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2 June 2008

Address to the House of Representatives

Ministerial Statement on Financial Stability

Mr Speaker

A year ago this month:

- shares in the Bear Stearns investment bank were still trading on the New York Stock Exchange at around \$150;
- the US federal funds rate had reached 5.25 per cent, after 17 successive increases;
- the Bank of England was looking to increase the cash rate;
- and both the United States and the United Kingdom were completing one of the most robust quarters of growth that either had experienced for some years.

It was widely and rightly said then that, over the previous five years, the global economy had experienced a boom the likes of which had never been seen in human history.

In the year since then, a great deal has changed.

Late last week the remnants of Bear Stearns were formally merged into JP Morgan Chase, ending the existence of an investment bank which had in its 85 years survived the Great Depression, World War II, innumerable financial crises in Latin America, Russia and Asia, to be brought down, not by a financial collapse in emerging markets, not by a global recession, not by a clever hedge fund or

derivative strategy gone wrong, but by the consequences of poor home lending standards in the American heartlands of Florida, Michigan, and California.

Bear Stearns was of course only a small instance of the damage wrought by what we have come to call the US sub-prime financial crisis.

Since mid September last year the US central bank has found it necessary to cut the cash rate seven times. US consumer confidence is close to a 15-year low. Partly because of that declining confidence, the downturn in the US housing market, which explains so much of the downturn in the US economy overall, continues to deepen.

The total announced asset write-downs and credit losses as a result of the global credit crisis for US financial institutions and global banks are now estimated to be \$380 billion.

Through its impact on financial markets and investment banking centred in London, the UK has also been affected by the US sub-prime crisis.

Through losses sustained by global banks based there, Europe too has felt the chill of this long and difficult financial episode.

Mr Speaker

Although to a much lesser extent, Australia also saw some of the impact of this financial crisis, and within days of its appearance in the United States.

Because of the global uncertainty, Australian banks also became reluctant to part with liquidity.

And in July last year the spread between the cash rate maintained by the Reserve Bank and the three month bank bill swap rate sharply increased.

Although sub-prime lending is only a very small proportion of overall Australian mortgage lending, by December the market for high quality securitised Australian mortgages - which is largely offshore - was as dead as the market for US securitised mortgages infected with sub-prime risk.

And though Australian business profits were strong and corporations were not highly leveraged, it became difficult for even the best names to borrow on reasonable terms directly in financial markets.

Our banks found that the global market for term funding was harder to access and very expensive.

They discovered, as banks abroad discovered, that at exactly the same time as they encountered new difficulties in funding their balance sheets, they also encountered sudden new demand for credit from borrowers who found it hard to obtain elsewhere.

All this occurred, I must emphasise, despite the fact that major Australian financial institutions had not then, and haven't now, any significant exposure to US sub-prime debt.

Or indeed had not then, and haven't since, experienced any significant increase in bad debt.

Mr Speaker

I can report to the House that the Australian Government agencies responsible for the health of our financial system performed their duties well in minimising the impact of this global crisis on the Australian economy.

APRA has conducted a rigorous program of risk evaluation and inspection in the years leading up to this crisis, a program which discouraged institutions from reckless lending.

It also moved quickly to step up its monitoring activities as the impacts of the financial turmoil hit our shores.

The Reserve Bank of Australia moved quickly in recognising the unusual and immediate liquidity needs of the Australian banking system.

It also recognised early that in the peculiar circumstances of this particular financial crisis, it needed to extend the range of financial instruments which it would accept as collateral in its lending operations.

The prompt action by the RBA in respect of both overnight and term lending stabilised the Australian financial system, maintained confidence, and permitted Australian banks to expand both their assets and liabilities to match the new demands placed on them by business and household borrowers.

The banks themselves also responded to the US sub-prime crisis in a timely manner.

They were able to rapidly expand their retail deposit liabilities in the second half of last year, for example, and in the first quarter of this year their high credit standing and strong global reputations permitted them to continue to access global debt markets, this time on a considerable scale.

Mr Speaker

There are certainly also problems we have encountered here during the crisis.

Because the market for residential mortgage backed securities remains dormant it has been difficult for many smaller mortgage originators to continue to compete.

Highly leveraged businesses with illiquid assets have found that their model no longer works as it did when credit was more plentiful and spreads were narrower.

The sharp fall in equity prices since the middle of last year has exposed the perils of speculation funded by margin lending.

Though still markedly higher than they were a year ago, credit spreads are today narrower than they were a few months ago and have continued to decline in recent weeks.

Credit growth in Australia has slowed, consistent with the rise in domestic interest rates over the past three years and tighter credit conditions.

But, we haven't seen a significant increase in bad debts.

Output growth and employment remain quite firm.

There have also been some positive signs in international credit markets, but I do not wish to suggest that it is all now plain sailing in the global economy.

The US economy remains very weak, and it is quite possible that further credit defaults, and in different areas, will be exposed as a result of the deterioration in business conditions in that economy.

Lending growth has slowed in that economy, credit spreads remain elevated and the lenders' appetite for risks is much diminished.

All this is occurring at a time of very high oil and other commodity prices, rising food prices, and global inflation.

In the past year the benchmark price for global crude oil has doubled, while the IMF's measure of global food prices has risen by almost 50 per cent.

Pressure on global oil prices in particular is set to continue.

Ongoing strong economic growth in much of the developing world, in particular China and India, is putting upward pressure on global oil prices.

At the same time, supply is struggling to keep up, due to significant under-investment in exploration and development, as well as uncertainty about the security of supply from important oil producer countries, not least in the Middle East.

This will continue to put pressure on family budgets right around the world, not least here at home, and constrain growth in major consumer nations.

This strong economic growth in emerging countries, and the associated higher oil prices, is also putting upward pressure on world food prices.

We are addressing this at home through measures to increase competition in the supermarket sector.

The Government is also assisting the world's poorest people, through \$30 million in emergency assistance to countries most affected by steep rises in the prices of essential food supplies.

The impact of higher commodity prices, in particular oil and food, will be a central theme of my discussion overseas, in particular at the G8 Finance Ministers' Outreach Meeting in Osaka.

We will discuss how to address the root causes of food insecurity in developing countries, and the role Australia can play, through increased development assistance, constructive participation in multilateral processes, and continued advocacy for international trade policy reform.

As a major world food producer, Australia has a central role to play in addressing this global challenge.

These are not circumstances in which we can relax our vigilance or declare the financial problems of the last year are now completely behind us.

Neither are its impacts.

We only need look at the forecasts in last month's Budget to appreciate the impacts that slower world growth, combined with higher domestic interest rates, will have on our economy.

These also demonstrate that much of the impact on the real economy is yet to be felt.

Mr Speaker

Though we have come through the last year in reasonable shape, the Government is still attentive to some sensible things we can do to further strengthen our financial system against the inevitable shocks of the kind evident in the last year.

Nor are we concerned only about our own regulatory framework.

We experienced here many of the effects of the US sub-prime financial crisis despite our financial institutions not sharing its causes. That experience reminds us that however sound our own financial system, we also need to do whatever we can to support a sound global financial system.

Both I and the Prime Minister have been in close contact with US, UK and European government leaders, with central bankers, and with the heads of the major international agencies who have been grappling with the financial crisis.

In the international forums in which we participate, including the Financial Stability Forum, the G20, and the IMF, Australia has pressed a firm view in support of international cooperation in addressing the crisis, greater transparency in the disclosure of risk, and strengthened systems for providing early warning of emerging global financial risks.

We ourselves have responded to the recommendations of these global forums.

The Financial Stability Forum, for example, has recommended strengthened prudential oversight of capital, liquidity and risk management, enhancing transparency and valuation, changes in the role and uses of credit ratings, strengthening the authorities' responsiveness to risks, and robust arrangements for dealing with stress in the financial system.

I have asked the financial regulators and my department to work closely together on the recommendations and to keep me regularly informed of developments.

The Government has also been developing two measures to strengthen our financial system.

The first is the increased issuance of Commonwealth Government Securities which I announced last month.

This action will support market liquidity and ensure sufficient market depth in the three and ten year parts of the government bond yield curve, to support consistent pricing in the Australian market for long term debt.

There will of course be no increase in the net debt of the Commonwealth because the increase in government bonds outstanding will be matched by the acquisition of new financial assets.

The Government is also broadening the range of securities that the Australian Office of Financial Management may invest in and accept as collateral for its securities lending facility.

The other change, which I am announcing today, follows a proposal from the Council of Financial Regulators for dealing with financial institutions experiencing difficulties.

The Government intends to establish a Financial Claims Scheme to give depositors in an authorised deposit-taking institution or ADI, as the legislation describes it, prompt access to funds in the unlikely event that such a financial institution should fail.

The Financial Claims Scheme will also cover general insurance claims by households, small businesses and not-for-profit entities, where the insurer has failed.

At the same time the Government will enhance the existing tools that Australia's regulators have to effectively manage an institution in difficulty.

This risk of failure of a bank, credit union or building society is - I must say - a very, very small one.

Our framework is designed to minimise the likelihood that any institution regulated by the Australian Prudential Regulation Authority could fail.

That is not to say the rules will prevent a regulated financial institution making a loss, which is something that all businesses risk.

But it is to say that the rules are designed to minimise the likelihood that a regulated institution could make a loss substantially bigger than its capital reserves or its capacity to replenish those reserves.

Even where the loss threatened the financial viability of the institution, the Australian government and its agencies would seek a commercial solution to see both the remaining assets and the deposit liabilities assumed by another entity.

So the outright failure of a regulated bank is something I think very unlikely, and indeed the history of the Australian financial system shows that such failures are rare events.

Were it to occur, Honourable Members will know that under the Banking Act depositors have first call on the assets of the failed institution.

They have priority over all other creditors.

This means that in the unlikely event that an ADI failed, liabilities to depositors would be paid out before any other liabilities were met.

I am advised that it is difficult to envisage circumstances in which the totality of those deposits would not be more than matched by the remaining assets of the failed institution.

In my view, however, it is not enough to know that depositors would very likely eventually get their money back through the liquidation process.

Many depositors, especially households and small businesses, depend on the funds in their bank accounts for day to day needs, and would suffer considerable hardship if they were unable to access those funds for some months, while an institution was wound up.

Most people for example have their wage paid into a bank, and draw it down as required.

Pensioners and superannuants have their pensions paid into a bank.

Students have allowances paid into a bank.

The Australian Government by and large these days pays family allowances and so forth through banks, preferably directly into the recipient's account.

It would cause considerable distress if these depositors were unable to access their funds for a considerable period of time.

What we now propose is that the Australian Government will establish a scheme under which depositors in a failed institution would within weeks of a failure be refunded their deposit, up to a limit per person of \$20,000.

The scheme will include checking deposits, savings deposits and term deposits. It will cover banks, credit unions, and building societies which are prudentially regulated by APRA.

The scheme will be administered by APRA and were it ever necessary to activate the scheme the Treasurer would seek advice from APRA, the RBA and the Treasury.

These proposals are not new; they have had a long gestation period, both under the previous government and under our Government.

I would also like to assure the House, and through it the Australian people, that these proposals are not a response to any concerns with Australia's ADIs, which - as I have said - have weathered the current turbulence well.

The proposed scheme is part of a comprehensive and thoughtful package of reforms proposed by the Council of Financial Regulators and agreed to by the Government.

The scheme I am announcing today had its genesis in policy reviews following the failure of HIH, and in the 2003 Study of Financial System Guarantees by Professor Kevin Davis.

These are changes that were supported in the IMF's Financial Sector Assessment of Australia, and that have been carefully considered by our leading financial regulators.

The Australian Government will fund the operation of the scheme in the first instance, with taxpayers' contributions recouped through the liquidation of the failed institution or - in the event that was insufficient - by a levy on relevant financial institutions which will be authorised in legislation accompanying the establishment of the scheme.

Honourable Members will readily understand that this scheme is limited, and designed to be limited. Its essential purpose is to have a reliable means of quickly giving retail depositors access to funds they need for their day to day expenses, should an institution fail.

It will fully cover the deposits of the vast majority of depositors in a failed institution.

I am advised that approximately four-fifths of depositors have balances of less than \$20,000.

It should be noted, however, that a small number of large depositors with balances over \$20,000 account for well over half of the volume of deposits in most institutions.

These larger depositors would have access to only \$20,000 under the scheme and would have access to the remainder of their funds in the usual way, through the liquidation.

This is not, and is not intended to be, a general deposit insurance scheme.

We are not seeking to protect large-scale investors from risk, nor to burden the banking industry with a pre-funded scheme that may never be used.

What I am announcing is a simple plan to minimise the distress for working families, for pensioners, for students, in the very unlikely event that an Australian ADI fails.

It will give them an assurance they will get their money, and get it quickly.

There is nothing in this scheme which will reduce the incentive for large depositors to prudently examine the circumstances of the institutions in which they have deposited money.

Nor is there anything in this scheme which abridges or circumscribes the ability of the Reserve Bank of Australia to offer liquidity facilities to an otherwise sound institution which for one reason or another is experiencing a withdrawal of deposits at a faster rate than it can realise assets to meet those withdrawals.

Mr Speaker

Australia and New Zealand are alone among OECD nations in not having a predetermined scheme to assist depositors in the event of the financial failure of a depositary institution.

This scheme I announce today meets that need and in a manner appropriate to Australia's circumstances, and that reflects the sound and successful arrangements already in place.

It is designed to minimise the cost to taxpayers and the burden on existing financial institutions.

It is also important to note, particularly given that the most recent failure of a regulated institution in this country was the HIH collapse, that the Government is also introducing measures to protect general insurance policyholders.

If an APRA-regulated general insurer fails, the scheme would compensate policyholders for the full amount of any valid claim under their policy.

In the same way as the scheme is intended to apply in relation to banks, the focus will be on those least able to bear the losses, with eligibility limited to individuals, small businesses and not-for-profit entities.

The scheme will not cover life insurance, superannuation or market-linked investment products where investors are motivated to increase their returns by taking greater risks.

Nor will the scheme apply to institutions which are not regulated by APRA.

Mr Speaker

In reviewing Australia's crisis management arrangements in the financial sector, the Council of Financial Regulators also considered the suite of powers available to regulators for managing financial instability and distressed financial institutions.

The Council has identified a number of reforms which would enhance the ability of regulators to effectively manage a distressed financial institution and to maintain financial stability.

These reforms include providing consistent arrangements for the transfer of business across banking, general insurance and life insurance, with appropriate oversight by the courts and the regulators.

The reforms will also provide for the judicial management of general insurers, and bring non-operating holding companies in the life insurance sector into the regulatory net, and remove potential legal barriers to the recapitalisation of a failing institution.

These are sensible enhancements to our existing regulatory arrangements and the Government will bring forward legislation to enact these proposals as part of the package of measures I am announcing today.

It is important that the Government ensures that APRA and the RBA have the tools they need to act swiftly and effectively to resolve and if possible, avoid any crisis in a regulated institution.

This is particularly important with our key financial institutions, where instability in one can quickly spread through the system and create instability in other, otherwise sound entities.

Mr Speaker

As I mentioned our financial system and our regulatory structures have weathered the financial turmoil of the past year well.

I have had my differences with the major Australian banks and I don't apologise for that, but there is no doubt about the strength and soundness of the Australian banking system over the last year.

I do not propose to say anything today about the proposed merger between Westpac and St George, which as Honourable Members will know will be subject to scrutiny by the ACCC and APRA as well as by me and my department.

We will review the facts which emerge from this scrutiny, and make our decision based on those facts.

But I do want to say that in my view the issue of whether or not that merger is approved does not bear on the four pillars policy which has been maintained, in one form or another, by four successive Prime Ministers and seven successive treasurers over nearly two decades.

Indeed I take our experience over the last year as a demonstration of the soundness of a four pillars policy.

These are banks which have performed as well as, or better than, any banks in the world during an exceptionally difficult period.

Quite apart from the need to sustain competition in the banking market, I would not be at all comfortable if the soundness of our banking system depended not on the strength and risk management skills of four banks, but on the strength and risk management skills of a lesser number.

Whatever may be the outcome of the banking merger now under consideration, this Government sees no case for changing the four pillars policy which has served Australia well.

Mr Speaker

The Australian Government is committed to working with the financial services sector to build Australia's regional presence as a financial services centre.

Innovative Australian providers of financial services have achieved considerable successes in global markets in recent years - but the potential is even greater as financial services markets in our region continue their rapid expansion.

The Government looks forward to working with the industry on a range of matters including education and training, overseas market access and tax and regulatory arrangements to strengthen Australia's competitiveness in regional and global markets for financial services.

Mr Speaker

As I mentioned earlier, Australia has been actively pressing for stronger international cooperation and an enhanced international early warning system for financial and economic risks to diminish the risks of future crises.

I propose to pursue this reform agenda in visits to London later this week, and to Beijing and then on to the G8 meeting in Osaka the following week.

At the same time I will be taking to the global financial markets of London, and to the leaders of the major economies in Osaka, a clear message about Australia's experience in the global financial crisis of the last year, and about our prospects for the coming years.

I will be telling the world that we have weathered the last 12 months of financial crisis well.

I will be saying that this was not because our financial system is closed against the influences of the global financial system.

Not because we have limited our engagement in the international economy.

But because we have sound financial institutions with good risk management practices, supported by a strong prudential regulatory framework, and an adroit central bank.

I will be saying that after 17 years of uninterrupted expansion the central economic objective of this Government is now to use our fiscal strength to invest in our infrastructure, in education, skills and training - areas we think essential to support our continued expansion, and which have been, for too long neglected.

I will be saying Mr Speaker that Australia is, and under this Government will remain, an exemplar of openness, of engagement with the global economy, and of willingness to invest in our own future.

I thank the House.

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