POST-IMPLEMENTATION REVIEW

GUARANTEE SCHEME FOR LARGE DEPOSITS AND WHOLESALE FUNDING

THE TREASURY

INTRODUCTION

1. This post-implementation review (PIR) is for the Guarantee Scheme for Large Deposits and Wholesale Funding (the Scheme), which was introduced in October 2008. A regulation impact statement (RIS) was not conducted when the Scheme was first introduced, as the global financial crisis required immediate action from the Government to restore confidence and stabilise financial markets.

2. The Scheme was closed to new liabilities at the end of March 2010 and will cease coverage for all liabilities (i.e. debts and deposits) by October 2015. Therefore, only a PIR is needed for the Scheme and a RIS will not be prepared.

3. The PIR does not consider the impact of the Government's Financial Claims Scheme (FCS), which was introduced at the same time as the Scheme. The Scheme and the FCS are different in substance. The Scheme was a temporary emergency arrangement, will be terminated in 2015, and applies to deposits over $1 million and wholesale funding, with a fee. The FCS is a permanent feature of Australia's depositor protection arrangements, established in the Banking Act 1959, and applied to deposits up to $1 million per depositor, per ADI. A new cap of $250,000 has been in effect since 1 February 2012. The combined PIR and RIS for the FCS was prepared in August 2011 and published on the Office of Best Practice Regulation website.

4. The initial announcement of the Scheme on 12 October 2008 did not include the $1 million threshold and the fee structure; the threshold and the fee structure were announced by the Treasurer on 24 October 2008; but the fee structure applied from 28 November 2008. This means that all deposits and wholesale funding were guaranteed without a charge only for approximately one and half months. Given the long term of wholesale funding and large deposits, the brevity of this period means the market could take very limited advantage and there is insufficient data available to make meaningful observations. Therefore, the PIR will not consider the impact of the Scheme without a fee separately.

5. The Scheme has achieved its designed objectives, such as restoring bank funding access and market confidence, stabilising financial markets, and ensuring flow of credit to real economy, which will be discussed in the PIR along with the Scheme's parameters. The PIR will focus on the impact analysis and the lessons learned.

Defined Problems and objectives

6. Over the course of 2007 and 2008, global financial markets sharply deteriorated. After the collapse of Lehman Brothers in September 2008, the financial crisis escalated dramatically. Faced with rising default risk, confidence in financial institutions plummeted around the globe. In September and October 2008, authorities in G20 nations including the US, UK and European countries, responded with extraordinary policy measures, including enhanced protections for depositors, guarantees of financial institutions' wholesale funding, recapitalisation of major financial institutions, injections of liquidity into financial markets, and coordinated interest rate cuts. However, these actions taken by other governments to shore up their financial institutions' access to funds would potentially put Australian institutions at a competitive disadvantage to their overseas counterparts.

7. Australia's financial system was relatively well placed to withstand the turbulence in credit markets as the global financial crisis unfolded. The banking system was, and remains, profitable and well capitalised, with minimal direct exposure to sub-prime assets and failed overseas financial institutions. Up until September 2008, Australian authorised deposit-taking institutions (ADIs) were still able to raise funds to finance their lending through deposits and long and short-term wholesale funding, albeit at wider spreads and shorter terms than prior to the crisis.

8. However, the Australian financial system was however being affected by the global events. The virtual freezing of international wholesale funding markets in September and October 2008 threatened the ability of Australian financial institutions to access funding market and created acute funding pressure for ADIs, including major banks, and posed potential risks to liquidity and stability in the financial system and the supply of finance to the Australian economy.

9. ADIs' access to funding is important, not just for the health of individual institutions and the stability of the financial system, but also to ensure the continued flow of credit to Australian household and business borrowers. Given the fundamental role of credit in supporting household consumption and household and business investment, the freezing of credit flows had the potential to restrict Australia's economic growth significantly, with consequential implications for employment and living standards.

10. In addition, notwithstanding the relative strength of Australia's financial institutions, the confidence of investors and depositors in Australian ADIs was shaken by the escalation of the global financial crisis. Their confidence was fragile following the failures of a number of large international institutions.

11. Confronted with these problems, on 12 October 2008, the Australian Government announced that it would make arrangements to guarantee the deposits and wholesale funding of ADIs. The objectives of the Scheme were clear: to restore ADIs' funding access to wholesale funding market; to restore investors and depositors' confidence in Australian ADIs; to stabilise the Australian financial system; and to secure the credit flow to the Australian economy.

The Scheme

Legal Framework

12. The Scheme is implemented using a contractual framework rather than through legislation. Under section 61 and 64 of the Australian Constitution and Regulation 9, 10 and 14 (at the time) of the Financial Management and Accountability Act 1997, the Government executed a Deed of Guarantee in respect of the Australian Government Guarantee Scheme for Large Deposits and Wholesale Funding. The deed came into effect on 28 November 2008. Before that date, an interim Deed of Guarantee was in effect.

13. The Government released the Guarantee Scheme for Large Deposits and Wholesale Funding Rules (the Scheme Rules) that commences on 20 November 2008. ADIs using the Scheme are required to comply with the rules.

14. The deed was prepared by the Australian Government Solicitor (AGS) on the instructions of the Treasury. Treasury has consulted the Australian Prudential Regulation Authority, the Reserve Bank of Australia (RBA) and the Australian Securities and Investments Commission on the terms of the deed and the accompanying Scheme Rules.

Guarantee Fee Threshold

15. The Government initially guarantee all deposits without a threshold. However, members of the Council of Financial Regulators (CFR) gave advice about the possible implications for the short term money market, including the RBA's domestic market operations, if deposits were to enjoy a free guarantee while commercial short-term debt securities up to 12 months were subject to a guarantee charge. Large and sophisticated investors may regard large deposits and wholesale securities as competing investment products.

16. To address this issue, the CFR proposed that a threshold be imposed on the deposit guarantee, which was announced by the Government on 24 October 2008 and implemented on 28 November 2008. Depositors who hold amounts above the threshold would be charged a fee in order to receive the benefit of the guarantee. Having consistent arrangements across large deposits and short-term wholesale securities would ensure minimum distortion on investors' decisions.

17. It was expected that the perceptions in the broader community would be that amounts exceeding $1 million would be consistent with the commercial or the wholesale segment of the market. The $1 million fee threshold was chosen to reduce the potential for adverse impacts on the short term money market.

Coverage

18. The Scheme covers, for a fee and on an opt-in basis, aggregate deposits over $1 million per customer, per institution held with Australian-incorporated ADIs, providing the deposit is at call or with a term of up to 60 months.

19. It also encompasses the guarantee of wholesale funding, comprised of a short-term wholesale funding guarantee (for securities with a maturity of up to 15 months) and a long-term funding guarantee (for securities with maturities of 15 months up to 60 months).

20. The short-term wholesale funding guarantee is available to all ADIs in Australia, including foreign bank branches which are branches of foreign banks not incorporated in Australia. The instruments eligible for coverage are restricted to bank bills, certificates of deposit, transferable deposits, certain debentures and commercial paper (for short-term liabilities of up to 15 months in maturity). Foreign bank branches can access the short-term guarantee, subject to certain limits and conditions.

21. The long-term wholesale funding guarantee is limited to Australian-incorporated ADIs. The guarantee includes the foreign branches of eligible Australian-incorporated ADIs but not their foreign subsidiaries. The instruments eligible for coverage are senior bonds, notes and certain debentures, with a term of up to 60 months. The guarantee applies for the full term of the relevant security including in the period following the closure of the scheme to new issuances.

22. For both the short-term and the long-term guarantee, only senior unsecured debt instruments of a non-complex nature issued by ADIs are eligible. This is intended to ensure that the guarantee is only used in relation to standard, 'plain vanilla' securities. The 'not complex' guidelines reduce the risk to the Government in providing the guarantee.

23. Same to the arrangements of large deposits, access to the Scheme for wholesale funding is voluntary and subject to approvals.

Fee Structure

24. The application of a fee provides an incentive for ADIs and their investors to cease using the Guarantee Scheme as market conditions normalise. It also helps to mitigate any impacts of the guarantee on the markets for other financial assets.

25. For guaranteed large deposits, the fee is payable by the ADI, based on the amount of deposits that the ADI nominates as covered by the Scheme. The fee only applies to the amount of each customer's total deposits above $1 million that is guaranteed. It is up to each ADI to determine the arrangements it makes with its customers, including whether and to what extent it passes the fee on to customers.

26. Consistent with the advice of the CFR, the fee schedule comprises a single rate fee for eligible large deposits and wholesale debt instruments, regardless of their term, with a different rate applying to eligible institutions based on their credit rating (Table 1).

Table 1: Guarantee Scheme fee schedule

Credit rating	Fee per annum
AA- and above	70 bps or 0.7 per cent
A- to A+	100 bps or 1.0 per cent
BBB + or below and unrated	150 bps or 1.5 per cent

27. Table 1 provides the fee per annum for ADIs with a credit rating of AA negative and above; A negative to A positive; and BBB positive or below and unrated to be .7%; 1.0%; and 1.5%, respectively.

28. The pricing was designed, as far as possible, to reflect market pricing, to reflect the risk borne by the Commonwealth. The risk-based fees were set with reference to risk spreads observed in financial markets for institutions with different credit ratings. It helps to ensure that ADIs of all ratings have incentives to exit the guarantee arrangements as market conditions normalise. This approach can also minimise any unintended consequences for other debt markets.

Closure

29. The Scheme was designed to be temporary. In announcing the Scheme on 12 October 2008, the Government indicated that it would be withdrawn once market conditions have normalised.

30. On 7 February 2010, the Government announced the withdrawal of the Scheme. The CFR advised that removing the Scheme would not materially affect banking sector funding costs. At that time, Australian banks had been able to wind bank their use of the Scheme, such that the bulk of their long-term debt issuance in middle and later 2009 had been unguaranteed. Since July 2009, ADIs have started their buyback of guaranteed liabilities. In addition, use of the large deposit guarantee had continued to decline. Clearly, bank funding conditions had improved such that the Guarantee was no longer need. In addition, most G20 countries had already removed their guarantee or would do so shortly.

31. The final date for ADIs to apply for access to the Scheme is 24 March 2010. From 31 March 2010, the Scheme will cease coverage to new issuance of deposits and liabilities. Existing guaranteed liabilities of ADIs will continue to be covered by the Scheme to maturity for wholesale funding and term deposits, or to October 2015 for at call deposits.

Impact Analysis

ADIs' Funding

32. The Scheme has successfully helped ADIs raise funds. ADIs raised approximately $43 billion and $75 billion guaranteed funds in December 2008 and January 2009 respectively. Since that time, their guaranteed funding had been increasing steadily and reached the peak in February 2010. At the height of the usage of the Scheme (February 2010), total guaranteed funds raised were approximately $170 billion, including funds raised by non-major ADIs of approximately $65 billion.

33. Under that extreme distress, the Scheme has played a critical role in assisting Australian ADIs to re-enter the global credit market. Aided by the Scheme, Australian ADIs raised long-term wholesale funds in nine different currencies at generally narrowing spreads between December 2008 and June 2009.

34. The AA rated major ADIs have been the largest users of the Scheme. The big four banks (all AA rated) have accounted around 60 to 70 per cent of total guaranteed liabilities. At the Scheme's closure, 31 March 2010, they had approximately $101 billion guaranteed funds. This is to be expected given their relative large size and their historic reliance on long term debt for their funding.

35. However, non-major banks have also been benefited. They have raised more guaranteed long term issuance relative to their stock of outstanding bonds than the major banks. In July 2009, long term guaranteed issuance of AA rated banks represented around 30 per cent of their stock of long-term bonds on issue as at September 2008; whereas long term guaranteed issuance of non-major banks (A rated and BBB rated) represented around 50 per cent of their stock of long-term bonds on issue as at September 2008.

36. While a significant number of A-rated, BBB-rated and unrated institutions have not raised wholesale funding at all under the guarantee, this is consistent with historical patterns of issuance. That is, most of these institutions did not source their funding via wholesale markets prior to the global financial crisis.

37. Banks were able to issue bonds in larger amounts and with longer maturities than had been possible since mid-2007, both in Australia and abroad. The average term of guaranteed debt has been approximately four years, around one year longer than during the months leading up to the crisis. Around one-third of all guaranteed long-term funding has been raised in Australian dollars, while the remaining two-thirds have been raised in foreign currencies. This is also consistent with the historical pattern of issuance. In contrast, nearly two-thirds of short-term guaranteed funds were denominated in Australian dollars, with the remaining one-third denominated in foreign currencies. More than 90 per cent of guaranteed deposits over $1 million were in local currency.

38. Banks and other ADIs have been generally supportive of the Scheme. Mr David Bell, the previous CEO of Australian Bankers' Association agreed that the wholesale guarantee was a prudent measure.[1] Westpac commented 'not to have done so would have put at risk the ability of our banking system to raise funds in capital markets.' [2] Regional banks, such as Bank of Queensland was very supportive of the Scheme. [3]

39. All short-term wholesale liabilities matured in March 2011. Since July 2009, ADIs have started their buyback of guaranteed liabilities. Until February 2012, around $15 billion guaranteed securities have been bought back. As at February 2012, approximately $100 billion liabilities was guaranteed in total, comprised $3 billion in large deposits and $97 billion in long-term wholesale funding.

40. Under the Scheme Rules, fees are payable on the average daily value of guaranteed liabilities over the preceding month. For January 2012, institutions participating in the Scheme paid guarantee fees of $72 million, taking the cumulative fees paid to $3,382 million.

Non-ADIs

41. Non-ADI financial institutions do not have access to the guarantees as they are not permitted to accept deposits and are not subject to prudential regulation. It is difficult to disentangle the impact of the crisis and the impact of the guarantees on those non-ADIs.

42. ASIC data indicates that the first mortgage trust fund was frozen in January 2008, well before the introduction of the guarantees. The RBA and APRA have noted that the 'trend of outflows from mortgage trusts was well established from early in the year'.[4] An October 2010 ASIC review suggests that a significant amount in fund assets was frozen before the announcement of the guarantees.

43. After the guarantees were introduced, the asset levels of finance companies, relative to ADIs, declined. This is consistent with the increased attractiveness of the ADI sector, as a result of its guarantees eligibility, but also with the security offered by prudential regulation.

44. Investors' reduced appetite for instruments issued by non-ADIs was already evident prior to the introduction of the guarantees, as a result of the broader financial crisis. RBA data indicates that the assets of finance companies relative to ADIs were falling before the guarantees were introduced, from 5.5 per cent in September 2007 to 5.3 per cent in September 2008.[5] In early October 2008, Australian Finance Conference had reports from various members that an increasing number of depositors and investors had been enquiring about the soundness of the institution and the safety of their deposit or investment. Money was starting to be withdrawn before the Scheme.[6]

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[1] Mr David Bell, Chief Executive Officer, Australian Bankers' Association, *Proof Committee Hansard*, 14 August 2009, p16.

[2] Westpac, *Submission* to the Senate Economic References Committee, 2009.

[3] Bank of Queensland, *Submission* to the Senate Economic References Committee, 2009.

4 Reserve Bank of Australia and Australian Prudential Regulation Authority, *Inquiry by the Senate Economics References Committee into Bank Funding Guarantees – Joint Submission from the RBA and APRA*, 24 July 2009, p6.

5 Reserve Bank of Australia, *Banks Assets B2* and *Finance Companies & General Financiers Selected Assets and Liabilities B10* at http://www.rba.gov.au/statistics/tables/index.html, accessed 08 July 2011.

[6] Australian Finance Conference, *Submission* to the Senate Economics References Committee, 2009.

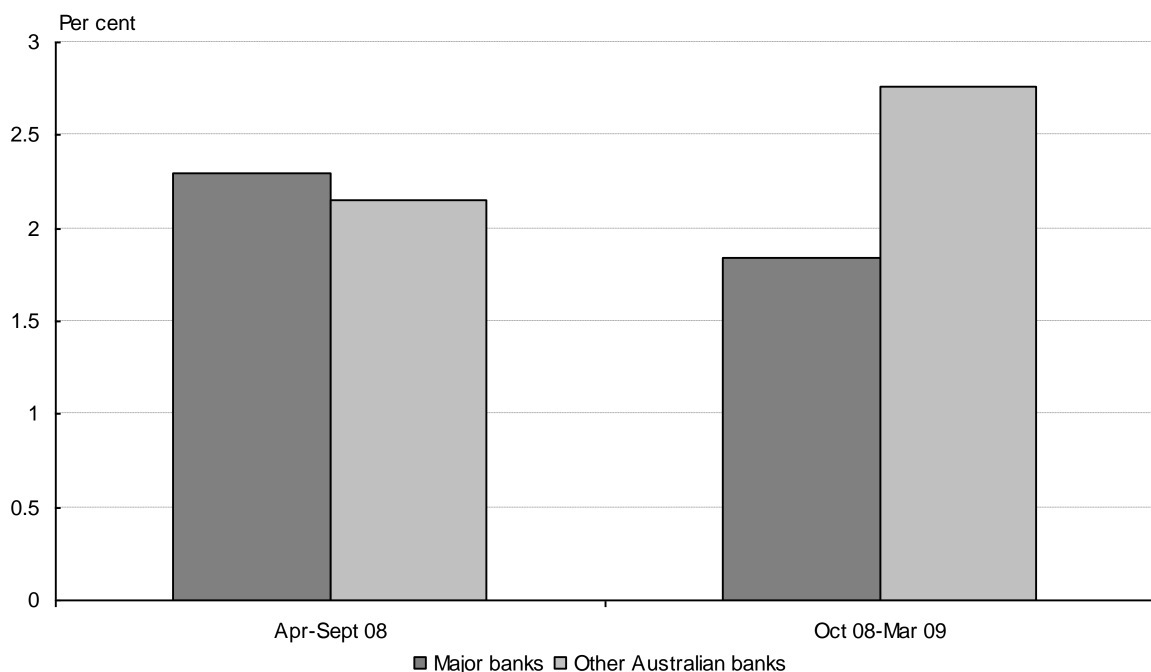
45. The outflow trend of non-ADI financial institutions is likely to have continued in the absence of the Scheme and the FCS, given the reduction in investor confidence and increased risk aversion following the collapse of Lehman Brothers in September 2008.

Deposits

46. Banks experienced strong growth in deposits from May 2008, as investors sought refuge from the volatility in investment markets. Growth in deposits (excluding certificates of deposit) held at banks increased sharply over the second half of 2008 and accelerated in October 2008 (rising by 5.7 per cent in the month). This 'flight to quality' also manifested in movements of deposits from some smaller institutions to the major banks, potentially impacting on smaller institutions' ability to finance their lending activities.

47. The introduction of the Government guarantees on deposits immediately stemmed these outflows of deposits from certain smaller institutions, and is likely to have contributed to strong aggregate deposit growth in the fourth quarter of 2008. Deposits grew by an average of 2.4 per cent per month in the December quarter 2008. Moreover, deposit growth has been more broad-based across the ADI sector since the guarantee was introduced, with deposits at non-major banks growing at a faster rate than those at the major banks (Graph 1).

Graph 1: Average growth rate of deposits (excluding certificates of deposit)



Source: APRA

48. Graph 1 shows the average growth rate of deposits for major banks and other Australian banks for the period of April to September 2008, and October 2008-March 2009. The average growth in deposits decreased amongst major banks between these two time periods, and increased amongst other Australian banks.

States' Borrowings

49. After the introduction of the Scheme, state financing authorities raised concerns that the Scheme was affecting their access to debt markets.

50. Funding costs for state governments increased relative to the Commonwealth Government both before and after the announcement of the Scheme. The crisis had also made investors more sensitive to risk before the introduction of the Scheme. In addition, subsequent to the announcement of the Scheme, the credit rating of Queensland was downgraded from AAA to AA+ and NSW released a mini-budget.

51. The Scheme made the debt issuances from ADIs a closer substitute to debt issued by state governments through giving ADI debt issuance the highest credit rating, which is comparable to the States' credit ratings. However, other differences between the debt issuances remained. For example, state government debt issuance included bonds with longer maturities.

52. On 25 March 2009, the Government announced that it would provide a temporary, voluntary guarantee over State and Territory government borrowing to assist these governments to continue to access funding in light of the considerable financial market turbulence. A fee of between 15 and 35 basis points applied to the face value of guaranteed borrowings. New South Wales and Queensland chose to utilise the Australian Government Guarantee of State and Territory Borrowing.

53. On 7 February 2010, the Government announced that the State Guarantee would close to new issuance on 31 December 2010. Guaranteed liabilities which existed on the 31 December 2010 remain guaranteed until their maturities.

RBA

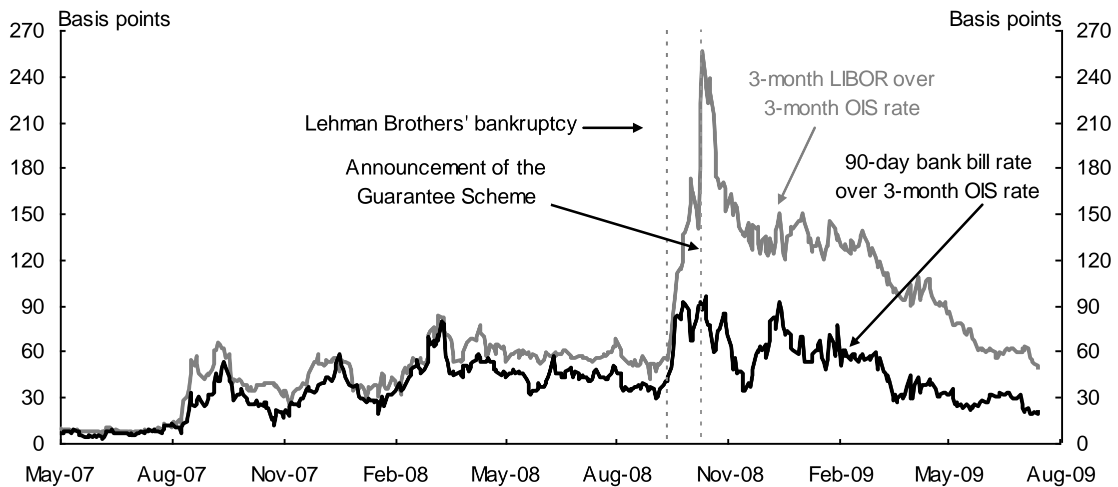
54. Under a deed signed by the Treasury and RBA, RBA is the administrator of the Scheme on behalf of the Government. Since the introduction of the Scheme, RBA allocated a team for the administrating the Scheme. They has been successfully managing the Scheme and collecting guarantee fees. It also has the duty to update the Scheme website where it is appropriate.

55. So far, RBA has released two papers on the Scheme in March 2009 and March 2010 respectively.

Financial System Stability and Market Confidence

56. The unprecedented global action in response to the escalation in the financial crisis, including the announcement of the deposit and wholesale funding guarantees by the Australian Government, had an immediate favourable impact on confidence and financial system stability. Key credit spreads, which had skyrocketed after the collapse of Lehman Brothers in September 2008, have continued to narrow following these announcements (Graph 2).

Graph 2: Key credit spreads in Australia



Sources: Bloomberg and RBA

57. After a period of gradual decline at the beginning of 2009, key credit spreads have fallen more rapidly over the following few months, in many cases returning to levels last experienced prior to the Lehman Brothers bankruptcy (Graph 2). Similarly, measures of household and business confidence have shown signs of significant improvement. The Westpac-Melbourne Institute Consumer Sentiment Index has increased by close to 40 per cent since July 2008.[7]

58. The impact of Australia's guarantee arrangements on confidence, financial stability and economic growth has been recognised internationally. For example, the International Monetary Fund noted that the Government's ADI guarantees have bolstered confidence in the financial system and allowed credit to continue to flow to the economy during the global financial crisis.[8]

59. Westpac commented 'the schemes have assisted in preserving confidence in the Australian banking system, and in maintaining the supply of credit in the economy at close to pre-crisis levels.'[9] Other ADIs have generally shared the same view.

Competition in Banking

60. The global financial crisis has impacted on the competitive dynamics of the banking system. Financial system participants whose business models relied on the cheap and ready availability of wholesale credit faced difficulties raising funds at commercially viable rates of interest when the credit cycle turned. As a result, from mid-2007, a number of financial institutions were forced to exit the market, merge with stronger entities, or relinquish market share to entities with more diversified sources of funding.

61. While the shift in competitive dynamics and market share began well before the introduction of the guarantees, concerns have been raised that the guarantees primarily benefit Australia's major banks, in part reflecting their high usage of the guarantees when measured in absolute terms. At the other end of the spectrum, concerns have also been raised that the guarantees have reduced the ability of non-ADI financial institutions to compete as they are not eligible for the guarantee arrangements (details in non-ADIs section).

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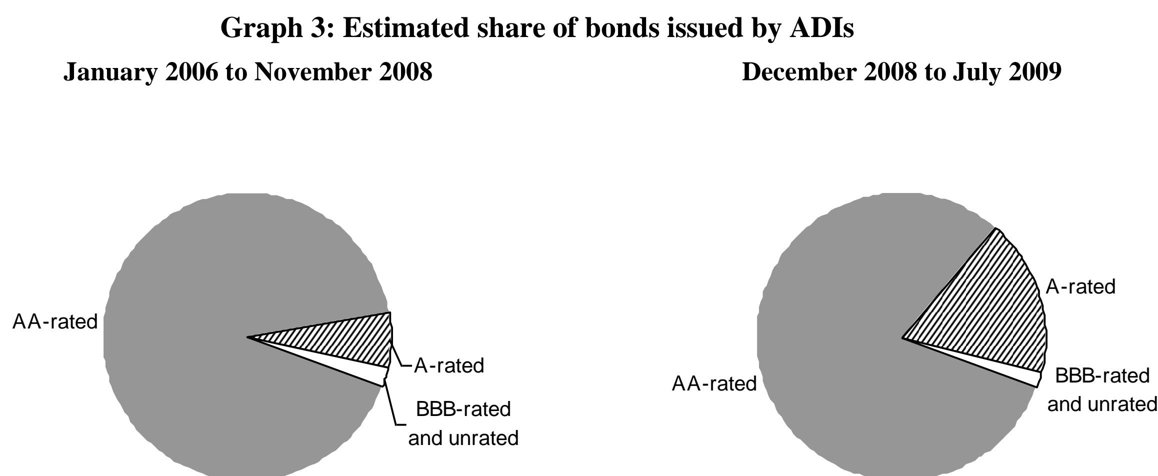
[7] The Westpac-Melbourne Institute Consumer Sentiment Index – increase from 79.0 per cent in July 2008 to 109.4 per cent in July 2009.

[8] Australia—2009 Article IV Consultation, Concluding Statement, 23 June 2009.

[9] Westpac, *Submission* to the Senate Economic References Committee, 2009.

62. The Scheme has supported access to funding for all ADIs which is required for new lending; this improves competitive pressure in lending markets. The Scheme are available to all 189 (at that time) eligible Australian ADIs. By providing broad coverage, the guarantees benefit a significant number of financial institutions that, collectively, represent the bulk of the banking services industry, thus supporting competition among a wide range of participants. Australia's major banks account for a significant proportion of total liabilities covered by the guarantees, reflecting the size of their balance sheets relative to smaller ADIs. However, as mentioned, access to the Scheme enabled the non-major ADIs to increase their share of wholesale debt issuance (Graph 3).

Graph 3: Estimated share of bonds issued by ADIs



Source: Bloomberg

63. Graph 3 provides the estimated share of bonds issued by ADIs for the periods of January 2006 to November 2008 and December 2008 to July 2009. Between these two periods, the share of AA and BBB and unrated bonds decreased, while the share of A rated bonds increased.

64. In relation to non-ADI financial institutions, the financial system regulatory framework has long distinguished between ADIs and non-ADIs, in relation to both the protections afforded investors and the regulatory imposts on the institutions. While extending the guarantees to non-ADIs would arguably assist them to compete, it would also provide such entities with an unfair and distortive competitive advantage relative to prudentially regulated institutions, because they are not subject to the same regulatory restrictions and compliance burdens as those which are prudentially regulated.

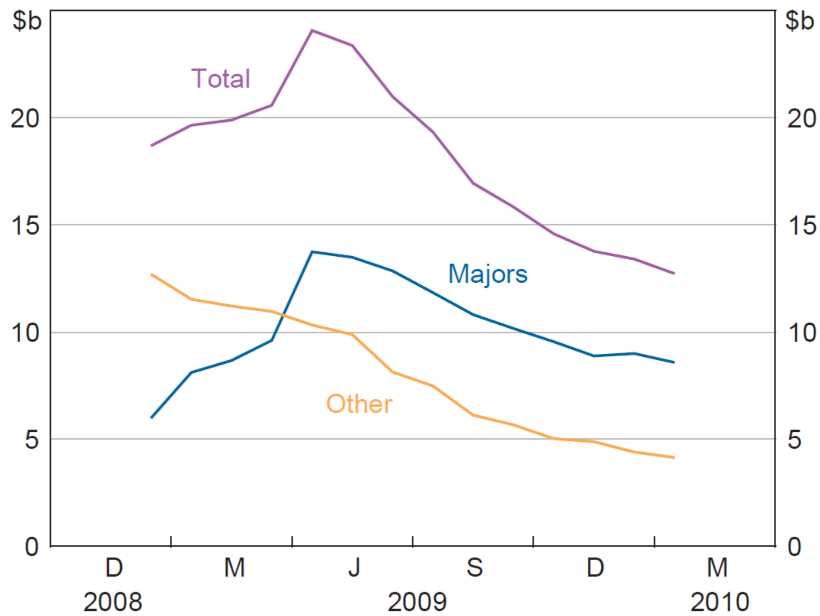
Closure Impact

65. As the market conditions tended to be normalised and few ADIs relied on the Scheme to raise funding, the Government announced the closure of the Scheme to new issuance in March 2010.

66. Early use of the Scheme for large deposits was encouraged by the market turbulence and the pricing practices of a number of ADIs that were absorbing all or some of guarantee fee to attract or retain customers. However, as concerns eased, ADIs became less willing to absorb the fee, and customers similarly became less inclined to pay for the additional security over what was already a low-risk investment. Although the bulk of ADIs have at least one Eligibility Certificate issued by RBA to offer guaranteed large deposits to their customers, only one-quarter of these institutions had a non-zero balance in January 2010. The value of deposits

covered under the Scheme amounted to only around 1 per cent of total deposits. The guaranteed large deposits had dropped steadily, from approximately $25b at the beginning of the June quarter 2009, to approximately $13b in the March quarter of 2010 (Graph 4).

Graph 4: Guaranteed Large Deposits*

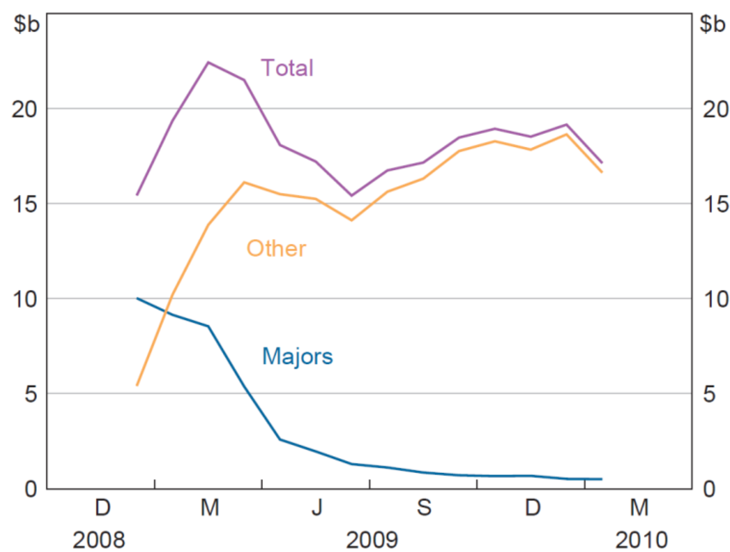


*Average daily values guaranteed under the Scheme

Source: RBA

67. A similar fall in use, though less pronounced, is evident in the value of guaranteed short-term wholesale liabilities (Graph 5). After peaking in February 2009 at $22.4 billion, guaranteed short term wholesale funding has fallen to average $17.1 billion in January 2010.

Graph 5: Guaranteed Short-term Debt*

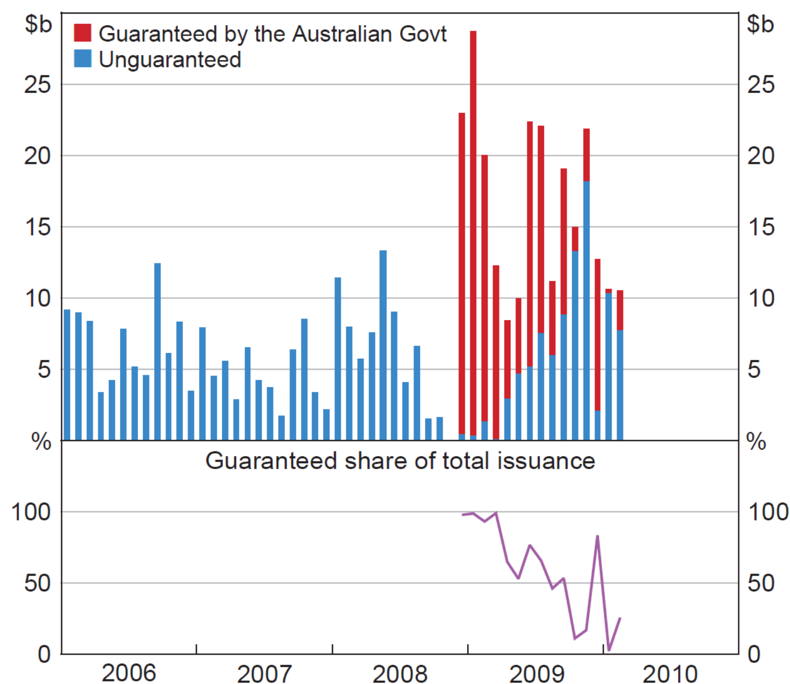


*Average daily values guaranteed under the Scheme

Source: RBA

68. The predominant users of the Scheme have been long term liabilities. As the conditions gradually eased and by the June quarter 2009 investors were again purchasing unguaranteed bonds. The share of guaranteed bond issuance has steadily decreased with the improving conditions – from close to 100% at the end of 2008 to approximately 20% in early 2010 (Graph 6).

Graph 6: Australian Banks' Bond Issuance*



*Average daily values guaranteed under the Scheme

Source: RBA

69. In addition, since middle 2009, ADIs, including majors and non-majors, have started buying back guaranteed long-term debts. The less reliance on the Scheme and the buying back activities mean that funding conditions were improving to a point where the Scheme was no longer needed.

70. As expected, the Scheme closure did not have a significant impact. This was proved by the little inaction from the market after the closure announcement.

71. A significant number of guaranteed liabilities will mature from 2012 to 2014, which is an extended period of time for ADIs to implement their funding strategies to replace the guaranteed debts. Therefore, when the Scheme finally terminates in 2015, the impact on all stakeholders and related areas is expected to be minimal.

Consultation

72. Due to the urgency to respond to the rapidly deteriorated crisis conditions, there was limited consultation taken in the design of the Scheme's parameters. The CFR members consulted thoroughly among themselves and with other government departments and then provided the recommendations to the Government.

73. However, following the announcement of the introduction of the guarantees, the CFR members and the Government consulted with the industry and key stakeholders on the further design of the Scheme, such as the guarantee fee threshold.

74. The industry raised their concerns that the possible outflow of funds from the short term money market into deposits given that the deposit guarantee was free and the wholesale funding guarantee was being provided at a cost. The industry was also consulted on the number of the threshold. The $1 million threshold was announced afterwards on 24 October 2008.

Conclusion - Lessons Learned

75. The Scheme was introduced in response to the extraordinary developments during the global financial crisis. It has made a positive and important contribution to the stability of the Australian financial system and the growth of the Australian economy by ensuring that ADIs continued to have access to funding markets during the most intense phase of the crisis. It has also ensured that the overall availability of funding has not been a material constraint on the capacity of Australian banks to lend and, for a time, served to mitigate the large increase in the cost of issuing debt.

76. Despite the success of the Scheme, there are a couple of lessons can be learned from the design and the management of the Scheme, which could contribute to future policy development.

Pre-announced Closing Date

77. The Government committed to closing the Scheme once market conditions normalised. The Government took the advice from the CFR on the appropriate timing of the closure of the Scheme. This was contrast to most other jurisdictions which announced explicit closing dates for their schemes.

78. Experience showed that in most major jurisdictions, pre-determined closing dates were pushed back as the consequences of the crisis endured. This undermined the credibility of those dates. However, once it became clear that conditions were improving (in late-2009) authorities began to implement scheme closures in, for example, the US, UK, Korea, and France.

79. Australia's approach allowed it to take into account international developments and market conditions in determining the appropriate timing of closure of the scheme. The approach of not having a pre-determined closing date was proven to be working effectively.

Fee Structure

80. Guarantee Scheme fees vary by credit rating, but not by maturity. The fee rates were set in October-November 2008 at a level between the then current price – the product of stressed conditions – and the price likely to prevail in more normal market conditions. This was to provide a basis for a natural exit mechanism, with the expectation that at some point investors would no longer be willing to accept the lower yields on guaranteed paper and banks would therefore no longer seek to guarantee their debt. Some jurisdictions varied the fee according to the term of guaranteed issuance, while others used other market based indicators, such as credit default swap prices, to set fee rates.

81. The tiered fee structure led to concern that the Scheme harmed competition by providing a relative benefit to the major banks. One aspect was that depositors would shift funds from small to large ADIs. There was little evidence of this occurring and demand for the large deposit guarantee was relatively low. The second aspect was that investors were looking through the government AAA-rating on guaranteed bonds and continuing to discriminate between ADIs on the basis of their credit rating. Smaller ADIs argued that this meant they were effectively being charged twice.

82. The proposed remedy was to flatten the fee across all ADIs on the basis that they were low default risk and subject to strong regulation. However, this approach has a risk that ADIs would take advantage of the low guarantee fees and excessively use the Scheme – opportunistic fund raising. That would significantly increase the financial risk of the Government and moral hazard risk of ADIs.

83. The Scheme fee structure represents the recommendations of the CFR in terms of the need to maintain a risk spectrum and to protect the Commonwealth in terms of the risks it was taking by guaranteeing the fund raising by a wide range of ADIs. It has provided an incentive for ADIs to gradually increase their issuance of non-guaranteed term funding as yield spreads had declined; helped to minimize the government contingent liability associated with the Scheme.

Level of Scrutiny of Applications

84. Other jurisdictions applied more stringent eligibility standards (eg UK, later US scheme). Given the relative health of the Australian banking sector and the high levels of usage, consideration could have been given to impose tougher conditions on applicants (eg demonstrating a need to use the guarantee) although this approach may have stigmatised participating institutions to their detriment.