Submission to the Financial System Inquiry

A review of the hidden costs and unintended side effects of explicit and implicit government guarantees of the Australian Financial System

And

Proposed policy responses to minimise competitive distortions and imbalances

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Executive Summary

Since the global financial crisis, the Basel Committee on Banking Supervision has devised numerous reforms to ensure that taxpayers will never again have to rescue banks teetering on the brink of collapse. Yet despite these moves explicit and implicit government exposures to banks are substantial and are distorting competition.

In Australia, the introduction of the Financial Claims Scheme, that provides a government guarantee of deposits held in A$s with ADIs incorporated in Australia per deposit-holder up to $250,000 as well as to policyholders of general insurance companies, is distorting the structure of household financial decision-making in regard to the relative competitive position of authorised deposit-taking institutions versus other financial market participants in the savings, lending and investment markets.

The RBA and APRA have agreed to allow participating Australian ADI's to partly fulfil the incoming Basel 111 Liquidity Coverage Ratio by paying a 15 basis point fee for a Reserve Bank committed liquidity facility. The RBA is clearly viewing the CLF as a liquidity facility only and pricing it accordingly with no margin for credit risk. However; as there is no liquid market for RMBS the facility is really a credit facility and therefore needs to be priced as such. With the tax-payer subsidised cost advantage to the banks (of taking advantage of the CLF rather than purchasing government bonds) being approximately 150bps based on current market yields, the annual cost of the subsidy to taxpayers amounts to $4.5Billion.

D-SIBs [i.e. the big four banks] do not pay for the benefits they derive from the market-perceived implicit government support which, as the IMF noted in its report on Australia's 2012 Financial Sector Assessment Program, include lower funding costs than their competitors.

In contrast to their smaller rivals, the D-SIBs are now regarded by credit rating agencies and investors alike as "too-big-to-fail". The D-SIBs get the benefit of credit ratings that have been explicitly lifted two notches higher than they would otherwise be the case. The introduction of the "covered bond" has been another market distorting development. Securing their covered bonds with billions of dollars of home loans has allowed the four AA- rated D-SIBs to win rare AAA ratings for their funding at the expense of unsecured lenders.

On 23 December 2013, APRA released a framework for D-SIBs, belatedly recognising that there is a market perception that the D-SIBs are too big to fail and that this should not be the reality. Unfortunately the APRA determined 1% higher loss absorbency (HLA) capital requirement effective 1/1/2016 that must be met from common equity tier 1 capital for the domestic systemically important D-SIBs does not sufficiently level out the competitive landscape.

D-SIBs share of estimated system wide $9.44Bn of annual subsidies	Estimated annualised dollar cost
Financial Claims Scheme – D-SIBs share of absence of ex-ante fee	$0.34Billion
Committed Liquidity Facility – under-pricing of fee	$3.0Billion
Too Big To Fail implicit government guarantee (funding advantage)	$2.5Billion
Setting the loss absorbency capital requirement at 1% instead of 3% in line with US, UK and other jurisdictions.	$1.8Billion
Aggressive RWA calculations for competitive advantage.	$1.8Billion
Aggregate tax payer funded subsidies.	$9.44Billion per annum

Policy Response Recommendations to mitigate the competitive distortions caused by the largely tax-payer funded FCS and the implicit 'too big to fail' guarantee and IRB models are:

1. Replace the FCS with a European style bank funded bail-out fund;
2. Establish a market owned mortgage insurer, "AusMorgij.";
3. Encourage greater consistency and objectivity in the credit rating of ADIs and of securities issued by ADIs;
4. Introduce an ex-ante fee for the FCS guarantee to reduce the cost to taxpayers and surviving institutions;

5. Reduce the cap on guaranteed deposits and restrict the guarantee to non- D-SIBs.

Alternative policy responses to the announced introduction of a Committed Liquidity Facility in Australia:

1. Revisit the pricing of the CLF;
2. Renew and strengthen the focus on internal ADI liquidity management;
3. Continue strengthening disclosure requirements;
4. Ensuring a risk based profitability framework permeates all functions and levels of ADIs;
5. Mandating the introduction of an external audit process for the quantification of risk embedded in the loan assets of all ADIs by independent expert risk analysis firms such as MARQ Services.

Policies to promote greater consistency in RWAs calculated by ADIs operating under Basel 11 Internal Ratings Based Approach (IRB):

1. APRA should consider narrowing the modelling options available to D-SIBs operating under IRB approach;
2. Introduction of a system of ongoing model vetting by the regulators;
3. Regularly conduct a Hypothetical Portfolio Exercise (HPE) to ensure consistency of RWA calculations under the IRB approach;
4. Revisit the simplified, standardized approach of Basel 1 to RWA determinations;
5. Improve transparency of models, data, and assumptions for independent, standardised analysis.

In summary, if Australia is to avoid the prospect of future tax-payer funded bailouts of ADIs, restore market confidence in ADI capital adequacy and risk measurement and analysis processes, and to eliminate the competitive distortions from explicit and implicit government guarantees then radical policy adjustments are urgently required including the establishment of a domestic market owned mortgage insurer and funding vehicle, "AusMorgij" and improved disclosure and transparency of internal RWA models, data and assumptions.

Explicit Guarantee #1 – The Financial Claims Scheme

According to APRA, the administrator of the scheme, the purpose of the Financial Claims Scheme (FCS) is to protect depositors of authorised deposit-taking institutions and policyholders of general insurance companies from potential loss due to the failure of these institutions.
For ADIs, the scheme provides protection to depositors up to the limit of the scheme ($250,000 per account-holder per ADI) and seeks to provide depositors with timely access to their deposits in the unlikely event of the failure of their ADI. An Australian Government guaranteed deposits seal has been developed. ADIs can choose to display this seal to help customers easily understand that their deposits are protected under the FCS.

Market distortion is resulting from the tax-payer funded FCS call option style guarantee

The Financial Claims Scheme is distorting the structure of household financial decision-making in regard to the relative competitive position of authorised deposit-taking institutions versus other financial market participants in the savings, lending and investment markets. In 2008 Macquarie Bank closed its $10Billion cash management trust and re-established the fund as an on balance sheet cash management account citing the planned introduction of the FCS as a key consideration. Given Australia's legislated depositor preference that applies in the event of a liquidation of an ADI, the FCS really is only of value to the smaller ADI because the D-SIBs, MBL, Suncorp have so much wholesale funding that is subordinated to deposits that the risk is extremely low given the continuation of the depositor preference in the event of the liquidation of an ADI.

A user pays system of deposit insurance is a logical alternative to the explicit government guarantee that would assist in reducing the competitive disadvantage of other financial market participants vis-à-vis ADIs that currently receive a government guarantee with no ex-ante fee payable; while leaving the Government (i.e. taxpayers with a potentially substantial unfunded liability). By not levying an ex-ante fee on ADIs for the FCS the government have effectively handed a tax-payer subsidy conservatively estimated to be worth $500million (assuming a 10bps fee on $500Billion of eligible deposits and further assuming that 68% of these deposits are held with D-SIBs). The credible pro-financial system competition policy option of a establishing a market owned mortgage insurer is expounded later in our policy responses section of this report.

Australia is also unusual compared with the rest of the world in that it has a system of legislated depositor preference. This means that depositors get preference over other unsecured creditors if an ADI fails. In the event of insolvency, banks would have to wipe out all of their profits and capital, and nearly half of their assets, before depositors incur a loss.

Depositor preference was introduced in the Banking Act 1945 but initially applied only to depositors in banks. The provision was extended to depositors in all Australian ADIs in 1998 following a recommendation from the Financial System Inquiry (1997). In addition, the responsibilities for prudential regulation and depositor protection were transferred from the RBA to APRA and broadened to encompass all ADIs, in accordance with the Inquiry's recommendations. Depositor preference arrangements were subsequently altered in 2008 upon the introduction of the FCS.

With the introduction of the FCS the definition of depositors who are protected by legislated depositor preference as well as for the FCS itself has altered. The definition of an "account holder" has now been aligned to the Income Tax Assessment Act 1997 definition of entity –

- an individual;
- a body corporate;
- a body politic;
- a partnership;
- any other unincorporated association or body of persons;
- a trust;
- a superannuation fund; and
- an approved deposit fund.

Where an account holder holds multiple accounts with one ADI the FCS applies per account-holder per ADI. It is applied on an aggregated basis across all eligible deposit accounts held by an account-holder with an ADI.

The FCS applies to deposits held with ADIs incorporated in Australia. This includes: Australian banks, building societies and credit unions; and foreign subsidiary banks.

The FCS applies to a wide range of deposits held with ADIs, including:

- savings accounts;
- call accounts;
- term deposits;
- current accounts;
- cheque accounts;
- debit card accounts;
- transactions accounts;
- personal basic account;
- cash management accounts;
- farm management deposits;
- pensioner deeming accounts;
- mortgage offset accounts, either 100 per cent or partial offset, that are separate
- deposit accounts;
- trustee accounts;
- retirement savings accounts; and
- first home saver accounts that are deposit accounts.

Significantly, the FCS only applies to deposits denominated in Australian dollars.

Explicit Guarantee #2 - Introduction of a low cost secured committed liquidity facility

The RBA and APRA have agreed to allow participating Australian ADI's to partly fulfil the incoming Basel 111 Liquidity Coverage Ratio by paying a 15 basis point fee for a Reserve Bank committed liquidity facility. The CLF will enable participating ADIs to access a pre-specified amount of liquidity by entering into repurchase agreements with the RBA. For the purposes of the CLF, the Reserve Bank will allow ADIs to present certain related-party assets issued by bankruptcy remote vehicles, such as self-securitised residential mortgage-backed securities (RMBS). The RBA is clearly viewing the CLF as a liquidity facility only and pricing it accordingly with no margin for credit risk. However; as there is no liquid market for RMBS the facility is really a credit facility and therefore needs to be priced as such.

Concerns raised by market commentators include the assertion that the pricing has been set too low with reference solely to a liquidity premium alone and that there is an absence of a credit risk premium. The cost of the CLF is very low i.e. 15bps pa, compared to the alternative. The CLF allows ADIs to originate mortgage assets and create RMBS rather than buying government bonds. With the Bloomberg Australia Sovereign Bond Index having an effective yield of 3.55% as at 10th February 2014 the net spread on mortgage assets or RMBS compared to government bonds is approximately 150bps or 10 times the CLF pricing point of 15bps per annum.

By proceeding with the 01/January/2015 commencement of the CLF the RBA and APRA run the very real risk of fostering even more of the excessive risk-taking financial activities that they and their international counterparts are seeking to reduce. By permitting ADIs to fulfil their LCR requirements by self-issuing RMBS's that are a class of security that as recently as 2007 – 2010 were in the bullseye of the US sub-prime mortgage crisis and wiped out $3.4trillion of US private savings alone and were clearly inappropriately awarded investment grade credit ratings by the world's "leading" credit rating agencies, the temptation for return on equity incentivised bank executives to fuel a housing finance bubble is likely to prove irresistible given the $300billion tax-payer subsidised backstop on offer from the RBA. With the tax-payer subsidised cost advantage to the banks (of taking advantage of the CLF rather than purchasing government bonds) being approximately 150bps based on current market yields, the annual cost of the subsidy to taxpayers amounts to $4.5Billion.

Implicit Guarantee – Perception that the D-SIBs are too big to fail.

D-SIBs do not pay for the benefits they derive from the market-perceived implicit government support which, as the IMF noted in its report on Australia's 2012 Financial Sector Assessment Program, include lower funding costs than their competitors. The IMF estimated that the funding cost advantage rose from 80 basis points to 120 basis points during the GFC, when government support for the banking system was made more explicit. The IMF says the D-SIBs enjoy implicit government support because of their systemic importance based on size, interconnectedness, and complexity. But banks that are 'too big to fail' distort competition and create new risks because they are backed by an implicit taxpayer guarantee.

In contrast to their smaller rivals, the D-SIBs are now regarded by credit rating agencies and investors alike as "too-big-to-fail". The D-SIBs get the benefit of credit ratings that have been explicitly lifted two notches higher than they would otherwise be the case because Standard & Poor's thinks they alone can depend on "extraordinary government support" in a crisis. This helps them raise money much more cheaply than their smaller peers, which in turn means it is almost impossible to compete effectively against them. Size thus begets more size.

When borrowing from the RBA, banks have to provide collateral. Included in the list of "eligible" assets the RBA will accept as collateral is any senior debt issued by an Australian bank that has an acceptable credit rating of BBB+ or higher, which excluded the debts issued by smaller regional banks and building societies. Since the D-SIBs were amongst the few that qualified for the RBA's funding, this helped further support investor demand for their bonds, and thus lowered their cost.

The introduction of the "covered bond" has been another market distorting development. The regulators allow banks to issue loans to investors that are secured by specific bank assets. The investors thus have a claim on these assets that ranks ahead of everybody else, including deposit holders. Securing their covered bonds with billions of dollars of home loans has allowed the four AA- rated D-SIBs to win rare AAA ratings for their funding at the expense of unsecured lenders.

The smaller banks do not have the D-SIBs credit ratings, which, as noted earlier, are lifted higher because the implicit too-big-to-fail guarantee. As the smaller banks have far lower credit ratings, they would have to pledge many more assets to secure a BBB+ or higher rating for their covered bonds – CRAs have too much power of cost and composition of bank balance sheets

The covered bond selling programs of the D-SIBs runs into the billions of dollars and has created a new ultra-safe, domestic asset-class. The competitive effect of these covered bond issues has been to make every other bond, including the unsecured, more lowly-rated bonds offered by smaller banks and building societies, more expensive. Covered bond issuance by two D-SIBs in the last quarter of 2014 raised $65Billion in funding. Taking the mid-point of the credit spread advantage of 25-50bps to the D-SIBs of approximately 35bps the funding advantage accruing to the D-SIBs is $910Million assuming annualised cover bond issuance of $250Billion.

Based on APRA and RBA figures the amount of wholesale funding for the D-SIBs was $700Billion at the end of 2013. Assuming the funding cost advantage derived by the D-SIBs compared to smaller ADIs by virtue of the implicit government guarantee and resultant credit rating uplift is 35bps,(which is a far more conservative estimate than the 80bps-120bps estimated by the IMF) then the current annualised funding cost advantage (i.e. subsidy) to the D-SIBs (inclusive of the $910million covered bond funding advantage) is approximately $2.5billion.

APRA introducing loss absorbency capital requirement for D-SIBs.

On 23 December 2013, APRA released a framework for domestic systemically important banks in Australia, belatedly recognising that there is a market perception that the big four banks are too big to fail and that this should not be the reality. Unfortunately the APRA determined 1% higher loss absorbency (HLA) capital requirement effective 1/1/2016 that must be met from common equity tier 1 capital for the D-SIBs does not sufficiently level out the competitive landscape and is at the minimum of the 1-3% range recommended by Basel 111. By allowing the D-SIBs to hold the minimum HLA capital, APRA is effectively providing the D-SIBs with a subsidy equivalent to 2% of their capital. With the D-SIBs in aggregate currently holding approximately $90Billion in tier 1 capital the annualised value of this effective subsidy is $1.8Billion. It is interesting to note that financial system regulators in other jurisdictions, including the US, UK, Sweden and Singapore have set their HLA capital requirement at 3%.

In the Australian banking system the normal risk / return trad-off has been flipped 180 degrees. The apparently lowest risk banks with the highest credit ratings consistently produce much higher ROEs than their smaller rivals. Clearly taxpayer funded subsidies are working for the benefit of shareholders and executives of the D-SIBs whose compensation is often linked to artificially high ROEs and in some cases, run to bonuses in the millions of dollars and even 10s of millions of dollars for CEOs.

Policy responses to mitigate the competitive distortions caused by the largely tax-payer funded FCS and the implicit 'too big to fail' guarantee and IRB models

To eliminate competitive imbalances the Government should remove the explicit guarantees offered to ADIs and the regulators need to make it very clear to the market that the "too big to fail" implicit guarantee has been abandoned in favour of free market discipline. The optimal way of achieving theses outcomes would be the introduction of policy responses 1, 2 and 3 below. Should it be deemed necessary to retain the FCS due to the international pervasiveness of deposit insurance, and agreement regarding its role as part of the core financial infrastructure, making any non-conformity with international norms an issue, then we propose that policy proposals 4 and 5 be introduced to augment the preferred policy options of 1, 2 and 3.

1. Replace the FCS with a European style bank funded bail-out fund.

In Europe a 55bn-euro fund is being established, financed by the banking industry over 10 years. The deal is aimed at minimising the need for taxpayer funded bailout. The ASX has operated a broker funded guarantee fund for decades to protect investors from the failure of a member firm.

2. Establish a market owned mortgage insurer and funding vehicle, "AUSMortgage."

A mortgage insurer owned by the market with backstop reinsurance for catastrophic loss provided by the government. The insurer would only insure loans sold to a central vehicle that pools the loans and securitises them. Loans would be assessed for risk and capital requirements using MARQ Services credit scores. Because of the markets first loss position the establishment of a private mortgage insurer will allow ADIs outside of the D-SIBs to be very competitive on mortgage pricing and profitability. In addition to providing mortgage insurance, AUSMortgage would act as a funding vehicle that purchases mortgages from non D-SIBs and funds them in the capital markets after insuring and securitising the mortgage pools.

3. Encourage greater consistency and objectivity in the credit rating of ADIs and of securities issued by ADIs.

While this is the topic of a separate research report (Credit Rating Agencies – Do their business models need to change in order to resolve conflicts of interests?), key recommendations would be to encourage credit rating agencies and specialist financial instrument risk quantification firms, such as MARQ Services, to issue credit opinions and credit scores that are quantitatively generated via fully transparent models; rather than rely solely on full blown credit ratings that the firm being rated has paid for.

4. Introduce an ex-ante fee for the FCS guarantee to reduce the cost to taxpayers and surviving institutions.

Payouts of deposits covered under the FCS are initially financed by the Government through a standing appropriation of $20 billion per failed ADI (although it is possible that additional funds could be made available, if needed, subject to parliamentary approval). The amount paid out under the FCS, and expenses incurred by APRA in connection with the FCS, would then be recovered via a priority claim of the Government against the assets of the ADI in the liquidation process. If the amount realised is insufficient, the Government can recover the shortfall through a levy on the ADI industry. This ***ex post*** method of funding FCS payouts contrasts with the ex-ante approach that is more common in other jurisdictions. An ***ex-ante*** approach involves charging deposit-taking institutions fees for the provision of the deposit guarantee, with the size of the fee typically determined either as a fixed proportion of an individual institution's insured deposits or based on an institution's assessed risk of failure. The ***ex-***

ante approach reduces the possibility that surviving institutions or taxpayers are burdened by a shortfall from the liquidation of a failed institution's assets.

Determining the appropriate fee level would be complicated by the continuing effects of market perceptions of implicit government guarantees of bank bond instruments.

5. **Reduce the cap on guaranteed deposits and restrict the guarantee to non- D-SIBs.**

   The current size of the cap, at a$250,000, is far in excess of the amount required to protect the deposits of most investors. The number of retail depositors with deposit account balances greater than $50,000 is relatively small. Moreover; cover for special situations, such as, large temporary deposits i.e. from the sale proceeds of a principal residence or to fund payrolls could be written into the guarantees. If the government and regulators are serious about promoting fair competition, then one way to eliminate the competitive advantages currently bestowed on the D-SIBs and to clearly signal to the market that the "too big to fail" implicit guarantee has been unequivocally revoked is to restrict the application of the FCS to Australian- ADIs excluding the D-SIBs.

Alternative policy responses to the announced introduction of a Committed Liquidity Facility in Australia

1. **Revisit the pricing of the CLF** to reduce the embedded taxpayer subsidy and to better reflect both liquidity and credit risk premiums.

2. **Renew and strengthen the focus on internal ADI liquidity management** including rigorous multiple scenario analysis and stress testing as proposed in APRA's draft May 2013 Prudential Standard APS 210.

3. **Continue strengthening disclosure requirements** for central bank repo. According to the Australian Securitisation Forum, The biggest development in our market over the past six months has been the introduction by the Reserve Bank of Australia (RBA), Australia's central bank, of RMBS data transparency requirements. This includes transaction, security and loan-level data, as well as requirements in relation to cash-flow waterfall models. Issuers of RMBS – or their information providers – will need to complete this data and make it publicly available in order for their securities to be

eligible for repurchase agreement (repo) with the RBA. This includes existing open market operations as well as the RBA's committed liquidity facility (CLF). This increased transparency requirement should also be extended to encompass all mortgages on ADI balance sheets.

4. **Ensuring a risk based profitability framework permeates all functions and levels of ADIs** from individual loan approval to incentivising staff and executives using a Return on Risk Adjusted Capital (RORAC) framework.

5. **Mandating the introduction of an external audit process for the quantification of risk** embedded in the loan assets of all ADIs by independent expert risk analysis firms such as MARQ Services.

Policies to promote greater consistency in RWAs calculated by ADIs operating under Basel 11 Internal Ratings Based Approach

Calculating RWAs under Basel II is highly complex, which increases the potential for different interpretations, and offers limited transparency. The formula relies on many parameters, with key inputs such as Probability of Default (PD), Loss Given Default (LGD), Exposure at Default (EAD) and Maturity (M). Indeed, as the Bank of England's Haldane recently observed; "the number of risk buckets has increased from around seven under Basel I to, on a conservative estimate, over 200,000 under Basel II. To determine the regulatory capital ratio of this bank, the number of calculations has risen from single figures to over 200 million. The quant and the computer have displaced the clerk and the envelope." Moreover; due to the market perceived implicit guarantees, the D-SIBs are able to be aggressive on RWA calculations effectively deriving yet another publicly provided subsidy. Revisions to models used by the D-SIBs that operate on the IRB approach have contributed to a significant slowing in the rate of growth in RWAs from 15% pa in 2008 to 4.5% in 2013. International studies of variations in RWA calculations by the IMF and BIS have not been able to determine the underlying reasons for changes made to Internal Ratings Based (IRB) model assumptions and have raised questions about D-SIBs aggressively lowering RWAs to gain competitive advantage. Assuming that the D-SIBs are deriving a 2% lower capital requirement from aggressive RWA calculations there is an effective $1.8Billion subsidy.

1. **APRA should consider narrowing the modelling options available to IRBs** for example by mandating the use of standardized data length and correlation assumptions.

2. **Introduction of a system of ongoing model vetting by the regulators** to ensure that changes to models are warranted and are not merely designed to artificially lower RWAs to gain a competitive advantage.

3. **Hypothetical Portfolio Exercise (HPE)** - Establish an ongoing external model audit process using standardized, hypothetical portfolio that is maintained and updated by MARQ Services, an independent provider of financial risk quantification services to ADIs. Each ADI will be asked to calculate Probability of defaults to determine RWAs on a quarterly basis. Each ADI will receive an analytics report demonstrating graphically how its risk assessment calculations compare to the mean of the study's responses with standard deviations also indicated to clearly indicate dispersion of risk calculations by participants in the HPE.

4. **Revisit the simplified, standardized approach of Basel 1 to RWA determinations –** e.g. 50% for residential mortgages as a way of restoring investor confidence in the capital adequacy framework.

5. **Improve transparency of models, data, and assumptions for independent, standardised analysis.**

Summary

In summary, if Australia is to avoid the prospect of future tax-payer funded bailouts of ADIs, restore market confidence in ADI capital adequacy and risk measurement and analysis processes, and to eliminate the competitive distortions from explicit and implicit government guarantees then radical policy adjustments are urgently required including the establishment of a domestic market owned mortgage insurer and funding vehicle for non D-SIBs, "AUSMortgage" and improved disclosure and transparency of internal RWA models, data and assumptions.

Acknowledgements

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