Submission 23*, p 2.

6 Further information about measures taken by other countries is contained in *Submission 9* from Challenger.

Table 1.1

Special measures to stabilise the financial system[1]

	AU	BR	CA	CH	DE	FR	GB	HK	IT	JP	KR	NL	US
Deposit insurance	✓			✓	✓		✓	✓	✓		✓		✓
Restriction on short selling	✓		✓		✓	✓	✓		✓	✓		✓	✓
Capital injections		✓		✓	✓	✓	✓	✓	✓	✓	✓	✓	✓
Debt guarantees	✓		✓		✓	✓[2]	✓		✓	✓	✓	✓	✓
Asset insurance							✓					✓	✓
Asset purchases	✓		✓	✓	✓		✓			✓			✓
Nationalisation					✓		✓					✓	✓

AU = Australia; BR = Brazil; CA = Canada; CH = Switzerland; DE = Germany; FR = France; GB = United Kingdom; HK = Hong Kong SAR; IT = Italy; JP = Japan; KR = Korea; NL = Netherlands; US = United States. ✓ = yes; blank space = no.

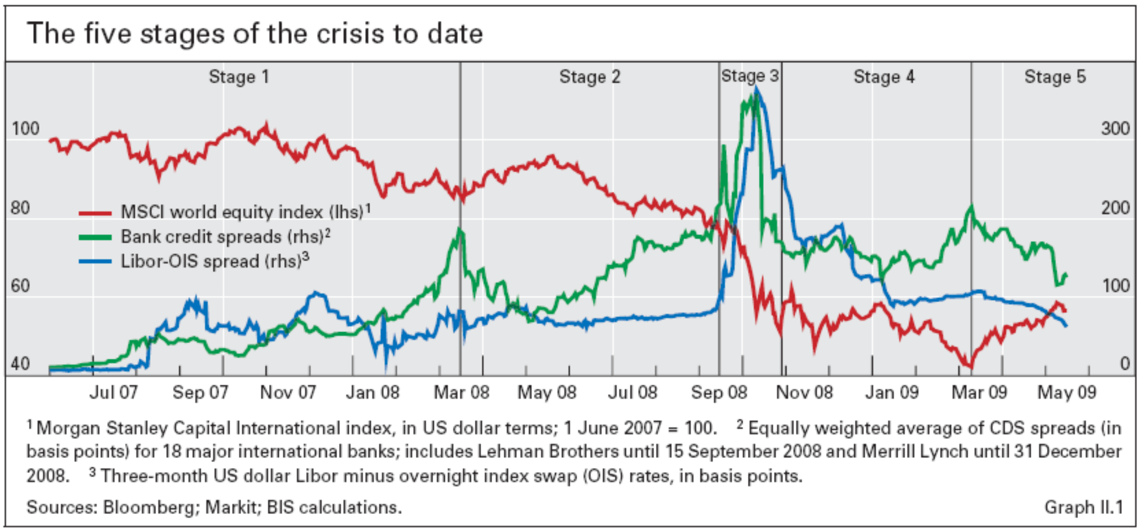
[1] Reflects information up to end-April 2009. [2] Via the Société de financement de l'économie française.

Source: National data. Table VI.2

Source: BIS, 79th Annual Report, 2009, p 103.

1.7 The wholesale funding guarantees were mostly introduced during the period September-November 2008 which the Bank for International Settlements (BIS) has identified as the most severe stage of the global financial crisis, when equity markets recorded the sharpest falls and interest rate spreads spiked (Chart 1.1) and many countries injected capital into financial institutions as central banks slashed their policy rates.

Chart 1.1



Source: BIS, 79th Annual Report, 2009, p 16.

1.8 The finance industry described the background as one of increasing unease by depositors:

> 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.[7]

1.9 This financial turmoil led to calls for government action to reassure depositors. On 10 October 2008, the Leader of the Opposition called for the proposed $20,000 cap on the deposit guarantee to be raised to $100,000. On 11 October, he advocated that the Government:

> Increase the proposed Government backed deposit guarantee scheme to cover deposits up to a minimum of $100,000. In the light of the current global economic crisis, the Coalition considers that the proposed $20,000 cap per person is less than adequate and, moreover, out of line with similar schemes in the rest of the world. Accordingly, the Coalition proposes that the cap be increased to allow Australians, including small businesses, additional assurance in these difficult times.[8]

Conduct of the inquiry

1.10 The committee advertised the inquiry in the national press and invited written submissions by 24 July 2009. Details of the inquiry were placed on the committee's website and the committee also wrote to a number of organisations and stakeholder groups inviting written submissions. The 27 submissions received by the committee are listed in Appendix 1.

1.11 Three public hearings were held by the committee, in Sydney on 28 July 2009 and in Canberra on 14 and 18 August 2009. A list of witnesses appearing before the committee at hearings is provided at Appendix 2.

1.12 The committee thanks all those who participated in this inquiry.

Structure of the report

1.13 The deposit guarantee and the wholesale funding guarantee are discussed in Chapters 2 and 3 respectively. Their impact on banks, other financial institutions and markets are the subject of Chapter 4. The final chapter examines the transition to a permanent scheme of depositor protection and the form it might take.

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7 Australian Finance Conference, *Submission 17*, p 2.

8 The Hon Malcolm Turnbull MP, 'Responding to the international financial crisis', *Media Release*, 11 October 2008.