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IFSA
Investment & Financial Services Association Limited
ABN 82 080 744 163

21 January 2009

The Hon. Kevin Rudd MP
Prime Minister
Parliament House
CANBERRA ACT 2600

Kevin
Dear ~~Prime Minister~~

Re: Australian Government's 2008 Deposit and Wholesale Funding Guarantees

I write to you concerning the government's guarantee of the deposits and wholesale funding of Australian deposit-taking institutions.

IFSA is a national not-for-profit organisation which represents the retail and wholesale funds management, superannuation and life insurance industries. IFSA has over 145 members who are responsible for investing over $1 trillion on behalf of more than ten million Australians.

IFSA is supportive of the government's ongoing actions to stabilise financial markets, restore the flow of market liquidity and support domestic economic growth. In reference to the 2008 Deposit and Wholesale Funding Guarantees, we recognise that the Government was required to support the domestic banking system in the context of the global financial crisis and the action taken by other governments to support their local banking sector.

As you are aware, there are a number of significant market distortions flowing from the current guarantee arrangements. We believe that changes are necessary in order to:

- Stimulate the economy by assisting and promoting business investment;
- Ensure financial market stability through avoiding contagion to non-guaranteed products and financial institutions (including superannuation funds and wealth management platforms);
- Restore a stronger linkage between risk and return within the guaranteed sector;
- Improve liquidity in the broader debt markets, particularly for the semi-government, (non bank) corporate and asset backed sectors; and
- Balance the fiscal costs and benefits of the guarantee's impact on the federal budget and industry.

The attached policy options paper details the current impact of the guarantee and outlines IFSA's recommendations on resolving the issues identified.

Prime Minister, we appreciate the leadership demonstrated by you and your government to stabilise financial markets and improve confidence. We would be grateful if you could give every possible consideration to the options we raise in this submission so that we can achieve a whole of government solution. Please do not

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hesitate to contact myself or Joseph Sorby on (02) 9299 3022 if you wish to discuss these matters further.

Yours sincerely

John O'Shaughnessy
Deputy Chief Executive Officer

Cc: The Hon. Wayne Swan MP
Treasurer

The Hon. Chris Bowen MP
Assistant Treasurer and Minister for Competition Policy and Consumer Affairs

Senator the Hon. Nick Sherry
Minister for Superannuation and Corporate Law

Dr Ken Henry AC
Secretary, The Treasury

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Investment & Financial Services Association Ltd

IFSA Policy Options Paper

January 2009

Australian Government's 2008 Deposit and Wholesale Funding Guarantees

Australian Government's 2008 Deposit and Wholesale Funding Guarantees

Background

IFSA is supportive of the government's ongoing actions to stabilise financial markets, restore the flow of market liquidity and support domestic economic growth. In reference to the 2008 Deposit and Wholesale Funding Guarantees, we recognise that the Government was required to support the domestic banking system in the context of the global financial crisis and the action taken by other governments to support their local banking sector.

However, the current guarantee arrangements have led to a number of significant market distortions. The main areas for concern in the financial services industry are:

Outflows from Bank Deposit Alternatives (BDAs)

1. IFSA's members remain concerned with the ongoing risk of significant outflows from BDAs (such as cash management trusts and, to a lesser extent, other money market funds and other income funds) as witnessed in the recent case of mortgage trusts, where redemptions were eventually frozen. For example:

    - Cash Management Trusts (CMTs) remain vulnerable, as they compete directly with guaranteed bank deposits. To varying degrees, IFSA members have reported an increase in CMT outflows and there is heightened concern reflected in the large number of investor inquiries. In response to investor concerns, many CMTs have repositioned their portfolios into 100% of securities that qualify for the guarantee. This is despite the CMTs' AAAm rating, which means that a large proportion of CMT assets are usually invested in securities, which qualify for the guarantee.

    - Pressure will also remain on other money market funds, such as Cash and Cash Enhanced Funds, which allow some change in capital and daily NAV (net asset value). Funds rated AAAf have a very high portfolio quality and compete to some extent with CMTs, although lack the transaction capability of CMTs[1]. Fund managers are currently responding to investor concerns in a number of ways:

        - By repositioning their existing portfolios into 100% of securities that qualify for the guarantee. However these securities are not actually guaranteed because the Fund will not invest in a bank security for which a fee is paid to secure the guarantee for amounts above $1 million.
        - By establishing a new "protected" cash fund, where securities will be invested in the banks' new guaranteed product (for assets over $1 million), with a commensurate reduction in expected returns. The net effect will be to reduce returns to investors and impose establishment and higher administration costs on fund managers.

[1] See Appendix A for a comparison of the S&P rating criteria for AAAm and AAAf, along with a comparison against US Treasury's Rule 2a-7, the criteria for the US Treasury guarantee extended to "money market funds" (see below).

- Other income funds, such as mortgage trusts, may come under further pressure, despite (in many cases) their relatively high asset quality.

Superannuation funds and investment platforms

2. Many investors in superannuation funds and investment platforms using an omnibus account to provide a cash option, do not have the benefit of the fee-free threshold. This could lead to pressure on small corporate superannuation funds, in particular. In response, some superannuation funds are developing dual cash products to offer members – with and without the government guarantee – at an additional cost to the superannuation fund and to the investor.

   We further note that as a result of the guarantee's coverage of banks' Retirement Savings Accounts, superannuation funds are subject to an uneven playing field. Ultimately these factors may distort the market and encourage the establishment of more Self Managed Superannuation Funds. This may be at a disadvantage particularly for lower income earners for whom it is uneconomic to have a self-managed superannuation fund.

Risk and return

3. Within the guaranteed sector, distortions are arising because of the lack of linkage between risk and return. Lower rated non bank ADIs may attract deposits away from AA rated banks and from the non ADI sector. Some non bank ADIs are offering significantly higher deposit rates than the banks under the same guarantee structure. The longer this persists, the greater the adjustment for lower rated ADIs when the guarantee is removed or reduced. While financial market stability is the top priority at this stage, the guarantee could delay necessary structural change in the second tier ADIs.

Reduced liquidity in the non government guaranteed debt markets

4. As investors move from Bank Deposit Alternatives to ADIs and as fund managers reposition their Bank Deposit Alternative portfolios to eligible guaranteed securities, there is less demand for corporate securities. Typically, the assets most impacted are securitised (RMBS, CMBS), Bank Term debt (bank subordinated paper) and Corporate Bonds.

   Given the impact on the semi government and asset backed market, the effect is to push non bank corporates into higher cost bank financing and, for high grade assets such as AAA prime RMBS pools, they are now trading at distressed levels (i.e about 300/400 basis points over swap) in the secondary market. Appendix B presents data showing the significant increase in corporate and semi government spreads over the past 18 months, as well as data showing the decline in corporate debt outstanding (while bank debt outstanding has increased). More recent data confirms that trend.

   In the absence of action to contain the flow of funds/ portfolios into the guaranteed sectors, corporate liquidity and financing will continue to be a problem.

Mortgage refinancing

5. If net outflows from mortgage trusts were to continue (even with the revised redemption arrangements), refinance will be more difficult. Given that banks are also rationing mortgage funding, the cost and availability of mortgages, particularly for small-medium commercial development, may become a larger problem as existing mortgages mature.

Ongoing impact statement

Significant redemption flows appear to have diminished recently, however investor concerns remain high. There are reports that investors are more concerned about ensuring they have a deposit guarantee than they are about their superannuation returns.

Further, there has been renewed public attention on the guarantee arrangements following commencement of the Government Guarantee Scheme for Large Deposits and Wholesale Funding (the Guarantee Scheme[2]) on 28 November 2008 with a new range of ADI products becomes available, offering guarantees on deposits above $1 million (for a fee).

Even with a more stable domestic environment, international events have the potential to trigger another bout of investor and broader market instability. The international economy is still volatile; major international financial institutions are still vulnerable; international authorities continue to announce new or revised bail-out packages; fiscal and monetary policies are still not properly set to cope with the crisis; and there is no sign of recovery in broader financial indices. This means that BDAs remain vulnerable, especially over the next 3 to 6 months.

In the longer term, even with a more stable market environment, BDAs will remain at a disadvantage, compared with ADIs. Further, the dysfunctions within ADI risk pricing and weak corporate liquidity are likely to remain – in the absence of changes to the guarantee arrangements.

IFSA recommendations

This paper canvasses a number of recommendations to amend the guarantee in order to resolve the market distortions discussed above. We submit that these proposed amendments are necessary in order to:

- Stimulate the economy by assisting and promoting business investment;
- Ensure financial market stability through avoiding contagion to non-guaranteed products and financial institutions (including superannuation funds and wealth management platforms);

[2] In response to the 28 November Introduction of the guarantee fee, banks are moving to establish fully guaranteed products for their customers with deposits over $1m. The banks are expected to offer their key products to customers in two varieties: standard (non-guaranteed) and guaranteed. The guaranteed product would attract a fee of 70 basis points for a AA rated bank for guaranteed amounts above $1m. It is expected that most of that fee will be passed on to customers.

Institutions outside the guaranteed sector – such as superannuation funds and wealth management platforms – will need to decide whether to offer their clients a choice of product. Those choices would then feed into ADI guaranteed/ not guaranteed products, with a commensurate fee differential (and return difference) for investors.

- Restore a stronger linkage between risk and return within the guaranteed sector;
- Improve liquidity in the broader debt markets, particularly for the semi-government, (non bank) corporate and asset backed sectors; and
- Balance the financial costs and benefits of the guarantee's impact on the federal budget and industry.

Accordingly, IFSA proposes the following key changes:

1. Narrow the existing guarantee

IFSA supports a gradual reduction of the $1 million threshold to $50,000 over 18 months (and in line with market conditions) with that level being retained for a further 18 months before being closed. Given current market uncertainties and weak investor confidence, we would support an announcement in the first quarter of the 2009 calendar year. At that time, and on the assumption of more stable financial conditions, the government could announce a phase-down of the cap. For example, the proposed timing and schedule may include:

1 March 2009: Announce revised cap arrangements
1 September 2009: $750,000
1 March 2010: $500,000
1 September 2010: $250,000
1 March 2011 $50,000
October 2012: $0

Progressively lowering the threshold would reduce (but not eliminate) the incentive to transfer funds from BDAs to ADIs. As the threshold reduced, investors with deposits above the revised threshold could still ensure they received the guarantee and would be required to pay a fee for the guarantee.

It is important that this change be made in conjunction with limiting the fee-free guarantee to individuals with total deposits below the cap across all ADIs. This would prevent depositors circumventing the lower cap by splitting their deposits across a number of ADIs.

We submit that the wholesale arrangements would remain – although the government could underline its intention that, subject to market conditions "normalising" (as per the government's stated conditions for removal), the funding guarantee would be removed in 12 months – that is, at the same time that the deposit guarantee was reduced.

2. Restrict the guarantee to a defined list of products and rate of return

As identified above, distortions are arising because of the lack of linkage between risk and return. Lower rated non bank ADIs are offering significantly higher deposit rates than the banks under the same guarantee while also attracting deposits away from AA rated banks and from the non ADI sector. This is having an adverse impact on liquidity and pricing transparency in the secondary market.

IFSA supports further restricting the guarantee to a tighter list of products with a consistent rate of return. The products could be specified by their nature (for example, limited to transaction accounts) or be based on return (for example, less than 2% or specified as a proportion of the cash rate).

As with the threshold proposed above this could be phased in, so that the restricted guarantee would fully apply in 12 months. Many ADIs divide their products into transaction and saving/investment products. Consequently, interest returns can vary significantly within each product, depending on the account balance and the term of the investment. This suggests that a number of criteria will need to be designed to effectively restrict the guarantee, for example: only transaction accounts; with no tiers; paying less than a 2% return; and with no term limit. While this may appear complex, it also minimises any ambiguity about the requirements of the guarantee.

Interim relief measure:

3. Permit look-through for individual investors in investment platforms and superannuation funds

As discussed above, an ongoing practical issue for investors through investment platforms (including a life policy), managed funds and superannuation funds with cash or term deposit investment options, or cash funds/accounts, is that they will generally be denied the benefit of the free deposit guarantee because the aggregated ADI deposit held collectively on their behalf is greater than $1 million.

Because the account holder with the ADI will be a custodian or trustee, and the account balance will be an aggregate of total member entitlements that will exceed the $1 million threshold, individual investors with funds less than $1 million in the ADI through a custodial arrangement will be subject to the guarantee levy if the aggregate sum deposited is to be guaranteed. This will impose additional costs borne by investors in collective investment schemes and continue to influence market distortions.

The Treasurer's response from 23 December 2008 to IFSA's November submission is sympathetic to the issue, but correctly identifies that a resolution will be complex. Consequently, we welcome the opportunity to work with government and The Treasury on resolving these issues and modifying the Deposit Guarantee Parameters to include an interim "look-through" provision to the underlying investors, unitholders and superannuation fund members with investments that are held in deposit accounts or certificates of deposit with ADIs. Ideally the Guarantee fee for deposits with ADIs in excess of $1 million should therefore be waived where:

- the deposit account is held by an entity on behalf of underlying investors and that holds an Australian Financial Services Licence and is registered as the responsible entity of a managed investment scheme, or licensed to operate an IDPS, or is an Approved Trustee or Life Company; and
- the balance of the underlying individual account holder is less than $1 million (subject to a gradual reduction of the threshold detailed under recommendation two).

Appendix A

Comparison of Rating Criteria

	AAAm	AAAf	US Rule 2a-7
Fund type	CMT	Other MMFs [1]	"MMF"[2]
NAV	Stable	Variable	Stable
Portfolio Quality	75% Minimum A1+ 25% Maximum A1 50% Minimum government and bank obligations	More than 12 months: AA or higher. Short term: A1 or higher (overnight A2 or higher)	95% Minimum first tier (government and highest rated)
Single issuer diversification	Non government: 33% A1+ 25% A1		Government: no limits. Other (first tier): maximum 5% by any issuer. Other (second tier):maximum of 1% by any issuer
Maturity – overall		No strict limits but requires a high proportion of AAA and/or AA issues maturing within 12 months and/or A issues maturing within 3 months	
Maturity within 7 days	10%	Na	Na
Weighted average maturity	< 70 days	Na	< 90 days
Maximum maturity	12 months (excluding Floating Rate Notes)	Na	397 days

[1] Such as Cash Funds
[2] Under the US Investment Company Act, a "money market fund" can only be described as such if it satisfies the Rule 2a-7 criteria.

Source: Standard and Poor's, Fund Credit Rating Criteria, Australia, March 2008
US Investment Company Act 1940, Rule 2a-7.

Appendix B

Pressures in the Semi-Government and Corporate Market

Table 1: Capital Market Spreads over Australian Government (basis points)

	Non-bank corporate spreads [1]		T-Corp spreads	
	AA	BBB	3 Years	10 Years
Jun 2007	34	62	27	41
Dec 2007	111	174	44	52
Jun 2008	188	308	58	57
Aug 2008	200	305	69	70
Sep 2008	339	439	77	69
Oct 2008	395	479	80	76
26 Nov 2008	442	534		

[1] 3 year maturity.

Source: RBA Bulletin, 20 November 2008, Table F2, Capital Market Yields – Government Bonds (for T-Corp data)
UBS Global Asset Management (for corporate data)

Table 2: Debt Securities Outstanding ($ billion)

	Short term		Long term	
	Banks and other financial corporations	Corporate	Banks and other financial corporations	Corporate
Jun 2007	348	7	78	48
Dec 2007	489	4	81	47
Jun 2008	481	3	99	45
Sep 2008	501	3	98	43

Source: RBA Bulletin, 20 November 2008, Table D4, Debt Securities Outstanding