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SENATE

ECONOMICS REFERENCES COMMITTEE

Reference: Bank funding guarantees

TUESDAY, 28 JULY 2009

SYDNEY

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SENATE ECONOMICS

REFERENCES COMMITTEE

Tuesday, 28 July 2009

Members: Senator Eggleston *(Chair),* Senator Hurley *(Deputy Chair),* Senators Bushby, Joyce, Pratt and Xenophon

Participating members: Senators Abetz, Adams, Back, Barnett, Bernardi, Bilyk, Birmingham, Mark Bishop, Boswell, Boyce, Brandis, Bob Brown, Carol Brown, Cameron, Cash, Colbeck, Jacinta Collins, Coonan, Cormann, Crossin, Farrell, Feeney, Ferguson, Fielding, Fierravanti-Wells, Fifield, Fisher, Forshaw, Furner, Hanson-Young, Heffernan, Humphries, Hutchins, Johnston, Kroger, Ludlam, Lundy, Ian Macdonald, McEwen, McGauran, McLucas, Marshall, Mason, Milne, Minchin, Moore, Nash, O'Brien, Parry, Payne, Polley, Ronaldson, Ryan, Scullion, Siewert, Sterle, Troeth, Trood, Williams and Wortley

Senators in attendance: Senators Bushby, Eggleston, Joyce and Pratt

Terms of reference for the inquiry:

To inquire into and report on:

(a) the circumstances and basis of the decision to introduce an unlimited bank deposit guarantee and of subsequent decisions to change or define the guarantee;

(b) the circumstances and basis of the decision to introduce an unlimited wholesale bank funding guarantee and of subsequent decisions to change or define the guarantee;

(c) the effect that the initial announcement of, and subsequent changes to, an unlimited bank deposit guarantee had on operations of the Australian financial sector, including for entities not regulated by the Australian Prudential Regulation Authority (APRA);

(d) the effect that the initial announcement of, and subsequent changes to, an unlimited wholesale bank funding guarantee had on the operations of the Australian financial sector, including for entities not regulated by APRA;

(e) the estimated effect of the bank deposit and wholesale funding guarantees on interest rates in Australia;

(f) how Australia's deposit guarantee and wholesale funding guarantee schemes compare with guarantees offered in other countries and the way in which these schemes were introduced and changed in major overseas countries;

(g) the interaction between the deposit guarantee scheme and other recent measures implemented by the Government since September 2008, including the wholesale funding guarantee and the purchases of residential mortgage backed securities;

(h) the nature of the financial and economic distortions that the unlimited deposit guarantee scheme has created vis-a-vis savings products that are not covered by the guarantee scheme;

(i) the optimal cap, if any, for the deposit guarantee in the light of international experience;

(j) recommendations for ameliorating the moral hazard associated with the deposit guarantee and wholesale funding guarantees;

(k) recommendations for timelines and for policies to credibly remove the wholesale funding guarantee and to reduce the deposit guarantee to any recommended optimal cap;

(l) the effects of the bank deposit guarantee and wholesale funding guarantee on competition within the financial sector;

(m) the effects of the announcement of the unlimited bank deposit guarantee and unlimited wholesale funding guarantee on consumer and business confidence;

(n) the broader economic and social consequences of these distortions;

(o) the size and nature of the contingent liability that the unlimited deposit guarantee has created for Australian taxpayers; and

(p) other matters relevant to the bank deposit guarantee and wholesale funding guarantee that the committee considers appropriate.

WITNESSES

ANDERSON, Ms Anne, Head of Fixed Income, Asia-Pacific, UBS Global Asset Management, Investment and Financial Services Association 45

CHAPMAN, Mr Keith, Executive General Manager, Supervisory Support Division, Australian Prudential Regulation Authority 31

EDEY, Dr Malcolm Lawrence, Assistant Governor, Financial System, Reserve Bank of Australia 19

GILBERT, Mr Richard, Chief Executive Officer, Investment and Financial Services Association 45

JOHNSON, Mr Graham Neal, General Manager, Industry Technical Services, Supervisory Support Division, Australian Prudential Regulation Authority 31

JOYE, Mr Christopher, Private capacity 2

PORGES, Mr Stephen, Chief Executive Officer, Aussie Home Loans 62

SCHWARTZ, MR Carl Justin, Deputy Chief, Financial Stability Department, Reserve Bank of Australia 19

SORBY, Mr Joseph, Senior Policy Manager, Investment and Financial Services Association 45

Committee met at 9.16 am

CHAIR (Senator Eggleston)—I declare open this hearing of the inquiry of the Senate Economics References Committee into bank funding guarantees. On 23 June 2009 the Senate referred this matter to the committee for report by 15 September 2009. These are public proceedings, although the committee may agree to a request to have evidence heard in camera or may determine that certain evidence should be heard in camera. I remind the witnesses that in giving evidence to the committee they are protected by parliamentary privilege. It is unlawful for anyone to threaten or disadvantage a witness on account of evidence given to the committee. Such action may be treated by the Senate as a contempt. It is also a contempt to give false or misleading evidence to a Senate committee. If a witness objects to answering a question, the witness should state the ground upon which the objection is taken and the committee will determine whether it will insist on an answer, having regard to the ground which is claimed. If the committee determines to insist on an answer, a witness may request that the answer be given in camera. Such a request may also be made at any other time.

[9.17 am]

JOYE, Mr Christopher, Private capacity

CHAIR—Welcome, Mr Joye. I invite you to make an opening statement.

Mr Joye—Thank you. I have prepared a 10-minute opening statement. Is it all right to proceed with that?

CHAIR—If that is what you want to do then so be it.

Mr Joye—Just by way of background, I previously worked with Goldman Sachs and the Reserve Bank of Australia. In 2003 I was the principal author of the report of the Prime Ministerial Task Force on Home Ownership. I served on the board of the Menzies Research Centre for several years and today I am CEO of Rismark International. But I am here today in a private capacity, at the invitation of John. Rismark, to be clear, has not sought any government guarantees or to benefit from them. It does not currently directly benefit from government guarantees. Rismark does not securitise. Its principal interest is a healthy financial system.

A crisis is a terrible thing to waste and Australian policymakers would be foolish to attribute the nation's tentative success in avoiding thus far the worst of this calamity to the prescient decision-making of their predecessors. Major reforms, including a fundamental rethink of the regulation of our domestic financial system, must be embraced today to ensure that we stand a better chance of weathering the storms of tomorrow. Perhaps the most important reform challenge policymakers face is the need to remedy the extreme regulatory asymmetry between institutions like the major banks, which rely on short-term retail deposits as their primary source of funding in combination with long-term wholesale debt, and many of their competitors—for example, smaller banks, building societies and nonbanks—that have for over a decade predicated their business models in part on the longer term and, ironically, matched funding furnished by the residential mortgage backed securities market.

Whereas banks benefit from a range of government subsidies, implicit and explicit deposit guarantees, term funding guarantees, RBA liquidity support and so forth—which glue together the massive asset liability mismatch created by funding 30-year home loans with walk-out-the-door-any-day deposits—Australia's regulatory architecture does nothing to maintain the liquidity and integrity of its securitisation market, which supplied 20 to 25 per cent of all the home loan funding prior to this crisis. This contrasts with the Canadian system, which actively supports the liquidity of its securitisation market in an intelligent fashion—with the unsurprising consequence that it has remained open and functional throughout the GFC. The problem is that the vast bulk of our financial regulatory framework was conceived before the advent of securitisation and non-bank lenders, which only emerged as a force in Australia in the mid-1990s. I note here at least one Australian bank could and likely would have failed as a result of the closure of the securitisation markets had it not merged with a peer. Designing a new regulatory architecture to oversee this market is a critical issue for both financial system stability and creating a level playing field on which all participants—major banks, regional banks, building societies and nonbanks—can compete.

Contrary to the repeated claims by policymakers and others that our visionary regulatory system should be thanked for saving the nation's bacon, it is easy to show that Australia has proven to be the lucky country. Setting aside our propitious endowments of natural resources and consequent leverage to industrialising countries like China and India, a valuable antipodal position and extraordinary population growth, the truth is that Australia's housing and mortgage markets and broader financial system bear striking similarities to their much more sickly UK cousins. Like Australia, the UK has enormous housing supply constraints combined with steady and rising population growth. Both countries' rates of home ownership are identical and the legal characteristics of their mortgage systems are unsurprisingly the same, given the cultural commonalities—owner-occupied properties being free of CGT and mortgage interest being non-deductible, except in the case of investment assets. Finally, both markets are dominated by a small number of major or high street banks and notably devoid of anything resembling the Frankensteinian public-private GSEs, Fannie and Freddie.

Arguably, the key difference was just one of relative progress. It is widely accepted that the UK mortgage industry was three to five years ahead of Australia's, with considerably high levels of securitisation, non-bank lending, broker intermediation and nonprime or nonconforming and low- to no-deposit lending. But experts agree that the local market was furiously following in the mother country's footsteps. With the benefit of hindsight, the UK's comparative maturity opened it up to greater vulnerabilities when global securitisation markets collapsed as a result of the US subprime crisis. The shocks in the US triggered the first run on a UK bank, Northern Rock, since 1866, which in turn precipitated severe credit rationing across the entire mortgage market. Notwithstanding the UK's acute housing shortages, the systematic inability to access credit pulled the rug from underneath house prices, which had fallen by 15 per cent since their peak. Australian house prices only fell by a modest 2.6 per cent in 2008.

The chain of events in the UK was the reverse of what we saw in the US, where the inability of borrowers to service loans led to rising defaults and house price falls, which snowballed into a debt spiral of growing investor risk aversion, capital market illiquidity, credit rationing and institutional failure. I note that I presented to the Obama administration in New York in February and was informed at that time that around 95 per cent of all US home loans were being funded by the government. In contrast, the UK was a somewhat independent casualty of the withering illiquidity imposed by the US cataclysm. The closure of the securitisation markets denied funding to a key institution, Northern Rock, the forced nationalisation of which coincided with a previously unimaginable spike in funding costs to compel a system-wide reduction in lending.

The key takeaway here is that policymakers need to consider fundamental reforms to the financial system that address the previously unknown and potentially catastrophic risks that have been unearthed by this crisis. The financial world that we see today is radically different from that which existed two years ago, and new approaches will be required to manage it. One strength of the centre-left Rudd government is that it has been comfortable taking decisive action to remedy perceived market failures, and here I would say that conservative politicians do sometimes have a habit of tying themselves up in ideological knots when it comes to defining the role of government—although I sympathise with Tony Abbott's statements yesterday around grounded pragmatism. Yet, as Kevin Rudd and Wayne Swan have discovered, there are unexpected side effects associated with these interventions. Throw the stone across the pond and it impacts both its target and indirectly every other point in the pond. So we had the run on mortgage trusts when the government guaranteed bank deposits. We also saw the cost of funding

in both the commercial paper and securitised mortgage markets skyrocket when the government offered its AAA rating to guarantee bank debts.

The principal problem here is that the Rudd government needs to formulate an overarching policy strategy to guide its actions. All of its interventions—the deposit guarantees, bank debt guarantees, mooted Rudd bank and the $8 billion investment in the residential mortgage backed securities market, amongst others, have been understandably reactionary responses to the unfolding chaos. Put differently, Rudd and Swan have been scrambling to apply bandaids to the symptoms of the underlying cataclysm in an attempt to shore up the system. But they must now design and implement more fundamental protections that will help mitigate the risk of future calamities. As conditions start to stabilise, the Prime Minister and Treasurer will need to step back from the fray and contemplate the new financial order—a world in which the probability of economic Armageddon is higher than anyone ever realised. Understanding this also requires one to appreciate that the origin of the next catastrophe may have nothing to do with our local circumstances. This is the downside to globalisation. The cost of sharing our risks with the rest of the world is that we occasionally get financial pandemics.

A final, more specific word on the policy options available to government: there is mounting speculation that the government will announce a new initiative to improve competition in the banking and finance sectors, which Graham Samuel has described as barely workable. In April, I argued that they should consider an arms-length guarantee of AAA rated commercial and residential property loans. A week later, Gordon Brown's government announced that they were doing exactly that, and the media have run extensive features on this proposal since. This initiative has several appealing attributes. By guaranteeing the underlying assets and not the institutions, one can create a level playing field amongst all lenders, not just the big banks, since the cost of the guarantee would be independent of the institution's size. Note, importantly, that it is much safer for taxpayers to guarantee AAA rated assets than for them to guarantee AA rated, A rated or BBB rated banks over which they have limited control.

There is a pricing precedent with the Commonwealth guaranteeing AAA rated state government debt, which costs 30 basis points. Industry liaison suggests that this measure, which is supported by the opposition and the likes of the Bank of Queensland and Bendigo, Adelaide, Challenger and Members Equity banks, amongst others, could reduce securitisation spreads back to economically viable levels of circa 100 basis points or less. There is a successful and longstanding benchmark in the form of the Canada Mortgage and Housing Corporation, or the CMHC. The CMHC guarantees have allowed Canada's securitisation markets to remain functional throughout the GFC. Canadian home loans also have among the lowest default rates in the world and, interestingly, lower than even Australia's according to the RBA.

Moral hazard could be mitigated by requiring securitisers to furnish a first loss equity piece to the government guaranteed pool so that the originator of the assets—that is, the lender—always takes the first hit in the event of default. This is precisely what the CMHC does and maybe one reason for Canada's low default rates. The guarantees would be off balance sheet and would not, therefore, directly increase public debt, although they would raise our contingent liabilities. They would be revenue positive for taxpayers and a guarantee of AAA rated commercial property loans, or CMBS, could provide support to the struggling commercial property sector and serve as a surrogate for Rudd bank to the extent that this was still deemed desirable.

The other option is to expand the government's existing $8 billion commitment to investing in securitised loans via the AOFM. I know a fair bit about this, since Joshua Gans and I were the original authors of this idea in March 2008. The issues here are threefold. First, the AOFM's efforts are being directly undermined by the government guarantees of bank debt, which has created an alternative $100 billion superclass of AAA rated securities. The intrinsic assets underlying them are obviously rated less than AAA—that is, they are AA or A rated banks, but they have a AAA rating since they have the sovereign's backing. This has in turn reduced demand significantly for RMBS. So, while the existing $8 billion has been effective in injecting the important lifeblood of liquidity into smaller lenders it has no impact whatsoever on the overall cost of funding. Indeed, following the government's announcement of the bank debt guarantees, RMBS spreads increased to unprecedented levels, where they remain today.

Second, the government is unlikely to want to do anything that raises public debt beyond the levels outlined in the latest budget and, hence, the expanding the AOFM facility would appear to be somewhat undesirable. Finally, given its reactionary nature, the AOFM measure needs to be contextualised within an overarching policy strategy. I would prefer to see the government announce that it was making an enduring commitment to support the liquidity of Australia's securitisation market, which had until the advent of this crisis supplied funding for up to one quarter of all Australian home loans. The government need not have disclosed the dollar quantum of their commitment or the timing of any interventions. In this way, they would have retained the flexibility to participate privately in the RMBS market, alongside other investors, to influence pricing during periods of extreme duress. This is exactly what the RBA does in the foreign exchange market when it judges that the price of the Australian dollar has materially departed from fair value.

The same rationale could be employed by the government to justify irregular interventions to influence the liquidity and hence the pricing in the securitisation market. But it needs to define a coherent policy framework before doing so. This should in turn be embedded within a broader recalibration of Australia's financial and regulatory architecture.

As a final comment, I commend to the committee the submission by John Quiggin, who is a leading academic economist, a leading centre-left economist, it should be noted, and also the submission by Challenger Financial, which I thought was outstanding. Dominic Stevens, the CEO of Challenger Financial, is widely regarded as one of the smartest participants in financial markets. What is interesting is that these contributors from somewhat difficult parts of the political spectrum are largely making the same point. I also note that, while I thought the RBA/APRA submission made some very valuable contributions in terms of outlining the scope and characteristics of the government intervention, I was extremely disappointed with their attempts to identify objectively the consequences of those interventions. I thought it was quite surprising the apparent oversights in those contributions.

CHAIR—Thank you very much, Mr Joye. I will ask you a quick question with respect to the Canadian securitisation market, which you say functions better. How difficult would it be as an exercise to introduce the sort of bodies that existing in Canada into the Australian financial scene?

Mr Joye—The government is already providing these guarantees, so you would not need to create a new institution, and I have not necessarily advocated the establishment of an institution. I think the problem with institutions is once they are created they are very difficult to remove.

CHAIR—But you do talk about a new kind of guarantee body.

Mr Joye—I do not talk about a new body.

CHAIR—A new system of guarantee.

Mr Joye—I certainly do say that we need to remedy this major asymmetry in the current system whereby we are guaranteeing the ADIs and the banks but we are largely overlooking the capital market sources that had underpinned the smaller banks like Adelaide, Bank of Queensland, Bendigo and Suncorp, and also building societies and the nonbanks. I think I noted that up to a quarter of all the funding for home loans in Australia was provided by these alternative sources, and the guarantees, as you will see in many other submissions, have resulted in a significant increase in the market power held by the four major banks. You will be aware that many of the smaller institutions have not even bothered to avail themselves of these guarantees. A simple way to create a level playing field amongst all institutions such that the price of the guarantee paid by Members Equity, Bendigo, Bank of Queensland or Challenger is all one and the same is to guarantee the assets and not the institutions. I would have thought that could be executed and implemented in exactly the same way that the current guarantees are implemented. So I do not think it necessitates any new institution.

CHAIR—One of the issues we have heard from the smaller banks is that they feel disadvantaged by this guarantee because they have to pay higher fees for it, which means they have to pass on higher fees to their borrowers. Would this kind of system that you are proposing eliminate that disadvantage for the smaller banks?

Mr Joye—It is certainly supported explicitly by all the smaller banks, and as I mentioned is supported by the opposition, which I think reduces the political risks to the government in some respects given certain considerations in relation to the opposition. I think it would provide, based on the evidence that we have, an immediate levelling of the playing field apropos the provision of finance in Australia. We all know that Bendigo and BOQ to my knowledge either have not used or have not used significantly the government guarantees. Bendigo I understand today is 90 per cent funded through retail deposits, but of course there is fierce competition in retail deposits. So the four major banks can avail themselves of these lower cost guarantees and then raise very large amounts of funding through the guarantees. They also have the benefit of being seen to be too big to fail and the reputational cachet attached to those institutions, so the influx of deposits has resulted from that given the risk aversion in the community at large.

To be honest, I think it is a bit of a no-brainer. I am yet to hear really any legitimate argument as to why you would not immediately introduce asset level guarantees of AAA rated RMBS and CMBS because for taxpayers, as I have noted, it is actually much less risky guaranteeing a AAA rated asset than guaranteeing ANZ or CBA. Furthermore, and I think this is an absolutely critical point, and John Quiggin made this point in his excellent submission, which I would also add I believe Guy Debelle, who is an assistant governor of the Reserve Bank of Australia, noted was worthy of consideration at a seminar held by the Whitlam Institute last week—the MP3 file is

available to download on the RBA website. John makes this point, which I have also made independently, that the global financial crisis has put into sharp relief that the banks, and particularly the larger banks, play a particularly unusual and unique role within the system in terms of aggregating savings and providing those savings in the form of loans and thus being the central conduits of liquidity throughout the economy. They are akin to public-private utilities.

It is unambiguously the case that the banks benefit, as I mentioned in my submission and in this opening statement, from a range of taxpayer subsidies, be it implicit and explicit deposit guarantees, term funding guarantees and critically, as Challenger lucidly albeit in a complicated fashion note, the liquidity services provided by the Reserve Bank of Australia through its repurchase or repo arrangements. We need to consider what is the quid pro quo the banks are providing in exchange for the raft of assorted services that the taxpayers are furnishing. One of the issues that I have raised privately with regulators and government in the past is that we are guaranteeing these ostensibly riskier bank liabilities insofar as they are AA rated and A rated relative to AAA rated CMBS and AAA rates RMBS, yet we have absolutely no control over what the banks do with these funds. This is a really important issue, because one of the central ironies and one of the big key hypocrisies that I perceive is that people like Ian Macfarlane have told us that the Australian financial system was insulated from the global financial crisis by virtue of the four pillars and the fact that our Australian banks did not have overseas exposures. This point has been repeatedly made: the fact that we have been isolated from the globalised nature of banking systems elsewhere has in turn been a key explanatory variable as to why we have been able to navigate the crisis. But at the same time, with the benefit of both deposit guarantees and liability guarantees, we see major banks running offshore to make substantial investments overseas. ANZ is looking at making a multibillion dollar equity investment in Asia. That seems somewhat illogical to me in terms of the broader sweep of the regulatory and financial system.

Senator PRATT—I wanted to ask about Treasury’s remarks in relation to the guarantees. Treasury had argued that the guarantees were expected to have a positive impact on stability, confidence and competition and that that stability and confidence is an important underpinning for a competitive market. So they have argued that it is something that enhances competition. Indeed, Westpac also submitted that they think it has enabled smaller banks to compete. Can you critique those statements for me?

Mr Joye—Unless they have information that I am not privy to, I would say that that is unequivocally incorrect. I think the guarantees were absolutely necessary and I do not think anyone would criticise these government interventions. I think criticisms have been levied as to the execution and whether a cap was necessitated on deposit guarantees and so forth. But had taxpayers not supplied these services, I think there is a pretty compelling case that Australia’s banking system would have failed, because the banks could not fund themselves. That was a function of what is known as an external or exogenous shock and the illiquidity in overseas markets.

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 but, at the same time, I am not in any way criticising the interventions in and of themselves. But I think as Challenger note, we need to now look at competitive neutrality. Given that the system is stabilising and given the Prime Minister is turning the crosshairs to exit strategies and the prospect of higher taxes and higher interest rates as we seek to fund these different interventions—which I think is quite reasonable—at the same time I believe that we need to now consider the broader financial architecture and how we can minimise the distortions that have unambiguously resulted from these interventions. There are clear policy options.

I am not sure whether the RBA and APRA did not want to raise these issues in their submission for fear of being perceived to be critical of the government, but it does not give me much comfort when these issues are not objectively canvassed in submissions by independent authorities that ultimately have, for instance, responsibility for system stability. Understandably, one of the key mandates of the RBA is system stability so they are not really concerned with competition. So in some respects the regulators have been very happy to observe the great health and integrity of the four major banks—and, again, I am not critical of that in any way, shape or form—but we need to strike a balance at some point in time.

I suppose you could make the argument, in relation to Treasury, that had we not had the guarantees, and had we not had these government interventions, there would have been no competition at all, because the system would have failed. I think that is a legitimate point. But in terms of competition as it is commonly understood, I think the guarantees have clearly undermined competition.

Senator PRATT—What kinds of things might happen if we do not correct these distortions?

Mr Joye—I think that one of the disappointing things, which I have raised repeatedly, is that the world evolves. One particularly salient point in this regard is that the Wallace inquiry in 1997 looked at a range of regulatory reforms and explicitly rejected the notion of any form of deposit guarantee. Obviously we have implemented explicit deposit guarantees, and that, in and of itself, is a profound indication of how our understanding of financial markets and the economy has radically revised. I have a quote here from Professor Ian Harper, who has been very supportive of the open letter that I co-authored with five other economists—that, unfortunately got sucked up into a whirlwind of media rhetoric around the people’s bank—who commented that the entire intellectual framework of the 1997 inquiry had been rendered redundant by the financial crisis. That is me talking, not him. Then he said: ‘Our framework was essentially the efficient markets theory. We thought we had found the ultimate fixed point in the universe, namely the market price, and so we built on top of that the regulatory framework. But then there was no market price.’ What he means by that is that the market failed.

One of the concerns I have is around the new markets that emerged in the 1990s—particularly the securitisation market, which unfortunately has something of a stigma attached to it. But I think it is useful to remember that certain commentators and journalists have criticised the smaller banks and the building societies—particularly the non-bank lenders, for being reliant on securitisation. But securitisation is actually a much safer form of funding than funding 30-year home loans with at-call, walk-out-the-door, any day deposits. If you are funding 30-year home

loans with ultra short-term deposits, those deposits can be withdrawn by a run on a bank. Then suddenly you have an insolvency event.

The problem with securitisation is that because it literally emerged for the first time in Australia in the mid-1990s, after the regulatory system was put in place, there have been no regulatory protections. And there is no regulation per se that accommodates that market. So I think we need to re-engineer the overall architecture to recognise new participants, such as non-bank lenders, and recognise the fact that the smaller the institution—the smaller the bank, the building society and, in the extreme case, the non-bank lenders—the more reliant they have been on these alternative sources of funding which are not recognised by the government guarantees, are not recognised by government regulation, and those regulatory failures have resulted in an extreme increase in the market power of the major banks, to the detriment of the overarching competition objective.

Senator PRATT—I want to return to the issue of the big banks running offshore to obtain overseas exposures and the fact that we still have a great many small businesses and property developers who are struggling to get credit here. Surely if we have underpinned those banks with a guarantee then their exposure belongs here.

Mr Joye—Yes. I think the senators and the committee would be aware that there has been quite significant credit rationing—that is, the restriction in the availability of lending, which I think almost everybody has acknowledged—to small businesses and corporates, which has caused all sorts of challenges for those institutions and also for commercial property participants. When taxpayers guarantee deposits, which are 50 per cent to 60 per cent these days, of the funding for the major banks—and, I would add, that that guarantee is free up to a certain level—and we then, in addition to that, guarantee the liabilities of those institutions, one has to ask oneself: 'What are we getting in return? What control do we have over Mike Smith when he decides to head offshore to buy Asian banks? What expertise do Australian bankers have running banks in China? Aren't we making precisely the same mistakes that the UK institutions purportedly made in having their exposures to other markets, particularly the US?' There seems to be a central incongruity there that again is unrecognised and unacknowledged by the regulatory framework.

One of the other points I have made in this statement and also various public pieces is that, by applying a AAA rated guarantee to AAA rated CMBS—that is, commercial property assets—and RMBS, which again would be less risky than guaranteeing banks as we are currently today, we would, arguably, provide a lot of new liquidity to those smaller lenders but, in turn, I suspect you would see a relaxation in some of the credit restrictions that have been imposed on small business, corporates and commercial property investors. Let me just quickly explain why. Residential home loans, because they are intrinsically so safe, particularly in Australia, they have a very low risk weighting. A risk weighting is something that is applied by APRA. The bottom line is that the risk weighting applied to the four major banks is around 15 per cent to 25 per cent. In contrast, a business loan attracts a 100 per cent risk weighting, which means it is more expensive—all other things being equal and setting aside the margins—for a bank to provide finance to a business than it is to provide residential mortgage finance. So what we have seen is massive reintermediation, as it is known, by the four major banks into the home loan market because it has certain attractive features.

The RBA analysis recently noted that the net interest margins in the residential mortgage market had not necessarily recouped all of the funding cost increases. I am not familiar with the assumptions underpinning the RBA analysis, but I would question whether that recognises that, over and above the net interest margins, the fees paid by banks when distributing loans through brokers are a fraction of what they used to be. They no longer need to offer discounted home loan rates, because of the demise of competition, the relative death of non-bank lenders and the fee competition in general—that is, the notion of waiving fees—has relaxed significantly. So I question whether, on an overall economic basis, the position of the banks is as tenuous as the RBA analysis suggested. It may be, but that is an open question.

But my central point was that, if you start filling these regulatory holes, it would not surprise me at all to see greater competition in the conventional residential mortgage market and then the banks being forced, as they were in the 1990s, back into the commercial property, small business and traditional corporate lending markets. But that is a speculative opinion.

Senator BUSHBY—First of all, thank you for your comments this morning. They were very interesting and, I think, more targeted towards the terms of reference than the submission that you jointly put in with the other gentlemen. I would have liked to have the chance to read what you said this morning and have a think about it, because there were a lot of concepts in there that would have been quite interesting to think about a bit more. Given that I have not had the advantage of that, I will ask some questions anyway. I take it from your comments that you are highly supportive of the need for an intervention by the government in terms of guaranteeing both deposits and the wholesale market, but you did raise that there were some issues about the execution and that there had been some comments about that. You also indicated that you believe that there were distortions that have resulted from those interventions in the markets. Given the manner of execution of the float guarantees, do you think that those distortions were foreseeable prior to those being implemented in the way they were?

Mr Joye—The chief distortions, which I think different submissions document, are obviously the adverse consequences for alternative savings products, particularly cash management trusts and mortgage trusts; the unfortunate consequences for the RMBS and CMBS markets; and the questions around arguably why smaller ADIs have not sought to avail themselves of the term funding guarantees whereas the larger institutions have done so with their ears pinned back. I think the circumstances of the time were unprecedented and extreme. With the benefit of Harry Hindsight you can be critical of the execution and the implementation. There is a legitimate debate around the deposit guarantees, and I think the RBA and APRA submission is an excellent summary of the different measures implemented around the world. I do not have any particular beef with the execution. I think there were shortcomings but, to be honest, the fact that the government acted so quickly and decisively is something that they should be congratulated for. I think that they did very effectively shore up the system. I think there are wrinkles around the edges on the deposit guarantees. The real issue I have is with the subsequent failure and the apparent unwillingness to seek to remedy those distortions. That I do not fully understand. So I think that, in the heat of the moment and with the extreme duress to which decision makers and policy makers were exposed when they had to make these decisions, largely they did a very good job—but, we now have ample opportunity to visit those distortions and seek to minimise them and I have seen basically no action whatsoever. Every day we are suffering the consequences, and I think it is a real failing.

Senator BUSHBY—I think you have made some very good points about the subsequent lack of action, but I want to focus on the execution a little bit further. Even in places like Ireland, where they also ultimately implemented an unlimited guarantee, they did it progressively. They did not just jump in feet first and say, ‘Bang, here is unlimited guarantee.’ They took it slowly. There is an argument that you could put that by progressively implementing a guarantee with a cap—putting it in, seeing how it goes, how it works and what the distortions are and adjusting it to suit—you could still be decisive—you could get in there, make sure there is a guarantee but limit it and adjust it upwards or downwards as the market requires. Is that something that you think could have been looked at the time?

Mr Joye—Absolutely. I think the unlimited guarantee was—

Senator BUSHBY—A bit more of a sophisticated approach, basically.

Mr Joye—The unlimited guarantee was certainly the exception rather than the rule.

Senator BUSHBY—Yes.

Mr Joye—It is somewhat puzzling, but I am sure that they thought about this at the time and I am sure that there are legitimate explanations. But in countries like the US and the UK, which were in far worse circumstances than those faced by Australia, there were deposit caps or caps and limits on the guarantees, to the best of my knowledge. I think that there are reasonable avenues of inquiry whereby you could question the decision making at the time, but I think largely the government has been quite effective and quite decisive. I do not consider myself a political partisan but, to turn the problem on its head, I question whether in a different situation with an alternative administration those ideological knots to which I referred before—that is, the failure of action—may have wrought somewhat adverse consequences.

Senator BUSHBY—I am sorry; I do not accept that. As to the allegations about ideological knots, certainly from my perspective, I am sure that we in the coalition would have taken decisive action, but it probably would have been slightly different.

Mr Joye—The point I make, though, is that there was obviously this controversy at the time in relation to the advice furnished by the RBA and whether the RBA was consulted and so on. As a lay, non-expert observer, I do not understand why that was not made transparent. Why don’t we have full information? We are guaranteeing circa a trillion dollars worth of deposits. We have had taxpayers guarantee about $100 billion worth of bank debts. I think taxpayers are entitled to understand, to your point, what the decision making process was, whether there were failures and whether we can improve in the future and avoid those same mistakes being made. Up until the mid-1990s the RBA regulated the banks, but I for one as a taxpayer would certainly like to understand whether there were disputes as to whether a cap should have been applied and whether the RBA was fully consulted. I cannot understand why that information would not be made freely available and transparent and I think the government should cop it on the chin in the event that they did make some mistakes. Quite frankly, that is the nature of the human condition. It would be understandable if they made mistakes, but I think that in the interests of transparency and full disclosure we should review those actions. There is also this overarching question: did the CFR, the Council of Financial Regulators, provide the advice, and was there a uniform position amongst the three key members of the CFR or was it the Treasury, as the principal

adviser to the government—albeit an adviser that is far removed from financial markets and which does not have anything like the expertise that the RBA possesses?

Senator BUSHBY—And which, by the admission of Dr Henry himself, is not as independent as the RBA.

Mr Joye—Yes, that is exactly right. Obviously *the Australian* covered the controversy at the time, but I think that would be a useful avenue of inquiry, and I do not think that the government should fear any ramifications from that—

Senator BUSHBY—The RBA are following on from you, so maybe they might give us some information that will assist in that regard. Coming back to Ireland as a example, I understand that the decisions that were made on bank guarantees there, and certainly in most other comparable jurisdictions, were made with the full advice of their central bank, and that was all publicly and transparently made available to the public.

Mr Joye—It could be the case that the government did have the benefit of the full advice of the central bank. I do not—

Senator BUSHBY—That is right, but we do not know.

Mr Joye—That is right.

Senator BUSHBY—You have talked about the distortions as they have affected liquidity and the availability of smaller banks and non-bank lenders or financial institutions to actually access funds. What does that mean in practice for the Australian economy, for Australian businesses? You have touched on the possibility that there is less competition for home loans, and presumably that means—and I think you actually said—that fewer discounted home loans or interest rates are being offered. That can have an impact on interest rates. It can also have an impact on small businesses who have loans with non-bank financial institutions as they roll over in terms of their ability to refinance. What other impacts have these distortions had as they have played out in practice in the economy?

Mr Joye—I think it is interesting that we have seen this decoupling of the relationship between the cash rate set by the Reserve Bank and the market rates applied by lenders. We saw a recent example of that, where the Reserve Bank cut the cash rate by 25 basis points but the vast bulk of that was not passed on by lenders. One lender in particular, NAB, decided not to pass on any cut at all and we subsequently saw CBA reverse out the cut that it did pass on. It is important to remember that there are about a trillion dollars worth of home loans outstanding. There is $3.9 trillion worth of residential property. It is a critical part of the economy. The fact is that we have seen a deterioration in the RBA's control over monetary policy, even though I think there has been a bit of ex-post-rationalisation and revisionism by 'authorities' as to why that is not such a bad thing. But the truth is that control over monetary policy has been to some extent—and when I say 'control over monetary policy', I mean the setting of market interest rates—

Senator BUSHBY—You are looking at the RBA too.

Mr Joye—has been to some extent taken away from the Reserve Bank and now rests in the hands of the four major banks. That is a somewhat worrying outcome.

Senator BUSHBY—Do you think the primary reason for that is the lack of competition or the cost of borrowing or a combination of it all?

Mr Joye—I think there are a range of explanations but there is a reasonable argument that greater competition would contribute to a closer relationship between those rates. I think it is also sobering to note that, up until the beginning of this year, most experts believed that the RBA had much ammunition left in reserve to stimulate the economy in the event of an adverse contingency. We have discovered and we have been told repeatedly by bankers that in fact there is no ammunition left at all. Business lending rates have hardly come down relatively speaking; mortgage rates have but this notion of a three per cent cash rate giving us a lot of ammunition to stimulate the economy—

Senator BUSHBY—So what you are saying there is that, even if the RBA reduced the official rate further, there is not a lot of scope according to the banks to actually reduce their interest rates.

Mr Joye—They have communicated that very, very clearly. I think the other point, returning to some previous comments, is that the extent of credit rationing we have seen to commercial property investors could be assuaged by the application of asset level guarantees. If we guaranteed AAA rated CMBS that would obviously provide a new source of finance. This was the chief objective obviously of Ruddbank but, again, rather than setting up a new institution if you just guarantee the assets and implement it, as we do with the state government debt guarantees and the bank guarantees, it should be relatively seamless. You would open up a pool of liquidity for commercial property investors. To the extent that you provided asset level guarantees of RMBS you would put all institutions, all lenders, on a level playing field. Insofar as there is greater competition in that realm and margins decline in that realm, presumably the major banks would retreat back to their stronger territory which is business lending and look to increase the scope of their business lending. That in turn would minimise the knock-on effects that we saw when, as a result of the advent of the GFC, there was a large re-intermediation and very strong double-digit growth in the home loan books of the major banks but very little to no growth in the business lending books because they had made the conscious decision that they would allocate capital, obviously, into the residential domain.

Senator BUSHBY—And there is not really an alternative market for business to access funds from in a lot of ways at the moment.

Mr Joye—That is right.

Senator BUSHBY—You promote the asset level guarantees as an option, how should we move to that from where we are at the moment? What should happen to the two guarantees that we have, the deposit and the wholesale? How do we transition from them or do we keep those?

Mr Joye—It is not complex. The fact of the matter is that taxpayers have bought nearly $8 billion worth of residential mortgages already through the AOFM. The only goal of the AOFM's intervention, speaking frankly, was to reduce the cost of financing in the residential market. One

of the points I made in my opening statement that may not have been clear but I will reiterate was that one of the few AAA rated assets available to investors around the world was AAA rated mortgage backed securities. Australian RMBS have among the lowest default rates in the world.

When the original $8 billion commitment was announced, there were reasonable expectations that spreads—that is, the cost of residential mortgage finance in the securitisation market, would fall, particularly with the $8 billion worth of money that the government committed. That was a bipartisan effort insofar as Turnbull and Swan both supported it. However, when the government announced the offer of guarantee of bank liabilities, spreads almost instantly increased to unprecedented levels because the government has created this new, as I mentioned, superclass of AAA rated securities that is effectively supplanting demand for traditional AAA rated assets. I cannot for the life of me understand why if we are buying $8 billion dollars worth of residential mortgages today—I know the guys at the AOFM and they have hired David Ziegler who is a specialist securitisation expert to review and research these assets—and we are proposing a much simpler and less consuming alternative, which is just the application of a guarantee, so you are not going to purchase those assets but arguably the same diligence requirements would be imposed, then I would venture that there is actually nothing at all preventing the immediate implementation of that solution.

Senator BUSHBY—The immediate implementation of that and what would you do with the guarantees?

Mr Joye—I think—and Challenger makes this point in their submission—so long as we require government guarantees of deposits and bank liabilities, particularly bank liabilities, you need to have these alternative remedying solutions in place. I agree with Challenger that when we seek to phase out the government guarantees of bank liabilities we would phase out any RMBS or CMBS guarantees.

But I would reiterate John Quiggin's point that the mere fact that taxpayers have been forced to guarantee these institutions writ large really begs the question as to the role of these institutions in our community and as to whether there are new forms of forward-looking regulation required, given the new lens with which we view these entities.

CHAIR—We will now go to Senator Joyce via teleconference.

Senator JOYCE—I have been interested in listening to what you have had to say. What would happen right now if we removed the guarantee? Would it really have any major effect?

Mr Joye—I presume you are talking about both guarantees?

Senator JOYCE—Yes.

Mr Joye—The RBA submission was excellent in terms of its content, but in terms of what was missing from it I thought it was somewhat disappointing. I think we are not yet in a position whereby the cost of funding available outside of guarantees—that is, outside of the government guaranteed debt markets—is lower than the cost of funding available in those markets, particularly on a longer term basis. As a result of that there is a case that, given we have this situation where governments around the world are all guaranteeing their institutional liabilities,

our institutions would be placed at a material comparative disadvantage and there would be quite adverse ramifications. That is to say, it is entirely possible that these institutions would face challenges funding themselves. I am not necessarily an expert on this subject but that would be my observation.

Senator JOYCE—If that is the case, either the whole world goes on funding them forever—which I am sure no one in the world wants to do—or there has to be a coordinated removal, otherwise there are going to be market discrepancies and money is going to flush around the world to wherever these guarantees still remain. Has there been any international process of removing these guarantees in a coordinated form?

Mr Joye—I think that is a very, very good question. I think that the Prime Minister has referenced a number of different forums—the G20 and the Financial Stability Board—and I know that our regulators, particularly the RBA and Treasury, are intimately engaged with their overseas counterparts. This is something that does need to happen; we need to have a globally coordinated approach to evaluating the application and then ultimate removal of guarantees. But we also need to have some level of global consensus on the future architecture and the manner in which governments will intervene in these capital markets going forward.

In relation to the six economists' call for a first principles review of the financial system at large—like a son of Wallis or a daughter of Campbell—part of that review has to consider the policy measures implemented around the world and how they impact on Australia. We need to have some institutionalised bodies that serve as global coordinating agents. But I do not think there is any simple answer to your question as to when they will be removed. I do not think that day is today, and I am not personally aware of any cogent transparent agreement between all of the major developed economies as to how they will remove them.

Senator JOYCE—You also talked about the discrepancy between federally coordinated monetary policy and the actual actions of the Bank and how this is getting more and more divergent. We have said before that the Reserve Bank can do what it likes and the banks will say, 'We know what we are paying for the money and this is what we are going to charge.' That, in itself, starts to show that your capacity to deliver a monetary policy outcome is being lost and one of the reasons it is being lost is the centralisation of the marketplace in the delivery of finance. Is there a role for the government to become involved in dealing with money at a retail level, not just at a Reserve Bank level? Obviously, the essence initially of the Commonwealth Bank was government involvement in the delivery of money at a retail level. The Queensland Industry Development Corporation and a couple of others, like the Bank of SA, were complete disasters. If it becomes apparent that they cannot deliver a monetary outcome purely from a position taken by the Reserve Bank, is there a role for the government to look at possibly re-entering, for a period of time, their role at a retail level?

Mr Joye—It is an interesting question and I do not think it should be dismissed out of hand, as some on the right have done. I would make the point that there seems to be a stereotypical aversion to the notion of any government activity in retail banking markets. The fact of the matter is we do have a publicly subsidised bank, the Reserve Bank, which is the central bank to the banks, and that appears to have been managed extremely well, and is certainly populated by world class individuals—Ted Evans was the former secretary of the Treasury and is chairman of Westpac; David Morgan was a senior Treasury official and he ran Westpac; and Ian Macfarlane

sits on the board of the ANZ. Ironically, and I think this is a nuance that has not really been touched on, I presume the government will be seeking retail funds—that is, they will be seeking mums and dads to invest in government bonds. The government will, in a sense, be taking retail deposits.

We know that that money is being used to fund or buy residential mortgage backed securities through the AOFM. The fact of the matter is, de facto, there will be government retail deposit taking channels in one form or another and, de facto, the government will be lending to mums and dads—and has already lent about $8 billion to mums and dads through the AOFM. I would encourage you, Barnaby, to read again John Quiggin's submission because he raises this point very explicitly. He highlights this bifurcation between the notion of narrow banking and broad banking. John's point, which I have a lot of sympathy with, is that banking is essentially a very commoditised activity, where you take in savings and you distribute those savings in the form of, ostensibly, low-risk loans. Perhaps there is a role for government to leverage off its infrastructure in the manner of a Kiwibank in New Zealand to provide commoditised services where it potentially has a comparative advantage by virtue of its unique infrastructure.

I would also say many folk, including government officials, have cast aspersions on this idea in light of the failed experiences Australians have had with the various state banks in the past. Private sector financial institutions fail all the time. We have seen a litany of private failures at the institutional level—the entire UK banking system has been nationalised; and Lehmans has gone, Merrells has gone and Bear Stearns has gone. So I do not think necessarily the private sector is a shining beacon of excellence and, moreover, the only reason, as we have noted already, that our major banks survive is due to the multiplicity of implicit and explicit subsidies that taxpayers supply them with. I am not necessarily endorsing the so-called people's bank—not terminology we have ever used but rather something that was apparently created—but I actually think it is a very healthy avenue of inquiry and it is something that should be undertaken, because, as I said before, the fact of the matter is our banking system is akin to a public/private utility. We need to understand what the 'pro quo' is for the quid that taxpayers are providing.

Senator JOYCE—I worked for the Queensland Industry Development Corporation before it became Suncorp. QIDC were small, had low overheads and was very effective. You can read about Suncorp in the paper. It was not a great move forward. About 50 per cent or so of the total securitisation of the banks is now underwritten by residential loans, or is it more?

Mr Joye—What is your question?

Senator JOYCE—How much of the four major banks' security is now supported by residential housing loans?

Mr Joye—I do not have the exact numbers off the top of my head, but I would assume it is about 50 to 60 per cent.

Senator JOYCE—What happens for all of us? I know that we have not suffered the same sort of collapse in the price of residential real estate, but if unemployment kicks on there then is really no reason we should not. If houses have been underwritten by 1½ or two salary or wage earners in a McMansion and we go down to one then what is going to happen to the large swathes of recently built mortgage belt properties? Are we now ourselves exposed, through the

use of the derivative—right back to every taxpayer in Australia—to the ramifications of our own real estate collapse? If that has been ruled completely out, why?

Mr Joye—I can tell you why. There are a lot of myths and misconceptions that surround residential housing in this country but, as I have mentioned many times in public and as others, such as the Reserve Bank, have noted, the Australian housing market is incredibly robust. We have what are believed to be the largest housing shortages in history. Building approvals in New South Wales have been near all-time lows. On the demand side, we have the strongest rate of population growth since 1971; I think that in December 2008 the rate of population growth was 1.9 per cent. House prices in Australia fell by 2.6 per cent in 2008, in contrast to the predictions from the likes of Steve Keen and Gerard Minack of between 20 and 40 per cent price falls. I can tell you that in the first five months of this year Australian residential property prices increased by four per cent. The June quarter numbers, which come out later this week, will show continued growth. Importantly, house prices are increasing modestly—that is, at a relatively slow rate—across all areas, so this claim that there is a first home buyer bubble is completely and utterly incorrect. The top 20 per cent most expensive suburbs in Australia are also registering price increases.

In the banks' defence, we have seen a huge increase in the conservatism of their lending practices, so the maximum loan-to-value ratio—LVR—available to residential borrowers today is the lowest it has been since the late 1980s. In many ways it is actually harder to get a home loan today than it has ever been before. The conservatism of our banking practices, inspired by the guidance of APRA and the RBA, has in turn perpetuated these extremely low default rates. According to the RBA's financial system review in March 2009—or whenever it was released—the 90-day default rate on bank balance sheet loans in Australia, which are the vast bulk of all loans, was only 0.58 per cent. That is about 15 per cent of equivalent US mortgage default rates and about 25 per cent of UK default rates. Residential property has actually served as a remarkably stable source of wealth for Australian households.

I make one final point, Barnaby, in response to your point about unemployment. In the 1991 recession, unemployment rose from 5.6 per cent in January 1990 to 10.9 per cent by December 1992. Over that time, Australian house prices actually increased by two per cent per annum. So house prices did not fall precipitously the last time unemployment rose to nearly 11 per cent. On the other hand, commercial property—as it has during this crisis—experienced substantial falls according to the available indices. So the banks, in their defence, are allocating capital to those areas that they perceive to be the ones that offer them the highest risk-adjusted returns, and residential mortgages are actually an incredibly safe investment. As the RBA has repeatedly noted, there have never been any losses that crystallised in these securities—obviously on a loan-by-loan basis there have been losses. So, again, I personally am not concerned about the impact of high rates of unemployment on the house prices.

Senator JOYCE—That is a great statement. I do have concerns, and I think that it is going to be an interesting one to watch, because at this time the valuations of houses are at the end of an immense spike in real estate valuations, which they were not back when we had the other headline unemployment rates. We were not at the back of a real estate boom.

Mr Joye—I would just say that people are prone to make all sorts of unsubstantiated assertions in relation to residential property. As the Reserve Bank noted in, I think, Tony

Richards's latest speech, the rate of house price growth in Australia since the end of the last boom—that is, the end of 2003—has been lower than both nominal GDP growth and nominal household disposable income growth. Alan Greenspan, in his memoirs, and the RBA itself—Ric Battellino, Tony and others—have repeatedly said that the residential housing market in Australia actually leads the US and the UK by circa three years. We actually had a correction last year. That 2.6 per cent fall was actually the largest in 26 years. I think your words of caution are justified; we should be cautious. There is certainly reason to watch this space very carefully, but I do not think that any of the sensationalist predictions that you sometimes see bandied around in newspaper headlines will come to pass.

CHAIR—Thank you, Mr Joye. I am afraid we have to stop there, although we would very much like to continue with your very interesting comments. Thank you for appearing.

[10.20 am]

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

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

CHAIR—I welcome the representatives of the Reserve Bank of Australia and I invite you to make an opening statement if you desire. You have all appeared before Senate committees previously, so you know the procedures.

Dr Edey—Thank you very much for inviting us to appear today. I do not intend to make a lengthy opening statement. We did make a fairly comprehensive submission to the committee. The thrust of that submission was to review the circumstances in which the guarantee was put in place. We think that the guarantee has worked well in achieving its purpose, which was to unblock key parts of the financial system that were seizing up, to restore confidence to deposit taking institutions and to allow the system to fund itself in wholesale markets and to keep lending. I think those key objectives are being met. In the submission we talk about how the scheme is progressing and the amounts that are being raised under guarantee and so on. We are happy to answer questions on any of that but I think if we take the submission as read, I do not have anything further to open with.

CHAIR—You say the guarantee has worked, but I notice that Australia was one of only five countries which had an unlimited guarantee. Some of the countries that we like to compare ourselves with, such as the United Kingdom, had only £50,000, which is $150,000 or thereabouts; and the US had $250,000 as their limit. Why did we have an unlimited guarantee? What was the thinking when comparable countries such as Belgium, Germany, Greece and so on, and the United States and the UK, had much lower limits?

Dr Edey—Obviously the parameters of the scheme that we ended up with are not the same as what was first announced. You have to recognise that a decision had to be made quickly at the time that all of this was put in place. If you think back to what the conditions were at that time, there was a lot of unhelpful speculation about whether the banks were safe. It was an environment where different countries were doing different things. It is true that a number of countries responded to these events by raising existing caps on deposit protection schemes. There were some that introduced unlimited guarantees and we refer to those in the submission, but the priority at that time was to get something comprehensive and simple out there quickly that would restore confidence and take these questions about whether the banks were safe—take all of that off the table. That was achieved. Obviously then the government, in consulting with agencies such as ourselves, had to go back and think about the details. One of the details that we had to think about was whether we needed a cap in order to stop the leakage between high-value deposits and low-value wholesale funding. We thought carefully about that and reached the view that a cap was needed, so that is how we came up with the scheme as it now stands. During that period we were also thinking about the nature of the pricing that would be attached to the

guarantee, and all of those details had to be filled in as well. As you would know, it took the best part of a couple of weeks to finalise all of those details.

CHAIR—Would you say that we have achieved a better outcome with our unlimited guarantee than countries like Belgium, Finland, Germany, the Netherlands and Spain, and Switzerland, the United Kingdom and the US with much lower guarantees?

Dr Edey—The scheme, as operating, with the exception of that very early period, has a $1 million guarantee. We can really only assess the scheme as it exists.

CHAIR—The first one is free but after that there is a fee.

Dr Edey—Early on, it was known that the parameters were still being thought about. You can really only assess the operation of the scheme in its entirety. You would have to say that the scheme has served its purpose. The purpose of the guarantee is essentially to stop people arbitraging between different parts of the scheme. You do not want people converting wholesale instruments into huge deposits and thereby shutting down the wholesale market. It was important to get that in place quickly and I think that was achieved.

CHAIR—The central banks of Hong Kong, Singapore and Malaysia announced recently that they would be coordinating their approach to exiting from a pool deposit guarantee. Do you also see it as desirable to coordinate with other economies in this transition? When do you think we will exit the guarantee?

Dr Edey—Exit has to be an important priority. Nobody envisaged that this would be a permanent arrangement, so a part of the strategy was to set the prices for the guarantee fees at levels which would themselves create an automatic exit mechanism. As conditions normalise, it will become less attractive to pay the fee for the wholesale guarantee. As far as exit arrangements go and whether they need to be coordinated, 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 discussions through various international forums, particularly the FSB and the G20.

Senator PRATT—By most reports, bank guarantees have been seen as successful and necessary. What of the future in terms of how we unpick this situation from here? We know that it has had an impact on non-bank lending and, indeed, created some distortions in terms of shoring up mortgages and home lending but that small businesses are still suffering some difficulties in accessing credit as well as other parts of, for example, the commercial property sector. The bank guarantee is seen as contributing to that in terms of biasing lending. What comment would you make about those issues?

Dr Edey—The big picture is that lending is still flowing and that would not have been the case if we had not had a guarantee scheme that allowed the banks to continue to attract funding. We would be in a much more difficult position now because banks would not be able to continue to lend as they have been doing. As I said earlier, it is important to find ways of getting off this

and getting to more normal conditions, but the scope to do that is going to depend partly on market conditions and on the speed with which confidence returns.

Senator PRATT—Our previous witness told us that one of the things that has been behind our success is that we were lucky our banks did not have offshore exposure. But, currently, some of our big banks that are backed up by the guarantee are going offshore and looking at things offshore. At the same time, we still have small businesses and property developers who cannot access credit. Can you comment on what sort of restraint there should be on the banks that are supported by this guarantee in terms of where their business should lie?

Dr Edey—We do not want banks taking unnecessary risks that put the system at risk. I think that APRA has done a good job of keeping track of that and containing it. That is one reason why our banks have come through all of this in good shape. Another point to note is that the business model of the banks right through the period leading into the crisis was one where they were borrowing offshore to fund their domestic operations, so the risks they were exposed to were quite different from, say, the European banks, who were holding large amounts of US structured securities, which were the instruments that got banks into trouble. Our banks did not take on those sorts of risks. Because they are well capitalised and profitable, they are well placed, once conditions do normalise, to expand their business. But I think everybody will have learned the lesson from this crisis that with structured instruments you have to be very careful with the risks that you take.

Senator PRATT—There might be those who argue that banks might be considering that that offshore exposure might have some risk attached to it. You would disagree. You think that banks are in a good position to make rational decisions about that. Provided they are not risky investments, you do not see a problem with the kind of exposure a bank takes on, despite the fact that they have this guarantee?

Dr Edey—All of this stuff has to be carefully looked at by the prudential supervisors, but I do not see the banks at the moment embarking on a course where they would be taking excessive risk that would put themselves or the system at risk.

Senator PRATT—Thank you.

Senator BUSHBY—My question goes to the terms of reference. Looking through your submission—and this was highlighted by the previous witness—you do not focus an awful lot on the consequences of the bank guarantees in the broader lending market, and particularly in the sectors of the lending market that are not actually covered by the guarantee. You do touch on it slightly and basically dismiss it by saying that there was a flight to safety anyway and that the bank guarantee fitted in amongst that somehow. Do you think that there were consequences? Did the bank guarantee have consequences for the ability of non-guaranteed financial institutions to compete with those who were guaranteed?

Dr Edey—There may well have been some consequences, but I think 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. When you are in an exceptional circumstance like this the priority has to be to protect the core of the system. The judgment was made—and nobody can really dispute that it was a judgment that had to be made—that 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. I can understand that they would feel that way, but I think the big picture of what was going on right through the period leading up to the guarantee was that there was a flight by investors to perceived safety and all of that was intensifying and becoming potentially more destabilising at the time that the guarantee was put in place. I think you cannot really separate that general mood from the effect of the guarantee itself.

Senator BUSHBY—Nobody disputes the need for action in terms of guarantees. There are certainly questions around the execution, the timing and the way that it was all put in place. It was Malcolm Turnbull who first publicly suggested that we actually have a guarantee with, from memory, a cap of $100,000. It was about a week or so later before the government came out and announced an unlimited guarantee, and I think they only went unlimited because the opposition had suggested putting a cap and they wanted to do something different. But the execution of it is more the issue, and then the consequences. Certainly there are submissions that we have received that suggest a more sophisticated approach to the execution. For example, even at Ireland, where they ended up with an unlimited guarantee, they started with a staged approach, where they had a cap and then they moved that, based on advice they received from their central bank and on the impact that it was actually having on the economy and in the markets. Surely in Australia, if there was concern about the consequences for those that fell outside the guarantee, a more sophisticated approach that maybe did introduce a cap and then looked at what consequences it had and adjusted it appropriately might have been better. Is that something that was looked at?

Dr Edey—Again, I have to come back to the point that decisions had to be made quickly—

Senator BUSHBY—But you can make a very quick decision to put cap on of $50,000 or $100,000—a guarantee in place to do that. It can still be a quick decision. A quick decision does not necessarily require an unlimited guarantee.

Dr Edey—No, it does not, but the scheme as it was finally designed, which was a couple of weeks after the original announcement, had a cap and it had a pricing structure for the wholesale component. With hindsight—

Senator BUSHBY—It is effectively unlimited, though, if you are willing to pay a fee. But that was not the initial announcement; that was actually a subsequent revision to the initial announcement.

Dr Edey—Yes, but I think anyone would concede that if you had perfect hindsight then you would have come up with the final structure on day one, but it took time to do the thinking that got you to that final structure.

Senator BUSHBY—But in other jurisdictions where they were facing far more urgent issues in terms of their banks and the problems that we are trying to deal with with a guarantee, they managed to take decisive action without actually coming out and just putting a blanket guarantee

on. They actually thought a little bit about what consequences might happen and they had more sophisticated approaches—and this was in jurisdictions where they really did have the emergency situations with banks and with runs on banks occurring, which we did not have. It is conceded that we needed to take some action to avoid that potential happening in Australia but we were not yet facing that. Yet in jurisdictions where they were, they still managed to sit back and think and actually apply a more sophisticated approach, not make an announcement and then spend the next two weeks trying to work out how they were going to implement it.

Dr Edey—Well, actually, I do not think it is at all unusual for countries to have made more than one announcement and to have had further details as time went on. The Irish certainly did that. The British did as well. I do not think you can make a case that you should have got the final system right on day one.

Senator BUSHBY—I am not suggesting you should have the final system, but in all those other jurisdictions, rather than coming in first with a sledgehammer, they actually worked up to it and said, 'Is going to be enough?' Obviously, if you put a blanket guarantee in the financial system it is going to have major ripple effects across the economy and across the financial services system. I would have thought that a more gentle approach that tests whether you have done enough to actually solve the problem whilst minimising the consequences is probably a more appropriate way of going—and, incidentally, is the way most of the other jurisdictions approached it—rather than coming in with the biggest one, which obviously is going to have the biggest consequential effect across the financial services sector, and then working back.

Dr Edey—I am not sure that that is the right logic at all because if you err in the other direction, of going too narrow—and I am not saying that most countries did this—one example of this was in the Northern Rock case in the UK where the government had more than one go at trying to make announcements that would shore up confidence in the institution. The fact that people were not quite sure whether it was comprehensive enough actually became a source of destabilisation, which eventually led to an unsustainable run on the institution. I think when you do these things, if you are in a position of making a quick decision you have to err on the side of making completely sure that it is comprehensive enough to take the whole issue off the table so that you have not still got people speculating about whether the banks are safe.

Senator BUSHBY—I concede as well that the RBA's role is not to consider competition as such. There are other elements of government that look at that, and your job really is the stability of the market. So I am not having a direct go at you in that sense. Nonetheless, making the decision to err completely on the side of eliminating the risk does come with other consequences. Although your comments tend to play down those consequences, all the other submissions we have received have suggested that those consequences were quite severe on not just the institutions themselves but the people who borrow from them, small businesses, and on the impact on interest rates. I will be interested in your views on that in a minute as well. There are consequences that flow through to Australians, and making a decision to completely shut down the risk by going to a completely unlimited guarantee maximises the potential for those consequences, whereas a more staged or more considered approach may have primarily eliminated the risk but minimised the consequences that might have occurred elsewhere.

Dr Edey—All I am saying is that it is understandable, given the circumstances, that any decision maker would want to err in the direction of being overcomprehensive rather than

undercomprehensive. That is one point. The second point is that we are talking about a window of less than two weeks between the original announcement and when the final parameters were put in place. I have not seen any analysis that says that that window itself was a source of problems.

Senator BUSHBY—No, I am not suggesting that window was problematic.

Dr Edey—But the people who are arguing about this are people who are arguing about where the boundary should be drawn, not about damage caused by a two-week window.

Senator BUSHBY—Before the initial announcement—I know we have been over this before but it was raised by a witness this morning—was the RBA consulted as to the appropriate action to be taken at that point?

Dr Edey—Do you mean at the time of the first or the second announcement?

Senator BUSHBY—At the time of the first announcement, had the RBA been approached and consulted as to what appropriate action should be taken in terms of bank guarantees?

Dr Edey—The RBA was consulted. I should just refer you here to the fact that the RBA governor was questioned about this by the House of Representatives economics committee in February, so I can paraphrase some of the remarks that were made then. The gist of that was that consultations took place over the weekend leading up to 12 October.

Senator BUSHBY—Was that with the RBA governor?

Dr Edey—The RBA governor was kept informed by the Treasury secretary.

Senator BUSHBY—Was his advice sought? There is a big difference between being kept informed and his advice being sought.

Dr Edey—I can only go by what is on the *Hansard* record, because I was not part of those consultations. What the governor indicated was that he was kept in the loop on that stuff and that he raised no objection to the announcement that was being made.

Senator BUSHBY—Okay, we will move on from there. In terms of interest rates, we had some evidence earlier that the lack of competition that has subsequently resulted from the global financial crisis, particularly exacerbated by the bank deposit guarantee—the wholesale guarantee obviously makes it cheaper for the AA rated banks to get the guarantee and therefore to get funds, and there are other aspects of the guarantee—has made it harder for non-guaranteed financial institutions to attract funds. Do you acknowledge that that has had the effect of lessening competition, particularly in the home mortgage market in Australia?

Dr Edey—There are institutions that have found it harder to compete in the circumstances—not, I would say, particularly as a result of the guarantee but simply as a result of market circumstances more generally. I think the point to make, though, is that all of the banks have benefited from the introduction of the guarantee. If you consider the alternative of there being no guarantee scheme in place, the banks would all be in serious difficulty raising funds and would

all be finding it harder to lend. So I think the most important point to make to keep the picture in perspective is that all the banks are benefiting from this. I understand that the lower rated banks are not happy about being charged a risk-based price in the fee structure, but it is actually a deliberate feature of the design of the system that risk should be charged for.

Senator BUSHBY—Why is that? Why has that been included, given that it also deliberately builds in a competitive disadvantage for smaller banks compared to the bigger banks? I am interested in the risk analysis of it, but it does build in a competitive disadvantage.

Dr Edey—Markets always price for risk; that is a basic feature of the market. When particular banks say that they are being disadvantaged by a fee structure, you have to ask the question: disadvantaged relative to what? The answer, in their view, is that they are disadvantaged relative to a flat fee structure.

Senator BUSHBY—But the purpose of the guarantee, as you have outlined today, is to provide stability in the banking market; it is not for the government to become a player in the market itself. Surely, as such, the government does not need to price it according to market; it needs to price it according to delivering outcomes that are good for the economy and for Australians. Having a flat fee structure would ensure an even playing field for banks and promotion of competition for banking products, which is good for Australians. But, in building in a competitive disadvantage for one part of the market compared to another, you are actually removing competition and potential benefits for Australians, which are ultimately the government's responsibility.

Dr Edey—I would make a couple of responses to that. One is that we should not really think of the guarantee scheme as being an instrument of competition policy; it is really a set of—

Senator BUSHBY—But it affects competition.

Dr Edey—It does, yes, but its primary purpose is that it is an exceptional measure designed to protect the system in a crisis. We have already talked about that; that aim is being achieved. With regard to the level playing field, I am not sure that I would accept the premise that a flat pricing structure constitutes a level playing field, because in normal market circumstances—if you were trying to replicate what would happen in normal times—markets would charge for risk.

Senator BUSHBY—Markets still charge for risk. If you are an A rated bank and you are out there with the guarantee, you still have to offer more—a higher yield—to actually attract funding than an AA bank would guarantee anyway. That is built in by the market. The government does not need to build in an additional level of disadvantage, does it?

Dr Edey—I still think it is a legitimate thing for the government to do. The government is providing the guarantee to assist banks, and the government is taking on risk to do that. I think it is legitimate for it to make a decision that it should charge something for risk.

CHAIR—We are going to have to go to Senator Joyce, Senator Bushby.

Senator BUSHBY—Okay, I will wrap it up. The stated purpose of the guarantee, which you say is being delivered—and therefore, in your assessment, the guarantee is working well in

achieving its purpose—is to stop people arbitraging. Surely that can be achieved without having differential levels of fees that actually introduce greater competitive disadvantage for one sector of the market against others.

CHAIR—The small banks.

Dr Edey—I can really only come back to the points I made before: that actually all the banks are benefiting from the guarantee and that—

Senator BUSHBY—Some just have to pay more for it than others.

Dr Edey—if you did not have the guarantee then the banks would be in serious strife.

Senator BUSHBY—I agree with that, but it is the execution.

Senator JOYCE—Dr Edey and Mr Schwartz, exactly how much is the Australian guarantee currently underwriting?

Mr Schwartz—The figures are in the submissions—the most recent figures available. I believe the figures that were published in the budget papers had the Financial Claims Scheme deposit guarantee covering around $650 billion, and the Guarantee Scheme for Large Deposits and Wholesale Funding is currently at around $130 billion.

Senator JOYCE—$650 billion and $130 billion is about $780 billion all up. When I worked in banking and we issued a guarantee, which we did all the time, there was always a belief that we could actually honour it if it was called on, but there is no way in the world we could honour $780 billion.

Dr Edey—I think that 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 this stuff. Neither of those has raised concerns about it. Other countries are doing the same thing. These are theoretical contingent liabilities of the government. The set of circumstances in which the amounts that we are talking about here would be called on are just so remote as to be unrealistic.

Senator JOYCE—This leads me to the next question. I can understand that, although I do query as to why we issue a guarantee for something we could not possibly honour, and I question whether there should have been more of a realistic approach to what was issued—that it should be limited to what you could possibly call on. So my question is: what could we honour?

Dr Edey—What you are really asking is whether I can put a figure on the maximum amount of debt that the government could have on issue.

Senator JOYCE—Could we honour half of it?

Dr Edey—You will appreciate that I cannot put a figure on that. Theoretically, a scenario that you are talking about is that the government has to pay out a lot of money and it has to issue a lot of bonds into the market to fund that. What is the government’s funding capacity in a scenario

like that? I cannot put a number on that, but you have countries around the world that have already got debts out there on issue of the order of 50, 100 or more than 100 per cent of GDP. You are talking about potentially huge numbers. The amount of prospective debt that our government would be incurring is nowhere near that order of magnitude, so there is huge capacity for our government to borrow more if it needed. All of that is very theoretical.

Senator JOYCE—Because we have issued the guarantee, has anybody in the Reserve Bank got a number, a rough idea or anything before them of exactly how much of the guarantee we could actually honour if it were called on us? Is it 10 per cent of the guarantee we could honour?

Dr Edey—I do not think it would be responsible for me to try and put a number on that. Sorry.

Senator JOYCE—Has anybody in the Reserve Bank actually done the calculation? I would only want you to take it on notice. I just want to know if anybody has done the mathematics to say what portion of the guarantee could actually be honoured if it were called on.

Dr Edey—I do not think that that would be a sensible thing for us to try to calculate.

Senator JOYCE—Has it been calculated, or has anybody even attempted to calculate it?

Dr Edey—I just said that I do not think it would be sensible to try to calculate a number like that.

Senator JOYCE—That would make me assume that it has not been calculated. So really we have a guarantee that no-one has actually done the modelling behind to see if there is any efficacy to it.

Dr Edey—I have made the general point that our government has a very large capacity to borrow, and we think the circumstances in which significant amounts of the guarantee would be called on are very remote.

Senator JOYCE—I will turn the question around. Seeing that it has relied on the premise that the government has a very large capacity to borrow, how much can the government borrow to?

Dr Edey—Again, I do not think that I can put a sensible figure on that. You would be aware of the figures as anyone, but all I can do is point you to amounts that other governments have been able to borrow. They are very large; they are large multiples of what our government has currently borrowed or is planning to borrow.

Senator JOYCE—Has anybody in the Reserve Bank done any assessment of what the actual level is that the government could borrow to?

Dr Edey—We are aware of what the international patterns are so it is pretty clear what the orders of magnitude are that countries are able to borrow in markets. We know what those figures look like. I can talk about those some more if you want me to, but I do not think it would make a lot of sense to try to pin it down to a single number.

Senator JOYCE—Do you have a confident belief that other governments have the capacity to pay back the magnitude that they borrow to?

Dr Edey—Yes, I believe so. I am not prepared to declare that any government around the world is insolvent or unable to pay back its debts.

Senator JOYCE—Has anybody in the Reserve Bank done even a fraction for the proportion of GDP that we would be able to borrow to or had any advice as to the fraction of GDP that we would be able to borrow to?

Dr Edey—Again I could talk to you about the proportions of GDP that other countries have borrowed and seem to have no difficulty servicing.

Senator JOYCE—That would be all well and good if I were having an interview with them, but I am actually interested in where we are in Australia—obviously, our position is unique and different to other nations—otherwise there is no purpose to you being there. With the implicit understanding of the Australian economy, where do you think we can get to in our borrowing?

Dr Edey—I raise other countries simply because well managed economies have a capacity to borrow; well-managed governments have a capacity to borrow. We do not believe that our capacity to borrow in relation to GDP is any less than that of any other well-managed country. The sorts of numbers that other countries either have borrowed or are likely to borrow over the next few years are of the order of 50 to 100 per cent of GDP, and that is a large multiple of what is projected for Australia.

Senator JOYCE—Can you give me an example of what in your purview is a well-managed economy overseas?

Dr Edey—Yes; the United States.

Senator JOYCE—What is the extent of the United States' borrowing now?

Dr Edey—I think it is about 60 per cent of GDP. I would have to check that figure, but I know it is higher than 50 per cent of GDP and it is projected to rise pretty quickly over the next few years.

Senator JOYCE—Obviously that interlinks very closely with us. Your assessment is that they have the capacity to repay that?

Dr Edey—My assessment is that they have the capacity to repay that and that markets do not have a concern or any doubt about that being the case.

Senator JOYCE—How much of our book is currently underwritten residential housing within our banking system?

Dr Edey—You are asking how much of bank lending is for housing?

Senator JOYCE—Yes.

Dr Edey—I think that would be about 60 per cent.

Senator JOYCE—We have already had evidence that we believe that is very secure, yet we have also seen obviously in the United States economy that that is not the case. I understand there is a difference in the terms and the capacity in America to walk away from a loan, which we do not have here with the bankruptcy laws. Have you done any statistical analysis or any modelling on what will be the effects of a higher unemployment rate and a lower capacity to meet repayments for housing loans that were sourced at the peak of a real estate boom? Very low equity was placed in those houses when those loans were sought.

Dr Edey—There was a large-scale exercise done on that a couple of years ago in conjunction with the IMF's financial sector assessment program and there is another exercise being conducted at the moment to look again at the same questions.

Senator JOYCE—When will that be complete?

Dr Edey—That is work that involves APRA. I cannot give you exact timing on that. You may want to ask the APRA spokesman about that later.

Senator JOYCE—Have you seen in the marketplace any lateral capacity for the value that has been attributed to these residential assets to be realised? Is there capacity to easily access the value that is written in the security papers should the need arise or has that capacity to cover the loan with the sale of the house been diminishing?

Dr Edey—I do not see any problem on that front. House prices have been reasonably stable recently, so the situation here is very different to what it is in the United States, where you have had a period of quite extensive ongoing falls in house prices. That has not been the case here, and loan-to-valuation ratios in general have been reasonably conservative, so I do not think there is any problem there at all.

Senator JOYCE—What is the connection between increase in unemployment and default rates in residential housing markets?

Dr Edey—You would expect in a time of rising unemployment that people would find it more difficult to service their loans and so you would expect to see some rise in default rates. It is already the case that the unemployment rate is up by about two percentage points from its trough, so you would expect to already have seen some of that sort of effect coming through to the extent that it is coming through. But in reality the increases in default rates that we have seen so far have been very modest.

CHAIR—Senator Joyce, I think we are going to have to wrap up there.

Senator JOYCE—I have one last question. How much money are we making from the guarantee?

Mr Schwartz—This information is also published on the government guarantee website. I think the cumulative total to date is around $480 million.

Senator JOYCE—Thank you very much.

CHAIR—We thank the witnesses from the Reserve Bank for appearing. We have gone through our morning tea break, but for the convenience of various officers and people in the room we will have a five-minute break. We will resume in five minutes.

Proceedings suspended from 11.01 am to 11.14 am

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

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

CHAIR—Welcome. Do you wish to make an opening statement?

Mr Chapman—Thank you. We are happy to be here and happy to talk to the committee about the issues as we see them from the regulatory perspective. In previous committee hearings the chairman of APRA, John Laker, has talked about the introduction of the guarantee and the processes around that, so we think that has been covered in *Hansard*. One of the reasons that we two are here today, particularly Mr Johnson, is that he was one of our front-line general managers at the time the guarantee was introduced, so we thought that might be useful for the committee if you wish to talk about what we had seen leading up to that and the pressures on the banks and how those pressures were relieved by the introduction of the guarantee.

I am not sure which areas you might want to delve into, but the other area that we would be very happy to talk about more, if you like, is the issue about how the deposit guarantee might actually work in practice. While it obviously passed parliament and had bipartisan support, as we are looking through the practicalities of it clearly there is a lot to work we have had to do about how that might actually work in an operational sense if we did need to utilise that guarantee.

Coming back to one of the issues you raised with the RBA towards the end there, primarily we see our role as being one of ensuring that the guarantees are not needed to be called. We cannot guarantee that every institution we supervise will always be solvent, and indeed that is explicitly recognised in the statement of expectations the government has issued for APRA, but in many ways it is our job. Our job is to make sure that banks remain solvent and depositors have the benefit of the protection of their deposits, and indeed, as it flows through the broader system, superannuation fund members and insurance policy holders as well. With that brief introduction, we are happy to answer the questions the committee might have for us.

CHAIR—Thank you. Do you wish to make any comment at all, Mr Johnson?

Mr Johnson—No, not at this stage.

CHAIR—I would like to go to one of the issues that was raised towards the end of the last session. Looking at chart 5 in your submission, can you elaborate on how the guarantees have affected competition between the big four banks and the smaller regional banks and between banks, building societies and credit unions? We feel there is an anti-competitive element there in that the smaller banks, in evidence given to another inquiry which we held on bank mergers, have complained that they have to pay a higher fee for accessing the guarantee, which they have to then pass on to their clients in the form of higher fees for mortgages, and that puts them at a competitive disadvantage. Could you comment on that?

Mr Chapman—I understand the issue. APRA has no view per se on the quantum of the guarantee fee. That is not a prudential issue as such. What I would say is that we have seen both guarantees, the funding guarantee and the deposit guarantee, being positive for the ADI sector as a whole. It is clear if you look at the chart that the larger banks have increased their share of deposits, but if you go back in time across the chart that has probably been an increasing share in any event because of the consolidation within the industry. We have seen lots of credit unions and building societies that have increased their deposit base, so it is not a question of their losing deposit base and it necessarily going to the banks. If you look at some of the other commentary in the submission, there is also the issue about consumer preferences, that there is definitely a view by consumers that an ADI deposit of one ilk or another was a safer haven, if we go back six, nine or 12 months, than other potential options. So from a practical point of view we see the guarantee being a benefit right across the sector, and in terms of relative competitiveness that is not directly an APRA concern. We are more interested in are the institutions themselves remaining solvent and are they going to remain solvent as we look forward.

CHAIR—In a way that is an issue about solvency, isn't there, in that if the smaller institutions are doing less business because of the higher fees and because of the uncompetitive outcomes engendered by that, that must in some degree fall within your orbit.

Mr Chapman—At morning tea I was talking to Senator Bushby about competition. I think there is a potential competition issue associated with that.

CHAIR—There is.

Mr Chapman—In some ways the solvency argument is quite the converse. If I am a small institution accepting higher deposits and I am making fewer loans, my solvency actually improves. So there is that conflict, and that is precisely why we have this regulatory structure of APRA, ASIC, the ACCC and the RBA, each one with a separate remit. We do not need to worry about the competition aspects, so we are looking at the prudential solvency aspects. In terms of doing less business, in many cases doing less business improves the solvency position, because you do not have the risk on the other side. It can create additional challenges in terms of what you do with the capital, and that is one of the things we look at for those institutions that are capital- and liquidity-rich. We do not want them to make risky decisions simply to use that capital or to use those deposits in order to maintain the frequency and degree of business running that they might have had in the past.

CHAIR—It is an interesting answer.

Mr Chapman—I think one of the issues there is the fact that we do have the different regulators looking at different aspects. One of the things that we say has been an advantage in Australia, in terms of what we have seen through the process from a prudential perspective, has been that there are very clear remits. We have just had the RBA talking about the system's stability. We have ASIC looking at consumer protection. We have the ACCC looking at competition—indeed, Graeme Samuel has already expressed some words about how little he would like to see more concentration in the ADI sector. That clear focus for each individual regulator, we would argue, has been a real positive as we have seen our way through the last 12 to 18 months. One of the important elements of that—and this comes up in a lot of discussion about the UK situation—is also the way in which the regulators work together through the

Council of Financial Regulators. That regular discussion between ourselves, the RBA, ASIC and Treasury is a real positive in trying to get a proper, systemwide perspective about where the pressures might be.

CHAIR—We understand Mr Samuel’s concerns when you have big banks like the Commonwealth Bank not passing on interest rate cuts and so on; it certainly says in a very loud voice that there is reduced competition out there if a bank like that is in a position not to pass on rate cuts.

Senator PRATT—Policy is that the guarantee is going to operate until conditions normalise. Can you explain to us what you would see as normalised conditions and how we extract ourselves from this?

Mr Chapman—I think the question about normalised conditions is not properly a prudential regulatory question. From our perspective, we would not want to see a major dislocation in banks’ capacity to raise funds. I assume you are talking about the funding guarantee as opposed to the policy guarantee.

Senator PRATT—Absolutely.

Mr Chapman—From our point of view, we would not want to see a cliff, for want of better terminology, where today there is a government guarantee and tomorrow there is not a government guarantee and all ADIs cannot raise funding to continue their businesses. I think—this is covered in the submission and has been covered in many other fora around the world as well—the issue of when the funding guarantee should be lifted is one that is going to take an awful lot of international coordination. If we all go back in time, the Irish got out of the gates with a guarantee first and everybody else followed. To the best of my knowledge, there was no prior international discussion about the Irish going first. To my way of thinking, the issue is not so much the timing but the manner in which the guarantee is removed and the fact that it is in a coordinated fashion so we do not get a hit to our ADIs’ capacity to raise money.

Senator BUSHBY—You are talking about the wholesale part of it?

Mr Chapman—Yes. I will try to keep the two separate.

Senator PRATT—I am not sure if this is a question for APRA, but I am interested in how regional banks are saying that they have to pay a lot more to raise wholesale funds than banks are. Why do you think that might be the case and is that impacting on the stability of regional banks? How are you looking at the viability of those bodies that you regulate and that do not have access to the guarantees? I have been lobbied by a few.

Mr Chapman—They all have access to the guarantee, except that they might have a differential rate that they are paying the government for the guarantee. The actual rate of the guarantee is a government policy decision. If it were twice that or half that or a steeper or narrower differential, it is not an issue per se for us as a prudential regulator. But in terms of how we would look at the solvency, perhaps I will flick that to Mr Johnson to discuss.

Mr Johnson—On the issue of their paying higher costs for wholesale funds, in the normal market a lower rated bank would be paying a higher cost for funds. As I think Senator Bushby said before, even now the market is not working as smoothly as possible in terms that, even though there is a guarantee, they are still paying a bit more perhaps. But in terms of our supervision, we look very closely on the funding side, how it feeds through to the lending decisions. We monitor closely the quality of the lending, we have our capital adequacy regime in place and we look at the underlying capital ratios of the banks. To be honest, in the current environment, the banks, despite what they may be saying, are remaining quite profitable and very well capitalised.

Senator PRATT—Indeed they are.

Mr Chapman—It is important to recognise on both a domestic and international basis that the banks have come through this environment very well compared to their oversees counterparts.

Senator PRATT—Could you explain to me what is going on in relation to competition between different institutions, as per graph 5 on page 7 of your submission? You have regionals, foreign branches and other Australian. What kinds of impacts are we seeing from the crisis on here? Can you characterise what is going on for each of those different sets of institutions?

Mr Johnson—The primary thing there, as we often see in uncertain financial markets, is that there is a flight to quality to the largest banks. You can see there that the foreign bank branches and foreign bank subsidiaries took a cut in their share of the total deposits. The regionals increased their share after the guarantee. The credit unions and building societies had come off but have more or less stabilised. So essentially it is a move in the share, not the total, because overall there was a huge shift of deposits into the ADI sector. The share moved away from some of the foreign banks primarily into the large banks.

Senator PRATT—This is not in your chart, but how did the guarantee affect competition between ADIs and the non-prudentially regulated sector such as property trusts and corporate debentures? What impact has it had on home loan lenders who fund themselves by securitisation? When I speak about who I have been lobbied by, they are the kinds of agencies who have come and expressed concern to me.

Mr Johnson—The securitisation market effectively was one of the first casualties of the GFC back in late 2007. When the subprime crisis hit the US, securitisation markets around the world were adversely impacted and a lot of the players here in Australia that relied on securitisation, including a number of ADIs but particularly the non-ADIs, found that access to that form of funding was not available.

Senator PRATT—What is the long-term prospect? I appreciate banks will always have that kind of advantage in the market, but that has now been exacerbated by the current crisis. How do you envisage that we might get some returned stability across those other sectors as well?

Mr Johnson—At some stage confidence must return; but, given the severity of what happened in the US and the lack of underlying confidence in instruments such as securitised bonds, it will be some time, as I think one of the other speakers said. The Australian residential mortgage backed securities market is one of the best performing in the world and has been for a

long period of time. The default rates are low and the quality of the assets is high, but if no-one wants to buy them that market is effectively closed.

Mr Chapman—I just digress a little bit, Chairman. I think that is one of the issues that we have taken out of the crisis, and we are encouraging our banks and, indeed, all our regulated institutions to think about. It was just inconceivable that Australian mortgage backed securities could not be sold, because there were no defaults, they were extremely well performing and very secure. Nobody looked in the crystal ball and said, ‘That entire market might just disappear from us.’ It is a good indication that I use all the time to talk to people about. We have to start looking at the risks that sit outside the normal one or two standard deviations that we look at. What is the risk that sits out here that we need to guard against in the future? Certainly, one of the issues that we have taken on and that we are encouraging and pushing through all our supervisory activity in the industries that we supervise is to look at a much broader spectrum of risks than we might have looked at in the past.

Senator BUSHBY—Thank you, to the officers from APRA for coming along today. I will just recap on what you were saying earlier: your remit is not to look at the effectiveness and efficiency of the financial services markets; it is more to look at their stability.

Mr Chapman—A few years ago, we had ‘financial stability’ added to APRA remit within the APRA Act. I do not want to mislead you by saying that we do not look at that, but our prime focus is the security of depositors in the ADIs.

Senator BUSHBY—I actually meant to say ‘solvency’ rather than ‘stability’. Your prime focus is solvency. The primary focus with all the measures that you recommend and the analyses that you conduct is to ensure the solvency of the institutions that you oversee.

Mr Chapman—That is right. It is much more than solvency at a point in time. There is a degree of alignment. We often have interesting discussions with boards where the boards say, ‘What’s good for shareholders is always good for customers,’ and sometimes we say, ‘Not necessarily.’ We have that sort of debate with them all the time. It is also a much more forward-looking process. We do not want bank X to be solvent today and insolvent in a month. Indeed, when we talk about the funding arrangements, one of the things that we have been pushing our ADIs to do for quite some time is to look at a much longer term funding profile. Obviously, last year they were back to somewhere between one and three months because that was all the international markets were prepared to fund. We are trying to move that forward so that we do not have—coming back to my earlier cliff analogy—a cliff where half of their funding base expires on 1 November 2010. Yes, we focus on solvency but also on ongoing solvency rather than purely at a point in time.

Senator BUSHBY—Just for clarification: do non-ADI financial institutions, mortgage trusts and things like that come within your purview?

Mr Chapman—They do not come within our purview at all from the banking side. As we said earlier, we have some peripheral involvement through things like superannuation and life insurance where they invest into those instruments. We certainly have a reasonable degree of regulatory work to do for the flow-on effects of what might happen to those but we do not regulate them directly. They are ASIC-regulated as managed investment schemes.

Senator BUSHBY—Am I drawing too simple a conclusion, particularly given your last comments, that if government decisions were made which shored up the solvency of those institutions that you do have responsibility to look at at the expense of those you do not, that would not be a concern to you?

Mr Chapman—Sorry, I am not quite sure what the question is.

Senator BUSHBY—I will be more direct in what I am asking. Most of the submissions that we have had, except for those coming from government, say that there were consequences in a big way from the bank guarantees. Obviously, there are other factors at play but the guarantees themselves specifically had consequences which basically meant that the mortgage trusts and cash management trusts and things like that became unworkable. As a result, there has been a concentration with the financial institutions that are deposit guaranteed, and that probably helps bolster the solvency of those institutions, which are the ones that you look after and which would make you happy because everything that you are looking to achieve is being delivered but at the expense of other sectors of the financial services economy.

Mr Chapman—That is correct. Our primary focus is on the ones that we regulate. We do obviously have regard to the market because, to use an extreme example, if you have two providers in the market and one has 99 per cent of the market then, obviously, some of their practices could lead to market abuse, there could be some processes that they run through which are highly risky and so on. Primarily, yes, you are right, our focus is on how is the guarantee affected, helped and indeed threatened—

Senator BUSHBY—How measures in general that the government might take might help to assist.

Mr Chapman—Yes, and again that is across all four sectors.

Senator BUSHBY—On that basis then, if you were asked to provide advice on a proposal or to come up with a proposal that was designed to help ensure solvency of those institutions that you are looking after in the long term, but it was apparent to you that there were consequences for those that were outside, would you raise those issues?

Mr Chapman—Yes, I would be very confident that we would. I might have painted a bit of a myopic view.

Senator BUSHBY—What you said was quite correct. There are a number of different agencies and there are areas that look at competition within banking sectors.

Mr Chapman—We would not necessarily go and look for those effects, but if it was an obvious one, for example, if we said that every insurance product in Australia should be written by an Australian owned insurer, that would have a lot of impact on availability of cover and everything else across the market. We realise that and we would give that advice to government in that situation but we would not be representing the interests of that sector, we would be trying to represent the interests of the Australian community where our strengthening proposal would potentially reduce something for the community.

Senator BUSHBY—When these guarantees were first being considered by government was APRA consulted as to the advisability or otherwise and the preferable construction of the guarantees?

Mr Chapman—As I said before, Dr Laker answered these questions in a couple of hearings at Senate estimates I think. There are two guarantees. On the deposit guarantee there had been a lengthy process that the Council of Financial Regulators had been through with the previous government in terms of developing that proposal. On the funding guarantee it was a much quicker issue that really got driven by international developments. Because I was involved in the deposit side I can talk about how we went through that development process.

Senator BUSHBY—Up to that point they were talking about a $20,000 cap on the deposit. Then they went to an unlimited cap and then we had it back to a million but still unlimited if you are willing to pay a bit of a fee over that.

Mr Chapman—But that is a policy decision rather than an APRA regulatory process.

Senator BUSHBY—But that policy decision in itself had ripple effect consequences in the financial services industry.

Mr Chapman—That policy decision, in my view, had a very strong confidence-building effect on the Australian community.

Senator BUSHBY—Moving it from $20,000 to unlimited?

Mr Chapman—A lot of the research that was done around whether it be $20,000, $50,000 or whatever the figures show that something like 80 per cent of people do not have more than $20,000, so it would cover the vast majority. But how do you start to explain to people—and this was a lengthy discussion with the Council of Financial Regulators prior to the actual implementation—who is in and who is out and where the complications are. I think there is a lot of merit in a broad, easy to understand approach. I cannot debate whether a million dollars is right or whether it should be $100,000 or $50,000. In terms of education of the community, there is a fair education effort to go through for people to understand how that happens and when it starts to get to the level where it interacts with their personal circumstances. Certainly, that was the experience in the UK when Northern Rock collapsed and there was a lot of concern because people were not 100 per cent covered. So the question people ask is ‘Am I in or out of the protection scheme?’

Senator BUSHBY—But in the UK they have only moved to £50,000.

Mr Chapman—Yes, but they changed it along the way.

Senator BUSHBY—It was £20,000, that is right but ultimately they ended up at £50,000 which is a long way short of $1 million.

Mr Chapman—But the dollar amount on that is not an APRA decision, it is a policy decision. On the funding guarantee side, and I think Dr Laker has commented on this before, my

understanding is that the advice to government was through the council and Dr Laker has answered questions about his involvement in that process previously.

Senator BUSHBY—Mr Chapman mentioned that you were working at the face of this at the time. Just for the benefit of the committee, would you mind outlining the pressures you saw building prior to the guarantee that led to the need for decisive action.

Mr Johnson—Yes. There was considerable disquiet in the funding markets moving into September 2008 and it really reached a trigger point when Lehmans went into bankruptcy in the middle of September. We had an internal ADI liquidity monitoring team, which was a group of people who were ringing up the treasurers of the major ADIs and a lot of the others day by day to find out just how the funding was going, whether deposits were flowing out and how they were accessing the wholesale markets. A couple of weeks prior to the guarantee, particularly the week before, it got to the situation where there were outflows from a number of ADIs. The larger ADIs that relied on wholesale funding markets found it very difficult to get anything other than very short-term money. As Mr Chapman said, the banks have traditionally tried to get longer term funding from these wholesale markets. They were reduced basically to overnight money. It was going like that from day to day and flows were very variable across a number of ADIs. After the announcement that weekend, things calmed down. Until the final wholesale guarantee was put in place in November, that market continued; it was available but it was still very short term until the details were worked out and then banks have subsequently been able to get a lot of longer term funding.

Senator BUSHBY—In terms of the deposit guarantee, was there evidence that people were pulling money out?

Mr Johnson—There were some ADIs that were having outflows.

Senator BUSHBY—Was there any particular class of ADIs where it was more obvious than others?

Mr Johnson—I would rather not comment on that. There were a number of ADIs that, for unique reasons, had outflows.

Senator BUSHBY—But it was not clear that they were regional banks or small banks.

Mr Johnson—It was not a particular sector which had it across every member of the sector, no.

Mr Chapman—To come back, Senator, on the deposit guarantee as well. Do not forget, if you are a large council, for example, the way you fund a bank is not by buying the term subordinated debt or something; it is by putting a deposit in. So there is that interaction process. They were the sorts of issues where we were seeing some concerns. It was the large depositors; it was not so much 150 people pulling out $1,000 each of an ADI. That is not a threat. It is where somebody might have a couple of hundred million and you start to get a conglomeration of five or six $200 million depositors who are shifting their cash at the time.

Senator BUSHBY—Do you think that depositors with that level of funds were concerned about the solvency of the institutions that they had their money with? Is that the motivation for why they might have been withdrawing deposits of that size?

Mr Johnson—Yes. There was a lot of concern about just where all this was going and whether it would affect some individual ADIs adversely.

Senator BUSHBY—As I mentioned this morning, I do not think there is any doubt that action was needed on the guarantee at the time. As I said, Malcolm Turnbull was the first person to publicly call for that. Mr Chapman, in terms of the answer to when you should withdraw wholesale funding, you said that it needed to be a part of an international strategy and timed well. To what extent do you think it will take care of itself by the market actually pricing non-guaranteed money and making it competitive with guaranteed?

Mr Chapman—You probably should have asked Dr Edey that. That would be the ideal outcome.

Senator BUSHBY—There is some evidence that that has been happening in recent months.

Mr Chapman—That is right. Some of the big banks have got away with non-guaranteed debt. In at least one case they got a rate at least comparable if not slightly better than a guaranteed debt, which is completely illogical. The ideal process would clearly be the market did look after it. To come back to Senator Pratt's question, the decision would be extremely simple. Take the guarantee off when the market is working.

Senator BUSHBY—Because when the market says it has basically become redundant, which may well happen in terms of the wholesale guarantee. The issue still exists in my mind about the pricing at which the variable parts of the market actually access that. I do not know that you are necessarily the people to ask about that, but in terms of the deposit guarantee it is another matter altogether. That is not going to take care of itself and that will need to be a policy decision of government as to when and if that actually gets wound down or removed. Do you have any views on the deposit guarantee and whether that should remain permanently or whether the cap needs to be wound back?

Mr Chapman—In terms of the time, and partly because of the issue I raised before about the large depositors and how that plays through to the system, we have been an advocate for quite some time that having a scheme in place prior to any failure occurring—which, of course, we all hope will not happen—would be a positive. We have no particular view on what the limit should be as long as how it all works can be clearly explained to people. One of the reasons that we have supported the idea of having a structured scheme in place has been, obviously, the events of HIH. But if we go back further than that to the Occidental and Regal days it is a much more logical and controlled process, where you have a legislative remit available from day one. Back when Occidental and Regal failed as life companies the government at the time had to get the legislation in place by—for want of a better terminology—making it up as everyone went along.

We are strong advocates for there being a scheme. We are strong advocates for getting the structural legislative underpinnings and the structural process in place, but we have no particular

view on what the quantum should be, other than the fact that it should be as clear as possible for people to understand what is covered.

Senator BUSHBY—Do you think that it necessarily has to be a guarantee scheme, or maybe a form of insurance scheme similar to the US?

Mr Chapman—One of the challenges with an insurance scheme is that you need to collect the premiums and invest the premiums. That works well in a structure such as the US or the UK, where—I am not sure what the numbers are—the US has a failed bank probably every day or two. So they have a couple of hundred a year because they have a much bigger market. One of the difficulties in our market is that we have had very few bank failures over the years, so how do I build up a pool of premiums which gives me the capacity to fund the failure of bank debts when bank debts could be anything from—I had better pick a fictional name—the West Woop-Woop Credit Union to a major institutional bank? We do not think that in our environment, in the structure of our banking system or the insurance system as well, that pre-funding is necessarily logical.

Senator BUSHBY—Pre-funding is one way. It also might remove the moral hazard of actually providing a blanket guarantee to banks which means they can go off and do whatever they like and they are going to be covered, whereas insurance has a slightly different approach and they have to be more responsible.

Mr Chapman—I agree—I think moral hazard is a real challenge in this regard. That is why I do not think in the long term it should necessarily be an unlimited guarantee. But also, do not forget that the moral hazard is only there to the extent that the banks are, as an example, 100 per cent aligned on protecting deposits. The banks have lots of stakeholders; they are servicing their shareholders, their depositors and lots of other people in the process. The guarantee is not guaranteeing that a bank will not fail: the guarantee is guaranteeing that you and I will get our money back out of the bank. The way the process would work on the deposit guarantee is: bank X fails, we crystallise the deposit base, which might be $100 million; the $100 million is paid out to the depositors; APRA is now the creditor for that $100 million and depositor preference applies to us. So the actual people who will benefit from the guarantee are only the depositors, and at the end of the day you are still not getting that sort of flow through to protect many of the other stakeholders. The creditors will come second, but the shareholders are the ones who are going to take the big hit.

Senator BUSHBY—But, nonetheless, it would still be a factor that—

Mr Chapman—Yes, it is definitely a factor, but the point I am making is that the banks are not only concerned about deposits.

Senator BUSHBY—I understand, yes. Thank you.

Senator JOYCE—Going to the whole structure of this, if I was to decide tomorrow that I wanted to set myself up as underwriting banks, and I am a man of modest means, could I do it? Could I issue a guarantee and collect a fee for it?

Mr Chapman—So you would go off to a bank and say, 'You pay me a premium and I will do it'?

Senator JOYCE—Yes. Could I do that?

Mr Chapman—Depending on how you structured it, we would have to authorise you as an insurer, but in principle, yes—

Senator JOYCE—That is exactly the point. In authorising me as an insurer, what are you looking for?

Mr Chapman—Substance in terms of capital; risk management and controls; proper valuation of liabilities; the fitness and propriety issues; the governance and expertise issues. So it is a fairly intensive process. But, after you have convinced us that we should give you an insurance licence, you have then got to convince an individual bank that you are the person they want to deal with.

Senator JOYCE—Would my capacity to actually meet those underwritings that I give, as and when they fall due, be one of the things you would analyse?

Mr Chapman—Yes, that is what the insurance process is all about. We have a structured process through the insurance requirements, where people need to work out what their claims are going to be on average and they need to then add capital factors on top of that. The theory goes, and we have seen no evidence to show that we are fundamental wrong with our policy and capital settings, that an insurance company has a 99.5 per cent probability of meeting all claims as and when they become due. Obviously, there are a lot of probability estimates that go into that. We work through that regularly with our regulated flock to ensure that they are making those assumptions on a reasonable basis and they are changing them and stressing them as necessary.

Senator JOYCE—The problem I seem to have is that the government is underwriting $780 billion, which I know from other discussions with Treasury we would not have a hope of repaying if it were called upon, not on top of the $315 billion of federal debt and the other $230 billion of subprefecture debt. Their words, and going to the most optimistic, were 80 per cent of our GDP, which is $900 billion. We would not even get within being able to honour half of this guarantee, if it were called upon. The problem I have is that we have managed to collect $480 million, or half a billion, for a guarantee that we could not possibly honour.

Mr Chapman—That is definitely not an APRA question. It is a policy question for the government.

Senator JOYCE—Is there something intrinsically wrong about collecting a fee for something you could not possibly honour?

Mr Chapman—That is not an APRA question, I am sorry, Senator.

Senator JOYCE—Would you be interested to know what sort of statistical analysis or modelling they have done? How would you envisage this bank guarantee being paid? We have

got four major banks, so if one went you would have a big lumpy hole in your guarantee straight away. Is that how it would work, or would you just pay out some of the bank's money?

Mr Chapman—They are questions to ask Treasury, I am afraid, Senator, not us.

Senator JOYCE—They just did not seem to want to answer it. The answer we got from them is that they have not done any modelling. Does that concern you at all?

Mr Chapman—That is not an APRA question, I am afraid, Senator.

Senator JOYCE—Would you run through again what sort of licensing arrangement you would wish to see in place before you allowed someone else to issue this guarantee?

Mr Chapman—If an entity applied to us for a licence and they said, 'We want to be in the business of guaranteeing debt, be it a bank or any other corporate entity,' and that was clearly structured as insurance—which is not always the case because you can provide guarantees which are not an insurance policy, they can just be a straight guarantee; but if they were looking at an insurance structure to do that—we would be looking at the entity itself, its history, its background, because one of the biggest risks we always see is people straying into areas which are outside their normal ones. We would be looking at their internal capacity to analyse data and the way in which they were looking at their future payments and future cash flows. We would be looking at how they were going to raise capital and what degree of capital they had there, because capital is not there to pay claims, in an insurance sense; capital is there to ensure that there is a buffer against adverse experiences. So there are a lot of individual processes that go to make up to the process. We would also be looking, of course, at the nature of the businesses they were proposing to undertake. If they were taking a highly concentrated approach to a particular business line we would usually be requiring them to hold additional capital or to have other mitigants in the process.

Senator JOYCE—How do the government manage to offer a product which they have collected half a billion dollars for and not do any of that?

Mr Chapman—That is not a question for APRA.

Senator JOYCE—It seems like a handy sort of business to be in—to be offering products that you cannot actually cover, to collect the money up front without doing any actual analysis of what you are doing and to have no statistical backing or modelling behind what you are doing. But let us move on to another area: let us look at the risk side. I have been told just now by the Reserve Bank that the premise of this is that it is matched against other well-run economies such as the United States of America. Do you see the United States of America currently as a well-run economy?

Mr Chapman—I am sorry to keep repeating myself here, but I do not think that question by itself is a question for APRA. We are happy to talk about some of the regulatory differences between us and the US, but I do not think that a status of the economy report is an APRA question. I think Dr Edey is much better qualified than either I am or we are to answer that specifically.

Senator JOYCE—When you are doing your analysis of banking and your prudential oversight, do you do any risk matrices or modelling of the banks to see exactly what their exposures are? Do you just create a contingent liability which sits on the books regardless of whether it has been paid out or is likely to be paid out? Do you do any forward analysis of a risk position for the debts that are currently held by the bank?

Mr Johnson—I can answer that one. We undertake quite a lot of what I think you are referring to: stress testing of the banks—

Senator JOYCE—Yes.

Mr Johnson—asset books, lending and the like for potential developments. We have been doing that for a number of years and we are continuing to do so. I think you mentioned the residential mortgage market earlier. APRA in 2003 did quite a comprehensive stress test of the full range of ADIs for a 30 per cent fall in housing prices and a commensurate rise in default rates to see what the impact would have been on the capital ratios. A small number of ADIs would have got to a position that we were uncomfortable with. We worked with them to develop a minimum capital level that was able to withstand that sort of stress test. We did, as Malcolm Edey said, stress tests with the IMF in the FSAP a couple of years ago. As part of the new Basel II arrangements, we also require banks to undertake regular stress testing and, for some of the smaller ADIs, to be able to have some basic capabilities there.

Senator JOYCE—Do you think it would be pertinent for a person offering a product, whether it is the Reserve Bank or anybody else, for there to be an analysis of exactly what is the total amount of debt that that entity, whether it is a government or a bank, should be able to issue?

Mr Chapman—I do not think that is a question for APRA. If someone is regulated by us, we put a lot of process into ensuring that the people regulated by us have as low a probability of loss to depositors or policy holders as could possibly be achieved. But, even in that environment, we cannot and should not make a promise that there will be no failures.

Senator JOYCE—I will put it this way. If one of the major four, next time you went down and had a squiz in their securities department, said, ‘Whilst you were away, we offered $780 billion worth of guarantees,’ would that be of concern to you?

Mr Chapman—Yes.

Senator JOYCE—What would then be your process of discussion with that bank?

Mr Chapman—We would probably quite shortly be having a major discussion with the chairman and the board.

Senator JOYCE—What would you do to try and see if that $780 billion could get underwritten? What would you be advising them?

Mr Chapman—Hypothetically—because we have not got it—and in a general sense, where we think any of our institutions, in any sector, are taking a risk which they have not properly

considered or mitigated, the process we will be doing with that institution would be to make sure it did take steps to do that.

This has come up, though not at that quantum, a number of times in the insurance sector and the mitigation taken in those circumstances is, for example, more reinsurance or a spread of risk so you are not only with one reinsurer. We would say, ‘If you’ve done this and you really meant to do it, what controls do you have in place to make sure that the residual risk is lowered?’ The gross risk might still be $780 billion but if the residual risk is much lower then by itself it is not much of a problem. If we found one of our institutions had gone into this in a big way, we would be extremely unhappy because we work cooperatively with the industry and we would expect them to talk to us about undertaking such a large risk.

Senator JOYCE—In essence, you would expect a very stringent exit plan to be delivered to you, so you had some confidence that the entity was under control. You would say, ‘What is your process for offsetting this and spreading this risk around and’—more pertinently—’what is your process for getting out of this position’?

Mr Chapman—Yes, that is fundamentally how we look at all the businesses that our regulated entities undertake.

Senator JOYCE—If someone presented you with just two bullet points that basically said that when things get better they will pay the money back, would that give you confidence that you knew what they were on about?

Mr Chapman—If one of our regulated institutions did that, the answer would be no.

Senator JOYCE—Thank you very much.

CHAIR—Thank you very much for appearing.

[12.01 pm]

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

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

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

CHAIR—Welcome. I invite you to make an opening statement if you so desire.

Mr Gilbert—Thank you for inviting us to appear today. IFSA is broadly supportive of the government's commitment to stabilise financial markets and restore the flow of capital and liquidity, and support domestic economic growth consequently. However, we remain concerned that there has been an adverse or spillover effect that has impacted the stability and operation of mortgage funds, cash management trusts and superannuation. For a time, post the events of October-November 2008, the equities market was the only market where liquidity was easily accessible. We believe that some of the downward spiral on the equities market was caused by the fact that people were dashing for equities in order to get a cash substitute.

What is the impact of the guarantee on IFSA's mortgage trust members? They have experienced massive redemptions and they have been placed in managed freeze mode. Mortgage funds serve a very similar function to bank deposits for investors looking for a regular and stable income, typically a monthly income stream. Mortgage funds are also an important source of funding for the commercial sector. For example, developers building low-rise home units and small businesses wanting to purchase their stock via finance are typical holders of first mortgages from mortgage trusts and these mortgages can be between three and five years duration.

We note particularly the comments by APRA and RBA. They indicated in their submission that one fund had failed—I think that was in March 2008—and that there had been a tightening in the market. That on one hand needs to be noted and I think that was a peculiar position for that fund. It may well have been a governance failure in the fund, but the rest of the industry up until the guarantee announcement was liquid and managing redemptions. What happened post the guarantee is that the bulk of my members in the mortgage sector experienced a 2½ thousand per cent increase in redemptions. I ask: could a bank withstand that? These funds that have been operating quite normally for up to 20 years had to place themselves into freeze mode.

Notwithstanding that, the law—that is the Managed Investments Act, which this parliament passed back in 1998—has worked well for the great majority of investors in these funds. Currently, I do not think we have a single dispute before the Financial Ombudsman Service. Interest payments are being made on schedule. No principal has been lost except for that fund that folded in March—I think principal will be lost there. But there are delays in redemptions. I know that is putting pressure on parliamentarians, and I know it was raised recently at the ASIC

oversight committee on 17 June, the Parliamentary Joint Committee on Corporations and Financial Services.

In the absence of an exogenous event, we are not going to be able to accelerate these redemptions. We define an 'exogenous event' as some assistance from the Office of Financial Management, which has helped some of the regional banks, and even some assistance from the RBA to purchase and re-sell some of the assets that are in these mortgage trusts.

If we have a private sector solution—as was suggested, I think, inferentially in some questioning at the parliamentary joint committee on 17 June—I can assure you that there will be one outcome: people will have a haircut of their assets. So we need to manage these redemptions, and to force the industry to liquidate assets fast would only put good mortgages out in the market at a discount. Apparently—we have heard informally—there are some vulture funds coming in that are offering to take over some people's assets with a 25 per cent discount. That would be absolutely adverse for the 250,000 unit holders who are in this freeze mode, and we strongly suggest that the committee not recommend that we be forced to have a fire sale of our assets.

Importantly in this process, the much-demonised financial planners have played a very constructive role. Most people in these mortgage trusts have gone in through a financial planner. They have held a mortgage trust as one of 10 investments, and so they have relied on other investments for liquidity. Consequently, that is why—unlike, say, Hong Kong, where there have been hundreds of thousands of people on the streets complaining about frozen funds or lost funds—we have not had people on the streets here. They have been managed well by the industry and also by the financial planners.

I want to get to the other genre of funds impacted by the bank guarantee. Essentially, eight per cent of our industry was impacted by the guarantee. That is about $80 billion or $100 billion out of $1.2 trillion. That other sector is the cash management trust sector. These are critical funds because they provide competition for the banks. I heard in the previous set of questions that APRA was being asked about regional banks versus big banks competition. The cash management trusts also provide competition for deposit taking and also the issuance of paper—whether it is government or commercial. These funds were also placed under great strain, and they experienced very abnormal levels of redemptions late last year. We watched them very closely, but they survived. Without any help from outside, they survived and they are now getting back on their feet in order to grow again. I do not think they are growing very strongly, but they are there. Again I can say that the Managed Investments Act worked well for these institutions. But they had to do one thing: they had to move out of commercial paper. That is a critical effect for the industry, because this is the paper that finances business. This pays for payrolls and it allows people to have cash in their businesses.

I have with me today Anne Anderson, who is the fixed interest CMT manager for UBS Global Asset Management. She runs the Australian operations and is also responsible for Asia. If you have any particular questions about cash management trusts and the technicalities of running those, she will be able to help you.

Let me get to my concluding remarks. While the financial crisis and banking panic extended for much of the fourth quarter of 2008 and for the first quarter of 2009, market conditions are

beginning to stabilise. We strongly believe that the timing is right for the government to actively review the banking deposit arrangements, including a reduction in the threshold and, if they are not going to scale down this threshold, then perhaps consideration should be given to charging bank depositors for the right to have a risk-free rate of return which a guarantee provides. In that regard, we did some survey work which was sent to government, which we would also be happy to give you. This survey work, which I will give to senators now, shows a relatively high level of general awareness in the population about the retail deposit guarantee, but the specific awareness about the terms of it and threshold is low. The other thing about the guarantee is what it suggests about people's perception of their bank balance. The average bank balance, it seems, is about $35,000. So it is nowhere near $1 million. I think that material might inform the committee about what the people think about guarantees, how large they should be, how extensive they should be, and how long they should last. That concludes my opening remarks. We would be very happy to take questions.

CHAIR—Thank you very much. You obviously have faced some problems in your sector. I notice in your submission you talk about the United States guarantee programs. The US Treasury announced in September 2008 the establishment of a temporary guarantee program for the US money market mutual fund industry. Would you like to tell us a little bit about that and about whether you think something like that could be done in Australia?

Mr Gilbert—We watch very closely those developments. The US mutual funds have a much bigger—relative and absolute—sized cash management trust or money market industry than we do. If the US government had not stepped in, major US private sector employers would not have been able to pay their payrolls because those funds were in great difficulty. Interestingly, these funds were given access to a guarantee, for which they had to pay. With hindsight, perhaps that should have been the track we went down in Australia. Anne might like to comment more.

Ms Anderson—I think also the US situation is unique, whereby the money market funds in the US have a criterion called 2a-7. They have a maximum exposure to a single issuer of five per cent. There is quite a different framework and process of intermediation through the capital markets in the US, whereby a lot of corporates borrow in their own name. They issue commercial paper. Following the Lehmans collapse, there was a run on one particular fund—the reserve fund—and then that triggered a run across the industry. That was a very serious issue for the US government. If they had not allayed those concerns, they would have cut off funding to a lot of corporates.

Australia is quite different. Our corporate market is relatively small, and the banks provide the large part of funding in our market. Hence, with our banking system, with its very concentrated status, all roads lead back to the banks. There is quite a different framework in Australia by which corporates gain funding, and that is why the money market is set up. My money market fund—or equivalent—primarily consists these days of 100 per cent high quality bank paper. I can invest in semi-government Treasury notes and I can also invest in asset backed corporate paper, and I currently do not. I used to. I do not do that, which in large part reflects investor preference and my view around liquidity that I need to correctly manage the fund.

CHAIR—You also talk about permanent responses and interim measures for the problems you have faced. You recommend:

… that the Government purchase units in eligible mortgage funds (subject to the establishment of an appropriate eligibility criteria).

Do you want to expand a little bit on that for us? Then could you talk about what you regard as your permanent response, which is the narrowing of the existing bank deposit guarantee.

Mr Gilbert—We have put to government—and we would be happy to provide our submissions to the committee if the committee wanted them—a number of proposals. We also put to the Australian Business Investment Partnership investment banking inquiry of the committee a proposal for our members to be given some assistance. We were not asking for a guarantee. What we were asking for was the government to look at the quality of the paper via its agencies and to decide whether it wished to bundle up that paper, securitise it and then onsell it. One could legitimately ask: what about the private sector doing it? As I said in my opening remarks, that would be costly to investors. The discount on the stock would mean that people would lose a lot of money. Anne, do you want to add to that?

Ms Anderson—I think, to expand upon that point, there are the vulture funds. That is the price of liquidity. The investors can take a cut on their principal, but that is the price of liquidity. I think it is disproportionate to the effort that they take to make the investment. They are earning seven or 7½ per cent and then they take a 25 per cent haircut.

The other aspect is the securitisation market. For all intents and purposes, the securitisation market is shut. Residential mortgage backed securities, as you would be well aware, were purchased by AOFM for non-bank originators. But at this time that market is unable to issue to people like us because the assets that we own are marked or valued in my book at 250 basis points—we talk about the spread—and AOFM is buying at a spread of half of that. I am unwilling to buy in at the spread at which AOFM is buying because I own assets which are valued at much wider spreads. So that is one part of the problem. Again, it is just another angle of what we are talking about. With the ways of restructuring the underlying assets within the mortgage funds it is almost the same thing—you are taking a haircut on your principal.

Mr Gilbert—That is the short-term imperative. The longer term imperative is that we believe that it is time for the bank guarantee to be wound back in time and also in value. We have put a submission to government on that. If the committee wants that submission, we would be happy to provide it.

CHAIR—Earlier we noted that some other countries, such as Singapore and Hong Kong, have wound back their guarantees. But the answer we got about Australia was a very vague one: ‘That will be done when it’s appropriate to do so.’ What criteria should apply for the winding back of that guarantee?

Mr Gilbert—In our submission we suggested that we keep the three-year time frame but between now and the three years we successively wind it back. What were the precise amounts?

Mr Sorby—Richard is right. It would be over three years. It would be reduced to about half a million within 18 months and then would be phased down over the following 18 months before finally being switched off in 2½ years time.

CHAIR—You talk about bringing it down to $50,000. We also noted that a lot of other countries in fact did not have anything like a million-dollar guarantee. Do you think that the guarantee being set at such a high level in Australia, compared to countries like the UK and so on, was really necessary?

Mr Gilbert—It was a tough call the government had to make. From some of the anecdotal evidence that I have received from our members, there were big amounts being switched out of accounts. So I guess the government reacted to that on the spur of the moment, on the spur of a couple of weekends experiences. But hindsight is a good teacher and we say that that guarantee needs to be much lower. The guarantee which was in place beforehand, which was even lower than $50,000, was something which we engaged in the consultation process on.

CHAIR—Were the same sorts of problems occurring in other countries, though? Was the Australian experience unique?

Mr Gilbert—Not really. The Australian government had access to video footage of people lined up in the UK and in Ireland to get their money out of the bank.

CHAIR—They still have lower guarantees.

Mr Gilbert—Yes.

Ms Anderson—It was an asset quality problem. The good thing for Australia is that the stability and health of our financial system held us in good stead. It was quite interesting that at the time a lot of investors or depositors actually thought that we did have the benefit of a guarantee. So when there was a guarantee put out there they said, 'Oh! I thought it was guaranteed.' I think it was the asset quality of the Australian banks and the liquidity position, but there was a genuine contagion effect and I think the government quite correctly took action at the time to allay any chance that that would happen here. I think Australia was unique in a good way.

Mr Gilbert—As I said in my opening speech, the investment industry or the funds management industry has been subject to good regulation. We have managed this. I noticed the RBA and APRA tried to draw a parallel between now and the property trust crashes in the late eighties or early nineties. I cannot agree with that comment. Those property trust crashes led to people losing half or two-thirds of their money. That has not happened here. These funds are still good funds, with first mortgages in them. The CMTs are still well run and are still returning to investors.

CHAIR—So what criteria would you apply as to whether market conditions are appropriate to reduce these guarantees?

Mr Gilbert—I think we should go for a technical answer here, and Anne will have a view about the stability of the market.

Ms Anderson—I think we have come a long way. We are not seeing flows out of our cash funds anymore; it has stabilised. The corporate bond market has reopened—in a small sense. Banks have raised in excess of $95 billion offshore. Interestingly, the spread of the unguaranteed

versus the guaranteed is starting to converge. It has not closed completely. There is a reason for that. The investors are now reaching for yield, so you are seeing a better balance of risk appetite. Natural risk is returning as the aversion fades away. I think it is not yet correct to say that markets have normalised, but we certainly are in a much more stable position now. The things that are left, for me, include the fact that lower rated banks still are finding it hard to compete. The cost of the guarantee for them is high and it is difficult for them to compete. Commercial mortgage backed mortgage funds and the residential mortgage backed market, which are a very important source of funding, remain for all intents and purposes closed. That is one thing that is left. It will thaw. It will repair, but it is going to take another 12, maybe 24 months, and some businesses will not be able to survive that long.

Mr Gilbert—To add to that, it is worth going to page 7 and 8 of the PowerPoint presentation we gave you. In terms of the guarantee and its perception by the retail users of the banks, the chart there shows that 64 per cent of the people surveyed believe that a guarantee of less than $100,000 is all they need right now.

Ms Anderson—That is talking about the deposit guarantee. There is also the wholesale funding. There are two aspects two it. Here we are talking about the deposit guarantee.

Mr Gilbert—But at the end of the day there is the technical answer from the point of view of the stability of the markets—and then you have consumer perceptions. I think this evidence is important for the committee.

Senator BUSHBY—It interests me that you get a bit of a backlash when you go from $1 million to $2 million. The numbers get bigger again.

Mr Gilbert—Yes. Most people would not dream of having a million dollars in their bank account. I wish I had!

Senator PRATT—I want to return to that time when we did have a lot of redemptions coming out of accounts. How much of that do we attribute to the global crisis and how much to the bank guarantees? How do you differentiate those issues? Can you?

Mr Gilbert—That is a very good question. The global crisis and the bank guarantee seemed to coincide; they were within a couple weeks of each other. Post that, we had evidence from financial planners that people were looking for the guarantee. So that was definitely a driver. For example, people in a master trust or wrap account for super did not have a guarantee in their cash account, so these people wanted to move to a guaranteed product so they could get it. Some of them were moving into self-managed super funds, where you can get it because you are not collectivised into the million-dollar category as you would have been because you were in a managed fund. All the anecdotal evidence we had was that people were in search of the guarantee. That was over a period of about two months.

Ms Anderson—It was October to November.

Senator PRATT—I suppose I would have quite liked to take my superannuation out and put it in a guaranteed institution. But it is pretty obvious that there are only certain types of accounts that you can protect. It was a very difficult decision that the government had to make in drawing

the line. I have been lobbied by organisations who have investors whose assets they have pretty much had to freeze. Those investors no longer have access to them. How long do you think it is going to be till those investors again have freedom to access their assets?

Mr Gilbert—Are we talking about mortgage trusts now?

Senator PRATT—Yes.

Mr Gilbert—These funds advised me that they have at least a three-year wind-down and are not taking any new deposits. Essentially, this part of the industry is frozen to new deposits. The funds could take deposits—or some of them could—but people are not putting money with them and the confidence has been lost. What you have to realise here is that, as the cash is coming in from the loans that they have made—the mortgages—they are distributing that on a managed basis. They cannot actually distribute it all short of selling off the assets and taking the discount, so this could be a three-year problem. That is why we have been to government on two separate occasions to make suggestions about how we can put liquidity back into these funds. So it is a vexed problem for us.

Senator PRATT—Putting liquidity back into those funds would not only help those investors but help lending as well—

Mr Gilbert—Absolutely.

Senator PRATT—in that we still have significant problems with access to credit for property, small business et cetera.

Mr Gilbert—Senator, you are right; this market has dried up. The lending part of these trusts has dried up. This was an $18 billion industry, with quite a large amount of lending, and it was lending to people who did not ordinarily have access to a bank. People would go to the bank and the bank would say, ‘No, you’re too risky,’ so they would go to a mortgage trust.

Senator PRATT—Thank you.

Senator BUSHBY—Thank you to IFSA and Ms Anderson for coming along today. I am interested in following up the question of Senator Pratt. The RBA and APRA have both quite clearly said—it was intimated in their submission, which you have probably read—that the bank guarantee did not have the massive impact on non-guaranteed deposit-taking institutions that most of our submissions say it did; they try to blame most of it on a flight to quality. I am interested in that. You mentioned a 2½ thousand per cent increase in redemptions. In what period was that observed?

Mr Gilbert—Over a two- or three-month period.

Senator BUSHBY—They were also saying that prior to the bank guarantees there was a trend towards the larger banks. What sort of increase in redemptions, if any, had you seen in the six to eight months before that?

Mr Gilbert—The way that rates were going, there was some flight to the better regulated, prudentially regulated institutions, but I would probably have to come back to that. I think it is a good question. It certainly was not 2½ thousand per cent. That 2½ thousand per cent was in a two-month time frame.

Senator BUSHBY—The graph might illustrate very simply, in a visual way, the actual impact. But you would say—Ms Anderson has said this, and this is your evidence—that you have a network of financial planners; you have people who interact with people and make any decisions as to what they do with their money every day.

Mr Gilbert—Yes.

Senator BUSHBY—They talk to them about the reasons why they do that. The feedback that you have got through your network is that a large part of the decision making that was going on at that time was to do with where the guarantee was.

Mr Gilbert—Absolutely.

Senator BUSHBY—That obviously is fed by the global financial crisis, so the flight to quality is part of that, but if you give a guarantee then you just force it to happen. You also mentioned in passing the fact that a lot of the mortgage trusts or mortgage funds actually lent money to the commercial sector, and in your submission you note that $8 billion per annum is lent to small business. You mentioned just a minute ago that part of the reason for that is that small businesses may have propositions for funding that may be seen as too risky for banks.

Mr Gilbert—Yes.

Senator BUSHBY—What has happened to small businesses with those sorts of funding needs since the bank guarantee came in?

Mr Gilbert—Essentially they have not grown or, indeed, have truncated themselves. I have personal experiences with friends. One of my colleagues in a Rotary club cannot get the funding rolled over, so he has ceased the project. That means jobs, ultimately.

Senator BUSHBY—Presumably these small businesses are not getting funding from the banks because they have entrepreneurial ideas which are unproven. Some will succeed and some will not, but some will succeed, and that is part of what you need in a healthy economy with growth.

Mr Gilbert—Yes.

Senator BUSHBY—This is truncating the ability of small businesses in those circumstances to go out there and have a go.

Mr Gilbert—I would agree with you totally. It is legitimate entrepreneurial activity, mostly in property, and that is critical. The property industry is a large employer of our workforce.

Senator BUSHBY—You also mentioned rollover. Presumably there are also small businesses that have gone out there, borrowed money from mortgage funds, had a crack at it and were making a go of it, and when the time comes to refinance on a rollover they are finding that they cannot. What impact is that having on businesses in those circumstances? Are they able to find funds from anywhere?

Mr Gilbert—Short of going to moneylenders and usurers, I think it means that if they cannot get the money from our sector they are not going to get it from a bank, in most cases; therefore, they have no option other than to close the business down.

Senator BUSHBY—There may well be businesses that have started up and are actually going well but because they cannot get the funding are having to close or wind back their operations.

Mr Gilbert—Absolutely.

Senator BUSHBY—Would you say that that was a direct result of the impact of the guarantees on mortgage funds?

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.

Senator BUSHBY—I note in your submission that IFSA released in July 2008 a *Best practice guidance for disclosure in the mortgage trust sector*. What period of time led to the development of that best practice guide and what drove the need for introducing that?

Mr Sorby—It was something we worked on with ASIC and they produced a guide subsequent to the release of IFSA's standard. The process was over a period of about 18 to 24 months.

Senator BUSHBY—So the process started well before the global financial crisis?

Mr Gilbert—Yes.

Mr Sorby—Yes. It was something developed by our mortgage trust steering group in conjunction with other stakeholders, including the regulators. We were really trying to tighten up some of the disclosure in this space, and we worked very closely with the advisers as well about the sort of information they need, particularly around liquidity in these funds, and trying to get some consistency around that information.

Mr Gilbert—We were not doing it solely in this area. We have been working on superannuation risk disclosure as well. That is equally critical. It is just a normal course of events that we look at areas of weakness of disclosure, particularly around risk.

Senator BUSHBY—How well implemented was this best practice guide by the end of last year?

Mr Sorby—We run an annual compliance process where members need to submit whether they comply with IFSA standards, including this standard.

Senator BUSHBY—This is mandatory, I note.

Mr Sorby—And it is mandatory for members. The last compliance round indicated they all complied with this standard.

Senator BUSHBY—Do you think the standard actually helped ride through the period, particularly October with the collapse of Lehman Brothers and the introduction of the bank guarantees?

Mr Gilbert—It would have helped in terms of the disclosure document and the adviser knowing the risks around investing in those funds. That would have been communicated in documentation and also in oral advice, I am quite confident. Members take our standard very seriously. Membership of IFSA is a serious business if you sign up to standards. I am proud of the fact that we refused membership of Fincorp because of standard issues. Do you remember Fincorp? Similarly, Westpoint did not become a member of IFSA because of the standards.

CHAIR—Was Fincorp a Western Australian company?

Mr Gilbert—No, it was New South Wales based. Westpoint might have been the Western Australian one. To summarise, our standards are critically important and should never be devalued.

Senator BUSHBY—Do those standards effectively provide a degree of confidence for investors, ultimately in the same way but on a different scale to the guarantee provided by the government?

Mr Gilbert—Absolutely. When these funds got into trouble, we met again and put standards out, particularly on redemptions and hardship to try and make sure that we protected members' interests.

Senator BUSHBY—You mentioned earlier that we have not had people marching in the streets because, on the whole, they have been treated fairly and they are getting their return on a regular basis, and where they do need to redeem there is an orderly and well communicated process for how they actually go about making applications for that.

Mr Gilbert—Yes, there is and, unfortunately, we cannot meet all applications. So we have to manage those. We probably can only meet about 20 per cent of the money that is being sought—is that right?

Mr Sorby—It varies, but between 20 and 30 per cent.

Senator BUSHBY—Primarily the reason your members cannot meet those redemptions is that they are not getting new money in because bank the guarantee is attracting it elsewhere to a significant extent—is that right?

Mr Gilbert—It set that psychological mind frame—if that is the word—in place. From then on I think these funds had trouble raising money. Yet right now, if these funds were raising money on the market, they would have better rates. The spread has gone in their favour. There is an attraction for the rates they can offer. That is correct, is it?

Ms Anderson—Yes.

Senator BUSHBY—So investors are basically missing out on a potentially higher return because of the way it has all—

Mr Gilbert—Yes. Rates were working against them prior to the freeze and now market rates are actually working in their favour.

Senator BUSHBY—Is that one reason why you say it will thaw? Is it because ultimately investors will be attracted to the higher rates?

Ms Anderson—Yes.

Senator BUSHBY—The risk aspect of it will balance better with the potential return?

Ms Anderson—Yes. I say that in a holistic sense across not just mortgage funds but commercial mortgage backed securities and residential mortgage backed securities.

Mr Gilbert—And cash management trusts. Cash management trusts have always had that edge on bank accounts—

Ms Anderson—Yes.

Mr Gilbert—by virtue of the fact that they do invest in slightly riskier asset bases so people can take the premium for risk.

Senator BUSHBY—That flows into some of the answers that the RBA provided this morning. They said essentially that the money was out there, that housing and other markets were being funded. I think they said commercial businesses—and small businesses in particular—were probably not to the extent that they should be. They said that, particularly in the housing area, people were getting money when they wanted to borrow it. You are saying that the market may well take care to some extent and help the problems that we see as the rate of return gets higher and people start to focus less on the risk and more on the return. Why then do we need to wind back the guarantee?

Mr Gilbert—We need to because we need a competitive economy. We need a competitive financial services industry, and relying on four big banks to provide all the deposit-taking and loan activities is just not good enough. If you want to create economic rent for the four big banks, that is what you are doing by cutting out the external to bank sector. This is a critical competition issue and a critical issue to drive efficiency in the industry and ultimately allow consumers to get loans at a lower rate of interest.

Senator BUSHBY—We had some evidence on interest rates this morning from our first witness. Basically, you are saying that without a sufficient level of competition in the financial services industry the banks have no reason or no incentive to offer competitive interest rates or banking packages to potential borrowers, because there is nobody out there who is competing with them and providing alternatives that might be more attractive.

Mr Gilbert—It is that and it is also culture. The banking culture is a very conservative culture. It comes back to your point about the fact that, in this country, we have a proud tradition of encouraging entrepreneurial activity and allowing people to fund that activity. By taking cash management trusts out of the equation—which essentially we have right now; their commercial bills are zero, as Anne has already said—and by taking the mortgage trusts out of the sector, you are actually taking out virtually $100 billion worth of lending activity, which is 10 per cent of our industry.

Senator BUSHBY—I am conscious of the time; I actually have to leave to catch a plane. You have proposed a number of solutions, both long term and short term. In the short term, you promote a look-through provision, particularly in respect of aggregate deposits and aggregate accounts. Do you want to outline a little bit to the committee how you think that would work?

Ms Anderson—It is the level playing field. What we do in cash management trusts is aggregate up a collection of smaller lenders, and we invest in eligible securities. The securities would otherwise be eligible for the guarantee except we have to pay for it; we have to pay the 70 or 100 basis points. If you go directly to the bank—that is, the very same bank—you do not have to pay for the guarantee. Investors are incentivised to put the money directly with the ADI rather than with our fund.

Mr Gilbert—That once again reduces competition.

Ms Anderson—Yes. It is a competitive point.

Senator BUSHBY—I would like to explore that a bit further but I do not really have time. The other issue you raise in your submission, which I am quite interested in, is the risk and return imbalances—noting the distortions that have been introduced as a result of this actually mean that the return that is available is not necessarily reflecting the risk. There is just a distortion generally. What impact could that lack of linkage have on the long-term economy in where money is being attracted once the crisis is over? Is that going to play out in any way that is not particularly favourable? I mean if the market is not actually sorting out where the money should go in a pure sense.

Ms Anderson—I think by and large it will—the market is quite efficient. It is a timing. But there is a bifurcation issue here at the moment whereby, for example, the way the fee is structured, the A and lower lenders—the regional banks, who perform a very important role; the credit unions—cannot compete, so they cannot grow their loan books and fulfil a need to niche borrowers, just the same as the mortgage trusts. If they do not prosper, there will not be some other lender necessarily that fills that niche lending, so that may disappear.

Mr Gilbert—There is also a pricing issue. It is worth noting that in the US when they put the guarantee for the mutual funds, or the money market funds, the cost of that for every investor's

return was 75 basis points. That will give you an idea of the imbalance. So a guarantee is worth nearly a per cent. If you can get a guarantee for nothing, where will you have your money?

Senator BUSHBY—Our first witness today promoted the idea of, rather than guarantees for institutions, actually having asset based guarantees. What are your thoughts on that?

Ms Anderson—In terms of if it is a deposit, if it is a bond?

Senator BUSHBY—Basically, guaranteeing a AAA rated asset.

Ms Anderson—Not the institutions but the assets?

Senator BUSHBY—Not the institution itself but the actual product.

Ms Anderson—Yes, I think there is some merit in that—but not all AAAs are created equal. Part of the issue around securitisations is: this AAA is not the same as that AAA. Investors use that, so there is potentially a hazard there if there is a flaw in the way the rating is applied.

Senator BUSHBY—Okay. Thank you. My apologies, I have to go now.

CHAIR—Thank you very much, Senator. Senator Joyce.

Senator JOYCE—Chair, how long have I got?

CHAIR—We could give you until one o'clock.

Senator JOYCE—I want to go back to the discussion about the interplay between the Australian Office of Financial Management and the spreads. How is the AOFM currently coming into the market that you are dealing with?

Ms Anderson—They have been purchasing residential mortgage backed securities that have been issued by non-bank financial intermediaries, because those institutions cannot issue those securities to the institutional market whereas two years ago they could.

Senator JOYCE—So the Australian Office of Financial Management is basically running out buying product that is underwritten by residential houses.

Ms Anderson—Correct.

Senator JOYCE—The AOFM are doing that, obviously, with borrowed money.

Mr Gilbert—To the extent that the budget is in deficit now, yes.

Senator JOYCE—I am interested in why we are borrowing money to purchase something that you guys could be purchasing.

Ms Anderson—Why are we?

Senator JOYCE—Yes.

Ms Anderson—I guess it is a policy decision on the part of the government, and I would think it is couched in the competitive forces that they wish to maintain, to have these nonbanks providing funding to housing and ensuring that they could gain access to funding.

Mr Gilbert—Also, Senator, some banks are in the program as well.

Senator JOYCE—Is this actually forcing your members out of the marketplace?

Ms Anderson—It is just a distortion that we as investors that invest on behalf of superannuation funds have purchased residential mortgage backed securities that are marked or priced in our portfolio at spreads that are somewhat wider than the securities that are getting issued to the AOFM.

Senator JOYCE—Because they are just getting them at spreads of 50—

Ms Anderson—They are issuing about 125. In my portfolio I cannot sell them because the market is very illiquid, but when my investors come and ask me for their money back, because it is a unit trust structure, I have to ensure that I have valued my assets at a fair market price. The thing with a lot of these securities is that it is an over-the-counter market, it is not traded on an exchange, so there is a very limited number of natural buyers and hence there is a very high liquidity premium. So the valuation in my portfolio is somewhat lower.

Senator JOYCE—We have had a lot of debenture issuing lending that has been affected by this government guarantee. You were also saying that we were ending up with a two-tier market, where there were the four major banks and users and it was really a non-commercial form of lending. It is a port of last resort. How do you see that in your day-to-day operations? Are you seeing that sort of middle tier just being completely squeezed out of the marketplace?

Ms Anderson—I would not say they are completely swept out. That was definitely true; fourth quarter last year it was completely closed. It was very frightening, as a capital market participant. I think it is very fair to say that conditions have improved somewhat, but there are still segments of the market—and the ones that I can identify that have not reopened are the commercial mortgage backed securities, the mortgage funds and certain industry classes—that banks have lent to but that over time will need to source capital market funding because the banks will become overexposed to certain industries or certain issuers.

Senator JOYCE—When you talk about the banks, are you including the Bank of Queensland and Bendigo Bank or are you talking about a primary position that the four banks are in that no-one else is in?

Ms Anderson—Generally, the major banks obviously lend the most in our market. It would include the regionals, but the regionals typically do not have capacity to lend to the very large borrowers. They perform a role in the intermediate sized institutions.

Senator JOYCE—You say that the current policy is bringing about a centralisation of the banking market down to the four pillars and that that really this is exacerbating the flow towards four banks running the show.

Ms Anderson—I definitely believe that it is amplifying it. We can see that market share. Again, we come back to the competitive point.

Senator JOYCE—With the removal of this guarantee obviously there would be huge problems because we would have disparities around the world. The next issue would be: how do you get rid of it without there being a flow of funds to where it is? Are these people who have been forced out of the market in a period of hiatus or are they actually out of the market for good? Is there capacity for the re-entry to the market of competitive forces to keep the major banks honest? Could this bring about a structural change which is really not reversible?

Ms Anderson—I think we will see a structural change for sure, but I think it will not be a momentous one. For example, the regional banks will thrive. As time passes by, I believe that conditions will normalise. Their biggest challenge at this time will be the pricing of the guarantee in the wholesale space. They will naturally find it difficult because they will have to pay a higher fee because of their lower credit quality but they are competing against the major bank lenders at a lower price.

Senator JOYCE—How many people do you represent who actually pay the guarantee?

Mr Gilbert—IFSA? Our members do not actually get the guarantee. We have 100 members, and none of them get a guarantee.

Senator JOYCE—Would they wish to avail themselves of the guarantee if it were there for them?

Mr Gilbert—A look-through similar to the retail guarantee? Yes. But a look-through and having to pay for the guarantee? No, because that would be competitive disaster for them.

Senator JOYCE—That is, they do not want the guarantee forced on them; they want it as an option—if they want to buy it they can but they do not have to?

Mr Gilbert—And they could then advertise it as that.

Senator JOYCE—Do you find it peculiar that the government have collected just shy of half a billion dollars—$480 million—issuing a guarantee which, if it were actually realised, they would not have the capacity to pay?

Mr Gilbert—It is a large amount of money. It is a matter of how much in the future you could tax Australians to pay that if there were a debt accumulated.

Senator JOYCE—What I have said from the outset is that the extent of the guarantee is beyond the capacity of the Australian economy to pay for it. There is $780 billion in it. We have no hope of paying that. But that is not really the issue. There is probably no likelihood—we

hope—that we would ever have to pay it, but what concerns me is that the government in their righteousness have charged people for something that they know they could not possibly honour.

Mr Gilbert—I would prefer not to answer that directly. But I would say that the international rating houses, like Standard and Poor's et cetera, would no doubt take that into consideration as they give us our credit rating. So in a way there is a mechanism to try to ameliorate that or equilibrate that and compare our arrangements to what is happening overseas.

Senator JOYCE—What is the total value of your membership's book, roughly?

Mr Gilbert—It is $1.2 trillion.

Senator JOYCE—What portion of the market is that?

Mr Gilbert—Before the GFC, that would have been more than the banking sector.

Senator JOYCE—So it is not just a corner issue, a slice of the market or a peculiar corner of the market of which there is a lot of noise but no real effect; it is a substantial competitive pressure in the market which is being affected by this current guarantee?

Mr Gilbert—Yes. The two genres of funds directly affected are the CMTs and the mortgage trusts, and that is about eight per cent of our market. Then you bring in fixed interest spreads—but that is more a general problem—which is another 20 per cent. So it is about 28 per cent when you look at money market type funds. In terms of direct effect it is eight per cent.

Senator JOYCE—My final question is this: if I were to wave a magic wand and you were the boss of the show and you could do whatever you wanted, what exactly would you be doing within the next year to try to recalibrate the show, bring it back into balance, and give your members a better chance?

Mr Gilbert—Clearly, there are two issues: firstly, wind back the guarantee sensibly and in consultation with industry; and, secondly, if there is a concern from the parliament about the fact that we have 250,000 people with frozen funds, what do we do through the Office of Financial Management and perhaps industry in order to defreeze them? Where is the antifreeze coming from? I guess that is the analogy.

Senator JOYCE—And where do you think we would get it from?

Mr Gilbert—At the end of the day, we have put forward the proposal for the ABIP bank, which I think the Senate has rejected as a proposal. This was never part of that package, but we think there would be an opportunity there to securitise some of these mortgages. The other way is for the government to actually put some of their deposits in these funds and show the people of Australia that they are very confident about the future of these funds and people should be reinvesting in them.

CHAIR—That concludes this section. Thank you very much for appearing. It has been very interesting evidence.

Proceedings suspended from 12.53 pm to 1.16 pm

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

CHAIR—Welcome. On behalf of Aussie, would you like to make an opening statement?

Mr Porges—Yes. We are here more to talk about going forward in that we see that the funding guarantee has been, in our opinion, a resounding success. There was obviously a flight of capital out of the country. If one assumes the original guarantees were to stop that then that without a doubt has been a success and I think it has been one of the reasons that the country has come through so far relatively unscathed. Going forward, however, we see some further challenges. Obviously, the guarantee has to come off at some stage; that said, it cannot come off unilaterally. We see it as somewhat difficult if you bring it off when the rest of the world still has one out there—and there will once again be a flight of capital. That may happen less when you get to the stage that some of the capital guaranteed governments are potentially less robust than some of our companies in themselves. It is not out of the question when some of our banks are doing so well.

In terms of going forward, we are starting to look at how one really can reinvigorate the competition in the mortgage market. When Aussie first started back in the early nineties, the margin gap that people paid between cash and mortgage was about five per cent. We take great pride in having squeezed that down to about one per cent. The population has benefited immensely through that. Over recent periods, however, we see that picking up again. Whilst this competition has gone away, yes, we are concerned about the congregation of business going through the major banks, but, more importantly we are concerned about the fact that this margin is starting to increase again. Things like the RBA are having much less effect as they try and force a reduction in rates for the consumer. That is really our concern going forward.

Obviously, there is a concern about the major four banks having the majority of the mortgage business at the moment. That said, the second-tier ones are just not competitive. It is not as though it is really a pricing issue per se; it is just that the second-tier institutions cannot raise capital at an adequate rate to give themselves some sort of return. Equally, from Aussie's perspective, to understand where we come from, if you looked at Aussie about five years ago, we were 100 per cent securitised and it was purely an Aussie product that we put out in the marketplace. That business model changed significantly. Now, about 95 per cent of our business goes to the banks and only about five per cent is our own product. As much as anything, that is because it is difficult to access the quantum of funds that we need to keep that competition. So the mortgage broking part of our business is a lot more significant than our own product at the moment. That is the main area we would like to focus on: what we can potentially do going forward with an active discussion going on in the government guarantee potentially on the RMBS market.

CHAIR—Thank you. We might reverse the order. Would you like to begin, Senator Joyce?

Senator JOYCE—Thank you very much, Chair. First of all, Mr Porges, at Aussie are you owned by, controlled by or tied into any of the major four banks?

Mr Porges—About six months ago we sold one-third of the business to the Commonwealth Bank. Two-thirds of it is still owned by John Symond. There is no management control whatsoever by the Commonwealth Bank. They have two out of the six seats on the board, but that is it.

Senator JOYCE—Where do you get your money from?

Mr Porges—As I say, at the moment we do not get a lot from anywhere. We have three potential sources of wholesale funding. At the moment the majority of it is probably with Macquarie Bank, ANZ and the Commonwealth Bank.

Senator JOYCE—You obviously understand about people underwriting. Why is the underwriting worth anything to the banks? I am trying to be tricky. The underwriting only has a value because people believe in the strength of the Australian capacity to pay for it—that would be fair enough, wouldn't it? Otherwise it is nothing more than a piece of paper.

Mr Porges—Yes, I am not going to disagree with that.

Senator JOYCE—How much debt do you think Australia can rack up before the value of taking another guarantee to underwrite something is kind of pointless?

Mr Porges—I am not going to make a call on government debt, but I think the challenge you have, slightly, is that it is all relative. The proportion of government debt to GDP in Australia is less than in a lot of other countries. If I am valuing insurance, I am always going to value relative insurance, so I would be happier with the Australian insurance than I would, for example, in a country that has a 100 per cent debt to GDP ratio.

Senator JOYCE—The problem we obviously have with this current guarantee is that, if it were ever realised, it would be about $780 billion, which we do not have a snowflake's chance of ever being able to pay.

Mr Porges—But—no, continue.

Senator JOYCE—The point is: surely it could be mitigated down to a form where you get a relevant amount that the government could actually cover and give greater capacity in winding it down to a more reasonable level to allow people like Aussie back into the market.

Mr Porges—There are two issues there. One is that, although you could not cover all of the guarantee at the moment, that would assume that every amount of money that was lent out by the banks ceased to exist and there were no assets there. I cannot envisage what could possibly create that apart from some sort of holocaust, and then no-one would be calling in any money anyway. I think it is a more relevant point that you really want to start thinking about how some of the guarantees that the government gives need to have assets behind them, whereas if you are just guaranteeing a bank generally then you are not really sure what they are going to do with those funds. Those funds may be paid as dividends, some may go in the mortgage market and some may go to hedge funds—who knows?—whereas if you can actually start using the guarantee to guarantee physical assets, as in the RMBS solution, then you really want to start

looking at only having mortgages over, let us say, 90 per cent, so you have a bit of a buffer there as well.

Senator JOYCE—Yes.

Mr Porges—But I agree completely that guarantees just over a general area are very difficult to manage when they are of the sort of size they are now.

Senator JOYCE—I suppose the point we are getting through this inquiry is that it is ridiculous—as you have said, you would need a holocaust before you would have a realisation of it—but the problem on the other side of the coin is that the government is managing to charge you for it. So it is charging you for something that it cannot actually deliver, yet that charge has brought in about half a billion dollars to the government, so it is happy. Obviously the banks have just handed the cost on, so they are ambivalent, but in the same process they have managed to get a form of market manipulation which centralises control back to the four pillars and forces you out of the market. Really, the value of the guarantee for them is the effect of restricting competition for you.

Mr Porges—To a degree, but at the same time I think you have to put a slightly larger hat on and talk from the Australian perspective. If the guarantee were not there, the country would have been in all sorts of trouble, so the guarantee had to come in. I am happy to accept that. The other side, though, is that it would be worth mentioning the meaning of insurance. If I knew that 100 per cent of what I insured would have to be paid, I would charge you 100 per cent insurance, so you would not insure. So, by definition, when you are making insurance you are making an assumption that only a portion of those claims will ever have to be paid out. You therefore make an informed judgment on what portion and therefore how much you charge for that insurance.

Senator JOYCE—This is an interesting discussion. The good thing about insurance, though, is that you have a multiplicity of participants—literally thousands and thousands. Not every house burns down, so you are covered, and that makes implicit sense. But what we have here is a guarantee where you are excluded from the capacity to be covered. What you are left with is a guarantee for four major banks. Banks do not go half broke—they go totally broke—so therefore you have an extremely lumpy call on that guarantee, for which there has been no factoring into how they have assessed it.

Mr Porges—But banks do not go broke without assets, remember. The bank may well go broke—and let us say that, in the worst case, it did—but there would still be all those mortgages that it had given out and all the loans to corporates. They would still be in place. It is just a case of how long it takes you to work those loans out. You still would not be exposed to losing all those funds.

Senator JOYCE—But what we are doing now is working towards a realistic analysis of exposure and exactly how it is going to work which, from our queries to the Reserve Bank, has never been done. This thing was basically plucked out of the air, the government said, ‘This is a great idea,’ and there is really not very much homework that sits behind it.

Mr Porges—But it had to happen that way. Once Ireland guaranteed, the UK guaranteed and everyone followed suit, if Australia had not guaranteed then it would have been a matter of 15

minutes before the country had funds running out of it so quickly that it would not have been a solution we could have come to then.

Senator JOYCE—But surely we have now had the time to look at it more closely and start saying, 'Let's wind back this guarantee to something that's more reasonable and start doing the homework.' If we have issued a product, which a guarantee is, and in the process collected a fee for it, which means that there is the belief that we can honour the commitment, we had better start doing some homework to show that we can actually honour the commitment, because if we cannot honour the commitment then we have just fraudulently accepted a fee. If the extent of debt of the government is, as we have heard the Treasurer say, $315 billion, and then there is the subprefecture debt of the states, at another $230 billion, then there is already half a trillion and upwards in debt that already has to be handled by the government. We have already heard Treasury say, in earlier inquiries, that 80 per cent of GDP is definitely the limit, and obviously they would have been saying something to placate the government, so my fear is that they would have gone to the top end. Our GDP is $1.2 trillion, so that is a $900 billion debt and then lights are out. A $780 billion underwriting is just impossible, impractical and illogical. Without the homework underneath it, it is nothing more than a gesture.

Mr Porges—I think that is correct, but I think that is what everyone is assuming; you have to back out of that guarantee at some stage and ease off the government guarantee there.

Senator JOYCE—So when do we start easing out of this guarantee, or when should we? If I wave a magic wand and make you the boss, how do we back out of it and ease off?

Mr Porges—Without G20 approval, you will not do it. There has to be a coordinated international response to removing the guarantees, and that will only happen once you have actually got to an understanding that the GFC is pretty close to over or at least once the corporates have all cleansed their balance sheets. Once that happens, you will have to have a coordinated global response unless you believe that Australia and the Australian banks are so much stronger than any other country that you will not have a flow of funds.

Senator JOYCE—In light of other things that are floating around at the moment, could Australia lead the way and get out of it first? Do you reckon the rest of the G20 would follow?

Mr Porges—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.

Senator JOYCE—It seems that on other things, such as the ETS, we believe we can lead the way, but you are saying that on this one we cannot because the reality is that the rest of the world would fall over laughing and take our money on the way.

Mr Porges—In my opinion, yes.

Senator JOYCE—So what would be appropriate? Will we move out of this guarantee in steps or do you believe that at some date we will just move out of it overnight?

Mr Porges—I think you have to move out of it in steps but, again, what I think is not all that relevant. It is going to be what the economic leaders of the G20 countries think.

Senator JOYCE—So who is going to coordinate that and where is that leadership coming from?

Mr Porges—That is something Australia could coordinate. We have a supremely respected Reserve Bank, and they could do that.

Senator JOYCE—In what horizon do we have the capacity, a process or a mechanism, to get this ball rolling?

Mr Porges—I am not a politician but I would suggest that you would want to do it sooner rather than later, because it is going to take a long time for it to actually be coordinated.

Senator JOYCE—In that sort of arbitrage, will it be the case that any person left with a guarantee will be in an extremely strong position and can absorb money, or will it really be that any person left with a guarantee whose economy underpinning it is extremely strong will be in an extremely strong position?

Mr Porges—That is the key: anyone whose economy is in a strong position.

Senator JOYCE—Going to whose economy is in a strong position, how strong is the American economy at this point in time?

Mr Porges—That is an interesting question. There is an argument to be made that the American economy is not in an extremely strong position. But, going to the Australian example, they have 250-odd million people who they can tax and, if they want to be in a strong position, it would not politically be a very palatable solution but they could actually raise enough capital out of consumers.

Senator JOYCE—How much debt do you think there is? There must be some ballpark figures, so that people have a rough idea of how much debt the US can put around their necks before it pulls them under the water.

Mr Porges—I have absolutely no idea, sorry.

Senator JOYCE—What about the English economy? Is it in a strong position?

Mr Porges—Having just returned from there, no, I do not think the English economy is in a strong position at all. Equally, I think that, as they have a much smaller number of consumers and a not rapidly recovering economy, apart from that which is exposed to finance, they are not in as strong a position as the US.

Senator JOYCE—What about the Eastern European economies? Are they in a strong position?

Mr Porges—I cannot see why they would be.

Senator JOYCE—What about the Russian economy? Is it in a strong position?

Mr Porges—No.

Senator JOYCE—Do any of the African countries?

Mr Porges—Keep going and you will get to China. They have a strong economy.

Senator JOYCE—So the Chinese economy is in a strong position. Who else, apart from China, is in a strong position?

Mr Porges—I am not sure that is something that I am qualified to discuss.

Senator JOYCE—Who, to the best of your knowledge, would have a comparative position moving towards China?

Mr Porges—China is overwhelmingly the strongest economy in the world.

Senator JOYCE—So, once we have moved away from there, it is either insignificant—that is, a strong economy but insignificant in the way the world plays the game—or degrees of weakness, basically.

Mr Porges—Yes, but that said, it does not take a strong economy. For example, if Ireland decided not to remove the guarantee and everyone else did, funds would flow to Ireland from all around the world.

Senator JOYCE—Funds would flow to Ireland now, with full knowledge of what the Irish economy is like?

Mr Porges—If their economy was acceptably strong.

Senator JOYCE—But it is not.

Mr Porges—It is not all that crash hot, but it is probably no worse than the Eastern European one.

Senator JOYCE—That is no different than if Iceland starting underwriting. People could not care; it is irrelevant. They are broke. Is there any role for the IMF to play in moving people out of this position?

Mr Porges—I am sure the IMF are thinking about it.

Senator JOYCE—When do you see Aussie being in a position to move back into the market as a competitive force, as that is obviously the main sort of queue that we want. We are seeing the distraction of money policy in our nation because monetary policy by the Reserve Bank is becoming more and more irrelevant to the banks. The banks will do as they wish once they have control of the marketplace. When do you see your capacity to come back to the market as a strong competitor for business happening?

Mr Porges—We need either the return of the RMBS market or for wholesale funds to be equivalent to retail funds. Everyone has this perception that wholesale is always cheaper than retail. When you are a bank, retail is your cheapest source of funds. On transaction accounts and things you pay pretty close to zero interest on them. But, if you go and raise wholesale money in the public markets, you are paying four, five or six per cent or whatever interest rate you are paying at the time, whereas a large of portion of retail funding is pretty close to free.

Senator JOYCE—And while this guarantee remains as it is that capacity is not there.

Mr Porges—No.

Senator JOYCE—Thank you very much for that.

Senator PRATT—In your submission, you talk about a shift in market share towards the major banks, reducing the Reserve Bank's ability to affect monetary policy outcomes. You indicated that the independent actions of those banks might not align with those policy outcomes. Can you go into some further detail about that particular dilemma?

Mr Porges—The more competition you have the greater chance you have the people will pass on all of an interest rate cut or try and pick up some additional competitive advantage. Whilst you have the majority of the business going to the four banks there is less incentive for them to get a lot more competitive. Equally, they still have a very serious cost of funds coming externally, even with the government guarantee. So they need to keep a higher margin. Why we have four successful banks is because they have kept higher margins. So we are constantly walking a tightrope where we want to keep the banks profitable, because that is why we have never been called on for the guarantee because we have profitable banks, but at the same time we want competition. At the moment, I think we have seen the competition disappear and the banks are using it as an opportunity, a rational and understood opportunity, to claw some margin back.

Senator PRATT—What you are really saying is that when the Reserve Bank wants to pull an interest rate lever, it is less influential?

Mr Porges—It is less effective, yes.

Senator PRATT—We have highlighted what we need to do to reinvigorate the mortgage backed securities market in Australia. What do you think of the idea of an asset guarantee as opposed to a deposit guarantee?

Mr Porges—Sorry, ask that again?

Senator PRATT—It was put to us by another witness that we could insure the value of the assets as opposed to the—

Mr Porges—Insure the value of all the homes! That is a good call. A lot of people would be happy to invest in real estate if they knew that the value of their house was never going to go down. If you want to go to Senator Joyce's concern, if the government was ever to guarantee the

price of real estate in Australia, I think Standard and Poor's and Moody's would have a lot to say about that.

Senator PRATT—Yes. I would like to ask you also about moral hazards. Some would argue that the funding guarantee can influence reckless lending. On one hand, the banks might do it because they are guaranteed; on the other hand, you might say that if you open that up to mortgage backed securities we might see the subprime mortgage crisis revisited in the US.

Mr Porges—It is not out of the question. We have always avoided the subprime in the US—and understand the majority of my financial credentials are from the US. Australia has not had that moral hazard and a lot of that is because we have stronger regulation. It is really an asset lend that you are talking about with mortgage backed securities because you would only lend 90 per cent of the value of the house or some such thing. You would have to make sure you had valuations done on the house. You would make sure all those other issues are in place. The regulations in Australia are also slightly different in that if someone lends money against an asset and they walk away from it, the bank can go to all sorts of other assets, whereas in the US you had the subprime predominantly so when the house price went down you just gave the keys back and walked away.

Senator PRATT—That is a key distinction.

Mr Porges—Yes.

Senator PRATT—I do not have any more questions. Thank you.

CHAIR—Senator Joyce was talking about ending the bank guarantee and you said how difficult that might be. We heard earlier witnesses saying that Hong Kong and Singapore, which also had unlimited guarantees, are now winding back their guarantees. What is the difference between those centres and Australia? Why is it possible for them to wind back?

Mr Porges—There are two things. I would want to look at what they have wound back and what they have put in place. You need to understand that Australia is a net importer of debt. We do not have the ability to fund all the infrastructure and corporatisation that we are doing here, so we need to import debt. Singapore and Hong Kong are less reliant on bringing debt through the country. As predominantly financial economies, they may well have taken the decision that they do not need a lot of debt coming in.

CHAIR—That is very interesting. It is very true that Australia does rely on foreign capital for many things and our market is not very deep.

Mr Porges—It is not necessarily a bad thing—so long as we can actually service that capital.

CHAIR—That is quite a useful answer. In another hearing, another subject of reference to this committee was to do with bank mergers. We have heard from some of the smaller banks that they feel that the guarantee has had quite an anticompetitive impact on their activities in that they have had to pay higher fees for the guarantee and that has meant that they have had to pass on higher fees on mortgages. Aussie, of course, is a non-bank lender. Realistically, what are the

prospects for smaller banks and non-bank lenders getting back into the mortgage market in Australia in the short term?

Mr Porges—We still get out there and battle each day. The smaller banks can theoretically get back into the marketplace if they accept a tighter margin for what they are lending. That said, if they do that then in many cases they do not necessarily have as efficient a business as some of the larger banks. So they have this double whammy: they have a slightly greater cost of running their business and a lower margin. That is a challenge for them. Realistically, I do not see any chance of any of the smaller institutions getting a significant stake in the mortgage market until the RMBS market, securitisation market or wholesale funds somehow open up again. As we look at it, the only option among those is the RMBS market opening up again. There is a lot of cash still being accumulated. There are still superannuation funds locally. There are still a lot of international investors with money who want to invest. They just need to get some comfort into those markets again. The interesting thing is that the Australian RMBS market is a much more efficient and secure market than international ones. It is much like the point we talked about before, where a mortgage backed security is not a lot of use in the US if people can just walk away from the mortgage. Here that is not the case. Until the RMBS market opens back up, I think the market is fairly closed for a lot of people.

CHAIR—That is interesting too. It has been said by some of the smaller banks that it takes a very long time for the smaller bank to grow—perhaps out of a building society or something like that—to a size where it can actually get into the banking market. The suggestion has been put that it will be a long time before we see small banks develop again in the Australian market, given the current circumstances and the power of the major banks, who have the capacity to buy up smaller competitors such as St George, Bankwest and so on. You just mentioned superannuation funds, which of course have huge amounts of money in them. Is the possibility that superannuation funds may get into the banking market a reasonable one to consider?

Mr Porges—They tried that to a degree through the Members Equity Bank, so it is reasonable that they may. The other way of doing that is that some of the smaller institutions may try to access some of that superannuation fund.

We need to understand, though, that we have the four majors but then there are the second-tier banks, and we still have more than 100 building societies and credit unions; and some of them are of a significant size. There are probably three that are around the same size as the Bank of Queensland. So we do have a relatively robust market there. That said, you do need some aggregation in some of those areas to form a fifth and a sixth competitor. If we put the Aussies and the Wizards together, you would probably end up with 10 per cent of the mortgage market. If you could put some of those second-tier institutions together, you could then have another significant competitor in the banking market. At the moment, when you have got the four majors and everyone else is getting smaller, it will be a while before you get another major competitor coming through.

CHAIR—I agree with that. In Western Australia we had Town and Country Building Society, which was quite a significant building society. It became the Town and Country Bank, which ANZ then bought. We had the Perth Building Society, the Challenge Bank, which Westpac took over. These institutions are very much cherries to be picked off the tree by the larger banks, I would have thought. I would have thought that it would be a reasonable proposition to say that

the prospects in the long term for broadening the banking field are not great and the major banks are going to dominate for a long time.

Mr Porges—Yes. In a previous life I used to run Newcastle Permanent Building Society, which is probably the largest building society in the country. It is not easy for people to just buy them. There has to be an agreement amongst the institutions nowadays either to be bought or to aggregate. That is a very difficult thing to do. Unless you get some rational behaviour or dictated behaviour into that sector of the marketplace, it is unlikely that any of them will grow big enough quickly enough. It is more likely that the competition in the marketplace generally will come from something like a Bendigo Bank or Bank of Queensland, that have managed to survive through this.

Senator JOYCE—Could I ask one question before you go. In the new development areas, the western suburbs of Sydney and the western suburbs of Brisbane, what do you think, as a sort of gut feeling, was the loan-to-valuation ratio in those?

Mr Porges—Previously or now?

Senator JOYCE—Previously.

Mr Porges—Previously I think it was around 95 per cent and up. Now, 90 per cent is relatively easy and 95 per cent is getting difficult. It was quite high previously.

Senator JOYCE—And this was people basically building a house—I suppose they would be looking at around half a million dollars and up; that was nothing unusual. That would have been sort of the mean?

Mr Porges—Roughly. I think our average loan size at the moment is $325,000 or something and our average LVR in the new product is about 80 per cent.

Senator JOYCE—And generally it is premised on two salary and wage earners?

Mr Porges—It is hard to say a general premise. A bank will look at the situation each time—how reliable the salary is, whether it is likely that one of the salary earners will decide to stay home with children, or have children, or how long they have been employed. All those things come into account, even more so now than they used to. With the restriction of credit, even if you apparently can service it, it is not that easy to get a loan nowadays.

Senator JOYCE—So the restriction of credit has brought down that loan-to-security ratio somewhat?

Mr Porges—Significantly, yes.

Senator JOYCE—In the past you could borrow up to 90 to 95 per cent of your house—

Mr Porges—Some people were borrowing 100 per cent.

Senator JOYCE—And now you would be borrowing, what, around 80 per cent?

Mr Porges—Yes, 80 per cent to 90 per cent. And there is nothing necessarily wrong with borrowing 105 per cent—if you have the ability to pay it back. If you have the ability to pay 200 per cent of your mortgage payments, then the bank is taking a view on 100 of that 105 is covered by an asset and five per cent is really just a lend against cash flow.

Senator JOYCE—But that was not unusual. There was certainly a fair bit of that out in the marketplace.

Mr Porges—Yes. Not in our product, thankfully, but there was some out there.

Senator JOYCE—Would a new suburb be more likely to have a congregation of these high-loan security ratios as opposed to an established suburb?

Mr Porges—Probably. The average mortgage in Australia actually gets paid out in only about eight years. In an established suburb and if someone has been there for a while, they will have paid their mortgage down. You need to be looking at the average across the entire suburb. If the entire suburb is brand new and people are just coming in and have not had time to pay that mortgage down, you do not have that seasoning effect, as they call it.

Senator JOYCE—That loan security ratio is purely on the house and not on the chattels inside the house?

Mr Porges—Just on the house

Senator JOYCE—The car in the garage is something entirely different and the stereo in the corner and all that sort of rubbish?

Mr Porges—The plasma screen and the surf skis that you find through the Hunter Valley, yes.

Senator JOYCE—Would the McMansions be the prime source of high debt and low equity? And of course the big houses need lots of things in them. You would have to say there is a lot of debt parked inside the houses as well as the bricks and mortar.

Mr Porges—Maybe. You actually find it is not necessarily the McMansion that is—

Senator PRATT—My weatherboard house has a lot of debt attached to it, I can vouch for that.

Mr Porges—Yes, it is not necessarily the McMansions. Quite often McMansions are built by people who have struggled and struggled for 20 and 30 years to really earn some capital and they want to build their lifelong dream. They do not usually build the McMansion as a first home. It is the first home owners who actually have a much higher portion of debt.

Senator JOYCE—No doubt you would have had to model unemployment into all this. What is the stringency between an increase in unemployment and an increase in arrears?

Mr Porges—If unemployment gets above about eight per cent, we start to worry. It is hard to model it as accurately as you would think because there is constant changing of the LVR and

thinking whether we start from rates being at 15 per cent before unemployment went up or at five per cent before unemployment went up. Our gut feel is that 7½ to eight per cent is the sort of unemployment before we would start to see stress which is less than you see internationally. Again, back to that point, Australians have huge pride in keeping their home and managing to pay it off, so they sacrifice a lot of things before you see that pick up. If you want to look for early warning signs, look in credit cards and look in the personal loans rather than looking in mortgages.

Senator JOYCE—Has there been any increase in stress in credit cards and personal loans?

Mr Porges—A little is starting to kick in.

Senator JOYCE—I have done a little time in banking and if we did not have about two or three per cent arrears, they would say you were not trying hard enough. What is a reasonable amount of arrears on your book? Is it 90 days plus?

Mr Porges—On our mortgage book?

Senator JOYCE—Yes.

Mr Porges—We would not see a lot more than that. We run a very conservative mortgage book because we are not a huge balance sheet business. We do not have access to things like the government guarantee, so we are extremely cognisant of taking any losses.

Senator JOYCE—Right. Thank you very much for that.

CHAIR—In a general way, we are seeing a recovery, are we not? We are moving slowly out of this GFC. Prices of properties are increasing, at least in parts of Australia.

Mr Porges—Australians are incredibly enthusiastic people. We believe there are green shoots. Senator Joyce might appreciate this more: the green shoots I do not think are necessarily the green shoots you see in a paddock after it has been burnt; the green shoots may well be just the first leaves you see out of one of the eucalyptuses that have just been burnt. It will be many years before we have the sort of economy we had three or four years ago. It will not be an immediate recovery, although we love to dream it might be.

CHAIR—I am not suggesting it would be immediate, by any means. It is interesting, as I read somewhere yesterday, that real estate prices are increasing around the country.

Mr Porges—They have stopped falling. There was this uncertainty across the entire country and real estate prices came into it. You did not know what was going to happen. Now I think we have seen a little bit of a bounce, which reflects that people are thinking, ‘The GFC is not over but the lift cannot fall any further, so now we are happy and starting to resume our normal life.’ Once that level of uncertainty is taken out, you get a natural blip but then you just have stagnation for a while.

CHAIR—Which raises another question in terms of bank guarantees and the general issue of the length of time it will take to recover from what we have just been through around the world.

How long would you suggest governments such as the Australian government will need to put in place measures to provide support to the economy in general?

Mr Porges—That is a very broad question and depends how you define ‘the economy in general’. We think you have to support the RMBS market only until the securitisation market or something picks, and I think that is only a couple of years. Some of the longer term changes—and we have seen some structural changes in the economy—have probably got many years to work their way through. I think financial markets, being very, very robust animals and being very early predictors of global recovery, will probably start to open up again in the next year to two years. I actually think the guarantee is going to work its way out naturally, but it is going to work out earlier than the economy recovers.

CHAIR—Thank you very much for those observations.

Committee adjourned at 1.56 pm