Australia's Experience in the Global Financial Crisis

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1. Introduction

Of developed economies around the world, Australia has emerged as amongst the least affected by the Global Financial Crisis (GFC). March quarter 2009 GDP growth of 0.4 percent (after one quarter of slightly negative growth), suggested that Australia had largely escaped the world-wide recession. Australia's banking sector was also less adversely affected than elsewhere, with no failures and profitability remaining strong, although down somewhat from previous levels and with increased bad debt levels.

However, there have been significant failures of listed financial/investment companies and large investor losses from structured products and investment funds, prompting concerns about financial market practices and investor protection. The Australian approach to regulation of securities and investment markets, based on disclosure, education and advice, did not prevent the marketing of high-risk financial products and levered investment structures to retail and (in hindsight) other "unsophisticated" wholesale investors (such as local councils) not fully appreciative of the market and counterparty risk involved. As at June 2009 the stock market had fallen by around 41 percent from its high of November 2007, creating significant losses for such investors as well as the large pension fund sector, and prompting concerns about the adequacy of the securities market regulatory structure.

The following review of the impact of the GFC and responses to it, suggest that Australia's comparative insulation from the immediate effects reflect both good economic management and regulation, and a dose of good luck, although some longer-term concerns still remain.

2. The Evolution of the Crisis in Australia

The pre-GFC structure of the Australian financial system suggests that Australia had significant potential exposure to the GFC. First, Australia was ranked as the second largest (outside the US) issuer of asset backed securities.[1] Second, the funds management sector (driven by compulsory private pension contribution arrangements) was the fourth largest in the world, with $1.2 trillion in funds under management.[2] Third, Australia had the largest (albeit still relatively small) hedge fund sector in Asia with no special regulation of hedge funds. Fourth, while the domestic corporate bond and commercial

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[1] Securitized products included 78% residential mortgage backed securities and 8% asset backed paper.

[2] All dollar amounts are AUD.

paper markets (excluding securitization) were relatively small, large Australian companies were active issuers in international bond markets. Fifth, the highly concentrated Australian banking sector, where the biggest four banks had a market share of Australian resident assets of 65%, had only around 40-50% of those assets funded by domestic deposits, relying instead heavily on offshore wholesale funding. In addition house prices had more than doubled in real terms since the mid 1990s with housing affordability at its lowest level since the late 1980s.

Transmission of the crisis to Australian shores happened quite rapidly through equity market adjustments but the real economy was buffered for some time by improved terms of trade associated with a resources boom driven by exports to China. Early effects of the crisis were reflected in the collapse of hedge funds Basis Capital and Absolute Capital which suspended redemptions in July 2007.[3] This was followed by the failure of RAMS Home Loans (a non-bank provider of residential home loans) when in August 2007 it was unable to roll over its extendable commercial paper in the U.S. as the commercial paper markets froze (even though the asset backing was high quality Australian residential mortgages).

In November 2007 the stock market peaked and by the end of January 2008 had dropped 17 percent. The ensuing bear market exposed business models and practices that relied on rising asset prices to be sustainable. A number of large non-bank listed finance/investment companies with highly leveraged structures (including Centro Property, MFS, Allco Finance Group and City Pacific) suffered catastrophic share price falls of between 50 and 90 percent from August 2007 to February 2008. These entities were highly complex and opaque with intra-conglomerate equity and debt linkages and cross-guarantees. The common theme was a highly levered structure financing illiquid real and financial (mortgage) assets which were held both on-balance sheet and sold into managed fund (unit trust) structures generating profits and a long-term stream of management fees for the parent company.[4]

Short selling, margin lending, securities lending practices, and financial advisory practices all came under scrutiny in the prolonged bear market, and exposed regulatory weaknesses. A number of broking firms had built up substantial margin lending businesses based on a securities lending model (where title was transferred to the provider of cash). Partly as a result of being unable to speedily regain title to stock it had on-lent, Tricom Securities caused considerable stock market disruption when it defaulted on settlement in January 2008. The combination of company insiders having large holdings highly leveraged through margin loans (structured on a securities loan transaction), together with inadequate reporting of short sale transactions led to major problems for other companies. In a number of cases speculation that margin calls on executives and directors would be triggered unleashed a wave of short selling, hastening the demise of companies (such as ABC Learning in February 2008) with unsustainable, highly levered, business models. Following similar moves around the world short selling

[3] Australian investors lost over $600 million in the collapses.
[4] Davis (2009) provides an outline of this business model which was popularized by Macquarie Bank and also used by the investment bank Babcock and Brown which subsequently failed.

was banned in September 2008 for all stocks. From November 2008 until May 2009 the ban applied only to financial stocks.

Problems with margin-lending and investor protection arrangements were highlighted by the failure of the broking firm Opes Prime, whose margin-loan customers lost title to their investments, and whose failure caused significant reputational damage to the major banks providing its funding. In December 2008, a large financial planning firm, Storm Financial, entered administration and ultimately failed, with many clients suffering major losses from highly leveraged investment portfolios. Major banks again suffered reputation damage because of their funding arrangements with that company. In February 2009 a parliamentary inquiry into corporate collapses, financial services and products was announced in response to these experiences.

The year 2009 saw a number of further collapses of highly levered finance/investment companies. Global investment and advisory firm Babcock and Brown failed in March 2009. Two large companies, Timbercorp and Great Southern which accounted for around 60 percent of the market in agribusiness managed investment schemes failed in April and May 2009 respectively.[5]

The Australian banks had only limited direct exposure to high-risk securities such as CDOs. The National Australia Bank, one of the four major banks reported an exposure to $US1.2 billion of investment vehicles in July 2008. But with the general economic downturn problem loans were on the rise and bank profitability, while still high, declined. Following the collapse of Lehman Brothers and the announcement by the Irish government of guarantees on bank deposits, the Australian government announced guarantee arrangements in October 2008 for bank deposits and wholesale funding, despite the strong capital position of the Australian banks. Reflecting their relatively strong performance each of the four major banks was still rated AA by S&P in mid 2009. There has been consolidation in the already concentrated sector with two of the four major banks acquiring the fifth and seventh largest rivals. Despite having suffered stock price declines in the order of 25 – 50 percent since the November 2007 peak, the four major Australian banks have been able to raise additional equity capital and had jumped significantly in international league tables to be in the top 40 banks worldwide by market capitalization in March 2009.

Another area severely affected by the GFC has been the mortgage/property trust (managed funds) industry. In the wake of the government guarantees on bank deposits, withdrawals from the trusts accelerated in the last quarter of 2008 following large outflows in the first three quarters. Most trusts responded with redemption freezes, with some of the suspended trusts in early 2009 offering withdrawals on a pro-rata basis. On another affected front, the Australian Government has set up a special purpose funding vehicle to provide finance for car dealers following the withdrawal of GE Money Motor Solutions and GMAC from Australia. The other sector badly hit has been the superannuation (pension fund) sector. Compulsory superannuation saw funds under

[5] D'Aloisio (2009) provides more detail on the extent of corporate failures and outlines responses by the securities market regulator (ASIC) to the market failings uncovered by the GFC.

management reach $1.2 trillion before the crisis. At December 2008 this figure had dropped to $1.05 trillion, reflecting falling asset prices.

Australia's securitization markets (despite being primarily high quality RMBS) froze, paralleling the experience in other countries. Spreads on non-government debt widened (although less than elsewhere) as risk aversion levels rose in the market. Initially the Australian Currency (AUD/USD) depreciated in August 2007 against the US dollar as speculators becoming increasingly risk averse unwound "carry trades" on the Australian dollar. Notably the Reserve Bank[6] continued to increase the official short term interest rate until mid 2008 to a comparatively high 7.2 per cent p.a. because of inflation fears and a strong economy, subsequently reducing it to 3.00 per cent p.a. in mid 2009. The currency appreciated against the US dollar[7], trading in a range of 0.80 to 0.97 from July 2007 to September 2008 depreciating to 0.61 in October 2008 and recovering to around 0.80 in July 2009.

3. The "Lucky" Country?[8]

Why has Australia been less affected by the crisis than most other developed countries. Luck, good management, and regulation have all had a role to play.

Considering first the banking sector, memories of the problems of the early 1990s (when two State Government owned banks failed) may have limited bank risk-taking. But the structure of aggregate financial flows was also relevant in influencing bank behavior. Australian banks were major borrowers in international wholesale financial markets, funding Australia's current account deficit, and therefore more focused on raising funds internationally for lending within Australia than on acquiring complex securities such as CDOs either on-balance sheet or within SIVs or conduits. High profitability from those domestic loan activities may also have lessened incentives for playing in a different, more risky game, and was reflected in a much lower reliance on trading income than overseas counterparts.

The major banks were also intensively engaged, at great expense, in developing their risk management systems in order to qualify for Advanced IRB status for the introduction of the Basel II prudential regulation framework in January 2008. Arguably, this attention to risk quantification and management may have helped them to avoid the excessive risk taking which occurred elsewhere (although the same factor should have been relevant internationally). Probably more relevant in limiting bank risk-taking, however, was the role of the prudential regulator, APRA[9], which had suffered severe embarrassment (and subsequent organizational restructuring) in 2001 when a major insurance company under its supervision failed (with a government decision to provide some $600 million

[6] The Reserve Bank of Australia (RBA) is Australia's central bank.
[7] Currency is quoted as 1AUD = *x*USD
[8] This is the title of an influential book (Horne, 1964) which argued that "Australia is a lucky country, run mainly by second-rate people who share its luck".
[9] The Australian Prudential Regulatory Authority (APRA) is responsible for the regulation of deposit taking institutions, insurance companies and superannuation (pension) funds.

compensation to policyholders imposing a significant cost on taxpayers). APRA's sole purpose role as a prudential regulator (with securities market regulation allocated to ASIC) may also be relevant in this regard.

Within the broader financial sector, the growth of pension funds looking for fixed interest style investments, in the absence of a significant local corporate bond market and a small government securities market, had prompted the growth of a significant securitization sector. Sub-prime style lending did not evolve reflecting, on the supply side, potential legal risks for lenders and originators from "unconscionable conduct" and higher regulatory capital requirements for non-standard loans. On the demand side, awareness of borrowers to the risk of loss of other assets from defaulting on "full-recourse" style mortgage loan contracts, and relatively high, by international standards of the time, interest rate levels, were also relevant.

At the real economy level, the strong growth of the Chinese economy and the resources boom (and strengthening terms of trade) during the early part of the crisis period, tended to shield the economy from the worldwide downturn, while also creating inflationary pressures. While a long-standing current account deficit exposed Australia to downturns in international investor confidence, the fact that the accumulated international debt was primarily private, and that the government budget had been in surplus for many years, meant that this did not come to pass. With the eventual slowing of the Chinese economy, ending of the resources boom, and reduced willingness of international speculators to continue the "carry trade" (speculating that high Australian interest rates would not be offset by exchange rate losses), the consequent fall in the exchange rate after July 2008, helped to moderate the downturn in economic activity.

4. Policy Responses and Implications

Policy responses by the Australian authorities can be grouped into four categories.

The first is Reserve Bank and Government actions to unfreeze and restore liquidity to financial markets (see Kearns, 2009, for more detail). Relatively early in the crisis, the Reserve Bank expanded the range of securities it would accept as collateral for repurchase agreements to include private sector securities such as residential mortgage backed securities (RMBS). The term for repurchase agreements was also extended out to as much as one year. In late September 2008, the Federal Government introduced a RMBS purchase agency within the Australian Office of Financial Management with the objective of government purchases of RMBS "restarting" the frozen RMBS market. A special purpose vehicle ("Ozcar"), jointly operated by the Government and the four major banks, was established in December 2008 to provide finance for car dealers following the withdrawal from the Australian market of the two largest providers of finance (GE Money and GMAC).

A second type of response has been actions designed to shore-up confidence in the strength and stability of the financial system, particularly the banking sector. Most notable here was the government announcement on October 12, 2008 of a blanket guarantee of all bank deposits and debt, following similar announcements by the Irish and, then, other governments, which threatened to undermine the international wholesale market funding of Australian banks. Subsequently, a fee based, opt-in guarantee scheme (for debt and deposits above $1 million) together with 100 per cent guarantee for deposits of less than $1 million was introduced on 28 November 2008 to run for three years.

A third type of response has been the introduction of new regulations aimed at preventing activities in financial markets and institutions from creating further instability. Most important here was the announcement of a ban on short-selling on the Australian Securities Exchange (ASX) on September 21st 2008, which applied to all stocks until November 19th, and to financial stocks until May 25, 2009. At that time, tougher regulation of margin lending was also foreshadowed. Also in June 2009, APRA released a consultation paper on proposals for ensuring that executive remuneration practices in financial institutions were consistent with good risk management.

The fourth type of response has been fiscal actions and official interest rate reductions (with significant flow-through into private sector rates which has eased pressures on heavily levered household balance sheets) to offset the crisis induced slowdown in economic activity. In October 2008, a large fiscal stimulus package was announced, and the 2009-10 Budget announced in May 2009 forecast a very much increased budget deficit. On 12 May the Federal Government announced a guarantee scheme for borrowings by the State and Territory Governments to ensure their access to debt capital markets for funding infrastructure.

Notably, a fifth type of response found in many other countries, that of government provision of debt or equity funding to distressed banks, their nationalization, forced mergers with healthier institutions, or “bail-outs” has not occurred. While there have been a large number of failures of debenture issuers and high profile financial firms who were using a heavily leveraged business model based on acquiring assets to place in mutual fund vehicles which they manage, stakeholders, including pension fund investors, rather than taxpayers have borne the losses arising from the failures of these non-prudentially regulated institutions.

5. Conclusion: Future Prospects

While Australia had, at mid 2009, withstood the world financial turbulence better than most[10], the situation was not without risks. Economic slowdown and increasing numbers of company and property developer failures were causing bank loan-losses to increase. Housing prices had not fallen significantly (but commercial property prices are down and vacancy rates up), despite their previous boom appearing to be cushioned by higher incomes and lower interest rates, which had improved affordability, together with the effects of ad hoc policy responses such as “first-home buyers” grants. While some

[10] Stevens (2009) provides an overview and interesting comparison with the experience of Canada. An analysis of the factors that were catalysts for the GFC and arguments as to why Australia was less affected than elsewhere, are provided in Gruen (2009).

analysts pointed to high population growth and a supply shortage as the source of high house prices, the risk of house price deflation remained significant. With household leverage having increased significantly over the past decade, potential risks for bank loan portfolios from the economic downturn and falling asset prices were of concern.

Substantial financial wealth had been destroyed by the stock market collapse, with much of the losses concentrated in both institutional and individual pension funds. But also significant was the extent of losses incurred by both retail and wholesale investors from exposures to high risk financial products and investment structures, prompting calls for a more proactive regulatory approach rather than *caveat emptor* (and several class action lawsuits).

Within the financial sector, the crisis has seen increased concentration in an already concentrated banking sector, and a decline in mortgage origination and funding outside of the banking sector. Ensuring effective competition and removing government guarantees which enshrine the dominant competitive position of large banks in the financial system are major challenges.

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