Senate Standing Committee on Economics

ANSWERS TO QUESTIONS ON NOTICE

Treasury Portfolio

Supplementary Estimates 22-23 October 2008

Question: sbt 28

Topic: **Wholesale Funding Guarantee**

Hansard Page: **Written**

Senator Bushby asked:

1. What will be the conditions of producing a guarantee of this kind?
2. Will it be available for short term programs?
3. Will this only apply to new issues?
4. How will the government determine commercial fees for the term funding guarantee?
5. How will the fee be structured?
6. How will it send an appropriate commercial signal?
7. How does this measure align and compare with other international jurisdictions?
8. Given that the US has adopted a fixed level of 75 basis points, how will Australia's approach to a price keep it competitive?
9. Are there risks of a significant expansion of AAA rated Commonwealth guaranteed bonds over pricing and access disadvantages compared to other AAA institutional borrowers such as central borrowing authorities?
10. Has Treasury made an assessment on projection of the contingent liabilities that the Commonwealth will assume as a result of this guarantee?
11. Will there be additional prudential supervision of the guarantees?
12. Will the arrangements supporting the wholesale guarantee require legislation?
13. How will the Government propose to deal with the 'moral hazard' of guaranteeing 100% of a borrower's liabilities under the guarantee?
14. What level of risk disclosure will banks be required to meet before receiving a government guarantee on term funding?
15. Will the government be establishing further prudential regulations for financial institutions covered by the funding guarantee?
16. Will there be conditions on executive salaries and bonuses in return for the guarantee?
17. How large are the term funding requirements of those institutions covered by the term funding guarantee?
18. Will the term funding guarantee apply to transfers from Australian banks to their subsidiaries overseas?
19. Will the term funding guarantee apply to transfers from international banks to our banks?
20. Has the Government received or requested any advice as to whether or not the proposed levy on the term funding guarantee will have any impact on interest rates?

21. Does the term funding guarantee apply to Australian banks lending internationally?
22. If you have a bank that is rated BBB and another rated AA – it would be normal for the BBB bank to offer a higher interest rate on its deposits. With the 100% deposit guarantee, both banks – from the perspective of the investor – are AAA rated. What are the likely implications for term deposit interest rates under theses circumstances?
23. Are you confident that banks might not try to imprudently attract market share by offering high interest rates for their government guaranteed deposits?
24. What is the likely contingent liability to be borne by the taxpayer from the 100% bank deposit guarantee?
25. Are you confident that the guarantee will be able to be withdrawn – or at least a cap applied – in three years?
26. What is likely to happen when a bank says that withdrawing the deposit guarantee will place its business in jeopardy and hence act as a de facto threat against the withdrawal of the guarantee? In other words, how can the Government credibly commit to impose a cap?
27. What are the likely effects on non-ADI debenture issuers – eg. corporates and finance companies – from the 100% government guarantee?
28. What is to prevent a deposit of (say) $100 million being made which would be otherwise from a wholesale debt raising to avoid the fee to be charged on wholesale funding for ADIs?
29. What are the moral hazard issues associated with the 100% guarantee of wholesale funding for ADIs?
30. What is the likely contingent liability to be borne by the taxpayer from the 100% wholesale funding guarantee?
31. How will banks be prevented from abusing the 100% wholesale funding guarantee?
32. Should a BBB bank be charged a higher fee than a AA bank for accessing the 100% wholesale funding guarantee?
33. Would you compare and contrast the various wholesale funding guarantees around the major countries?
34. When will the wholesale funding guarantee be withdrawn?
35. What is likely to happen when a bank says that withdrawing the wholesale funding guarantee will place its business in jeopardy and hence act as a de facto threat against the withdrawal of the guarantee? In other words, how can the Government credibly commit to its withdrawal?
36. Do you think the moral hazard associated with the wholesale funding guarantee is similar or more than that of the deposit guarantee?
37. How will the wholesale funding guarantee be implemented?
38. What new powers with be given to APRA to mitigate the moral hazard from the deposit guarantee and wholesale funding guarantee?
39. What are the lessons for Australia from the present financial crisis?
40. Is APRA appropriately resources to undertake its important duties?

41. Would you release the legal advice the Government has sought on whether legislation is required to implement the Government's 100% guarantee for bank wholesale funding?

42. Recognising the temporary nature of the wholesale funding guarantee, would you outline the Government's exit strategy so as to ensure that the wholesale bank funding guarantee does not become a permanent feature of Australian banking.

43. What could be the implications for interest rated from the Government's 100% guarantee for bank wholesale funding?

44. In what circumstances would the Governments 100% guarantee for bank wholesale funding pose a threat to the credit rating of the Commonwealth?

45. Will the fees to be charged on the Government's 100% guarantee for bank wholesale funding fully account for the risk-weighted contingent liability and be independently actuarially certified so to do?

46. How much of the Reserve Bank's 1 percentage point reduction in interest rates has been passed onto small business borrowers?

47. What are the implications for competition in the bank sector form the deposit and wholesale funding guarantees?

48. I understand that the Government is of the view that the wholesale funding guarantee does not require legislation except to payout (through an appropriation). Would it not be better to bring forward legislation to validate the scheme and appropriation ex ante rather than run the risk of the Parliament rejecting an appropriation bill ex post?

49. Will the amounts and terms of all guarantees provided by the Commonwealth in respect of wholesale term funding by Australian banks be fully and promptly made public (to inform the markets and taxpayers)?

Answer:

1. The Government has provided a guarantee of eligible wholesale funding of authorised deposit-taking institutions in Australia until market conditions normalise.

From 28 November 2008, wholesale funding will be guaranteed if an institution has applied for the guarantee and agreed to pay the relevant fee.

The wholesale funding guarantee is available to Australian owned banks, Australian ADI subsidiaries of foreign banks, credit unions and building societies ('eligible ADIs'). Foreign bank branches can also access the guarantee arrangements subject to additional restrictions (see below). The guarantee applies to the foreign branches of eligible ADIs but not their foreign subsidiaries.

The guarantee will be extended on an issue by issue basis. Eligible securities will be restricted to securities issued by eligible ADIs with a term of up to 60 months with the guarantee to apply for the full term of the relevant security including in the period following the closure of the scheme to new issuances.

The facility will be restricted to senior unsecured debt instruments. Certificates of deposit and bank bills will be covered by this facility. They will not be covered by the deposit guarantee. The guarantee will not cover structured debt. The facility will apply to debt issuance in all major currencies including AUD, NZD, Euro, USD, Sterling, Yen and HKD. It will apply to eligible securities issued domestically or off-shore.

Foreign Bank Branches

APRA-regulated foreign bank branches are eligible to apply for a guarantee in respect of their short-term liabilities held by Australian residents with maturities up to the end of 2009. This is on the basis of the same fee schedule applying to other ADIs.

APRA-regulated foreign bank branches are also eligible to apply for a guarantee in respect of their deposits held by Australian residents. This is on the basis of the same fee schedule applying to other ADIs, but the maximum maturity of guaranteed liabilities is 31 December 2009 and there is no fee-free threshold.

Access to these guarantees will be subject to the following conditions:

- The amount guaranteed is limited to 110 per cent of the combined average value of short-term wholesale liabilities and deposits held by Australian residents in the 30 days up to and including 24 October 2008.
- Branches cannot use guaranteed liabilities to directly support the parent bank or group (of which they are part) outside Australia.
- The guarantee is only available if the liabilities are not guaranteed by the home authorities and the branch provides additional information about the parent bank's prudential compliance.

These requirements will ensure the funding is used for Australian operations only and that Australian taxpayers' funds are protected.

2. Yes.

3. No. ADIs may apply for the guarantee to cover existing programs.

4. The Government set the fee schedule following advice from the Council of Financial Regulators.

5. Fees are set at a single rate for all maturities for eligible securities up to 60 months, with a different rate applying to eligible ADIs based on their credit rating.

The fee scale, on a per annum rate, is outlined in Table 1.

Table 1

Credit Rating	Fee
AA	70bp
A	100bp
BBB and Unrated	150bp

6. As market conditions normalise and funding markets 'thaw', it is expected that it will no longer be commercially viable for entities to rely on the guarantee.

7. A range of jurisdictions have moved to shore up their Financial Systems, in particular ways. Generally this has involved guarantees of wholesale funding and deposits as well as equity injections and asset purchases where required.

Australia's measures are generally consistent with international measures.

Information on a sample of international schemes is attainable via the following links:

UK – http://www.dmo.gov.uk/documentview.aspx?docname=cgs/press/mktnotice08.pdf

NZ – http://www.treasury.govt.nz/economy/guarantee/wholesale

US – http://www.fdic.gov/regulations/resources/TLGP/index.html

Netherlands – http://www.dsta.nl/index.cfm?lang=ENG&template=nieuws&id=161&

8. The US has revised its arrangements and is no longer charging a flat fee of 75 basis points.

Australia will keep the parameters of the guarantee arrangements under constant review.

9. The pricing of the guarantee is designed to ensure that it is not overused. The take-up of the guarantee will be monitored closely.

10. The Government's Mid-Year Economic and Fiscal Outlook for 2008-09 notes that the expected liability under the wholesale funding guarantee is remote and unquantifiable.

Government expenditure would arise under the guarantee only in the unlikely event that an institution fails to meet its obligations with respect to a commitment that is subject to the guarantee and the guarantee is called upon. In this case, the Government is likely to be able to recover any such expenditure through a claim on the relevant institution. The impact on the Government's budget would depend on the extent of the institution's default and its ability to meet the Government's claim.

11. APRA has a broad range of supervisory powers that will allow it to factor in monitoring of the use of the scheme by institutions.

The eligible institutions are regulated by APRA and subject to prudential standards and safeguards. Any unacceptable behaviour will lead to serious consequences for their future operations.

To have liabilities guaranteed, institutions will need to provide a statement of prudential compliance to the RBA and APRA. If APRA has concerns about the accuracy of the statement, these will be raised with the RBA. The RBA will reject any applications for coverage under the guarantee where prudential compliance statements are incorrect or cannot provide assurance of the soundness of the institution's financial position.

In addition, institutions will need to execute a counter-indemnity that will require them to reimburse the Commonwealth for any payments made under the guarantee. They will also be required to agree to abide by the scheme rules, which require them to have their reports relating the guarantee subject to audit by agents of the Commonwealth.

12. The large deposits and wholesale funding guarantee is implemented though a contractual approach. Legislation has been enacted to provide an appropriation.

13. The risk of 'moral hazard' is limited by APRA's stringent prudential supervision of Australia's financial institutions. Institutions continue to be constrained by APRA's ongoing prudential requirements.

See also response to question 11.

14. The application process requires institutions to disclose a range of information. Information on the application process is available on the www.guaranteescheme.gov.au website.

15. No. APRA's powers are sufficient for monitoring the use of the scheme by institutions.

16. No. The Government's policy on excessive executive salaries is provided in the Government's response to general business notice of motion no. 293, moved by Senator Bob Brown on 25 November 2008. This response was tabled in the Senate on 4 December 2008.

17. As noted in the September 2008 RBA Financial Stability Review, total short- and long-term debt securities on banks' domestic books (including offshore debt and inter-bank debt) was $739.6 billion at July 2008. This excludes debt in the form of deposits.

Under the guarantee arrangements, wholesale debt funding is only guaranteed if an authorised deposit-taking institution opts-in to the guarantee and agrees to pay the relevant fee. At this stage, it is too early to tell how much of the existing wholesale debt will be covered by the guarantee and what proportion of future debt funding will be brought under the guarantee.

18. The wholesale funding guarantee is restricted to senior unsecured debt instruments. It does not apply to transfers. Transfers to overseas subsidiaries are limited by APRA's prudential regulations.

19. The wholesale funding guarantee applies to specified debt instruments, it does not apply to transfers between international and Australian banks.

20. We are unable to provide a response to this question, as it goes to the nature of policy advice to Government.

21. The facility will apply to debt issuance in all major currencies including AUD, NZD, Euro, USD, Sterling, Yen and HKD. It will apply to eligible securities issued domestically or off-shore.

22. If an institution decides to guarantee its large deposits, it will pay a fee to the Government for its deposits over the $1 million threshold based its credit rating (refer to fee schedule in response to question 5).

An institution's interest rates and any decision to pass on guarantee fees is a matter for each institution. Term deposit interest rates are impacted by a range of factors and it is expected that different institutions may take different approaches.

23. It is expected that there will continue to be healthy competition for both guaranteed and unguaranteed deposits.

APRA has a range of supervisory tools at its disposal that could be used if it considers that an institution is engaging in imprudent behaviour.

24. The Mid-Year Economic Fiscal Outlook notes that the expected liability under the deposit guarantee is remote and unquantifiable.

The total value of deposits that are either guaranteed for free or eligible to be guaranteed in return for a fee is estimated to be approximately $1 trillion, based on data as at 30 September 2008.

Government expenditure would arise under the guarantee only in the unlikely event that an institution fails to meet its obligations with respect to a commitment that is subject to the guarantee and the guarantee is called upon. In this case, the Government is likely to be able to recover any such expenditure through a claim on the relevant institution. The impact on the Government's budget would depend on the extent of the institution's default and its ability to meet the Government's claim.

25. Yes.

The Financial Claims Scheme (FCS), as established by the *Financial System Legislation Amendment (Financial Claims Scheme and Other Measures) Act 2008,* provides depositors in authorised deposit taking institutions with a guarantee of their deposits of up to the $1 million threshold. For amounts over the threshold a fee will need to be paid for an institution to get the benefit of the guarantee.

The Government announced that the deposit guarantee would apply for a period of three years.

The Government has indicated that it will consider the appropriate arrangements for the FCS at that stage.

26. The mechanisms are in place for the Government to impose a cap.

The Government will give regard to the appropriate thresholds and fees and how adjustments to these can be used in transitioning institutions away from using the guarantee.

27. A process of re-intermediation from savings held with non-bank financial institutions back to prudentially-supervised ADIs was already underway in the present market downcycle before the deposit guarantee was announced. In addition, a process of de-leveraging and of savers reducing property and stock market risk was also already underway.

28. There is no incentive to switch from wholesale funding to large deposits as the same fee schedule applies to large deposits (over $1 million) and wholesale funding.

29. See response to question 13.

30. See response to question 10.

31. Use of the scheme will be closely monitored – see response to question 11.

In addition the fee is intended to ensure the guarantee is not overused.

32. Under the wholesale funding guarantee different fees apply to eligible ADIs based on their credit rating. Under the fee schedule a BBB rated bank will pay a fee at a rate of 150bp per annum whereas an AA rated bank will pay a fee of 70bp per annum.

33. See response to question 7.

34. The wholesale funding guarantee will be withdrawn when market conditions normalise.

35. The Government will give regard to the appropriate thresholds and fees and how adjustments to these can be used in transitioning institutions away from using the guarantee.

36. Australia's robust prudential regulation framework minimises moral hazard implications of either guarantee.

37. See response to question 12.

38. See responses to questions 15, 13 and 11.

39. Australia has weathered the crisis relatively well due to our strong regulatory framework and prudent behaviour by our institutions. Australia is working in international forums to reform the international financial regulatory architecture. Australia has been pro-active in the G-20's development of responses to the international financial turmoil and in implementing the recommendations of the Financial Stability Forum.

40. Yes. To ensure that our regulators continue to have the resources they need to maintain the strength of Australia's financial system during the global financial crisis the Government recently announced additional funding for APRA. Specifically, APRA will receive $9 million in 2008-09 and $18.5 million in 2009-10, and $9 million in each of 2010-11 and 2011-12 to enable it to manage the effects of the global financial crisis.

41. An opinion from the Australian Government Solicitor on the validity and enforceability of the large deposits and wholesale funding guarantee deed is available on the www.guaranteescheme.gov.au website.

42. See response to question 35.

43. The wholesale funding guarantee will ensure that banks can continue to access funding to support lending activities. This would have positive implications for lending interest rates.

44. Credit ratings agencies have not indicated any threat to the Government's credit rating.

45. Given that the expected liability under the deposit guarantee has been assessed as being 'remote and unquantifiable' it is not possible to actuarially assess the fees.

Government expenditure would arise under the guarantee only in the unlikely event that an institution fails to meet its obligations with respect to a commitment that is subject to the guarantee and the guarantee is called upon. In this case, the Government is likely to be able to recover any such expenditure through a claim on the relevant institution. The impact on the Government's budget would depend on the extent of the institution's default and its ability to meet the Government's claim.

46. From July 2007 through to end November 2008 the RBA cash rate was reduced in net terms by 100 basis points, from 6.25 per cent to 5.25 per cent. Over this same period the average actual variable lending rates for small businesses increased by 62 basis points from 8.64 per cent to 9.26 per cent.

47. The guarantees are expected to have a positive impact on stability, confidence and competition. Stability and confidence are important underpinnings for efficient, competitive markets. The guarantees support access to funding for all ADIs which is required for new lending – this improves competitive pressure in lending markets.

48. The Guarantee Scheme for Large Deposits and Wholesale Funding Appropriation Act 2008 received Royal Assent on 27 November 2008.

49. The Guarantee Scheme's website — www.guaranteescheme.gov.au — includes statements of publicly issued guaranteed liabilities.

The Government will publish on the website the details of participating institutions and the liabilities that are covered.

The Government will provide six-monthly reports to the Parliament on the Guarantee Scheme's operations, including:

- the extent of the liabilities covered by the guarantees;
- whether any calls have been made under the guarantees for payment; and
- payments, if any, made by the Commonwealth under the guarantees.