Chapter 3
The bill

Background - the Financial Claims Scheme

3.1 The Financial Claims Scheme, or 'deposit guarantee' as it is more commonly known, has been the subject of a recent report by the Economics References Committee.[1]

3.2 At present the Scheme offers a 'free' guarantee on all deposits up to $1 million. There is an optional guarantee (under the 'Large Deposits Guarantee Scheme') for larger deposits at a fee equivalent to that charged for the guarantee on wholesale funding. However, this broad coverage reflects the extraordinary circumstances of the current global financial crisis. The Government has announced it will only operate until October 2011.

3.3 The scheme envisaged before the crisis struck, originally known as an 'early access facility', was to only apply to deposits up to $20,000.[2] It has not yet been decided to what level of deposits the permanent scheme will apply.

3.4 Such 'deposit insurance' schemes are common around the world. It has been noted that:

> An IMF survey has referred to average coverage levels in (pre-crisis) deposit insurance schemes being around one to two times per capita GDP… 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.[3]

Should the banks face obligations in exchange for the deposit guarantee?

3.5 It has been suggested that the bank funding guarantees provide a substantial benefit to the banks at a potential cost to the public purse and that it is therefore reasonable to expect the banks to provide something in return. For example, the Finance Sector Union suggest:

> …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

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1 *Government measures to address confidence concerns in the financial sector - The Financial Claims Scheme and the Guarantee Scheme for Large Deposits and Wholesale Funding*, 17 September 2009.

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

3 *Government measures to address confidence concerns in the financial sector - The Financial Claims Scheme and the Guarantee Scheme for Large Deposits and Wholesale Funding*, 17 September 2009, p 50.

> observation of social obligations ensuring that banks do not withdraw services to disadvantaged communities or groups.[4]

3.6 Another example of a possible obligation is to accept some restraint on their mortgage interest rates as envisaged by this bill.

3.7 On the other hand, the banks argue that no obligation should arise as the deposit guarantee is underwritten by the banks collectively rather than taxpayers.[5] This is presumably a reference to the industry levy proposed for the original financial claims scheme with the $20,000 cap.

3.8 Professor Sathye was the only witness to give (qualified) support to the bill. However, he argued the requirements should be tied to the temporary wholesale funding guarantee rather than to the ongoing Financial Claims Scheme:

> …I support the bill where the public wholesale funding guarantee is provided. This means that there needs to be a full pass-through of the quantum of the OCR [official cash rate] reduction.[6]

Impact on monetary policy effectiveness

3.9 An argument for tying movements in bank lending rates to those in the official interest rate is that it makes monetary policy more effective. The bill would mean that the Reserve Bank would know that the movement it chooses to make in its official rate will be fully reflected in the interest rate affecting household spending decisions (although deposit rates which also affect households' decisions to spend or save, credit card interest rates and business loan rates would still not be tied to the official rate).

3.10 This is the basis for Professor Sathye's qualified support for the bill:

> The OCR, the official cash rate, is reduced to push more credit into the economy and raised to curb credit expansion. I would particularly support the bill when the OCR is being reduced to kick-start the economy. When banks do not do a full pass-through, the monetary policy, in my opinion, gets stunted…[7]

3.11 However, Professor Sathye is less supportive of the bill in an environment where the Reserve Bank is increasing interest rates, which most commentators expect to be the case for the foreseeable future:

> However if it is the other way around and the OCR [official cash rate] is being raised in order to curb credit expansion in the market and the banks end up trying to raise their lending rates above the OCR, then probably the

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4 Finance Sector Union, *Submission 11* to Economics References Committee inquiry on bank funding guarantees, p 2.

5 Australian Bankers' Association, *Submission 24* to Economics References Committee inquiry on bank funding guarantees, pp 6-7.

6 Professor Milind Sathye, *Committee Hansard*, 5 October 2009, p 2.

7 Professor Milind Sathye, *Committee Hansard*, 5 October 2009, p 2.

> monetary policy objective is being achieved through the banks' actions…. [when interest rates are rising the bill] is probably not very desirable in the sense that we do not want to go to a system of prescribed interest rates.[8]

3.12 Under section 18F a bank *cutting* mortgage interest rates in the absence of a cut in official rates, or failing to pass on (in full) an increase in official rates would not have to send an explanation to the treasurer, even though this is also going against the policy intentions of the Reserve Bank.

3.13 The Reserve Bank itself does not seem particularly perturbed about banks not always exactly following its movements in official interest rates.

> …the banks' overall funding costs have not come down quite as much as the cash rate has, so the overall rates that they have to earn off the whole portfolio of loans were not going to come down as much as the cash rate did. Of course, we took account of that in deciding how far down to go on the cash rate.[9]

> Of course, in setting the cash rate, the Reserve Bank has taken account of these shifting relationships, just as it does shifts in other relationships in the monetary transmission mechanism.[10]

3.14 Home loan lenders believe the bill would not be helpful to monetary policy as by requiring the treasurer's assent to some bank decisions it would 'politicise' interest rates:

> The bill politicises interest rate setting by giving the Treasurer the power to determine bank product prices through interest rate control. This is a form of price control which is inconsistent with a market based economy and has been rejected by the last two major inquiries into Australia's financial system, the Wallis inquiry in 1997 and the Campbell inquiry in 1980. One of the reasons why the Campbell inquiry rejected price control was that it ultimately proves unfair to low-income earners. Politicisation of interest rate setting is inconsistent with sound monetary policy, whereby it is recognised that interest rate setting should be independent of the political arm of government. This is why the government has exchanged letters with the Reserve Bank assuring the central bank that it should act independently in setting official interest rates. The same principle should apply to retail rates.[11]

> Price intervention in response to a highly political and public issue will compromise the Reserve Bank's ability to act independently and sets a very dangerous precedent for the wider community. It has always been

8 Professor Milind Sathye, *Committee Hansard*, 5 October 2009, p 3.

9 Mr Glenn Stevens, Governor, Reserve Bank of Australia, *House Economics Committee Hansard*, 20 February 2009, p 8.

10 Mr Glenn Stevens, Governor, Reserve Bank of Australia, Address to Smart Capital 2008: The Euromoney Australian Financial Markets Innovation Congress, Sydney - 27 March 2008, cited by Australian Bankers' Association, *Submission 3*, p 1.

11 Mr David Bell, Chief Executive Officer, Australian Bankers' Association, *Committee Hansard*, 5 October 2009, p 7.

> government policy that interest rates are set independent of government. We do not support government intervention in rate setting in the manner proposed in the Bill.[12]

Coverage and definitions in the bill

3.15 The bill only covers standard variable rate mortgages, which are the majority of home loans. It would have caused a problem if it also referred to the rate charged on new fixed rate mortgages as these rates are generally set based on deposit rates of a corresponding maturity, which reflect the *expected* official rates over the term, rather than the *current* official rates.

3.16 The bill uses the term "bank" to refer to 'an authorised deposit-taking institution to which Division 2AAA applies'. As their industry body, Abacus, notes, this means it covers building societies and credit unions as well as banks.[13] This could prove an administrative problem if a large number of credit unions wanted to move rates around the same time (in the absence of a move in official interest rates) as there are over 100 credit unions.

3.17 Under section 18D, 'movements in official interest rates' are those announced 'following meetings of the Reserve Bank board'. It might be argued that the bill would not apply to cases where the board had given the Governor limited discretion to act between meetings, or decisions were taken by a more informal contact between board members.

3.18 Under section 18F, the bill applies to three cases;

- a bank not making a corresponding cut to its mortgage rate (within five business days) when the Reserve Bank cuts the official rate[14];
- a bank increasing its mortgage rate when the Reserve Bank has not moved the official rate; and
- a bank increasing its mortgage rate by more than the Reserve Bank has increased its official rate.

3.19 The bill is unclear whether a bank making such a move must automatically send an explanation to the treasurer (as implied by s18B(2)(b)) or whether it is up to the treasurer to request in writing such an explanation (as implied by s18G(1)).

3.20 If the bank fails to provide a satisfactory explanation to the treasurer, the treasurer can tell the bank to set its mortgage rate at a different level and/or declare that the bank's decision is 'contrary to the public interest'. This term has been criticised by a submitter:

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12 Abacus, *Submission 6*, p 2.

13 Abacus, *Submission 6*, p 1.

14 The exact wording is 'within 5 business days of a reduction in official interest rates, the bank fails to reduce its standard variable rate by at least the same amount, **or at all**'[emphasis added]. Professor Sathye would like 'or at all' dropped, as he is concerned that a bank can meet the requirement by cutting its interest rate by 0.001 per cent; *Submission 1*, p 4.

> I find the term public interest too vague and that it will give ample occasion for greediness to find a way through.[15]

3.21 If the bank fails to comply with the treasurer's direction, then the treasurer can determine that the Financial Claims Scheme will cease to apply to that bank. (The treasurer can later revoke such a determination.)

3.22 It is not clear whether this would mean that the Scheme would not apply to new deposits or also to existing deposits. It may be argued that it is unfair to depositors that have placed funds in a term deposit on the understanding that they would be covered for that guarantee to be withdrawn before the deposit matures. It could also undermine the aim of the scheme which is to support confidence in bank deposits:

> …when you give a guarantee and then you withdraw the guarantee, the decision of the investor who invested the money at the time when the guarantee was in place is now affected because of the withdrawal of the guarantee. The investor will not know at the time when he invests the money how the bank will comply with the requirements of the government. Another thing that can happen is that it will impact the fundraising by other banks, because investors may then be wary as they may not know whether these banks will also be complying with the government rules or not and whether there is a risk of the guarantee being withdrawn. So in my opinion this is likely to affect the investor decisions. And from that perspective I feel that, instead of giving the signal to the market, it is always useful to keep it internal and impose a financial penalty rather than a withdrawal of the guarantee itself.[16]

3.23 It is also unclear whether the bill applies to deposits of over $1 million, for which a fee is being paid for the guarantee. Professor Sathye has commented that the reference to 'funds' in s18B(1) of the bill needs to be clarified.[17]

Is the penalty credible?

3.24 Doubts have been raised about whether removing the deposit guarantee from a bank is a credible threat:

> Such a power in my opinion would be hard to exercise in practice. Withdrawal of deposit guarantee for whatever reason would result in a run on that financial institution which the government could ill afford. A bank may *not* set mortgage interest rates in line with the official cash rate as it knows that the government can’t revoke guarantee due to financial stability considerations. The proposed Amendment then is ineffective and is only a paper tiger![18]

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15 Ms Irene Schardijn, *Submission 2*, p 1.

16 Professor Milind Sathye, *Committee Hansard*, 5 October 2009, p 2.

17 Professor Milind Sathye, *Submission 1*, p 3.

18 Professor Milind Sathye, *Submission 1*, p 3.

3.25 As the Professor argues, the withdrawal of the guarantee from one bank may remove the confidence-inspiring effect of the guarantee on other banks. He suggests as an alternative:

> An alternative could be to insert a penalty provision which could require erring banks to pay to the government a penalty equivalent to (official cash rate minus the actual rate charged by the bank) multiplied by the total loans and advances outstanding.[19]

Impact on banks' rate setting

3.26 It is possible that the bill could discourage lenders cutting mortgage interest rates in the absence of a cut in official rates, as the bill would prevent them later (even partially) reversing such decreases. Similarly, the bill may discourage a lender refraining from passing on (in full) an increase in official rates, as if they leave it more than five days the bill would not allow them to 'catch up'.

> Mutual ADIs have frequently reduced their interest rates outside of changes to the RBA cash rate for the benefit of their members. This Bill would place pressure on institutions to limit their mortgage rate changes to movements in the cash rate – this would not necessarily be of benefit to consumers.[20]

3.27 Home mortgages amount to about half of banks' loans. If banks are restricted from raising interest rates on these loans, it might be argued this would put upward pressure on interest rates on personal and business loans:

> The proposed Bill applies only to mortgage rates and therefore poses the risk that other forms of credit will become more expensive or that fees will rise. Younger people, who rely on personal loans and credit card debt, will find themselves subsidising those who hold a mortgage; a poor outcome for consumers.[21]

3.28 Alternatively, there is a risk that the bill will make mortgage lending less profitable than other forms of lending and so lead to a return to the credit rationing that occurred when interest rates were heavily regulated in the 1950s and 1960s. There were also 'hidden charges' such as banks only lending to customers who had shown 'loyalty' (some would say 'fealty') by placing funds for a long period in low-interest deposit accounts:

> The Australian financial market was substantially deregulated in the 1980s. Before this the interest rate which a bank could charge for a home loan was controlled. Quantitative lending controls placed ceilings on interest rates that could be charged to borrowers. In this period, access to housing finance for many consumers was limited. The regulatory restrictions on the price of credit caused a restricted credit supply. As a result, only customers with a

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19 Professor Milind Sathye, *Submission 1*, p 4.

20 Abacus, *Submission 6*, p 2.

21 Abacus, *Submission 6*, p 2.

> very good credit record and high income or savings were able to obtain a home loan without needing to resort to supplementary forms of finance.[22]

3.29 When the ABA appeared at the hearing, they referred to the Campbell inquiry, which found that interest rate controls disadvantaged low-income earners:

> …if you have a control and you are restricting the bank in recovering costs then the bank looks for other ways to cover those costs, such as doing more business with those who have got high levels of collateral or who have got higher offsetting balances in deposit accounts. These tend to be people who are wealthier.[23]

Confidentiality of bank affairs

3.30 Under section 18I of the bill, the treasurer can require APRA, ASIC or the Reserve Bank to provide information 'including a matter relating to the affairs of a bank'. This could involve the disclosure of commercial-in-confidence information.

Committee's conclusions

3.31 The committee is not convinced of the merits of the bill. In particular, it is concerned that the bill may discourage banks from competing in reducing interest rates, could lead to higher bank fees and/or reduced lending to homebuyers, could raise doubts about the deposit guarantees and so reduce confidence in the safety of bank deposits and could be perceived as politicising the setting of bank interest rates.

3.32 The goal of increasing the accountability of banks could be better achieved by increasing information as addressed in the first recommendation. The goal of discouraging banks from unduly increasing interest rate margins at the expense of homebuyers can be better achieved by measures to make the market more competitive, such as the recent initiative by the Government to facilitate customers moving between banks.

Recommendation 2

3.33 The Committee recommends that the Senate not pass the bill.

Senator Annette Hurley

Chair

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22 ANZ Bank, *Submission 4*, p 2.

23 Mr Nicholas Hossack, ABA, *Committee Hansard*, 5 October 2009, p 12.