The Senate

Economics
References Committee

Government measures to address confidence concerns in the financial sector - The Financial Claims Scheme and the Guarantee Scheme for Large Deposits and Wholesale Funding

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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.

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

[1] Morgan Stanley Capital International index, in US dollar terms; 1 June 2007 = 100. [2] Equally weighted average of CDS spreads (in basis points) for 18 major international banks; includes Lehman Brothers until 15 September 2008 and Merrill Lynch until 31 December 2008. [3] Three-month US dollar Libor minus overnight index swap (OIS) rates, in basis points.

Sources: Bloomberg; Markit; BIS calculations. Graph II.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.

Chapter 2
The deposit guarantees

The introduction of the deposit guarantees

2.1 The Government developed the deposit guarantee in consultation with Treasury, the Reserve Bank of Australia (RBA) and APRA, following discussions going back to early 2008.[1] The Government had announced in June 2008 its intention to introduce a 'Financial Claims Scheme' with a cap of $20,000 per depositor.

2.2 On 11 October, the Coalition called for the proposed cap to be raised from $20,000 to $100,000 in response to the deterioration in the international financial environment.[2]

2.3 On Sunday 12 October, after a meeting with the Secretary of the Treasury, the Treasurer announced a package of changes to Australia's financial system, including an uncapped guarantee for three years on all deposits of Australian authorised deposit-taking institutions.

2.4 The immediate aftermath of the announcement saw a run on redemptions for those institutions not benefiting from the proposed guarantee, together with controversy surrounding the extent to which the Government fully consulted on the proposed changes with the appropriate agencies, specifically the RBA.

2.5 From there the chronology was as follows:

> The Australian Government also moved to reassure depositors and investors in Australian ADIs, and to ensure that Australian ADIs were not disadvantaged compared to banks in other countries, by announcing guarantee arrangements for deposits and wholesale funding. This was announced on 12 October, with further details – including a guarantee fee on large deposits – announced on 24 October following advice from the Council of Financial Regulators. The Government noted in its announcement that the guarantee scheme arrangements would be reviewed on an ongoing basis and revised if necessary. The guarantee arrangements became fully operational on 28 November after a period of close co-ordination between Council agencies – in consultation with ADIs – to establish the necessary rules, processes, documentation and architecture.[3]

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1 Dr Ken Henry, Secretary, Treasury, *Estimates Hansard*, 22 October 2008, pp 10-11; Dr John Laker, Chair, Australian Prudential Regulation Authority, *Estimates Hansard*, 23 October 2008, p 7.

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

3 RBA & APRA, *Submission 7*, p 1.

2.6 Although it remains unclear to what extent the Government consulted and fully considered the impact and potential intended and unintended consequences of these measures, prior to first announcing them, what is evident from this chain of events, is that the Government was struggling in terms of its response to the financial crisis and that it found it frustrating that the Leader of the Opposition was calling for needed reforms prior to their announcing them.

2.7 Nevertheless, the Australian government eventually moved further than many other governments – even those facing more serious problems – in jumping from no guarantee or deposit insurance to an unlimited scheme.[4] This decision clearly increased the impact on non-bank financial institutions outside the scheme, a matter taken up in Chapter 4.

The fee for deposits over $1 million

2.8 While the deposit guarantee as eventually implemented was not subject to a cap, the guarantee offered for non-deposit forms of wholesale funding had a fee. The Government's position is now that that it was therefore necessary to impose a corresponding fee on very large deposits or there could be distortions in the financial markets as wholesale funding became reconfigured as very large 'deposits' to benefit from the free guarantee. The Government set $1 million as the threshold over which the fee would be payable, at the same rate as that applying to wholesale funding.

2.9 As the Treasury Secretary put it:

> A large deposit could in fact be a source of wholesale funding for a financial institution…If we continue with an unlimited guarantee for deposits, for which there is no charge, there is no insurance premium charged, but at the same time for short-term wholesale funding, we say, 'Yes, there is a guarantee but there is a charge,' then we will distort the short-term money markets.[5]

2.10 For large deposits, there has been relatively little demand for this guarantee, with the guarantee fee being paid on around $20 billion of deposits, around 2 per cent of total deposits.[6] The Reserve Bank and APRA report:

> Liaison with ADIs suggests that most depositors with over $1 million are not seeking the guarantee when they have to pay for it. The major exception is depositors with very conservative mandates, such as trustees and councils.[7]

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4 Professor Sathye notes 'Australia has the unique distinction of announcing an 'unlimited guarantee' from a 'no guarantee' situation'; *Submission 23*, p 2. Dr Ken Henry, Secretary, Treasury, gave evidence that, notwithstanding some media reports to the contrary, Treasury and the Reserve Bank were in agreement that the guarantee should be unlimited; *Estimates Hansard*, 22 October 2008, pp 16, 27 and 28.

5 Dr Ken Henry, Secretary, Treasury, *Estimates Hansard*, 22 October 2008, p 32.

6 RBA & APRA, *Submission 7*, p 10.

7 RBA & APRA, *Submission 7*, p 10.

2.11 APRA-regulated foreign bank branches are eligible to apply for a guarantee for liabilities from Australian residents with maturities up to the end of 2009 but they have to pay a fee for all these liabilities.[8]

The threshold for the fee

2.12 The $1 million threshold above which the guarantee is no longer free is essentially arbitrary. It was designed to be dramatically different to the $20,000 cap envisaged for normal times and to provide sufficient assurance to prevent bank runs.

2.13 It is hard to know whether $1 million was the 'right' amount to choose. As Professor Harper put it:

> …could they have done that with a guarantee of $250,000 or $500,000 or $100,000? I do not know the answer to that. In a sense, what I am saying is that I would far rather that the government erred on the side of too big a hit than too small a hit, because you only get one chance to do that in those circumstances. Fortunately, the government's intervention worked and I do not know if it would have worked at $500,000 or $250,000. If it had not worked, the chances of a second round working would have been much lower and we would have been in a much more difficult situation.[9]

2.14 Contrary to a view that bank runs result from small, less sophisticated and informed, investors (whose concerns could be addressed by a relatively small threshold), Professor Harper argued:

> These things start in the wholesale markets. The irrationality that you are talking about was amongst wholesale investment funds. Frankly, the banks, including our major banks, stopped lending to each other…you are not talking about ordinary Herald Sun-reading folk on the train…The ones who ought to have known better were frightened to the point of closing their balance sheets, not lending and hoarding cash—the whole lot. That is why, in my view, the best thing to do was to convince people who had a lot of money that it was all safe rather than the mums and dads with not that much.[10]

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8 Treasury, answer to question on notice sbt28, Supplementary estimates 2008-09. There are also further conditions; The amount guaranteed is limited to 110 per cent of the combined average value of short-term wholesale liabilities and deposits held by Australian residents in the 30 days up to and including 24 October 2008; branches cannot use guaranteed liabilities to directly support the parent bank or group (of which they are part) outside Australia; and the guarantee is only available if the liabilities are not guaranteed by the home authorities and the branch provides additional information about the parent bank's prudential compliance. AFMA makes the case for allowing foreign banks to participate; *Submission 20*, p 4. See also Treasury, *Submission 22*, p 9.

9 Professor Ian Harper, *Proof Committee Hansard*, 14 August 2009, pp 43-4.

10 Professor Ian Harper, *Proof Committee Hansard*, 14 August 2009, pp 44.

Criticism of the fee tiering

2.15 The fee structure matches that applying to the wholesale funding guarantee. A controversial feature of both fee structures is the relation between the fee and the credit rating of the ADI concerned. This is discussed in the following chapter.

International comparison

2.16 Many comparable countries extended the coverage of their deposit insurance schemes in the face of the crisis (Table 2.1 and Chart 2.1).

2.17 Comparing the Australian arrangements with those overseas, the Reserve Bank and APRA comment:

> The Australian arrangements share many common features with those introduced in other countries although, on balance, the range of parameters are generally at the more supportive end of those internationally.[11]

Table 2.1

Table 2: Changes in Selected Countries' Deposit Guarantee Arrangements

	Previous Limit	Current Limit	Termination Date
Australia	--	Unlimited: first $1 million is free, then voluntary access via Guarantee Scheme	12-Oct-11
Austria	€20 000	Unlimited	31-Dec-09
Belgium	€20 000	€100 000	--
Denmark	DKK300 000	Unlimited	30-Sep-10
Finland	€25 000	€50 000	Until further notice
Germany	€20 000	€50 000*	--
Greece	€20 000	€100 000	30-Oct-11
Hong Kong	HKD100 000	Unlimited	31-Dec-10
Ireland	€20 000	€100 000 (Unlimited for selected institutions)	28-Sep-10
Netherlands	€40 000	€100 000	--
New Zealand	--	NZ$1 million	12-Oct-10
Singapore	SGD20 000	Unlimited	31-Dec-10
Spain	€20 000	€100 000	--
Sweden	SEK250 000	The higher of €50 000 or SEK500 000, depending on exchange rate	--
Switzerland	CHF30 000	CHF100 000	--
United Kingdom	£31 700	£50 000	--
United States	US $100 000	US$250 000	31-Dec-13

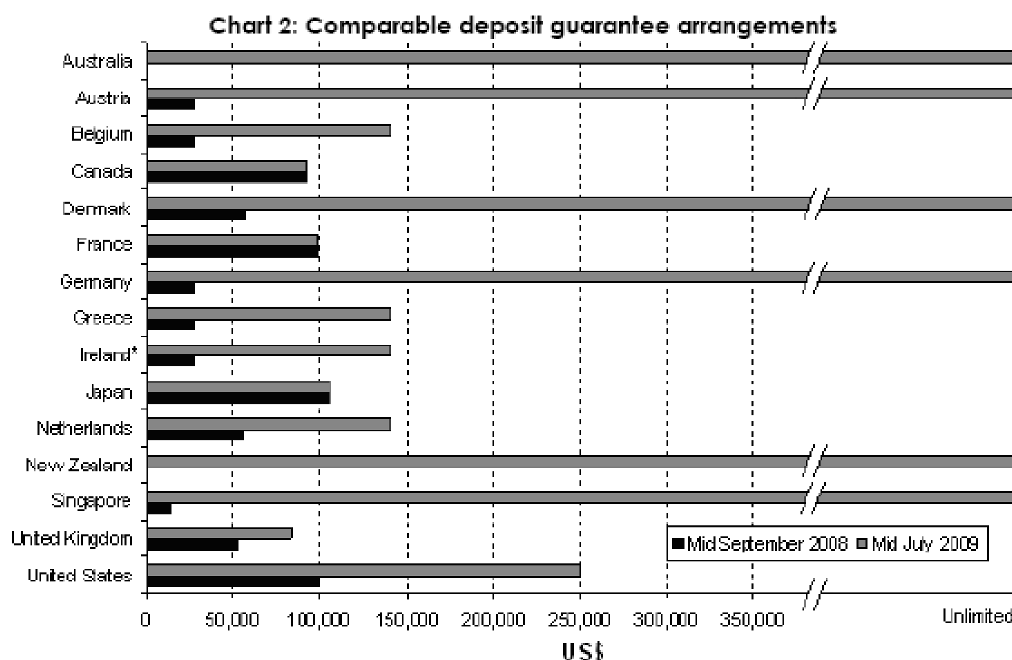
* Intended to increase to €100 000 in January 2011

Source: BIS; Countries' deposit insurers and regulators

Source: RBA & APRA, *Submission 7*, p 3.

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

Chart 2.1



Sources: Bank for International Settlements (BIS); Bloomberg; RBA; Treasury departments, central banks, debt management offices and guarantee administrators., XE.com.
Coverage limits converted into US dollars using bilateral exchange rates as at 1 August 2009.
* The Irish Government has also provided a 100 per cent guarantee for seven of its credit institutions and subsidiaries.

Source: Treasury, *Submission 22*, p 12.

2.18 The Committee questions whether, in a country where banks have remained well capitalised, highly profitable and well regulated, it was necessary to take action 'at the more supportive end of those internationally' to achieve the desired stability of the system, given some of the consequences discussed in this report.

Corresponding obligations

2.19 Some witnesses argued that the provision of a deposit guarantee should be associated with some increased obligations on banks:

> …such conditions should include measures to safeguard Australian jobs against practices such as off-shoring, maximise Australian employment, lend responsibly and effectively to all market segments and require the observation of social obligations ensuring that banks do not withdraw services to disadvantaged communities or groups.[12]

2.20 There have also been suggestions that banks should be restrained in their ability to increase housing loan interest rates (especially if the Reserve Bank has not made a corresponding increase in its policy rate), charge high interest rates on credit

12 Finance Sector Union, *Submission 11,* p 2.

cards and pay executive salaries exceeding $1 million when they are benefiting from funding guarantees.[13]

2.21 As these matters are currently being examined by the Economics Legislation Committee's inquiry into the Banking Amendment (Keeping Banks Accountable) Bill, they are not pursued further here.

13 *Herald-Sun*, 17 June 2009, p 33.

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.

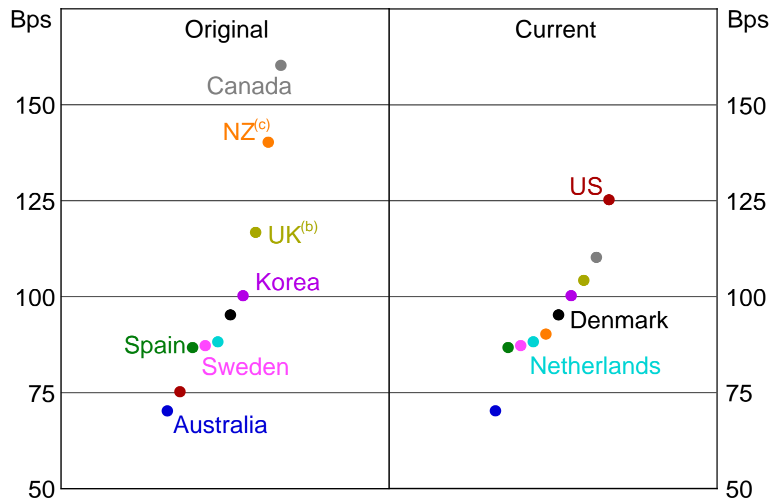
10 RBA *Financial Stability Review*, March 2009, p 46.

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]

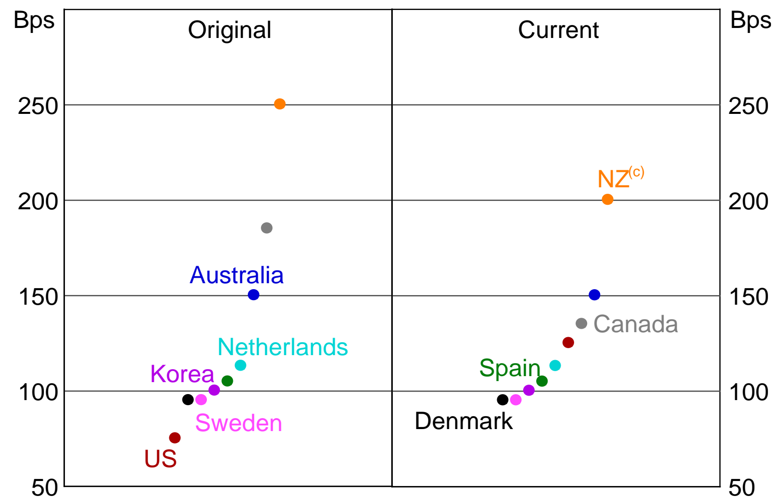


(a) Schemes where banks issue in their own name. Dispersion along horizontal axis is for presentation purposes only.
(b) RBA estimate based on CDS premiums
(c) New Zealand dollar fee (subtract 20 basis points for foreign currency fee)
Sources: BIS; treasury departments, central banks, debt management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

---

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.

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

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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.

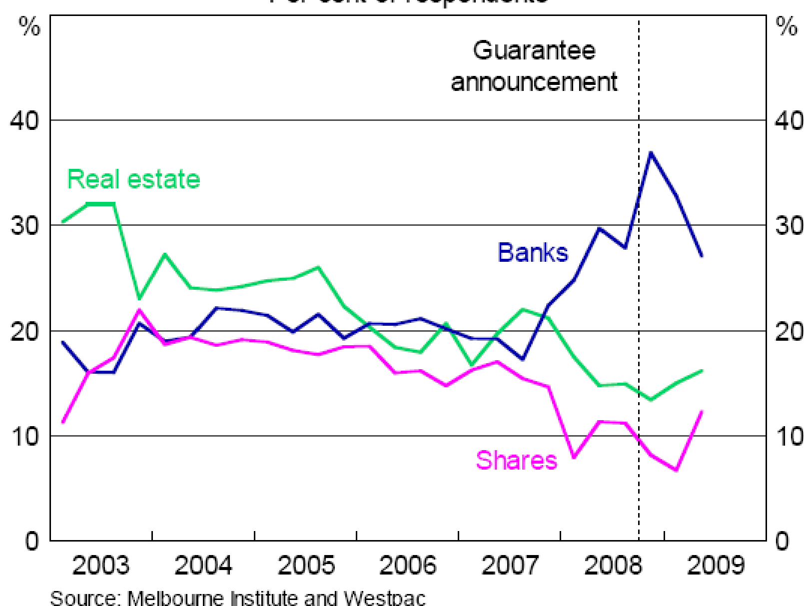
> ensured that households and businesses have been able to secure credit through the economic downturn.[6]

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:

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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.

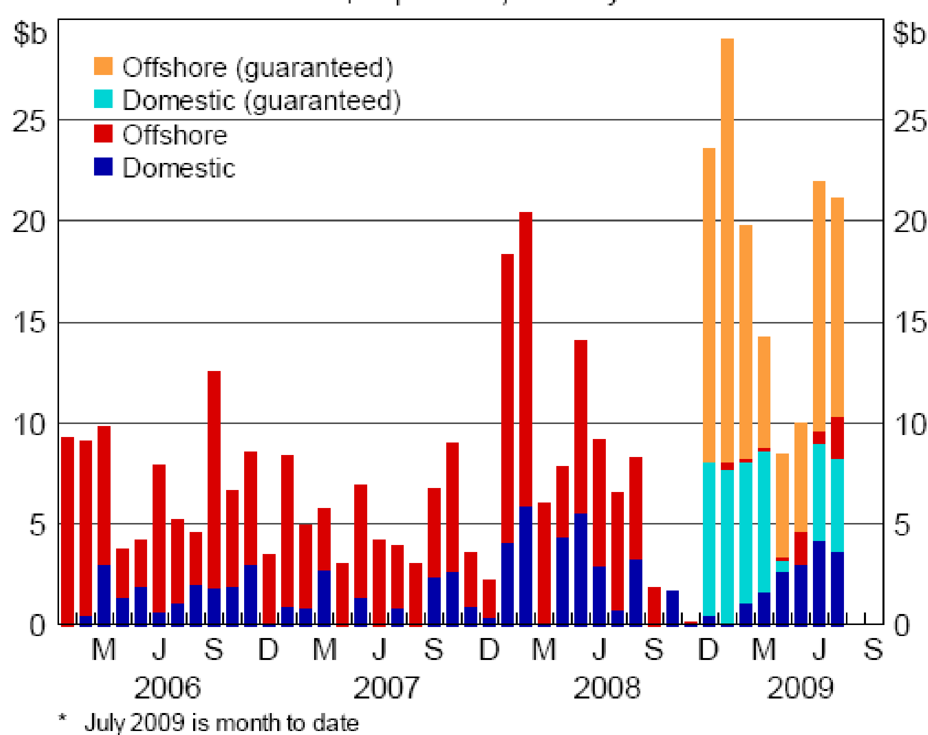
> Domestically, feedback from our regulated institutions is that the government's deposit and term funding guarantee, which APRA fully supports, has calmed what was a growing disquiet on the part of some depositors.[9]

> 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.

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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.

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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

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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]

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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]

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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

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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]

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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

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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]

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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.

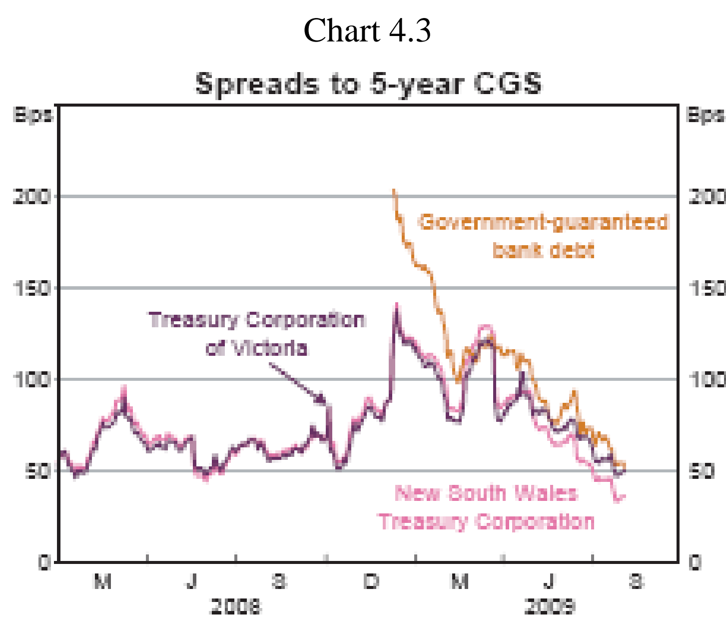
50 Mr Chris Dalton, Australian Securitisation Forum, *Proof Committee Hansard*, 14 August 2009, p 51.

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]

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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

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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).

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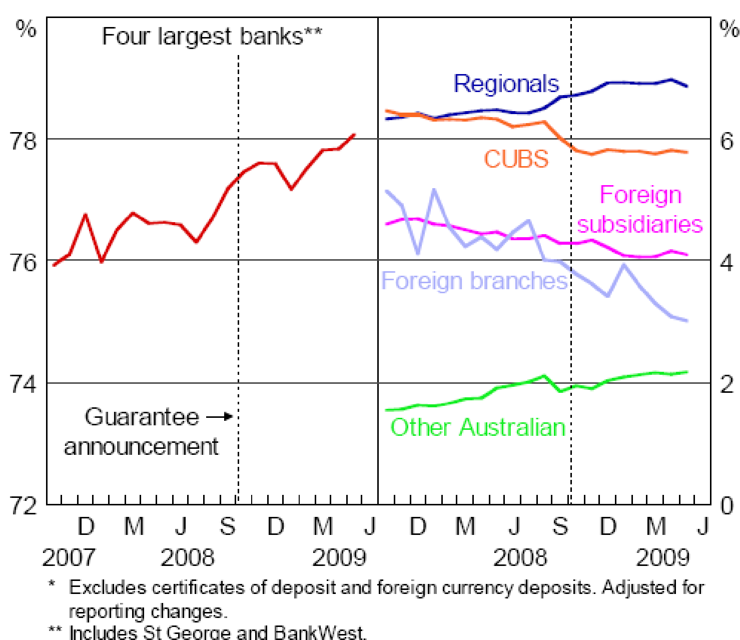
56 Mr Jim Murphy, Treasury, *Proof Committee Hansard*, 18 August 2009, p 3.

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



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.

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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,

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

62 Westpac, *Submission 6*, p 2.

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

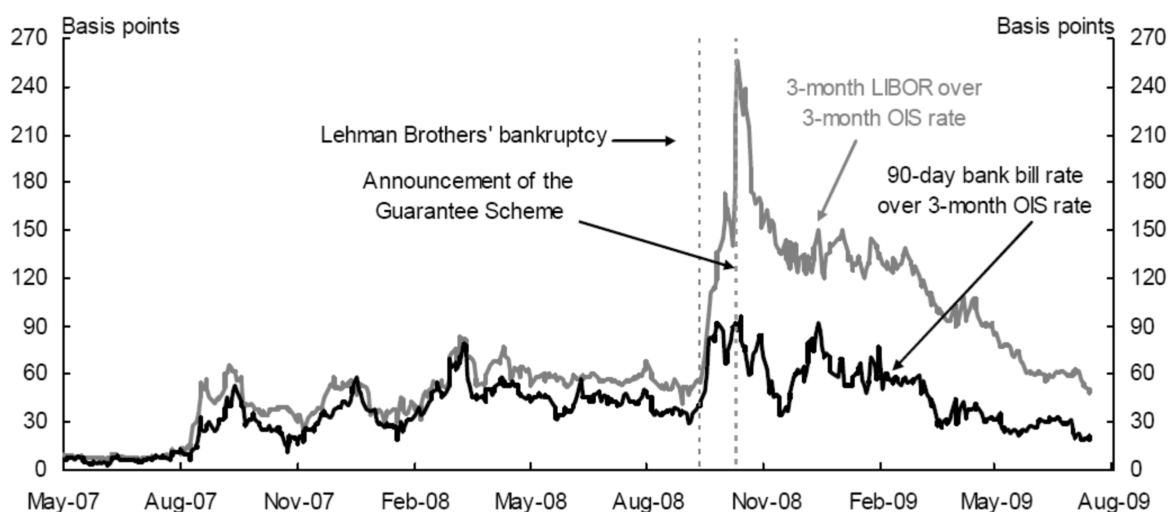
64 Dr Ken Henry, Secretary, Treasury, *Estimates Hansard*, 22 October 2008, p 67.

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.

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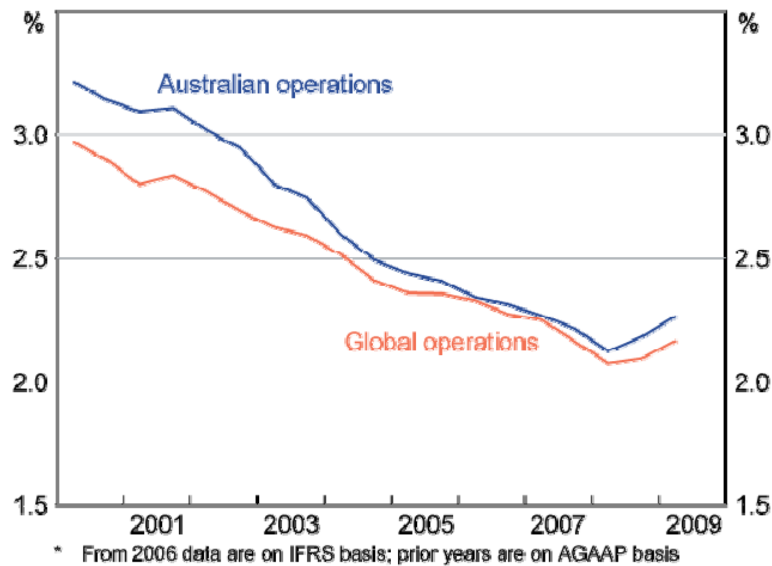
65 Australian Bankers' Association, *Submission 24*, p 4.

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.

Chapter 5
The transition to a permanent scheme

5.1 The global financial crisis constituted extraordinary circumstances calling for unusual responses. As Professor Harper put it:

> … the whole point of financial regulation is to achieve an appropriate balance between competitive efficiency and system stability. Something like the GFC obviously upsets that balance and raises the premium which a government should place on system stability at the expense of competitive efficiency, at least until things return to normal.[1]

5.2 While the Government has paid lip service to the need, once the global financial crisis eases (and evidence exists that it already is), for a transition to a more limited, permanent, scheme of depositor protection and no support for wholesale fundraising, it has done little to indicate how or when this might occur. This is despite calls by the Reserve Bank for the transition to start soon:

> For their part, banks will need to reduce their reliance on the extended guarantees and stand on their own feet before too much longer. The banks of the United States and Europe are starting down this path on their wholesale issuance, having recognised that it is in their own interests to do so. It would make sense for Australian banks, which have accounted for 10 per cent of global issuance of government‑guaranteed bank debt over the past nine months, to step up their efforts to do likewise.[2]

Removing the guarantees

5.3 Treasury is monitoring the situation:

> …I think it is a little premature to be thinking about exiting at this time…It may be that the second-tier banks will need the guarantee longer than, say, the majors.[3]

5.4 There are risks involved in leaving the guarantee in place too long:

> If you leave these things in place, you unduly strengthen the institutions that are inside the cordon, relative to their competitors on the outside of the cordon. The longer you leave it there, the more competitive strength they gather, which is really drawn on the strength of the guarantee rather than on competitive performance. In the worst case, you debilitate the system by

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1 Professor Ian Harper, Senior Consultant, Access Economics, *Proof Committee Hansard*, 4 August 2009, p 34.

2 Mr Glenn Stevens, Governor, Reserve Bank of Australia, Address to The Anika Foundation Luncheon, 28 July 2009.

3 Mr Jim Murphy, Treasury, *Proof Estimates Hansard*, 4 June 2009, p 26.

> making life so difficult for those outside the cordon that they eventually begin to fail or are absorbed by those inside the cordon and you create for yourself an inner core in the system which becomes certainly very stable but really too profitable for the long-term good of the efficiency of the system.[4]

5.5 An opinion poll conducted in June 2009 suggested the public still wanted the deposit guarantee in place then:

> Only 30 per cent of those surveyed said they would be comfortable keeping money in the bank with no guarantee. A guarantee of deposits up to $50,000 would satisfy 50 per cent of the population. A $100,000 guarantee finds two-thirds public support, while a $500,000 guarantee brings in 80 per cent.[5]

5.6 Of course, most Australians prior to the crisis thought their funds were already guaranteed!

5.7 The wholesale funding guarantee should be subject to a gradual phase-out, or what the RBA and APRA have called a 'natural exit mechanism':

> As market conditions normalise and funding markets ‘thaw’, it is expected that it will no longer be commercially viable for entities to rely on the guarantee.[6]

> …at some point investors will no longer be willing to accept the lower yields on guaranteed paper and banks will therefore no longer seek to insure their debt.[7]

> As the price and availability of credit normalises, non-guaranteed debt issues will become relatively more attractive, and at some point, paying the guarantee fee will become an uneconomic proposition.[8]

5.8 The Reserve Bank Governor was asked about this recently and commented:

> On the wholesale front, when the pricing of the fee for the guarantee was set it was set in a way that we hoped would be such that when market conditions normalised it would be too expensive to issue with the guarantee and would naturally therefore fall into disuse. We are probably not that far actually from that stage. I think that it would be good for our institutions to just start to issue in their own name anyway as much as they can. That is happening in other countries. I think that conditions have pretty much now sufficiently stabilised that it would be sensible for them to start doing that

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4 Professor Ian Harper, Senior Consultant, Access Economics, *Proof Committee Hansard*, 14 August 2009, p 35.

5 The poll was conducted for IFSA. *Australian Financial Review*, 7 August 2009, p 56.

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

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

8 Westpac, *Submission 6*, p 2.

even if it did cost slightly more in the short term, and I have said that publicly.[9]

5.9 Professor Swan said that this might apply to some banks but perhaps not the weaker banks:

I think that particularly the weaker banks who have trouble borrowing will want to go on relying on the guarantees as much as possible...[10]

5.10 One foreign bank emphasised the risks from uncertainty about the removal of the guarantees:

Certainty as to the mechanisms and timing of any changes or removal of the Government Guarantee arrangements is critical to maintaining confidence and stability in both retail and wholesale funding markets.[11]

5.11 There have been calls for considerable notice of any phase-out:

For the Wholesale Bank Funding Guarantee Scheme, the Government will provide a minimum notice period of 12 months prior to the closure of the Scheme to new issuance, and the Government will not provide such notice prior to the point in time that funding markets have normalised for all ADIs currently qualifying to utilise the Guarantee. (Investec believes that such “normalisation” is unlikely to be achieved prior to 1 January 2010).[12]

…information about the removal of the bank funding guarantee should be clearly communicated to the market well in advance of its scheduled implementation.[13]

5.12 Even some critics of the guarantees believe it needs to be phased out gradually rather than abruptly:

If the guarantee is now removed abruptly a flight of funds from small financial institutions to banks is likely which may endanger the very survival of these institutions. Consequently, the deposit guarantee roll back needs to be done with caution.[14]

5.13 Specific timetables for removal have been suggested:

…a gradual reduction of the $1 million threshold to $50 000 over the next 12 to 18 months (and in line with market conditions) with that level being retained for a further 12 months before being closed.[15]

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9 Mr Glenn Stevens, Governor, RBA, *Proof House of Representatives Economics Committee Hansard,* 14 August 2009, p 34.

10 Professor Peter Swan, *Proof Committee Hansard*, 14 August 2009, p 4.

11 Investec, *Submission 5*, p 3.

12 Investec, *Submission 5*, p 4.

13 AFMA, *Submission 20*, p 7.

14 Professor Milind Sathye, *Submission 23*, p 4.

15 IFSA, *Submission 8,* p 5.

> I suggest that the government 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.[16]

5.14 The Tasmanian Government suggested that markets should have been regarded as 'normalised', and so the guarantees withdrawn, once most of the following conditions (Table 5.1) have been met for one to three months.[17]

Table 5.1: Tasmanian Government criteria for normality

Market criteria	Measurement
The price of bonds guaranteed by the Commonwealth, relative to comparable Commonwealth bonds, is consistent with risks faced by investors	• Material contractions in credit spreads between Commonwealth bonds and Commonwealth-guaranteed bonds
Market pricing suggests there should be no bias for authorised deposit-taking institutions between issuing guaranteed and non-guaranteed bonds	• Increased issuance of non guaranteed debt by ADIs • Cost of issuing guaranteed debt and unguaranteed debt are closely aligned
Consistent demand for primary issues of semi-government bonds	• Central financing authorities are able to issue long-term debt (guaranteed and non-guaranteed) at a time and method of their choosing
Liquid secondary markets for semi-government bonds	• Reduced bid/offer spreads
Other entities are able to access credit markets to raise funds	• Increased primary issuance of bonds and other securities by corporates and non-bank lenders

Source: Tasmanian Department of Treasury and Finance, *Submission 16*, p 2.

International co-ordination of the transition

5.15 The Committee was presented with a broad consensus that the removal of the guarantee should be related to similar action in other countries:

> …we need to have a globally coordinated approach to evaluating the application and then ultimate removal of guarantees.[18]
>
> …any exit from the Guarantee Scheme for Large Deposits and Wholesale Funding should be gradual and implemented in a coordinated way, with other countries, in an atmosphere of international cooperation.[19]

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16 Professor Milind Sathye, *Submission 23*, p 1.

17 Tasmanian Department of Treasury and Finance, *Submission 16.*

18 Mr Christopher Joye, *Proof Committee Hansard*, 28 July 2009, p 15.

19 Mr Mark Degotardi, Abacus, *Proof Committee Hansard*, 14 August 2009, p 60.

We think that our banking system is strong enough to be a magnet for funds so long as they do not have to compete against other banks which have government guarantees. That is why the international agreement to remove them all is important for us.[20]

…the issue of when the funding guarantee should be lifted is one that is going to take an awful lot of international coordination.[21]

…the Government should also consider what international practice is… 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.[22]

…given the interconnectivity of global financial markets, the wholesale funding guarantee can only be removed when other members of the G20 do so.[23]

Australia could lead the way in discussions, but if Australia just made an announcement then there would be a rash of money running out of the country.[24]

…the guarantees should be removed in an orderly way, coordinated with similar actions in the major European and North American economies.[25]

…the removal of bank guarantee arrangements should be coordinated with similar actions in key overseas jurisdictions to ensure this is achieved in a smooth and non-disruptive manner.[26]

…it is also important to ensure that some kind of coordination exists amongst countries for terminating the government backed debt program.[27]

5.16 Treasury and the Reserve Bank have referred to global co-ordination:

Exit strategies from various actions that governments have taken are matters that are being discussed in the G20, the Financial Stability Board and other international meetings on these issues.[28]

…it is important to have some degree of coordination. I would not say that everybody has to do everything all at once or that you need to have some formal agreement because I think countries do have scope to go their separate ways. What we do will partly depend on market conditions and what happens in other countries. All of these things are part of ongoing

20 Mr Nicholas Hossack, Australian Bankers' Association, *Proof Committee Hansard*, 14 August 2009, p 23.

21 Mr Chapman, APRA, *Proof Committee Hansard*, 28 July 2009, p 34.

22 Investec, *Submission 5*, p 4.

23 Bank of Queensland, *Submission 10,* p 3.

24 Mr Porges, Chief Executive Officer, Aussie, *Proof Committee Hansard*, 28 July 2009, p 65.

25 ANZ, *Submission 18*, p 4.

26 Australian Financial Markets Association, *Submission 20*, p 1.

27 Professor Fariborz Moshirian, *Submission 25*, p 5.

28 Mr Jim Murphy, Treasury, *Proof Committee Hansard*, 18 August 2009, p 17.

> discussions through various international forums, particularly the FSB and the G20.[29]

5.17 Some other economies are planning to coordinate their measures. For example, the Hong Kong Monetary Authority, Bank Negara Malaysia and the Monetary Authority of Singapore announced recently the establishment of a 'tripartite working group to map out a coordinated strategy for the scheduled exit from the full deposit guarantee by the end of 2010 in their respective jurisdictions'.[30]

5.18 A recent press report warned that achieving global agreement will take time:

> …few expect a swift multi-lateral agreement given that some national banking systems are still on life support.[31]

5.19 Some countries have indicated termination dates for their schemes, although in a number of cases the original closing dates have already been extended (Table 5.2).

Table 5.2: Expiry dates for guarantee schemes

	Maximum maturity date / debt no longer covered		Final date for guaranteed issuance	
	Original	Change (if any)	Original	Change (if any)
Australia	Rolling 5 years	--	Unspecified	--
Belgium	31-Oct-11	--	31-Oct-09	--
Canada	30-Apr-12	31-Dec-12	30-Apr-09	31-Dec-09
Denmark	30-Sep-10	31-Dec-13	30-Sep-10	31-Dec-10
Finland	30-Apr-12	31-Dec-14	30-Apr-09	31-Dec-09
France	31-Dec-14	--	31-Dec-09	--
Germany	31-Dec-12	31-Dec-14	31-Dec-09	--
Ireland	29-Sep-10	--	29-Sep-10	--
Korea	30-Jun-12	31-Dec-14	30-Jun-09	31-Dec-09
Netherlands	31-Dec-12	31-Dec-14	31-Dec-09	--
New Zealand	Rolling 5 years	--	Unspecified	--
Spain	01-Jul-12	15-Dec-12	01-Jul-09	15-Dec-09
Sweden	30-Apr-12	31-Oct-14	30-Apr-09	31-Oct-09
UK	13-Apr-12	09-Apr-14	09-Apr-09	31-Dec-09
US	30-Jun-12	31-Dec-12	30-Jun-09	31-Oct-09

Sources: BIS; Treasury departments, central banks, debt management offices and guarantee administrators

Source: RBA & APRA, *Submission 7*, p 5.

29 Dr Malcolm Edey, Assistant Governor, Reserve Bank of Australia, *Proof Committee Hansard*, 28 July 2009, p 20.

30 Hong Kong Monetary Authority, *Press release*, 22 July 2009.

31 *Australian Financial Review*, 7 August 2009, p 56.

An ongoing deposit insurance scheme

5.20 There have been discussions about a possible deposit insurance scheme in Australia for a long time. In mid-2008 Australia and New Zealand were the only OECD countries not to have such a scheme.[32] There are around 100 deposit insurance schemes operating around the world, according to the International Association of Deposit Insurers.

5.21 Deposit insurance is regarded as a standard feature of the financial system in much of the world:

> Deposit insurance is a natural, optimal and permanent part of the financial system architecture in every country in the OECD for very good theoretical and practical reasons. It builds a firewall into the financial system that prevents large shocks to the banking system propagating to the household and business sectors.[33]

5.22 One reason deposit insurance had not been introduced in Australia is that the 1996 Wallis Inquiry recommended against it.[34] However the IMF supported such a scheme in its 2006 assessment of the Australian financial system.[35]

Committee view

5.23 The Committee considers such an alternative should be considered as part of the examination of options for an ongoing deposit guarantee.

The optimal cap for a permanent scheme

5.24 The Council of Financial Regulators advocated an Early Access Facility, which would provide early repayments of up to $20,000 per depositor in a failed institution.[36] In June 2008, the Government announced its intention to introduce a Financial Claims Scheme along these lines.[37]

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32 Mr Jim Murphy, Executive Director, Treasury, *Estimates Hansard*, 22 October 2008, p 188.

33 Dr Sam Wylie, *Submission 16*, p 1.

34 Professor Quiggin comments: 'the Committee's 1996 discussion paper did suggest looking at deposit insurance, but the idea was howled down so effectively that it made no appearance in the final recommendations'; *Submission 3*, pp 6-7.

35 RBA *Financial Stability Review*, September 2008, p 59.

36 RBA *Financial Stability Review*, March 2008, p 65.

37 RBA *Financial Stability Review*, September 2008, p 59. The scheme was to work as follows; 'the Scheme would be administered by APRA, with the necessary payments initially being funded by the Government. APRA, on behalf of the Commonwealth, would also be able to borrow from the Reserve Bank for the purpose of the Scheme. APRA would then have first claim over the assets of the failed entity. Only in the highly unlikely situation that APRA was unable to recover the full cost of the Scheme through the sale of the failed ADI's assets, would an industry levy be required.'

5.25 However, with the introduction of the guarantee schemes, deposits are currently guaranteed up to $1 million under the Financial Claims Scheme. This is believed to cover 99 per cent of depositors.[38]

5.26 There are a range of views about the appropriate cap for a permanent deposit insurance scheme:

> The monetary cap on deposit protection under the permanent financial claims scheme should be set at a level well below $1 million. The $20,000 threshold that was originally proposed is low relative to the international standard.[39]

5.27 Some lessons for design of deposit insurance have been drawn by the run on Northern Rock in the UK, the first on a UK bank for 130 years. The Reserve Bank commented:

> One aspect of the UK arrangements that has featured prominently in the post-crisis evaluations is the design of the deposit insurance scheme. Prior to the run, depositors were guaranteed to receive repayment of the first £2 000 of any deposit in a failed bank, and 90 per cent of the next £33 000. There were, however, no arrangements in place to make these repayments to depositors in a timely fashion. The combination of the 10 per cent 'haircut' on repayments above £2 000 and likely delays in repayment are widely thought to have contributed to the scale of the run.[40]

5.28 A key lesson in this is the timing issue. Whatever is put in place must deliver quick access to a substantial portion of depositors' funds.

5.29 An IMF survey has referred to average coverage levels in (pre-crisis) deposit insurance schemes being around one to two times per capita GDP, although they note:

> That ratio, however, is only a statistical description of deposit insurance systems and is not meant to be considered as a desired design feature.[41]

5.30 Given Australia's GDP of over $1 trillion and population of over 20 million, in round terms, one to two times per capita GDP would translate into a range of $50 000 to $100 000 as a coverage limit.

5.31 Some features of pre-crisis deposit insurance schemes are given in Table 5.3. Many of the schemes are long-established and are generally compulsory. One way in which they attempt to reduce moral hazard is by having risk-related premia.

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38 RBA *Financial Stability Review*, March 2009, p 43.

39 AFMA, *Submission 20*, p 6.

40 Reserve Bank of Australia, *Financial Stability Review*, March 2008, p 65.

41 Hoelscher, Taylor and Klueh, The Design and Implementation of Deposit insurance Systems, IMF Occasional Paper 251, 2006.

Table 5.3: Pre-crisis deposit insurance schemes

	Enacted	Compulsory?	Risk-adjusted premium?	Coverage US$'000 (ratio to per capita GDP)
Austria	1979	√	x	22.6 (0.7)
Belgium	1974	√	√	22.6 (0.8)
Canada	1976	√	√	42.8 (1.2)
Finland	1969	√	√	28.3 (0.9)
France	1980	√	√	79.1 (2.8)
Germany	1966	√	√	22.6 (0.8)
Hong Kong	2006	√	√	12.8 (0.6)
Japan	1971	√	x	82.3 (2.6)
Netherlands	1979	√	x	22.6 (0.7)
Norway	1961	√	√	282.5 (5.8)
South Korea	1996	√	x	42.0 (3.4)
Sweden	1996	√	√	30.9 (0.9)
Switzerland	1984	x	√	22.3 (0.5)
UK	1982	√	x	57.2 (1.9)
USA	1934	√	√	100.0 (2.8)

Source: Secretariat, calculated from data in Hoelscher, Taylor and Klueh, *The Design and implementation of deposit insurance Systems*, IMF Occasional Paper 251, 2006.

Senator Alan Eggleston

Chair

Labor Senators' Dissenting Report

Labor Senators dispute the accuracy of some of the views expressed in the majority report and are concerned about potential ramifications. Some of the statements made are at best misleading and at worst completely incorrect and may have the potential to negatively impact economic confidence. We believe that in a self-serving attempt to score political points, the report overlooks the serious challenge that the Government faces in steering Australia through the worst global economic downturn in three quarters of a century.

The Governments deposit and wholesale funding guarantees were introduced following the global deterioration in financial markets in September and October 2008. Treasury's submission to this inquiry notes the unprecedented circumstances that give context to this decision.

> ..the freezing of global credit flows and the introduction of financial sector guarantees internationally threatened the ability of Australian financial institutions to access funding. This had potentially serious implications for the health of individual financial institutions, the stability of the financial system, the flow of credit to Australian household and business borrowers, and consequently Australia's economic growth.[1]

Introduction of the Guarantees

Firstly Labor Senators would like to highlight one of many inaccuracies and inconsistencies in the majority report and clarify the order of events that brought about the introduction of the funding guarantees.

The Government developed the deposit guarantee in consultation with the Council of Financial Regulators, following discussions going back to early 2008. The Government had announced in June 2008 its intention to introduce a financial claims scheme (FCS) with a cap of $20,000 per depositor.

On the weekend of the 11-12 October 2008 the G7 and G20 Finance Ministers agreed to urgent and unprecedented action to address the credit crisis, including the strengthening of depositor protection and measures to assist financial institutions to raise funds.

The Government acted upon this decision immediately and on the 12 October the Government brought forward the introduction of the FCS. Legislation establishing the FCS was passed by Parliament on 16 October 2008 and received Royal Assent the following day. The Government noted in its announcement that the guarantee scheme arrangements would be reviewed on an ongoing basis and revised if necessary.

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[1] Submission 22, p5

On 28 October, following further advice by the Council of Financial Regulators, the Government announced that deposits under $1 million per depositor per ADI would be covered under the FCS whilst deposits above $1 million would be eligible for coverage under the Guarantee Scheme for Large Deposits and Wholesale Funding Scheme.

Treasury state in their submission to the inquiry that:

> *While introduction of the legislation was swift, development of the FCS had been under active consideration by the Council of Financial Regulators since 2004.*[2]

The majority report's assertion that the Government introduced the guarantees following calls for action from the Opposition is an absurd and a desperate attempt to take credit for the Government's ongoing and proven economic credibility.

Guarantees are not unlimited

The report's consistent referral to "unlimited" deposit and wholesale bank funding guarantees is highly misleading. The deposit guarantee is limited to deposits below $1 million dollars and will operate until 12 October 2011, at which time the cap will be reviewed. Treasury note that "the FCS is intended to remain in place as a permanent addition to Australia's depositor protection and crisis management framework"[3].

The wholesale funding incurs a fee as outlined in the majority report and is a temporary measure introduced due to the global financial recession that will be removed once conditions normalise. In fact the majority report specifically notes that the Government has so far earned approximately $0.5 billion in fees.

Labor Senators also note the irresponsible use of inflammatory language utilised in the report. In describing the "aftermath" of the announcement to introduce bank deposit guarantees the report describes "a run on redemptions for those institutions not benefiting from the proposed guarantee".

These types of descriptions are irresponsible in the current climate of economic uncertainty. Labor Senators are concerned that these kinds of remarks could lead to diminishing consumer confidence.

Premiums for ADI

Labor Senators note that, as explained in the majority report, the current premium tiers mean that ADI's with a lower credit rating are facing disproportionately higher premiums on funds than other schemes internationally. Under the current scheme,

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[2] Submission 22, p6

[3] Ibid, p7

ADI'S 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, whilst others pay 150 basis points.

Labor Senators note the RBA and APRA comment that:

> 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.[4]

ADI's such as regional banks, member owned or mutual financial institutions are subject to higher costs of raising funds. These institutions make the salient point that they are subject to the same level of government prudential management as the larger banks and therefore might be regarded at the same risk level. Labor members support a review of the fees charged for the wholesale funding guarantee, with a particular focus on narrowing the range to a more internationally consistent level.

Labor Senators do note that there is a need to plan for a cessation of the government guarantee and that the fees charged do play a role in the orderly withdrawal of this guarantee. This, of course, applies equally to differently rated banks.

Recommendation 1

Labor Senators recommend the Government review the application and range of existing wholesale funding guarantee fee schedule for ADI's to ensure that the fee levels charged are fair and consistent given contemporary market and economic conditions.

Residential Mortgage Backed Guarantees

Labor Senators would also like to draw attention to the inconsistencies throughout the report in regards to whether the guarantees go too far or whether they don't go far enough. The majority report says that:

> The Committee questions whether, in a country where banks have remained well capitalised, highly profitable and well regulated, it was necessary to take action 'at the more supportive end of those internationally'. [5]

The report also provides some detail on the "moral risk" and potential unintentional consequences of government bank guarantees and refers to the "lip service" paid by the Government in transitioning away from the guarantees.

However it goes off on a tangent to then recommend the introduction of a residential mortgage backed guarantee. So, on the one hand the report argues the existing guarantees have gone too far and should begin to be pared back but on the other hand

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

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the government should go further and introduce a residential mortgage backed guarantee in addition to the deposit and wholesale funding guarantees. This position advocates a further significant intervention by Government, which could certainly lead to the kind of serious unintentional consequences the majority report had previously found so iniquitous. Labor Senators find these opposing positions difficult to fathom.

Labor Senators nevertheless recognise the serious submissions put forward regarding the market in securities and the ability of smaller ADIs and non ADI institutions to raise and retain funds since the introduction of the bank guarantees. The risk aversion noted since the beginning of the global financial crisis has skewed the securitisation market. It is important to maintain competition and a range of financial products in the marketplace. We believe the Government should reassess the benefits of temporarily guaranteeing Residential Mortgage Backed Securities and therefore broadly agree with the recommendation of the majority report.

A very small debt – weathering the storm

Labor Senators would like to acknowledge and concur with the points made at the conclusion of chapter 3 in the report regarding Australia's very small debt compared to other countries as a result of the global recession. Labor Senators believe table 3.2 highlights the comparative strength of Australia's economic position internationally. This provides further evidence that the Government have acted responsibly and decisively throughout the economic crisis, to support Australian jobs and assist the Australian economy to weather the storm.

Senator Annette Hurley
Deputy Chair

Senator Louise Pratt

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:

[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

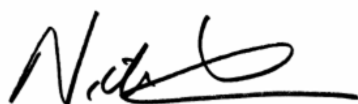
That the government look to phase out the Guarantee Scheme in stages, and that adequate notice is provided to authorised deposit-taking institutions.

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.



Nick Xenophon
Independent Senator for South Australia

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

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

APPENDIX 1

Submissions Received

Submission Number	Submitter
1	Name withheld
2	Professor Joshua Gans, Dr Nicholas Gruen, Christopher Joye, Professor Stephen King, Professor John Quiggin, Dr Sam Wylie
3	Professor John Quiggin
4	Suncorp Group
5	Investec Bank (Australia) Limited
6	Westpac Group
7	RBA and APRA
8	Investment and Financial Services Australia
9	Challenger Financial Services Group
10	Bank of Queensland
11	Finance Sector Union
12	Aussie
13	Confidential
14	Members Equity Bank
15	Dr Sam Wylie
16	Tasmanian Department of Treasury and Finance
17	Australian Finance Conference
18	ANZ
19	Abacus-Australian Mutuals
20	Australian Financial Markets Association
21	Professor Peter Swan
22	The Treasury
23	Professor Milind Sathye
24	Australian Bankers' Association Inc.
25	Professor Fariborz Moshirian
26	Australian Securitisation Forum
27	Mr Michael Peters

Additional Information Received

Received on 29 July 2009 from the Investment & Financial Services Association (IFSA). Two previous submissions by the IFSA regarding the government's guarantee of the deposit and wholesale funding of Australian deposit-taking institutions.

Received on 22 August 2009 from Professor Peter Swan. An article submitted in response to a Question on Notice, *The political economy of the subprime crisis: Why subprime was so attractive to its creators,* published in the European Journal of Political Economy, vol. 25, no. 1, March 2009.

Received on 11 September 2009 from Treasury. Charts relating to the funding composition of ADIs submitted in response to a Question on Notice.

TABLED DOCUMENTS

28 July 2009, SYDNEY NSW:

- Investment Trends Pty Ltd report *'IFSA: The Government's Guarantee on Bank Deposits - Key Findings'*

APPENDIX 2

Public Hearings and Witnesses

SYDNEY, Tuesday 28 July 2009

ANDERSON, Ms Anne, Head of Fixed Income, Asia-Pacific, UBS Global Asset Management, Investment and Financial Services Association

CHAPMAN, Mr Keith, Executive General Manager, Supervisory Support Division, Australian Prudential Regulation Authority

EDEY, Dr Malcolm Lawrence, Assistant Governor, Financial System,
Reserve Bank of Australia

GILBERT, Mr Richard, Chief Executive Officer,
Investment and Financial Services Association

JOHNSON, Mr Graham Neal, General Manager, Industry Technical Services, Supervisory Support Division, Australian Prudential Regulation Authority

JOYE, Mr Christopher,
Private capacity

PORGES, Mr Stephen, Chief Executive Officer,
Aussie Home Loans

SCHWARTZ, Mr Carl Justin, Deputy Chief, Financial Stability Department,
Reserve Bank of Australia

SORBY, Mr Joseph, Senior Policy Manager,
Investment and Financial Services Association

CANBERRA, Friday 14 August 2009

BELL, Mr David Peter, Chief Executive Officer,
Australian Bankers' Association

DALTON, Mr Chris, Chief Executive,
Australian Securitisation Forum

DEGOTARDI, Mr Mark, Head of Public Affairs,
Abacus-Australian Mutuals Ltd

HARPER, Professor Ian Ross, Director,
Access Economics Pty Ltd

HOSSACK, Mr Nicholas, Director, Prudential, Payments and Competition Policy,
Australian Bankers' Association

KANGATHARAN, Mr Ram, Group Executive and Chief Financial Officer,
Bank of Queensland

LAWLER, Mr Luke, Senior Adviser,
Abacus-Australian Mutuals Ltd

SATHYE, Professor Milind,
Private capacity

SWAN, Professor Peter,
Private capacity

TUTTLE, Mr Patrick, Deputy Chairman,
Australian Securitisation Forum

CANBERRA, Tuesday 18 August 2009

BATH, Mr Michael Paul, Director, Financial Risk,
Australian Office of Financial Management

HYDEN, Mr Neil Francis, Chief Executive Officer,
Australian Office of Financial Management

MARTINE, Mr David, General Manager, Financial Systems,
Treasury

MURPHY, Mr Jim, Executive Director, Markets Group,
Treasury

WIJEYEWARDINE, Ms Kerstin, Manager, Banking Unit,
Treasury