Minority Report by Senator Xenophon

Introduction

1.1 The inquiry into Bank Funding Guarantees was established to examine their impact on the Australian financial sector, interest rates, consumer and business confidence and government contingent liabilities, and to compare the guarantees with similar arrangements overseas.

1.2 Following the serious deterioration of global financial markets in September-October 2008, Australia followed other governments to change or introduce caps on wholesale funding guarantees applying to existing deposit-protecting arrangements.

> "The Irish Government was the first to act in late September by providing a guarantee with an unlimited cap for deposits at the largest institutions, an approach followed by Austria and Denmark. In other countries, including the United States, United Kingdom and a number of EU countries the existing caps were significantly increased."[1]

1.3 Australia's measures were announced on 12 October 2009; guarantee arrangements for deposits and wholesale funding and a guarantee fee on large deposits.

> "They were designed to support confidence of depositors in authorised deposit-taking institutions and to help ensure that these institutions continued to have access to capital markets."[2]

Under the Financial Claims Scheme, all deposits under $1 million with Australian banks, building societies and credit unions and Australian subsidiaries of foreign-owned banks are automatically guaranteed by the Government, with no fee payable.

Under the Guarantee Scheme for Large Deposits and Wholesale Funding, eligible authorised deposit-taking institutions can, for a fee, obtain a government guarantee on deposits greater than $1 million, and wholesale funding with maturity out to five years.

The guarantee arrangements became full operational on 28 November 2008, following consultation between Council agencies and authorised deposit-taking institutions.[3]

1.4 Australia's measures were unprecedented in terms of its duration, the amount covered, fee and its scope. According to Professor Milind Saythe, from the ANZSOG Institute for Governance,

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[1] Joint submission from the RBA and APRA, *Submission 7,* pg 1

[2] Joint submission from the RBA and APRA, *Submission* 7, pg 1

[3] Joint submission from the RBA and APRA, *Submission* 7, pg 1

"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)."[4]

The effects on competition

1.5 Under the Guarantee Scheme, the government introduced a series of tiers based on the institutions credit rating, to determine its fee per annum.

For institutions rated AA- and above, the fee per annum is 0.7 percent (70 basis points);

For institutions rated A- to A+, the fee per annum is 1 percent (100 basis points); and

For institutions rated BBB+ or below and unrated institutions, the fee per annum is 1.5 percent (150 basis points).

1.6 Abacus–Australian Mutuals, which represents credit unions and mutual building societies and authorised deposit-taking institutions, argued in its submission to the Committee:

"In order to put competitive pressure on major banks in the interests of Australian households and small businesses, mutual authorised deposit-taking institutions (ADIs) need to be able to access wholesale funding, either directly in the case of large mutual ADIs, or indirectly through aggregation vehicles in the case of small mutual ADIs."[5]

1.7 This argument was also supported by the Finance Sector Union of Australia (FSU).

"Successive Australian Governments have endorsed the 4-pillars policy that prohibits mergers between the major banks. The FSU endorses this policy but has ongoing concerns that Australia appears to be moving slowly by inexorably towards a banking system that has only 4 pillars. The major banks largely dominate the Australian market – the guarantee should not assist them to become even more dominant."[6]

The Finance Sector Union goes on to state:

"The first priority of the guarantee was understandably to ensure stability and confidence in the banking system at a time of crisis (which it achieved); however it is

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[4] Professor Milind Sathye, *Submission23*, pg 2

[5] Abacus-Australian Mutuals, *Submission 19*, pg 4

[6] Financial Sector Union of Australia, *Submission11*, pg 3

critical that competition in the sector not be further eroded due to unintended ongoing consequences of the guarantee."[7]

'Moral Hazard'

1.8 One of the unintended consequences of bank guarantees by government is that there is the propensity for 'moral hazard'.

Moral hazard' is a notion that says a party insulated from risk may behave differently from the way it would behave if it were fully exposed to the risk.

1.9 In his submission to the Committee, Dr Sam Wylie from the Melbourne Business School at the University of Melbourne stated:

> "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 the 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."[8]

1.10 Similarly, Professor Milind Saythe stated in his submission that:

> "Unlimited guarantees, in particular, increase moral hazard and distort financial flows and investor behaviour, incentives and choice of institutions undergo a change. This was confirmed when Colonial and other institutions froze funds withdrawal within days of the announcement."[9]

1.11 Professor Peter Swan from the Australian School of Business at the University of New South Wales also shares these concerns, and says that there has been a long history of 'bank protectionism' in Australia, and says that these guarantees are:

> "… consistent with the Governments encouragement of the major banks to absorb the next layer of banks, St George, BankWest, RAMS, Aussie and Wizard, and thus further establish the Australian banking system as probably the most concentrated in the world, thus hampering the growth of competition."[10]

1.12 Professor Swan goes to say in his submission that:

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[7] Financial Sector Union of Australia, *Submission11*, pg 2

[8] Dr Sam Wylie, *Submission 15*, pg 7

[9] Professor Milind Sathye, *Submission23*, pg 2

[10] Professor Peter Swan, *Submission21*, pg 2

> "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. The taxpayer is, but other than voting the government out, can do very little about it. In order to protect the Australian taxpayer and solvency of Australian banks, the Government and Treasury should act now to phase out the scheme."[11]

Moving forward

1.13 When the bank funding schemes were announced in October 2008, the Government said it would continually monitor the Guarantee Scheme and will look to phase it back when market conditions normalise.

1.14 Professor Milind Sathye suggests that the government uses a phase-out approach to withdraw the scheme:

> "… roll back the deposit guarantee scheme in stages: to $100,000 by December 2009, to $60,000 by June 2010 and to $20,000 by December 2010."[12]

1.15 A number of economies are planning to coordinate their 'exits' from the full deposit guarantee in their respective jurisdictions – the Hong Kong Monetary Authority, Bank Negara Malaysia and the Monetary Authority of Singapore[13], for example. It was suggested in another of submissions to the Committee that Australia similarly look to mirror its withdrawal actions on other countries.

> "… given the interconnectivity of global financial markets, the wholesale funding guarantee can only be removed when other members of the G20 do so."[14]

> "… the Government should also consider what international practice is, in respect of guarantee arrangements, as critical factor in determining the timing and nature of the alteration or removal of the Australian government's Guarantee arrangements, so as to protect against any potential for a significant outflow of funds from Australia that may seek to "chase the Guarantee" of other jurisdictions."[15]

1.16 In addition, the Finance Sector Union recommends that the Government look to attach conditions to the guarantee in the interim, such as:

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[11] Professor Peter Swan, *Submission21*, pg 5

[12] Professor Milind Sathye, *Submission23*, pg 1

[13] Hong Kong Monetary Authority, *Press Release*, 22 July 2009

[14] Bank of Queensland, *Submission 10*, pg 3

[15] Investec, *Submission 5*, pg 4

- End off-shoring and maximise Australian jobs;
- Lend responsibly and effectively to all market segments; and,
- Observe basic social obligations.[16]

These conditions are designed to ensure that given the indirect taxpayer's support of banks, institutions are unable to use the financial crisis as "an excuse to retrench workers, downsize Australian operations or increase their interest rate margins"[17].

The FSU suggests breaches against these proposed conditions by authorised deposit-taking institutions could result in sanctions placed the institution such as the withdrawal of the guarantee.

Recommendation 1

That the government look to phase out the Guarantee Scheme in stages, and that adequate notice is provided to authorised deposit-taking institutions.

Recommendation 2

That second-tier banks are offered the same fees as the major banks for guarantees, or that an alternative pricing model for second tier banks is established, to ensure they are able to remain competitive.

Recommendation 3

That the Australian Prudential Regulation Authority monitors the investment behaviours of authorised deposit-taking institutions to ensure that it is not of greater risk than would normally occur without a Government Guarantee.

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[16] Financial Sector Union of Australia, *Submission11*, pg 3
[17] Financial Sector Union of Australia, *Submission11*, pg 2