National Financial Crisis Contingency Planning

Governments internationally, Australia included, have been making financial crisis contingency plans on the run. This process, necessary as it is, involves significant risks.

One is that of making poor decisions with adverse long term implications for financial structure and efficiency. Another is that hurried design involves arrangements which risk either excessive costs to taxpayers or unwarranted dilution (or expropriation) of bank shareholders. Implications for future financial sector competition and structures is a third.

Prime Minister Rudd's announcement of guarantees of deposits, bank debt and additional government purchases of RMBS raise a number of such issues.

Like the US TARP scheme, the proposal to buy RMBS, focuses primarily upon "unfreezing" financial markets by providing liquidity to the system.

Details of both schemes are still emerging, but a critical design question relates to what types of purchase arrangements are implemented. For example, if an auction system is to be used, should successful bidders receive their bid price, or should all successful bidders receive the highest successful price? Both theory and experience tells us that the design of auction arrangements matters.

The US approach is also being questioned on the grounds that the fundamental problem has moved on from one of liquidity to a need for bank recapitalizations. In Europe, Britain has addressed this issue with its recent proposals which many have labelled as "nationalization".

This involves significant risks of transfers of value between taxpayers and bank shareholders (with the direction depending on the "price" involved). Recapitalization if necessary, should have Government provision of equity capital as the last resort.

This could be achieved by requiring rights issues of shares by banks, underwritten by Government, at a near pre-announcement market price. Only if existing shareholders were unwilling to take up their entitlements would government become a "shareholder of last resort".

Australian banks are well capitalized, and such steps currently unnecessary. (And it would not be feasible for the mutual credit unions and building societies, but they generally have even stronger capital adequacy positions). But hopefully, some such contingency arrangements are carefully filed away in our regulatory agencies.

Another international crisis response has been to increase deposit insurance guarantees – in some cases to 100 per cent. Australia has now joined this club – from a prior position of being one of only two OECD nations not in the deposit insurance club.

Depositor preference arrangements mean that deposits in Australian ADIs (banks, building societies and credit unions) are, in the absence of a run by depositors, extremely safe. But depositors can be fickle creatures, and the authorities have judged that that risk of panic was sufficient to warrant such dramatic measures.

It may, however, give inappropriate signals about the perceived underlying strength of Australian ADIs, and rectifying this by hurrying along annual profit releases of the major banks warrants consideration.

Why a three year horizon for deposit guarantees was chosen (and whether that means a terminating maturity date of October 2011 or guarantees over any three year deposit accepted over the next three years) is yet to be explained. How competition and merger policy in banking is to be applied in this environment is also to be explained.

Depositor preference has a flip side – other creditors of banks rank behind depositors. Australian banks borrow heavily in international debt capital markets (thereby being a principal mechanism for funding our balance of payments deficit) and investors in such subordinated debt are currently very spooked.

Our banks face potential risks to their longer term competitive position and stability if forced by necessity to borrow at temporarily very high spreads in international debt markets. And the risk that sentiment may worsen and funding simply be unavailable is not zero.

Here, contingency planning could have involved the Australian Government issuing debt into the international markets, and subsequently on-lending the funds to Australian banks (perhaps even being a nice arbitrage play for the government).

Instead the Government has opted to guarantee bank debt, if requested by banks, for an insurance premium, yet to be determined. This achieves a similar result, although the devil is in the yet to be announced detail, One issue is the appropriate premium to be charged, and potential stigma for any bank requesting insurance.

Another issue is why, as appears to be the case from the PM's statement, outstanding, rather than only new, issues of bank debt can be guaranteed. The critical issue is the cost of new debt financing, rather than the price of secondary trading of "old debt" – unless this is seen as important for the functioning of international capital markets.

There is much devil in the detail in introducing such crisis response measures. The general, broad, measures announced should prevent the feared "melt-down". Time will quickly tell whether Australian policy makers have been better prepared in developing the detail than their international counterparts appear to have been.

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