Executive Summary

The Secretary of the Senate Committee on Bank Funding Guarantee advised that the Committee is interested in having a submission from me on the guarantee scheme. Accordingly, I am making this submission.

Soon after the blanket guarantee was announced, I commented on the decision in *The Australian* through two op-eds. I argued that it would accentuate moral hazard and distort consumer incentives and risks significantly and suggested that the guarantee be wound back.

In this submission, I elaborate on some of the earlier arguments and also advance a few more for consideration by the Committee. The arguments have been supported with relevant data and literature.

I argue that the unlimited deposit guarantee was unnecessary and had severe adverse impact for smaller financial institutions. These institutions not only lost their share in the deposit market but their profit also declined significantly. Major Banks, on the other hand, gained considerably. I estimate that the government guarantee has enabled banks (majors in particular) to make approx $1.34 billion profit over the next three years – essentially a tax payer funded subsidy.

Liquidity in the financial system gravitated and got stored mainly with the banks. The guarantee created a liquidity imbalance in the financial system and institutions like the Colonial had to freeze withdrawals creating anxiety for several consumers. Authorities have been quoted as saying that the unlimited guarantee was necessary to create confidence among consumers and businesses. Available evidence, however, doesn't support that there was any wide spread confidence problem.

Scrapping the deposit guarantee abruptly will not be prudent. I suggest that the government roll back the deposit guarantee scheme in stages: to $100,000 by December 2009, to $60,000 by June 2010 and to $20,000 by December 2010. The government may like to keep it at this level as originally planned, though personally, I am not in favour of any explicit guarantee. Such a guarantee provides an implicit subsidy. Australian financial system has worked well without any explicit guarantee for years and other financial safety measures are also available.

Though the wholesale funding guarantee had some justification when it was announced, global market conditions have generally stabilised and the guarantee may be scrapped as soon as possible. Incidentally, the wholesale funding guarantee has created a number of anomalies.

I have made - and bolded for easy reference- several other comments which may be of interest to the Committee.

A. Bank Deposit Guarantee

1. Impact on the Australian Financial Sector

When the blanket guarantee was announced on 12 October 2008, it was unprecedented in terms of its duration, amount covered, fee and scope. 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 (several countries restricted it to retail deposits and certain institutions only) and was fee free (several countries had fee in place).

Ten days later, on 22 October 2008, the government announced some changes. There were to be two arrangements now (a) without fee (free) financial claims scheme (scheme) for deposits up to $1 million and (b) with fee (paid) large deposits and wholesale funding (LDWF) guarantee for deposit balances in excess of $1 million, at a single Authorised Deposit Taking Institution (ADTI). In this submission, a reference to guarantee includes both the claim scheme and the LDWF guarantee.

Only nine countries out of 33 OECD countries had unlimited coverage (Schich, 2008). Of these nine, Australia has the unique distinction of announcing an 'unlimited guarantee' from a 'no guarantee' situation. Interestingly, Canada which has robust banking system like Australia didn't opt for an unlimited guarantee and countries facing serious banking crisis like the US and UK opted for only limited guarantee. Schich 2008 (Table A2) provides a comparative position of the coverage in several OECD countries.

Unlimited guarantees, in particular, increase moral hazard and distort financial flows as investor behaviour, incentives and choice of institutions undergo a change. This was confirmed when Colonial and other institutions froze funds withdrawal within days of the announcement. Schich (2008, p.57) warns 'it is important on efficiency grounds for policy makers to carefully assess the potential benefits against the likely cost of policy intervention and to refrain from unnecessary activism'.

The impact of blanket guarantee needs to be considered in the context of community confidence in the Australian financial system prior to the announcement. Though Lehman collapsed on 14 September the Westpac Consumer Sentiment Index actually rose in September 2008. Obviously, at least at that stage Australians were unconcerned and considered Lehman as a US problem. RBA governor confirms that there was no evidence of any widespread loss of public confidence at that stage. Naturally, when the shocking announcement of blanket guarantee was made people might have thought that the government has information not available to them which necessitated such an announcement. As a result, they lost confidence instead of gaining it as is evidenced by decline in confidence index post announcement. There is reason to believe then that it is the announcement of the guarantee that underpinned the changes that took place post guarantee.

The guarantee had a differing impact on several actors within the Australian financial system. Major Banks benefitted the most. Smaller financial institutions and foreign banks, in particular, lost considerable market share and the guarantee also adversely impacted on their profit. The guarantee necessitated establishment of the Rudd Bank, financial institutions like the Colonial were advised to apply for banking licence so as to seek the guarantee cover, and consumers were asked to tap the Centre Link. The decision obviously affected the actors in the Australian financial system significantly.

1.1 Credit unions and building societies

Table 1 below shows that despite the guarantee shift in call/demand and term deposits from credit unions/ building societies to the banks continued.

Table 1: Change in proportion of Deposits of ADTIs

		Demand		Rise over Sep08		Term		Rise over Sep08
	Dec07	Sep08	Dec08		Dec07	Sept08	Dec08	
All banks	95.75	95.96	96.03	0.07	93.67	94.40	94.54	0.14
Credit Unions	3.10	2.99	2.94	-0.05	3.90	3.62	3.55	-0.07
Bldg Socs	1.15	1.05	1.03	-0.02	2.42	1.98	1.91	-0.07
Total	100	100	100		100	100	100	

(Source: Compiled by the author from APRA Quarterly Bank Performance Statistics, 2008, Dec. - Tables 2, 5, 8 and 11).

Edey (2009, p.1) recently stated that 'competition was already being eroded because of a 'flight to safety' by clients moving their money to bigger institutions that are perceived as more secure, that was occurring *before* the guarantee was put in place' (emphasis added).

Granted that the flight to safety was witnessed in earlier quarters, but the guarantee couldn't stabilise it – so the objective of the guarantee to create confidence was not fully achieved from the perspectives of small financial institutions.

The RBA governor conceded 'Australian banks having raised very large quantities of deposits in the past couple of months ……..making use of the government guarantee' (Stevens, 2008, p.11).

1.2 Foreign banks

The share of foreign bank subsidiaries / branches in the deposit market declined considerably.

Table 1 (a): Market share of deposits held by type of bank ($ million)

Bank type	Dec 07		Sept 08		Dec 08		Col 7- Col. 5
1	2	3	4	5	6	7	8
Major	931,144	68.59%	1,066,121	70.59%	1,262,135	80.28%	9.69%
Other domestic	189,028	13.92%	213,295	14.12%	134,562	8.56%	-5.56%
Foreign banks	111,522	8.21%	108,936	7.21%	69,558	4.42%	-2.79%
Foreign Bank Branches	125,868	9.27%	121,974	8.08%	106,008	6.74%	-1.33%
All	1,357,562	100.00%	1,510,326	100.00%	1572263	100.00%	0.00%

(Source: compiled by the author from APRA Quarterly Bank Performance Statistics, 2008, Dec. - Tables 2, 5, 8, 11 and 14).

If St George and BankWest deposits as at the end of September 2008 are adjusted from the majors to other domestic banks category then the position is as under:

Table 1 (b): Adjusted market share of various banks ($ million)

Bank type	Adjusted Dec 08		Diff (Col 3 – Col 5 of Table 1 (a))
1	2	3	4
Major	1,168,978	74.35%	3.76%
Other domestic	227,719	14.48%	0.36%
Foreign banks	69,558	4.42%	-2.79%
Foreign bank branches	106,008	6.74%	-1.33%
All banks	1,572,263	100.00%	0.00%

(Source: compiled by the author from APRA Quarterly Performance Statistics for Dec 2008 - Tables 2, 5, 8, 11 and 14).

The loss of share by foreign banks in the deposit market, among others, may have contributed to the problems in the financing of commercial property sector by these banks. The government then had to announce establishment of the Australian Business Investment Partnership (ABIP) - the ‘Rudd Bank’- to overcome the problem.

If the guarantee is now removed abruptly a flight of funds from small financial institutions to banks is likely which may endanger the very survival of these institutions. Consequently, the deposit guarantee roll back needs to be done with caution.

I suggest a roll back of deposit guarantee to $100,000 by end of 2009, to $60,000 by end of June 2010 and to $20,000 by December 2010 - and retention at that level thereafter. It would still cover more than 60 percent households (COA, 2004).

1.3 Impact on other financial institutions

One of the major consequences for the non-ADTI sector was the pressure from clients for funds withdrawal. The return on bank deposits became more attractive, with the blanket guarantee in place - it was like a risk free return.

The investments in financial institutions such as the Colonial became less attractive and liquidity in the financial system started gravitating and getting stored with the ADTIs. No wonder the non-ADTIs like the Colonial had to freeze withdrawal of funds.

Media reports indicated that ‘at least 13 investment funds not covered by the Government's guarantee have frozen almost $12 billion in assets, leaving investors unable to withdraw their capital’ (AAP, 2008).

Government intervention in the financial system had the impact of actually sapping consumer confidence in financial institutions like the Colonial as risk incentives changed.

The financial system became more concentrated in the hands of ADTIs during 2008 which *in part* could be attributed to the government intervention in the market.

Over the period September to December 2007, the total assets of non-ADTIs declined by 0.66 percent while assets of the ADTIs rose by 4.69 percent, however, during the corresponding period in 2008, the decline was 6.04 percent for non-ADTIs while the rise was 8.40 percent for the ADTIs (calculations by the author from RBA, 2009, B1 Statement of assets and liabilities).

1.4 Changing the financial landscape

The government refused to extend the guarantee to the non-ADTIs (and rightly so), and instead asked the affected financial institutions to apply for a banking licence if they want to avail the protection accorded by the blanket guarantee. Further, despite the unlimited deposit guarantee to foreign banks, the need to establish the Rudd Bank couldn’t be avoided.

An unintended consequence of the blanket deposit guarantee was the potential it had to change the financial landscape of Australia in some way!

1.5 Impact on the non-bank securities market

During the year 2007-08, the non-bank securities market had already started contracting. The *2008 Australian Financial Markets Report* states:

‘Trading and issuance of non bank securities has been **negatively impacted** by the credit crunch and consequently borrowers turned to their banks and other markets for funding’ (AFMA, 2008, p.14).

The magnitude of this negativity could be seen from the following statistics available in the same Report (AFMA, 2008, p.14). While the annual turnover in bank securities rose from $122,679 million (2006-07) to $247,495 million (2007-08) - rise of 101.7 percent - during the same period the turnover in corporate securities declined from $196,632 million to $105,069 million (decline of 46.6 percent).

Data for the subsequent period is not readily available to do further comparison of the effect of bank guarantee announcement in particular.

When businesses were facing credit crunch, it was obvious that providing a bank funding guarantee would further skew the market in favour of the bank securities. With government guarantee for banks, it would obviously become hard for others to raise debt. Further as the risk free rate was now the rate available on the bank securities (backed by government guarantee) funding became potentially more expensive for the businesses.

Yet another consequence was that banks became the sole conduit of financial flows in the economy. The process of disintermediation assiduously encouraged by several committees in the past got reversed by the stroke of a pen! As a matter of fact precisely at a time when businesses needed money to survive (and to retain jobs) they were subjected to the mercy of the major banks for financial needs. ABC (2009) quotes Becton Property Group chief executive Matthew Chun ‘the greatest challenge facing developers is a lack of available credit’.

As per the Australian Bureau of Statistics (ABS), the commercial finance continues to show negative growth month over month since October 2008 (ABS, 2008-09). The businesses were left to fend for themselves while the banks stored liquidity using government guarantee. This was less than desirable outcome. Intermediated funds would also be costly for businesses than funds raised directly from the market.

Table 2: Growth in Lending Finance in 2008-09: Commercial (Month over Month)

2008			2009		
Sept. –Oct	Oct-Nov	Nov- Dec	Dec -Jan	Jan-Feb	Feb-Mar
0.4	-1.6	-1.7	-0.4	-2.6	-1.1

(Source: ABS (2008 and 2009), *Lending Finance,* Catalogue 5671 for various moths)

Government intervention actually exacerbated the credit problems of the businesses and also raised their borrowing cost. Table 3 below shows the pass through of interest rates by banks.

Table 3: Pass through of interest rates by banks

Date	RBA cash rate	Weighted variable interest rate (under $2 million)	Excess interest charged by the banks over the cash rate
3 Sept. 2008	7.00	10.0	3.00
8 Oct. 2008	6.00		
5 Nov. 2008	5.25		
3 Dec. 2008	4.25	8.5	4.25
4 Feb. 2009	3.25		
8 Apr. 2009	3.00	7.4	4.40

(Source: Reserve Bank of Australia (2008 and 2009), Statement D08 Bank Lending to Business: Selected Statistics and A02 Monetary Policy Changes).

The banks, however, refused to pass on the rate cut to the businesses or households. 'National Australia Bank has raised the ire of the government by refusing to pass on any of the RBA's reduction' (Thelwell and Fagg, 2009).

It is important to note as has been explained later that the interest rate spread of major banks actually rose by 21 basis points in the six months to June 2009. This was largely because of the government guarantee available at much lower cost (70 basis points) than available in other countries and the significant increase in the deposits due again to fee free deposit guarantee.

Yet, the reason given by banks for not giving full pass through was rising cost of funding. 'NAB ……cited the bank's rising cost of funding as preventing it from passing on any of the Reserve Bank of Australia's 25 basis point reduction……' (Thelwell and Fagg, 2009).

2. Impact on interest rates

As deposits gravitated to ADTIs, the excess supply coupled with government guarantee brought down the interest rates and so the return to the depositors significantly.

2.1 Reduced return on deposits

The interest rate on $10,000 online savings account was 7.30 percent in August 2008 but declined to 4.60 percent in December 2008 and further to 3.15 percent by April 2009 (RBA Bulletin Statistical Tables, 2009, F 4).

The reduced interest rates would have adversely impacted the return to depositors.

2.2 Reduced funding cost for banks

Deposit guarantee generated excess supply of deposits and reduced interest rates would have helped bring down funding costs of the ADTIs. In addition, the banks had wholesale funding guarantee to raise funds from the debt market at a lower fee (compared with banks in other countries), favourably impacting the funding cost.

Consequently, the banks benefitted significantly in comparison to small financial institutions especially credit unions.

This can be vouched from the decline in the ratio of interest expenses to total liabilities in December 2008 as compared to September 2008 quarter. The ratio of interest expenses to total liabilities (QOQ for Dec 2008) showed a decline of 0.27 percent for the banks and 0.11 percent for the credit unions.

Table 4: Ratio of Interest Expenses to Total Liabilities in 2008 (Quarter ending)

	June	September	December	Col. 4 – Col. 3.
1	2	3	4	5
Banks	1.45	1.45	1.18	0.27
Credit unions	1.34	1.43	1.32	0.11

(Source: Compiled by the author from APRA Quarterly Statistics of Banks, Credit Union and Building Society Performance, 2008, December)

The deposit guarantee resulted in large financial flows from the non-ADTIs and other ADTIs to the banks. In addition, the government guarantee to raise debt in international market, significantly increased total assets of banks and lowered those of smaller financial institutions as can be seen from the following Table.

Table 5: Change in proportion of assets held by ADTIs ($ million)

	Dec 07		Dec 08	
All Banks	2,161,322	97.26%	2,671,649	97.63%
Credit unions	39,449	1.78%	44,011	1.61%
Bldg Societies	21,437	0.96%	20,982	0.77%
Total	2,222,208	100.00%	2,736,642	100.00%

(Source: Compiled by the author from RBA Bulletin Statistical Tables B2, 7 and 8)

The table above indicates that the proportion of total assets held by all banks in the total assets of all ADTIs increased while that of the smaller financial institutions declined.

The share of major banks as a proportion of assets of all banks has also increased from 84% (Dec 07) to 91% (Dec 08) – calculated separately by the author. One can’t say though that the government guarantee was the sole reason given that the assets of St George and BankWest are now included in the major banks category.

Small financial institutions are increasingly getting marginalised in the Australian financial system.

As and when a fresh financial system inquiry is launched by the government, this aspect will need to be considered.

3. Impact on consumer and business confidence

It has been contended that the rationale behind the blanket guarantee was to create confidence among the consumers and businesses. 'The aim was to get something simple out there to regain confidence' (Edey, 2009, p.2). The evidence presented in the following paragraphs indicates that the objective was far from being achieved.

3.1 Consumer confidence

The loss of consumer confidence was not as wide spread as was being made out. The RBA Governor stated 'Some in the community were worrying …..it certainly was not widespread..' (Stevens 2009, p. 18). Let the Westpac-Melbourne Institute Consumer Sentiment Index tell the story (Table 6).

Table 6: Consumer Sentiment Index in later half of 2008

Month	**Index**	**Month**	**Index**	**Month**	**Index**
July 2008	79.0	October	**82.0**	Jan 2009	94.9
August	86.2	November	**85.5**	Feb.	85.8
September	**92.2**	December	92.0	March	85.6

(Source: RBA 2009 Indicators of Spending and Confidence)

Lehman failed in mid September 2008, yet the index actually rose in the months leading up to the announcement of the guarantee. It fell in October 2008 when the guarantee and the stimulus package were announced. Probably the dramatic announcement woke the consumers up only to lose confidence as can be seen from the table. Even in December 2008 – three months after the guarantee announcement - the index continued to linger at a level lower than the September 2008 level.

Interestingly, in April 2001 –the Dot Com bust year –the index fell to 90.2, and during the Asian crisis years, it fell to 94.0 (June 1998) yet the government of the day didn't feel the need to 'get something simple out there' to restore consumer confidence.

A question that begs an answer is how the authorities in the UK or the US could build the necessary confidence without resorting to a *blanket* guarantee while the authorities in Australia couldn't.

These countries faced worst economic situation - even the semblance of which was not seen in Australia. It appears that unlimited guarantee was a case of 'policy-making under pressure'.

Obviously, the Australian Government overreacted. This is further confirmed when one looks at the trend of bank deposits in the months closer to the announcement of the guarantee.

Table 7: Monthly trend of deposits of all banks in 2008 ($ billion)

Month	Deposits	Month	Deposits
May	1,194	Sept	1,280
June	1,216	Oct	1,306
July	1,227	Nov	1,324
August	1,249	Dec	1,326

(Source: RBA Bulletin Statistics, 2008, Statement B03 Banks-Liabilities)

The evidence presented above, doesn't support the claim that community confidence in the Australian financial system was so low that it needed a blanket deposit guarantee, unless the government had some other sources of information to measure confidence.

We take pride that the Australian prudential regulation framework and well capitalised/ well managed banks saved us from the financial tsunami. However, we forget that it was the budget surpluses of prior years and low current account deficit that has put Australia in good shape. 'The current account deficit narrowed to a seven year low of 2.2% of GDP at the end of 2008, driven by a trade surplus' (Government of Australia, 2009, p. 14). The US, UK, Ireland and other countries had large current account deficits and funds were flowing from countries like China especially to the US in search of yield (FSA, 2009). Flush with funds, banks in the US resorted to sub-prime lending.

If Australia faces similar situation, I am afraid the risk appetite of Australian banks too would increase. Banks now know that the government would rescue depositors anyway. 'The financial industry is always short-sighted and always in denial……they always think they're very clever and have good risk-assessment, but they always repeat old behaviour patterns' (Kiander quoted in Todd, 2009).

In future, if depositors (both retail and wholesale) see any risk of loosing their deposits, pressure would mount on the government in power to revive the blanket deposit guarantee and that too uncapped with 100 percent cover citing the precedent now set by the government.

The unprecedented action of blanket guarantee was an unnecessary activism and gave rise to unwanted signalling effects on the Australian financial system.

3.2 Business confidence

Business confidence was on the decline the world over as well as in Australia particularly after the collapse of Lehman Brothers in September 2008. But did the blanket guarantee help restore it? As can be seen from the table below, the business confidence index actually improved in September 2008 compared to June 2008 (though continued to be negative). However, it was substantially lower in December 2008 quarter even though the guarantee and the stimulus measures were in place. These measures couldn't restore the index to September 2008 quarter level.

Of course, one can argue that without these actions, the index could have dipped even further and the measures helped stem its slide below -30.5. But such propositions can't be tested.

Table 8: NAB business confidence index in later half of 2007-08 (Quarter ending)

	Index		**Index**
Dec-07	5.8	Sep-08	-6.6
Mar-08	-4.2	Dec-08	-30.5
Jun-08	-7.5	Mar-09	-24

(Source: RBA 2009 Indicators of Spending and Confidence).

In September 1998 (Asian Crisis) the index was -5.6 and it was -23.7 in December 1990 (recession in Australia) - the worst ever in pre-global financial crisis years - and yet the government of the day didn't think it was necessary to introduce a blanket guarantee to restore business confidence.

The Reserve Bank Governor commented as under about business confidence '.. turned abruptly much weaker in October, and remained weak thereafter (Graph 1). There was some recovery in March. (The behaviour of Australian household confidence surveys has not been as weak, as I shall come to later). While official data are yet to show it, it is likely that business investment spending is in the process of declining sharply. Hiring intentions have been scaled back quickly. Residential investment and exports have fallen' (Stevens, 2009, Road to Recovery).

Thus, even six months after the announcement of blanket guarantee, the business confidence index languishes at much worse levels than the September 2008 level when the stated intention of the government was 'to get something simple out their to ***restore*** confidence' (emphasis added).

There was no need of a blanket guarantee as the consumer confidence wasn't even below some of its worst levels in the past. It was also ineffective to build business confidence back to the September 2008 level six months after.

4. Impact on government contingent liabilities

It is unlikely that the deposit guarantee would get invoked given the robust banking system in Australia and recent indications that overseas financial situation is stabilising. However, an abrupt withdrawal of deposit guarantee could trigger financial flows from small institutions to major banks. This may have the potential to bring some of these institutions in serious financial difficulties necessitating the reinstatement of the guarantee.

4.1 Fee free deposit guarantee

The Australian premium (fee) free guarantee up to $1 million was also unique feature when compared to other countries. Several other countries levied premium on the deposit guarantee.

Table 9: Percentage premium rate on deposit insurance

Country	Premium	Country	Premium
USA	0.05-0.43	Philippines	0.2
HK	0.05-0.14	Singapore	0.03-0.08
India	0.1	Taiwan	0.02-0.07
Indonesia	0.2	Thailand	0.4
Japan	0.083-0.115	Vietnam	0.15
Korea	0.1-0.3		

(Source: Federal Reserve Bank of San Francisco. 2008)

B. Wholesale funding guarantee

The wholesale funding guarantee was needed to match similar arrangements proposed in other countries so as to establish a level playing field and help Australian banks seek funding at competitive cost.

Bank guarantee generated significant profits for banks in the US. ‘The government's guarantee since November on new debt issued by financial firms such as Citigroup Inc. and General Electric Co. will save those companies about $24 billion in borrowing costs during the next three years’ (WSJ, 2009, July 28).

The lower fee contributed significantly to bank profits in the US and the case would be similar here in Australia as the fee charged by the government on the wholesale funding guarantee is even lower as compared to the US.

The estimates of such government guarantee generated bank profits are not available in Australia. I have, however, made an attempt to compute the likely gains for Australian banks. As major banks were the main issuers of the debt the analysis is largely applicable to them.

5. Estimating bank profits from government guarantee

One of the ways to compute the profit would be to check the savings made by banks in borrowing costs due to government guarantee. The saving would be equal to, the without guarantee rate prevailing in the market minus the rate actually paid by banks plus the guarantee fee. I use an alternative method.

As per the *KPMG Financial Institutions Performance Survey* (2009) the interest spread of majors increased from 167 basis points (December 2008) to 188 basis points (June 2009). The excess interest spread of 21 basis points could be attributed to lower borrowing cost of banks due to the government guarantee. Banks (mainly the majors) raised about $106 billion government guaranteed debt by June 2009 (Australian Government, 2009, LDWF Guarantee Statistics).

Assuming that the entire debt was raised on 1 January 2009, the profit made by the banks (mostly by major banks) is about $223 million ($106 b x 21 bps) in six months to June 2009.

The excess operating profit after tax made by banks in half year to June 2009 as compared to half year to June 2008 was $719 million ($8,949 million - $8,230 million). Assuming other factors constant, nearly 32 percent of the profit ($223 million / $719 million) could be attributed largely to the lower cost of debt due to the government guarantee.

Nearly 90 percent of the $106 billion wholesale funding was for long term. As at the end of June 2009, Government issued 310 certificates under the guarantee of these 147 were for 3 year period ending 2012, 48 for 4 years ending 2013, and 75 for 5 years ending 2014. The remaining 41 were for periods two years or less.

We assume the entire debt was raised for a three year period. Accordingly, the total profit by banks would be of the order of $1.34 billion ($223 million x 6) over three years.

This excludes the profits that the banks could have generated by attracting enormous amount of deposits at lower rates following the deposit guarantee announcement. The table below provides an estimate of the excess deposits attracted by major banks due to the government guarantee.

Table 9: Deposits of major banks ($ billion)

Month	Deposits	Growth rate	Excess Deposits	Excess Deposits
Sept 2007	861			Due to
Dec 2007	931	8.13	70	Guarantee
Mar 2008	949	1.93	18	
Jun 2008	985	3.79	36	
Sept 2008	1066	8.22	81	
Dec 2008	1262	18.38	196	115

(Source for deposits: APRA Quarterly Performance Statistics as above)

Deposits of major banks grew by 18 percent in December 2008 quarter as against by 8 percent in September 2008 quarter ((The figures of growth rate in corresponding period in 2007 were also 8 percent). The excess growth of 10 percent or $115 billion could be attributed to the government guarantee. However, as deposit balances fluctuate quite often, it may be hard to compute the profit made by the major banks on the excess deposits – something which APRA or RBA may like to attempt and are in a better position to determine.

Putting it another way, $1.34 billion is a tax payer funded subsidy for banks – mainly the majors which are the main issuers of the debt. Interestingly, the majors were not prepared to pass on the rate cut citing higher funding costs as already indicated earlier.

The subsidy is a windfall for banks and this taxpayer funded subsidy would be used eventually to pay dividends to bank shareholders and compensation to bank executives!

6. Anti-competitive pricing

Issues have been raised about comparatively lower fee charged by the government to Australian banks. Australian government charges a fee of 70 basis points while the US which charged 75 basis points for its banks have now raised it to 125 basis points (Stutchbury, 2009, p. 10).

While the major banks benefitted the most from the government guarantee (they largely raised the debt and that too at lower fee), the smaller financial institutions were actually put to a disadvantage. The regional banks were required to pay a fee of 150 basis points on wholesale funding as against 70 basis points for the majors. This would directly impact the interest spread of the domestic banks and consequently their profitability.

KPMG (Update 2009, p.3) states ‘The regionals, credit unions and building society sectors all experienced lower profitability in the 2009 financial year to date’.

The fee structure accorded preferential treatment to major banks, when all banks - including the majors – were experiencing liquidity crunch.

KPMG (Update 2009, p.4) rightly points out ‘this has a direct impact on their ability to compete with the majors and is at least part of the reason behind the regional’s 68% decrease in net profit after tax compared to the increase in the majors’ profits in the most recent half year results’.

Edey (2009, July 29) is quoted by media as saying that such risk-based pricing was a deliberate feature of the system. The argument could be acceptable in a normal situation. However, the financial dislocation was faced by all banks - including the majors- consequently the US policy of charging a fee based on the term of the instrument would have been more equitable. Applying risk-based pricing in an abnormal situation was discriminatory against smaller financial institutions.

Government intervention seems to have resulted in increase in profits of the major banks and a significant reduction in profits of smaller financial institutions.

C. Concluding remarks

The blanket guarantee announcement could have far reaching consequences for the Australian financial system.

Major banks gained significantly while foreign banks, regional banks, credit unions and building societies lost not only their market share but also experienced decline in profit. The wholesale funding guarantee alone brought a windfall profit of approx. $1.34 billion to Australian banks –mainly the majors.

The government needs to consider whether the banks could be allowed to retain such tax payer funded subsidy and how best the tax payer could be rewarded for providing this assistance to our major banks.

The guarantee hastened the erosion in competition in the deposit market at the peril of small institutions like credit unions and building societies. Liquidity in the financial system was gravitating and getting stored mainly with the banks which led to extreme action by institutions like the Colonial to freeze withdrawal and created anxiety for consumers at least at that point in time.

In sum, the unlimited deposit guarantee did more harm than good to the Australian financial system. It was unnecessary activism on the part of the government and the decision was probably made without adequate consultation. It would have long term repercussions as moral hazard issues become most relevant when the deposit insurance is unlimited.

The deposit guarantee needs to be rolled back in stages while the wholesale funding guarantee needs to be scrapped as soon as possible.

(Acknowledgement: I acknowledge that the submission greatly benefitted from the comments on earlier version received from Mrs Suneeta Sathye, Lecturer at the University of Canberra, a former central bank employee and my wife).

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