MONASH University

AUSTRALIAN CENTRE FOR FINANCIAL STUDIES

Even Our Second-Tier Banks Are Too Big to Fail, Government Would Bail

24 May 2017

Author:
Professor Rodney Maddock

MONASH BUSINESS SCHOOL

Thought Leadership in the Financial Sector

Budget Bank Levy: Too Big to Fail, Not Too Big to Take a Hit

24 May 2017

Standard & Poor's has just downgraded the credit rating of many of Australia's banks. Its view depends on two concerns: first, that there are potential problems for the institutions in the housing market, and second that the government is unlikely to support any of them that got into difficulties.

The state of the Australian housing market has been a central concern of analysts for more than a decade. To the extent that mortgages are written at variable interest rates the risk in housing lies with individuals, not with the banks. The risk to the system from these mortgages arises if there is a big lift in unemployment so that lots of individuals cannot meet their mortgage payments at the same time. The situation is different for fixed-rate mortgages. With these, banks are taking the risk of movements in rates and hence are much more exposed. The balance of bank risks is thus changing as we move away from variable rate mortgages, and it is appropriate to rethink bank risk.

The issue of which institutions the government would support if they got into trouble is more open. It is very hard to imagine that any Australian government would allow any of the second-tier banks to fail.

Lessons From BankWest

There are some lessons here from the last crisis. Bankwest effectively failed. The regulatory response was to invite the major banks to buy it at a substantial discount. Commonwealth Bank jumped at the opportunity to buy up one of its competitors cheaply. The purchase is one of the reasons for its current market leadership. Its share of the mortgage market rose from about 19 per cent to 25 per cent as a result of the purchase. As is appropriate, the shareholders of Bankwest were the big losers and the shareholders of CBA the big winners.

Do policy makers regret the decision? Would any government allow one of the major banks to buy one of the second-tier banks, even if it were failing?

There are lots of banks in Australia and some of the very smallest could fail and either close or be bought with little market impact. That is not the case with the second-tier banks. If Westpac or Commbank were to buy one of Bank of Queensland, Suncorp or Bendigo and Adelaide Bank, it would move close to 30 per cent share of the mortgage market. Governments are unlikely to sanction this.

A second option would be for one of the other second-tier banks to buy the failing bank. Given the similarity in size of these banks, that path does not seem practical.

Government Would Step In

It seems far more likely that if one of the second-tier banks were failing the government would step in as happened in Britain and help the business trade out of its problems. There would be losses to equity holders but it is unclear that bond holders would necessarily suffer. Clearly it would be tempting to force the bond holders to take a loss, but government would be careful in doing so given the reputational issues, Australia's dependence on foreign capital and the small numbers involved.

Again, looking back to our experience during the last financial crisis is instructive. The government allowed Bankwest to be bought by CBA, and when the pressure came on Suncorp soon after, the majors lined up for a chance to buy it. Instead, the policy approach changed, and the government guaranteed the banks' borrowings. This protected the small banks from impending takeovers. There was clearly not a lot of appetite for allowing any of the majors to buy up more of the second-tier banks.

The other lesson from the crisis is encapsulated in this quote from former Treasury Secretary Ken Henry saying " … when the crisis hits, is there any financial institution which is not systematically important? It was my view … after the collapse of Lehman, that there was not any financial institution in Australia which could not be regarded as systemically important".

The prime minister at the time was of a similar view: "a run against any bank, however small, was unconscionable".

S&P should go back and consider its decision to lump 23 smaller institutions together. The large second-tier banks are different. The impact in Queensland of having one of its local champions swallowed by a major means that Suncorp and Bank of Queensland will inevitably be protected by the government. And the idea that Australia's champion regional bank, Bendigo, would be allowed to fail is equally remote. All of the political focus is on restraining the power of the majors – and the second-tier banks are extremely important in that challenge.

They would not be allowed to fail.

About the Australian Centre for Financial Studies

The Australian Centre for Financial Studies (ACFS) is a public interest research centre within the Monash Business School.

It aims to facilitate industry-relevant, rigorous research and independent commentary, drawing on expertise from academia, industry and government to promote thought leadership in the financial sector.

Together, ACFS and Monash Business School aim to boost the global credentials of Australia's finance industry, bridging the gap between research and industry and supporting Australia as an international centre for finance practice, research and education.

For further information see: www.australiancentre.com.au | business.monash.edu