

INQUIRY BY THE SENATE ECONOMICS REFERENCES COMMITTEE INTO BANK FUNDING GUARANTEES - JOINT SUBMISSION FROM THE RBA AND APRA

The government guarantee arrangements for deposits and wholesale borrowing were introduced in response to extraordinary developments in the global financial system. They were designed to support confidence of depositors in authorised deposit-taking institutions (ADIs) and to help ensure that these institutions continued to have access to capital markets. The arrangements have been successful in meeting these objectives and as such, they have made an important contribution to the stability of the Australian financial system. They have also ensured that the overall availability of funding has not been a constraint on the capacity of Australian banks to lend.

The paper is structured as follows. Section 1 discusses the background to the introduction of the guarantee arrangements. Section 2 outlines the arrangements, with reference to those in place internationally. Section 3 examines developments in various markets following the announcement of the guarantee arrangements. Section 4 details the use of the arrangements, with a focus on long-term wholesale funding.

1. Background to introduction of the guarantee arrangements

In the latter part of 2008, heightened risk aversion led to pressure on the availability and cost of funding for banks around the world. In September 2008, the collapse of Lehman Brothers triggered extreme uncertainty about the stability of the global financial system, and a virtual closure of parts of global capital markets. Despite their ongoing good performance, Australian ADIs were affected by these developments with increasing reluctance among investors to buy long-term bank debt, and signs of nervousness among some depositors.

Against this backdrop, a number of governments announced strengthening of deposit protection arrangements and the provision of guarantees for wholesale debt. In many cases, the former involved changes to the caps applying to existing deposit protection arrangements. The Irish Government was the first to act in late September by providing a guarantee with an unlimited cap for deposits at the largest institutions, an approach followed by Austria and Denmark. In other countries, including the United States, United Kingdom and a number of EU countries the existing caps were significantly increased. Around the same time as they extended deposit protection arrangements, many governments also provided guarantees over wholesale funding, partly in response to the Irish Government's decision to do so. (Details of international deposit protection and wholesale guarantee arrangements are provided in the section below).

The Australian Government also moved to reassure depositors and investors in Australian ADIs, and to ensure that Australian ADIs were not disadvantaged compared to banks in other countries, by announcing guarantee arrangements for deposits and wholesale funding. This was announced on 12 October, with further details – including a guarantee fee on large deposits – announced on 24 October following advice from the Council of Financial Regulators. The Government noted in its announcement that the guarantee scheme arrangements would be reviewed on an ongoing basis and revised if necessary. The guarantee arrangements became fully operational on 28 November after a period of close co-ordination between Council agencies – in consultation with ADIs – to establish the necessary rules, processes, documentation and architecture.

2. The Australian guarantee arrangements in an international context

There are two aspects to the Australian guarantee arrangements.

Under the Financial Claims Scheme (FCS), all deposits under \$1 million with Australian banks, building societies and credit unions and Australian subsidiaries of foreign-owned banks are automatically guaranteed by the Government, with no fee payable.

Under the Guarantee Scheme (GS) for Large Deposits and Wholesale Funding, eligible ADIs can, for a fee, obtain a government guarantee on deposits greater than \$1 million, and wholesale funding with maturity out to 5 years. Unlike the FCS, the GS is also available, with some restrictions, to branches of foreign-owned banks.¹ To obtain the guarantee under the GS, eligible ADIs must apply to the Reserve Bank which administers the scheme on behalf of the Government. This involves assessing applications from ADIs, issuing guarantee certificates to successful applicants, administering and reporting monthly fee payments, monitoring guaranteed liabilities and maintaining a website with relevant information about the scheme and the liabilities that have been guaranteed.

Guarantee fees vary by credit rating, but not by the maturity or the currency denomination of the debt (Table 1). In setting the premiums on the guarantee the Government considered a range of factors, including international settings and the need to ensure that the arrangements did not continue indefinitely. The fees were set at a level between the then current risk spreads – the product of very stressed conditions – and spreads likely to prevail in more normal market conditions. This was to provide the basis for a natural exit mechanism, with the expectation that at some point investors will no longer be willing to accept the lower yields on guaranteed paper and banks will therefore no longer seek to insure their debt.

Table 1: Current Guarantee Scheme Pricing

Credit Rating	Fee per annum (basis points)
AAA to AA–	70
A+ to A–	100
BBB+ and below and Unrated	150

The Australian arrangements share many common features with those introduced in other countries although, on balance, the range of parameters are generally at the more supportive end of those internationally.

2.1 Deposits

In Australia, the combined effect of the schemes is that there is no limit on the size of deposit that can be guaranteed, although for a guarantee on deposits over \$1 million per customer at eligible ADIs a fee is payable. The Australian arrangements for the FCS were announced with a termination date of three years.

As mentioned, many governments responded to heightened uncertainty by increasing the monetary cap on the amount of deposits guaranteed under pre-existing schemes, but there is significant variation among countries both in terms of the starting point and the subsequent

¹ The differing treatment to foreign bank subsidiaries reflects that, unlike the subsidiaries, foreign bank branches are not separate entities incorporated and independently capitalised in Australia – they are part of the foreign bank incorporated overseas.

increase. For example, the cap was increased on a temporary basis to \$250 000 from \$100 000 in the United States, the minimum cap in European Union (EU) countries was raised to €50 000 from €20 000 previously, and some EU countries went further to introduce unlimited caps (Table 2). Many countries that introduced increases, particularly those with an unlimited cap, nominated a set period for the arrangements to apply, typically around two years.

Table 2: Changes in Selected Countries' Deposit Guarantee Arrangements

	Previous Limit	Current Limit	Termination Date
Australia	--	Unlimited: first \$1 million is free, then voluntary access via Guarantee Scheme	12-Oct-11
Austria	€20 000	Unlimited	31-Dec-09
Belgium	€20 000	€100 000	--
Denmark	DKK300 000	Unlimited	30-Sep-10
Finland	€25 000	€50 000	Until further notice
Germany	€20 000	€50 000*	--
Greece	€20 000	€100 000	30-Oct-11
Hong Kong	HKD100 000	Unlimited	31-Dec-10
Ireland	€20 000	€100 000 (Unlimited for selected institutions)	28-Sep-10
Netherlands	€40 000	€100 000	--
New Zealand	--	NZ\$1 million	12-Oct-10
Singapore	SGD20 000	Unlimited	31-Dec-10
Spain	€20 000	€100 000	--
Sweden	SEK250 000	The higher of €50 000 or SEK500 000, depending on exchange rate	--
Switzerland	CHF30 000	CHF100 000	--
United Kingdom	£31 700	£50 000	--
United States	US \$100 000	US\$250 000	31-Dec-13

* Intended to increase to €100 000 in January 2011

Source: BIS; Countries' deposit insurers and regulators

2.2 Wholesale Funding

Details of wholesale funding schemes also vary considerably across countries in structure, fees, the eligible maturity of debt covered and the period of availability of the guarantee.

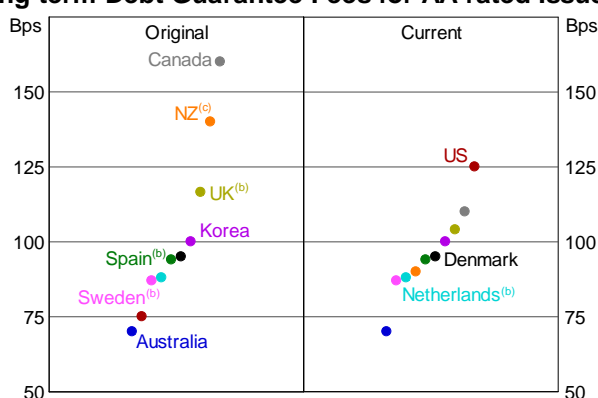
Most schemes are structured to allow private financial institutions to issue government-guaranteed debt, but some countries (France and Austria) established a separate state controlled agency to raise funding and on-lend to eligible private institutions.

The fees charged for the government guarantees on wholesale funding are typically based on the credit rating of the issuer, credit default swap premiums or a combination. In the United States, the fee charged is dependent on the term of the instrument but not the rating of the issuer. The fee structure adopted in the Netherlands and New Zealand also depends partly on the term of issuance.

At the time the Australian GS was introduced, the pricing was similar to that in the United States, but below that in the United Kingdom. Since the original announcements, the United States has

raised its fees on bank long-term issuance from 75 basis points to up to 125 basis points, as part of its strategy for exiting from the current arrangements. In contrast, schemes with fees at the higher end, including the United Kingdom, have decreased their fees, partly due to concerns about the competitive implications for their banks of charging high fees. As a result, the range of fees has narrowed (Graph 1). Given the changes that have taken place elsewhere, the pricing of the Australian guarantee for long-term debt now looks relatively low for AA rated banks. Internationally, fees on comparable schemes have converged at around 90 to 110 points, above the 70 basis point charge for AA rated Australian banks.² The Australian fee structure also has a relatively large differential between banks with different ratings. Further details are provided in the Appendix.

Graph 1
Long-term Debt Guarantee Fees for AA-rated Issuers^(a)



(a) Schemes where banks issue in their own name
 (b) RBA estimate based on CDS premiums
 (c) New Zealand dollar fee (subtract 20 basis points for foreign currency fee)
 Sources: BIS; treasury departments, central banks, debt management offices and guarantee administrators

The GS permits a maximum eligible maturity of a rolling 5 years. In comparison, most governments nominated a maximum maturity date, beyond which debt would not be guaranteed (Table 3). This date has of necessity, been extended in a number of countries, including the United States and United Kingdom, such that most schemes have a fixed maturity limit of sometime in 2012 or, for some, 2014 (i.e 3 to 5 years since the introduction of the schemes). The rolling 5 year maturity eligibility of the Australian GS has the advantage for ADIs of accessibility to a less crowded part of the yield curve, and avoids bunching of refinancing risk around specific dates.

The Government announced that the GS would remain in place ‘until conditions normalise’. In comparison, most other countries nominated a fixed date by which debt had to be issued. Given the continuation of difficult conditions, however, a number of countries – including the United States, United Kingdom and Canada – have subsequently extended the cut-off date (Table 3).

² The only scheme where the fee appears to be lower is the French scheme where debt is issued by a centralised borrowing authority and fees partly reflect the centralised borrowing authority’s cost of funds

Table 3: Other Guarantee Scheme Parameters

	Maximum maturity date / debt no longer covered		Final date for guaranteed issuance	
	Original	Change (if any)	Original	Change (if any)
Australia	Rolling 5 years	--	Unspecified	--
Belgium	31-Oct-11	--	31-Oct-09	--
Canada	30-Apr-12	31-Dec-12	30-Apr-09	31-Dec-09
Denmark	30-Sep-10	31-Dec-13	30-Sep-10	31-Dec-10
Finland	30-Apr-12	31-Dec-14	30-Apr-09	31-Dec-09
France	31-Dec-14	--	31-Dec-09	--
Germany	31-Dec-12	31-Dec-14	31-Dec-09	--
Ireland	29-Sep-10	--	29-Sep-10	--
Korea	30-Jun-12	31-Dec-14	30-Jun-09	31-Dec-09
Netherlands	31-Dec-12	31-Dec-14	31-Dec-09	--
New Zealand	Rolling 5 years	--	Unspecified	--
Spain	01-Jul-12	15-Dec-12	01-Jul-09	15-Dec-09
Sweden	30-Apr-12	31-Oct-14	30-Apr-09	31-Oct-09
UK	13-Apr-12	09-Apr-14	09-Apr-09	31-Dec-09
US	30-Jun-12	31-Dec-12	30-Jun-09	31-Oct-09

Sources: BIS; Treasury departments, central banks, debt management offices and guarantee administrators

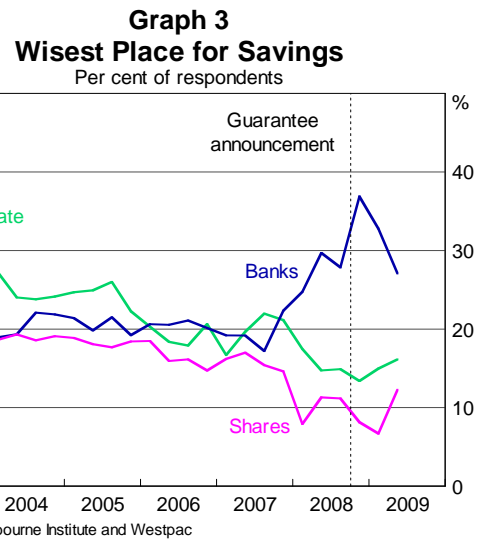
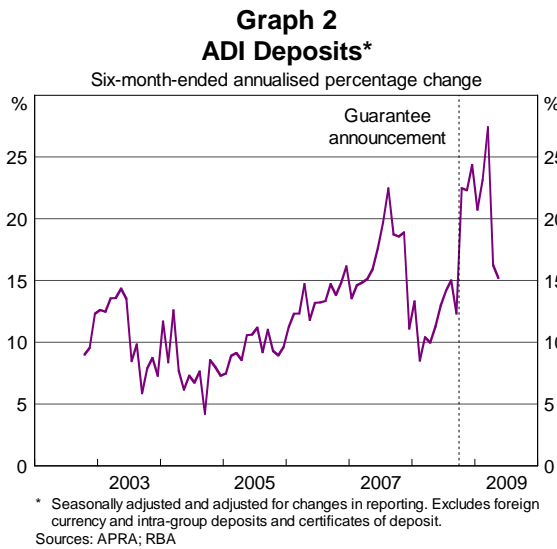
3. Effect of the guarantee arrangements

3.1 Deposit markets

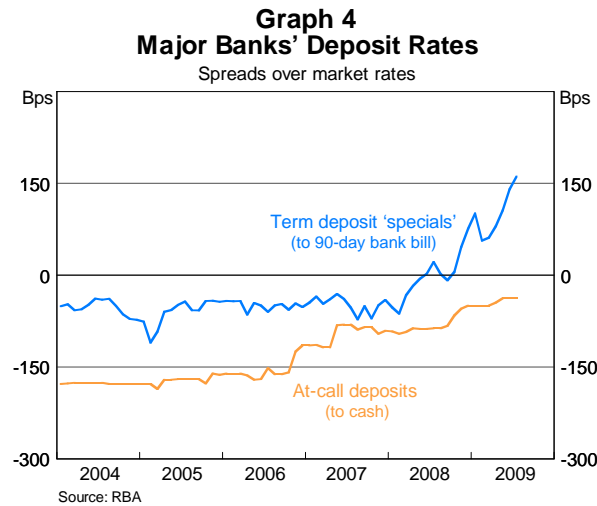
The announcement of the Government guarantee arrangements on 12 October 2008 had a clear effect of stabilising confidence in ADIs. The effects were seen most immediately in movements in deposits, to which the guarantee immediately applied. In particular, following the announcement there was a reversal in potentially destabilising deposit outflows from a number of ADIs that had been evident in early October. By guaranteeing all deposits under \$1 million, the FCS reduced the incentive for depositors to move away from ADIs that they perceived as being at risk.

The guarantee also supported overall ADI deposit growth, adding to the pre-existing trend. Deposit growth at ADIs had been picking up over 2008, consistent with growing risk aversion by households and businesses amid the uncertain environment (Graph 2). In September 2008, around 30 per cent of households in the Westpac-Melbourne Institute Survey of Consumer Sentiment nominated banks as the wisest place for savings, up by 10 percentage points over the year, as household preferences moved away from riskier assets such as real estate and shares (Graph 3). This is not an unusual reaction in periods of uncertainty; an increase in the perceived safety of banks was also evident in the early 1990s.

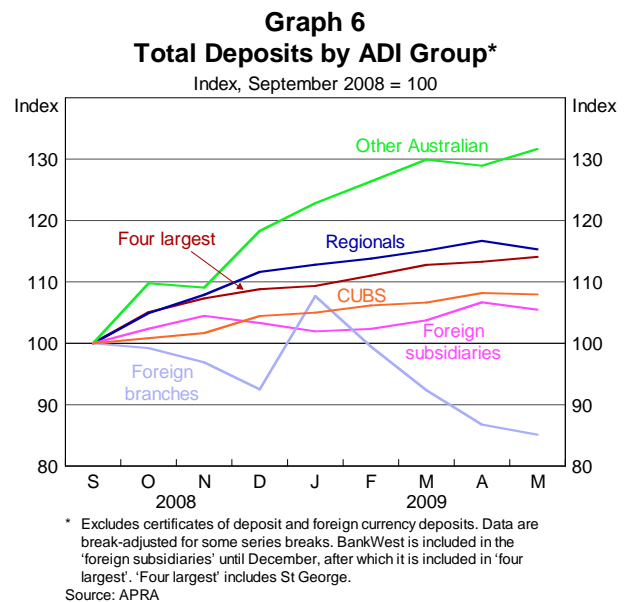
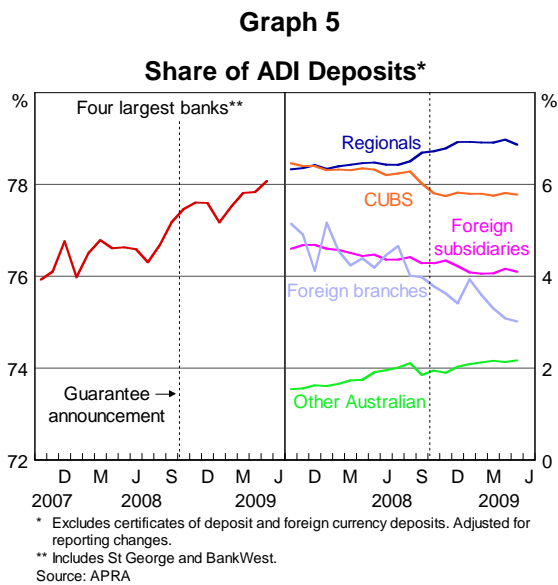
Following the guarantee announcement, there was a further sharp increase in deposit growth, and the share of households nominating banks as the wisest place for savings also increased. These developments are likely to reflect both the guarantee reinforcing the security of deposits, and the extremely uncertain global and domestic environment in late 2008 following the failure of Lehman Brothers. More recently, as nervousness has eased, both the pace of deposit growth and the share of households nominating banks as the wisest place for saving have fallen.



Another factor supporting overall deposit growth is that ADIs have responded to funding pressures by competing aggressively for deposits. As a result, interest rates available on deposits are at historically high spreads to market rates (Graph 4). Part of the increase in deposit funding is likely to reflect switching from short-term wholesale debt instruments, which have fallen as banks concentrate on accessing funding through deposits and long-term wholesale funding.



There has been interest in the evolution of deposit market shares among different categories of ADIs in the period since the introduction of the guarantee. Australian banks have gained market share during this period (Graph 5) with deposits of the regional and smaller Australian banks growing more quickly than those of the four majors (Graph 6). Most of the gain in market share by Australian banks during 2008 was at the expense of subsidiaries and branches of foreign-owned banks. Credit unions and building societies (CUBS) also lost some market share in the period leading up to September, but this stabilised after the introduction of the guarantee.



3.2 Deposit-like products

Outside the ADI sector, there are also difficulties in separating the effect of the guarantee from pre-existing trends.

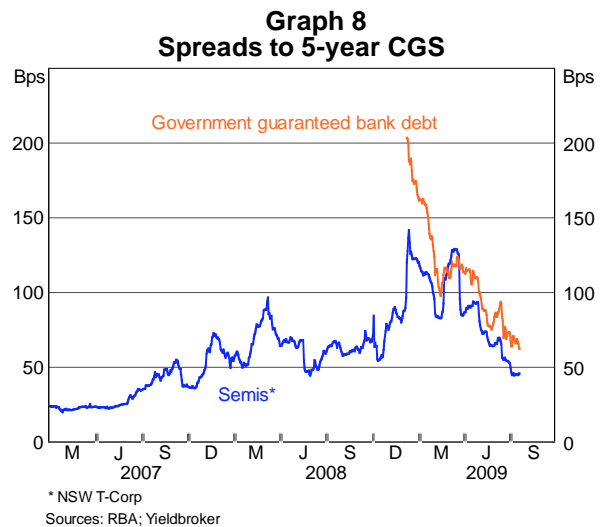
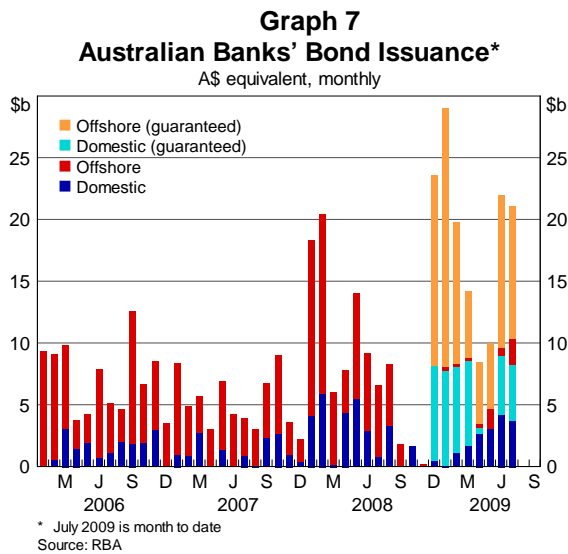
- Available data show a significant outflow from mortgage trusts in October 2008, and the fall would have been larger if the majority of large funds had not suspended redemptions in the month. However, the trend of outflows from mortgage trusts was well established from early in the year, with a large mortgage trust suspending redemptions as early as March. These developments had parallels in the early 1990s, with significant outflows from a range of unlisted public trusts prompting at least one large failure, and the imposition of a blanket 12 month redemption freeze.
- Cash management trusts have also been in focus, with some concerns that the guarantee would lead to a run on this asset class. In the event, however, any effect has been muted. Available data suggest that funds under management fell only slightly in the months following the guarantee, and as at May 2009 aggregate outstandings were only a few percentage points below the level in September.
- Among Registered Financial Corporations (which are not regulated by APRA), liability growth has fallen in the wake of the guarantee announcement. There has also been a decline in debt securities issued. These movements are largely accounted for by a number of relatively large RFCs shrinking their operations, such as the ANZ-owned finance company Esanda being brought into the bank. As with a number of the movements already discussed, a shrinking in RFC liabilities is not unusual by the standards of past periods of uncertainty, with RFC liabilities also contracting for a number of years in the early 1990s.

3.3 Debt Markets

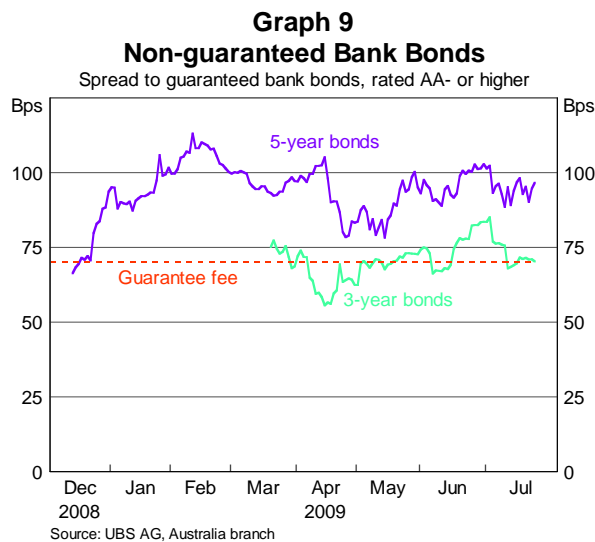
With extreme risk aversion prevailing in global financial markets, ADI's access to funding through long-term bond issuance was heavily curtailed, particularly in offshore markets. In the period between the Lehman Brothers collapse and the guarantee announcement there was only

\$0.2 billion in offshore long-term issuance by ADIs, in contrast to the average monthly offshore issuance of \$6½ billion in the 12 months to August 2008 (Graph 7). Rather, banks were sourcing funds during this time through increased use of short-term wholesale markets and market operations of the RBA. The dearth of long-term issuance continued during the period between the guarantee announcement and the time the GS became operational in late November.

The GS enabled ADIs to, once again, access wholesale long-term funding. In the early months of the GS issuance was very strong, as ADIs caught up on their funding plans and sought to lengthen the maturity structure of their liabilities. Issuance volumes then eased for a few months, but have picked up again more recently as the yield spread above government securities that investors demand for guaranteed bank paper has continued to narrow (Graph 8). The ability to access wholesale term funding has underpinned the stability of the financial sector, and the provision of credit through the economy.



Over this period there has been relatively little unguaranteed issuance. While this has increased recently, the banks for the most part have found it more cost-effective to issue guaranteed debt. For example, for a bank rated AA- or higher, available data suggest that the yield for issuing 5 year bonds unguaranteed has always exceeded the yield on guaranteed bonds by more than the guarantee fee of 70 basis points (Graph 9). For 3 year bonds, however, the cost differential has been smaller, with the yield spread generally close to the guarantee fee.



4. Use of the guarantee arrangements

As outlined, the government guarantee under the FCS is automatic for deposits of \$1 million or less with eligible ADIs. At March 2009, deposits covered by the FCS were estimated to be around \$650 billion.³

Under the GS, eligible ADIs must apply to the Scheme Administrator to offer guaranteed liabilities, with slightly varying detail required for large deposits, short-term wholesale and long-term wholesale. The majority of institutions have obtained at least one guarantee certificate for large deposits, with a much smaller number obtaining guarantee certificates for short-term wholesale funding, and fewer again for long-term funding (Table 4).

Table 4: Number of Institutions with one or more Guarantee Certificate
By category of institution and liability type

Institution Category	Deposit	Liability type		Total number of institutions
		ST Wholesale	Term Funding	
Australian-owned Banks	13	9	8	14
Foreign Subsidiary Banks	8	6	3	9
Branches of Foreign Banks	10	8	0	35
CUBS and Other ADIs	104	1	1	136
Total	135	24	12	194

Source: RBA

In June 2009, the average daily value of guaranteed liabilities under the GS was \$127.3 billion (Table 5). Reflecting the strong issuance discussed in the previous section, this predominantly reflects long-term wholesale debt, with the average value of outstanding guaranteed long-term wholesale debt almost \$91 billion. Balances have risen quite consistently since the inception of the GS (Graph 10).

Table 5: Guarantee Scheme for Large Deposits and Wholesale Funding
Average daily values guaranteed, June 2009

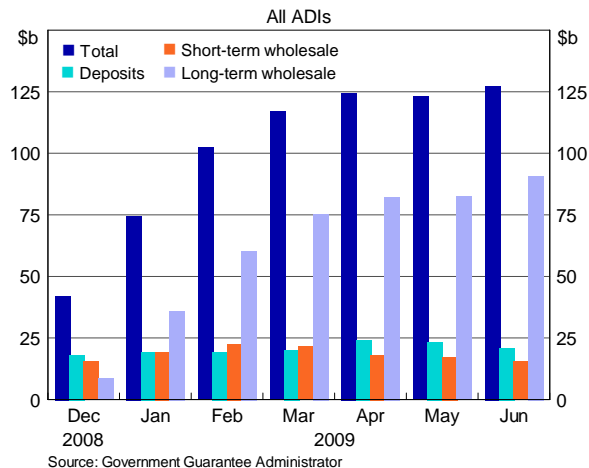
	Total	
	\$b	Per cent*
Large Deposits	21.0	1.9
Wholesale Funding	106.3	10.1
<i>Of which:</i>		
S-T Wholesale	15.4	1.5
L-T Wholesale	90.9	8.6
Total	127.3	5.9

* Large deposits expressed as a share of total ADI deposit liabilities as at 31 May 2009. Wholesale funding expressed as a share of total ADI wholesale funding liabilities as at 31 May 2009.

Source: Government Guarantee Administrator

³ 2009-10 Budget, *Budget Paper No. 1: Budget Strategy and Outlook* page 8-27 at <http://www.budget.gov.au/2009-10/content/bp1/downloads/bp_1.pdf>

**Graph 10
Guaranteed Liabilities**



In contrast, usage of the guarantee for large deposits and short-term wholesale liabilities is relatively limited.

- \$21 billion of deposits (around 2 per cent of total deposits) are guaranteed under the GS, an amount that has declined slightly over the past few months (Graph 7). Liaison with ADIs suggests that most depositors with over \$1 million are not seeking the guarantee when they have to pay for it. The major exception is depositors with very conservative mandates, such as trustees and councils.
- Similarly, for short-term wholesale debt (maturities of 15 months or less), most investors have not required a guarantee, with \$15.4 billion in short-term wholesale liabilities (1½ per cent of wholesale liabilities) guaranteed. This amount, too, has fallen in recent months.

Guaranteed long-term wholesale issuance has been concentrated among larger, more highly rated institutions, reflecting a number of considerations. Firstly, it reflects pre-existing funding patterns, with the larger and more highly rated institutions historically making more use of wholesale long-term debt issuance. Secondly, pricing is more favourable for these institutions, both in terms of a lower guarantee fee and lower risk spreads generally being charged on their issuance by investors, commensurate with their lower risk profile. Finally, these institutions have a larger financing need.

In an international context, Australian banks are relatively large issuers of government guaranteed long-term bonds, accounting for over 11 per cent of global issuance (Table 6). In aggregate, the Australian banks have issued more of their guaranteed bonds in foreign currency than in domestic currency, consistent with their historical pattern of issuance.

Table 6: Government-guaranteed Bank Bonds*

	Issuance (US\$ billion)
US	272.9
UK	131.8
France	115.5
Australia	93.7
Germany	51.0
Netherlands	47.8
Spain	44.8
Ireland	23.8
Austria	23.1
Sweden	22.9
Portugal	6.9
NZ	3.7
Slovenia	2.1
Greece	1.4
South Korea	1.0
Total	842.4

Sources: RBA; Thomson Reuters

* May exclude some private placements

24 July 2009

Appendix 1: Debt Guarantee Pricing Arrangements

	Date of amendment	bps per annum					
		AA ⁺ or better		A ⁺ to A ⁺		Less than A ⁺	
		< 1year	> 1year	< 1year	> 1year	< 1year	> 1year
Fee structures with no risk differential							
Ireland		- EUR1 billion over nine participants -					
Korea ^(a)		100	100	100	100	100	100
US ^{(b) (c)} Current (issuance after 30 June 2009 or maturing after 30 June 2012)	17-Mar-09	75 - 100	125	75 - 100	125	75 - 100	125
US ^{(d) (e)} - Current (issuance before 30 June 2009 and maturing before 30 June 2012)	17-Mar-09	50 - 75	110	50 - 75	110	50 - 75	110
US ^{(d) (f)} - 1st change	21-Nov-08	50 - 75	100	50 - 75	100	50 - 75	100
US - original	--	75	75	75	75	75	75
Credit rating-based fees							
Australia	--	70	70	100	100	150	150
Canada ^(g) - current	12-Nov-08	110	110	110	110	135	135
Canada ^(g) - original	--	160	160	160	160	185	185
New Zealand ^(h) - current	27-Jan-09	70	90	130	150	180	200
New Zealand - original	--	85	140	145	200	195	250
Market-based fees ⁽ⁱ⁾							
Denmark ⁽ⁱ⁾		95	95	95	95	95	95
Finland ^(k)	--	50	n/a	50	n/a	50	n/a
France ^(l)		59	59	n/a	n/a	n/a	n/a
Germany ^(m)	--	50	n/a	50	106.9	50	108.8
Netherlands ^{(n) (o)}	--	50	73 - 88	50	93	50	113
Spain ^(p)	--	50	86.5	50	94.8	50	104.8
Sweden ^{(n) (p)}	--	50	74 - 87	50	95	50	95
UK ^{(q) (r)} - current	15-Dec-08	99 - 109	99 - 109	95 - 125	95 - 125	n/a	n/a
UK ^{(q) (s)} - original	--	109 - 124	109 - 124	112 - 162	112 - 162	n/a	n/a
Average		75.7	93.3	85.9	107.5	94.5	117.2

^(a) Additional fee may be charged as determined by the administrator.

^(b) 31- 180 days = 75 bps; 181 - 364 days = 100 bps

^(c) Add an additional 25 basis points for non-insured depository institutions

^(d) 31- 180 days = 50 bps; 181 - 364 days = 75 bps

^(e) Add an additional 10 basis points for non-insured depository institutions issuance < 1year, and 20 basis points for non-insured depository institutions issuance > 1year

^(f) Add an additional 10 basis points for non-insured depository institutions issuance

^(g) Excludes 20 basis point fee for foreign currency issuance

^(h) NZD fee. Subtract 20 basis points for foreign currency fee

⁽ⁱ⁾ Based on CDS where available. Otherwise usually resorts to credit ratings to determine the fee.

^(j) Where CDS spreads available, mean 5-year CDS between 1 Jan 2007 & 31 Aug 2008. Otherwise, use CDS spreads of comparable rating category + 50 bps. Otherwise, 95 basis points.

^(k) LT debt: Where CDS spreads available (or CDS of comparable rating category), mean 5-year CDS between 1 Jan 2007 & 31 Aug 2008 + 50 bps. Otherwise, use total fee for lowest rating.

^(l) SFEF Issuance spread to swap + Median 5Y CDS Spread 1 Jan 2007 to 31 Aug 2008 + 20bps

^(m) LT debt: Where CDS spreads available, mean 5-year CDS between 1 Jan 2007 & 31 Aug 2008 + 50 bps + 10 bps.

⁽ⁿ⁾ Lower end of range refers to AAA-rated banks. Higher end refers to AA-rated banks

^(o) Where CDS spreads available, "based on historical credit default swap spreads" + 50 bps. Otherwise, ratings based fee used (which is also the max fee applied to each rating category).

^(p) Where CDS spreads available, mean 5-year CDS between 1 Jan 2007 & 31 Aug 2008 + 50 bps. Otherwise, ratings based fee used (which is also the max fee applied to each rating category).

^(q) RBA estimate based on CDS premiums. Range refers to highest and lowest fees for banks within AA or A credit band. Excludes 3 per cent foreign currency fee.

^(r) Mean 5-year CDS between 2 Jul 2007 & 1 Jul 2008 + 50 bps.

^(s) Mean 5-year CDS between 8 Oct 2007 & 7 Oct 2008 + 50 bps.

Note: the additional US fee for non-insured affiliates applies where the issuing entity is an affiliate of an insured entity, and the insured institution's assets are less than 50 per cent of the group's consolidated assets.

Sources: BIS; Bloomberg; Treasury departments, central banks, debt management offices and guarantee administrators