Chapter 3

The wholesale funding guarantee

The introduction of the wholesale funding guarantee

3.1 The wholesale funding guarantee is available on an issue by issue basis for securities with a term of up to 60 months. The guarantee will apply for the full term of the relevant security even after the scheme is closed to new issuances and can be applied to existing as well as new securities.[1]

3.2 The facility is restricted to senior unsecured debt instruments in major currencies, whether issued domestically or offshore. There is restricted availability for issues by foreign bank branches in Australia. (These may be eligible for coverage from similar schemes in their home countries.)

3.3 The Treasury Secretary described the measure as prompted by similar actions by foreign governments:

> …circumstances had reached a point in Australia—particularly because of decisions that had been taken the week earlier by the United Kingdom government and steps that we understood might have been under consideration more broadly in Europe and also in the United States—where a failure to act in a timely way in Australia could have had severe implications for the ability of Australian financial institutions to access wholesale term funding in international markets.[2]

3.4 APRA had a comparable perspective:

> …there was a great danger that Australian banks, in particular our strongly performing banks, would struggle in global funding markets against the competition coming from banks that were subject to a government guarantee from their governments. Major Australian institutions fund themselves in part through these wholesale offshore markets, and they were turning their back on Australian banks.[3]

3.5 The measures by overseas governments are described by the Reserve Bank:

> …many governments moved to provide guarantees on wholesale funding by financial institutions. These moves followed the action taken by the Irish Government in late September 2008 to provide a guarantee on new and existing debt for Irish-based financial institutions. This decision had a cascading effect, as concerns arose about the ability of financial institutions that did not have access to guarantee arrangements to continue to access

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1 Treasury, answer to question on notice sbt28, Supplementary estimates 2008-09.

2 Dr Ken Henry, Secretary, Treasury, *Estimates Hansard*, 22 October 2008, pp 23-24.

3 Dr John Laker, Chair, Australian Prudential Regulation Authority, *Estimates Hansard*, 23 October 2008, p 14.

> funding. In the weeks following the Irish announcement, governments in over a dozen countries, including Australia, followed suit with wholesale funding guarantee schemes…[4]

3.6 A minority of witnesses opposed Australia responding to these global actions. Professor Swan is not convinced the Australian response is warranted given overseas events:

> Australian banks are perhaps the most concentrated and most profitable in the world, and in the present climate where major global banks have sustained huge losses…[foreign banks] are not in the position to be effectively competing in markets like Australia…These banks are not in a position to put Australian banks out of business by providing very cheap, economic or low-cost loans to Australian businesses…[5]

Monitoring and disclosure

3.7 There will be ongoing monitoring of the operation of the guarantee by the Council of Financial Regulators.[6]

3.8 The Government publishes on www.guaranteescheme.gov.au the details of participating institutions and the liabilities that are covered. The Government will provide six-monthly reports to the Parliament on the Guarantee Scheme's operations, including:

- the extent of the liabilities covered by the guarantees;
- whether any calls have been made under the guarantees for payment; and
- payments, if any, made by the Commonwealth under the guarantees.[7]

Setting the premia for the guarantee

3.9 The setting of the premium has been described by the Reserve Bank, APRA and Treasury:

> In setting the premiums on the guarantee the Government considered a range of factors, including international settings and the need to ensure that the arrangements did not continue indefinitely. The fees were set at a level between the then current risk spreads – the product of very stressed conditions – and spreads likely to prevail in more normal market conditions.[8]

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4 Reserve Bank of Australia, *Financial Stability Review*, March 2009, p 9.

5 Professor Peter Swan, *Proof Committee Hansard*, 14 August 2009, p 2.

6 Mr David Martine, Treasury, *Proof Estimates Hansard*, 4 June 2009, p 25.

7 Treasury, answer to question on notice sbt28, Supplementary estimates 2008-09.

8 RBA & APRA, *Submission 7*, p 2.

> The Guarantee Scheme fee schedule is based on the credit ratings of the issuing institutions and is set at levels between the prices of ADIs' wholesale debt instruments at the height of the financial turmoil and the prices that had prevailed in more normal market conditions. This approach provides an incentive for ADIs and their investors to cease using the Guarantee Scheme as market conditions normalise, helps to mitigate any impacts of the guarantee on the markets for other financial assets, and ensures that the fee schedule reflects market-based pricing signals and the risks borne by taxpayers.[9]

International comparison

3.10 Placing the Australian charges in a global context, the RBA described:

> The fees charged for the government guarantees on wholesale funding are typically based on the credit rating of the issuer (Australia, Canada and New Zealand), or credit default swap premiums (France, the Netherlands, Spain and the United Kingdom). In contrast, in the United States the fee charged is dependent on the term of the instrument but not the rating of the issuer. The fee structure adopted in the Netherlands and New Zealand also depends partly on the term of issuance. In a number of countries, including Canada, New Zealand and the United Kingdom, the fee has been revised lower from initial settings, while in the United States it has been revised higher. [10]

3.11 Assessing the position after these changes, the RBA and APRA comment:

> Internationally, fees on comparable schemes have converged at around 90 to 110 points, above the 70 basis point charge for AA rated Australian banks. The Australian fee structure also has a relatively large differential between banks with different ratings.[11]

3.12 Treasury comment:

> Australia's wholesale funding guarantee fee schedule (which also applies to large deposits) is currently at the lower end of the international spectrum, but is broadly consistent with international arrangements if the cost of swapping debt raised in foreign currencies into Australian dollars is taken into account. These swap costs have been unusually elevated due to the impact of the crisis. Australian ADIs, along with those in New Zealand and the UK, are in the unusual position of issuing the majority of their debt in foreign currencies, and hence incur higher funding costs relative to their counterparts in the US, Europe and parts of Asia.[12]

3.13 The Australian fees are compared to those overseas in Charts 3.1 and 3.2.

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9 Treasury, *Submission 22*, p 2.

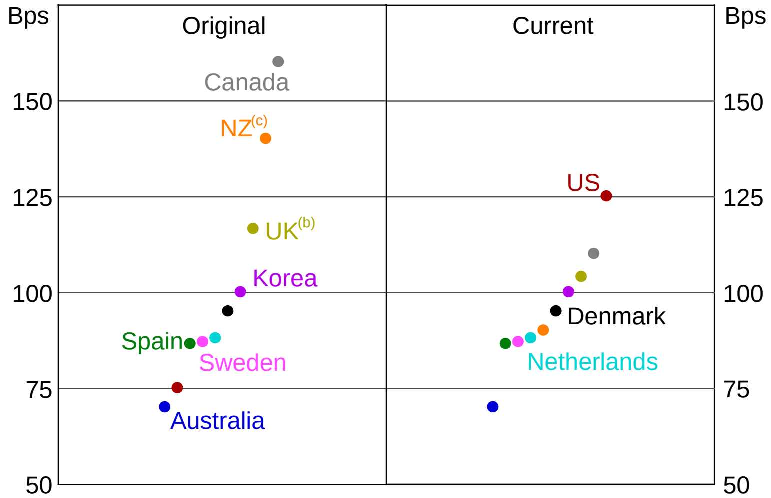
10 RBA *Financial Stability Review*, March 2009, p 46.

11 RBA & APRA, *Submission 7*, p 4.

12 Treasury, *Submission 22*, p 13. See also table on p 14 of the submission.

Chart 3.1

Long-term Debt Guarantee Fees for AA-rated Issuers (a)

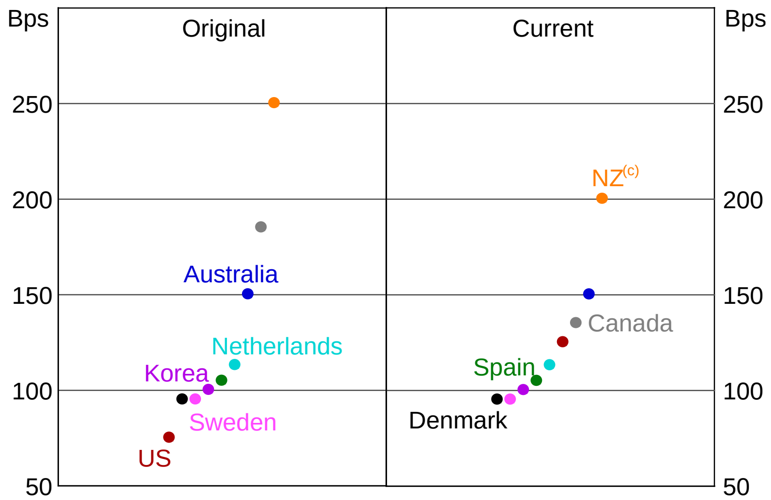


(a) Schemes where banks issue in their own name. Dispersion along horizontal axis is for presentation purposes only.
(b) RBA estimate based on CDS premiums
(c) New Zealand dollar fee (subtract 20 basis points for foreign currency fee)
Sources: BIS; treasury departments, central banks, debt management offices and guarantee administrators

Source: RBA & APRA, *Submission 7*, p 4.

Chart 3.2

Long-term Debt Guarantee Fees for BBB-rated Issuers (a)



(a) Schemes where banks issue in their own name. Dispersion along horizontal axis is for presentation purposes only.
(b) RBA estimate based on CDS premiums.
(c) New Zealand dollar fee (subtract 20 basis points for foreign currency fee)
Sources: BIS; treasury departments, central banks, debt management offices and guarantee administrators

Source: Reserve Bank of Australia

3.14 The Australian scheme uses a relatively simple fee structure. This may have been a good thing. The BIS noted that in overseas countries 'the take-up under government debt guarantee programmes was slower than expected as issuers were deterred by the terms and the costs…the complexity of these guarantee programmes and the varying treatment across jurisdictions deterred some investors'.[13]

Tiering of the premia

3.15 The premia for the guarantee are tiered. ADIs with credit ratings of AAA to AA- pay 70 basis points per annum; those with credit ratings of A+ to A- pay 100 basis points while others pay 150 basis points.

3.16 This tiering was criticised by some lenders, particularly the smaller ADIs:

> This fee structure created an unlevel playing field for the first time in the deposit space, as previously Australian retail deposits had always been priced without regard for the credit rating of a financial institution. It also sent a message to the public that ADI's with lower credit ratings are not as "safe" as those with higher credit ratings.[14]
>
> Presumably all depositors and all ADIs are protected the same way, and yet we have got a different risk differential premium applied to us for deposits with us [mutuals].[15]
>
> The Guarantee cost tiering should be more representative of the market cost... A differential of 80 basis points between major bank costs and ME Bank (70 basis point guarantee cost versus 150 basis points) would, in time, force the Bank to increase the rates on its consumer products including residential home loans.[16]
>
> … premiums on the wholesale funding guarantee should narrow, but there are differences of opinion amongst our banks on the extent of this narrowing.[17]

3.17 It was also criticised by the Finance Sector Union and Professor Swan:

> It is arguable that a differential pricing structure for the deposit guarantee is not consistent with the accompanying prudential framework which aims to give equal protection to all regulated deposits.[18]

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13 BIS, *79th Annual Report*, 2009, p 106.

14 Bank of Queensland, *Submission 10*, p 2. They elaborated at the hearing that the major banks exacerbated this impression by their advertising; Mr Ram Kangatharan, Chief Financial Officer, Bank of Queensland, *Proof Committee Hansard*, 14 August 2009, p 29.

15 Mr Degotardi, Abacus, *Proof Committee Hansard*, 14 August 2009, p 67.

16 Members Equity Bank, *Submission 14*, pp 1 and 4.

17 Mr David Bell, Chief Executive Officer, Australian Bankers' Association, *Proof Committee Hansard*, 14 August 2009, p 16.

18 FSU, *Submission 11*, p 1.

> With very big differences between the subsidy rate to more highly rated banks and that to more lowly rated banks, it further biases the banking system towards the larger banks. I think in the longer term, if this continues, it will tend to further reduce competition in the Australian market.[19]

3.18 Treasury justified the tiering on the following grounds:

> That fee schedule represents the recommendations of the Council of Financial Regulators in terms of the need to maintain a risk spectrum and to protect the Commonwealth in terms of the risks it was taking by guaranteeing the fundraising by a wide range of institutions. We cannot escape the fact that a BBB-rated institution will have to pay more for its funding than an AA-rated institution.[20]

3.19 Professor Harper argued that not having the tiering would expose the government to greater risk:

> There is a risk spectrum in the financial system. The reality is, I would have argued, that those on the margin, those further out, have a higher probability of succumbing than those further in. That is why there is a risk spectrum; that is why the market charges some of the non-banks and other institutions and regional banks a higher rate than it charges the majors…[21]

3.20 Even if the magnitude of the tiering was initially appropriate, it has been argued that it should now be reviewed:

> …they should have been finetuning the level and the relative rates for different classifications of banks over time. That would have meant, with the lowering of risk premiums and the lowering of global rates, that they… should have narrowed that differential…[22]

3.21 One argument against the tiering is that the smaller ADIs are still having to pay more to raise funds, even when the government guarantee is in place:

> Operation of the Scheme has also revealed that lower rated ADIs are in effect penalised twice, as the market has required an additional premium from them on top of the higher fee payable to the Government even though the debt carries the Government's AAA rated guarantee.[23]

3.22 As well as the smaller ADIs affected, this 'double whammy' effect is regarded as undesirable by Professor Sathye:

> I would agree with a risk based sliding scale in normal situations, but we were not dealing with a normal situation; it was an abnormal situation, where we wanted banks to raise money in order to be able to fund

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19 Professor Peter Swan, *Proof Committee Hansard*, 14 August 2009, p 2.

20 Mr Jim Murphy, Treasury, *Proof Committee Hansard*, 18 August 2009, p 4.

21 Professor Ian Harper, *Proof Committee Hansard*, 14 August 2009, p 44.

22 Professor Swan, *Proof Committee Hansard*, 14 August 2009, p 3.

23 Abacus (Australian Mutuals), *Submission 19*, p 4.

> businesses and others. The sliding scale is actually acting something like a double whammy for the smaller financial institutions.[24]

3.23 It appears this outcome was not anticipated – or at least not with any confidence – when the scheme was being designed. The discussion with Treasury at the hearing went as follows:

> Senator BUSHBY—Was it the case that they thought by providing the government guarantee that the market would then treat them equally and not actually price differentially?
>
> Mr Murphy—There were wide-ranging discussions about the fee schedule and what the appropriate schedule was. It was a dramatic and quite innovative approach which, as has been demonstrated, was necessary. At the time we were trying to get to a position where all institutions would have access to wholesale funding at an appropriate price…
>
> Senator BUSHBY—…But if the Council of Financial Regulators decided deliberately to put a differential on, knowing full well that the market would still differentially price the cost of funds, then that is another thing altogether. I would like an indication of whether there was a consideration of that before the decision was made.
>
> Mr Murphy—Those issues were discussed, but at the time no-one really knew…
>
> Senator BUSHBY—Was the assessment that they thought that the market would price the risk in the same way given that there was Commonwealth backing for all institutions?
>
> Mr Murphy—There was some uncertainty about that. You could look at it in two ways. What has eventuated is that the market, in effect, looks through the government guarantee and makes its assessment.
>
> Senator BUSHBY—Yes, and that is what has happened. But what I am interested in is whether the decision they made initially was in the expectation that the market would not look through the government guarantee.
>
> Mr Murphy—From recollection, the matters were discussed, and realistically we did not know.[25]

3.24 The Australian Bankers' Association commented:

> …at the time of that announcement perhaps no-one could have anticipated this looking-through issue.[26]

3.25 The reason why the market is apparently not heeding the guarantees is unclear. The ABA has suggested:

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24 Professor Milind Sathye, *Proof Committee Hansard*, 14 August 2009, pp 9-10.

25 *Proof Committee Hansard*, 18 August 2009, pp 10-11.

26 Mr David Bell, Australian Bankers' Association, *Proof Committee Hansard*, 14 August 2009, p 22.

> One contributory reason for this is that the current design of the guarantee does not give investors confidence that, in the event of default, the government will make good on the guarantee within an acceptable timeframe.[27]

3.26 It is also argued that basing the fees on credit ratings is inconsistent with the performance of the ratings agencies. Abacus acidly notes:

> Local councils trusted the opinions of credit rating agencies rather than Australia's prudential regulatory system and chose to invest in AAA-rated exotic securities when they would have been better off depositing funds in an unrated mutual ADI.[28]

3.27 The Bank of Queensland is also unimpressed by the rigour of the rating agencies:

> the regional banks in Australia are actually safer institutions and the credit rating that they have is more a function of size than true risk.[29]

3.28 The ABA and Abacus argued that the differential between the fees for large and small banks is wider in Australia than overseas.[30] Comparing with overseas schemes, Treasury observes:

> Most countries' fee schedules differentiate between institutions on the basis of risk, with more risky institutions paying a higher fee. However, there are different approaches to calculating the fee differential, with countries such as Australia, Canada and New Zealand using credit ratings, while countries such as the UK, France and Germany are using market-based benchmarks such as credit default swaps. The US, Ireland and Korea charge the same fee regardless of the riskiness of the institution. Most nations' fee schedules charge a higher fee for longer-term issuance, whereas Australia's fee schedule does not differentiate between securities with different term structures.[31]

3.29 An alternative suggestion is that as risk increases with the size of exposure, so should the premium charged:

> … for the first $50 billion you are only going to pay half of a per cent; for the next $50 billion you are going to pay one per cent; for the next $50 billion you are going to pay 1½ per cent; and for the next $50 billion you will pay two per cent. It is all available to you but the call is yours as to how much of the guarantee you want.…This would both look after the

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27 Australian Bankers' Association, *Submission 24*, p 7.

28 Abacus (Australian Mutuals), *Submission 19*, p 3.

29 Mr Ram Kangatharan, Chief Financial Officer, Bank of Queensland, *Proof Committee Hansard*, 14 August 2009, p 26. The Bank of Queensland argues that the regional banks have lower bad debts relative to loans than do the major banks; pp 26 and 29.

30 Mr David Bell, Australian Bankers' Association, *Proof Committee Hansard*, 14 August 2009, p 22.

31 Treasury, *Submission 22*, p 13.

> smaller banks and also give encouragement to the bigger banks to move out.[32]

3.30 The Bank of Queensland saw some merit in such a modification:

> …the majors would lose the advantage of the large deposit bases and the advertising capabilities et cetera that they have. I think that would effectively level the playing field of the large and small banks.[33]

3.31 Professor Sathye said that as all ADIs are subject to the same supervision by APRA they should be charged the same rate:

> …all institutions are APRA regulated, so on that front they are all equal, and if they are all equal, then why is there a discrimination on the risk basis at a time when risk was pretty high?[34]

3.32 On the contrary, Professor Hogan has argued that the differential may be too small:

> From top to bottom the range is only 80 basis points. This is much less than the spreads often witnessed in international capital markets between the highly-rated and the lesser-rated…[35]

Committee view

3.33 While Treasury is coy about the extent to which the market was anticipated to 'look through' the guarantees, 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

3.34 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).

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32 Senator Barnaby Joyce, *Proof Committee Hansard*, 14 August 2009, pp 7, 11 and 32.

33 Mr Ram Kangatharan, Chief Financial Officer, Bank of Queensland, *Proof Committee Hansard*, 14 August 2009, p 33.

34 Professor Milind Sathye, *Proof Committee Hansard*, 14 August 2009, p 11.

35 Professor Warren Hogan, 'The bank deposit and wholesale guarantees of 12Ooctober 2008: an appraisal', *Agenda*, vol 16, no 2, 2009, pp 9-10.

The contingent liability from the guarantees

3.35 Symptomatic of the confused approach of the Government in its response to the financial crisis, initially it had been thought legislation would not be required but in November 2008, the Guarantee Scheme for Large Deposits and Wholesale Funding Appropriation Bill 2008 was passed through the parliament to provide an appropriation in the unlikely event this is required.

3.36 In theory the contingent liability arising from the guarantees would be the total size of deposits under $1 million and larger deposits and wholesale funding for which the guarantee fee has been paid. This currently amounts to around $770 billion. This liability would be realised if all the banking system's assets became worthless.

3.37 However, Treasury explained that even in the remote possibility of a bank collapsing the cost to the government would be much less than the size of the bank's deposits:

> …you then need to think through some other important safeguards. One in particular I will mention is the fact that all ADIs are required under the Banking Act to hold sufficient assets to cover their deposit liabilities. So if, for example, there was a collapse of a bank and the appropriate action was that the institution be wound up then while amounts might be paid out under the Financial Claims Scheme upfront, because the whole purpose of that is to ensure that depositors can get their money quickly, the assets, as required under the Banking Act, will more than offset the deposit liability. So if that was the course of action that was decided, APRA would step in—and the institution would be wound up and over time the assets would be extinguished. They would all come back to the government. In that situation I would argue that the actual contingent liability if it eventuated, whilst it is unquantifiable, if you had to try to quantify it, would be incredibly small…And the other important feature announced by the government at the time was that if there is a shortfall then the government of the day has the option to introduce a levy on the rest of the industry to make up that difference.[36]

3.38 The Treasury Secretary commented:

> …my present understanding is that we were likely to refer to the contingent liability in the statement of risks in the budget, and in talking about the contingent liability we would describe it as 'a remote and unquantifiable liability'. I would imagine that people who are responsible for rating sovereign debt would take the same view.[37]

3.39 The Reserve Bank agreed:

> ..the circumstances in which an amount of that scale would be called upon to be honoured is so remote as to be completely unrealistic. It is not just me saying that; the markets and rating agencies are all keeping a close eye on

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36 Mr David Martine, Treasury, *Proof Estimates Hansard*, 4 June 2009, pp 24-25.

37 Dr Ken Henry, Secretary, Treasury, *Estimates Hansard*, 22 October 2008, p 75.

> this stuff. Neither of those has raised concerns about it. Other countries are doing the same thing.[38]

3.40 The risk to the taxpayer from the wholesale funding guarantee is limited by it being restricted to APRA-supervised entities (who are required to have adequate capital and risk management procedures) and standard 'plain vanilla' bonds.[39] Nonetheless, the Committee notes that the insistence that any risks are miniscule appears inconsistent with the tiered fees that are justified as reflecting differences in risks.

3.41 The Australian Bankers' Association questions whether the contingent liability is anywhere near $770 billion. They argue the government/taxpayer is only exposed to $110 billion of it, as the deposit guarantee is underwritten by the banks collectively.[40] This is presumably a reference to the industry levy proposed for the original financial claims scheme with the $20,000 cap.

3.42 It has been suggested that the Government could not possibly meet the $770 billion cost of this guarantee if fully called upon and so this is a fraudulent representation. However, it is hard to envisage circumstances short of the country being annihilated in a nuclear war where the value of every Australian bank loan – and the houses and business assets which are mortgaged to support them – falls to zero and all the capital of the banks is wiped out. (It is equivalent to saying that the insurance companies could not deliver on their promises if every insured house burnt down at once or every insured person died at once; or that the banks could not deliver on their promises if every depositor unexpectedly wanted to withdraw their deposits in cash on one day.)

3.43 If this extremely hypothetical event were to occur, and the government met the guarantee by borrowing $770 billion, this would add an amount equivalent to 64 per cent of GDP to government debt.

3.44 Reflecting the prudent fiscal policies adopted over the previous decade, which saw Australia enter the financial crisis with a strong positive net asset and cash position, Australia has a much smaller government debt than most other countries. Indeed, despite the Labor Government taking us back into a net debt position, because of past Coalition policies, Australia's fiscal position is so strong that even adding debt worth over 60 per cent of GDP would still leave gross government debt a smaller proportion of GDP than it is in many other countries which continue to readily borrow in international markets (Table 3.2).

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38 Dr Malcolm Edey, Assistant Governor, Reserve Bank of Australia, *Proof Committee Hansard*, 28 July 2009, p 26.

39 Treasury, *Submission 22*, p 30.

40 Australian Bankers' Association, *Submission 24*, pp 6-7.

Table 3.2: General government financial liabilities

Per cent to GDP, 2009

	gross	net			gross	net
Australia	16	-5		Netherlands	70	31
Austria	73	38		New Zealand	27	-14
Belgium	100	81		Norway	63	-137
Canada	78	27		Sweden	53	-11
France	86	50		Switzerland	46	12
Germany	78	51		United Kingdom	75	48
Japan	190	97		United States	87	59

Source: *OECD Economic Outlook*, June 2009.

3.45 The above discussion has focused on risks from providing the guarantee. It also needs to be noted that in exchange for taking on the contingent liability the Government has so far earned about $½ billion in fees.