Senate Standing Committee on Economics

Bank Funding Guarantees

Submission by Bank of Queensland
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INTRODUCTION

Bank of Queensland (BOQ) welcomes the opportunity to provide the following submission in relation to the Government's bank funding guarantees, for the Committee's consideration. BOQ has only provided comment on those terms of reference that it believes it is best placed to provide an opinion on.

TERMS OF REFERENCE

(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

BOQ was very supportive of the Government's announcement on the 12th October 2008 to introduce a bank deposit guarantee, as there were clear signals in the marketplace and in the media of a significant level of public concern as to the safety of banks, and therefore the safety of deposits.

BOQ understands the subsequent cap of $1 million for the deposit guarantee was introduced in response to distortions the unlimited guarantee was having in the wholesale funding markets.

However, BOQ does not support the tiered fee that was introduced for guarantees over $1 million, which are based on an institution's credit rating (ie. 70 basis point fee for deposits with an AA-rated ADI, 100 basis points for an A-rated ADI, and 150 basis points for BBB and unrated ADI's). This fee structure created an unlevel playing field for the first time in the deposit space, as previously Australian retail deposits had always been priced without regard for the credit rating of a financial institution. It also sent a message to the public that ADI's with lower credit ratings are not as "safe" as those with higher credit ratings (ie. major banks), which is a one-dimensional view of safety as it doesn't take in to perspective factors such as the conservatism of lending portfolios (ie. portfolios focused on consumer and housing lending vs portfolios skewed to corporate lending).

(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

BOQ was very supportive of the Government's announcement on the 12th October 2008 to introduce a wholesale bank funding guarantee, which was important for the ability of Australian financial institutions to continue to access overseas funding markets given several other countries had introduced a similar guarantee.

However, BOQ does not support the tiered fee structure that applies to ADI's to access the Government guarantee. This is explained further in section (l).

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

The estimated effect of the bank deposit guarantee on interest rates for deposits under $1 million would be negligible, given there is no price attached to this guarantee.

The estimated effect of the bank wholesale funding guarantees on interest rates is difficult to categorically understand, given the varying market forces involved. However given a fee for this guarantee is charged by the Government, varying from 70 basis points to 150 basis points, it is inevitable that there is some flow through of this in to housing and business lending rates.

This fee obviously impacts more on lower rated ADI's, as they are charged more to access the guarantee, but can't pass this on in its entirety to customers due to the competitive imperative to keep rates in close alignment with other competitors. The effect in this instance is disadvantageous to lower rated ADI's margins and shareholders.

Over the long term this will disadvantage smaller ADI's by increasing their cost of capital and thereby reducing their rate of lending growth – which could lead to higher interest rates, and therefore a lessening in competition.

(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

BOQ was very supportive of the announcement of the Government's intention to support the securitisation market by purchasing residential mortgage backed securities (RMBS). This, coupled with the deposit and wholesale funding guarantees, were all measures that we believe had a clear intent to both support and promote the financial markets and industry in Australia.

The securitisation market has traditionally been a cost effective funding mechanism for smaller ADI's and non-banks, and BOQ believes reviving this market is imperative to not only ensure there are a number of finance providers available in the market, but also that these institutions are able to access funds in order to effectively compete – which is for the benefit of all Australian consumers and businesses.

BOQ refers the Committee to the Access Economics report of 20th July 2009 titled 'Options for restarting Australian securitisation markets' for further insight in to this issue.

The Government's current program of purchasing RMBS via the AOFM has been useful and appreciated, however we do not believe it has had a major impact on containing the cost of funds. BOQ recommends that the funds allocated to the Government's current program via the AOFM be increased, and specifically be earmarked for supporting smaller ADI's to ensure competitiveness and system stability. Furthermore, we believe allocations should favour those lenders who continue to expand lending, particularly in housing and small business, which is critical in underpinning the recovery of the Australian economy.

(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

BOQ believes that given the interconnectivity of global financial markets, the wholesale funding guarantee can only be removed when other members of the G20 do so.

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

The bank deposit guarantee benefitted all ADI's through restoring confidence in the banking system, however as canvassed in (a) above, BOQ believes the application of a tiered fee system based on credit ratings sends a negative (and incorrect) message about the implied safety of lower-rated ADI's, which can affect the competitive positioning of these institutions.

With respect to the wholesale funding guarantee, BOQ believes that the existing fee structure has had unintended consequences of benefiting major banks only, and is uneconomic for non-major banks.

To summarise BOQ's key issues:

1. The Government guarantee is an expensive form of funding for non-major banks when compared to major banks' funding costs under the scheme, and the associated rising cost of funds for non-major banks and compression in net interest margins, results in more expensive mortgage pricing from non-major banks, and lessens competition for consumers.

2. The current tiered Government guarantee fee structure makes it uneconomic for non-major banks to issue Government guaranteed term funding.

3. Financial markets are looking through the AAA rating of the Government guarantee to the underlying credit rating of the borrower, resulting in non-major banks actually being charged twice for the guarantee.

The solution advocated by BOQ is to introduce a flat Government guarantee fee for all ADIs (of 70 basis points), that would promote an economic and equitable outcome for both major Banks and non-major banks.

Please refer to Schedule A for more analysis on this particular issue.

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

BOQ believes the announcements of the guarantees (particularly the deposit guarantee as it has more direct relevance to the majority of the public), were received positively and helped restore confidence.

In respect of the deposit guarantee, there was a level of confusion in the weeks following the announcement until the parameters were set and confirmed, as many consumers and businesses were unsure of logistical issues such as whether the guarantee applied to each individual account or cumulatively to all accounts an individual held within an institution (and therefore whether they need to split their accounts amongst institutions to ensure the guarantee applied); how the guarantee was applied to joint accounts; whether accounts such as trustee accounts were included etc.

Cost of Commonwealth Government Guarantee

Executive Summary

This document seeks to provide evidence to the Commonwealth Government of Australia that the existing fee structure for Government guaranteed term funding has had unintended consequences, and is uneconomic for non-major banks.

The issues that non-major banks have with the existing Government guarantee scheme include:

1. The Government guarantee is an expensive form of funding for non-major banks when compared to major banks' funding costs under the scheme, and the associated rising cost of funds for non-major banks, and compression in net interest margins, results in more expensive mortgage pricing from non-major banks, and lessens competition.

2. The current tiered Government guarantee fee structure makes it uneconomic for non-major banks to issue Government guaranteed term funding.

3. Financial markets are looking through the AAA rating of the Government guarantee to the underlying credit rating of the borrower, resulting in non-major banks being charged twice for the GG.

Other Government assistance programmes such as the support provided by the AOFM to Residential Mortgage Backed Securities, whilst useful and appreciated, have not had a major impact on containing the cost of funds.

The solution proposed by this paper is to introduce a flat Government Guarantee fee for all ADIs that would promote an economic and equitable outcome for both Major Banks and Non-major Banks.

Introduction

Background

In light of recent global financial market instability, the Commonwealth Government of Australia introduced the Australian Government Guarantee Scheme for Large Deposits and Wholesale Funding Rules ("Government Guarantee", or "GG") for Approved Deposit-Taking Institutions ("ADIs"). Scheme rules were introduced for Large Deposits and Wholesale Funding in excess of A$1M for Eligible Institutions who seek to have their debt guaranteed. These rules require a fee to be paid for a Government Guarantee based on an ADI's underlying credit rating. Refer Table 1 below.

Table 1

Long Term Credit Rating of ADI[1]	Fee (in basis points per annum)
AAA to AA-	70
A+ to A-	100
BBB+ and below and Unrated	150

1. The credit ratings shown are those supplied by Standard & Poors and Fitch. For those ADIs rated by Moody's the equivalent rating scale will apply. Source: http://www.guaranteescheme.gov.au/rules/pdf/schedule-5.pdf

Rationale

The objective of the Government Guarantee scheme is stated as follows:

"*The arrangements are designed to promote financial system stability in Australia, by supporting confidence and assisting ADI's to continue to access funding at a time of considerable turbulence. They are also designed to ensure that Australian institutions are not placed at a disadvantage compared to their international competitors that can access similar government guarantees on bank debt*". *Source: http://www.guaranteescheme.gov.au/*

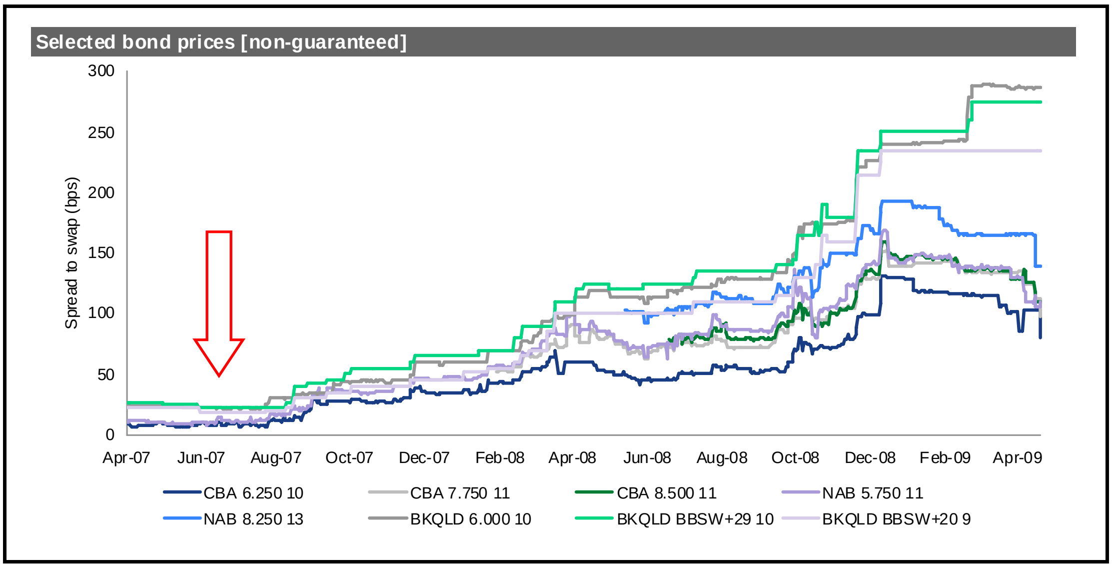
The GG scheme has achieved the stated objective of stabilising the Australian financial system. However it has not assisted all ADI's to access funding in a cost effective manner. The current tiered GG Fee structure is uneconomic for Non-major Bank ADI's issuing wholesale term debt under the GG scheme.

Impacts of the GG Scheme for wholesale funding on Non-major Banks

1. It is an expensive form of funding for Non-major Banks

Graph 1 below is a chart of non-guaranteed ADI bond spreads, focussing on the period prior to August 2007 (pre global financial crisis). It indicates that the difference on term funding spreads between non-GG AA rated banks ("Major Banks") and non-GG BBB rated banks ("Non-major Banks") for a 3 year term issue, is a spread of approximately 30 to 40 basis points.

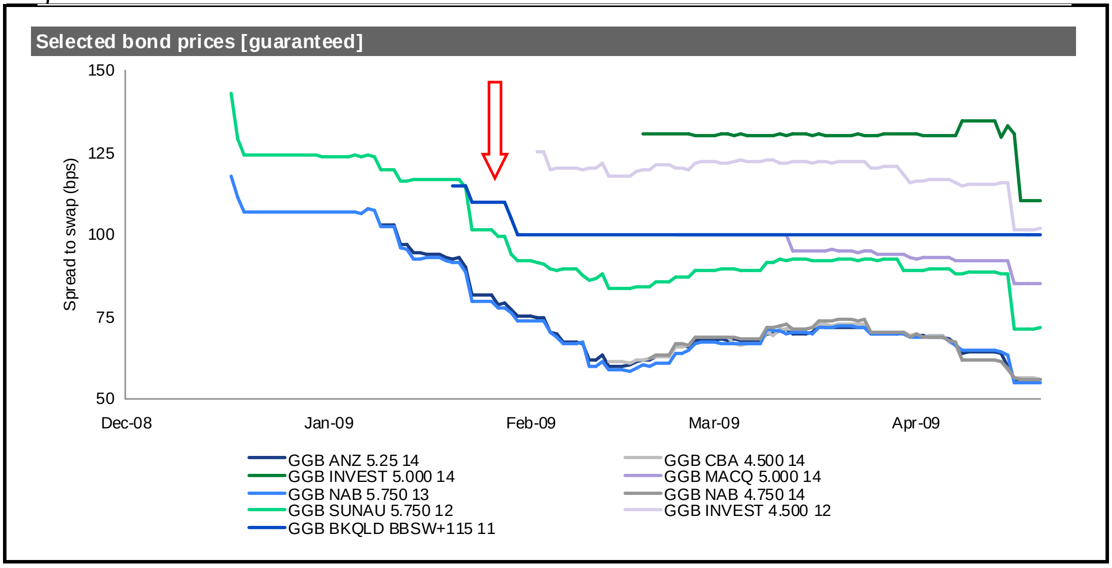
Graph 1



Source: UBS Investment Bank, Sydney

Graph 2 overleaf, from late January 2009, following the introduction of the GG, shows that the differential between Major bank GG issues and Non-major Bank GG issues, on a 3 year term issue, is approximately 30 to 40 basis points.

Graph 2



Source: UBS Investment Bank, Sydney

The market has determined that a credit premium between a Major and a Non-major Bank is still approximately 30 to 40 basis points for guaranteed debt with a 3 year tenor. However, if we add in the GG fee then the differential between a Major and a Non-major Bank becomes 120 basis points. The calculations are detailed below (assuming a 3 year tenor):

	Major Bank	Non-major Bank
Issue Margin:	75 basis points	115 basis points
Plus GG	70 basis points	150 basis points
Total	145 basis points	265 basis points

Market prices as at Jan-09

There has been a greater relative deterioration in term funding costs post the introduction of the GG for Non-major Banks. The spread differential required for a Non-major Bank issuing under the GG acts as a deterrent to wholesale GG debt issuance as the all in cost of funds is now approximately 80 basis points higher compared to the Major Banks. Refer to Table 2 for some examples of GG issued wholesale term funding across different issuer ratings.

Table 2 – Major and Non-major Bank GG issuance

Issuer	Credit Rating of Issuer*	Issue date & Term	Issued Margin over swap	Government charge	Margin + charge over swap	Trading Margin over swap** (excl. government charge)
Investec Bank	BBB*	09-Feb-09 09-Feb-12 (3.0 years)	+125 basis points	150 basis points	+275 basis points	~85 basis points
Bank of Queensland	BBB+*	28-Jan-09 28-Oct-11 (2.75 years)	+115 basis points	150 basis points	+265 basis points	~60 basis points
Bank of Queensland	BBB+*	09-Jul-09 22-Oct-12 (3.25 years)	+65 basis points	150 basis points	+215 basis points	~65 basis points
AMP Bank	A*	09-Feb-09 09-Feb-12 (3.0 years)	+90 basis points	100 basis points	+190 basis points	~ 75 basis points
ANZ	AA*	16-Jan-09	+85 basis points	70 basis points	+155 basis points	~35 basis points

		16-Jan-12 (3.0 years)				
NAB	AA*	26-Mar-09 26-Mar-12 (3.0 years)	+60 basis points	70 basis points	+130 basis points	~30 basis points

* All securities rated AAA / Aaa Standard & Poor's / Moody's
** Market prices as at 6-Jul-09

This forces Non-major Banks to focus on other funding options such as growing retail deposits as a source of alternative funding and shorter term wholesale funding from Capital Markets, which is more expensive, and shortens their maturity profile. The GG scheme has seen Non-major Banks seek alternate sources of funding. The demand for alternate funding has intensified competition in the retail deposit market as Banks compete for market share, and as a result, Non-major Banks' retail cost of funds have increased and net interest margins have been squeezed.

2. It is uneconomic for Non-major Banks to Issue GG Term Funding

The current pricing on the GG makes Major Banks indifferent as to whether they issue guaranteed or unguaranteed debt. An example of this is below:

On the 6th April 2009 the CBA priced A$1.2bn of 3 year senior unsecured unguaranteed debt at 130 basis points over swap. In comparison, the NAB issued A$2bn of 3 year GG Debt at 60 basis points over swap on the 18th March 2009. To compare the relative borrowing cost of issuing under the GG versus an unguaranteed issue, if the 70 basis point GG fee is added to the market cost of the NAB issue, it results in an all in cost of borrowing which is equivalent to the CBA's non-GG issue (ie. 60bps spread + 70bps GG fee = 130 basis points, the same as the CBA issue).

A Major bank is indifferent between issuing GG term funding verses non-GG term funding and is able to access large volumes of funding via these wholesale markets. Major banks continue to issue senior unsecured unguaranteed debt evidenced by the recent NAB tap of an existing 3 year unguaranteed issue on 18th June 2009 for A$1.2bn at 115 basis points over swap. Non-major banks have not done a unguaranteed senior unsecured issue in 2009.

For Major banks the GG scheme has been successful in providing ADI access to term funding markets. Major Banks have been the dominant GG issuers in the market in the half quarter of 2009.

In comparison, the all in cost for a Non-major Bank like BOQ to issue GG term funding, has increased significantly. This makes it uneconomic to fund under the GG, contrary to the Government's intention for the GG to continue access to funding for Banks.

3. Financial Markets are looking through the AAA rating of the GG to the underlying credit rating of the Borrower

Issue spreads for Major Bank versus Non-major Bank GG issuance clearly demonstrate that investors are looking through the GG AAA rating to the underlying issuer's credit rating. The graphical information previously presented indicates that the market is looking through to underlying credit ratings and is charging a primary market credit premium based on an ADI's credit rating. The result is that a Non-major Bank is effectively charged twice for the GG, once by the market and then again by the Government. If the original GG tiered fee schedule is maintained then issuers will continue to be charged twice and will be deterred from borrowing in term capital markets.

Unintended Consequences of current fee structure

The tiered GG fee structure has had unintended consequences and effectively has meant that institutions like BOQ and Bendigo & Adelaide Bank have not been able to pass on as much relief to borrowers in the form of rate cuts when compared with Major banks. The inability to pass on rate reductions fully is a negative by-product of the GG and ultimately works against the Government's objective of supporting credit growth to provide a source of stimulus in a contracting economy.

The inability for regional and smaller ADIs to tap GG funding sources at cost effective prices will result in increased lending margins for Australian households and businesses and is likely to ultimately stifle competition in the Australian banking sector. Already margin pressure has resulted in BOQ having to price its mortgage products relatively more expensively than the Major Banks, reducing its ability to be competitive in its market.

Providing cost effective wholesale funding supports the viability of smaller financial institutions, and therefore competition, as lending by them will not be limited by the availability of customer deposits. Smaller financial institutions are also significant employers in their regional areas, and the continued presence of strong financial institutions in regional Australia will act to stabilise unemployment in parts of Australia already impacted by the global financial crisis.

Other Government Assistance

The Commonwealth Government has provided other assistance to Non-major ADIs and Non-bank mortgage originators via the arrangements announced on 26th September 2008 where the Australian Office of Financial Management ("AOFM") indicated it would support the Residential Mortgage-Backed Securities (RMBS) market by purchasing up to A$8 billion of RMBS issued, with at least A$4 billion to be allocated to Non-bank mortgage originators.

The AOFM assistance program for the RMBS market, whilst a positive development for this market, and supported and appreciated by all market participants, has not had a significant impact on driving down Non-major Banks' cost of funds to a point where they are able to compete with the Major Banks' mortgage pricing. Ultimately the uncertainty around access to funding from this source has not allowed the marginal lenders to compete on price with the Major Banks.

Given the limited size of the support program and the uncertainty around an institution successfully being provided funding under the AOFM tender process, this assistance program has not had a major impact on containing the cost of funds for Non-major Banks, or promoting competition across the mortgage market. Higher borrowing spreads in the RMBS market and limited access to funds has also contributed to the compression in net interest margins, and the expensive pricing of Non-major Banks' mortgage products relative to the Major Banks.

Proposed Solution

A flat GG fee of 70 basis points for all ADI's would promote an economic and equitable outcome for both Major Banks and Non-major Banks. See below calculations of 3 year cost of borrowing for both Non-major Banks and Major Banks under a flat fee.

	Major Bank	Non-major Bank
Issue Margin:	35* basis points	65* basis points
Plus GG	70 basis points	70 basis points
Total	105 basis points	135 basis points

* Market trading margins as at 6-Jul-09

A Non-major Bank under a flat fee structure would pay 135 basis points all in versus a Major Bank paying 105 basis points all in. A flat fee structure would make the spread differential between Major Bank issued GG levels and Non-major Bank GG levels more consistent, with historic levels of approximately 30 to 40 basis points maintained. Non-major Banks would also be indifferent between borrowing under the GG or in the senior unsecured wholesale funding markets, addressing the issues identified above in this regard.

Conclusion

Under the current tiered fee structure the GG scheme is uneconomic for Non-major Banks. If the fee structure was amended from a tiered structure to a flat 70 basis point fee the Major and Non-major Banks could both access wholesale funding in a cost effective way, and would both be indifferent when borrowing in either the senior unsecured or GG markets.

If a flat fee is adopted then a more equitable outcome is likely to be the result. The Non-major Banks would be indifferent between issuing GG debt and non-GG debt, and the new costs structure would be economic. This would promote an earlier recovery of markets and less reliance on the GG, eventually facilitating the Government's exit from the GG scheme.

Cost effective access to GG funding markets will also promote competition in residential and business lending, and stronger, viable Non-major Banks which will ultimately act to stabilise regional employment markets.