

Australia-New Zealand Shadow Financial Regulatory Committee

Statement Number 6, September 22, 2009

Is a Credible Exit from Government Debt and Deposit Guarantee Programmes Possible?

In this statement ANZSFRC discusses how policymakers should exit from government debt and deposit guarantees initiated in reaction to the recent disruption in financial markets. The statement makes the following points

1. ANZSFRC **believes** that governments should generally avoid providing guarantees. Nevertheless, in circumstances where the absence or removal of a guarantee is not credible, some continuing form of government guarantee may be unavoidable.
2. Where guarantees are unavoidable, ANZSFRC **believes** that they should, as far as possible, be priced to reflect their underlying value. If this is technically difficult, then additional regulatory interventions may be justified.
3. Although ANZSFRC **accepts** that the Wholesale Funding Guarantees introduced by the Australian and New Zealand governments in 2008 may have achieved their desired short-term objective, it is clear that they have adverse implications for banking sector risk and competition.
4. Accordingly, ANZSFRC **recommends** that the Wholesale Funding Guarantee facility should be withdrawn immediately upon confirmation that conditions have “normalised”. Specifically, the Australian and New Zealand governments should, with all due haste, identify a parsimonious set of conditions that define a return to “normal” conditions. As soon as these conditions are satisfied, the governments should not offer any new loan guarantees.
5. Although the adverse effects of deposit guarantees are well known, ANZSFRC **believes** that a return to the claimed *caveat emptor* pre-crisis situation would not be possible. With their governments having introduced Deposit Guarantee Schemes in 2008 prior to any bank failure occurring, Australian and New Zealand depositors are unlikely to view any withdrawal of these schemes as credible.
6. Accordingly, ANZSFRC **recommends** that the Australian and New Zealand governments should replace the current Deposit Guarantee Schemes with versions that promote competition and discourage excessive risk taking.

Background

The global financial crisis of 2007-2009 produced many reactions from governments around the world struggling to protect their economies from the market turmoil. When the magnitude of the crisis became apparent in October 2008, regulatory authorities in Australia and New Zealand introduced schemes to guarantee the liabilities issued by a wide range of financial institutions in their respective countries. The stated intentions of both countries were similar, but their enacted guarantee schemes had differences, despite the same four major banks dominating both markets. One element common to the schemes was their relative novelty – prior to the crisis, neither nation had deposit insurance arrangements in place, almost uniquely among developed nations’ financial systems.

One year on, we examine the principles that should underpin these types of schemes, consider how the implemented schemes have met those principles, and outline what we believe constitute desirable futures for these schemes.

In October 2008, the Australian Government introduced a blanket guarantee on deposits through until October 2011. This was subsequently refined to a scheme in which the first A\$ 1 million was to be guaranteed free of charge, with larger and foreign branch deposits able to be insured for a fee. It is estimated that the guarantees cover more than 16 million deposit accounts in Australia and over 99 per cent of depositors.

At the same time, the New Zealand Government introduced a similar scheme, originally scheduled to operate until October 2010. It differed from the Australian version by being “opt-in” rather than compulsory, by allowing participation from a wider range of financial institutions, and by imposing more risk-sensitive pricing. The initial coverage was NZ\$1 million per deposit-holder per institution, but this was reduced to NZ\$500,000 for bank deposits and NZ\$250,000 for non-bank deposits in September 2009 when the scheme was extended to the end of 2011.

Both governments also introduced unlimited wholesale bank debt funding guarantee schemes available for new borrowings. These schemes were intended to last until conditions normalized and to cover senior unsecured debt instruments with maturities up to 60 months. Both schemes charged risk based fees with the New Zealand charges being generally higher and more risk sensitive (including higher fees for longer maturities).

Principles

In reviewing the options for the future of the loan guarantee and deposit guarantee schemes for Australia and New Zealand, ANZSFRC has based its thinking on a number of guiding principles.

1. Governments should generally avoid providing guarantees, both implicit and explicit. While only sovereigns can provide risk-free guarantees, they do not have a comparative advantage over the private sector in assessing the true risk of

- private sector activities, and hence in the appropriate pricing of guarantees over these activities.
2. Nevertheless, in circumstances where the absence of a guarantee is not credible, some form of explicit government guarantee may be unavoidable. In such a “second-best world”, distortions created by liability guarantees may themselves require other offsetting regulatory distortions
 3. One size doesn’t fit all. In considering the design or removal of guarantee schemes, the problem being addressed needs to be carefully considered. Guarantees over new issues of debt are fundamentally different from guarantees over the stock of existing deposits.
 4. Where guarantees are unavoidable, they should, as far as possible, be priced to reflect their underlying value. If appropriate charges are not levied explicitly, other forms of indirect charges – through regulatory requirements - may be justified.
 5. Rapid access matters.¹ In determining the appropriate “financial safety net” structure (of which loan and deposit guarantees currently form a part), regulatory responses to financial institution failure should involve as quick a resolution as is possible.

Wholesale Funding Guarantees

In both countries, the stated intention of Wholesale Funding Guarantees (WFGs) was to facilitate the continued access of local financial institutions to international financial markets on a scale commensurate with the overall financing needs of their respective countries. In other words, the WFGs were designed to address short-term funding and liquidity issues - rather than solvency problems – created by the global financial crisis. They were introduced because of a “flow” problem arising from the disruption of financing channels in international wholesale debt markets, and were to apply only to the new flow of debt issues

In both countries, eligible financial institutions (henceforth “banks”) are charged on a risk-adjusted basis for accessing the WFG. Although these risk premia are generally higher, and more risk-sensitive, in the New Zealand scheme, the pricing in both countries is essentially arbitrary. However, this is probably unavoidable given the international financial turmoil that, at the time of introduction, had frozen many markets (including those for credit default swaps) and called into question the accuracy of credit ratings on which the pricing of WFGs was based.

Although the WFGs may have had a beneficial impact on the particular short-term problem they were designed to address, it is also clear that they create several medium-term problems: governments are forced to operate in a sphere – insurance – in which they have no particular expertise or comparative advantage; banks are able to avoid disciplines normally imposed by the market; and institutions not covered by the WFG are placed at a competitive disadvantage, potentially leading to increased concentration in the banking

¹ Australia-New Zealand Shadow Financial Regulatory Committee “Managing Bank Failure in Australia and New Zealand: Rapid Access Matters” Statement No. 1, Sydney, December 14, 2006

sector.

Given these problems, ANZSFRC has no doubt about what the future should hold for the WFGs: they should be withdrawn immediately upon confirmation that conditions have “normalised”. Specifically, *the Australian and New Zealand governments should, with all due haste, identify a parsimonious set of conditions that define a return to “normal” conditions. As soon as these conditions are satisfied, the WFGs should cease operating, i.e., the governments should stop offering any new loan guarantees.*

Some will dispute this recommendation. One argument is that the WFGs have provided, thus far, much-needed revenue to governments now faced with years of budget deficits. But this is a false nirvana: such short-term benefits are dwarfed by the long-term costs of a scheme that weakens market discipline, reduces competition, and exposes the government to massive contingent liabilities in an unfamiliar sphere of operations.

Another popular claim is that eliminating the WFGs will force Australian and New Zealand banks to pay the higher returns demanded by foreign creditors on non-sovereign-backed loans and hence erode their competitiveness. But this too has little credence – many Australasian banks are already eschewing the WFGs when tapping foreign markets, suggesting that the additional financing costs are largely (if not totally) offset by avoidance of the costs of WFG access. And because the WFGs only affect the marginal interest cost of new bank wholesale funding and not that of the existing stock, their removal would have little immediate effect on bank risk, and could actually provide a credible signal about the solvency of Antipodean banks.

What about post-WFG? As noted earlier, the WFGs arose from a failure of private credit and credit protection markets, due primarily to asymmetric information issues. The long-term first-best solution would, therefore, be to address and eliminate the information problems. However, doing so is not something achievable by Australia and New Zealand alone, and, indeed, is unlikely to be successfully achieved by international co-ordination – information difficulties may be endemic to financial markets. Consequently, it seems likely that similar crises will occur again in the future, from which a demand for WFGs will inevitably arise. Regrettably, therefore, we envisage a long-term future that involves occasional use of WFGs. This gives rise to the risk that banks will come to see government loan guarantees as a more-or-less permanent part of the financial landscape, with all the adverse consequences for discipline and efficiency that this implies. To preclude this very undesirable outcome, *we recommend that governments develop a (i) transparent and (ii) credible set of conditions that explicitly spell out the circumstances that must exist before the temporary establishment of any future WFG schemes.*

Deposit Guarantee Schemes (Deposit Insurance)

The purpose of Deposit Guarantee Schemes (DGSs) is, in general, to prevent panic and uncertainty from causing bank runs leading to collapses of institutions. They may also be intended, as in the case of Australia and New Zealand on this occasion, to preserve competition by preventing a flight of deposits from smaller institutions into larger ones

that are perceived by depositors either to be sounder or to be “too-big-to-fail”. An additional objective might be to provide a (virtually) risk-free asset for retail savers in order to encourage, or preserve, levels of savings. Unlike WFGs, they apply to the entire stock of eligible deposits, not just new deposits made after the introduction of the guarantee.

The adverse effects of deposit guarantees are well known: they dilute the effects of market discipline, raise the spectre of moral hazard, and potentially encourage the migration of deposits to riskier institutions. These consequences are exacerbated by blanket guarantees that do not distinguish between institutions on the basis of risk.

For these reasons DGSs are not a first-best policy option. Yet, before the crisis, most countries (excluding Australia and New Zealand) had some such scheme in place. Then, facing an increased possibility of deposit flight as a consequence of the global financial crisis, existing schemes were expanded and new ones instituted. We are now in a distinctly second-best world. Having introduced a deposit guarantee scheme, it is difficult – and probably impossible - to credibly exit.

The introduction of DGSs made explicit the implicit guarantee that many depositors in Australia and New Zealand already believed they had, and undercut the credibility of any future claim by governments that they would not bail depositors out. Once guarantees have been used in the emergency manner of this financial crisis, depositors are unlikely to believe that they would never be used again. Realistically, no return to the claimed *caveat emptor* pre-crisis situation is possible. In particular, any attempt to remove the guarantees completely risks significant migration of deposits from smaller institutions to the “too-big-to-fail” banks, reducing competition in the sector and weakening system stability. Of course, governments could try to distinguish between guarantees needed when the entire system is under threat and a limited guarantee scheme covering situations where an isolated institution may fail. But this distinction is difficult to maintain in practice, a problem that depositors will certainly recognize, and respond accordingly.

These changed circumstances mean that while we have previously expressed some ambivalence² about the need for DGSs in Australia and New Zealand, we now accept that the continued existence of some version of such schemes is probably inevitable for the foreseeable future. The challenge is to design a DGS that avoids the worst pitfalls of such schemes.

It should be noted that there is no perfect scheme – there are many possibilities which all involve packages of measures that attempt to offset the known disadvantages of deposit insurance. It is unlikely, for technical reasons, that any post-crisis scheme will be able to charge guarantee fees that fully reflect the benefits to institutions covered and the risks insured. Consequently, *the DGS may need to be accompanied by various measures that mitigate excessive risk taking and support competition*. Examples of such measures could include, but are not limited to:

² Op cit

- limitation on the coverage of guaranteed deposits (perhaps only to transactions deposits), while offering differential pricing of optional insurance for larger and/or non-transactions deposits
- some variation of Prompt Corrective Action to deal with individual failing institutions, i.e. explicit winding up provisions for banks, including large, systemically important ones – which increases risk of loss to bank owners from excessive risk-taking by the bank
- improved disclosure of bank conditions to enhance market discipline
- strict implementation of director liability,
- provision of alternative risk free assets for Australian retail investors (such as risk-free government bonds which are available as Kiwi Bonds in New Zealand).

Whatever features are ultimately established, we recommend that the principles and characteristics of this replacement scheme be announced and introduced as soon as possible, subject to legislative constraints.

Australia-New Zealand Shadow Financial Regulatory Committee

Following the example of the Shadow Financial Regulatory Committees in Asia, Europe, Japan, Latin America and the United States, a group of well known professors from Australia and New Zealand, who are all experts in the fields of banking, finance, and the regulation and supervision of financial institutions and markets, set up the *Australia-New Zealand Shadow Financial Regulatory Committee* (ANZSFRC). The ANZSFRC had its inaugural meeting in Sydney in December 2006 when its first statement entitled “Managing Bank Failure in Australia and New Zealand: Rapid Access Matters” was issued during the 2006 Australasian Finance and Banking Conference.

Co-chairs of the ANZSFRC are Prof. Glenn Boyle and Prof. Kevin Davis. Glenn Boyle is Professor of Finance at the University of Canterbury, Christchurch. Kevin Davis is Professor of Finance at the University of Melbourne and Director of the Melbourne Centre for Financial Studies. They can be reached at glenn.boyle@canterbury.ac.nz and kevin.davis@melbournecentre.com.au.

Members of the Committee

The ANZSFRC currently consists of the following 14 members:

Christopher Adam

Professor of Finance, University of New South Wales, Sydney
Associate Dean, ASB Postgraduate Programs and Director, AGSM, University of New South Wales, Sydney

Jonathan Batten

Professor of Management, Macquarie Graduate School of Management, Sydney

Glenn Boyle

Professor of Finance, University of Canterbury

Steven Cahan

Professor of Financial Accounting, University of Auckland

Jenny Corbett

Professor of Economics, Australian National University
Executive Director, Australia-Japan Research Centre

Kevin Davis

Professor of Finance, University of Melbourne
Director, Melbourne Centre for Financial Studies

Alex Frino

Professor of Finance, University of Sydney

Ian Harper

Professor Emeritus, University of Melbourne; Director, Access Economics

David Mayes

Adjunct Professor, Europe Institute, University of Auckland

John Piggott

Professor of Economics, University of New South Wales, Sydney

Ian Ramsay

Professor of Commercial Law, University of Melbourne

Director, Centre for Corporate Law and Securities Regulation, University of Melbourne
Lawrence Rose

Professor of Finance, Massey University, Auckland

Pro Vice-Chancellor, College of Business, Massey University, Auckland

Alireza Tourani Rad

Professor of Finance, Auckland University of Technology

Chair, Department of Finance, Auckland University of Technology

Andrew Worthington

Professor of Finance, Griffith University, Nathan

Harald Benink (invited member)

Professor of Finance, Erasmus University Rotterdam

Senior Research Associate, Financial Markets Group, London School of Economics

Chairman, European Shadow Financial Regulatory Committee

Statements

Since December 2006 the following statements have been issued:

1. “Managing Bank Failure in Australia and New Zealand: Rapid Access Matters” (Sydney, December 2006).
2. “Lessons from Recent Financial Turmoil”, jointly with the Shadow Financial Regulatory Committees of Asia, Europe, Japan, Latin America and the United States (Copenhagen, September 2007).
3. “Responding to Failures in Retail Investment Markets” (Melbourne, September 2007).
4. “Mortgage Markets after the Sub-Prime Crisis” (Wellington, June 2008)
5. “Making Securitization work for Financial Stability and Economic Growth”, jointly with the Shadow Financial Regulatory Committees of Asia, Europe, Japan, Latin America and the United States (Santiago, August 2009).

Independence of the Committee

The Australia-New Zealand Shadow Financial Regulatory Committee meets approximately twice every year in one of the major cities in Australia and New Zealand. The ‘shadow’ function of the ANZSFRC is related to the Committee’s purpose of following and analysing critically the existing and evolving regulatory framework for financial institutions and markets. At the end of each meeting the ANZSFRC issues a public statement on topics discussed during its meeting and presents this at a conference or briefing session. The Committee is fully independent of the providers, regulators and supervisors of financial services whose behaviour it aims to evaluate.

Analytical Mission

The analysis of the regulatory framework is based on existing and proposed national regulations in Australia and New Zealand, recommendations by international forums such as the Basel Committee and the Group of Thirty, and on relevant academic research in this field. Typically, the Committee tries to translate concepts drawn from academic literature into concrete policy recommendations with respect to certain subject areas.

Worldwide Network of Shadow Committees

The ANZSFRC is part of an emerging worldwide network of Shadow Financial Regulatory Committees (SFRCs). Once every year or two years the Shadow Committees of Asia, Australia-New Zealand, Europe, Japan, Latin America, and the United States meet in a major international city to discuss a theme of common interest, resulting in a joint policy statement. The last joint meeting took place in Santiago (Chile) in August 2009.

The other SFRCs are:

Asian SFRC (www2.hawaii.edu/~fima)

European SFRC (www.ceps.be)

Japanese SFRC (www.econ.keio.ac.jp/staff/masaya/shadow/shadow.html)

Latin-American SFRC (www.claaf.org)

U.S. SFRC (www.aei.org)