

A sign of strength - Government withdraws Bank and State guarantee

Economic note

8 February 2010

- In a sign of confidence in the Australian banking system, the Commonwealth government has announced that its guarantee of Australian banks wholesale funding and large deposits will be withdrawn on 31 March 2010.
- This move comes as the use of the guarantee to raise money in global markets by the banks has fallen significantly in recent months and, as such, the impact on bank funding costs is likely to be small.
- The Commonwealth has also announced the withdrawal of its guarantee scheme for State-government bond issues, but not until 31 December 2010.
- This longer time-frame will give the States time to build up liquid lines of non-Commonwealth guaranteed bonds to ensure a smooth transition for the market.
- While the Commonwealth guarantee of both Australian bank and State-government debt was a vital part in seeing Australia through the worst of the global financial crisis, the decision to withdraw the guarantees should be seen as a sign of the strength of the local economy and financial system – strengths that still remain in short supply in many other countries around the world.

A sign of strength – Withdrawal of Bank guarantee on 31 March 2010:

As the impact of the global financial crisis swept across the world's financial markets in October 2008, the Australian government implemented a guarantee (on 12 October 2008) of wholesale funding and deposits of Australian banks (authorised deposit-taking institutions or ADIs). Given that Australian ADIs had traditionally raised a significant amount of their required funding from international markets, and that other countries around the world had implemented similar schemes, this guarantee was a very necessary step to ensure the ongoing strength of the local financial system and the flow of credit to the economy.

It seems fair to say that the Commonwealth's guarantee of bank funding has been one of the key factors that helped Australia outperform other developed nations through the global recession.

Yesterday the Commonwealth Treasurer announced that the Commonwealth guarantee for large deposits (i.e. over A\$1m) and wholesale funding would be withdrawn on 31 March 2010. (Note: this decision does not affect the Financial Claims Scheme, which will continue to guarantee deposits by Australians up to A\$1m until the cap is reviewed in October 2011).

Government estimates are that the banks in Australia have raised approximately A\$160bn under the scheme since its introduction, while the second-tier banks had raised around A\$32bn. The banks had paid to the government around A\$1.1bn in fees and would pay a total of approximately A\$5.5bn in total over several years to use the guarantee.

The decision by the government to withdraw the guarantee comes at a time where the major banks have substantially reduced their borrowing under the system and, despite recent concerns over sovereign credit - especially in Europe; the strength of the Australian banking system is well recognised in global markets.

The decision to withdraw the guarantee was taken by the government under advice from the Council of Financial Regulators – which includes the RBA, Treasury, ASIC and APRA. The Council advised the government that “funding conditions have improved such that the guarantee is no longer needed, and that no Australian institution will need the guarantee to fund themselves.” The Council also advised that “removing the guarantee will not materially affect banking sector funding costs.”

These conclusions seem appropriate when observing the two charts below, both from last week’s “Statement on Monetary Policy” from the RBA. They show both a clear trend to tighter spreads for bank funding and a dramatic reduction in the use of the guarantee by the banking system to raise funds in both domestic and global markets.

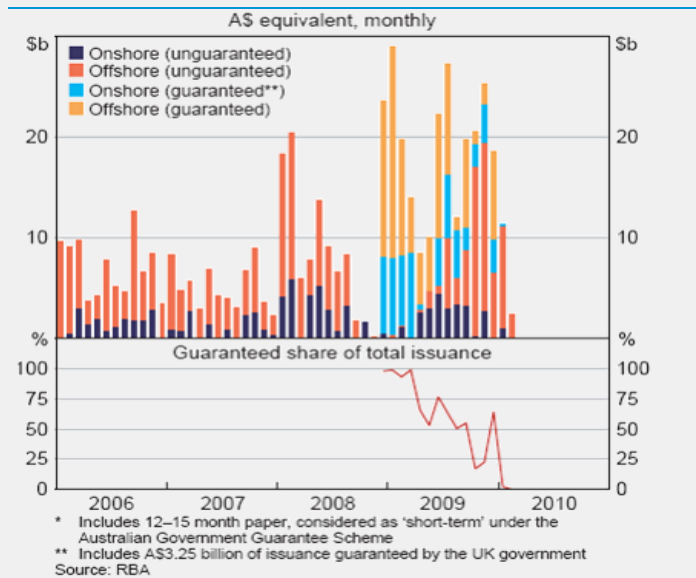
In the press conference announcing the decision, the Treasurer stated that “there will be absolutely no justification, because of the withdrawal of the guarantee, for any bank to raise interest rates beyond any Reserve Bank movements. No justification whatsoever.” – that seems like a pretty clear message!

The Treasurer has also noted that “existing guaranteed liabilities of ADIs will continue to be covered by the government to maturity for wholesale funding and term deposits, or to October 2015 for at call deposits.”

Major Australian banks bond pricing* and use of guaranteed debt



Australian banks’ bond issuance*



State Guarantee to go on 31 December 2010:

The Treasurer yesterday also announced the withdrawal of the Commonwealths (voluntary) guarantee of State government debt. As shown in the chart below, the global financial crisis also led to a dramatic increase in the relative cost of debt for the Australian States – despite the fact that the States remained highly rated and that a strong implicit Commonwealth guarantee was imbedded in markets.

To ensure a flow of fund to the States, in part to help fund nationally significant infrastructure projects, in late March 2009 the Commonwealth government announced that it would offer an explicit guarantee to State government debt. This guarantee was, however, voluntary in nature and in fact was only used, for both existing and new debt, by NSW and Queensland – the States with the largest borrowing needs.

Nevertheless, the Commonwealth offer of a guarantee on State debt played a very important part in stabilising and then improving the demand, both locally and globally, for State government debt which has, in turned, helped State/Commonwealth bond spreads narrow sharply from their highs – as has shown in the chart below.

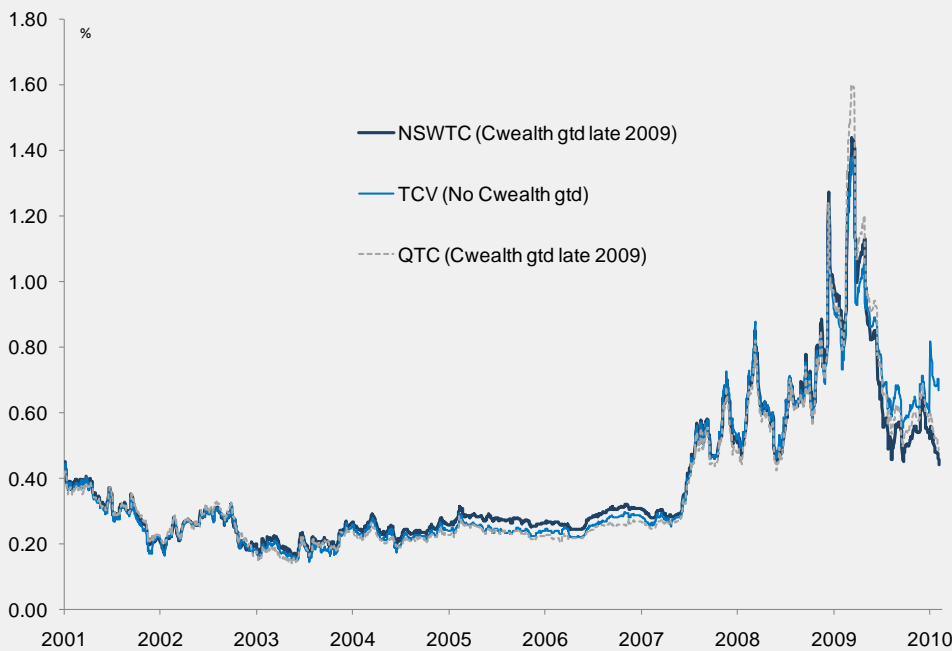
The withdrawal of the Commonwealth guarantee on State debt will not occur, however, until 31 December 2010. This extra time before the withdrawal of the State guarantee will allow time for the various State issuing authorities to build up greater liquidity in their unguaranteed benchmark bonds, to ensure a smooth transition to the new system.

The decision to announce the withdrawal of the State guarantee comes after the highly successful issue of a non-Commonwealth guaranteed 5.75% November 2014 bond by QTC on 21 January 2010. The strong demand for this bond, with a massive A\$4bn issued on the day, was likely a key factor in the decision to announce the withdrawal of the Commonwealth guarantee. Other State issuing authorities that have used the Commonwealth guarantee, i.e. NSWTC, could now be expected to begin issuing non-Commonwealth guaranteed bonds.

It could also be expected that local and global demand for State-government bonds without the Commonwealth guarantee would likely remain strong, given the higher yields available on these bonds relative to other markets around the world and the ongoing relative strength of the State-government credit ratings, i.e. AAA/Aaa (S&P and Moody's) for NSW, WA, Victoria and SA, AA+/Aaa for Tasmania and AA+/Aa1 for Queensland.

It is also worth noting that existing lines of Commonwealth guaranteed State bonds will continue to be covered by the guarantee until either they mature or are bought back and extinguished by the issuer.

NSWTC, QTC and TCV long-dated spreads to Commonwealth bond



Source: Citi

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