

Chapter 12

Government guarantees and support

Government guarantees for bank funding

12.1 During the global financial crisis the Government took unusual action, quickly introducing in October 2008¹ two schemes—the Financial Claims Scheme (FCS) and the Guarantee Scheme for Large Deposits and Wholesale Funding (Funding Guarantee Scheme)—to guarantee bank funding:

At the time of the guarantees...it virtually was a time of emergency. As the governor commented, the No. 1 priority was the stability of the financial system. The financial system affects everyone's daily life. It would very much be a matter of great concern to governments if there was a shock to the financial system. The wholesale funding guarantee and the deposit guarantee ensured that that did not happen in Australia.²

12.2 At least in part the schemes were a response to similar measures taken overseas:

...circumstances had reached a point in Australia—particularly because of decisions that had been taken the week earlier by the United Kingdom government and steps that we understood might have been under consideration more broadly in Europe and also in the United States—where a failure to act in a timely way in Australia could have had severe implications for the ability of Australian financial institutions to access wholesale term funding in international markets.³

12.3 Yet compared with other countries, the Australian guarantees had a very broad coverage:

The duration announced was three years (longer than that announced by several other countries), amount of coverage was without limit and 100 percent (several countries had put limits on amount and percentage insured), and it included both retail and wholesale deposits at all banks

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- 1 The Bank for International Settlements identified September–November 2008 as the most severe stage of the global financial crisis; BIS (2009, p 16).
 - 2 Mr Jim Murphy, Executive Director, Markets Group, Department of the Treasury, *Committee Hansard*, 13 December 2010, p 27.
 - 3 Dr Ken Henry, Secretary, Department of the Treasury, cited in Senate Economics References Committee, *Government measures to address confidence concerns in the financial sector – The Financial Claims Scheme and the Guarantee Scheme for Large Deposits and Wholesale Funding*, September 2009, p 11. APRA expressed a similar view.

(several countries restricted it to retail deposits and certain institutions only) and was fee free (several countries had fee in place).⁴

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.⁵

Financial Claims Scheme

12.4 From early 2008 the Government had been developing a deposit guarantee scheme with a \$20,000 cap. The Opposition called on them to raise this to \$100,000 and the Government went even further. Under the FCS all deposits under \$1 million with locally-incorporated ADIs are automatically guaranteed by the Government, with no fee payable. The FCS will remain in place in this form until October 2011.

12.5 In the event of failure, the Government would provide initial funds to depositors and then recover funds through the wind up process, with the option of an industry levy if there is a shortfall.

12.6 The Australian Bankers' Association's interpretation is:

In the unlikely event that a bank or other ADI fails and there is not enough money for depositors, the legislation in place providing the guarantee authorises the Government to recover any money used for the guarantee from banks and other ADIs. (In other words, should a bank or other ADI fail, the scheme is actually underwritten by the banking industry, not taxpayers.)⁶

12.7 The wording in the legislation, however, gives the government the right but not the obligation—it says ‘they may’—to ask other ADIs to help out in the event of a failure. The Commonwealth Bank thought ‘it is a right that may well be exercised’ but (apparently) do not regard it was a contingent liability for which provision should be made in their balance sheet.⁷

Funding Guarantee Scheme

12.8 Under the Funding Guarantee Scheme, the Government provides a guarantee, for a fee, on deposits greater than \$1 million, and wholesale funding with maturity out

4 Professor Milind Sathye, cited in Senate Economics References Committee, *Government measures*, p 19.

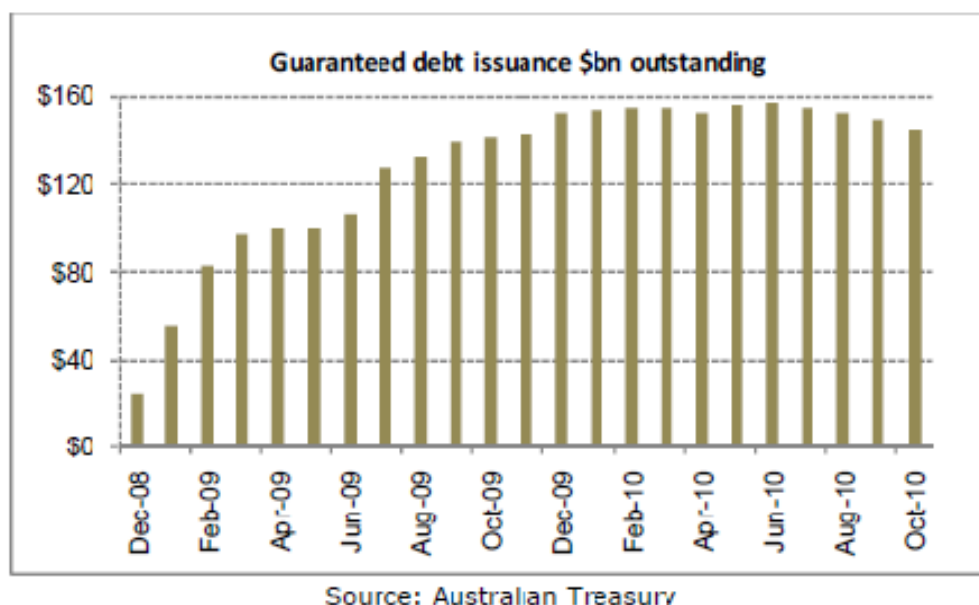
5 Reserve Bank of Australia and Australian Prudential Regulation Authority, cited in Senate Economics References Committee, *Government measures*, p 9. A table with an international comparison is also given in that report.

6 Australian Bankers' Association, *Submission 76*, p 12.

7 Mr Ralph Norris, Chief Executive Officer, Commonwealth Bank of Australia, was asked twice about provisioning but did not answer; *Committee Hansard*, 15 December 2010, p 69.

to five years.⁸ At its peak in mid-2010, the amount of guaranteed debt was almost \$160 billion (Chart 12.1).

Chart 12.1: Government guaranteed bank debt



Source: Australian Bankers' Association, *Submission 76*, p 92.

12.9 The scheme was hailed by some smaller banks:

It was the saviour for the Australian financial services market...⁹

12.10 Sometimes neglected in the discussion of the wholesale guarantees is that the banks paid for them:

While banks have used the government's wholesale funding guarantee, they have paid for that privilege. In the case of the Commonwealth Bank, we expect to pay the government almost \$1 billion for the use of this guarantee.¹⁰

For this guarantee, Australia's banks are currently paying \$100 million a month to the Government. So far, Australia's banks have paid over \$2 billion, and are expected to pay a further \$3.5 billion by the end of the scheme.¹¹

8 Unlike the FCS, the Funding Guarantee Scheme also guarantees, with some restrictions, issuance by foreign-bank branches.

9 Mr David Liddy, Chief Executive Officer, Bank of Queensland, *Committee Hansard*, 9 February 2011, p 19.

10 Mr Ralph Norris, Chief Executive Officer, Commonwealth Bank of Australia, *Committee Hansard*, 15 December 2010, p 43.

11 Australian Bankers' Association, *Submission 76*, p 12.

Around \$5.5 billion will be paid by banks to the government for credit enhancement by the time the last of the guaranteed wholesale funding expires.¹²

12.11 On 7 February 2010, the Government announced that the Funding Guarantee Scheme would close to new borrowing from 31 March 2010, though debt previously issued under the Scheme continues to be covered until it matures.

Impact of the schemes

12.12 The Reserve Bank views these measures as successful in meeting their goal:

The announcement of the FCS, and the arrangements for large deposits and wholesale borrowing, helped to maintain public confidence in the Australian banking sector.¹³

12.13 As one major bank put it:

...banks in Australia would have survived without the scheme. However, they would have found it difficult to maintain an adequate supply of affordable credit in the economy. This could have had significant ramifications for the Australian economy and may have delayed the economic recovery.¹⁴

12.14 The GFC was accompanied by a move of deposits to the major banks, both from smaller banks and from non-ADIs. Some have suggested this was caused, or accentuated, by the guarantees:

CHAIR—...I think the decision by the government to guarantee deposits of only ADIs reinforced that flight to quality. Do you agree with that? I see you nodding, for the benefit of the Hansard.

Mr Lloyd—We would completely agree with that and would go further: the guarantee in the way it is structured, particularly now that we have four ADIs that everyone knows will not be allowed to fail, has given those very large ADIs an extra competitive advantage courtesy of the government and the taxpayer.¹⁵

The failure to include BDAs [bank deposit alternatives]¹⁶ in the deposit guarantee served to significantly widen the gap with regards to the

12 Mr Michael Smith, Chief Executive Officer, ANZ Banking Group, *Committee Hansard*, 15 December 2010, p 117. See also Australian Bankers' Association, *Submission 76*, p 23.

13 Reserve Bank of Australia, *Submission 41*, p 26.

14 ANZ Bank, *Submission 94*, p 7.

15 Mr Richard Lloyd, International Policy Adviser, Choice, *Committee Hansard*, 14 December 2010, p 29.

16 As defined by the Financial Services Council, these include cash management trusts, mortgage trusts and certain bond funds.

perception of the underlying risk between bank deposits and BDAs...it effectively discourages investors from investing in BDAs.¹⁷

...there is no doubt that at the time they [deposit guarantees] had a detrimental effect on the non-bank savings sector, the non-ADI savings sector. That was probably most obviously felt with the requirement of mortgage trusts within our sector to freeze redemptions.¹⁸

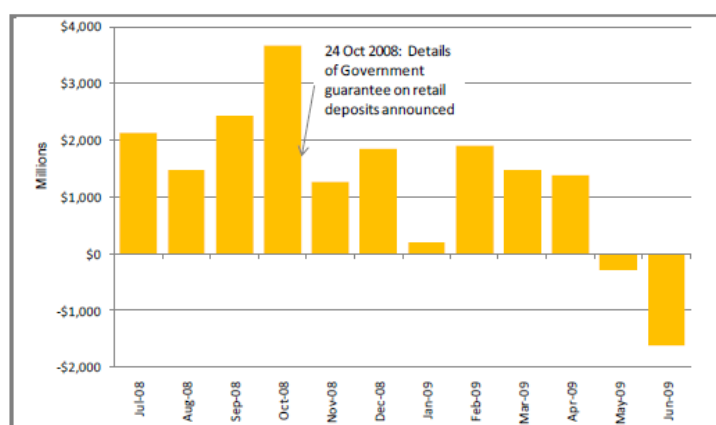
The members of the Provic Group saw the average deposits in their companies fall from \$118 million in 2008, to \$75 million in 2009 as a result of the global financial crisis and being excluded from the government guarantee...¹⁹

12.15 The evidence from Treasury is that:

...a drift of money back into the ADIs, deposit-wise, from other forms of holding investments was happening before the deposit guarantee was actually put in place...the introduction of the guarantee just reinforced that...²⁰

12.16 The Commonwealth Bank presented data suggesting that, rather than accelerating it, the guarantee halted the flight of funds to the major banks (Chart 12.2).

Chart 12.2: Change in Commonwealth Bank retail deposits



Note: The growth in Dec 2008 and then again in Feb, March and April 2009 was influenced by the Government stimulus payments which were made in these months and largely spent in the following months. Retail deposits are household deposits as defined by APRA

Source: Commonwealth Bank of Australia, *Submission 88*, p 18.

17 Financial Services Council, *Submission 121*, p 4.

18 Mr John Brogden, Chief Executive Officer, Financial Services Council, *Committee Hansard*, 21 January 2011, p 19. See also Aussie, *Submission 39*, p 5.

19 Provic Group, *Submission 123*, p 6.

20 Mr Jim Murphy, Executive Director, Markets Group, Department of the Treasury, *Committee Hansard*, 13 December 2010, p 28. The Reserve Bank expressed a similar view; Senate Economics References Committee, *Government measures*, p 30.

12.17 This was also the view of the other major banks:

The majors [banks] contend that the flight to quality during the GFC meant that, inevitably, lenders would prefer them over lower-rated, smaller institutions but that the government guarantee particularly of deposits stemmed the extent of this flight to them.²¹

12.18 Some non-ADIs believe Australia should have extended the guarantees more broadly as they argued occurred in some other countries:

...the broader guarantee offered by the New Zealand Government to their financial institutions including debenture issuing companies.²²

12.19 It is inevitable that, whenever a somewhat arbitrary decision is made to help institutions of a certain type, institutions just outside the boundary will feel aggrieved. The Governor of the Reserve Bank commented:

The question really is: can you guarantee everything?...My view would be that you cannot. In a situation such as the one that we faced in October 2008, I would argue for stabilising the core of the system...And that is essentially what was done, and I think it was right.²³

12.20 This view is supported by Treasury:

The issue is...whether the guarantee should have been extended to finance companies and other mortgage providers. The governor said that they needed to draw the line somewhere and his primary aim was the financial system. We agree with that and that was the thinking behind it.²⁴

12.21 APRA was asked what smaller companies would need to do to become ADIs and therefore be covered by the scheme. APRA replied:

It needs to have adequate capital for the sort of business that it wants to take on. It needs to have a strong and robust board if it is coming into Australia and we are presuming it is here already but wants to be a locally incorporated ADI. It has to have strong risk management systems and strong personnel that can run those systems...It is a tough test to get past.²⁵

12.22 A large building society recounted how, to their surprise, the guarantees were used by smaller ADIs:

21 Australian Securitisation Forum, *Submission 74*, p 11.

22 Provic Group, *Submission 123*, p 6.

23 Mr Glenn Stevens, Governor, Reserve Bank of Australia, *Committee Hansard*, 13 December 2010, p 13.

24 Mr Jim Murphy, Executive Director, Markets Group, Department of the Treasury, *Committee Hansard*, 13 December 2010, p 28.

25 Dr John Laker, Chairman, Australian Prudential Regulation Authority, *Committee Hansard*, 14 December 2010, p 9.

Given their preferential treatment in the pricing of the wholesale guarantee it is logical to assume that the big banks would have made most use of the facility. In fact, while major banks were significant issuers in the early stages of the GFC, ongoing difficulties within securitisation markets forced some smaller, lower rated banks to continue to utilise guaranteed wholesale funding even though the cost was much higher relative to the big banks because of the increased guarantee fee and the additional premium demanded by investors because of perceived risks associated with lower rated ADIs...Since the wholesale guarantee was removed in March 2010 only one senior debt wholesale markets transaction has been completed by an ADI with a credit rating below A (long term). Heritage believes the Government needs to level the playing field in relation to access to funding at cost effective levels by reintroducing the wholesale guarantee for smaller ADIs.²⁶

Pricing of the guarantees

12.23 The Reserve Bank explained the considerations behind the average level of the fees:

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 that were considered likely to prevail in more normal market conditions. This was designed to act as a natural exit mechanism, so that when pricing of risk improved, the yield spread between unguaranteed and guaranteed debt would narrow to below the guarantee fee and it would become cost-effective for issuers to return to unguaranteed issuance.²⁷

12.24 Controversially, the fees charged for the wholesale guarantees differed between ADIs. The fees were set in relation to credit ratings, as an indication of the risk involved. ADIs rated AAA to AA- were charged 70 basis points, those rated A+ to A- were charged 100 basis points and others were charged 150 basis points.

12.25 The differential charges were strongly criticised by Abacus, the smaller banks and others:

...during the GFC the largest banks accessed a wholesale government guarantee that we were not able to access because of the differential pricing on that guarantee. The cost for us therefore was too expensive. And that did put us at a disadvantage.²⁸

26 Heritage Building Society, *Submission 113*, pp 3-5.

27 Reserve Bank of Australia, *Submission 41*, p 27.

28 Mr Mark Degotardi, Head of Public Affairs, Abacus, *Committee Hansard*, 13 December 2010, p 92.

There are differences of guarantee and differences in the price of guarantee, which has disproportionately benefited the major banks.²⁹

Entities in the Australian marketplace which are regulated by the one entity, APRA, are subject to the same prudential standards...I do not believe the 150 basis points that we were charged was reasonable.³⁰

...if you equalise the cost arrangements in respect of the wholesale funding guarantee, that is going to be a direct advantage to those second-tier institutions, and they would have the capacity to flow that through...it certainly would allow them to compete more actively on price.³¹

12.26 The differential charges for the guarantees were defended by the Governor of the Reserve Bank:

The government was going to provide effectively a guarantee on wholesale obligations. The question is: should that be done without any regard to the rating of those entities or not? The decision was taken—in my view, correctly—that the fees should be related to the strength of the institution. We used publicly available credit ratings in order to do that. I think that was appropriate. It is still the case that, even for those institutions that are paying the higher fee, they have been able to borrow using the guarantee and paying the fee more cheaply than they otherwise would have.³²

12.27 While it is true that the lower-rated intermediaries were able to borrow, as the borrowings cost them more than the big banks there was an adverse impact on their ability to compete.

12.28 The pricing structure was similar to that in many but not all comparable countries:

The fees charged for the government guarantees on wholesale funding are typically based on the credit rating of the issuer (Australia, Canada and New Zealand), or credit default swap premiums (France, the Netherlands, Spain and the United Kingdom). In contrast, 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.³³

29 Mr Richard Lloyd, International Policy Adviser, Choice, *Committee Hansard*, 14 December 2010, p 31.

30 Mr John Minz, Chief Executive Officer, Heritage Building Society, *Proof Committee Hansard*, 4 March 2011, p 13. See also Mr James McPhee, Chief Executive Officer, Members Equity Bank, *Committee Hansard*, 25 January 2011, p 11.

31 Mr Peter Anderson, Chief Executive, Australian Chamber of Commerce and Industry, provide effectively *Committee Hansard*, 15 December 2010, p 114. See also Chamber of Commerce and Industry Queensland, *Submission 43*, p 19.

32 Mr Glenn Stevens, Governor, Reserve Bank of Australia, *Committee Hansard*, 13 December 2010, p 17.

33 Reserve Bank of Australia, *Financial Stability Review*, March 2009, p 46.

12.29 The Australian scheme used a relatively simple fee structure. This may have been a good thing. The Bank for International Settlements noted that in overseas countries 'the take-up under government debt guarantee programmes was slower than expected as issuers were deterred by the terms and the costs...the complexity of these guarantee programmes and the varying treatment across jurisdictions deterred some investors'.³⁴

12.30 The problem was that, surprisingly³⁵, investors seemed to ignore the guarantee when deciding what interest rate they would demand on the guaranteed bonds from smaller banks:

The unintended consequence around that is essentially that the assumption was that everyone would be priced off the sovereign curve for the pricing; however, the market looked through that and essentially priced against the credit ratings of the various institutions, and on top of that was a fee differential.³⁶

This fee structure had an unintended consequence of a 'double dip' on any non-AA rated ADI, as the credit markets 'looked through' the guarantee to the issuer's underlying credit rating anyway – for example, BOQ on its first issuance paid 150bps to the Government for the fee on top of 115bps to the market. By comparison, the major banks were paying ~75bps to the market and only 70bps as the fee to the Government for the guarantee.³⁷

12.31 The Bank of Queensland quantified the impact:

If the government guarantee on wholesale funding were flattened to the fee that the major banks pay for all remaining payments, BOQ would be able to immediately reduce our variable mortgage rate by 20 basis points.³⁸

12.32 The Reserve Bank noted that:

The fee applicable to AA-rated institutions under the Australian Guarantee Scheme (70 basis points per annum) was at the low end of the international range for schemes with this structure...The differential between institutions with different credit ratings under the Australian Guarantee Scheme was, however, relatively large by international standards...³⁹

34 BIS (2009, p 106).

35 The CEO of the Australian Bankers' Association said '...at the time of that announcement perhaps no-one could have anticipated this looking-through issue'; cited in Senate Economics References Committee, *Government measures*, p 17.

36 Mr David Foster, Chief Executive Officer, Suncorp Bank, *Committee Hansard*, 9 February 2011, p 10.

37 Bank of Queensland, *Submission 44*, pp 4-5.

38 Mr David Liddy, Chief Executive Officer, Bank of Queensland, *Committee Hansard*, 9 February 2011, p 16.

39 Schwartz, (2010, p 20), cited by Abacus, *Submission 53*, p 8.

12.33 With the benefit of hindsight, there are some alternatives that would have avoided relying on credit rating agencies but not involved the government underwriting unduly risky institutions, and would have been pro-competitive:

Heritage recommends a flat fee be applied and, to manage the Government's total exposure, suggests that the guarantee only be made available to smaller ADIs that satisfy key balance sheet metrics.⁴⁰

...a better outcome would have been achieved by pricing the guarantee exactly the same for all ADIs whilst limiting the amount each ADI could raise under the guarantee. This would have preserved the existing market dynamic and avoided the outcome of the major banks using the artificial pricing advantage that emerged to make significant grabs for market share.⁴¹

12.34 The Committee examined the guarantee in 2009 and concluded:

The Committee recommends that, in view of the experience of markets not pricing all guaranteed debt identically, the Government review the need to apply differential premia for ADIs with different ratings for the wholesale funding guarantee (and hence also that applying to deposits over \$1 million).⁴²

12.35 Unfortunately the Government has either not conducted such a review or not released the results. While the guarantee no longer applies to new borrowings, it still applies to a significant amount of longer-term debt and the resulting additional imposts on lower rated ADIs impedes their ability to compete.

Recommendation 20

12.36 The Committee recommends that, to increase the competitiveness of smaller lenders, the Government immediately standardise the fee for all borrowers under the wholesale funding guarantee to a uniform rate of 70 basis points.

Permanent deposit insurance or guarantee scheme

12.37 Abacus, the peak body representing building societies and credit unions, believes a permanent deposit insurance or guarantee scheme would be pro-competitive as it would reduce the advantage the major banks have from being perceived as 'too big to fail'⁴³:

40 Heritage Building Society, *Submission 113*, p 5.

41 Mr Mike Hirst, Managing Director, Bendigo and Adelaide Bank, *Committee Hansard*, 15 December 2010, p 78.

42 Senate Economics References Committee, *Government measures*, p 19.

43 The notion that the major banks are 'too big to fail' is discussed in Chapter 11.

The FCS [Financial Claims Scheme] levels the playing field for large and small banking institutions and is a procompetitive factor. Any reduction in the FCS cap from \$1 million will benefit the four major banks to the competitive detriment of other regulated banking institutions. Rather than being seen as a risk to the taxpayer, the FCS should be seen for what it is – an early access facility for depositors’ funds in the event of an institution failing.⁴⁴

The threshold

12.38 While the \$1 million threshold was an essentially arbitrary choice, it did seem to succeed in retaining confidence in bank deposits. As Professor Harper commented:

...could they have done that with a guarantee of \$250,000 or \$500,000 or \$100,000? I do not know the answer to that. In a sense, what I am saying is that I would far rather that the government erred on the side of too big a hit than too small a hit, because you only get one chance to do that in those circumstances. Fortunately, the government’s intervention worked and I do not know if it would have worked at \$500,000 or \$250,000. If it had not worked, the chances of a second round working would have been much lower and we would have been in a much more difficult situation.⁴⁵

12.39 Contrary to a view that bank runs result from small, less sophisticated and informed, investors (whose concerns could be addressed by a relatively small threshold), Professor Harper argued:

These things start in the wholesale markets. The irrationality that you are talking about was amongst wholesale investment funds. Frankly, the banks, including our major banks, stopped lending to each other...you are not talking about ordinary Herald Sun-reading folk on the train...The ones who ought to have known better were frightened to the point of closing their balance sheets, not lending and hoarding cash—the whole lot. That is why, in my view, the best thing to do was to convince people who had a lot of money that it was all safe rather than the mums and dads with not that much.⁴⁶

12.40 Abacus argues for the retention of the \$1 million ceiling:

...the retail deposit guarantee at a level of \$1 million helps us compensate for some of the lack of community understanding of the fact that we operate under the same regulatory system... you should not move from the \$1 million, that people understand it, that it is simple, that it gives the vast

44 Abacus, *Submission 53*, p 12.

45 Professor Ian Harper, cited in Senate Economics References Committee, *Government measures*, p 7.

46 Professor Ian Harper, cited in Senate Economics References Committee, *Government measures*, p 7.

majority of retail depositors comfort in dealing with a smaller bank or a credit union or a building society.⁴⁷

12.41 Abacus note that in comparable international jurisdictions:

All US credit union members are protected by a government backed 'share insurance' scheme of \$250,000 per member [and] many Canadian credit unions are covered by unlimited government guarantees explicitly designed to support their growth and competitiveness...⁴⁸

12.42 An international comparison done by the Committee for an earlier report suggested the Australian threshold is well above the global norm.⁴⁹

12.43 An opinion poll conducted in June 2009 suggested the public still wanted the deposit guarantee in place then:

Only 30 per cent of those surveyed said they would be comfortable keeping money in the bank with no guarantee. A guarantee of deposits up to \$50,000 would satisfy 50 per cent of the population. A \$100,000 guarantee finds two-thirds public support, while a \$500,000 guarantee brings in 80 per cent.⁵⁰

12.44 One suggestion to build competition to the major banks was to only apply deposit insurance to some of their rivals:

Credit unions and building societies have in the past been a valuable alternative to banks. We submit that the government create further assistance in making the mutual segment a more attractive place to deposit your moneys, by guaranteeing Australian depositors exclusively in relation to mutuals.⁵¹

...the government needs to take actions that are decidedly in the favour of smaller financial institutions. The smaller financial institutions, the cooperatives, the mutuals, need to be given some kind of favourable financial institution status. If the deposit guarantee is restricted to the smaller players then that will clear the competition for the majors...I would suggest that that wholesale funding guarantee should be reinstated for the smaller financial institutions.⁵²

12.45 The banks are happy to see the FCS continue as a permanent scheme:

47 Ms Louise Petschler, Chief Executive Officer, Abacus, *Committee Hansard*, 13 December 2010, pp 83 and 88. This argument is supported by Credit Union Australia, *Submission 85*, p 11 and Heritage Building Society, *Submission 113*, p 5.

48 Abacus, *Submission 53*, p 32.

49 Senate Economics References Committee, *Government measures*, pp 50-51.

50 The poll was conducted for IFSA. *Australian Financial Review*, 7 August 2009, p 56.

51 Mr Mark Bouris, Executive Chairman, Yellow Brick Road Wealth Management, *Committee Hansard*, 13 December 2010, p 96.

52 Professor Milind Sathye, *Committee Hansard*, 15 December 2010, p 40.

The Federal Government should retain the Financial Claims Scheme (FCS) and consultation should be conducted to ensure an orderly transition and to avoid anti-competitive effects.⁵³

12.46 A permanent form of deposit insurance seems to be generally welcomed, although some felt the banks should be paying for it:

...we welcome the confirmation of the permanency of the Financial Claims Scheme...⁵⁴

...there is one proposal to make the government guarantee on retail deposits permanent using the government protected deposit slogan. Again, I do not disagree with this policy. The government must acknowledge that there is risk transfer here. Eventually an ADI in Australia will fail—it is inevitable at some stage; this will happen—and I believe that ADIs should pay a premium for this taxpayer guarantee, similar to the FDIC in the United States. Such a levy would help protect taxpayers in the inevitable event of an ADI failing.⁵⁵

...where we need to move to improve competition in the Australian banking system is to make the federal government insurance of the banking system explicit...as the insurer, the government (1) should correctly work out the actuarial risk associated with banking activities and charge the banks an insurance premium and (2) should take an active role in preventing the banks from engaging in activities that create too much risk.⁵⁶

12.47 The banks could either pay through an annual fee, or a one-off levy when a bank fails. The problem with the latter is:

...in the event that one financial institution falls, it is likely that the others are going to be under stress. That is the time that they are least able to do it. So it is not an easy solution, because all these other financial institutions are probably under the same stress and inevitably it will be in a recession.⁵⁷

12.48 The industry body for mutuals argues:

The deposit guarantee poses no risk to the taxpayer because:

1. the prudential regulatory framework ensures that it is highly likely that the remaining assets of a failed institution will be sufficient to recover funds paid out under the FCS to depositors; and

53 Australian Bankers' Association, *Submission 76*, p 51.

54 Mr Chris Dalton, Chief Executive Officer, Australian Securitisation Forum, *Committee Hansard*, 14 December 2010, p 16.

55 Mr Jonathan Mott, UBS Securities Australia, *Committee Hansard*, 14 December 2010, p 145.

56 Professor Stephen King, *Committee Hansard*, 21 January 2011, p 99.

57 Mr Jonathan Mott, UBS Securities Australia, *Committee Hansard*, 14 December 2010, p 160.

2. in the unlikely event of there being a shortfall, regulated banking institutions will be levied to make up the difference.⁵⁸

12.49 In deciding which intermediaries should be covered by an insurance scheme, Professor King suggests:

The obvious starting point is the deposit-taking institutions that we have already.⁵⁹

12.50 Yellow Brick Road argues that it should be restricted to those ADIs that need it and that:

...the Government should limit future retail deposit guarantees for the Major Banks and their subsidiaries, both in duration and value per deposit account, as their need for this support has declined.⁶⁰

12.51 These are the organisations covered by APRA's prudential supervision. This accords with the, admittedly not disinterested, view of Abacus:

Non-ADI industry bodies have argued that financial products that are “close substitutes” to deposits are disadvantaged by being outside the FCS. However, such products are not direct competitors with deposits if issuers of such products are not subject to prudential supervision and requirements on capital, liquidity, risk-management, reporting, auditing and governance.⁶¹

The Government's decision

12.52 The Government confirmed that the FCS would be a permanent feature of the financial system in December 2010, with a permanent cap set from October 2011.⁶²

Recommendation 21

12.53 The Committee recommends that the financial claims scheme should be retained in its current form pending the outcome of a full inquiry into a deposit insurance scheme, possibly charging risk-related premia. The inquiry should also examine the issue of guaranteeing non-ADI products that are close substitutes for deposits, with a view to being better placed to provide such a guarantee as future need arises.

58 Abacus, *Submission 53*, p 12.

59 Professor Stephen King, *Committee Hansard*, 21 January 2011, p 101.

60 Yellow Brick Road, *Submission 101*, p 9.

61 Abacus, *Submission 53*, pp 13-14.

62 Australian Government, *Competitive and Sustainable Banking System*, December 2010, p 18.

Other government support for competitors to the major banks

12.54 As discussed in other chapters of this report, the Government has encouraged mutuals to apply to use the term 'bank', and has instructed Treasury to accelerate work on designing the most appropriate structure for bullet RMBS issuance by smaller institutions.

12.55 The Government also plans an information campaign to promote competitors to the major banks:

We'll put our mutual credit unions and building societies, together with our regional and other smaller banks, right at the centre of this awareness campaign, to properly inform consumers about the safe and competitive alternatives they offer to the big banks.⁶³

12.56 A tangible manifestation of this is the introduction of a new 'Government Protected Deposit' symbol.⁶⁴

12.57 A more direct way for the government to create stronger competitors to the four major banks would be by capital injections into competitors:

If for example the Federal Government wished to engender competition, it could simply do so by purchasing a substantial shareholding in the smaller banks by way of a designed share issue, so as to increase their shareholder capital, and thus increase their capacity to lend into the market by way of credit creation using existing bank capital.⁶⁵

Committee view

12.58 The Committee supports the introduction of the 'Government Protected Deposit' symbol as a means of allowing mutual and smaller ADIs to compete on a more equal footing.

12.59 The Committee notes that, unlike in many other comparable countries, the Australian government did not have to take equity stakes in banks during the GFC and regards such stakes as a practice to be avoided.

63 Australian Government, *Competitive and Sustainable Banking System*, December 2010, p 14.

64 Australian Government, *Competitive and Sustainable Banking System*, December 2010, p 14.

65 Mr Mervin Reed, *Submission 5*, p 11.

