Unwinding Financial Guarantees

Government guarantees of financial institution liabilities distort the workings of the financial sector- but in a crisis may be preferable to a non-functioning financial sector. Minimizing the undesirable distortions and winding-back broad guarantees is an urgent policy challenge which the Government has now started to address.

Ensuring confidence in the core of the financial system, the Authorised Deposit Taking Institutions (ADIs), is fundamental given their roles as a "safe haven" for investors and providers of payments services. But when community risk aversion is high, investors will respond to perceived changes in relative risk created by selective government guarantees.

The most obvious impact of blanket deposit guarantees has been on those managed funds previously seen as relatively close substitutes for deposits. Faced with mass outflows, unlisted funds face liquidity crises when assets cannot be easily sold.

Property and mortgage trusts are prime examples, but even cash funds face problems in current market conditions. In the US, the Government is buying assets from cash funds to prevent them "breaking the buck". Such a drastic step is hopefully not needed in Australia if cash funds are able to access the RBA's repurchase facilities – pledging such securities against RBA loans of cash to meet outflows.

But the unlisted property and mortgage trusts face a major problem – as they did in the early 1990s when the fundamental inconsistency in their business model was previously exposed – and not properly resolved.

It is challenging, to say the least, to offer investors the option to withdraw funds when assets held are large scale, illiquid, property investments or mortgages. Credit lines from a friendly bank (if one can be found) help, but the security demanded worsens the leverage and unit values of remaining unit-holders and does little to prevent further runs.

Ultimately, freezing redemptions to allow an orderly asset sale (or panic to subside) is necessary as a temporary solution. Unfortunately, in dysfunctional markets, valuation problems limit the scope for government purchases of assets (or their use as collateral for loans) as a resolution mechanism. Ultimately, conversion to listed entities enabling market mechanisms to establish unit values and provide an exit mechanism for investors is a preferred solution which the Government should be seeking to hurry along.

Another effect has arisen from the "mercantilist" nature of government guarantees which provide implicit subsidies only to local institutions. Indeed, free trade in banking services has been a casualty of international responses to the crisis.

In this regard, the decision to extend the fee-based guarantee option to funds raised by local foreign bank branches from Australian residents has some merit on competitive equality grounds.

But whether the fees proposed, for both domestic and foreign bank debt issues and large deposits, adequately compensate Australian taxpayers for the risk involved, and do not further harm the position of non-bank competitors will be a matter of some debate. The proposed fees of 70 and 100 basis points for AA and A rated banks (p.a. it is assumed – but not explicitly stated) are well below recent market spreads (of 200 plus and 300 plus basis points respectively) over the government bond rate.

They are above the 56 and 67 basis point average AA and A spreads in the three boom years leading up to the crisis, and thus closer to "normal" historical averages which would seem appropriate for measures designed to restore some measure of normality to financial markets.

But what "normality" means in the new financial order is an open question – and careful monitoring of demand for guarantees and adjustment of guarantee charges will be required. And at a technical level, setting equal fees for guarantees of (large) deposits and debt – when the former rank ahead of the latter under depositor preference legislation – seems inappropriate, although of second order importance in the current environment.

Comment [KD1]: This could go if space is an issue

The expansion of the "risk free space" will also be compounded by the likely increased issuance of government debt to offset the planned purchase of mortgage backed securities by the Government's Office of Financial Management. And the supply of risk-bearing corporate debt is likely to further decline with intermediated financing via the banks being cheaper – even if (as is likely) the banks do not pass on much of the benefits of the below-market guarantee fees.

Comment [KD2]: This could go if space is an issue

Placing a cap on automatically guaranteed deposits (even if at far too high a level of $1 million) is a positive move. A further desirable step in the current circumstances would be to charge a fee for all deposit guarantees and allow ADIs to issue categories of both guaranteed and non-guaranteed deposits. The differential interest rates demanded by depositors would provide useful signals of trends in consumer confidence, the appropriate pricing for deposit guarantees, and fee based guarantees would impact less adversely on the rest of the financial sector.

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