

BANKS' USE OF THE WHOLESALE GUARANTEE¹

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Abstract

At the peak of the financial crisis, the Australian Government announced that it would offer to guarantee financial institutions' wholesale funding. The guarantee enabled banks to access funds at a reasonable cost and at longer terms at the height of the turbulence in markets. Banks' use of the guarantee diminished as market conditions improved. Following the closure of the Guarantee Scheme, banks have continued to have good access to funding.

Introduction

The Australian Government introduced the Guarantee Scheme for Large Deposits and Wholesale Funding in late 2008 in response to the dislocation in global financial markets and following similar announcements in a number of other countries. The arrangements promoted financial system stability in Australia. At the peak of the crisis, the guarantee enabled banks to access funding at a time of considerable turbulence. It lowered banks' cost of funds and enabled banks to issue larger volumes and at longer terms. It also ensured that Australian banks were not placed at a disadvantage compared with their international competitors that could access similar government guarantees on bank debt.

The Guarantee Scheme was closed to new wholesale liabilities in early 2010. This reflected the improvement in funding conditions and the recent or imminent closure of wholesale funding guarantee schemes in a number of countries. In the lead up to the closure of the scheme, Australian banks had increasingly tapped wholesale markets without the support of the guarantee as it became cost-effective to do so, and have continued to have good access to capital markets since then. This article focuses on the wholesale guarantee. It discusses the events leading up to the introduction of the Guarantee Scheme, its main features, how it was used and its closure.

The Guarantee Scheme

In late 2008, international developments led to extreme pressure on the availability and cost of funding for banks globally. The failure of Lehman Brothers and the near-bankruptcy of a number of financial institutions in the

¹ This article draws heavily on Black et al (2010) and Schwartz (2010).

United States and Europe triggered high uncertainty about the stability of the global financial system, and international long-term wholesale funding markets essentially closed for a short period to non-sovereign borrowers. Despite their ongoing strong capitalisation, earnings and asset quality, Australian banks were affected by these developments, with investors reluctant to buy long-term bank debt.

Against this backdrop, governments in a number of countries announced the provision of guarantees for financial institutions' wholesale debt. The Australian Government also moved to reassure investors and to ensure that Australian banks were not disadvantaged compared with banks in other countries. The Australian Government announced in October 2008 that it would offer to guarantee debt issued by eligible financial institutions. The scheme was in place for 16 months – commencing on 28 November 2008 and closing on 31 March 2010.

Banks were able, for a fee, to obtain government-guaranteed wholesale funding with a maturity out to five years (less in the case of foreign-bank branches).² The cost of the guarantee was 70 basis points for institutions rated AA- or higher, 100 basis points for institutions rated between A- and A+, and 150 basis points for institutions rated BBB+ or below and unrated institutions.

The Australian Guarantee Scheme shared many features with wholesale guarantee arrangements announced in other countries although, on balance, it was more flexible and generally at the more supportive end of the international range.

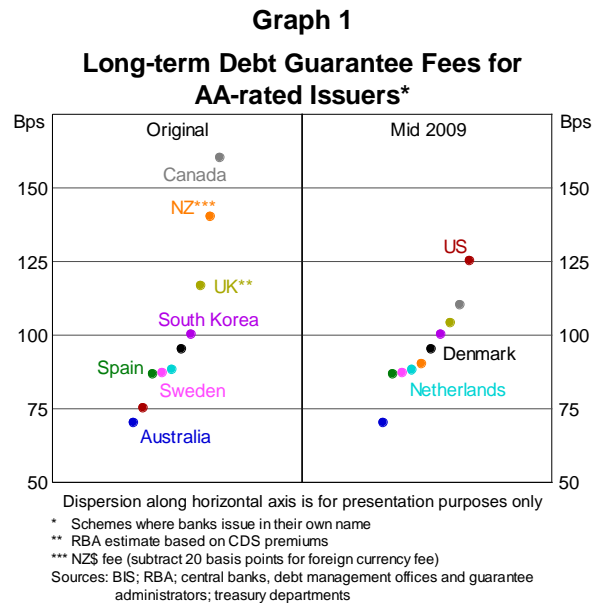
- *Closure date:* The Government did not set a fixed date for closure of the arrangements, announcing that the Guarantee Scheme would remain in place 'until conditions normalise'. Most other countries announced a fixed window for new borrowing, often between six to nine months. As difficult conditions extended well into 2009, many of these countries extended their arrangements, often on more than one occasion.

- *Term of guaranteed debt:* The Guarantee Scheme allowed guaranteed debt with a rolling maturity date of five years, whereas most countries specified fixed maturity dates that were relatively sooner, amounting to two to three years from the commencement of the borrowing arrangements. Again, most countries subsequently extended these dates, reflecting both the continuation of difficult conditions and an increased preference to spread banking sector debt maturities.

- *Fees:* The fee applicable to AA-rated institutions (such as the major banks) under the Australian Guarantee Scheme (70 basis points per annum) was at the low end of the international range for schemes with this structure (Graph 1). While initially similar to the fee in the United States (75 basis points), the United States

² Foreign branches had restricted access to the Guarantee Scheme including a shorter maturity limit (initially out to 31 December 2009, and subsequently amended to a rolling 15-month maturity). The differing treatment reflected that, unlike the foreign bank subsidiaries, foreign bank branches are not separate entities incorporated and independently capitalised in Australia – they are part of the foreign bank incorporated overseas.

subsequently raised its fee as part of its exit strategy. The differential between institutions with different credit ratings under the Australian Guarantee Scheme was, however, relatively large by international standards.



Use of the Wholesale Guarantee

Debt issuance under the wholesale guarantee was categorised as:

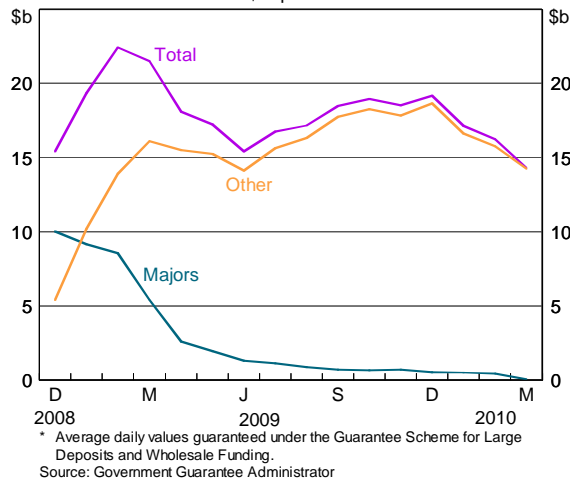
- Short-term – which had an initial maturity of up to 15 months; and
- Long-term – which had an initial maturity greater than 15 months and up to 5 years.

At March 2010 when the wholesale guarantee was closed to new issuance, the value of the stock of guaranteed debt outstanding amounted to \$166 billion, accounting for 7 per cent of banks' debt.³ The bulk of this was long-term debt (\$140 billion).

Use of the guarantee for raising short-term funds peaked soon after the introduction of the scheme, when uncertainty was at its highest (Graph 2). However, even at this stage, the value of guaranteed short-term debt was relatively low, at less than \$25 billion. In broad terms, there was a general decline in the value of guaranteed short-term debt over the life of the scheme. The decline was led by the Australian banks, particularly the major banks whose outstanding guaranteed short-term debt was run down to negligible levels as market conditions improved. In contrast, the use of the guarantee by foreign branches increased from May 2009, after the Government increased the maturity limit for them from the original fixed date of 31 December 2009 to a rolling 15 months (reflected in the sharp increase in "other" institutions in Graph 2). The increase was consistent with moves in a number of countries extending guarantee arrangements and maturity limits beyond those initially announced.

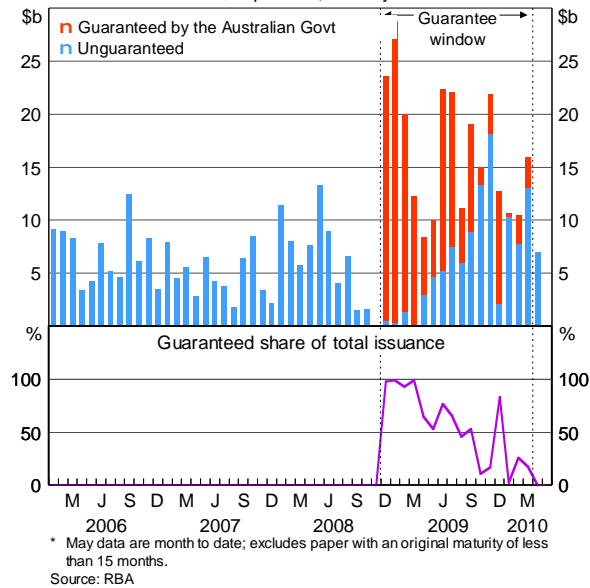
³ Based on the exchange rate at end March 2010.

Graph 2
ADIs' Guaranteed Short-term Debt*
 A\$ equivalent



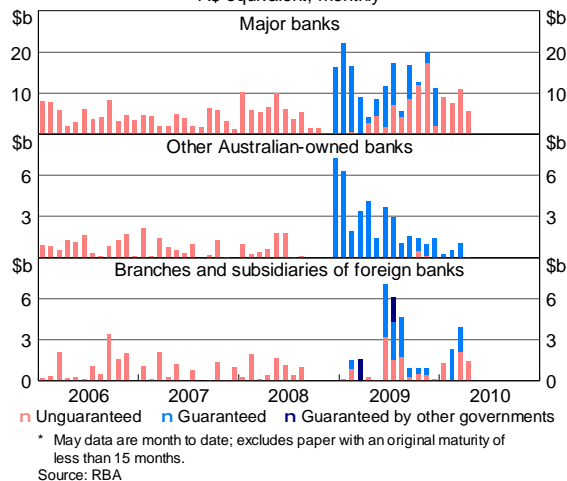
Banks predominantly used the wholesale guarantee to raise long-term funding. In the initial stage of the financial crisis – prior to the introduction of the Guarantee Scheme – Australian banks had good access to bond markets and continued to issue large volumes, albeit at higher spreads (Graph 3). However, in the months following the collapse of Lehman Brothers, there was virtually no demand globally for unguaranteed financial institution debt, particularly for terms greater than one year, and what little unguaranteed debt was issued globally was at exceptionally high spreads. During this period of greatest dislocation, the guarantee enabled Australian banks to issue larger volumes and at much longer terms than would have been possible in unguaranteed form. The banks were able to issue a large volume of bonds because the guarantee broadened the investor base, by attracting investors whose mandate covered sovereign-guaranteed debt guarantee, and it also made regular buyers of financial institutions' debt more comfortable with the risk (as the debt was afforded the Australian Government's AAA rating). Given the historically high spreads at the time, the guarantee substantially reduced the cost to financial institutions of issuing term debt (discussed further below).

Graph 3
Australian Banks' Bond Issuance*
 A\$ equivalent, monthly



While the smaller, lower-rated Australian-owned banks have traditionally issued bonds only sporadically, they used the guarantee to issue more bonds than they did prior to the crisis (Graph 4). In the past, many lower-rated institutions have made more use of the residential mortgage-backed securities (RMBS) market for funding, and this market has shown signs of improvement in recent months.

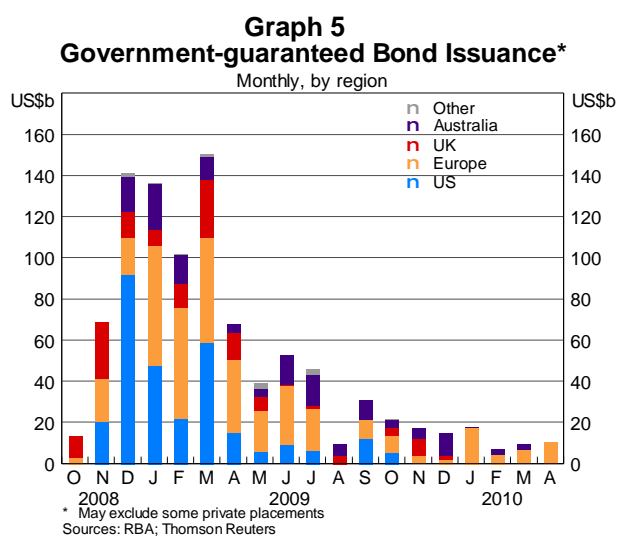
Graph 4
Australian Banks' Bond Issuance*
 A\$ equivalent, monthly



As conditions improved over 2009, the major banks recommenced issuance of unguaranteed debt, although for some time guaranteed debt was still issued as there was investor demand specifically for the guaranteed debt and it was also cheaper. While 85 per cent of bonds issued in the first half of 2009 were guaranteed, that share fell to around 45 per cent in the second half of the year, declining to close to zero in early 2010 prior to the Guarantee

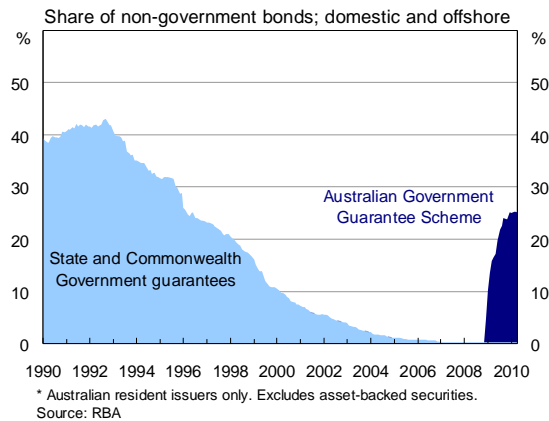
Scheme closing. Since the closure of the Guarantee Scheme, the banks have continued to source funds from the bond market.

The overall pattern of declining use of the guarantee over 2009 was also evident in other countries (Graph 5). In addition to narrowing spreads making unguaranteed debt issuance more attractive, subdued guaranteed issuance also reflected that, in many countries, banks' overall requirements for new debt were not high, as both they and their customers were focused on repairing their balance sheets. In a number of countries, alternative funding sources have been tapped; for example, European banks have issued into the covered bond market, a market that has been supported by purchases from the European Central Bank.



At March 2010 when the Australian wholesale guarantee was closed to new issuance, guaranteed bonds accounted for around 25 per cent of the Australian non-government bond market. While this is a large share of the bond market, and has increased significantly compared to the prior decade, government bond guarantees were used widely in the past. Prior to the widespread privatisations in the mid to late 1990s of financial, utility, transport and communication companies, around 40 per cent of non-government Australian bonds were guaranteed by either state or Commonwealth governments (Graph 6).

Graph 6
Government Guarantees of Australian Bonds*



Pricing

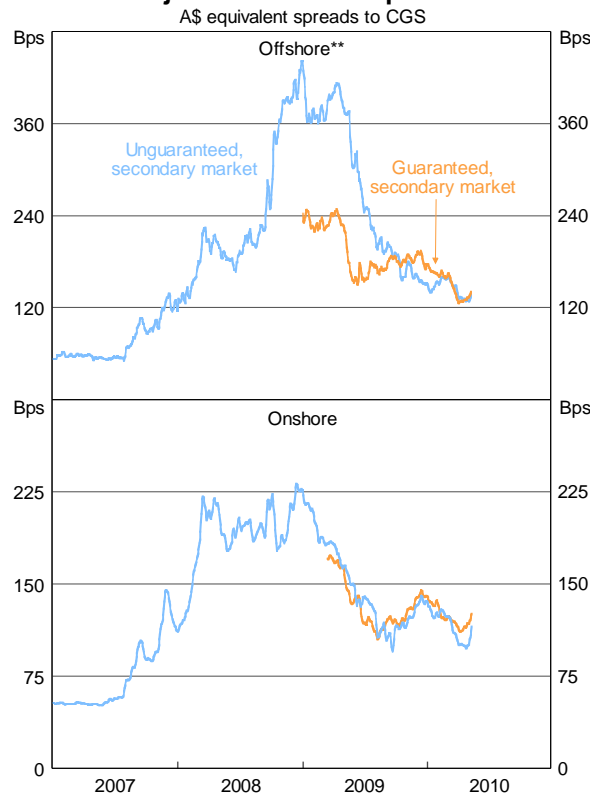
Australian banks tend to raise funds domestically or in various offshore markets depending on where it is most cost-effective to borrow Australian dollar equivalent funds at that time.⁴ In this way, they take advantage of pricing differentials between alternative funding markets, using derivatives to manage the associated exchange rate risks.⁵ In the same way, pricing differentials (including the cost of the fee) influenced whether banks issued guaranteed or unguaranteed debt.

It is possible to compare the costs incurred by the major banks – including the cost of the guarantee fee and after hedging – from issuing guaranteed and unguaranteed bonds onshore and offshore (Graph 7).

⁴ See D'Arcy, Shah Idil and Davis (2009).

⁵ Australian banks hedge almost all of their foreign currency bond issuance back into Australian dollars by undertaking interest rate and cross-currency swaps at the time of issuance, effectively raising Australian dollar funds.

**Graph 7
Major Banks' Bond Spreads***



* Bonds >A\$100 million only. Guaranteed spreads include the 70bps guarantee fee. Secondary market spreads are 5-day moving averages.
 ** A\$ cost of US\$ issues after hedging
 Sources: Bloomberg; RBA; UBS AG, Australia Branch

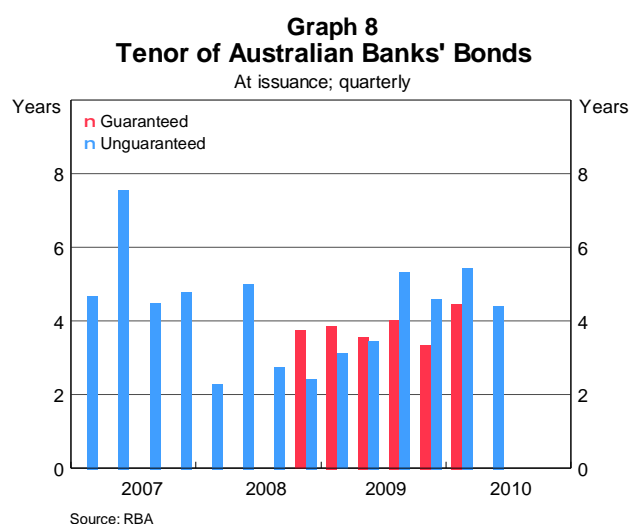
In late 2008 following the failure of Lehman Brothers, the cost of raising unguaranteed funds increased sharply. The guarantee helped to alleviate some of these cost pressures, with guaranteed issuance initially cheaper both offshore and onshore (including the fee). Accordingly, the banks utilised the guarantee. The greater dislocation in offshore markets also saw the cost of offshore funding rise further, so banks increasingly tapped the onshore market during this period (and used the guarantee in doing so).

Increasing investor demand for unguaranteed debt in 2009 – both onshore and offshore – as market conditions improved, saw spreads on unguaranteed bonds narrow more sharply than on guaranteed bonds. As a result, unguaranteed debt became cheaper to issue than guaranteed debt for the major banks. Initially this was for shorter terms, and then for bonds up to five years (the limit of the Guarantee Scheme). Subsequent to the closure of the Guarantee Scheme, secondary market spreads on unguaranteed bonds continue to be lower than on outstanding guaranteed bonds.

Bond maturities

In the years leading up to the financial crisis, the Australian banks issued bonds mostly with maturities of 2 to 6 years, with an average of around 5 years. With the onset of the financial crisis and the decline in risk tolerance, investors were less prepared to lock up funds for extended periods and so the distribution of bond maturities at

issuance shifted toward shorter terms, with the average maturity at issuance shortening to around 2½ years during the most severe part of the crisis (Graph 8). The guarantee alleviated some of these concerns for investors, with the average maturity of guaranteed issues at almost 4 years in the 6 months following the introduction of the guarantee, over 1 year longer than unguaranteed issues during the same period. Banks were constrained, however, in the tenor of bonds they could issue under the Guarantee Scheme, which capped the initial maturity of guaranteed securities at a maximum of five years from the date of issuance.

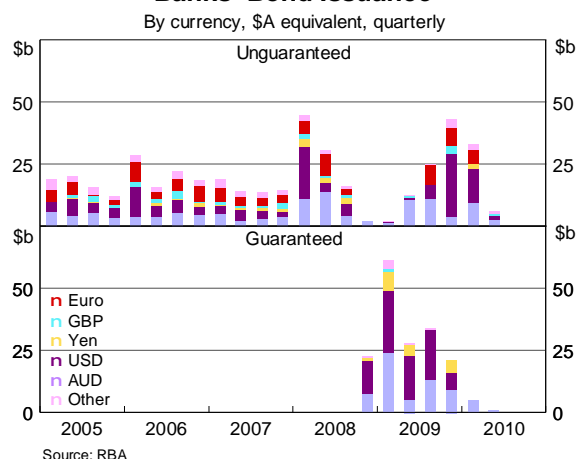


As conditions in financial markets improved, banks increasingly issued unguaranteed bonds with longer tenors, including beyond the five-year limit of the Guarantee Scheme. By the September quarter 2009 the average tenor of unguaranteed bonds exceeded that of guaranteed bonds and was around its pre-crisis average of five years. The willingness of investors to purchase unguaranteed issues with longer maturities is reflected in the fact that around one-quarter of unguaranteed issues recently have been at tenors of 10 years or more.

Markets of Issuance

The Australian banks, particularly the major banks, have historically diversified their sources of funds by issuing bonds into a variety of markets and currencies (Graph 9). In this way they are able to tap a wider range of investors, enabling them to have more reliable access to markets as well as contributing to a lower cost of funds. Prior to the financial crisis, around 20 per cent of bonds were issued in the domestic market, with the remaining 80 per cent issued in a range of overseas markets. The bulk of banks' offshore bond issuance was denominated in US dollars and euro, though the current stock of banks' bonds outstanding is denominated in at least 15 different currencies.

Graph 9 Banks' Bond Issuance



While guaranteed bonds were also issued into several different markets, guaranteed issuance was a little less diversified than unguaranteed issuance prior to the crisis. Guaranteed issuance was concentrated in those markets that were less impaired and retained greater liquidity, such as in the US, Australia and Japan. Issuance into these markets may have also reflected the domicile and/or preferred currency of those (often mandate constrained) investors that purchased the AAA bonds. Nonetheless, the guarantee enabled banks to tap offshore markets at the height of the financial crisis; virtually no unguaranteed bonds were issued offshore in the nine months to June 2009, during which time investor risk aversion and home bias were at their most extreme. As market conditions improved over 2009, the investor base for unguaranteed bonds broadened and unguaranteed issuance became a little more diversified than guaranteed issuance.

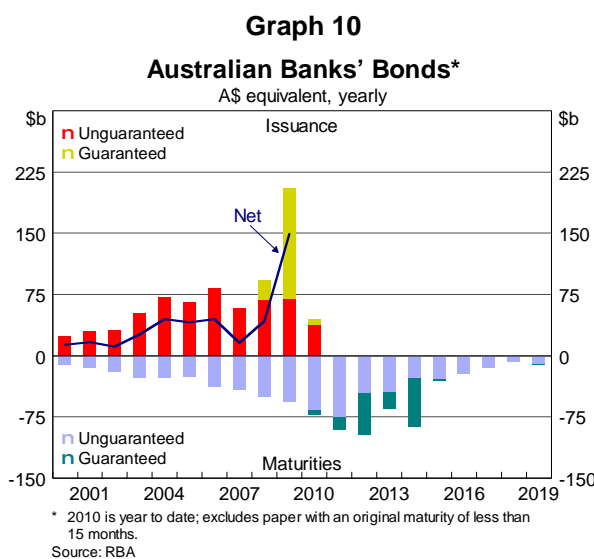
The closure of the Guarantee Scheme

When the Guarantee Scheme was introduced, the Australian Government had announced that it would remain open until markets normalise. On 7 February 2010, the Government announced that the Guarantee Scheme would close to new borrowing from 31 March 2010.

Market conditions had improved significantly by that time and the recent use of the Guarantee Scheme appeared to be largely a response to small pricing advantages rather than reflecting problems of market access. Also, a number of other countries recently had closed their schemes, or announced they would do so imminently. There was no need for Australia to have a Guarantee Scheme in place for significantly longer than other countries.

Following the closure of the scheme, Australian banks have continued to have good access to wholesale funding markets. This continued the pattern of an increasing volume of unguaranteed issuance in the lead up to the Guarantee Scheme being wound-up. In addition, the securitisation market, which has been a useful source of funds for Australian banks in the past, has also shown further signs of improvement.

For Australian banks, with guaranteed issuance permitted out to five-year maturities, the overall bond maturity profile drawn from market data suggests that refinancing needs for guaranteed debt are relatively well distributed going forward (Graph 10).



Conclusion

The Guarantee Scheme was introduced in response to extraordinary developments in the global financial system. It contributed to the stability of the Australian financial system by ensuring that institutions continued to have access to capital markets during the peak of the crisis. With the support of the guarantee, banks were able to issue bonds in large volumes and for long terms. The guarantee also substantially reduced the cost of issuing debt, although this cost advantage gradually declined over time.

As conditions in financial markets settled, banks reduced their use of the guarantee. Due to the significant improvement in market conditions and consistent with similar arrangements in a number of other countries closing, the Guarantee Scheme closed to new borrowing from end March 2010. Since this time, banks have continued to have good access to wholesale debt markets.

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