

Department of Treasury and Finance

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Mr John Hawkins
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Senate Economics Committee
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Dear Mr Hawkins

INQUIRY INTO THE BANK FUNDING GUARANTEES

I am writing to provide information to the Committee on Tasmania's experience in the credit market since the unlimited deposit and wholesale funding guarantee were announced and perspectives on assessing market conditions with a view to withdrawing the guarantee at the earliest opportunity.

Tasmania's experience

As I noted in the State's submission to the inquiry into the *Guarantee of State and Territory Borrowing Appropriation Bill 2009*, the wholesale funding guarantee altered the credit market's perception of relative risk by elevating the banks above the States.

As soon as the guarantee was announced, it became difficult for the States to issue long-term debt as the market anticipated that the banks would issue large volumes of guaranteed debt. This was confirmed when the guarantee was implemented, which effectively crowded the States out of the market. While the Australian Government's pending guarantee on State and Territory borrowing has eased the market access concerns, conditions remain difficult for some of the smaller States and Territories relative to the banks.

I would also like to draw the Committee's attention to another impact of the unlimited deposit guarantee and wholesale funding guarantee. Like other lenders, the Tasmanian Public Finance Corporation has a range of clients with different funding requirements. Around 60 per cent of loans are for amounts less than \$10 million.

In the past, these were funded from a combination of long term preferred stock and short term commercial paper, and Tascorp minimised the cost of its long term debt program by:

- issuing sufficient volumes to maintain a liquid market;
- issuing in uniform amounts, with standard repayment terms and few discrete maturity dates; and
- managing any resulting risks by swapping to floating rates and reinvesting excess funds in highly-rated liquid assets and associated hedging.

These reinvestment activities traditionally generated a positive spread between Tascorp's issue yield and the bank swap rate, with the cost savings passed on to Tascorp's clients. This spread increased in the early stages of the global financial crisis, reflecting the market's favourable perception of the risk of semi-government debt relative to bank debt.

However, this reinvestment spread reversed when the respective bank guarantees were announced, and has not corrected even though the guarantee of State and Territory borrowing is about to be implemented. The lack of liquidity in high quality asset-backed securities — which is exacerbated by the banks' relatively unconstrained funding capacity and increasing market share — also prevents alternative reinvestment strategies. These conditions result in Tascorp potentially losing earnings on any excess funds that are raised in advance of client requirements, and higher funding costs.

Withdrawing the bank guarantees

When financial markets settle and liquidity returns, it is inevitable that the credit market will be different to the period before the global financial crisis, particularly in the treatment of risk. The impact of distortions such as the unlimited bank deposit and wholesale funding guarantees may be difficult to isolate by that time. Accordingly, it is not possible to recommend a firm timeline for removing the bank guarantees, although Tasmania believes that it would be prudent to withdraw the wholesale funding guarantee at the earliest opportunity.

Market conditions should be assessed regularly and holistically, embracing multiple credit market participants (including the States and their central financing authorities) and multiple data sources (including monthly surveys by the Reserve Bank of Australia).

The ongoing assessment should also be supported by a number of objective criteria that can be quantified, such as the following which are based on the premise that a 'normal' financial market is efficient, liquid, transparent and competitive:

Market criteria	Measurement
The price of bonds guaranteed by the Commonwealth, relative to comparable Commonwealth bonds, is consistent with risks faced by investors	<ul style="list-style-type: none"> • Material contractions in credit spreads between Commonwealth bonds and Commonwealth-guaranteed bonds
Market pricing suggests there should be no bias for authorised deposit-taking institutions between issuing guaranteed and non-guaranteed bonds	<ul style="list-style-type: none"> • Increased issuance of non guaranteed debt by ADIs • Cost of issuing guaranteed debt and unguaranteed debt are closely aligned
Consistent demand for primary issues of semi-government bonds	<ul style="list-style-type: none"> • Central financing authorities are able to issue long-term debt (guaranteed and non-guaranteed) at a time and method of their choosing
Liquid secondary markets for semi-government bonds	<ul style="list-style-type: none"> • Reduced bid/offer spreads
Other entities are able to access credit markets to raise funds	<ul style="list-style-type: none"> • Increased primary issuance of bonds and other securities by corporates and non-bank lenders

In order to facilitate the guarantees being withdrawn at the earliest opportunity, I propose that meeting most or all of the conditions for one to three months should be sufficient to demonstrate that markets have 'normalised' for a sustained period without unnecessarily prolonging their distortionary impact in the credit market.

Thank you for the opportunity to provide a submission to this inquiry.

Yours sincerely

A handwritten signature in blue ink, appearing to read 'D W Challen', with a horizontal line underneath.

D W Challen
SECRETARY

29 July 2009