

Introductory Report on Australian Government Guarantee Scheme

By Deborah Deng

The definition of *Australian Government Guarantee Scheme* in this report includes the *Financial Claim Scheme* which became effective on 18 October 2008, and the *Australian Government Guarantee Scheme for Large Deposits and Wholesale Funding* (hereinafter called *Guarantee Scheme or Scheme*).

Foreword: why this topic?

Like most Chinese legal practitioners, scholars and officials who had very limited knowledge of the Australian financial system, I used to think that the Australian Government would generally take a hands-off approach by not intervening in the running and operation of the Australian market as I had understood from the indices of economic freedom that the Australian market to be one of the most laissez-faire capitalist economies.

My belief proved to be incorrect when the Australian Government issued the Australian Government Guarantee Scheme for Large Deposit and Wholesale Funding Rules (the ***Guarantee Scheme***) in response to the current global financial crisis. Such measures are intended to be temporary measures to enable the provision of a guarantee for the deposits and wholesale funding of Authorised Deposit-taking Institutions (ADIs), which was effective from 28th November 2008 through to 12 October 2011.

Obviously, at least at the Federal Government level, it might be the first time for the Australian Government to play a role as a direct intervener in the laissez-faire market economy, in particular in the banking and finance business market, since such market was established hundreds years ago.

Such a fundamental shift in the Federal Government's approach could be considered as a landmark in the history of Australian market economy.

In this paper I will be focussing on the following few key aspects of these Scheme and Rules, trying to learn, describe and analyse that,

- (a) reasons as to why the Australian Government dealt with the global financial crisis by introducing the Guarantee Scheme;
- (b) key features and principles of the Guarantee Scheme;
- (c) legal and economic controversies surrounding the Guarantee Scheme; and
- (d) likely short-term and long-term impact of the Guarantee Scheme on the Australian market economy.

1. Historic and current background of the Government Guarantee Scheme

The need to deal with the current global financial crisis aside, the introduction of the Guarantee Scheme is also a reflection of lessons learned from corporate collapses and failures in the last 10 years.

1.1 Previous approaches dealing with financial system failures

In the wake of the collapse of the HIH Group in Australia in 2003, the Australian Government has tightened its prudential regulations dramatically. It also created a tailored a guarantee framework to maintain and improve the Australian financial system.

A detailed examination of the merits of the limited explicit guarantee system for the Australian financial system is found in the 300-page Davis Report produced by Professor Kevin Davis and his research team in Melbourne University.

A key recommendation of the Davis Report was that the Government can offer limited explicit guarantee which reduces the extent of losses on a certain range of products, included but not limited to deposits and insurance products. In my view, this recommendation should be regarded as forming the basis of the current Guarantee Scheme.

1.2 International economic background—Worldwide financial crisis of 2007-2009 necessitates more secured and proactive reactions from the Australian Government to lessen risks and losses

Since July 2007, the extremely severe sub-prime mortgage crisis broke out in the United States, and shortly spread to most of the developed countries, where the capital markets and banking business have been adversely affected. The list of banks and companies involved in bankruptcy, administration or other insolvency proceedings grows longer by the day. The most astonishing aspect of it is that the list includes previously solid (or widely perceived to be so) blue chip companies such as New Century Financial corporation, American Freedom Mortgage, American Home Mortgage, Bernard L. Madoff Investment Securities LLC, Charter Communications, **Lehman Brothers**(bankruptcy), Mervyns, NetBank, Terra Securities (scandal), Sentinel Management Group, Washington Mutual, Saab Automobile, Chrysler, Thornburg Mortgage, **Babcock & Brown, Allco Finance Group**, and so on.

Nobody could avoid the impact of the global financial crisis due to the intertwined nature of the financial markets around the world thanks to the relentless globalisation especially in the past 20 years.

1.3 Domestic financial background ----Two heartbroken cases in Australia

Regardless of how indifferent you might have been towards the current financial crisis, the global nature of it means that the Australian economy and many Australian financial institutions and companies were inevitably affected due to their being part of the global financial community.

Case One: Failure of Babcock & Brown (ASX: BNB)

Babcock & Brown was a global investment and advisory firm based in Sydney, Australia, which was a distinguished player in financial markets for structured finance deals. Totally there are 28 offices and more than 1,500 employees worldwide.

Headquartered in Sydney, B&B expanded aggressively in both Europe and the United States which won it a nickname "Mini Macquarie" when it was frequently compared with larger competitor Macquarie Bank. In December 2006, it had a market capitalisation of just over \$8.5 billion, and in 2007 its share price peaked at AU\$ 33.90.

However by October 2008 its share price had collapsed by 96% to AU\$ 1.40 and by December 2008 by 99.6% to AU\$ 0.14, representing a market capitalisation of less than \$50 million. On March 13, 2009 this company was placed into voluntary administration.

Case Two: Failures of Allco Finance Group (ASX: AFG and others)

Headquartered in Sydney Australia, Allco Finance Group was a fully integrated global financial services business listed on the Australian Stock Exchange. Its major services are structured asset finance, funds management and debt and equity financing.

Allco had over AU\$ 4.3 billion in assets, and financed over AU\$ 60 billion of transactions. In its most visible public transaction, Allco was a part of Airline Partners Australia, the consortium that unsuccessfully attempted to buy Qantas. Allco is now in administrative receivership following difficulties in refinancing its debt and its share price fell by 99% since the beginning of the sub-prime mortgage crisis.

Additional case from National Australia Bank (NAB)

In July 2008, another incident sent shivers down the spine of the Australian financial market which saw the already weak market confidence become even weaker. NAB, one of big four banks in Australia, had to reduce its planned A\$850 million bond sale by two thirds following investor flight and was forced to completely write off a clutch of "senior strips" of AAA-rated collateralized debt obligation (CDO) worth A\$900 million.

Obviously, these influential but negative cases, like a domino effect, combined with other even more horrible failures of financial institutions abroad have caused the collapse of the confidence and trust of investors, banks and the public. Moreover, trust between the banks and financial institutions themselves also evaporated, strangling liquidity and confidence in any transaction.

An advertisement says: Keep Sydney Safe, Keep Information Floating. Here I would say the same, Keep Financial System Working, Keep Money Flowing. Without liquidity and trust, banks would die shortly.

The financial markets (domestic and abroad) were in such a bad shape that it warranted government intervention in order to stabilise the situation.

1.4 International Comparison of Developments in Guarantee Arrangements by Government

Meanwhile, faced with the situation of heightened uncertainty and declining confidence, many other affected developed countries responded by increasing the monetary cap on the amount of deposits guaranteed under such scheme. For instance, in the USA, the cap on insured deposits with eligible institutions was increased temporarily from US \$100,000 to US \$250,000, while the minimum cap required in EU countries was from €20,000 to €50,000. Some EU countries such as Germany, Austria, Denmark and Ireland went further by providing a guarantee over all deposits, introducing unlimited caps. Most countries that introduced unlimited caps nominated a set period for the arrangements to apply, typically around two years.

In summary, the Guarantee Scheme was designed to ensure that Australian institutions are not disadvantaged compared to their international competitors that can access to similar government guarantees on their wholesale funding.

2. key functions and features of the Guarantee Scheme

2.1 functions

In summary, the purposes of the Guarantee Scheme are fourfold:

- (a) Efficiently and effectively re-build the trust and confidence among banks, investors and the public;
- (b) Reduce and control impact of failed financial institutions on the rest of the market;
- (c) Prevent and minimise losses to consumers with greater certainty, and
- (d) Encourage lending activities and liquidity flow in the market.

2.2 features

- (a) a strong sign of timely reaction against the crisis by the Government;

I found that although Australia suffered least in terms of the impact of the crisis amongst developed countries, its government reacted more sufficiently and effectively in dealing with such impact;

- (b) a transparent and realistic protection approach from the Government;

This Guarantee Scheme is well-designed and explicit, which can be more efficient than the previous implicit guarantee;

- (c) a temporary arrangement which lasts for about three years.

However, during this maturity, the Guarantee Scheme remains in place until market conditions have normalised, which itself contains features and variables that may require adjustment in light of market developments. The Government will keep reviewing on an ongoing basis and revise it if necessary.

3. Main controversial arguments over the Guarantee Scheme

Effectiveness as it might have been in stabilising the Australian financial market, the Guarantee Scheme nonetheless is not without controversies.

3.1 Are there any moral hazard problems as consequences of the Guarantee Scheme?

Many analysts and experts doubt that the Scheme may encourage excessive risk-taking behaviour, which can offset any potential benefits. This problem arises for banks as their ability to attract deposits do not reflect the risk of their asset portfolio, thus they would be motivated to take projects with excessive risks.

As a result, eligible institutions under the Scheme, such as banks, building societies and credit unions, may not compete on the quality of their promises but aggressively on price, cover or service.

Therefore, from relatively long term perspective, the Guarantee Scheme may lead to a higher likelihood of financial institution failures.

3.2 Three years, too long?

While major banks and wealth management groups have publicly welcomed the Guarantee Scheme as a necessary mean to retain confidence in the banking system, they have privately expressed concerns that three years is too long and could distort deposit markets.

On the contrary, most of smaller authorised deposit-taking institutions and building societies in Australia are worried about certain undesirable consequences such as a flood of withdraws after the expiry of the Government Guarantee Scheme in three years since they believe that people would want to put their money in bigger institutions which are perceived to be "safer" for their deposits. As a result, smaller ADIs will be facing tougher competition in the market than usual.

The three-year guarantee period is longer than that in EU countries (up to two years), USA (less than one year), Canada and UK (one year).

Some bankers suggested that if markets remain relatively stable, the Government should set out its exit strategy for the Guarantee Scheme. Furthermore, they warned that it must quickly and publicly spell out arrangements for ending the Scheme or face the risk it becomes part of the financial system.

Generally, more analysts agree that the Guarantee Scheme is an "extraordinary measure" which should only operate in "extraordinary times" and might have undesirable effect of propping up business models that would otherwise be unsustainable.

3.3 Is it fair for Government to charge on the Guarantee Scheme in term of credit rating of the eligible institutions?

The same fee schedule applies to an ADI's wholesale funding as to its large deposits, but all bases on its credit rating, which means higher rated institutions pay lower fee, and vice-versa, please see below,

Credit Rating	Fee per annum
AAA to AA-	70 basis points (0.7 per cent)
A+ to A-	100 basis points (1.0 per cent)
BBB+ and below and Unrated	150 basis points (1.5 per cent)

Such a fee schedule is based on credit risk-weighted by rating agencies. Obviously, there is a large gap of fee between the highest rated ADIs and the lowest rated ones which is more than double payment of fee for the Guarantee.

Smaller ADIs with lower credit rating argue that they have been placed in the miserable situation to compete with their rivals by paying much higher costs for the same Guarantee Scheme.

The heavy reliance on credit rating agencies in determining the charges implies that without a proper regulation of the agencies, which is widely considered as a key suspect of the financial crisis, the system is potential vulnerable for abuse by them what have huge conflict of interest.

4. What impacts of the Government Guarantee Scheme to Australian current and future financial system?

4.1 Short-term impact on the market

- (a) The number of nervous customers ploughing funds into bigger banks has dramatically slowed within two weeks after the Government declared that it would stand behind all Australian bank deposits in the middle of last October; not mention that the Scheme successfully took into effect later in November 2008;
- (b) Some banks which suffered a significant outflow of deposits before manage to win back customers after the introduction of the Scheme such as BankWest, which was in the process of being acquired by Commonwealth Bank of Australia, increased deposits by \$158 million to more than \$36 billion;
- (c) All of the Big Four banks plus some other key institutions, such as Suncorp and Macquarie have used the Scheme within short time after the Scheme launched. Australian domestic banks are half way through 2009 and importantly, are borrowing at increasingly better rates than a few months ago;
- (d) The cost of raising wholesale funding backed by the Government Guarantee has been going down. For example, NAB has raised \$US 2.5 billion in three-year bonds priced at 0.85 of a percentage point above swap, which is cheaper than the 1 percentage point about swap that ANZ and Westpac paid when they raised \$US 1.25 billion and \$US 1.5 billion each in three-year bonds before;
- (e) On the other hand, some regional Banks, which have a lower credit rating and therefore must pay a higher fee to use the Government Guarantee are using it less, but some have used it. It is relatively more expensive for them to use because of the fee structure of the Guarantee. So, NAB, Westpac, Commonwealth and ANZ (the "Big Four" banks all rated "AA") pay the lowest fee to use it. As a result, these banks are given a competitive advantage to use the Government Guarantee over the smaller, lower rated regional banks such as Suncorp, Bank of Queensland, Bendigo Bank etc.

4.2 Long-term impact on the financial system

The Guarantee Scheme has served as a shelter to smaller and lower rated financial institutions who might otherwise have suffered more difficulties as a consequence of the current crisis. The availability of the Guarantee Scheme may encourage risk taking behaviours in financial institutions and act as a disincentive for them to improve their productivity and innovation. As the Scheme only has a limited life span and its existence goes against the free market philosophy, distortion will inevitably result in the market and the impact of which may take years to be remedied.

The extent and the depth of the current crisis is such that no one is able to predict exactly how long the financial markets, in particular, the credit market is able to recover fully. If the withdrawal of the Scheme is an untimely one, then the demise of the less competitive (usually the smaller players) may result. Consequently, there will be less competition which would be a bad news for consumers.