Chapter 4
The impact of the funding guarantees

The impact on banks

4.1 Submissions from banks and other ADIs have been generally supportive of the guarantees:

> … the government's wholesale guarantee was a prudent measure, because of the actions of foreign governments to guarantee the funding of their banks.[1]
>
> …as other Governments around the world moved to guarantee their weaker banking systems, the Australian Government had little option but to implement similar arrangements. Not to have done so would have put at risk the ability of our banking system to raise funds in capital markets…The evidence is that the schemes have assisted in preserving confidence in the Australian banking system, and in maintaining the supply of credit in the economy at close to pre-crisis levels.[2]
>
> BOQ was very supportive of the Government's announcement on the 12th October 2008 to introduce a bank deposit guarantee, as there were clear signals in the marketplace and in the media of a significant level of public concern as to the safety of banks, and therefore the safety of deposits.[3]

4.2 An exception is some foreign banks operating in Australia as branches rather than subsidiaries, which have expressed their concern in October 2008 about their exclusion from the scheme.[4]

4.3 The Reserve Bank and Treasury have taken a positive view:

> These arrangements have been successful in sustaining depositor confidence and in ensuring that Australian banks have continued access to capital market funding.[5]
>
> Treasury believes the guarantees have been effective. They have made an important contribution to the stability and strength of the Australian financial system; maintained depositor confidence in Australian ADIs, thus securing a large portion of ADIs' funding; and enabled Australian financial institutions to continue to access wholesale funding markets, which has

---

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

2 Westpac, *Submission 6*, p 2.

3 Bank of Queensland, *Submission 10*, p 2. They make almost identical comments about the wholesale funding guarantee.

4 *Estimates Hansard*, 23 October 2008, pp 20-21.

5 RBA *Financial Stability Review*, March 2009, p 27.

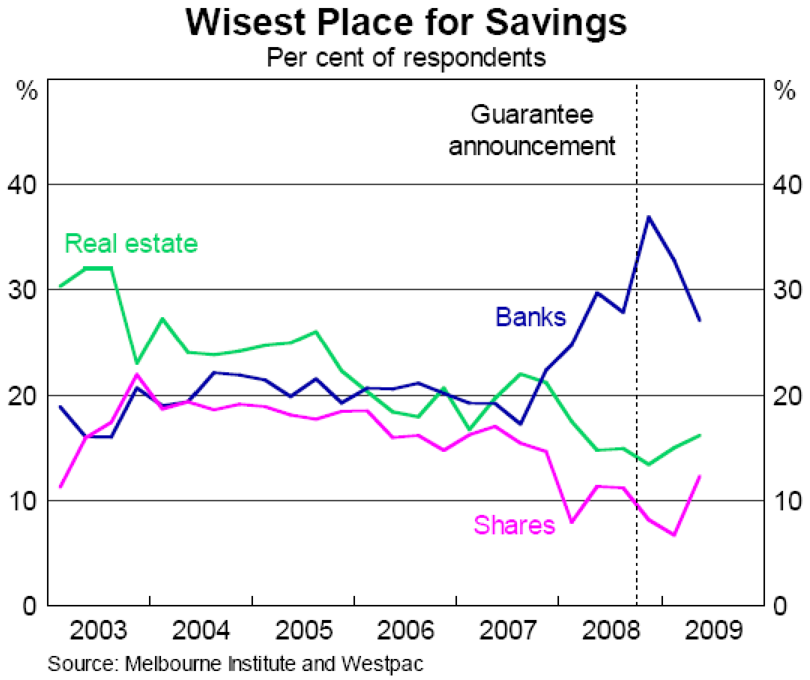
> ensured that households and businesses have been able to secure credit through the economic downturn.[6]

4.4 The RBA had noted that in the period between the outbreak of the crisis and the introduction of the deposit guarantee, large banks had been gaining market share in deposits at the expense of small banks.[7] This was understandably (due to the Commonwealth backing now provided) halted by the guarantees:

> …following the announcement there was a reversal in potentially destabilising deposit outflows from a number of ADIs that had been evident in early October. By guaranteeing all deposits under $1 million, the FCS reduced the incentive for depositors to move away from ADIs that they perceived as being at risk.[8]

4.5 The public seems reassured by the guarantees. The Westpac and Melbourne Institute Survey of Consumer Sentiment, for instance, showed that the introduction of the guarantees led to a jump in the proportion of surveyed households who viewed bank deposits as the 'wisest place for savings' (Chart 4.1).

Chart 4.1



Source: RBA & APRA, *Submission 7*, p 6.

4.6 APRA has also taken a positive view in successive Estimates appearances:

---

6 Mr Jim Murphy, Executive Director, (Markets Group), Treasury, *Proof Committee Hansard*, 18 August 2009, p 2

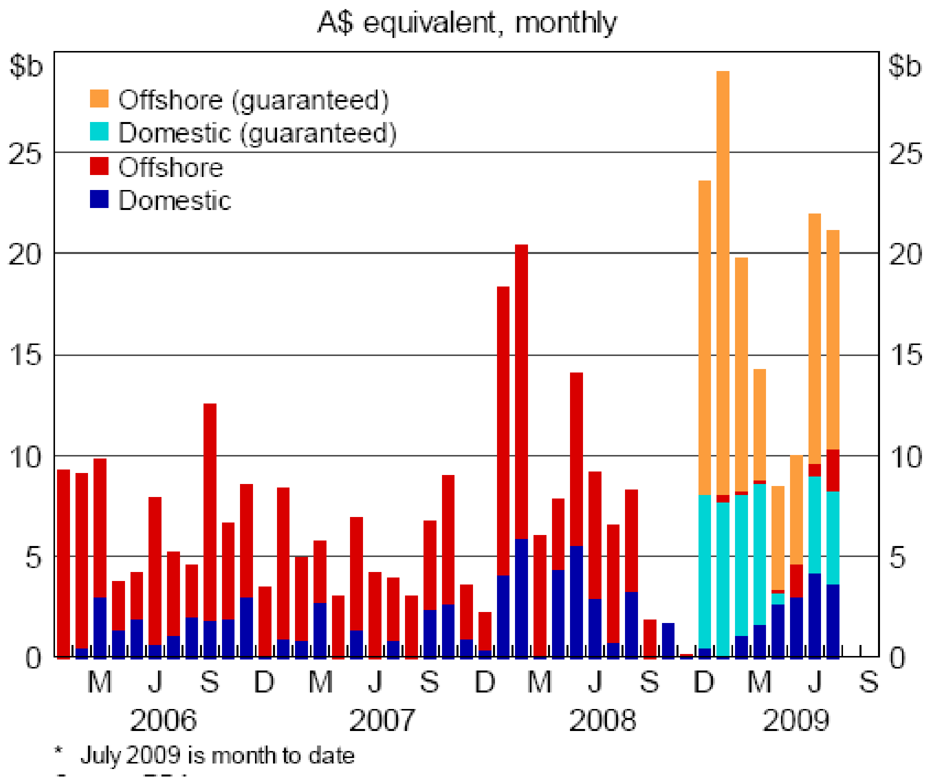
7 RBA *Financial Stability Review*, March 2009, p 29.

8 RBA & APRA, *Submission 7*, p 5.

> Domestically, feedback from our regulated institutions is that the government's deposit and term funding guarantee, which APRA fully supports, has calmed what was a growing disquiet on the part of some depositors.[9]
>
> Australian banks have raised over $60 billion of longer term wholesale financing since the Australian government's guarantee of wholesale funding came into effect at the start of December. This funding is expensive, though, with spreads still well above pre-crisis levels. Retail deposits have continued to grow strongly, underpinned by the introduction of the government guarantee.[10]
>
> Australian banks have raised over $80 billion of longer term wholesale funding under the Australian government's guarantee arrangements. Encouragingly, some of our major banks recently have raised term wholesale funds, domestically and offshore, without recourse to the guarantee.[11]

4.7 The introduction of the guarantee has been followed by a resumption of bond issues by the banks (Chart 4.2).

Chart 4.2: Australian Banks' bond issuance



Source: RBA & APRA, *Submission 7*, p 8.

---

9 Dr John Laker, Chair, Australian Prudential Regulation Authority, *Estimates Hansard*, 23 October 2008, p 5.

10 Dr John Laker, Chair, APRA, *Estimates Hansard*, 25 February 2009, p 158.

11 Dr John Laker, Chair, APRA, *Estimates Hansard*, 4 June 2009, p 58.

Longer-run concerns about moral hazard

4.8 While the guarantees address an urgent problem, there are some concerns that they may increase the probability of future crises. This is the question of 'moral hazard': will assisting banks now make them less prudent as they will expect to be assisted in future difficulties?

4.9 From an international perspective, the Bank for International Settlements commented:

> …the pursuit of short-term stability has raised some difficult questions about moral hazard. By limiting the losses of large banks' equity and liability holders as well as the rewards of managers and traders, rescue packages are reducing the incentive for both insiders and outsiders to monitor risk-taking in the future…*Fortunately, officials in many countries understand all of this and are looking for solutions.* [emphasis added] The truth is that as financial institutions grow more complex, the demands on risk management grow much more quickly. A large, integrated financial institution today has hundreds of subsidiaries, all operating quasi-independently; it is impossible for any individual to understand what all the parts of such an organisation are doing, much less how they will interact in response to a major event. Enterprise-wide risk management would seem to be an impossibility in such cases. Moreover, some banks are not only too big to fail but, in having important relationships with a large number of other institutions, are also too interconnected to fail. Officials must insist that institutions be comprehensible both to those who run them and to those who regulate and supervise them. And, in the future, a financial firm that is too big or too interconnected to fail must be too big to exist.[12]

4.10 However, domestically, the Treasury Secretary has remarked:

> In concept—that is, as an abstract theoretical proposition—one should of course admit the possibility that government guarantees have an element of moral hazard associated with them and one should therefore be very careful about the circumstances in which they are used. Perhaps I could go so far as to say that they should only be used in exceptional circumstances. I said this morning that the circumstances that governments around the world have been confronting and dealing with over the last few weeks are very much in the nature of exceptional circumstances.[13]

4.11 APRA is well aware of the issue:

> …the government guarantee was not a reason for institutions to lower their guard on managing risk and it certainly would not be a reason for APRA to lower its guard as the prudential supervisor. Our supervisory intensity will be as strong, if not stronger, now with the government guarantee in place as it was beforehand, because we are conscious that institutions might think that the liquidity problem that they were facing might therefore be solved and it is hats in the air. Our institutions do not think that. I think they are

12 BIS, *79th Annual Report*, 2009, p 120.

13 Dr Ken Henry, Secretary, Treasury, *Estimates Hansard*, 22 October 2008, p 66.

> being responsible and very cautious and prudent going through this period. We want to make sure that they maintain that focus. That is how we will address possible unintended consequences.[14]

4.12 One submitter put it this way:

> The Government eliminates the adverse selection problem of depositors by insuring them against default by the bank. In doing so the Government creates a moral hazard problem for itself. The deposit insurance gives banks an incentive to make higher risk loans that have commensurately higher interest payments. Why?, because they are then betting with taxpayer's money. If the riskier loans are repaid the owners of the bank get the benefit. If not, and the banks assets cannot cover liabilities, then the Government must make up the shortfall. Another way of looking at this is to recognize that deposit insurance is equivalent to the bank having an option to put the remaining assets of the bank to the Government in exchange for the funds to repay the depositors. The price of exercising this option is the assets of the bank. As with all options, the bank's put option is increasing in value with the volatility of the underlying asset. Increasing the riskiness of the bank's assets increases the value of the put option (the option to walk away from the liabilities and let the Government pick up the tab).[15]

4.13 Professor Swan was perhaps the most strident submitter and witness in arguing moral hazard as a reason to phase out the scheme quickly:

> If some of the most profitable banks in the world cannot stand on their own two feet, something is seriously wrong. If the scheme is allowed to linger on with ever increasing guaranteed borrowings, there is always the likelihood of major bankruptcies and defaults. Banks and their shareholders are not responsible for their actions when they borrow with governmental guarantees.[16]

> I do not see any need to subsidise and guarantee wholesale borrowing by Australian banks, and the sooner this scheme is phased out the better, in my opinion... banks may in future make very risky decisions, thinking that they will be bailed out as have the very poorly performing US banks to the tune of billions of dollars. So we want to try not to give bank executives the feeling that they will be bailed out in one form or another in future.[17]

Committee view

4.14 Despite clearly being aware of the risk, the comments by officials suggest they were dismissive of the potential threat from moral hazard. They do not seem to be among the officials referred to by the Bank for International Settlements as looking for solutions.

---

14 Dr John Laker, Chair, Australian Prudential Regulation Authority, *Estimates Hansard*, 23 October 2008, p 5.

15 Dr Sam Wylie, *Submission 15*, p 7.

16 Professor Peter Swan, *Submission 21*, p 5.

17 Professor Peter Swan, *Proof Committee Hansard*, 14 August 2009, pp 2 and 5.

The impact on non-ADI financial institutions

4.15 It is surprising that the Government appeared unconcerned about the impact on non-ADI financial institutions of providing guarantees to ADIs, given that the Treasurer acknowledged at the outset the likely ramifications:

> The non-prudentially regulated investment sector typically includes mortgage trusts, non-listed property trusts and debentures. It provides investment capital to a range of projects (e.g. property development) and offers investment returns to retail investors. These vehicles are an important form of capital for the real economy.
>
> Concerns have been expressed by industry about the impact of the current global financial crisis on this sector.
>
> The Secretary to the Treasury and the Chairman of the Australian Securities and Investments Commission, in consultation with other financial regulators, are currently assessing all relevant actions that might be appropriate to foster the ongoing health and vitality of individual firms in this important sector of the economy.[18]

4.16 The Reserve Bank suggested there is an inevitability with a guarantee scheme that those just missing out may feel hurt by it:

> …there had to be some guarantees to protect the core of the system. Nobody thinks that you can guarantee everything. Governments cannot guarantee the entire economy and so there have to be boundaries set around the parts that are guaranteed and then some people are going to find themselves outside it. It is understandable that people who run institutions or investments that found themselves on the outside of the boundary would feel that they would rather the boundary had been set more widely so that they could be inside it.[19]

4.17 Some investment funds have frozen redemptions. The most recent data show that at least 80 investment funds, with a combined total of over $26 billion of funds under management, have applied withdrawal limitations.[20]

4.18 One submitter expressed his personal concern that his superannuation fund was frozen:

> …due to the Government's Bank Guarantee and remains frozen...The fund is paying only a very small return on the investment because they know I cannot do anything about it. If and when it can be released, it can contribute to my future pension payments. Therefore I appeal to the Committee to

---

18 The Hon Wayne Swan, *Treasurer's media release*, no 117, 24 October 2008.

19 Dr Malcolm Edey, Assistant Governor, Reserve Bank of Australia, *Proof Committee Hansard*, 28 July 2009. This emphasis on protecting the 'core' was echoed by Professor Ian Harper, *Proof Committee Hansard*, 14 August 2009, p 34.

20 Treasury, answer to question on notice, bet 166, Budget estimates June 2009.

> understand that the Government guarantee is having adverse as well as positive effects.[21]

4.19 While the global financial crisis contributed to the freezes, the funds view the guarantee on bank deposits, which made unregulated products less attractive, as the main source of the problem facing them.

4.20 Mortgage trusts (which pool investors' funds and invest them in residential, commercial and industrial property mortgages) have been particularly hard hit since the bank guarantees were announced:

> 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.[22]

> The Challenger Howard Mortgage Fund…had operated for almost a quarter of a century, including through other periods of financial turmoil, providing daily redemptions without interruption. But like its competitors, with the announcement of the deposit guarantee, it immediately came under extreme pressure with respect to its liquidity as many unit holders sought the certainty of a government guarantee.[23]

4.21 A submission from the finance industry argues:

> The enquiries and withdrawals from ADIs stopped once the announcement was made and confidence in the ADI sector returned. However, wavering confidence in the non-ADI sector was not addressed and the guarantee compounded this.[24]

4.22 The Investment and Financial Services Association (IFSA) argued the problems for the mortgage funds worsened after the introduction of the guarantees:

> What happened post the guarantee is that the bulk of my members in the mortgage sector experienced a 2,500 per cent increase in redemptions.[25]

4.23 IFSA saw this as a causal relationship:

> Mr Gilbert—The mortgage funds are frozen and they are not issuing new loans.

> Senator BUSHBY—Your evidence was that that primarily became a problem after the bank guarantees were introduced.

> Mr Gilbert—Yes, a chain of causation.[26]

---

21 Name withheld, *Submission 1*, p 1.

22 IFSA, *Submission 8*, p 2.

23 Challenger, *Submission 9*, p 5.

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

25 Mr Richard Gilbert, Investment and Financial Services Association, *Proof Committee Hansard*, 28 July 2009, p 45.

4.24 Treasury refers to similar experiences:

> Some finance companies have suggested that the guarantee arrangements contributed to their difficulties in raising funds following the events of September 2008. These include some larger corporations that fund themselves through the wholesale markets and some smaller entities that fund themselves primarily through the issue of debentures to retail investors. Other finance companies reported difficulties for other reasons such as creditor default or difficulties affecting the overseas parent.[27]

4.25 Professor Sathye observes:

> Government intervention in the financial system had the impact of actually sapping consumer confidence in financial institutions like the Colonial as risk incentives changed.[28]

4.26 The impact on investment funds was exacerbated by the guarantee being unlimited. Investment funds tend to receive larger deposits than do, for example, credit unions and building societies. They would have been less affected if the guarantee had been capped at, say, $100,000.

4.27 The role of the guarantees in causing problems for the non-ADI institutions is downplayed by ADI representatives:

> Well before the wholesale funding guarantee was introduced, it was widely argued by academics and commentators that the global financial crisis had made defunct the business model of non-bank housing lenders.[29]

> Even if the guarantee of ADI deposits had not been introduced, large numbers of investors in non-ADI products seeking to exit those products in the context of the global financial crisis would still have created liquidity problems in those non-ADI products. It is misleading to suggest that the guarantee of deposits is the main cause of liquidity problems in non-ADI funds. APRA and the RBA have advised this inquiry that the trend of outflows from mortgage trusts was well established from early in 2008, with a large mortgage trust suspending redemptions as early as March 2008.[30]

4.28 This supports the Reserve Bank and Treasury's interpretations:

> …the main thing has been the flight to safety. That was already occurring in the lead-up to the period where the guarantee became necessary...[31]

---

26 Mr Richard Gilbert, Investment and Financial Services Association, *Proof Committee Hansard*, 28 July 2009, p 53.

27 Treasury, *Submission 22*, p 26.

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

29 Australian Bankers' Association, *Submission 24*, p 3.

30 Abacus (Australian Mutuals), *Submission 19*, pp 2-3.

31 Dr Malcolm Edey, Assistant Governor, Reserve Bank of Australia, *Proof Committee Hansard*, 28 July 2009, p 21.

> …it is clear that the difficulties faced by non-ADI institutions had already emerged prior to the introduction of the guarantees and are likely to have persisted in the absence of the guarantees.[32]

4.29 One submitter's interpretation was that the problem was with disclosure:

> A lack of disclosure is the main problem in the mortgage trust episode of late 2008. Many mortgage trust investors were not properly informed by their investment advisors or the mortgage trusts that redemptions could be frozen.[33]

4.30 The Committee acknowledges that the increasing lack of investor confidence building in 2008 was having an impact on non-ADI financial institutions. However, it was also impacting on ADIs and this was why the deposit guarantees were introduced. The introduction and implementation of the guarantees served to greatly increase the lack of confidence in those institutions not the beneficiaries of guarantees, with the consequence that most experienced unsustainable requests for redemptions within a very short period.

Impact on residential mortgage securitisation

4.31 Banks commented that the global financial crisis had a marked impact on securitisation markets:

> The Global Financial Crisis (GFC) effectively ended ME Bank's ability to rely on securitisation as a funding source, and has required a total realignment of the funding model.[34]

4.32 The decline in demand for Australian residential mortgage-backed securities (RMBS) has in large part been a result of 'contagion' from overseas markets than an inherent loss in the quality of Australian securities:

> If you look at the defaults on the underlying assets on the securities it is pretty low, so the Australian RMBS market has actually performed well. The problem is that, given the very extensive increase in risk aversion and also the problems associated with these types of securities in the US through the subprime loan problems, there has been a risk aversion which has really impacted this market.[35]

4.33 However, it is also partly a reassessment of the efficiency of the securitisation model of financing in comparison with the more traditional bank financing model, as a result of the global financial crisis. A Professor Harper put it:

> The lessons we have learnt, however, is that the capital markets are not as efficient as the people assumed they would be… Once you understand that

---

32 Treasury, *Submission 22*, pp 4 and 26.

33 Dr Sam Wylie, *Submission 15*, p 8.

34 Members Equity Bank, *Submission 14*, p 2.

35 Mr Nicholas Hossack, *Proof Committee Hansard*, 14 August 2009, p 20.

> capital markets are nowhere near as efficient at solving information asymmetries—resolving these information problems—people thought they were, then suddenly of course you are looking again at the old technology and thinking, 'Well, maybe these guys knew a bit more about us than we gave them credit for, or maybe this model…If the information cannot be extracted by the market through buying and selling, then the old ideas, which of course involved tyre kicking and credit risk management and all of the techniques that bankers have used probably since the 16th century… starts to look it is much more efficient relative to securitisation in securing the underlying risks than we might have given it credit for. We know it is expensive, but it actually does a better job maybe.[36]

The AOFM programme

4.34 The Opposition first called for support for the RMBS market, to at least partly offset the impact on it of the funding guarantees, on 21 September 2008. This call was initially criticised very heavily by the Treasurer, who within a week, then moved to instruct the Australian Office of Financial Management (AOFM) to invest up to $4 billion in RMBS.

4.35 The Opposition argued this was insufficient, calling for the Government to:

> increase the investment into AAA rated Residential Mortgage Backed Securities (RMBS) through the AOFM. Given the continuing demand for liquidity in the mortgage finance area, and having consulted widely with the industry and other experts our view is that this level of investment should be raised to at least $10 billion. This compares to an RMBS issuance of around $18 billion per quarter prior to the sub-prime crisis, but nonetheless it will make a more meaningful contribution to supporting competition and do so without compromising in any way the prudent investment standards of the AOFM under its Act.[37]

4.36 The Government subsequently increased its direction to $8 billion, and asked that at least $4 billion of this should be directed towards non-ADI lenders.

4.37 The Australian Securitisation Forum (ASF) argued this programme has been very supportive and particularly helpful for regional banks:

> Adelaide Bank and Bendigo Bank were quite significant securitisors of their residential home loans… it has really been the…the $8 billion program administered by the Australian Office of Financial Management, to purchase highly rated, highly creditworthy residential mortgage backed securities that has kept the non-bank lending sector and the smaller ADIs continuing to be active in the lending market. [38]

---

36 Professor Ian Harper, *Proof Committee Hansard*, 14 August 2009, pp 39-40.

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

38 Mr Chris Dalton, Chief Executive, Australian Securitisation Forum, *Proof Committee Hansard*, 14 August 2009, p 47.

4.38 However, it has not attracted as many other investors into the market as had been hoped:

> When the AOFM program came in, the intent was they would be cornerstone investor and would attract others. Unfortunately, while it has been incredibly helpful to the sector, it has not actually attracted the other investors that we thought would come to the party.[39]

4.39 The AOFM itself viewed the impact of the programme as follows:

> The program has been designed to encourage investors to return. In recent months, investors who have come into the market have been doing so in issues that we have been a cornerstone investor for and their focus has been on the shorter maturity tranches. So there is still a way to go before they are investing in the longer term tranches with confidence… what we have done so far through the program has at least kept a number of existing institutions functioning or helped them to continue functioning with some funds through securitisation so that they have not had to stop lending; they are still taking customers and generating mortgages.[40]

4.40 The ASF, Aussie and the AFC have argued for increased purchases of RMBS by AOFM.[41]

4.41 There have been some calls for similar support for other securitised assets:

> … there is a need to support funding of other secured asset classes such as for portfolios secured over motor vehicles, equipment, other real property and consumer credit.[42]

Guarantees for RMBS

4.42 A guarantee for RMBS was supported by a number of witnesses and submitters from the finance industry:

> …there is a proposal around to guarantee our MBS securities, to try and get more liquidity in that market. The ABA would support that.[43]

> The ASF strongly believes further government assistance is necessary for securitisation to allow the primary debt capital market additional time for normal trading conditions to return…The introduction of a guarantee of RMBS could also be a way for the Government to exit the bank funding

---

39 Mr Patrick Tuttle, Deputy Chairman, Australian Securitisation Forum, *Proof Committee Hansard*, 14 August 2009, p 51.

40 Mr Neil Hyden, Chief Executive Officer, Australian Office of Financial Management, *Proof Committee Hansard*, 18 August 2009, p 8.

41 Aussie, *Submission 12*, p 2; Australian Finance Conference, *Submission 17*, p 4; Mr Ram Kangatharan, Chief Financial Officer, Bank of Queensland, *Proof Committee Hansard*, 14 August 2009, p 27; Mr Chris Dalton, Chief Executive, Australian Securitisation Forum, *Proof Committee Hansard*, 14 August 2009, p 47.

42 Australian Finance Conference, *Submission 17*, p 4.

43 Mr Hossack, Australian Bankers' Association, *Proof Committee Hansard*, 14 August 2009, p 19. The ABA are not keen on such a guarantee if it extends to securities issued by non-ADIs.

> guarantee but still leave the option for banks and other mortgage lenders to fund through issues of RMBS guaranteed by the Government.[44]

4.43 Professor Harper argued it was 'fair' to support the securitisation model as well as the bank lending model.[45]

4.44 The ASF suggested the AOFM could run a guarantee scheme for MBS.[46]

4.45 Professor Swan doubted whether such a guarantee was the best response:

> I would much rather see the implicit subsidies of the larger banks being taken away than have government guarantees for these mortgages provided by banks.[47]

Committee view

4.46 The Committee accepts the logic that the securitisation model of financing should be supported through its current difficulties, as well as the ADI lending model. However, there will need to be care taken in the design of such a scheme to avoid any further unintended consequences.

Recommendation 2

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

Covered bonds

4.48 There have been calls to allow ADIs to issue 'covered bonds'.[48] These are bonds which are secured against specified assets, such as mortgage loans, which remain on the banks' books unless needed to cover a default on the bond.[49] They may allow a AA-rated institution to issue a AAA-rated security.[50]

---

44 Australian Securitisation Forum, *Submission 26*, p 2. See also Challenger Finance, *Submission 9*, p 30; Mr Ram Kangatharan, Chief Financial Officer, Bank of Queensland, *Proof Committee Hansard*, 14 August 2009, p 27.

45 Professor Ian Harper, *Proof Committee Hansard*, 14 August 2009, pp 41-2.

46 Mr Chris Dalton, Chief Executive, Australian Securitisation Forum, *Proof Committee Hansard*, 14 August 2009, p 55.

47 Professor Peter Swan, *Proof Committee Hansard*, 14 August 2009, p 7.

48 For example, Australian Securitisation Forum, *Submission 26*, p 2 and *Submission 26a*.

49 Mr Chris Dalton, Australian Securitisation Forum, *Proof Committee Hansard*, 14 August 2009, p 51. Often the bonds are over-collateralised; the security is over a larger amount of mortgages than the face value of the bonds.

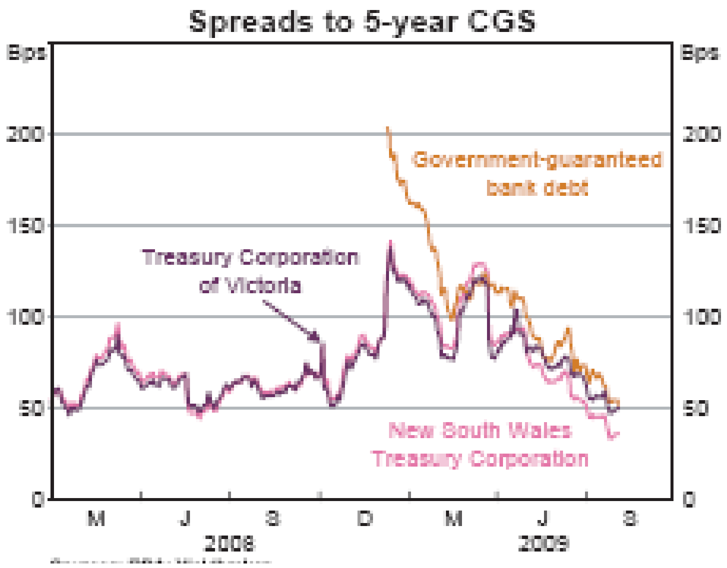
50 Mr Chris Dalton, Australian Securitisation Forum, *Proof Committee Hansard*, 14 August 2009, p 51.

4.49 The issue of covered bonds would seem to clash with the principle of depositor priority which has been an important element of the Australian system of reassuring depositors and require revision to the *Banking Act*. Covered bonds would reduce the protection for depositors by pushing them down the queue as claimants on a failing bank's assets. It was argued that this is less of a concern if deposit insurance becomes a permanent feature.[51]

Impact on other bond markets

4.50 As well as the impact on the RMBS market, the provision of a guarantee to ADIs also made it harder for state governments to raise funds. The spread between yields on state government and Commonwealth government paper had already widened as the global financial crisis made investors more sensitive to risk, and the guarantees reduced the relative risk of some issuers competing with the state governments. This pushed the spread up further in October 2008 (Chart 4.3).

Chart 4.3



Source: Reserve Bank of Australia, *Statement on Monetary Policy*, August 2009, p 53.

4.51 The Tasmanian Government submitted that:

> As soon as the guarantee was announced, it became difficult for the States to issue long-term debt as the market anticipated that the banks would issue large amounts of guaranteed debt.[52]

51 Mr Tuttle, Australian Securitisation Forum, *Proof Committee Hansard*, 14 August 2009, p 57.

52 Tasmanian Department of Treasury and Finance, *Submission 16*, p 1. See also AFMA, *Submission 20*, p 4.

4.52 This problem was resolved by the Australian Government moving to provide guarantees for state governments, for which they charged lower premia than are applied to the lower-rated banks. The Economics Legislation Committee concluded:

> All submissions to the inquiry supported the bill on the basis that the guarantee is critical in providing certainty for investors and allowing states to access the funds needed for large, infrastructure investment programmes. Such programmes will be an important measure to provide short term stimulus and liquidity to the national economy and well as long-term benefits to productivity. The Committee is confident that, as the credit rating agencies are unlikely to consider the guarantee when making an assessment about the fiscal position of a state, there is still sufficient incentive for states to manage their borrowing programme responsibly. The guarantee is very unlikely to be called on, but should allow the states to raise funds for needed infrastructure projects at lower cost.[53]

Impact on competition in financial markets

4.53 Concerns have been expressed that the global financial crisis has had the effect of increasing concentration within the banking and finance sectors, notably in housing lending:

> It is an empirical fact that the market share of the banks has skyrocketed. We know that the three non-bank pioneers that were the source of so much effective competition in this market— Aussie Home Loans, RAMS and Wizard—are now owned by the four major banks. RAMS was bought by Westpac, Aussie is one-third owned by CBA but, critically, 100 per cent funded by CBA. So when you go to Aussie to get a home loan branded by Aussie you are effectively getting a CBA loan. Aussie in turn acquired Wizard. Obviously CBA also acquired Bankwest and Westpac acquired St George. So I think there has been a demonstrable decline in competition…[54]

4.54 Evidence received backed the argument that the funding guarantees may even be exacerbating this:

> …the greatest recipients of the benefit provided by the Bank Funding Guarantees has been the limited number of stakeholders and proprietors of the four banks.[55]

4.55 Treasury state that they do not believe the guarantees have hurt smaller institutions:

> The introduction of the Financial Claims Scheme stemmed an outflow of deposits from some small institutions to larger institutions. According to

53 Senate Economics Legislation Committee, *Guarantee of State and Territory Borrowing Appropriation Bill 2009 [Provisions]*, June 2009.

54 Mr Christopher Joye, *Proof Committee Hansard*, 28 July 2009, pp 7-8.

55 Dr Michael Peters, *Submission 27*, p 1.

> APRA data, smaller institutions' deposits have grown at a faster rate than those of the large banks since the introduction of the guarantee schemes. A larger proportion of smaller institutions' funding is guaranteed automatically and for free under the Financial Claims Scheme relative to that of the four major banks. Lastly, a number of small institutions have actually increased their share of total wholesale term funding—that is, government guaranteed and non-guaranteed—since the guarantees were introduced.[56]

4.56 Concerning competition *between* banks, Treasury commented:

> The guarantees are expected to have a positive impact on stability, confidence and competition. Stability and confidence are important underpinnings for efficient, competitive markets. The guarantees support access to funding for all ADIs which is required for new lending – this improves competitive pressure in lending markets.[57]

> Non-major Australian banks' deposit bases have grown at a faster rate than the major banks' since the guarantees were introduced, and non-major institutions have increased their share of the wholesale term funding market. In addition, a larger proportion of smaller institutions' funding is guaranteed automatically and for free under the FCS relative to that of the four major banks.[58]

4.57 Unsurprisingly, Westpac claimed that the guarantee had not disadvantaged the smaller banks in competing with the major banks:

> …in the absence of a guarantee, it is more likely that a greater share of deposit funds would have flowed to larger ADIs (with relatively higher credit ratings) on the basis of the perceived greater security of these funds. On this basis, the Bank's position is that the guarantee has operated to preserve a level of stability of deposit funds within the system.[59]

4.58 APRA data show that the major banks increased market share in terms of deposits as the crisis developed, but not apparently at the expense of the regional banks. The guarantee appears to have arrested the loss of deposit market share being experienced by the credit unions and building societies (Chart 4.4).

---

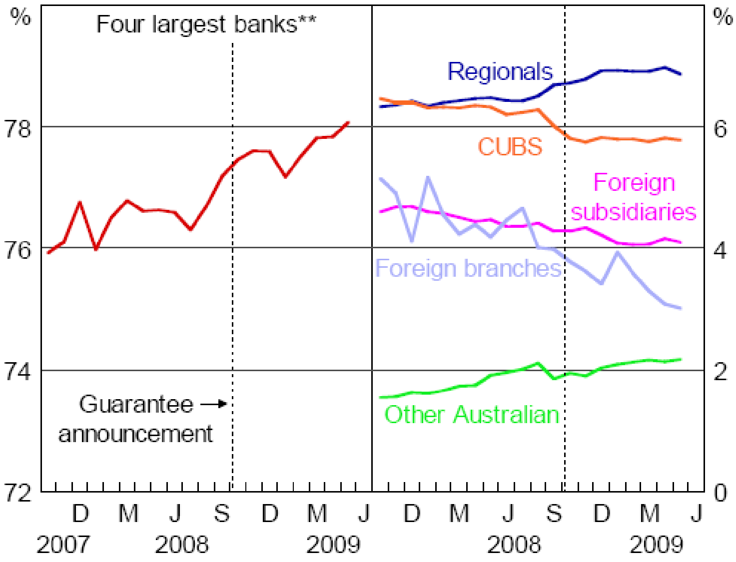
56 Mr Jim Murphy, Treasury, *Proof Committee Hansard*, 18 August 2009, p 3.

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

58 Treasury, *Submission 22*, p 2.

59 Westpac, *Submission 6*, p 3.

Chart 4.4: Share of ADI deposits



* Excludes certificates of deposit and foreign currency deposits. Adjusted for reporting changes.
** Includes St George and BankWest.

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

4.59 These matters overlap with the Economics References Committee's current inquiry into aspects of bank mergers. (The reduction in competition in interest rates is discussed in the following section.)

Committee view

4.60 There is always a tension between solvency and competition. To take an extreme case, a monopoly bank would be very profitable, and so robust in a crisis, but would be unlikely to provide low-cost or innovative products to its customers. APRA commented to the Committee that this tension is one reason why prudential supervision and competition are the responsibility of different agencies.[60]

4.61 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.

60 See discussion in *Proof Committee Hansard*, 28 July 2009, pp 32-3.

The impact on interest rates

4.62 Treasury argued that in the short-term:

> In the aftermath of the collapse of Lehman Brothers, it is likely that low liquidity in financial markets would have resulted in ADIs paying a substantially higher yield on issues on non-guaranteed securities, if they were able to sell them at all. In the absence of the Guarantee Scheme, it is likely that ADIs would have responded to such a high cost of funds by borrowing fewer funds in total, reducing the supply of credit, and passing the higher costs of funds to their new and existing borrowers. That is, the Guarantee Scheme is likely to have put downward pressure on borrowing costs for Australian households and businesses.[61]

4.63 As a beneficiary of the low-premium guarantee, it was unsurprising that a major bank said the guarantee meant domestic interest rates were lower than they otherwise might have been:

> …the guarantee has operated to moderate increasing pressures on overall bank cost of funds, with beneficial downstream impacts for our customers.[62]

4.64 The guarantees did not lower the cost of funds for smaller banks as much as had been anticipated:

> It was assumed that a relatively small differential would be applied by investors to guaranteed issues as the ultimate credit was the AAA Commonwealth of Australia. A small premium was expected to reflect potential liquidity differences and other factors. In practice, investors looked through the Guarantee and applied a full differential to AA and A credits in line with that being applied by the Government for the provision of the Guarantee. Investors continue to apply a 25-35bp spread differential between AA and A rated banks for Government guaranteed paper.[63]

4.65 The Treasury Secretary has referred to some initial impact:

> [The guarantee] has arguably already had an impact on interest rates. I stand to be corrected on this, but I think that the ANZ Bank in its announcement some days ago that it was cutting its mortgage lending rate by, I think, 25 basis points indicated that one of the reasons it was able to do so was the existence of these new arrangements.[64]

4.66 The Australian Bankers' Association concluded:

> The impact of the wholesale guarantee is likely to be negligible. While the government guarantee has the effect of reducing the risk-premium of lending to Australian banks, the government has imposed high premiums for this benefit. The premiums range between 70-150 basis points,

61 Treasury, *Submission 22*, pp 2-3.

62 Westpac, *Submission 6*, p 2.

63 Suncorp, *Submission 4*, pp 1-2.

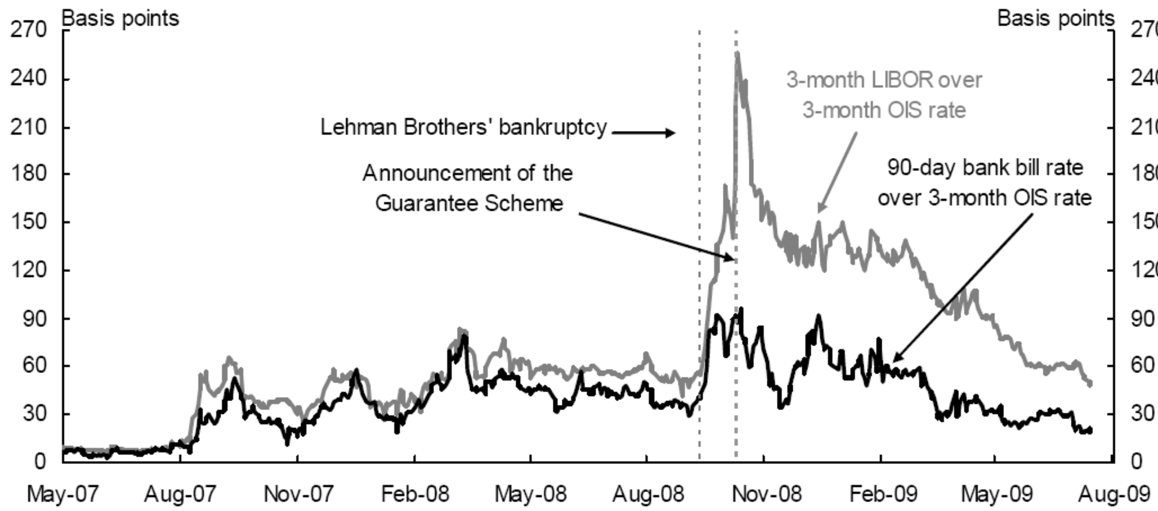
64 Dr Ken Henry, Secretary, Treasury, *Estimates Hansard*, 22 October 2008, p 67.

depending on the institution's credit rating. These premiums obviously feed into the retail interest rates of housing and business lending products. Competition between lenders has had the effect of keeping interest rates in close alignment, so the effect of differential premiums for the wholesale guarantee will be to disadvantage those institutions that have to pay the higher premiums. However, these same institutions are probably also the relatively higher beneficiaries of the non-priced deposit guarantee.[65]

4.67 The Reserve Bank recently published a comprehensive analysis of banks' funding costs.[66] The absence of any reference to the guarantees could be taken as a sign that the RBA did not regard them as having a large aggregate impact.

4.68 The measures had a significant impact on credit spreads (Chart 4.5).

Chart 4.5: Key credit spreads in Australia



Sources: Bloomberg and RBA

4.69 In the medium term, borrowers may face higher interest rates and depositors receive lower rates as the increased emphasis being placed on financial stability is reflected in less competition. The four major banks have regained market share in home lending, now accounting for around 80 per cent of new home loans. Bank interest margins, which had been narrowing for a long while, have recently widened again (Chart 4.6).

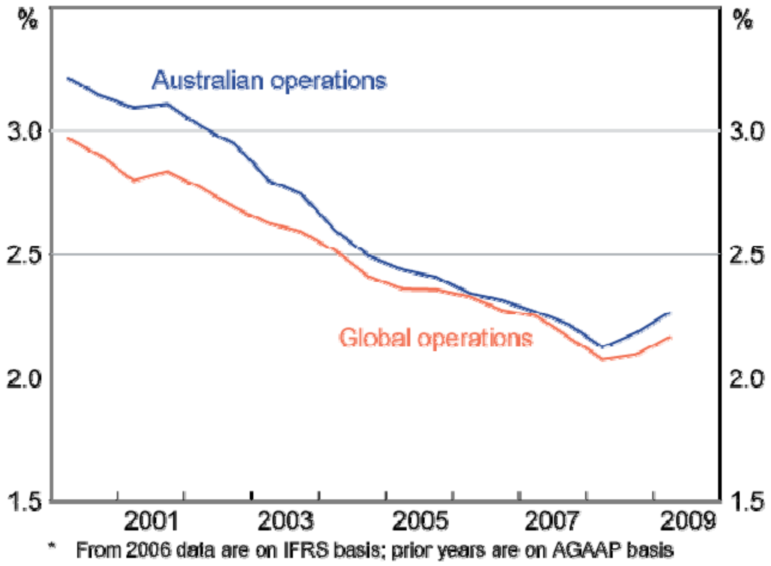
4.70 With less competition, there is more scope for banks to raise loan interest rates even without any increase in official interest rates by the Reserve Bank.

---

65 Australian Bankers' Association, *Submission 24*, p 4.

66 M Davies, C Naughtin and A Wong, 'The impact of the capital market turbulence on banks' funding costs', *Reserve Bank Bulletin*, June 2009.

Chart 4.6: Major banks' net interest margin



Source: Reserve Bank of Australia, 2009, 'The impact of the capital market turbulence on banks' funding costs', *Reserve Bank Bulletin*, June, p 4.

Committee view

4.71 The Committee believes that close consideration needs to be given to shifting the balance between stability and competition back toward the latter as conditions improve (as they already are) to ensure any medium- to long-term impact on competition is minimised.