A HISTORY OF LAST-RESORT LENDING AND OTHER SUPPORT FOR TROUBLED FINANCIAL INSTITUTIONS IN AUSTRALIA

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Abstract

This paper surveys the history of last-resort lending and other support provided to financial institutions in Australia and compares the practical implementation of lender-of-last-resort policy with policy prescriptions derived from the theoretical literature. Last-resort support serves to counter the market failures that can see fundamentally sound financial institutions fail due to a lack of liquidity, and to protect the economy from the systemic costs of such failures. The provision of lender-of-last-resort support, however, creates moral hazard costs.

During the nineteenth century, Australian colonial governments and banking industry groups provided support to troubled financial institutions in a variety of ways that reflected both the resources they could draw on and their ability to constrain moral hazard behaviour. Since 1900, Australia's experience has been unusual by international standards: the central bank has rarely acted as a lender of last resort; and, despite this, virtually no Australian bank depositor has lost money. Direct loans were provided only twice: once as a last-resort loan and once to ease the exit of a failed bank. Instead, support has come in more indirect forms. Loans were provided to three banks in support of their efforts to provide funds to illiquid building societies. Most instances of disruptions to financial institutions' access to liquidity, however, have been successfully staunched by the central bank's issuance of reassuring public statements.

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1. Introduction

Last-resort lending can be defined as the discretionary provision of liquidity to individual financial institutions (or to the market as a whole) by the central bank to overcome a shortfall in liquidity caused by a withdrawal of funds from those institutions because of doubts about their financial standing.[1] While the theoretical literature focuses most on direct lending, Australia's history shows that there are a number of other ways that public authorities have supported financial system stability, including the issuance of statements assuring the public of the soundness of troubled banks, and declaring bank-issued securities to be legal tender. This paper surveys the history of last-resort lending and the provision of other forms of support in Australia, and compares the practical implementation of lender-of-last-resort policy with policy prescriptions from the theoretical literature.

While the Australian banking crisis of the 1890s was among the most severe anywhere in the world during the nineteenth century, since then the Australian banking system has shown itself to be remarkably stable. The twentieth century saw just three Australian banks suspend payment. Direct loans from the central bank have only been provided twice: once as a last-resort loan and once to smooth the exit of a failed bank. In addition, indirect last-resort lending, where the central bank lent to private banks that were lending to non-bank financial institutions experiencing depositor runs, was provided three times during the 1970s. With the exception of depositors at one small bank, who lost just 1 per cent of the value of their deposits, no Australian bank depositor has lost money since 1900. Boom and

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[1] Last-resort lending involves 'the provision of liquidity support in circumstances where either the system or individual institutions are experiencing funding difficulties of an exceptional nature' and, therefore, is to be distinguished from the central bank's operations in the short-term money market to implement monetary policy and to ensure the smooth functioning of that market (Quinn 1993).

bust during the nineteenth century, however, resulted in two waves of banking failures – in the 1840s and 1890s – and isolated failures at other times. In these episodes, some depositors incurred outright losses or had their deposits converted into claims on the banks that could not be readily withdrawn (in some instances, full repayment of such claims took more than twenty years). The central bank (the Reserve Bank and its predecessor, the Commonwealth Bank) has been the source of last-resort support since early in the twentieth century. However, prior to its establishment, both the banking industry association and colonial governments provided last-resort support to troubled banks in the nineteenth century.[2] The resource constraints faced by these institutions have been important in determining the type of last-resort support provided, in particular whether a direct loan was made or the liquidity support came in some other form.

Lender-of-last-resort policy aims to counter the potential for market failure to cause solvent banks to fail due to liquidity constraints. In some instances, it may also seek to insulate the economy from the systemic effects of bank failure. By providing such protection, however, the lender of last resort risks undermining market discipline of banks' risk-taking. Theoretical analysis of lender-of-last-resort policy focuses on how support can be provided in ways that maintain incentives for banks to prudently manage their risk-taking. In Australia, the methods used to maintain such discipline have included specific caveats on last-resort loans, lending only against high-quality collateral and allowing insolvent institutions to fail.

2. Theoretical Approaches to Lender-of-last-resort Policy

The case for a lender of last resort rests on the need to compensate for two types of market failure: the existence of information asymmetries in banking markets and the systemic consequences of bank failure. A lender-of-last-resort facility, however, involves some costs, particularly moral hazard costs. The question, then,

[2] This paper will confine itself to discussion of the provision of last-resort support by Australian entities. Up until the 1920s, capital flows and parity between the British and Australian pound meant that the Australian banking system was largely an extension of the British financial system. On a number of occasions, Australian banks received last-resort support from the Bank of England.

is how lender-of-last-resort policy can best be shaped so as to minimise these costs.[3]

2.1 The Case for a Lender of Last Resort

The structure of banks' balance sheets distinguishes them from other types of firms. On the liability side, bank deposits have a fixed nominal value and are paid out on a first-come-first-served basis. Most of their assets comprise loans that are not readily marketable. This combination of fixed-value deposits and illiquid assets makes banks susceptible to depositor runs and results in externality costs to the economy if a bank fails.

That deposits of fixed nominal amounts are paid out on a first-come-first-served basis creates the potential for coordination problems amongst depositors. Each depositor knows that if other depositors rapidly withdraw funds, banks will be forced to sell illiquid assets at a loss and, as a result, are unlikely to repay all deposits. Diamond and Dybvig (1983) argue, therefore, that any external event that causes depositors to believe others will withdraw their deposits may trigger a run.

A core element of banks' business is the provision of loans to those borrowers who are unable to obtain finance directly from debt markets. Banks specialise in lending to firms that lack sufficient capital to pledge as collateral or the widely known reputations that would allow them to raise funds directly in capital markets. By accessing inside information on firms, banks overcome the information costs that make debt issuance direct to the market prohibitively expensive for many companies (Fama 1985). Due to the inherently opaque nature of such assets, depositors are not readily able to observe the financial condition of banks. This creates an information asymmetry between depositors and bank management. Since depositors are not able to monitor, and therefore price, the riskiness of individual banks, they cannot effectively penalise risk-taking by demanding higher interest rates. Instead, they can only discipline managers by withdrawing their funds (Calomiris and Kahn 1991).

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[3] There are a number of comprehensive surveys of the theoretical literature concerning lender-of-last-resort policy, including Freixas *et al* (1999); Moore (1999) and Bordo (1990).

Systemic risk arises from the potential for problems at one bank to cause difficulties at other banks. Sources of contagion include asymmetric information problems and interbank exposures. Since depositors cannot monitor bank risk-taking, difficulties at one institution may cause depositors to doubt the liquidity of other banks, leading to a generalised flight to cash (Docking, Hirschey and Jones 1997). In addition, interbank exposures arise from the operation of the payments system (Rochet and Tirole 1996).

Banking illiquidity may impose externality costs on the broader economy. Due to the information-intensive nature of banking relationships, difficulties at an individual bank may disrupt the supply of finance to firms that are unable to obtain financing through other means. For those firms, re-establishing banking relationships is likely to be a lengthy and costly process (Greenbaum and Thakor 1995). Moreover, since the health of financial institutions and the economy are closely linked, banks are more likely to experience difficulties in periods of broad economic slowdown and may, as a result, amplify cycles in the real economy (Suarez and Sussman 1997).

2.2 The Costs of Lender-of-last-resort Policy

A lender-of-last-resort facility provides a form of insurance for both banks and their depositors. By reducing the costs of risk-taking, a lender of last resort can reduce the incentive for banks to manage their own liquidity and for depositors to monitor banks' activities. This opens the way for banks and depositors to adopt moral-hazard driven behaviour. This can result in a more fragile banking system, as banks take on more risk and depositors cease to demand risk premiums from more risky banks, as they would if banks were fully exposed to the consequences of their risk-taking. Thus, while a lender of last resort may reduce the frequency of bank runs, it may create an environment where the runs that do occur are more severe.

While authors such as Schwartz (1986) acknowledge the market will not always deliver the first-best outcome, they argue that the resulting costs are less than those arising from inappropriate public support of financial institutions. The loss of information-intensive business relationships brought about by banking illiquidity may be no more costly than the failure of other types of firms (Kaufman 1994).

Proponents of free banking, such as Selgin and White (1987) and Dowd (1992) make the case against a lender of last resort more strongly, and deny the need for any government-sponsored lender of last resort. They argue that the fundamental cause of bank panics is the legal restrictions on the banking system, particularly the government's monopoly in the issue of currency. If banks were free to issue their own notes, secondary markets in bank notes would provide adequate information to note holders about the condition of each bank. In a system free of restrictions, the market would produce a stable financial system through the development of institutions, such as clearing house associations, mitigating banks' information asymmetries.

2.3 Issues in the Design of Lender-of-last-resort Policy

One of the first to set out the ways in which lender-of-last-resort policy should be conducted to minimise the moral hazard costs of last-resort support was Bagehot (1962). Implicit within Bagehot's discussion of lender-of-last-resort policy was the notion that liquid funds should be provided to the financial market rather than directly to individual financial institutions. Schwartz (1986) and Goodfriend and King (1988) concur, arguing that the central bank does not have superior, or more timely, information than the market as a whole. Therefore, liquidity support should be provided to the market, with the market then allocating the liquidity. Seen in this light, the provision of liquidity to individual institutions involves discretionary government assistance that is likely to distort the competitive landscape. While private market solutions may be able to handle idiosyncratic failures, only the central bank can address an economy-wide increase in demand for liquidity occasioned by a macroeconomic shock (Bordo 1990). However, it can also be argued that responding to difficulties at an individual institution by providing liquidity to the market is not true last-resort lending as it can only succeed if market participants are prepared to continue to extend finance to the troubled institution.[4]

Bagehot advocated that, in operating a lender-of-last-resort facility, a central bank should:

- offer liquidity support 'freely and vigorously', but at a penalty rate;
- accommodate anyone with good collateral; and
- make clear in advance the central bank's readiness to lend freely.

In recommending that the lender of last resort offer support freely, Bagehot advocated that it should lend to any sound borrower – non-banks as well as banks. Subsequent theoretical analysis, such as that outlined in Section 2.1 above, argues that provision of last-resort support should be confined to those financial institutions that are of systemic importance and that a special case can be mounted for the provision of support to banks.

Charging a penalty rate strengthens the incentives facing financial institutions, encouraging them to make their own arrangements to insure against liquidity shortfalls. Penalties must be well targeted. Setting penalties too low may result in overuse of last-resort lending. Charging a penalty rate that is too high may impair a borrowing institution, which is likely to already be in a fragile position. Moreover, penalty-rate financing that is too costly may create an incentive for institutions to 'gamble for resurrection' by adopting high-risk strategies in an attempt to trade out of any difficulties (Levonian 1991).

Bagehot's second caveat was that the lending should be based on good collateral. This means that last-resort support should be available to illiquid, but not insolvent, banks. Such an approach aims to separate the risk of system-wide fire

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4 Another way of ensuring greater market involvement in lender-of-last-resort arrangements is through public sponsorship of concerted private sector lending. This has the advantage of 'bailing in' the private sector, increasing the incentives for banks to actively monitor their bank counterparts. However, the coordination problems that affect depositors can also affect the interbank market. The central bank, by virtue of its role at the centre of the payments system, has an advantage in organising private sector liquidity support. Coordination problems may be resolved by the central bank bringing banks together – once the banks are able to reassure one another they will not run, interbank lending may resume (Freixas *et al* 1999).

sales of assets prompted by liquidity shocks from idiosyncratic bank failures due to inefficiency or mismanagement. In this way, Bagehot was seeking to distinguish between instances where fundamentally sound banks were brought down by market failure and closures of poorly managed banks, where the full force of market discipline should be applied.

In the midst of a crisis, distinguishing between illiquid institutions that are solvent and institutions that are insolvent may be extremely difficult. In many cases, liquidity support is sought at the very time that the market itself is having difficulty assessing the solvency of an institution (Goodhart 1985). Bagehot recognised it is difficult, particularly in times of financial distress, to accurately value financial assets. In a period of asset deflation and disruption of price relativities which often surrounds banking difficulties, it is difficult to establish whether the fall in the price of a particular financial instrument is due to short-term illiquidity or inherent weakness. Bagehot argued, therefore, that collateral should be valued at pre-panic prices. This, however, presupposes that pre-panic valuations are sound and not distorted by asset-price bubbles (see Kent and Lowe (1997)), which are often seen in the run-up to banking crises.

If systemic consequences are taken into account, it is possible that public action may be required to ensure the smooth exit of a clearly insolvent institution. It also may be the case that providing support to an insolvent institution may be less costly than allowing it to fail (Guttentag and Herring 1983).

The third element in Bagehot's recommendations was that central banks should make clear in advance their readiness to lend unsparingly. During a bank run, anything that increases depositors' fears that their deposits will not be repaid is likely to exacerbate a run. Bagehot argued that the lender of last resort should allay depositors' apprehension by publicly declaring that liquidity would be available. However, maintaining some uncertainty about the conditions under which lender-of-last-resort policy may be activated ('constructive ambiguity') may induce financial institutions to be more cautious than they would be if they were certain of being bailed out (Enoch, Khamis and Stella 1997).

Constructive ambiguity, however, gives central banks the scope to overuse their lender-of-last-resort powers by appealing to the systemic consequences of bank illiquidity. Central banks face an asymmetric pay-off when conducting lender-of-last-resort policy. On the one hand, there is always some chance that failure to provide liquidity support may lead to cascading financial distress and macroeconomic costs – an outcome which would attract heavy criticism. On the other hand, much less criticism might be expected if the central bank provided (inappropriate) liquidity support to an institution since such support could always be justified on the basis that the central bank's assessment of the (unobservable) probability of financial instability was high. It is argued, therefore, that central banks will systematically overestimate the threat to the macroeconomy when an illiquid institution cannot meet its payments.

Another difficulty with the systemic-risk approach is that it risks fostering the presumption that certain institutions are 'too big to fail'. This creates a competitive distortion favouring larger banks over smaller banks.

Kindleberger (1978) proposed that the provision of lender-of-last-resort support should be uncertain and, in addition, responsibility for the provision of last-resort support should be divided among a small number of institutions. The division of responsibility is needed to ensure credible ambiguity. Spreading responsibility disperses public pressure for assistance, reducing the likelihood that individual public officials will fall sway to the demand of lobbyists seeking to be bailed out.

An alternative approach to overcome the asymmetric pay-off faced by central banks is the application of a rules-based approach. Mishkin (1998) argues that, in adopting a systemic-risk focus, monetary authorities should adopt a rule that the first large institution should be allowed to fail in any period of financial stress. Authorities should then stand prepared to extend the safety net to the rest of the financial system if they perceive there is a serious systemic risk. While this approach goes some way towards preventing overuse of the lender-of-last-resort facility, it may not fully address the trade-off between short-term financial disturbances and longer-run moral hazard costs. For example, it may lead a troubled institution to do whatever it can to forestall disclosure of its own difficulties; ultimately, this could lead to deeper and more widespread problems.

Rather than seeking to reduce public sector intervention, one approach to minimising moral hazard costs is to recognise that last-resort support yields a second-best result that warrants additional regulation (Goodhart 1985). Prudential regulation, such as requirements on the proportion of assets that banks must hold in liquid form and capital adequacy rules, specifically target banks' proclivity for risk-taking.

Although there were times during the nineteenth century when neither governments nor banking industry groups were prepared to act as a lender of last resort, the case for a lender of last resort has been widely accepted for most of Australia's history. This history is sketched out in the remainder of the paper. For reference, a brief chronological summary is presented in Appendix A.

3. The 1820s

The Australian history of official support for troubled financial institutions began just under forty years after the formation of the New South Wales (NSW) colony. The first bank to operate in Australia, the Bank of New South Wales, was established with the active support of the colony's Governor in 1816. Within the first 11 years of the bank's operation it was struck by liquidity crises three times. While the bank was able to withstand the first in 1821 without outside support, it sought assistance from the colonial administration in 1826 and again in 1828. In both cases, loans were granted by the NSW Governor out of concern for the potential effect of the bank's failure on the colony's economy. Although a penalty rate of interest was not charged, the loans were subject to caveats that restricted the bank's ability to take on new risks, required the bank to increase its capital reserves and strengthened the colonial administration's oversight of the bank.

3.1 The Establishment of Australia's First Bank

The NSW colony's recurrent shortages of currency and the inefficiency and scope for fraud in the private issuance of promissory notes led Governor Lachlan Macquarie to favour the establishment of a colonial bank. In late 1816, the Bank of NSW was established as a privately owned bank. Macquarie granted the bank the privilege of limited liability, usually obtainable only by Royal Charter. If the proprietors had been prepared to establish the bank as a partnership with unlimited liability – the usual form of corporate structure at the time – no special charter would have been required. Macquarie believed that the proprietors would not risk subscribing to the bank without some guarantee against losing more than their subscribed capital if the bank were to fail (Holder 1970).

Macquarie, in fact, had no specific power to approve such a charter. The British administration instructed Macquarie to refrain from providing any implicit support for the bank and to inform the bank's shareholders that the bank would have to trade as an ordinary partnership.[5] Macquarie delayed responding to this direction. And while questions about the validity of the charter arose from time to time, the bank continued its business.

Macquarie's patronage helped the bank to establish itself within the colony. The bank's notes were specified as the medium of payment for customs duties and for various properties sold by the government. Macquarie, however, stopped short of making the Bank of NSW the banker to the colonial administration (Butlin 1953).

The bank experienced its first serious difficulties in late 1820 when its cashier defrauded it of £6 000 (equivalent to 10 per cent of the bank's assets). In January 1821, word of the fraud became public, sparking a brief deposit run. The run was stemmed by the bank's president, in his capacity as Provost-Marshal, undertaking to accept the bank's notes in official payments, and by some 20 merchants (most of them shareholders) advertising their willingness to take the bank's notes. The bank itself promised that all notes presented would be met in government bills or coin.

3.2 The Liquidity Crisis of 1826

The early 1820s saw a boom in the colony's economy. The boom was marked by rapid population growth, pastoral expansion, and sharp rises in the prices of agricultural stock. Against this background, the Bank of NSW expanded its lending at a rapid rate. Its total loans grew from £23 577 in 1820 to peak at £95 408 in May 1826 (Butlin 1953). By 1826, however, the bank found itself in extreme difficulties. These arose from two main sources: increased competition, and an

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[5] Earl Bathurst to Governor Macquarie, 29 October 1818, *Historical Records of Australia*, 1, IX, pp 840–841.

acute shortage of currency throughout the colony. Mismanagement of the bank compounded its problems.

The first source of competition came from the Waterloo Company. While the company began as a flourmill, as a sideline it also accepted deposits and issued its own notes. More significantly, a second bank – the Bank of Australia – opened in the colony in July 1826. Payment of capital subscriptions to the new bank drew cash and deposits away from the Bank of NSW.

The April 1826 foreign exchange crisis created a serious drain on the colony's liquidity. An import boom resulted in large currency outflows. In addition, the colonial administration moved the colony to the sterling standard.[6] This precipitated large exports of Spanish dollars, which were more rapid than offsetting imports of sterling, leading to a generalised shortage of coin.

In May 1826, the Bank of NSW found itself unable to discount bills denominated in Spanish dollars. Although the bank's cash reserves were almost exhausted, the bank was solvent (Sykes 1988). The bank applied to the government for a loan of £20 000. Liquidation of the bank's assets risked triggering widespread bankruptcy in the colony.[7]

Governor Ralph Darling commissioned a Board of Inquiry to assess the bank's affairs. The Inquiry attributed the Bank of NSW's difficulties to the import boom. While it did not find that there had been any fraud, the Inquiry recommended that any support should be subject to the condition that '… the management of the Bank should be conducted with more circumspection than appears to have been lately observed'.[8]

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6 Up until 1826, the colony had no official currency. Coin circulating in the colony came from a variety of countries, although the Spanish dollar was the most prevalent currency, as was the case in most British colonies.

7 Earl Bathurst to Governor Darling, 1 December 1826, *Historical Records of Australia*, 1, XII, p 703.

8 Quoted in Sykes (1988, p 14).

Governor Darling agreed to support the bank. The conditions attached to the loan included:

- the appointment of three directors (to be added to the existing board of seven) acceptable to the Governor;
- the reduction of the bank's weekly lending by a quarter for the remainder of 1826; and
- the full payment of capital that had been subscribed, but not fully paid, by the end of the year, with no dividend to be paid to shareholders in that time.

The announcement of the provision of support was sufficient to shore up public confidence (deposits exceeded withdrawals by the end of May). Although the bank sharply curtailed its lending, in August it was forced to draw on the government loan. It was able to repay the loan by January 1827.

3.3 Further Runs on the Bank of New South Wales, 1828

In late 1827 and early 1828, divisions among the management and shareholders of the Bank of NSW further undermined the bank and public confidence in it. In its weakened state, the Bank of NSW was poorly placed to withstand the colony's slide into depression in late 1827 (Butlin 1953).

A run on the bank developed in the closing weeks of 1828, and the bank again applied for government assistance. Concern about the consequences of the Bank of NSW calling-in its loans at a time of economic distress saw the government agree to offer support.[9] A number of witnesses to the colonial administration's inquiry, called to consider the bank's request, suggested that suspension of the Bank of NSW could trigger a general panic and a run on the Bank of Australia.[10] Governor Darling was also mindful of the benefits of having two banks operating in competition and the need to avoid the perception of using his position for personal gain (his family were shareholders in the Bank of Australia).

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[9] Governor Darling to Sir George Murray, 29 December 1828, *Historical Records of Australia*, 1, XIV, p 549.

[10] Extract from the Proceedings of the Executive Council, Minute No 14, *Historical Records of Australia*, 1, XIV, pp 551–555.

This time the support was subject to more stringent conditions:

1. the wind-up of the bank within a year;
2. a progressive reduction in lending;
3. no dividend payments until repayment of the loan;
4. a government-appointed director and the submission of weekly statements of accounts to the Governor; and
5. bills from the bank selected by officers of the government were to be taken as security against the loan.

Again, the government's support succeeded in quelling public anxiety.

In response, the bank strengthened its efforts to collect overdue loans and improved its liquidity sufficiently to repay the government loan in May 1829. The bank then defied the government's order to wind-up its affairs. In the face of the substantial improvement in the bank's condition, the Governor relented and allowed the bank to continue trading.

4. The 1840s Depression

During the 1830s, the expansion of the pastoral industry and whaling, the spread of land settlement and capital inflows from Britain fuelled rapid growth. In this environment, the existing banks expanded their activities, British banks entered the Australian market and a number of new colonial banks were established.

Economic conditions began to turn in 1840. The wool industry had reached the bounds of profitable expansion onto new land. Severe drought in 1838–1840 necessitated wheat imports and payment for this drained liquidity from the colonies. The British financial crisis of 1839 heightened British investors' sensitivity to declining returns in the colonies, which in turn slowed capital inflow. A slump in land sales, falling prices and incomes culminated in an upsurge of insolvencies that substantially weakened the banks.

The depression of the early 1840s precipitated the first wave of bank failures seen in Australia. Although six banks failed (and one merchant company abandoned its banking operations), they were relatively small, and in most cases depositors fully recouped their funds. In line with the prevailing philosophy that the government should not intervene in banks' operations, there was no official intervention in these failures. The government, however, was more ready (on social rather than economic grounds) to intervene to protect depositors who had placed funds with the colonies' savings banks.

4.1 Trading Bank Failures

Throughout the nineteenth century, Australian trading banks operated in a largely unregulated environment. The charters and acts under which the banks were established imposed a range of restrictions on banks, including limitations on the types of lending, particularly against real property, that could be undertaken. The 1840 Colonial Bank Regulations stipulated simple capital adequacy requirements, some restrictions on bank lending and that all bank notes were to be payable on demand in coin (Baster 1929).[11] These constraints were widely evaded and progressively relaxed by legislative changes.[12]

The largest bank to fail in 1843 was the Bank of Australia. It was particularly affected by the failure of one large borrower – a milling and merchant firm. Two banks jointly provided a loan to the Bank of Australia enabling it to repay all creditors other than the banks. In the wind-up of the bank, shareholders lost twice the value of their shareholding (requiring shareholders to pay-in funds on top of the loss of their initial capital investment) offset by a portion of the real estate held by the bank (Sykes 1988). Auctions of the bank's assets allowed it to settle its debts and finally close in July 1851.

The other well-established bank to fail was the Derwent Bank. During the 1830s, it had expanded by offering mortgage finance, attracting borrowers who were refused finance elsewhere (Butlin 1953). The bank continued in operation until 1849 by borrowing from other banks. In 1849, the banks refused to continue to extend

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[11] Up until 1910, individual banks were permitted to issue their own bank notes. While bank deposits were not transferable, bank notes circulated widely in the colonies as a means of payment. Although note holders were afforded greater protection than depositors, it was not until the 1880s that bank notes became a first charge on bank assets, ranking ahead of deposits in the event of the wind-up of a bank.

[12] For example, several banks were able to operate for a number of years before legislation governing their incorporation was passed (Teare 1925).

finance and the bank's shareholders resolved to wind-up the bank. Most outstanding notes and deposits were repaid within a few months.

Three small domestic banks, established at the peak of the expansion in 1839 and 1840, failed in 1843. Loan defaults and heavy borrowing by the bank's own directors saw the Port Phillip Bank fail in January 1843. In April 1843, investigations of the accounts of the Sydney Banking Company unearthed management fraud, leading shareholders to close the bank. The Colonial Bank's losses in the first half of 1842 led proprietors to question whether to wind-up the bank. This triggered a run that cut the bank's note circulation by half and deposits by a third. In an environment where the shareholders themselves were pressed for cash, they opted to cut their losses and close the bank. In each of these cases, note holders and depositors were quickly repaid.

Of the two other banking failures during the 1840s, one involved the withdrawal from banking by Archers Gilles and Company. The company acted mainly as a merchant and trader. The Union Bank's bailout of the company was conditional on the transfer of its banking business to the Union Bank. This involved no loss to depositors or note holders. The second failure involved the fraudulent operation of the Royal Bank of Australia. While the bulk of the bank's deposit liabilities and shareholders were based in Britain, most of its assets were in Australia. The bank, formed in 1839, never carried out more than cursory banking operations. Instead, its funds were fraudulently used to finance Benjamin Boyd's pastoral, shipping and whaling activities in Australia (Sykes 1988). In 1846, the bank's directors in London discovered Benjamin Boyd's deception. Liquidation of the bank imposed heavy losses on both depositors (few of whom were Australian) and British shareholders.

Throughout the whole period, the few deposit runs that did occur did not spread much beyond the troubled institutions. With the exception of the Royal Bank, note holders and depositors lost almost no money. Given shareholders' preferences to cut losses and close their banks, there was little scope for government intervention. The banks themselves, in their submissions to the NSW Select Committee on Monetary Confusion (*sic*) held in August 1843, argued that the 'natural course of events' should be allowed to run.

In NSW, two legislative initiatives did help banks and borrowers withstand the depression. In December 1841, legislation was passed relaxing the treatment of insolvents, permitting debtors with real prospect of ultimately paying to retain and use their property. This gave banks greater scope to restructure non-performing loans. The introduction of wool liens and stock mortgages in 1843 expanded the range of assets banks could take as collateral. This made it easier for squatters, who had no fixed property assets, to obtain finance.[13] The volume of such loans did not offset the overall decline in bank loans, but helped sound squatters withstand the depression (Butlin 1986).

4.2 Savings Banks

The first savings bank in Australia, the New South Wales Savings Bank, was established in 1819 as a private initiative, although with the Governor's patronage.[14] The bank struggled to attract funds and, in 1832, the Savings Bank of NSW was established in its place.[15] The colonial administration took a more active role in running the new bank. The Governor was president of the bank, while management was vested in trustees appointed by the Governor.

In May 1843, a run on the Savings Bank of NSW occurred as a result of rumours that the Governor, after examining the bank's securities, had declared them to be worthless. There were also concerns that the trustees had lost money in the failure of the Bank of Australia. The bank met deposit withdrawals by rediscounting bills with other banks. A Board of Inquiry, appointed by Governor Gipps, found that the savings bank was solvent. In response to the run, the government undertook to guarantee trustees' borrowings, if taken out to meet the bank's repayments, of up to £50 000. Larger loans could also be guaranteed with the consent of the Governor-in-Council. These arrangements were put in place for fear of the social consequences that might follow if depositors were unable to access their funds.

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[13] Squatters were farmers who settled on Crown land to run stock, especially sheep, initially without government permission, but later under a lease or licence arrangement.

[14] Savings banks were distinguished from trading banks by their focus on small deposits and constraints on their lending that saw them invest mostly in government securities, and later (after the 1910s) in residential mortgages.

[15] The savings bank was quite separate from the Bank of NSW.

Between 1835 and 1865, savings banks were established in each of the other colonies either as government-owned and controlled entities or under the management of a board of trustees over whose appointment governments usually exercised some control. In Queensland, South Australia and Western Australia, private initiatives to establish savings banks were ultimately supplanted by government-owned institutions.

5. Intermittent Failures and Runs, 1850–1890

While overall conditions remained comparatively calm between the depressions of the 1840s and the 1890s, economic and political fluctuations, peppered with fraud, triggered isolated liquidity crises and bank failures in South Australia (in 1852 and 1885), Queensland (in 1866) and Victoria (in 1879). While the difficulties experienced in South Australia and Queensland prompted responses from the public sector, depositor runs in Victoria marked the first mutual support provided by the banking industry, which was coordinated by the Associated Banks of Victoria.

5.1 South Australia

Gold rushes in NSW and Victoria in 1851 triggered an exodus of both people and cash from South Australia. This led the South Australian Government to introduce a package of measures to shore-up banks' liquidity and the liquidity of the colony more broadly. Under the *Bullion Act* of 1852, banks were required to accept gold ingots as deposits. The notes issued by banks in exchange for the ingots were declared legal tender for a year. This gave banks time to ship coin from London. As well as easing the general liquidity shortage, it is likely that the government's actions saved the Bank of South Australia from suspending payment (Butlin 1961a). The bank had been particularly hard hit by the liquidity squeeze since it accounted for around half of the colony's banking business.

Drought in 1885, combined with falls in the world price of copper, weakened South Australia's main agricultural and mining businesses, creating bad debt problems for the banks. In February 1886, fraud on top of bad debts brought down the Commercial Bank of South Australia (which accounted for 9 per cent of deposits in South Australia). In the weeks before the bank's closure, it sought assistance from the Associated Banks in Melbourne (an alliance of the strongest Victorian banks). After examining the bank's books, the Associated Banks declined to take over the bank's business (Sykes 1988). While legal complications delayed the liquidation of the bank, by 1893 all depositors had been repaid.

5.2 Queensland

As a result of the Queensland colony's heavy dependence on foreign borrowings for the development of road and rail infrastructure, the Queensland Government was caught up in the financial turmoil in England in May 1866. The failure of the government's agent for the sale of its debt in London led it to seek other avenues for emergency borrowing. The government proposed an issue of inconvertible, legal tender notes. Queensland's Governor, however, withheld assent. The ensuing political crisis triggered a change of government. The new government adopted the note issue plan, although the notes issued were convertible into gold and were not legal tender. A large circulation was never achieved (between 1866 and 1869, the government notes averaged at most 17 per cent of total note issue in Queensland) and the notes were withdrawn in 1869 (Butlin 1986).

When news of the British crisis reached Brisbane in July 1866, there were generalised runs on banks, particularly the government-backed savings banks.[16] The Colonial Treasurer's statement that all demands for payment would be 'faithfully met' eased the position of the savings banks.

The deposit runs precipitated the closure of the Bank of Queensland (which had been formed in London in 1863). By 1866, the bank was the fourth largest in the colony, accounting for 15 per cent of bank deposits (Sykes 1988). Although the bank was solvent, it did incur a loss in 1866 as drought in Queensland in the mid 1860s impaired the pastoral industry's ability to meet its debts. In the face of Queensland's political turmoil, the London shareholders chose to liquidate the bank, rather than inject fresh capital. By July 1867, all depositors were repaid in full (Butlin 1986).

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[16] Runs by British depositors also affected Australian banks. The National Bank of Australasia found itself unable to meet its obligations in London. It obtained a last-resort loan from the Bank of England until funds could be shipped from Australia (Blainey 1958).

5.3 Victoria

Melbourne had become Australia's main financial centre following the Victorian gold rushes in the 1850s. In the absence of a central bank, and with the government unwilling to intervene to assist troubled banks (other than the savings banks), the trading banks began to take collective action to provide limited last-resort support through their industry association. The Associated Banks of Victoria was formally constituted in 1877 by those banks that conducted the government's banking business in Victoria.[17] It therefore represented the largest and strongest banks operating within Victoria. [18]

Three banks, the Provincial and Suburban Bank, the Australian and European Bank and the City of Melbourne Bank, sought assistance from the Associated Banks in 1879. Each of these banks was small.[19] The first of these was deemed to be too weak to warrant support. The second received limited support, while the third, which was the soundest of the three, received strong public support from the Association. The differential treatment afforded to the troubled banks reflected both the Associated Banks' concern to protect their own viability (by only lending to sound institutions) and moral hazard concerns (refusing to support banks that had been managed recklessly). Debate within the Associated Banks concerning the public's ability to discriminate between notes issued by different banks saw the banks grapple with the systemic consequences of bank failure, albeit in a limited way.

The Provincial and Suburban Bank made losses in all seven years of its operation (which were masked by misstating the bank's accounts). Following its closure in May 1879, the Associated Banks' investigation of its operations confirmed that the bank had been 'founded, reared, and ended in fraud'.[20] Some banks within the

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[17] No such industry organisation was established in any of the other colonies, although the Australian banks in London formed an association in 1875 (Butlin 1961b).

[18] The Association consisted of the four Anglo-Australian banks whose main Australian office was in Melbourne (the Bank of Australasia, the Union Bank, the London Chartered Bank, the English, Scottish and Australian Chartered Bank) and six colonial banks based in Melbourne (the National Bank of Australasia, the Commercial Bank of Australia, the Bank of Victoria, the Colonial Bank, the City of Melbourne Bank and the Federal Bank).

[19] The Provincial and Suburban accounted for just 0.3 per cent of all Victorian deposits, the Australian and European Bank 1.8 per cent and the City of Melbourne Bank 1.4 per cent.

[20] ES Parkes (Superintendent of the Bank of Australasia) quoted in Butlin (1961a, p 233).

Association argued that the public did not discriminate between notes issued by sound and weak banks, and therefore other banks should honour the Provincial and Suburban's notes. The prevailing view, however, was that the Provincial and Suburban was widely known to be unsound, and no support was provided.[21] In the liquidation of the bank, note holders received just 10 per cent of their notes' value, depositors received a little over 40 per cent of their funds, while shareholders lost all of their capital investment (Sykes 1988). This marked the last time in Australia's history that bank notes were not fully paid (Polden 1977).

Underlying bad debts led to the suspension of payment by the Australian and European Bank in June 1879. The Associated Banks agreed to cash Australian and European's notes and advance the bank £50 000. The Associated Banks' support combined with payments of uncalled capital by shareholders and the extension of the maturities of a number of large deposits enabled the bank to re-open a fortnight after its closure (Wood 1990). A more generous offer by the Associated Banks, accompanied by harsher conditions (the Associated Banks offered to meet all of the bank's obligations if it went into liquidation at once), was refused by the bank's directors (Blainey 1958). Not long afterwards, in August 1879, the Australian and European Bank was taken over by the Commercial Bank of Australia, and all creditors were eventually repaid.

The suspension by Australian and European sparked a run on the City of Melbourne Bank (which was the only other bank of issue that was not a member of the Associated Banks). The Associated Banks inspected the bank's securities and found the bank to be in a sound condition. The Associated Banks resolved that they were prepared to lend £40 000 if necessary, and issued a statement indicating they were prepared to offer the bank 'whatever assistance may be required to meet their engagements in the present emergency'.[22] The deposit run quickly subsided and no financial assistance was required. A similar, but less severe, run on the Commercial Bank of Australia also stopped. Depositors most likely believed that the Associated Banks would also support one of their own members (Butlin 1961a).

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[21] The *Australian Insurance and Banking Record* reported that the closure of the Provincial and Suburban Bank 'caused no astonishment in banking circles' and 'produced no effect whatever up on the price of other bank shares' (9 June 1879, Vol 3, p 163).

[22] Text reproduced in the *Australian Insurance and Banking Record*, 9 June 1879, Vol 3, p 158.

While the Victorian Government stood aside from the banking difficulties of 1879, pressure in the late 1880s led to legislation strengthening the protection of holders of bank notes. Problems from the Oriental Bank's Asian and African operations led it to suspend payment in May 1884. The Victorian Government insisted on priority for debts owed to it, at the expense of note holders and depositors. This prompted proposals for banking reform to protect note holders.[23] On the recommendation of the 1887 Royal Commission on Banking, legislation was passed which made notes the first charge on each bank's Victorian assets (Butlin 1961a).[24] Most of the witnesses to the Commission's inquiry argued that bank notes should be afforded particular protection as they were widely accepted without question, whereas customers could exercise their own choice over the placement of their deposits.

6. The 1890s Depression

The depression, which saw real GDP fall 17 per cent over 1892 and 1893, and the accompanying financial crisis, which reached a peak in 1893, were the most severe in Australia's history. The overextension of the 1880s property boom and its unravelling led to an abrupt collapse of private investment in the pastoral industry and urban development and a sharp pullback in public infrastructure investment. A fall-off in capital inflow from Britain, adverse movements in the terms of trade and drought in 1895 accentuated and prolonged the depression.

The 1880s property boom was financed by rapid expansion in bank lending. In addition, many building societies and property finance companies, known as 'land banks', sprang up during the 1880s. The increased competition from such new entrants weakened banks' prudential standards (Merrett 1989). While some recognition of this came in 1888, when the Associated Banks increased interest rates and adopted stricter capital standards, for many financial institutions the damage already done was too severe to be repaired (Boehm 1971).

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[23] Amendments to the Colonial Bank Regulations in 1846 had limited banks' note issue to the amount of paid-up capital. In addition, by the late 1860s, most colonies required shareholders to bear unlimited liability for banks' note issues. (In most cases, bank shareholders were liable for twice the value of shares subscribed to repay creditors in the wind-up of a bank.)

[24] Similar concerns saw the South Australian *Banks Notes Security Act* make bank notes a first charge on banks' assets in 1889.

The collapse in property prices in 1889 led to a spate of building society failures in 1890. As it became clearer that the fall in property prices was not just a temporary fluctuation, the financial collapse spread to the land banks. As the number of failures and frauds grew, public confidence in financial institutions faltered, spreading the crisis to the institutions at the core of the financial system – banks that issued their own bank notes.

Counting banks as any institution that called itself a bank and solicited public deposits, 54 of the 64 institutions operating in 1891 had closed by mid 1893; 34 of these closed permanently. Defining banks more narrowly, to exclude institutions more akin to building societies, only nine of 28 banks remained open continuously throughout the 1890s. Of the banks that suspended payment, six closed permanently (either failing outright or being taken over). Several of the banks that reopened were later taken over by stronger banks. At the height of the crisis in April and May 1893, the banks that suspended payment accounted for 56 per cent of deposits and 61 per cent of the note issue in the six Australian colonies (Butlin 1961a).

6.1 Bankruptcy Law

The widespread runs on building societies and land banks, which were forcing institutions to conduct fire sales of assets, prompted both the NSW and Victorian Governments to pass emergency legislation revising liquidation procedures in 1891. The aim of the legislation was to give financial institutions more time to resolve their difficulties by delaying bankruptcy proceedings and deferring depositors' claims. In NSW, the legislation provided that any single creditor's ability to force compulsory liquidation could be overridden by an agreement amongst a numerical majority of creditors holding three-quarters of a company's liabilities. The Victorian arrangements were slightly different. The *Voluntary Liquidation Act* (which was passed on 3 December 1891 and applied for one year) provided that compulsory liquidation of a company could only go ahead if one-third of creditors, *both* by number and by value of shares, joined in application to the court.

That Victoria's requirements were expressed in terms of both the number and the value of shares made meeting the conditions needed to press for liquidation nearly impossible to achieve. This tilted control towards bank directors and left depositors with little option but to agree to defer their claims.[25] The *Voluntary Liquidation Act* also allowed many companies to be wound-up without any independent investigation. While the pretext of the Act was that companies needed secrecy in order to avoid panicking investors, it allowed past dishonesties to be hidden (Cannon 1966). In contrast, under the NSW legislation bank directors had to at least convince creditors of the soundness of any reconstruction scheme.

In response to public criticism, the *Voluntary Liquidation Act* was modified in 1892. The revised arrangements provided that, if a scheme of reconstruction were endorsed by three-quarters of creditors it would become binding on all creditors. This brought the Victorian requirements more into line with the NSW arrangements. Importantly (and unlike the NSW model), the court was unrestricted in its duty to see that the schemes of arrangement were just (Boehm 1971).

These temporary liquidation laws opened the way for the banks to implement reconstruction schemes in 1892 and 1893. The details of reconstruction schemes varied across banks, but all followed the same broad pattern. Shareholders were called on to invest fresh capital in the reconstructed bank and were released from liability for calls on unpaid capital from the old bank. The major part of depositors' claims were extended for long periods, generally for a minimum of four years, before any withdrawals could be made, and in some cases these claims were converted into preference shares.

6.2 The Associated Banks' Mutual Support

In December 1891, two small Victorian trading banks, the Metropolitan Bank and the Standard Bank, failed. Both banks applied to the Associated Banks for aid. The Metropolitan Bank, however, suspended payment before its application was considered. The Associated Banks determined that the Standard Bank was in such poor condition that there was no point in delaying its closure and refused to provide support (Butlin 1961a).

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[25] That the Victorian Government's legislation more strongly favoured the interests of bank owners is largely attributable to the heavy involvement of the leading Members of Parliament in the activities of frail land companies and banks.

The Mercantile Bank of Australia had been weakened by fraud and large loans to its own directors. It approached the Associated Banks for assistance in March 1892. The Association offered to lend £100 000, conditional on the provision of security and full disclosure of the bank's accounts. The Mercantile refused to allow inspection of its books and the offer was withdrawn. The bank closed on 5 March.

The Associated Banks met several times at the end of March 1892 to discuss joint action to allay the growing panic. A number of the weaker banks favoured all members providing an unqualified guarantee to each other. The stronger banks, however, were not willing to take on such an open-ended obligation. In the event, the Association publicly announced 'the Associated Banks in Melbourne have agreed on mutual satisfactory conditions on which they will extend their support to any of their number requiring it'.[26] The press interpreted this as virtually a blanket mutual guarantee and the statement was successful in alleviating panic. The conditions under which support would be provided were not published. These conditions limited support to 'a reasonable amount upon the sound basis of approved securities'.[27] The guarantee, therefore, was of little practical substance.

The Associated Banks also considered a proposal for joint action in lending to those depositors whose funds were frozen. The banks resiled from the prospect of a rush of holders of frozen deposits many of whom would, even in good times, be refused finance (Butlin 1961a). The proposal was not acted upon.

In January 1893, the Federal Bank failed. It was the smallest and weakest of the Associated Banks. In 1885, it had been granted a share of government business that allowed it to become a member of the Associated Banks. In 1889, the Associated Banks changed their rules to exclude any bank with direct ownership links to a building society. To remain in the Association, the Federal Bank sold its stake in the Federal Building Society. Continuing links between the management of the bank and the building society, however, created suspicion in the public mind. In the 10 months up to January 1893, the bank lost a third of its Australian deposits.

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[26] Text reproduced in *Australasian Insurance and Banking Record*, 18 April 1892, Vol 16, p 245.

[27] Text reproduced in *Australasian Insurance and Banking Record*, 18 April 1892, Vol 16, p 245.

Some banks supported proposals that the Associated Banks take over the Federal Bank, no matter what the cost, for fear that the closure of the bank (which would impose losses on the Federal Bank's British depositors) would see all Australian banks lose their British deposits. The Anglo-Australian banks, however, argued that British depositors might be more alarmed if they discovered that the Associated Banks had taken over the Federal Bank to conceal its insolvency, since such action would suggest that the Melbourne banks had much to hide (Blainey 1958).[28] The Associated Banks attempted to persuade the Bank of Victoria to take the bank over, while the National Bank of Australasia, the Bank of Adelaide and the City of Melbourne Bank inspected the bank with a view to buying parts of its operations. When these attempts failed, the Association was invited to jointly undertake the liquidation of the bank. The Associated Banks responded that they would only consider supervising the liquidation of the Federal Bank if directors would guarantee almost half of the bank's uncalled capital (an amount of £400 000) (Holder 1970). The directors were unable to give such a guarantee. The Association, therefore, stated that 'the liquidation of one of their number was foreign to their ordinary functions, and as liquidation had become inevitable, under any circumstances it had better proceed in the ordinary manner'.[29] Although all depositors were repaid in full in the liquidation of the bank, the Associated Banks' statement undermined their public statement of 28 March 1892 offering support to all of its members. This prompted runs on those members of the Associated Banks that were suspected of being weak, especially the Commercial Bank of Australia.

The Victorian Treasurer, CD Carter, met with the Associated Banks and pleaded for some public gesture of mutual aid. The result was a public statement on 14 March 1893, declaring that they 'have agreed to act unitedly in rendering financial assistance to each other, should such be required; and that the Government of Victoria have resolved to afford their cordial co-operation'.[30]

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[28] The Anglo-Australian banks were headquartered in London, but conducted the bulk of their business, particularly their lending, in Australia. While almost all Australian banks obtained funds from British depositors, the Anglo-Australian banks were particularly dependent on British finance.

[29] Text reproduced in *Australasian Insurance and Banking Record*, 18 February 1893, Vol 17, pp 74–75.

[30] Text reproduced in *Australasian Insurance and Banking Record*, 18 March 1893, Vol 17, p 153.

Again, the press interpreted this as a sweeping mutual guarantee. However, the superintendent of the Bank of Australasia, who had not been represented at the Association's meeting, argued that the refusal of the Associated Banks to support the Federal Bank had destroyed any value in such assurances unless the banks were prepared to specify the degree of support they would give. As a result, the Associated Banks re-conferred and issued a clarification of their agreement the next day: 'that they will in the future, as in the past, be willing to render financial assistance to each other on such terms, and to such an extent as may seem justifiable to each of them, if, and when the occasion arises'.[31] This made it clear in the public mind that there was no guarantee. Doubts also arose about whether the government was strong enough to guarantee the Commercial Bank, particularly since the Treasurer's action was not endorsed by the Premier. Deposit runs intensified.

The Commercial Bank had been the fastest growing bank during the 1880s. By September 1892 it accounted for 17 per cent of total bank assets in Victoria. It had also lent heavily to building societies. For over a year its deposits had been draining away. The three largest banks – the Union Bank, the Bank of Australasia and the Bank of NSW – canvassed possible means of arresting the outflow of deposits from the Commercial. One proposal was that the three banks reduce interest rates on deposits, though this risked undermining confidence in those banks that could not match the interest rate reduction. Another proposal was to refuse to take new deposits for amounts greater than £300 (Holder 1970). The acceleration of Commercial's problems overtook further consideration of these proposals.

On 28 March, the Victorian Government proposed a fund be formed that would be available to any bank requiring help.[32] Based on this model, the Associated Banks offered £1.9 million in assistance to the Commercial Bank. The Commercial argued that the assistance was insufficient and demanded the Associated Banks undertake to meet all of its deposits (which were around £11 million, 10 per cent of

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[31] Text reproduced in *Australasian Insurance and Banking Record*, 18 March 1893, Vol 17, p 153.

[32] The assistance was to be made up of direct advances of £100 000 by each member bank, an advance of the same amount by the Bank of NSW (which was not a member of the Association), and transfers of government deposits of £100 000 by each member.

all bank deposits in Australia) and make a public declaration of their open-ended support (Wood 1990). The Commercial also sought a public guarantee of government support. The government declined to offer such an unqualified guarantee, Premier Patterson opining that the closure of the Commercial would not have ‘any serious consequences’ (Cannon 1966). The bank suspended payment on 5 April adopting a reconstruction plan that allowed it to re-open fully on 6 May.[33]

Also in April, the bankruptcy of the general manager of the Colonial Bank triggered a run on the bank, even though the bank itself was sound. The Colonial sought the transfer of £50 000 of government deposits from each of the six members of the Association that remained open. On 17 April, the Associated Banks (and the Bank of NSW) offered a much smaller amount of assistance: a loan of £75 000 in coin, for six months, on the security of the title deeds to the bank’s branches and the transfer of £75 000 in government deposits to the bank (Blainey 1958). This enabled the Colonial Bank to stay open until the May banking holiday.

The City Bank of Sydney also came under pressure in April and sought assistance from the other Sydney-based banks. The amount required was not large and the banks agreed to provide support. The Australian Joint Stock Bank, however, found itself in greater difficulty. It sought assistance from the Commercial Banking Company of Sydney, the Bank of NSW, the Bank of Australasia and the Union Bank, requesting £2 million and raising the possibility of eventually needing an additional £1 million. Given just one day to respond to this request, the four banks refused to take on such a large liability (Holder 1970). The refusal of the banks to support the Australian Joint Stock Bank undermined the confidence built up by the publicity that had followed the support of the City Bank. A brief run on the other Sydney banks ensued, but the banks were able to meet withdrawals and the run ebbed away in a day or two.

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[33] The bank re-opened in a limited capacity on 8 April. Its business was confined to taking deposits that were placed in new accounts held in trust (*Australasian Insurance and Banking Record*, 18 April 1893, Vol 17, p 40). By this means, the bank was able to stem the loss of customers prior to the formal opening of the reconstructed bank (Wood 1990).

6.3 The Victorian Government's Response

In March 1893, the Victorian Treasurer (who was a director of the Bank of Victoria) tried to form a tighter alliance among the five members of the Associated Banks that were headquartered in Melbourne, suggesting that they withdraw from the full association and pledge all their resources to any of the five whose coin was depleted.[34] In return, the government offered to concentrate all its funds in those banks. The five banks already held half the government's deposits and so did not regard this as providing much benefit, particularly since the government refused to forgo interest on its deposits (Blainey 1958). The banks, therefore, did not take up the Treasurer's plan.

At the end of April, the National Bank of Australasia privately advised the Victorian Premier that it intended to suspend payment. The Victorian Cabinet met and declared the whole week a banking holiday. Many believed the main motive for calling the holiday was the government thought reconstruction of several of the remaining banks was inevitable and that the holiday would give those banks time to draft their reconstruction schemes (Holder 1970).

The Union Bank and the Bank of Australasia defied the bank holiday, and by the end of the Monday runs on their accounts had eased.[35] After closing on the Monday, the Bank of NSW re-opened on the second day of the holiday. The banks with branches in several colonies presumably realised that panic would be created among depositors in other colonies if they joined the bank holiday. By the end of the week, all banks, except the Colonial (which suspended payment on 6 May), had re-opened. On 5 May, the suspended banks that held government deposits released a proportion of those deposits to strengthen the Associated Banks that had not closed (Blainey 1958).

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[34] The five banks being the National Bank of Australasia, the Commercial Bank of Australia, the Bank of Victoria, the Colonial Bank and the City of Melbourne Bank. Excluded from the proposed scheme were the four English-based banks operating in Victoria: the Bank of Australasia, the English, Scottish and Australian Bank, the London Chartered Bank of Australia and the Union Bank.

[35] Both of these banks had large investments in London, which they drew on to bolster their cash reserves. In addition, the Union Bank was given a stand-by line of credit of £1 million by the Bank of England, but it did not draw on this (Butlin 1961b).

The Victorian Government was more willing to provide direct support to savings banks. In 1853, the Savings Bank of Port Phillip had been restructured into a system of Commissioners' Savings Banks, and a second savings bank, the Post Office Savings Bank, was established in 1865 with more direct and definite government backing for depositors.[36] The Commissioners' Savings Banks were large creditors to the Commercial Bank of Australia. In April 1893, depositor runs on the Commissioners' Savings Banks saw them run down their cash reserves and the Commissioners sought government aid. In return for a government guarantee and the provision of the necessary funds, the government required that the Commissioners' banks be amalgamated with the Post Office Savings Bank, and that the Commissioners hand over to the Treasury the cash and bank deposits they held with those Associated Banks that had not suspended payment. The Commissioners agreed to these conditions. With the government guarantee announced on 29 April 1893, the savings banks were specifically exempted from the bank holiday called in the first week of May.

6.4 The NSW Government's Response

Holders of bank notes were not, prior to the crisis, afforded the protection of having first claim on banks' assets in NSW.[37] On 3 May 1893, the NSW Government passed legislation that provided that all bank notes were to be a first charge on banks' assets and the notes of any solvent bank might be declared legal tender. While this increased the liquidity of the notes by requiring merchants to accept bank notes as payment for goods, it stopped short of a complete government guarantee of the banks since bank notes were required to be convertible into gold on presentation at each bank's head office. The banks resisted the government's intervention arguing that this would exacerbate public doubts about the banks. To mollify the banks' opposition, the legislation provided that no bank's notes would be declared legal tender unless it specifically requested assistance. The major banks held back from seeking such assistance for fear that the public would interpret such a request as a sign of weakness (Butlin 1961a).

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[36] Each branch of the Savings Bank of Port Phillip was constituted as an independent entity. The five Commissioners of the bank (who were appointed by the Colonial Governor) appointed local trustees to manage each branch. In contrast, the government had direct control over the Post Office Savings Bank's deposits, which were paid to the Colonial Treasurer and placed in a trust fund before being invested in government bonds.

[37] Victoria and South Australia introduced this requirement in 1888 and 1889 respectively.

Only one bank, the City Bank of Sydney, was anxious to have its notes made legal tender. To avoid singling out the City Bank, the government made a deposit with the bank large enough to meet its liquidity requirements for at least six months (Boehm 1971). But the run on the surviving banks in NSW continued.

In the face of the Commercial Banking Company of Sydney declaring its intention to suspend payment and reconstruct, the government promised assistance if the bank remained open and threatened to remove government deposits and concentrate its support on the Bank of NSW if the Commercial suspended payment. Nevertheless, the Commercial did suspend payment.

The government then overrode the banks' objections and declared the notes of all banks that were still open legal tender for six months from 16 May 1893. In October, Governor Dibbs indicated that he was prepared to extend the proclamation if required. Such an extension risked creating fresh doubts about the banks' ability to ultimately honour their notes. Instead, legislation was passed which placed limits on the total issue of bank notes and made the notes legal tender throughout NSW, except in Sydney. This saved banks the risk and expense of distributing coin across the colony (Holder 1970). Declaring bank notes legal tender freed up banks' reserves of coin. In June 1893, bank notes in circulation amounted to £1.3 million, almost 30 per cent of the value of coin and bullion held in NSW. The expansion in liquidity also allowed the banks to move coin to meet depositors' demands in other colonies.

The NSW Government took two further steps to bolster liquidity. Firstly, to mobilise gold held by the Australian Joint Stock Bank while its payments were suspended, Governor Dibbs pressured the bank's liquidator to accept notes instead of coin as payment from other banks and required the liquidator to pay gold for Australian Joint Stock Bank notes presented for payment by the other banks.

The government's second step was to issue its own legal tender notes that were made available to the banks for advances against current accounts frozen in suspended banks. The *Current Account Depositors' Act* was passed on 26 May and gave the Treasury power to pay depositors in Treasury notes redeemable in gold within five years against certificates stating the amount of their credit balances in the suspended banks. Between May and August, note issuance under the Act covered almost 9 per cent of the value of frozen current accounts (Holder 1970).

As well as the problems experienced by the trading banks, the Savings Bank of NSW was subject to runs. Governor Dibbs issued a proclamation stating that deposits in the Savings Bank were fully guaranteed by the government. To ensure greater liquidity, the government also promised that £400 000 of the bank's government securities should be repayable in cash on demand (Griffiths 1930).

6.5 Queensland

Queensland also proposed legislation for government note issue. The aim was not so much to ease financial crisis, which was mild compared to Victoria and NSW's experience, as to tap an easy source of finance for the government (Butlin 1961a).

The Queensland National Bank, the Bank of North Queensland and the Royal Bank of Queensland suspended payment within three days of each other in mid May 1893. These three banks accounted for just over half of Queensland banking assets (and around 8 per cent of Australian banking assets). The Queensland Savings Bank survived a brief run. In Queensland, bank notes were not a first charge on assets. As a result, the surviving banks would not immediately accept notes issued by the suspended banks. This generated a brief liquidity squeeze.

The Queensland Government's response to these events included three measures. First, bank notes became the first charge on assets. Second, following the example set by NSW, the government passed legislation authorising the Treasury to make advances secured against deposits in banks that had suspended payment (Teare 1925). The third, and most substantial step, which drew from Queensland's experience in the 1860s, was the introduction of a government note issue. In Queensland, Treasury notes were supplied to banks that paid 25 per cent of the notes' face value in gold. The notes were declared legal tender. A government monopoly over note issue was established by increasing the tax on private bank note issues from 3 per cent to 10 per cent (Mackay 1931).

Strong links between the Queensland National Bank and members of the Queensland Parliament saw the bank receive considerable government support throughout the 1890s, well after the broader financial crisis had passed. Thomas McIlwrath was a member of the bank's board for five years before becoming Premier in 1879. The same year the bank was awarded all of the Queensland Government's business. In April 1892, the proceeds of Queensland Government loans raised in London were used to meet depositor withdrawals from the bank. A run by Scottish depositors in May 1893 prompted the bank to suspend repayment and reconstruct.[38] The government auditor inspected the books and reported that the bank was definitely solvent. The government therefore agreed to a scheme of reconstruction, which locked up £2 million of its deposits (which accounted for around one-fifth of the bank's total deposits) for between 6 and 12 years.

During 1894 and 1895, the bank's losses were concealed by accounting fraud. In 1897, a government-appointed committee investigated the bank and found it to be deeply insolvent. The committee did not, however, recommend liquidation, as it believed that the best return to creditors could be achieved by keeping the bank open. Realising that publication of the committee's report would precipitate a run on the bank, the government passed the *Queensland National Bank Limited Guarantee Act*, which guaranteed all deposits for a year. Under the second scheme of reconstruction, the government's deposits were to be repaid from the bank's profits in stages between 1897 and 1921. In the event, the government was fully repaid in 1918 (Blainey 1958).

6.6 Discussion

The 1937 Royal Commission into Monetary and Banking Systems argued:

> It is possible that a strong central bank (had such then existed) might have been able to limit the unhealthy expansion that eventually brought about the crisis. It is possible also that when the crisis was imminent prompt and decisive action by a central bank might have limited its effects to those institutions that were actually

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[38] When British depositors withdrew their money in December 1891, the bank received a last-resort loan from the Bank of England (Blainey 1958).

> insolvent, and have gained time for others that were sound to rearrange their affairs in an orderly manner without suspension.[39]

Criticism has been levelled at the Associated Banks for not providing more support to troubled institutions (Gollan 1969). Four main factors hindered the Associated Banks' ability to act as an effective lender of last resort: competition between banks, doubts about the fundamental solvency of those banks that suspended payment, resource constraints and the Association's inability to constrain its members' risk-taking.

From a competitive perspective, it was not in the interests of the strongest banks (operating with high liquid reserve ratios) to help the weaker banks (Pope 1989). Particularly since, at least in the early stages of the crisis, customers were able to differentiate between institutions (the most severe runs were on banks most heavily exposed to property and property financiers) and funds were transferred from the weaker banks to the older, more conservative banks (Merrett 1991). The banks themselves grappled with the conflict between the need to buttress public confidence and giving undue aid to their competitors. For example, in March 1892, the superintendent of the Bank of Australasia wrote:

> Had these banks [the Federal, Commercial and City of Melbourne Banks] closed their doors…there is no saying where the crash would have stopped, and in any case the depreciation in values would have been so great as to entirely throw into the shade any benefits which we would have derived from acquiring new accounts from the failed institutions.[40]

Secondly, the dramatic fluctuations in property prices during the years immediately preceding the banking crisis made it difficult to assess the banks' true value. At the time, some argued that the banks that suspended during April and May 1893 were, from a longer-term point of view, solvent (Boehm 1971). Others, however, such as Merrett (1991), argue that most of the banks that suspended were insolvent. Pre-crash property prices were excessively high and could not be used as a basis for valuing troubled banks (in fact, property prices took up to two decades to

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39 Royal Commission into the Monetary and Banking Systems (1937, pp 100–101, paragraph 215).

40 Quoted in Butlin (1961a, p 289).

recover to the levels seen at the height of the boom during the late 1880s (Murray and White 1992; Cannon 1966)).

Thirdly, since the liquidity of the banks was constrained by the supply of gold and coin, the Associated Banks faced binding resource constraints. Commercial prudence dictated that they could only offer small amounts of last-resort support to demonstrably sound institutions. While the solvent banks possessed the resources necessary to save those banks that suspended payment, to do so would have left the rescuing banks with only a slim margin of capital. The capital ratio of the Victorian banks would have shrunk to less than 1 per cent (Merrett 1993). The loans to the Colonial Bank by the Associated Banks and to the City Bank by the larger Sydney-based banks indicated that, where the provision of assistance could be comfortably met from the banks' resources, they were willing to provide support.

Lastly, the Associated Banks lacked effective mechanisms to constrain moral hazard-driven behaviour among its members. Unlike the Clearing House Association in New York, which coordinated effective bank rescues around the same time, the Associated Banks did not impose any prudential requirements, such as minimum capital ratios and the publication of audited accounts, on its members (Merrett 1993). The Association's revision of its rules to exclude banks with ownership interests in building societies from its membership was one attempt to keep the more risky institutions out of the Association. The links maintained between the Federal Bank and its former building society affiliate, however, demonstrated that such attempts had little practical effect.

Having the option of reconstruction available to them, several banks did not seek assistance from the Associated Banks before suspending payment. The schemes of reconstruction (which were a combination of public policy and market-based solutions to the crisis) were criticised for placing too much burden on banks' depositors and other creditors (Pope 1987). However, the schemes were successful in bringing the crisis to an end. Reconstructed banks were able to re-open quite quickly. On average it took two months for the banks to resume business fully and several banks re-opened to accept deposits on behalf of trusts associated with the reconstructed bank within a few days of suspending payment (Mackay 1931). If the banks had been put into liquidation, they would have been forced to realise assets at the worst possible time. Reconstruction provided greater certainty about the losses faced by both depositors and shareholders than liquidation. The schemes did allow substantial injections of fresh capital into the banking system.

Although depositors bore losses indirectly due to the freezing of accounts, all unsecured creditors of reconstructed banks were eventually repaid in full. More than half of the £32 million of suspended deposits, preference shares and interminable stock held in Australia had been repaid by the end of 1896, and more than three-quarters by 1901 (Merrett 1991). Full payment of suspended deposits was not finalised in some cases until as late as 1918 (Fisher and Kent 1999). £4.6 million interminable stock, however, was still outstanding in 1936 (Royal Commission into the Monetary and Banking Systems 1937). Most preference shares had been extinguished by bank mergers by 1936. However, in the case of the Commercial Bank of Australia, £2.1 million in preference shares remained on the bank's books until its merger with the Bank of New South Wales in 1982.

Three factors mitigated the losses borne by depositors. Firstly, secondary markets in deferred deposit receipts developed, allowing depositors to realise their deposits at a discount. Secondly, all bank notes and most current accounts were exempted from the reconstruction schemes (Merrett 1991). Thirdly, in a number of instances the courts modified reconstruction schemes in response to appeals from depositors (Mackay 1931).

Directors also bore some of the costs as reconstruction schemes involved changes in the composition of bank boards. In a number of cases, representatives of depositors were appointed to the board of the reconstructed banks.

The Victorian Government was criticised for its decision to call the banking holiday, and for its failure to adopt policies to bolster liquidity in the colony as NSW had done. If the stronger banks had observed the holiday, the weaker banks had quickly reconstructed and other steps been taken to improve the public's confidence in the banks, the banking holiday may have been effective. The *Australasian Insurance and Banking Record*, however, characterised the decision to call a banking holiday as 'floundering' on the part of the government, based on the 'principle that in order to put out a fire the right thing is to shower petroleum upon it'.[41] The three smaller Victorian banks that complied with the banking holiday were all forced to suspend payment and reconstruct later in the same month. The banking holiday, therefore, did not succeed in its attempt to buy time for those banks. Moreover, declaration of the holiday sparked runs on those banks that did choose to remain open, although those banks were able to withstand the deposit outflows. The failure of the holiday supports Bagehot's prescription that crises in public confidence should be met by generous provision of liquidity. The holiday had done the reverse by freezing all liquid funds other than coin.

At least three reasons may be adduced for the Victorian Government's reticence to adopt policies similar to those implemented in NSW. Firstly, the links between the banks and several Members of Parliament meant the government lacked the will to push ahead with proposals opposed by the banks (as Governor Dibbs had done in NSW).[42] Secondly, Dibbs' actions cut across the economic orthodoxy of the time, which carried a strong bias against government intervention and particularly against inflationary policies of any type. Thirdly, the depression weakened the government's own financial position limiting its capacity to provide direct support. Coghlan (1918) suggests that, had the credit standing of the colonial governments been stronger, they may have been better placed to help. In the face of mounting pressures for greater budget constraint, Victoria was particularly awkwardly placed following a period of 'excessive and imprudent borrowing' for public works (Boehm 1971).

In the absence of more effective Associated Banks or government intervention, the market itself developed means of mollifying the effect of the crisis. The reconstructed banks set up trust operations quarantining new deposits from those frozen under reconstruction schemes. Secondary markets in bank claims helped to make frozen deposits more liquid.

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[41] *Australasian Insurance and Banking Record*, 19 May 1893, Vol 27, p 299.

[42] For example, at least nine of the 14 members of the Legislative Council also served as bank directors during the early 1890s.

7. Proposals for Government Note Issue and the Development of a Central Bank

The financial turbulence of the 1840s and 1890s prompted calls for revision of Australia's monetary system. The most significant changes to come from this were the replacement of private bank note issue by the Federal Government note issue in 1910 and the creation of the Commonwealth Bank. While the Commonwealth Bank was established in 1911, it was not until the mid to late 1920s that the bank began to take on a central banking role.

7.1 Government Note Issue

Prior to the establishment of the Federal Government note issue, high-powered money consisted of sterling coin.[43] This made it difficult for the colonial governments to supply liquidity to the banking system. The declaration of bank notes to be legal tender by the NSW Government in 1893 and the South Australian Government in 1852 was one way around this problem.

Between 1843 and 1896, parliamentary committees in New South Wales, Victoria, Queensland and South Australia recommended the establishment of a government-owned bank and state monopolisation of the note issue. Under these proposals, the government bank would have been empowered to act as lender of last resort (Gollan 1969; Griffiths 1930). However, the proposals were overtaken by debate about federation.

In 1910, the Federal Government's legal-tender note issue was introduced. Initially, it was required that the government's gold reserve cover one-quarter of the value of notes issued up to £7 million. For any note issuance above £7 million, one-for-one backing was required. In 1914, however, the gold reserve provision was relaxed so that the required gold reserve was one-quarter of the value of notes on issue regardless of the size of the total note issue.

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[43] High-powered money consists of those forms of money that are directly exchangeable for real goods (i.e. commodity money, such as gold coin, and instruments declared to be legal tender). While, up until 1910 the notes issued by banks and backed by gold were also highly liquid, the fact that their widespread acceptance relied on public confidence in the banks that issued those notes indicated that they were one step removed from high-powered money.

7.2 Establishment of the Commonwealth Bank

At its federal conference in July 1908, the Labor Party added the establishment of a Commonwealth Bank to its policy platform. It was proposed that the bank should be one of issue, deposit, exchange and reserve and that the bank should, in times of crisis, sustain credit by rediscounting the securities of other banks (Gollan 1969).

The Act to establish the Commonwealth Bank, passed in 1911, was a compromise between those pressing for a central bank to smooth the operation of a system of private banks and those seeking to nationalise the banking sector. While Prime Minister Andrew Fisher put stress on central banking objectives, the legislation confined itself to the establishment of a government-owned bank with ordinary banking powers. Nevertheless, Denison Miller, the Commonwealth Bank's first Governor, stated the bank 'should grow so strong that should there be a crisis we will be able to stand behind the other banks and help them'.[44] During the 1920s, the Commonwealth Bank gradually began to act as the banker to the private banks, providing the means for interbank settlements and occasionally providing loans to other banks to finance short-term liquidity shortfalls. However, the development of the bank's central banking powers was slow.

In 1921, the Commonwealth Bank proposed that the banks settle their interbank payments through accounts with the Commonwealth Bank. The banks were not prepared to keep clearing deposits with the Bank unless they had an assurance that the funds would not be used in competition with them. This assurance was not given, and the banks refused to take up the proposal.

In 1924, legislation was passed which transferred responsibility for note issuance from the Treasury to the Commonwealth Bank and required the banks to settle their exchanges through the Commonwealth Bank.[45] It was these two reforms that enabled the Commonwealth Bank to become the sole producer of high-powered money. The banks, however, retained their clearing pool reserve separate from the

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[44] Quoted in Coombs (1931, p 35).

[45] The Act also gave the bank full control over the note issue. The Federal note issue was first administered by the Treasury. Between 1920 and 1924 Treasury and the Commonwealth Bank jointly exercised control of the note issue.

Commonwealth Bank. The reserve served as a guarantee of payment of each bank's settlement obligations (a precaution established during the 1890s). It was not until 1938 that the pool's funds were placed on deposit with the Commonwealth Bank.

During the 1920s, the Commonwealth Bank's lending to the private banks was modest. To assist in financing exports, the Commonwealth Bank offered the banks loans totalling up to £5 million between 1922 and 1925. However, only very small advances were actually made. During the October 1924 liquidity squeeze, the Commonwealth Bank offered to lend the banks up to £15 million; just £2.8 million was lent under this scheme (Giblin 1951).

8. The 1930s Depression

The depression was ushered in by the drying up of overseas loans to Australia and a sharp fall in export prices. Australia's terms of trade fell dramatically, causing a balance of payments crisis in 1929. Like the depression of 1892, real GDP fell about 10 per cent in the first year of the depression 1931. The 1930s depression, however, was not as protracted. Growth resumed in 1932 and the level of real GDP recovered to its pre-depression level in 1934.

Unlike the 1890s, the financial system proved to be comparatively robust. Only three banks failed during the 1930s – two small trading banks (the Primary Producers Bank and the Federal Deposit Bank) and the Government Savings Bank of NSW. The Government Savings Bank was brought down by political turbulence as much as the economic conditions. While the Commonwealth Bank provided some limited support to two of these banks, it was later criticised for not taking a more active role, particularly since two of the banks were solvent when they suspended payment.

8.1 Trading Bank Failures

In 1930, the Primary Producers Bank of Australia accounted for less than 0.5 per cent of Australian banks' deposits. Most of its customers were farmers, and as the prices of primary produce fell the bank suffered a steady drain on its resources. Over the 18 months prior to the bank's closure, it lost 40 per cent of its deposits.

In April 1931, the bank sought the assistance of the Commonwealth Bank in anticipation of a run following the suspension of the Government Savings Bank. The Commonwealth Bank provided an unsecured overdraft of £100 000 and a loan of £295 000 secured by government bonds, a fixed deposit at another bank and the bank's premises. The Primary Producers Bank actively sought amalgamation with the other trading banks and overseas financial groups. While the Commonwealth Bank considered arranging joint action with the trading banks to avoid closure of the Primary Producers Bank, the other banks decided against the proposal. In the wind-up of the bank depositors were not quite fully paid, losing just 1.25 per cent of the value of their deposits (Royal Commission into the Monetary and Banking Systems 1937).

A few days following the closure of the Primary Producers Bank, the chairman of the Commonwealth Bank made a public statement in an attempt to prevent depositor withdrawals spreading to other banks:

> …during the last few years the banking system of this country has been developed and strengthened through the recognition by the trading banks of the Commonwealth Bank as a central reserve bank…it must be prepared at any time to issue currency to its banker depositors, when called upon, and to render any assistance which is justified in the interests of national welfare…I suggest to depositors generally that they stand behind the institutions with which they have been doing business in the past…[46]

The general uneasiness following the failure of the Primary Producers Bank and the suspension of the Government Savings Bank of NSW led to a steady loss of deposits from the Federal Deposit Bank. This bank was more a building society than a fully-fledged bank and accounted for less than 0.2 per cent of Australian banks' deposits. The directors of the bank sought assistance from the Commercial Banking Company of Sydney, which released fixed deposits the Federal Deposit Bank held with it and lent to the bank against its holdings of government securities.

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[46] Text reproduced in *Australasian Insurance and Banking Record*, 21 September 1931, Vol 55, p 758.

As the Federal Deposit Bank continued to lose deposits, it applied for assistance from the Commonwealth Bank. The Commonwealth Bank took the view that the circumstances did not justify intervention. The Federal Deposit Bank suspended payment on 4 September 1931, and was taken over by the Brisbane Permanent Building and Banking Company. The Federal Deposit Bank's depositors were repaid in full in instalments over a number of years.

The day after the Federal Deposit Bank suspended payment, the Queensland Deposit Bank was subject to a heavy run. The bank withstood this run with aid from the National Bank of Australasia, which lent it £50 000 in bank notes (Blainey 1958).

In reviewing the Commonwealth Bank's handling of these failures, the 1937 Royal Commission into Australia's Monetary and Banking Systems argued that the Commonwealth Bank should have taken a more active role. In giving evidence to the Royal Commission, the Commonwealth Bank argued:

> The central bank attitude must be dependent upon the general economic circumstances prevailing, the nature and cause of the trouble, the security position of the bank concerned, the general outlook and the other responsibilities of the central bank. In general, the central bank would be prepared to re-discount treasury-bills, to make advances against or to purchase London funds or advance against trade bills or government or other acceptable securities…
>
> Although the tendency of recently established central banks is to extend the types of security eligible as the basis of central bank assistance, it is clear that it is customary for central banks to regard their obligations to other banks as strictly limited. The Commonwealth Bank, however, would in an emergency be prepared to give assistance to a bank which had conducted its business on prudent lines beyond the ordinary limits of central bank practice, provided that in making the loan it had some assurance that the bank concerned would punctually meet its obligations to the central bank.[47]

This suggests that the Commonwealth Bank had both broader financial system stability and moral hazard considerations in mind. Since both trading banks that

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[47] *Evidence to the Royal Commission*, Vol 1, pp 85–86.

failed were small, and the contagion in terms of runs on other banks was well contained, it could be argued, with the benefit of hindsight, that there was no systemic case for providing last-resort support.

With regard to moral hazard considerations, the difficulty faced by the Commonwealth Bank was that its ability to monitor the behaviour of the other banks was quite limited. Even during the height of the balance of payments crisis in 1929, the Commonwealth Bank lacked the power to obtain data on individual banks' London funds. The Royal Commission acknowledged this to some extent, arguing that if the Commonwealth Bank found a troubled bank to be solvent it might undertake to guarantee the bank's deposits, provided it was given adequate security and some control over the bank.[48]

Two other reasons might be advanced for the Commonwealth Bank's reluctance to provide stronger support. The first was a concern to conserve its own resources. This was borne out by the bank's objective that any recipient of assistance be able to repay its obligations. The second was that, although the bank's powers had gradually expanded during the 1920s, it remained relatively inexperienced in acting as a central bank. In 1929, when discussing the development of central banking, the directors of the Commonwealth Bank reported that 'the establishment of the Central Reserve Banking System in Australia still remains an open question'.[49] 1931 was the first time the Commonwealth Bank was called upon to act as a lender of last resort. The criticisms made by private banks regarding the conflict of interest arising from the combination of commercial banking and central banking within the Commonwealth Bank, which held back the accretion of the bank's central banking powers in the 1920s, also biased the bank towards being tentative in its relations with the other banks.

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[48] The Royal Commission also recommended that the Commonwealth Bank be given the statutory power to obtain such information as it required from banks for its purposes as a central bank.

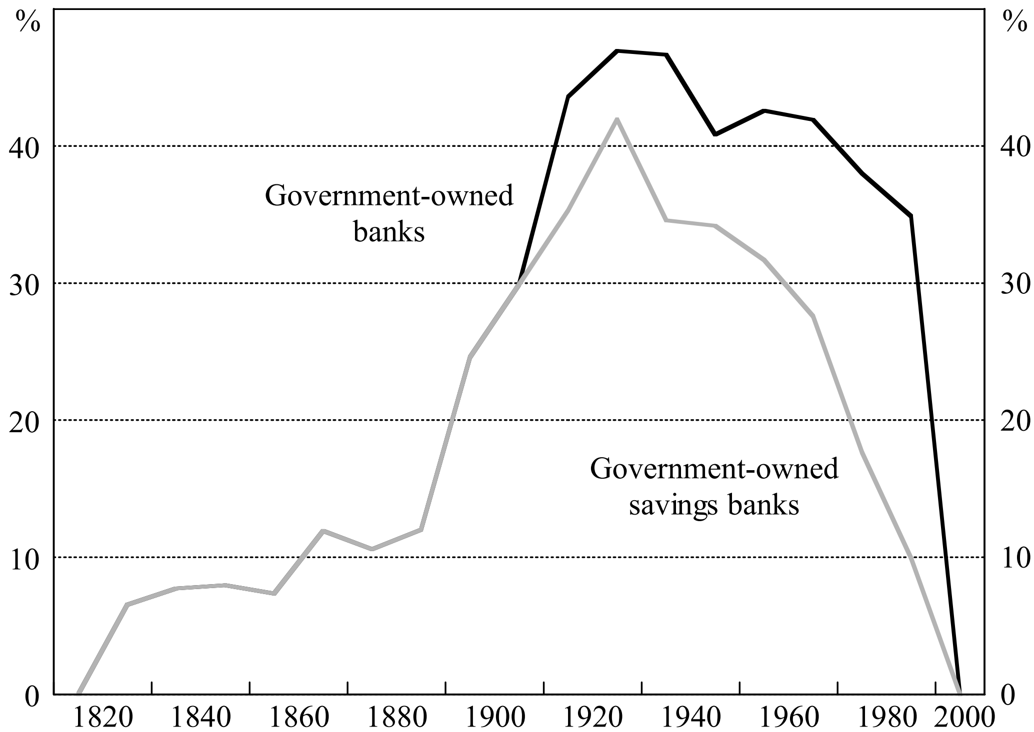
[49] Quoted in Wilson (1952, p 45).

8.2 Savings Bank Failures

8.2.1 Government Savings Bank of New South Wales

During the depression, all savings banks lost funds as unemployment and wage cuts compelled depositors to draw on their savings.[50] In the case of the Government Savings Bank of NSW, however, political uncertainty added to the economic depression, resulting in runs that forced the bank to close. This came at the time when the market share of government-owned savings banks had peaked at over 40 per cent of all banks' deposits (Figure 1).

Figure 1: Share of Bank Deposits



Sources: Butlin (1953, 1986); Butlin, Hall and White (1971); White (1973) and Reserve Bank calculations.

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[50] Prior to the depression, the savings banks had grown steadily. There were a few hiccups, one being a brief run on the Government Savings Bank on 5 August 1914, the day after the declaration of World War I. Statements by the bank's management affirming the bank's soundness were sufficient to stop the run.

The October 1930 NSW election campaign was fought between the incumbent Nationalist Party and the Labor Party led by JT Lang. Lang's policy was to oppose the deflationary economic program agreed upon by the Commonwealth and State Governments in July 1930, and to repudiate interest payments to holders of NSW Government securities. The Nationalist Party alleged that, if elected, Lang would commandeer savings held in the Government Savings Bank to finance its expansionary policies. These allegations prompted an acceleration in deposit withdrawals. The Government Savings Bank issued leaflets emphasising its independence from the government, which steadied the panic. It also asked the Commonwealth Bank if it would provide assistance if necessary, and what form such assistance might take. The Commonwealth Bank responded that the request was 'too nebulous to be dealt with in a practical manner'.[51] While the Labor Party's electoral victory triggered a brief spate of withdrawals, these were not as severe as those during the election campaign.

In February 1931, the NSW Treasury defaulted on interest payments and maturing government stock owing to the bank, the single largest holder of NSW Government securities. When news of the default became public, deposit withdrawals accelerated again. Confidence was further shaken when the *Reduction of Interest Bill* was introduced to Parliament on 18 March. The Bill proposed reductions in the rate of interest paid by the NSW Government on its own securities. The Government Savings Bank would have suffered a substantial cut in income, but the Bill was shelved on 25 March.

At the end of March, NSW defaulted on its interest obligations to British bondholders, but the Commonwealth Government stepped in and made the payments to preserve Australia's credit standing overseas. The default led to another surge in deposit withdrawals. The bank sought aid from the NSW Treasury, but received no cash. The bank, together with the Premier, placed advertisements in the daily newspapers assuring depositors that the bank was free from political control and their money had the backing of 'all the assets of New South Wales'.[52] This did little to slow the rate of deposit withdrawals, and if anything, strengthened the community's doubts (Polden 1970).

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[51] Quoted in Polden (1970, p 147).
[52] *The Sun*, 5 April 1931.

The bank sought specific assistance from the Commonwealth Bank, asking for funds and some reassuring statement by the Commonwealth Bank suggesting it would stand behind the bank. The Commonwealth Bank indicated it was not willing to make so large a guarantee (deposits of the Government Savings Bank were around £60 million, compared with the Commonwealth Bank's total assets of £52 million). However, it did indicate it was willing to prepay the fixed deposit the Government Savings Bank held with it and discount fixed deposits the Government Savings Bank had placed with other banks. This assistance totalled nearly £3 million, but was insufficient to meet continuing depositor withdrawals.

The Chairman of the Commonwealth Bank then suggested that the Commonwealth Bank would be prepared to consider amalgamating with the Government Savings Bank. On 21 April, the NSW Cabinet agreed to proceed with amalgamation. Lang publicly announced that he was seeking a takeover. The Commonwealth Bank's press statement, however, was non-committal, indicating that, while the bank was willing to explore the proposal, it had not committed to taking over the Government Savings Bank. The Commonwealth Bank had argued that no public statement should be made until the NSW Government had formally approved the proposal, the Commonwealth Bank had investigated the bank's accounts, and an approach had been made to the Federal Treasurer (Giblin 1951). The public statements by the State Government and the Commonwealth Bank triggered such heavy withdrawals (both from depositors concerned the Commonwealth Bank would not support the bank and those seeking to avoid any suspension of payment that may have come with the amalgamation) that the Government Savings Bank was forced to suspend payment on 22 April.

Once the Government Savings Bank had suspended payment, the Commonwealth Bank offered to make funds available to the Government Savings Bank to allow it to release the funds of the most needy depositors. Between 23 April and 27 July, the Commonwealth Bank advanced £1.8 million on this basis.

The shock of having their funds in the Government Savings Bank frozen led depositors to question the safety of other banks. A run on the Commonwealth Savings Bank (a division of the Commonwealth Bank) began on 1 May. On 3 May, the Chairman of the Commonwealth Bank, Robert Gibson, made a radio broadcast to assure the public of the bank's safety:

> As the Commonwealth Bank has control of the note issue, it can command resources in the form of currency to any extent which in the opinion of the Bank Board is deemed necessary. It is, therefore, in the strongest possible position…I am authorized by the Prime Minister, Mr Scullin, to say that his Government will support the Bank Board in any measure which it deems advisable to take…The bank will never close its doors, so long as the nation itself stands![53]

The statement was effective in stopping the run.

During June and July 1931, negotiations to arrange an amalgamation were conducted between the Government Savings Bank, the Commonwealth Bank and the NSW Government. The Commonwealth Bank was concerned to ensure that its financial position was not jeopardised. Lang objected to conditions proposed by the Commonwealth Bank requiring the NSW Government to guarantee full payment of its obligations to the Government Savings Bank. The negotiations came to an impasse. At the end of July, Lang abandoned the request for amalgamation and submitted an application for a rehabilitation loan of £10 million. The Commonwealth Bank responded that it could not fund such a large sum, and that, in any event, depositors would rapidly withdraw their funds from the re-opened bank.

On 3 September, the Lang administration attempted to re-open the Government Savings Bank. By mid October, it was evident that this attempt had failed. A compromise amalgamation was announced on 23 November and effected on 15 December 1931. At first, some rationing of withdrawals from former Government Savings Bank accounts was imposed by the Commonwealth Savings Bank; but from 14 January 1932 depositors were permitted to draw freely against their balances.

8.2.2 Western Australia and South Australia

Two other state savings banks, in Western Australia and South Australia, sought the Commonwealth Bank's assistance in 1931. Unlike NSW, the governments were honouring their debts and the savings banks were not involved in substantial

[53] *Evidence to the Royal Commission*, Vol 1, pp 667–668.

short-term financing of the state. As a result, the Commonwealth Bank was much more willing to provide support.

Loss of deposits from the State Savings Bank of Western Australia in September 1930 prompted the Western Australian Premier to approach the Commonwealth Bank to broach the possibility of amalgamation. But nothing came of this.

In August 1931, the State Savings Bank of Western Australia's liquidity fell further. The Western Australian Premier took immediate action and negotiated an amalgamation with the Commonwealth Bank in only 11 days. The conditions in Western Australia made it much easier for the Commonwealth Bank to agree to offer support than had been the case in NSW. The State Savings Bank of Western Australia had not suffered runs anywhere near as severe as the Government Savings Bank, and the Premier readily agreed to accept the conditions the Commonwealth Bank placed on the merger. When signs of a run became evident in late August, after the bank was already under agreement to amalgamate with the Commonwealth Bank, the Commonwealth Bank's Chairman made a radio broadcast promising to depositors of the State Savings Bank that 'the Commonwealth Bank will see that you are paid'.[54]

In October 1931, the Savings Bank of South Australia's liquidity fell sharply, but there was no evidence of an uncontrollable run. The Commonwealth Bank was concerned to conserve its own resources and to lend only as a true last resort when the State Bank of South Australia had exhausted its own liquid reserves. The Commonwealth Bank, therefore, offered to assist on the condition that the Savings Bank of South Australia first deplete its cash reserves of over £3 million. The bank refused to accept this condition, and was able to withstand its liquidity shortage without any further calls for assistance.

8.2.3 Discussion

The failure of the NSW Government's guarantee to prevent the closure of the Government Savings Bank highlights the fact that a credible lender of last resort needs to be able to readily generate liquidity. Throughout the life of the

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[54] Radio broadcast, 27 August 1931. Quoted in Polden (1970, p 244).

bank, the government guarantee was in the form of a claim upon the NSW Consolidated Revenue Fund. During 1931, the consolidated revenue could barely meet the essential demands of government. The weakness in the government guarantee was that the state government lacked the power to create high-powered money (which rested with the Commonwealth Bank).

Since it was clear that the Government Savings Bank was solvent, and given the possibility that the bank might have been able to avoid suspending payment if support had been provided earlier, it has been questioned why the Commonwealth Bank did not provide more support earlier. There are five main reasons why it did not.

First, the Board of the Commonwealth Bank was critical of Lang's radical policies and shied away from the political controversy that involvement with the NSW Government engendered. Gibson, speaking to a conference of savings banks after the Government Savings Bank closed said: 'We could not stand behind the State Savings Bank of New South Wales in its recent trouble because it was occasioned by political insanity'.[55]

Second, supporting the Government Savings Bank was seen to be a risky proposition. The NSW Government was the principal debtor or guarantor for about 70 per cent of the Government Savings Bank's investments and had already defaulted on interest payments. The Commonwealth Bank, therefore, was concerned to ensure its rights to repayments would be specifically guaranteed.

The third reason was that the Commonwealth Bank sought to avoid inflationary credit creation. Since consumer prices were falling at the time, the fear of inflation would seem to have been an unreasonable one; nevertheless it seems to have been influential. The Commonwealth Bank's ability to issue notes was subject to legislative limitation.[56] In March 1931, the Commonwealth Bank held gold sufficient for it to issue an additional £13 million in notes. The bank, therefore, had

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[55] Quoted in Sykes (1988, p 270).

[56] The bank was required to maintain a minimum gold reserve of 25 per cent of the notes on issue (although the required gold reserve was reduced to 15 per cent in June 1931). Although Australia went off the gold standard at the end of 1929, it was not until the introduction of new banking legislation in 1945 that the gold reserve requirement was completely abandoned.

sufficient resources to provide a considerable injection of liquidity into the Government Savings Bank. The Commonwealth Bank, however, eschewed such an expansionary policy. In November 1930, the Federal Government had put a series of proposals to the Commonwealth Bank asking it to create credit to finance the government deficit and the needs of private industry. Directors of the Commonwealth Bank emphasised that such a drain on banking funds would undermine the monetary system. In April 1931, the Commonwealth Bank indicated to the Government the limit beyond which it would provide no further credit. If not willing to extend more credit to the Commonwealth Government, the bank could hardly lend to the Government Savings Bank.

Fourth, just as the Commonwealth Bank was inexperienced in acting as a central bank for the trading banks, it had had little practice in providing central banking services to savings banks. During the 1920s, most attention was devoted to the Commonwealth Bank's role as banker to the trading banks; little consideration had been given to the savings banks.

Fifth, it has been suggested that the Board did not want to see the Government Savings Bank survive since it adhered to the policy that there should be only one savings bank (Giblin 1951). The Prime Minister, Andrew Fisher, on the establishment of the savings bank arm of the Commonwealth Bank in 1911, stated that ultimately there should be only one savings bank in Australia. In 1912, the Commonwealth Bank made offers to each state to take over their savings banks. It amalgamated with the Tasmanian State Savings Bank in 1913 and the Queensland Government Savings Bank in 1920 (Jauncey 1933). Polden (1970), however, argues that the Commonwealth Bank's actions were not so much influenced by a desire to remove a competitor as its lack of confidence in the NSW Government.

9. The Post-war Period

War-time banking controls gave the Commonwealth Bank authority to regulate trading banks' lending and purchases of government securities, and required banks to lodge surplus funds in a 'Special Account'. The emergency measures also gave the Commonwealth Bank comprehensive powers over foreign exchange transactions and bank interest rates. The aim of the regulations was to minimise the inflationary impact of war expenditure, to divert financial resources to war purposes and to control banks' profits.

While efforts to nationalise the Australian banking system were defeated, banking legislation in 1945 put into permanent form much of the banking structure that had emerged during the war and cemented the Commonwealth Bank's role as the central bank. For both financial stability and consumer protection reasons, the Commonwealth Bank was given responsibility for the protection of bank depositors.[57] The prime focus of the extension of central banking powers, however, was macroeconomic policy. Controls on interest rates and the supply of liquidity constrained banks' ability to lend. In such an environment, credit rationing on a non-price basis left little room for banks to take risks. As a result, loans to banks were made for monetary policy reasons rather than out of need for last-resort support.

In mid 1947, the Commonwealth Bank offered the banks short-term loans as an alternative to the release of special accounts as a means of improving banks' liquidity without adding to their profitability. The Commonwealth Bank regarded the loans as temporary to permit banks to make 'essential' advances.[58] However, the loans were renewed fairly automatically. Although the rate charged was intended to be high enough to encourage banks to quickly repay any borrowings, some banks found it profitable to remain substantially in debt to the central bank (Butlin 1983).

By mid 1949, the banks' reliance on loans from the Commonwealth Bank became a matter of concern. Several banks had virtually abandoned liquidity management and relied on the central bank for their day-to-day cash needs. In January 1950, therefore, withdrawals from special accounts were permitted on the condition that the funds were used to either buy government securities or repay central bank advances (Butlin 1983). In 1952, the Commonwealth Bank moved away from

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[57] Paragraphs 11–13, *Banking Act (1945) No 14*, Commonwealth Government Printer, Canberra.

[58] The value of these loans outstanding averaged a little under $70 million between June 1947 and June 1952 (Schedvin 1992).

providing loans to banks virtually on demand.[59] This left the central bank to focus on cyclical and last-resort liquidity.

The Liquid Assets and Government Securities (LGS) convention came into force in March 1956. Under the convention, banks agreed to keep a certain proportion of their depositors' funds in liquid assets and Commonwealth Government securities. If a bank fell below the minimum it was required to borrow from the central bank. The terms and conditions of any loan were at the central bank's discretion, and depended on whether the bank was complying with the central bank's overall credit policy. In practice, lending under the convention was not infrequent, particularly during the seasonal run-down in liquidity at the end of each financial year as tax payments fell due. The interest rate charged on the loans was not always penal, although higher rates were charged on larger loans. The loans were intended to be short term (up to 30 days), but, on occasion, they were outstanding for several months. Depending on the circumstances, higher interest rates were sometimes charged on such longer-term loans. By smoothing seasonal and other short-term fluctuations in liquidity such lending served as a tool of the Commonwealth Bank's monetary operations rather than financial stability policy.

Similarly, the development of the official short-term money market in 1959 saw the Commonwealth Bank agree to provide liquidity support to authorised dealers. Although loans, which were termed last-resort loans, were made on a regular basis, they were not so much directed at overall financial system stability as the smooth day-to-day functioning of the short-term money market and the operation of monetary policy.[60]

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[59] For example, the Governor of the Commonwealth Bank wrote to the ANZ Bank stating that it had been guilty of misusing loans from the central bank; these were a temporary source of funds, and not to be used as a means of expanding banks' lending. The Governor indicated penal interest rates would be increased to ensure the ANZ did not continue to rely on central bank loans for other than exceptional and temporary purposes (Merrett 1985).

[60] Total loans outstanding reached upwards of $70 million in the 1960s, $370 million in the 1970s, and $825 million in the 1980s. In May 1989 this line of credit was changed to an end-of-day repurchase facility. This repurchase facility was withdrawn in August 1996 as part of broader changes to the Reserve Bank's domestic market operations. This marked the end of the official short-term money market, and the authorised dealing companies were either wound up or absorbed into their parent organisations.

In 1955, the private banks entered the savings bank market. This prompted the Commonwealth Bank to revisit the support it was prepared to offer to savings banks. In 1959, the Commonwealth Bank agreed to help savings banks sell their holdings of government securities if they found themselves losing liquidity.[61] In 1959, the central banking and commercial banking operations of the Commonwealth Bank were separated with the formation of the Reserve Bank of Australia. In 1965, the Reserve Bank extended the degree of support it was prepared to provide, indicating that the savings banks would be eligible to receive emergency support in the form of direct loans, although the conditions to be placed on such loans were left open (Schedvin 1992).

10. The 1970s

Following the comparative calm of the 1950s and 1960s, the growth of non-bank financial institutions fuelled a property boom in the early 1970s. The 1974 liquidity squeeze brought the boom to an abrupt end. The failure of a number of property financiers precipitated runs on building societies in several states, particularly South Australia and Queensland. Building societies in Queensland also experienced difficulties in 1976 and 1977. Weakness in the property market brought down the Bank of Adelaide later in the decade. The Reserve Bank provided some liquidity support in each of these cases, although it did not lend directly to non-banks.

10.1 The 1974 Liquidity Squeeze

Following a boom in lending by banks and non-bank financial institutions, the Reserve Bank tightened monetary policy in 1973. This was accompanied by a drain in liquidity resulting from a deterioration of the balance of payments and a government budget surplus. As interest rates soared, property prices began to collapse triggering the failure of several property development companies.

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[61] For example, a confidential agreement between the Commonwealth Bank and the State Bank of Victoria specified that, if depositors' withdrawals were exceeding deposit inflows and the State Bank was not at the same time making new loans, the Commonwealth Bank would buy Commonwealth Government securities from the State Bank at a price that would guarantee the rate of return earned by the State Bank (Murray and White 1992).

On 30 September 1974, the property financier Cambridge Credit went into liquidation. The failure of two other substantial property developers (Home Units Australia in July and Mainline Corporation in August) preceded Cambridge Credit's closure. While those failures prompted sharp falls in the share prices of other property developers, finance companies and banks, Cambridge Credit's failure saw public nervousness spread directly to other financial intermediaries. The following day, runs developed on building societies in NSW, Victoria, Queensland and South Australia. While the runs in NSW and Victoria were comparatively small, the runs in Queensland and South Australia were far more severe. On 2 October, the Acting Federal Treasurer announced that the Reserve Bank had told the trading banks to consider sympathetically any request for finance from financial institutions that were responsibly managed and had adequate asset backing. The Reserve Bank would stand behind any bank that provided liquidity to troubled building societies.[62] A similar statement by the Acting Prime Minister was released the following day, and the runs in Queensland tapered off by the end of the day. The form of words contained in these two press releases was to be used on several occasions over the next two decades.

Although the Hindmarsh Building Society in South Australia was financially sound, it was subject to the most severe run.[63] The run, based on rumours the society had lent to failed property companies, continued, little affected by the Acting Treasurer's statement. The run exhausted the society's cash reserves. The National Australia Bank lent the society cash until the National also ran low. On 3 October, the South Australian Premier, Don Dunstan, addressed customers queuing outside the Hindmarsh's offices, assuring them that their funds were safe. The run subsided the next day. Dunstan tabled, but never proceeded with, the *Building Societies Temporary Assistance Bill*, which would have authorised him to borrow $10 million from the Reserve Bank to lend to the building societies.

Precedents for such state government support of building societies were established in the 1930s, 1940s and 1950s when the state governments introduced guarantees over building societies as part of policies designed to encourage housing construction (Abbott and Doucouliagos 1999). Official reserve or

62 Press Statement by the Acting Treasurer, the Honourable Bill Hayden, MP, Press Release No 80, 2 October 1974.

63 The Co-operative Building Society in South Australia suffered a less severe run.

stabilisation funds were also set up for building societies and credit unions in several states. The funds typically provided for the protection of depositors in the event of insolvency; some also provided for temporary financial assistance in the event of financial difficulties (Australian Financial System Inquiry 1981).

Accentuating the liquidity squeeze was the variable deposit scheme that required those borrowing from overseas to place one-third of the amount of their loan in a deposit paying no interest.[64] Introduced in December 1972 to address a ballooning capital account surplus, this constrained the capacity for capital inflow to offset the tightness in domestic liquidity conditions.

The liquidity squeeze of June–September 1974 saw the banks forced to borrow from the Reserve Bank to preserve their LGS ratios. At the height of the squeeze, borrowings from the central bank peaked at $353 million (more than 3 per cent of bank deposits). In June, the Special Reserve Deposit (SRD) requirement (which was the successor to the special accounts regime) was lowered to alleviate the pressure on the banks. At the same time, the variable deposit requirement was reduced from 33⅓ per cent to 25 per cent. It was further reduced to 5 per cent in August.

In October 1974, the Reserve Bank also introduced a Special Drawing Facility that allowed banks to borrow, at a concessional rate of 0.25 per cent below the 180-day Treasury note rate, amounts equivalent to 1 per cent of their deposit liabilities.[65] While the original term of the loans was for six months the loans were later extended and were not repaid until July 1975. The Special Drawing Facility was much more a safety valve to smooth the operation of the domestic money market rather than last-resort lending. Under the facility funds were allocated to each bank in line with its share of total deposits. All banks initially drew down their full quota.

In November, in addition to the broader liquidity provided by the Reserve Bank, a special line of credit for a further 1 per cent of a bank's deposits was made

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64 There was also an absolute embargo on foreign borrowing for maturities of two years or less.

65 One alternative to the Special Drawing Facility discussed between the Reserve Bank and the private banks, but not pursued, was a proposal that the banks be allowed to defer settlements of foreign exchange with the Reserve Bank.

available to banks involved in support of non-bank financial institutions on a substantial scale. Unlike the Special Drawing Facility, this was regarded 'as an exceptional and temporary arrangement'.[66] Although the provision of funds was not specifically tied to a bank's loans to troubled financial institutions, banks applying for funds from the Reserve Bank were required to submit details of the assistance they had provided to those financial institutions. Two banks drew on this facility, the Commercial Bank of Australia (banker to Queensland Permanent Building Society) and the ANZ (banker to the Industrial Acceptance Corporation).

While the loans were not made directly to the troubled institutions, since the extension of loans to the two banks was prompted by the non-banks' demands for liquidity that would not otherwise have been met by the market, the Reserve Bank was acting as lender of last resort. This support was provided at a rate that was neither concessional nor penal, but at the same rate then applying to loans under the LGS convention. The provision of this additional finance was not publicly announced. Although a press statement was drafted, it was not released for fear that it might undermine confidence in those institutions receiving support. Instead, the Federal Treasurer made a general statement about the broad easing of monetary policy.

This marked the first occasion on which funds were lent under the Reserve Bank's policy confining the provision of last-resort loans to banks, while standing ready to support any bank that found its own liquidity strained as the result of providing assistance to an illiquid, but solvent, non-bank financial institution. This policy remained in place until the 1990s (Fraser 1990).

There were two main rationales for this policy. Firstly, banks were viewed as being central to overall system stability – an approach endorsed by the Australian Financial System Inquiry (the 'Campbell Committee') in 1981. In the Campbell Committee's view, banks deserved special treatment because of their role in the payments system and as a safe haven for small investors, and the impact that a banking collapse would have on the economy as a whole.

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[66] Letter from the Reserve Bank to the chief executive of each major trading bank, 8 November 1974.

Secondly, while the *Banking Act 1959* required the Reserve Bank to protect bank depositors, it was not directly responsible for the interests of depositors at other financial institutions. Moreover, since the Bank did not supervise the non-banks, this limited the scope for it to control moral hazard-driven behaviour that may have followed from the provision of direct support. The banks that dealt directly with the non-banks were better placed to assess their underlying solvency. In 1985, Reserve Bank Governor Robert A Johnston stated:

> Basically, we see the Reserve Bank's role as to ensure that there are adequate liquid funds in the market place whilst leaving it to the market place to determine the allocation of funds amongst competing institutions. Our concern would be the avoidance of a loss of confidence in the financial system generally, rather than the fate of individual members.
>
> 'Thou may not kill, but need not strive to officiously keep alive'.[67]

The Australian Financial System Review Group (the 'Martin Review'), in 1984, argued that the risk of loss to a building society's bank would impose useful commercial discipline, since it would be easier for a private bank to refuse assistance to induce a society to run down its own liquidity reserves before seeking aid (Australian Financial System Review Group 1984).

10.2 Queensland Permanent Building Society

While the runs in October 1974 eased quickly, weakness in Queensland building societies persisted for several years. On 13 March 1976, the Queensland Treasurer suspended the ailing Australian Permanent Building Society. On 17 March, the Treasurer placed one society under administration, while another five suspended payment. Three weeks later, the Treasurer announced that the five suspended societies would either have to sell their assets to other societies or be amalgamated into one large organisation under the aegis of the State Government Insurance Office.

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[67] 'Prudential Supervision of Banks', address to the Victorian Division of the Securities Institute of Australia and the Institute of Chartered Accountants by Robert Johnston, Melbourne, 21 February 1985. Reproduced in Reserve Bank of Australia *Bulletin*, March 1985, pp 571–575.

On 28 September 1977, the Queensland Permanent Building Society closed its doors, after having suffered a run and finding itself unable to reconcile its own accounts. The same day, the Acting Federal Treasurer issued a press release distancing Queensland Permanent from other building societies and stating that 'there was no need for concern on the part of investors in other building societies'. The statement added, 'the permanent building society movement had the full support of the Government in its role as a major provider of housing finance in Australia'.[68] The statement also mentioned the Reserve Bank's policy that banks should look sympathetically at requests for assistance from sound building societies.

In October 1977, the Acting Federal Treasurer issued a press release foreshadowing a Queensland Government scheme to 'rescue' Queensland Permanent and avoid denying depositors access to their funds until liquidation processes were completed. The statement also noted that the Reserve Bank stood ready to address any liquidity problems at banks that might arise from possible 'rescue' schemes.[69] The trading banks, however, refused to directly support Queensland Permanent. The Queensland Government hurriedly introduced legislation giving it wide-ranging powers to buy time in the liquidation process, including the power to obtain liquidity for the society through a process of compulsory loans from other building societies. However, the government's attempts to re-open the society were unsuccessful and the society was taken over by the State Government Insurance Office. All depositors were repaid without any loss. The takeover was financed by compulsory loans from other building societies and direct payments by the Queensland Government.

Queensland Permanent's closure triggered a run on the Metropolitan Building Society (Queensland's largest building society at the time). The Reserve Bank provided a line of credit to the Commonwealth Bank, which in turn lent to Metropolitan. Like the loans provided to the Commercial Bank and ANZ in November 1974, the line of credit should be regarded as a last-resort loan. The Reserve Bank publicly announced that arrangements had been made to provide

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[68] Press Statement by the Acting Treasurer, the Honourable Eric L Robinson, MP, Press Release No 108, 28 September 1977.

[69] Press Release by the Minister for Post and Telecommunications and Minister Assisting the Treasurer, 77/69, 5 October 1977.

'ample support' for the Metropolitan, and that it had provided a substantial line of credit to the society's bankers.[70] The loan to the Commonwealth Bank was provided at the non-penal rate then applying to loans under the LGS convention.

10.3 St. George Permanent Building Society

In March 1979, a run on the St. George Permanent Building Society developed following the broadcast of unfounded rumours that it was in danger of imminent collapse. At the time, St. George was the second largest building society in NSW. On the evening of 2 March, the NSW Premier addressed investors stating the Government guaranteed that they would not lose their money.[71] Despite this, the run continued. On 5 March, the Acting Federal Treasurer issued a press release that included reference to the Reserve Bank's understanding with trading banks that they consider sympathetically requests for finance received from solvent building societies. The statement added that St. George had large amounts of liquid assets available to it, and that building societies generally were sound. The run substantially eased following this second statement.

St. George contacted the Reserve Bank regarding financial assistance; however, the Bank redirected the society to its banker. The Reserve Bank reminded the bank of the arrangements for providing emergency assistance to non-bank financial institutions. The bank in question did not see a need to support St. George, which in its view had ample liquid assets to meet withdrawals. St. George's liquid assets were, in the event, sufficient for it to weather the depositor run. In April, however, St. George was forced to stop lending for a time to strengthen its liquidity. While the NSW Government considered proposals to support the society, it was ultimately able to trade out of its difficulties.

The Reserve Bank recognised that its policy could 'sometimes appear unsatisfactory, especially because the fate of an institution might effectively be left in the hands of competitors'; however, it looked to the banks 'to respond responsibly and sympathetically to reasonable requests for assistance'.[72] The criticism by St. George of these arrangements led the Campbell Committee to

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[70] Reserve Bank of Australia Press Release, 13 October 1977.
[71] *The Sydney Morning Herald*, 3 March 1979.
[72] Fraser (1990).

recommend that governments examine the feasibility of an industry-based support mechanism for the non-banks. The Martin Review Group, however, rejected the proposal that the Reserve Bank stand ready to lend to such liquidity-support entities, on the grounds that this risked extending Commonwealth Government responsibility to non-banks' liabilities.

10.4 The Bank of Adelaide

During the 1960s, the Bank of Adelaide acquired the Finance Corporation of Australia (FCA), which focused on the more risky aspects of property finance, such as lending to property developers and residential second mortgages. FCA grew to become a large component of the bank's overall business. In 1978 FCA's operations accounted for just over 60 per cent of the bank's profits. Falling property prices, however, quickly eroded that profitability. In April 1979 the Reserve Bank expressed its concern about the effect of transfers of capital from the Bank of Adelaide to FCA on the bank's ability to meet its own liabilities (particularly, its obligations to depositors).

A British bank, Standard Chartered Bank, made an offer for the bank that was blocked by the Federal Government. The takeover would have breached the Government's restrictions on foreign ownership of banks and its requirement that no one shareholder may hold more than 10 per cent of a bank. The Bank of Adelaide also sought a merger with the Bank of NSW, but rejected the Bank of NSW's bid as undervaluing FCA (Sykes 1988).

Following its rejection of the offer from the Bank of NSW on 26 April, the Bank of Adelaide approached the South Australian Government for an equity injection. The bank asked the government to subscribe to $40 million worth of shares partly paid to 10 cents each. The South Australian Government was not prepared to take on such a large liability. The government offered to subscribe for $10 million worth of shares if the bank could find others to take up the remaining $30 million. After examining FCA's affairs, a group of the major trading banks decided that they were not prepared to give it direct support.

On 3 May, the Bank of Adelaide reported that the profitability of FCA had slumped dramatically, due to the crash in property prices (Sykes 1988). On

10 May, the Reserve Bank told the Bank of Adelaide that it should not give any further support to FCA and instructed the Bank of Adelaide to find a merger partner within a matter of days. Following pressure from the Reserve Bank, which sought to smooth the bank's exit from the industry, the major trading banks agreed to make a subordinated loan of $50 million to the Bank of Adelaide. At the same time, the Reserve Bank provided the bank with a $10 million specific liquidity facility as an extension of the bank's right to borrow under the LGS convention. On 14 May, the Reserve Bank issued a press release indicating that the facilities provided to the Bank of Adelaide were sufficient to ensure the Bank of Adelaide could meet fully its commitments.[73] The Australian Bankers' Association and the Bank of Adelaide also released supporting statements. The liquidity facility and coordinated public statements were successful in preventing any run on the Bank of Adelaide. On 22 May, the ANZ takeover of the Bank of Adelaide was announced. Despite opposition from some shareholders and a proposal that the Bank of Adelaide issue new capital to cover FCA's losses, ANZ's takeover came into full effect on 1 October 1980.[74]

Since the Bank of Adelaide was small (its share of trading bank deposits averaged around 2 per cent throughout its life (Merrett 1985)), it is difficult to argue that its failure posed a threat to the stability of the financial system. The liquidity facility provided by the Reserve Bank was a means of ensuring the orderly exit of the Bank of Adelaide – consistent with the former's depositor protection responsibilities – rather than a last-resort loan.

11. The Deregulated Era

In 1981, the Campbell Committee released the results of a broad-ranging review of the conduct of monetary policy and banking, which recommended lifting much of the regulation imposed on the banking system. As a result, the means for conducting monetary policy moved from direct control to open market operations.

[73] Reserve Bank of Australia Press Release, 14 May 1979.

[74] Opposition to ANZ's takeover from some shareholders led to an inquiry by the South Australian Full Court into what alternatives to ANZ's offer were considered by the Bank of Adelaide's management. This inquiry was set a tight deadline for fear that an extended delay would see ANZ withdraw its offer (Sykes 1988).

The Campbell Report also set out detailed recommendations for the conduct of lender-of-last-resort policy.

In the newly deregulated environment, competition intensified and banks' credit standards softened. The resultant boom in commercial lending, particularly property finance, unwound in 1990. While public confidence became fragile, issuance of press statements in support of individual institutions were sufficient to stem several deposit runs. Although a large building society and two state banks failed, no liquidity assistance was required in those cases.

11.1 The Campbell Report

The Campbell Report's recommendations for lender-of-last-resort policy were very much in line with Bagehot's prescriptions. While no legislative prescription for lender-of-last-resort policy was proposed or implemented, the report endorsed 'the well-established tenet of central banking practice that, above all else, it is the function of a central bank to ensure a sufficient availability of liquidity to preclude a financial crisis stemming from a loss of confidence in the capacity of viable financial institutions to meet their obligations'.[75]

The report argued that provision of liquidity support facilities by the central bank, unless applied with great restraint, risked creating moral hazard problems. Last-resort lending should be only associated with 'rare and unusual circumstances'. The Reserve Bank should also satisfy itself that a troubled institution could not meet its liquidity needs via other avenues without jeopardising market confidence in its viability. Moreover, last-resort lending should generally entail a penalty (except where the circumstances giving rise to the emergency were clearly beyond the control of an individual institution).

The Committee considered that, except where there were strong reasons for believing that the overall stability of the financial system would be impaired, non-viable financial intermediaries should be allowed to fail to preserve efficiency and competition within the financial system. The Committee also argued, however, that the manner in which a failure is handled is important. The exit of an insolvent

[75] Australian Financial System Inquiry (1981, p 100).

institution should be managed in a way that did not cast doubt on the viability of others.

In 1985, the LGS convention was replaced by the Prime Asset Ratio requirement, a prudential, rather than monetary policy, requirement. This marked the end of automatic lending to the banks. Instead, any lending to banks would be at the Reserve Bank's discretion and the Bank would aim to ensure that the banking system's need for liquidity would be met without recourse to direct lending to banks.

11.2 The 1990s Recession

Deregulation in the mid 1980s intensified competition in the banking industry. Credit growth ran ahead of banks' risk assessment procedures, which, in many institutions, had not adjusted to the newly liberalised environment. In 1989, the combination of high interest rates and a softening in the commercial property market brought broadly based credit quality problems to light. The banking industry experienced its worst losses since the 1890s. The largest losses were recorded by the State Bank of Victoria and the State Bank of South Australia. The state government owners of these banks provided significant capital injections in the resolution of these problems. Westpac and ANZ (the second and third largest banks in Australia) recorded large losses for their 1991/92 financial year following revaluation of their property assets. Both banks had sufficient capital to cover their losses.[76] Against this background, public confidence became more fragile, with runs on a number of non-bank financial institutions including building societies, friendly societies and property trusts. Although this nervousness spread to some of the smaller banks, at no time were there serious concerns about the overall system.

11.2.1 Building societies and regional banks

By early 1990, the Farrow Corporation and its building society subsidiaries (Countrywide, Federation, Geelong and Pyramid), accounting for just over half of building society assets in Victoria, but less than 1 per cent of the assets of all deposit-taking institutions in Australia, had been subject to rumours about their

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[76] In Westpac's case, the losses were covered, in part, by an issue of shares that was not fully subscribed. The issue's underwriters covered the shortfall in the share issue.

soundness for some time. Following adverse press reports, a run developed on 12 February 1990. Press statements were issued by Victorian Registrar for Co-operative Societies, and the State Treasurer and Attorney-General (jointly) indicating 'depositors' funds in Pyramid building society are secure'.[77] The latter statement also referred to the Reserve Bank's longstanding policy of supporting banks that provided liquidity to building societies that are responsibly managed and have adequate asset backing. The statements were not successful in stemming the deposit outflow. The Farrow Group had already fully drawn on its lines of credit with several banks, and they refused to increase those credit lines without the provision of substantial security.

The group's liquidity continued to deteriorate, and the group went into liquidation in June. The Victorian Government arranged for the State Bank of Victoria to make a direct payment to unsecured Farrow depositors to cover the par value of all deposits and withdrawable share capital (Kane and Kaufman 1992). The Reserve Bank issued a press statement in July 1990 noting 'the Bank believes that the problems of the Farrow group are not shared by other societies in Victoria (or any other State)…the banks will assist the building societies in maintaining liquidity' and, 'the Bank will provide any necessary liquidity support to the banks involved'.[78]

Three aspects of the Reserve Bank's approach were criticised by the Victorian Inquiry into the failure of the Farrow Group (Habersberger 1994). The first was the Reserve Bank acquiesced to the inclusion of the references to it in the press statement issued by the Victorian Treasurer and Attorney-General that could be taken as implying Reserve Bank backing for the group. The Bank, however, sought to emphasise that this was a statement of the Bank's broad policy rather than any specific assurance of finance to the Farrow group.[79] The Victorian Government's press releases were the eighth instance where the Reserve Bank's

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[77] Text reproduced in Habersberger (1994, pp 1314–1317).

[78] Reserve Bank of Australia Press Release 90-16, 2 July 1990.

[79] Reserve Bank of Australia (1995, p 46).

policy had been referred to in statements issued by the Federal Government, State Governments or the Reserve Bank (see Appendix B).[80]

Second, it was argued that the Bank should have done more to smooth the closure of the Farrow group. As was the case with difficulties experienced by building societies in other states, however, the Victorian Registrar of Building Societies' role as supervisor saw the Victorian Government carry the responsibility for the liquidation.[81]

The third criticism of the Reserve Bank's role was that it underestimated the systemic implications of Farrow's failure. While the failure had a severe impact on the Geelong region and caused some contagion for non-bank financial institutions in Victoria, the spillover to other financial institutions and other regions was well contained. The Farrow group was found to have fuelled its growth by adopting highly risky lending policies, misstating its accounts and deliberately breaching the regulations that applied to building societies. Therefore, if support had been provided to allow the Farrow group to continue in operation on systemic grounds, this would have entailed particularly high moral hazard costs (Kane and Kaufman 1992).

Public concerns about non-bank financial intermediaries spilled over to the Bank of Melbourne, which had converted from building society status in June 1989. On 16 July, the Governor released a statement that noted the bank was meeting all prudential requirements and that 'the Reserve Bank would ensure that the bank has adequate liquidity'.[82] Following the Bank's press release, the outflow of deposits slowed, but it was not until a month later that the bank's total deposits once again began to rise. Over this time, the Bank of Melbourne was able to meet all withdrawals from its own resources, without recourse to the standby facility provided by another private bank.

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[80] In fact, the Reserve Bank had not been given the opportunity to review the wording of the press statements before they were made public and so the statements were more suggestive of direct support than had been the case in previous public statements.

[81] Reserve Bank of Australia submission to the Farrow Group Inquiry. Text reproduced in Habersberger (1994, p 1630).

[82] Reserve Bank of Australia Press Release 90-18, 16 July 1990.

In Queensland, Metway Bank (which converted from building society status in July 1988) had similar problems in September and October 1990. The bank's management moved to quash suggestions of the bank's instability, pointing out that it had no exposure to any major entrepreneurial borrowers, and the bulk of its portfolio was made up of residential mortgages. This statement seemed to exacerbate the run. On 3 October, the Reserve Bank responded with a press release along the same lines as that issued in relation to the Bank of Melbourne in July. This time, the Bank's statement had an almost immediate effect, ending the run that day.

The spillover of concerns about building societies to the smaller banks mirrored earlier problems in Western Australia. In August 1987, bad loans at the West Australian Teachers' Credit Society led the Western Australian Government to legislate to allow the society to be taken over by the state-owned Rural and Industries Bank of Western Australia. The Western Australian Government funded the resulting losses borne by the Rural and Industries Bank. In October, Challenge Bank, a former building society that converted to bank status, was subject to a brief run. The trigger for the run was a malfunction in the bank's automatic teller machine network. The Governor of the Reserve Bank issued a press release, which 'scotched rumours in the Western Australian media concerning the stability of Challenge Bank', adding that 'the Reserve Bank stook squarely behind' the bank.[83] Within a few days the run ceased.

Contagion effects were a concern in each of the instances of support for the regional banks. However, each of the banks affected was small and, like the case of the Bank of Adelaide, depositor protection responsibilities, rather than broader systemic concerns, motivated the Reserve Bank's statements of support.

11.2.2 The State Banks

As the losses made by the State Bank of Victoria and the State Bank of South Australia came to light in 1990 and 1991, the Reserve Bank discussed the possible need for liquidity support with the banks and their state government owners.

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[83] Reserve Bank of Australia Press Release 87-27, 30 October 1987.

The primary source of State Bank of Victoria's problems was losses in its subsidiary, Tricontinental, which were more than 3.5 times greater than the value of State Bank of Victoria's capital. The Reserve Bank was prepared to offer short-term emergency liquidity support to the State Bank (provided the Victorian Government indemnified it against any losses) if the bank were to exhaust its stock of liquid assets. The Reserve Bank also offered to help the State Bank sell its portfolio of Commonwealth Government securities if the need arose, either by assisting the sale of those securities in the market or by buying them itself. In the event, no such arrangements were required. In August 1990, the State Bank was sold to the Commonwealth Bank.

The problems at the State Bank of South Australia were occasioned by the rapid growth of the bank (between 1985 and 1990 the bank's average annual growth in assets was almost 44 per cent), which saw it take on substantial bad loans. By 1998, the South Australian Government had provided the bank with assistance amounting to almost 3 times the bank's 1989 capital. The government assumed full control of the division managing the bank's impaired assets and sold the remainder of the bank to a private bank. The closure of the bank was conducted without recourse to Reserve Bank liquidity support.

The Rural and Industries Bank, owned by the Western Australian Government, became the subject of a brief run in January 1992. The Reserve Bank Governor issued a statement that noted deposits with the Rural and Industries Bank were guaranteed by the State Government of Western Australia, but added that the Reserve Bank would take whatever steps necessary to ensure the bank had adequate liquidity.[84]

11.3 Current Arrangements

In July 1998, following the Financial System Inquiry (the 'Wallis Inquiry'), the Australian Government implemented wide-ranging reforms to Australian financial regulation. One element of the reforms was the transfer of responsibility for supervision of banks from the Reserve Bank to the newly formed Australian Prudential Regulation Authority (APRA).

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[84] Reserve Bank of Australia Press Release 92-02, 6 January 1992.

The Wallis Inquiry argued that the central bank's involvement in monetary policy, management of system liquidity and provision of the interbank settlement system provided it with the powers, tools and knowledge to be best placed to manage systemic risk (Financial System Inquiry 1997). Under the new arrangements, therefore, the Reserve Bank remains responsible for overall financial system stability, including lender-of-last-resort arrangements. In providing support, the Bank's preference would be to do this through its usual daily operations in the cash market, providing liquidity to the market as a whole rather than to individual institutions. Nevertheless, in principle, a lender-of-last-resort loan could be made to any institution supervised by APRA. However, the Bank has clearly stated that 'the Reserve Bank's balance sheet is not available to prop up insolvent institutions' (Macfarlane 1999). In sum, it remains the case that:

> …in the highly unusual case in which a fundamentally sound institution was experiencing liquidity difficulties, and the potential failure of the institution to make its payments posed a threat to overall stability of the financial system, the Bank would be able to provide a lender-of-last-resort loan directly to that institution.[85]

In April 1998, the Reserve Bank introduced new prudential guidelines concerning banks' liquidity management. Responsibility for these arrangements now lies with APRA. Rather than relying solely on minimum liquidity ratios, the new arrangements emphasise institutions' liquidity management policies, including their ability to meet a five-day 'name' crisis.[86] In doing so, institutions cannot assume that the Reserve Bank would provide support (Reserve Bank of Australia 1998).

12. Conclusion

During the nineteenth century isolated bouts of illiquidity and broader swings in the economic cycle prompted colonial governments and the banking industry association to provide last-resort loans and other forms of support to troubled

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[85] Macfarlane (1999).

[86] A name crisis is one in which an individual institution experiences liquidity difficulties due to events specific to that institution.

banks on several occasions. Since Federation, however, there have been just two instances where last-resort support has been provided:

1. the loans provided to the Primary Producers Bank by the Commonwealth Bank in 1931; and
2. the loans provided to three private banks by the Reserve Bank in support of those banks' efforts to provide funds to illiquid building societies in 1974 and 1979.

The third instance of lending to a troubled financial institution, the Reserve Bank's provision of a liquidity facility to the Bank of Adelaide in 1979, was not a last-resort loan but rather a means of smoothing the takeover of the Bank of Adelaide by the ANZ.

Australia's experience highlights three preconditions that are needed to ensure the effectiveness of a lender of last resort. The lender of last resort needs to be able to readily generate liquidity, be immune from competitive pressures and limit the moral hazard consequences of the provision of support.

Firstly, a lender of last resort needs to have the means to provide substantial injections of liquidity to the banking system. The Associated Banks were constrained in the liquid resources they could draw on during the 1890s as the member banks were in straightened circumstances. The colonial governments also faced budgetary constraints through that period. They, therefore, adopted measures that did not require direct expenditure. The NSW Government's declaration of private banks' notes to be legal tender was successful in making banks more liquid without the government incurring any expense. In contrast, the Victorian Government's declaration of a week-long banking holiday froze most of what liquidity remained in the banks. While the Commonwealth Bank had ample capacity to provide liquidity during the 1930s, its concern (however misguided) to avoid inflationary expansion limited its willingness to provide support. The NSW Government's inability to produce high-powered money saw its guarantee of the Government Savings Bank count for nought.

Where the public sector is able to create high-powered money this gives it an advantage in the provision of last-resort support. Nevertheless, private sector support has been effective in several instances. The Associated Banks' support of the City of Melbourne Bank in 1879, support for the City Bank of Sydney from other Sydney-based banks in 1893, the National Bank of Australasia's financing of the Queensland Deposit Bank in 1931 and bank loans to building societies during the 1970s all suggest that the market is well able to address idiosyncratic or isolated liquidity difficulties.

Once it is publicly known a lender of last resort has the resources to effectively meet system-wide demands for liquidity, this gives the lender credibility that makes it easier to nip potential crises in the bud. Bagehot argued that a lender of last resort should clearly state its willingness to lend. In such a case, rather than direct lending, all that may be required is a reassuring public statement. The Commonwealth Bank's declaration of its strength and the government's support quelled the run on the Commonwealth Savings Bank in 1931. Statements regarding Reserve Bank support for regional banks were sufficient to stem runs between 1987 and 1992. However, the Australian experience also demonstrates that a lack of clarity in lender-of-last-resort policy can exacerbate public doubts in times of financial instability. The Associated Banks' reticence to publicly state the terms under which they were prepared to provide support added to public confusion concerning their role. Similarly, the equivocal nature of the Commonwealth Bank's statements concerning the amalgamation with the Government Savings Bank weakened public confidence.

The second aid to the successful conduct of lender-of-last-resort policy is immunity from competitive pressures. While industry associations in some other countries have successfully served as lenders of last resort, in Australia the Associated Banks struggled to move beyond the narrow interests of individual members. Similarly, charges of a conflict of interest between the Commonwealth Bank's central banking responsibilities and its commercial banking operations impaired its ability to act as a lender of last resort during the 1930s.

Since the 1930s, it has been the preference of the Commonwealth Bank, and then the Reserve Bank, to provide support via the market rather than directly to individual institutions. So long as the regulatory environment constrained competition, the Reserve Bank was able to persuade banks to override strategic considerations (which might have seen the banks leave their competitors starved of funds) when considering appeals for support. As a result, the arrangements for the support of building societies and the takeover of the Bank of Adelaide worked well. As deregulation proceeded and competition within the financial sector intensified, however, this approach became more difficult to apply. St. George's criticism of the terms of the support provided to it in 1979 was one symptom of this.

The third precondition for successful lender-of-last-resort policy is an ability to limit moral hazard costs. Australia has seen remarkably few instances of moral-hazard-driven behaviour (Provincial and Suburban, the Queensland National Bank and Farrow being notable exceptions). This suggests that, overall, lender-of-last-resort policy, in combination with other banking policies, has been successful in avoiding undue support of banks' risk-taking.

In three instances, an inability to monitor or limit potential moral hazard behaviour restricted the provision of last-resort support. The Associated Banks had little ability to monitor or penalise imprudent behaviour among its members. The limitations on the Commonwealth Bank's ability to monitor the operations of the private banks reinforced its bias against providing extensive support during the 1930s. Since the Reserve Bank had no regulatory responsibility for building societies, it confined its lending to institutions it directly supervised and relied on market discipline in providing funds to building societies during the 1970s.

In Australia, penalty rates have rarely been applied to last-resort loans. Instead, more direct constraints on banks' risk-taking have been applied. The conditions accompanying the government's loans to the Bank of NSW in the 1820s applied a very direct brake to the bank's risk-taking. The imposition of prudential standards on banks supported the Reserve Bank's public statements of support for regional banks in the late 1980s and early 1990s.

Another constraint on moral hazard behaviour is the restriction of last-resort support to solvent institutions. This requires distinguishing between illiquidity and insolvency. The Associated Banks did successfully discriminate between illiquid and insolvent institutions in handling the three requests for assistance it received in 1879. During the 1890s, however, broader considerations concerning the Associated Banks' ability to provide support largely overrode distinctions between illiquidity and insolvency. During the 1930s, the Commonwealth Bank relied heavily on banks' ability to provide suitable collateral for last-resort loans to separate illiquidity and insolvency. In providing support to the Primary Producers Bank and the Government Savings Bank, the Commonwealth Bank was prepared to lend against all assets that were conventionally regarded as good collateral. The Commonwealth Bank did not, however, attempt to look beyond the banks' current condition to form some assessment of their pre-panic value.

Some, such as Mishkin (1998), posit that central banks should adopt a rules-based approach to combat moral hazard. At no time, however, have fixed rules been used to determine lender-of-last resort policy in Australia.[87] During the twentieth century, the central bank has preferred to make the provision of last-resort support contingent on conditions in financial markets and the economy. For example, the Commonwealth Bank argued that such considerations contributed to its decision not to support the Federal Deposit Bank in 1931. While stopping short of complete ambiguity, such an approach does engender some uncertainty as to the exact conditions under which support would be provided to individual institutions, thus reducing moral hazard. Judging the systemic impact of potential bank failure, however, adds another element of difficulty to implementing lender-of-last-resort policy. The Victorian Government, for example, thought that the failure of the Commercial Bank of Australia in 1893 would have little systemic impact.

The provision of support to banks (and other deposit-taking institutions) has often been motivated by considerations other than financial stability. While the loans provided to the Bank of NSW in the 1820s were made out of concern for the effect of the bank's closure on the colony's economy, the need to foster competition was also an important consideration. Government involvement in savings banking was based on social policy considerations (the encouragement and protection of low-income depositors) and as a means of supporting regional development. The Queensland Government's introduction of a government note issue in 1893 was partly motivated by a desire to tap a cheap source of funding. State government support of building societies aimed to foster housing construction. While contributing to those objectives, the provision of such support muddies public perception of the riskiness of banks and risks fostering moral hazard behaviour.

[87] The automaticity of lending under the LGS convention followed from the convention's role as an instrument of monetary policy, rather than lender-of-last-resort considerations.

This is illustrated by the failure of the Farrow Group of building societies and the State Banks of Victoria and South Australia during the early 1990s.

The need to balance the provision of relief for sound institutions experiencing liquidity problems with moral hazard costs of supporting unviable institutions suggests that the ability to ensure smooth exit of troubled financial institutions is an important adjunct to the lender of last resort. This was borne out by the effective containment of spillover effects from the closure of the Bank of Adelaide.

The failures that have occurred, however, reinforce the notion that the systemic label should not be overapplied. The banks that failed in the 1840s were fundamentally insolvent. The banking system was well able to continue functioning while they failed. While liquidity shortages forced most banks to suspend payment during the 1890s, the banking system as a whole continued to function. Similarly, the systemic consequences of the failure of the Primary Producers Bank and the Federal Deposit Bank in 1931 and the Bank of Adelaide in 1979 were limited. Although the failure of the Farrow Group did spill over to other non-bank financial institutions and smaller banks that had not long converted from building society status, overall financial contagion was well contained. On several occasions, market-based solutions have developed to ease the banking difficulties. During the 1890s, secondary markets in frozen bank deposits developed. Such markets also sprang up during the Government Savings Bank's suspension of payment in 1931.

Appendix A: Financial Disturbances in Australia – A Chronology

Date	Institution	Incident	Public sector response
1826 & 1828	Bank of New South Wales	The bank experienced severe liquidity problems.	The colonial government granted the bank loans to cover its short-term illiquidity.
1843	Colonial trading banks	The Bank of Australia, Derwent Bank, Port Phillip Bank, Sydney Banking Company, Colonial Bank, Archers Gilles and Company and Royal Bank of Australia failed.	In NSW, legislation was passed relaxing the treatment of insolvents and allowing movable property to be mortgaged to increase the supply of securities that banks could hold.
1843	Savings Bank of NSW	The trading bank failures led to a run on the Savings Bank.	Government guarantees of the trustees were extended.
1852	South Australia	Illiquidity due to gold rushes in neighbouring colonies.	Gold ingots were declared legal tender for one year.
1866	Queensland	Colonial government financing crisis. The Bank of Queensland failed.	Temporary issue of government notes which were not legal tender.
1879	Provincial and Suburban Bank, Australian and European Bank, City of Melbourne Bank	The Provincial and Suburban Bank and the Australian and European Bank failed. The City of Melbourne Bank suffered a depositor run.	The Associated Banks provided no aid to Provincial and Suburban and limited assistance to the Australian and European Bank. A public statement of support for the City of Melbourne Bank by the Associated Banks stemmed the run.
1886	Commercial Bank of South Australia	Failed due to bad debts and fraud. The failure also triggered a run on the Savings Bank of South Australia.	The Associated Banks declined assistance.
1893	Banks, building societies and finance companies	Of the 23 banks of issue, 13 were forced to suspend payment.	In Victoria, a week-long banking holiday was declared. NSW declared banks notes to be legal tender and allowed depositors to convert suspended deposits into Treasury notes.
1893 & 1895	Queensland National Bank	Bad loans and accounting fraud caused the bank to fail.	The Queensland Government guaranteed the bank’s deposits for one year.

Date *(continued)*	Institution	Incident	Public sector response
1931	Government Savings Bank of NSW	The NSW State Government's political and financial problems led to a deposit run.	The Government Savings Bank merged with the Commonwealth Bank.
1931	Primary Producers Bank of Australia	Anticipating a run, the bank approached the Commonwealth Bank for assistance.	The Commonwealth Bank provided a small loan but declined further requests for support.
1931	The Federal Deposit Bank	The bank suffered a run following the run on the Government Savings Bank.	The bank was denied Commonwealth Bank support.
1931	State Savings Bank of Western Australia	The bank suffered a run following the closure of the Government Savings Bank.	The State Savings Bank merged with the Commonwealth Bank.
1974	Banks and building societies	The property market crash.	The Reserve Bank established a liquidity facility for all banks and an additional line of credit for banks that were providing support to building societies. These lines were drawn upon.
1977	Queensland building societies	Problems were experienced by several Queensland building societies due to bad loans.	The Reserve Bank issued a press release stating its support for banks that provide liquidity to building societies.
1979	St. George Permanent Building Society	In March 1979, a run developed following a radio broadcast of rumours of its imminent collapse.	The Acting Federal Treasurer issued a press release noting the Reserve Bank's support for banks that provide liquidity to building societies.
1979	Bank of Adelaide	The bank suffered large losses in its subsidiary Financial Corporation of Australia.	The Reserve Bank arranged a merger of the bank with the ANZ and provided a liquidity facility.
1987 1990 1990	Challenge Bank Bank of Melbourne Metway Bank	These banks were subject to rumours about their solvency leading to deposit runs.	In each case, the Reserve Bank issued a media release denying the rumours and stating that depositors were fully protected.
1990	Farrow Corporation	Following depositor runs the Farrow group of building societies failed.	The Victorian Government made payments to unsecured depositors. The Reserve Bank issued a statement distancing other societies from the Farrow group's problems and

Date *(continued)*	Institution	Incident	Public sector response
			reiterating its support for banks that provide liquidity to building societies.
1990 1991	State Bank of Victoria State Bank of South Australia	Both banks incurred large losses from non-bank subsidiaries.	The state governments injected funds to cover the losses. The banks were eventually sold.
1992	R&I Bank	The R&I Bank of Western Australia incurred losses.	The Reserve Bank issued a press release noting the WA Government guaranteed the bank's deposits, and stating that the Bank would take whatever steps were necessary to ensure the R&I had adequate liquidity.

Appendix B: Press Releases Addressing Difficulties at Financial Institutions 1974–1992

Date	Troubled institution(s)	Statement issuer
2 October 1974	**Building societies in Queensland and South Australia**	**Acting Federal Treasurer (Hayden)**

…the Reserve Bank has advised the trading banks to consider sympathetically requests for finance that were received by the banks from financial institutions which were responsibly managed and had adequate asset backing. Mr Hayden said that the community could rest assured that the Reserve Bank, as always, would stand behind the banks in regard to their liquidity needs.

3 October 1974	**Building societies in Queensland and South Australia**	**Acting Prime Minister (Cairns)**

Dr Cairns re-affirmed that it was the policy of the Government to ensure that adequate liquidity was available to enable the banking system to meet the essential needs of business and the community. He said that particularly as regards financial institutions the Reserve Bank was in close touch with the trading banks with a view to ensuring that they were in a position to consider sympathetically requests for finance from them.

28 September 1977	**Queensland Permanent Building Society**	**Acting Federal Treasurer (Robinson)**

…the Reserve Bank had a continuing understanding with trading banks that they would consider sympathetically the requests for finance received from building societies which were responsibly managed and had adequate asset backing.

5 October 1977	**Queensland Permanent Building Society**	**Acting Federal Treasurer (Robinson)**

…the Reserve Bank has made it clear to the banks that it stands ready to discuss constructively with them any liquidity problems that may arise from whatever scheme of arrangements might be developed.

13 October 1977	**Metropolitan Permanent Building Society**	**Federal Treasurer (Lynch)**

…there was absolutely no basis for uncertainty among depositors in operating building societies. Mr Lynch drew attention to the announcement today by the Governor of the Reserve Bank, which had been made after close consultation with the Government, that a very substantial line of credit had been made available to the Commonwealth Trading Bank to back up the liquidity of the Metropolitan Permanent Building Society…He reiterated that in these circumstances there is a continuing arrangement whereby banks stand behind building societies and other financial institutions. The Reserve Bank, in turn, as always stands behind banks in regard to their liquidity needs.

Date (*continued*)	Troubled institution(s)	Statement issuer
13 October 1977	**Metropolitan Building Permanent Society**	**Reserve Bank Governor (Knight)**

…arrangements had been made to provide ample support for the largest Queensland building society, the Metropolitan Permanent Building Society. The society's bankers, the Commonwealth Trading Bank, were, with the support of the Reserve Bank, making a very substantial line to credit to the society which will enable the Metropolitan to fully match demands for withdrawals of depositors' funds. This action is a particular instance of the general arrangements by which against the background of the Reserve Bank's support of banking liquidity, banks stand behind financial institution which are responsibly managed and have adequate asset backing.

5 March 1979	**St. George Building Society**	**Acting Federal Treasurer (Robinson)**

…the Society had very large amounts of liquid resources available to it…the Reserve Bank had a continuing understanding with trading banks that they would consider sympathetically requests for finance received from building societies which were responsibly managed and had adequate asset backing.

14 May 1979	**The Bank of Adelaide**	**Reserve Bank Governor (Knight)**

The Governor of the Reserve Bank of Australia, Mr HM Knight, confirmed today the provision by the Reserve Bank of a liquidity facility to The Bank of Adelaide. This was one of several actions that had been taken in respect of The Bank of Adelaide group as announced by the Chairman of that Bank and the Chairman of the Australian Bankers' Association. The arrangements were made in consultation with the Reserve Bank and with its full concurrence…The facilities now available to the Bank of Adelaide ensured that it remains in a position to meet fully its commitments.

30 October 1987	**Challenge Bank**	**Reserve Bank Governor (Johnston)**

Mr RA Johnston, today scotched rumours in the Western Australian media concerning the stability of Challenge Bank Limited. He said that in any case the Reserve Bank stood squarely behind the Challenge Bank.

13 February 1990	**Farrow Corporation**	**Victorian Treasurer (Jolly) and Victorian Attorney-General (McCutcheon)**

…depositors' funds in the Pyramid Building Society are secure…rumours circulating about the Society are without foundation…The Minsters said Pyramid has extensive lines of credit into the banking system, and is supported by leading national banks. The Treasurer has been assured that adequate liquidity support will be available under these arrangements. The Reserve Bank has a long standing understanding with banks that they will consider sympathetically requests for finance received from building societies which are responsibly managed and have adequate asset backing…the Treasurer has been given a written statement by the independent auditors of the Pyramid Building Society that, in their view, there is 'absolutely no reason to be concerned that depositors' money is at risk'.

Date (*continued*)	Troubled institution(s)	Statement issuer
2 July 1990	**Farrow Corporation**	**Reserve Bank Governor (Fraser)**

The Reserve Bank is not responsible for supervising building societies or for protecting their depositors. It is, however, charged with upholding the stability and integrity of the financial system as a whole. The Bank therefore has been monitoring closely developments in relation to building societies following the decision by the Victorian Government last week to put the Farrow Corporation…under official administration…From its enquiries, the Bank believes that the problems of the Farrow group are not shared by other societies in Victoria (or any other State for that matter)…The Bank has participated in the discussions leading to the arrangements agreed by the Victorian Government with representatives of the major banks and the Victorian Building Societies Association…Under these arrangements the banks will assist the building societies in maintaining liquidity. For its part, the Bank will provide any necessary liquidity support to the banks involved…The Reserve Bank believes that these arrangements will fully protect the depositors in the societies concerned.

16 July 1990	**Bank of Melbourne**	**Reserve Bank Governor (Fraser)**

…Mr Bernie Fraser, today scotched rumours concerning the stability of the Bank of Melbourne…the Reserve Bank will ensure that Bank of Melbourne has adequate liquidity and that its depositors are fully protected.

3 October 1990	**Metway Bank**	**Reserve Bank Governor (Fraser)**

Metway Bank is a sound bank and rumours concerning its stability have no substance. Depositors in any event are protected by the Reserve Bank of Australia…depositors could be assured that the Reserve Bank would take whatever steps were necessary to ensure that Metway Bank Limited had adequate liquidity and that its depositors were fully protected.

6 January 1992	**R&I Bank of Western Australia**	**Reserve Bank Governor (Fraser)**

…rumours which had been circulating concerning the viability of the R&I Bank of Western Australia were totally lacking in substance…Deposits with the R&I are guaranteed by the State Government of Western Australia…depositors could also be assured the Reserve Bank would take whatever steps were necessary to ensure that R&I had adequate liquidity.

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