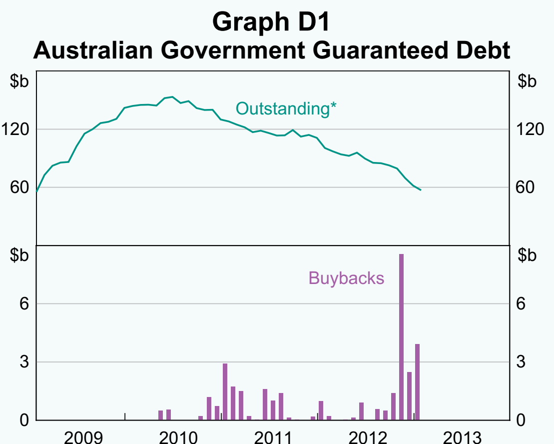
Box D

Buybacks of Government Guaranteed Securities

In October 2008 the Australian Government Guarantee Scheme for Large Deposits and Wholesale Funding was enacted by the government as part of a suite of measures responding to the global financial crisis.[1] The Scheme permitted Australian authorised deposit-taking institutions (ADIs) to issue securities with maturities of up to five years that were fully guaranteed by the Australian Government.[2] ADIs were charged a monthly fee for using the Scheme based on their outstanding stock of guaranteed securities and the institution's credit rating: AA-rated institutions were charged a fee of 70 basis points per annum, while A-rated and BBB-rated institutions were charged 100 and 150 basis points, respectively. By the time the Scheme closed to new issuance in March 2010, a total of 16 ADIs had issued around $166 billion of guaranteed securities in the domestic and offshore markets, with the final guaranteed instrument due to mature in March 2015. The Scheme is administered by the Reserve Bank of Australia on behalf of the Australian Government. By end December 2012, the Scheme had generated around $3.8 billion in fees for the government.

Around the time the Scheme was closed to new issuance, funding conditions in financial markets began to improve. ADIs started buying back guaranteed bonds, at first in small amounts but increasing in size as conditions became more favourable. By mid 2012 around $16 billion of guaranteed bonds had been repurchased. In late 2012 and early 2013 several ADIs, including some of the biggest issuers of guaranteed bonds, undertook large-scale repurchases, buying back around $15 billion of guaranteed bonds. These buybacks, together with bond maturities and revaluations due to the appreciation of the Australian dollar, have contributed to a decline in the remaining stock of outstanding guaranteed bonds to around $57 billion (Graph D1). This has been a faster decline in the Australian Government's contingent liabilities than would have occurred without these buybacks.



* Adjusted for monthly exchange rate movements; numbers in the text are based on original Australian dollar equivalents

Source: RBA

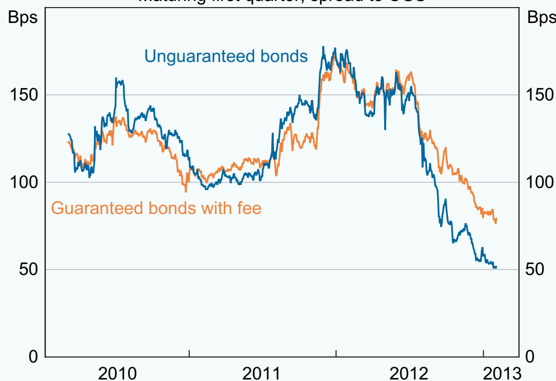
While wholesale debt guarantee schemes were enacted in at least 15 OECD countries during the global financial crisis, large-scale buybacks have not been a feature of guarantee schemes in other countries. Fees under these schemes were paid up front and were non-refundable. In contrast, under the Australian scheme the fee is applied each month on the balance of outstanding guaranteed bonds, which permits the bond issuer to repurchase the

1 See Prime Minister of Australia (2008), 'Global Financial Crisis,' Media Release, 12 October. The Scheme is further described in Schwartz C (2010), 'The Australian Government Guarantee Scheme', RBA *Bulletin*, March, pp 19–26.

2 The Scheme also permitted ADIs to offer guaranteed deposits of more than $1 million. Deposits of less than $1 million were automatically guaranteed through the Financial Claims Scheme, which was also introduced in October 2008. This cap was revised to $250 000 in February 2012.

guaranteed bonds when wholesale funding market conditions improve.

A buyback of a bond issued under the Scheme is optimal when the value of the guarantee to an investor is less than the cost of the guarantee to the issuer. The value an investor places on the guarantee can be measured by the difference in yield between a guaranteed bond and an unguaranteed bond of equivalent maturity from the same issuer. At the height of the global financial crisis, 5-year guaranteed bonds issued by the major banks yielded around 90 basis points less than unguaranteed bonds, rendering guaranteed bonds 20 basis points cheaper for these ADIs to issue after accounting for their 70 basis point guarantee fee. As global financial market conditions have improved, the spread between unguaranteed and guaranteed bonds has narrowed, reflecting investors' increasing confidence that banks will be able to honour their contractual payments. At the same time, the maturity profile of the guaranteed bonds has shortened. As a result, it is now economical for the major banks to buy back most guaranteed bonds with between 12 to 18 months remaining to maturity (Graph D2). Meanwhile, access to alternative funding markets has steadily improved since the beginning of 2012. By late last year, credit spreads had tightened considerably, and Australian banks were able to issue significant volumes into the unsecured domestic and offshore markets, allowing them to refinance guaranteed bonds with longer-dated issuance.



ADIs have also sourced an increasing share of their funding from domestic deposits, which have grown rapidly in recent times as ADIs actively target this source of funding. In addition, the introduction of covered bonds in late 2011 presented investors with an alternative AAA-rated ADI-issued security. Some investors in guaranteed bonds are constrained by their mandates to invest only in AAA-rated paper, and had purchased Australian ADI securities for the first time when the Scheme was enacted. The advent of covered bonds, which are also AAA-rated, has provided an avenue for these investors to continue investing in Australian ADI-issued securities, and has facilitated their participation in the buybacks.

Banks have offered a premium of around 10 basis points to secondary market spreads to encourage investors to participate in the buybacks. Nonetheless, not all bond holders have participated, in part due to the scarcity of alternative highly rated Australian dollar-denominated securities. This has been especially the case for official sector investors, such as reserve asset managers, many of whom are limited to investing in government or quasi-government securities. Some buy-and-hold investors have also preferred to continue to earn the premium offered by guaranteed bonds, a result of their lower liquidity relative to Commonwealth Government Securities (CGS). One-year guaranteed bank paper, for example, currently offers a yield that is around 10 basis points higher than that of CGS, while retaining the credit risk profile of the Australian Government. ✠