Submission to the Study of Financial System Guarantees by the Australian Government

Lodged by the
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Introduction

As is well known, Australia is one of the few developed countries that does not provide some form of depositor insurance or guarantee, save for the untested depositor preference requirement, provided for under the Banking Act.

While it might be said that the Australian financial system is not unique, it does bear interesting similarities to Canada, while being vastly different from that of the United States of America.

It is understood that the introduction of deposit insurance in the United States resulted from the lack of community confidence in banks, after the Great Depression. Its introduction facilitated the level of confidence needed for the development of the banking system.

It is also understood that the introduction of deposit insurance for credit unions in the United State of America occurred in 1970 and whilst the precise reasons for its creation are unknown, it is assumed that it was done in relation to competitive and confidence reasons.

Within Australia, credit unions have a long history of “deposit insurance”, through various state funds initially, which at the outset were operated on a voluntary basis. Subsequently, a number of those state funds were legislated for and in 1992 when the Financial Institutions Scheme was implemented, funds were established in each of the states and were entitled contingency funds. These funds, as with their forerunners, were capital funds holding approximately 1% of credit unions assets and the earnings of the funds met the cost of the supervision system involved. The objective was to ensure that retained earnings would be sufficient to meet any claims on the fund in the event of a credit union failing.

In fact, there were no real failures of credit unions causing claims on the funds, however various strategies were devised in respect of the contingency funds to underwrite the deficiency where a credit union that was likely to fail, or was in a poor financial position, could be transferred to a stronger credit union.

This has been the history of experience with Australia’s credit unions. In the early 1980’s there were over 700 credit unions while today there are less than 190. That dramatic reduction in numbers has been managed without any loss of funds to depositors thanks to the two pronged approach of having had sufficient credit unions being prepared to absorb weaker ones and having the financial resources available to ensure the ongoing viability of the merged entity.

The balance of our comments are structured in the form of the items detailed in the terms of reference, at the scope of the study:

a) The economic rationale for and against explicit guarantees is well documented in various areas and we will not attempt to repeat those matters here, other than to say that on balance, it would appear that in this day and age, community

expectations of the safety of their savings is extremely high and it is at its own peril that a Government does not adequately address this matter.

The Pyramid Building Society collapse in Victoria is perhaps the most dramatic recent example in this regard and the behaviour of management in that organisation stands in contrast with the often quoted concern with deposit insurance, that it will promote poor management and risk taking activities.

b) Given the design of the Australian financial system in relation to deposit taking institutions, it would appear logical that the only suitable model would be a national one, as events have clearly overtaken the prospects for state based arrangements.

A major consideration would be whether such a scheme should cover all ADI's, or each segment should have their own. A range of arguments clearly exist for and against both options.

A significant concern exists in relation to the amount of the limit of the guarantees, ie. individual deposits to $100,000 could reasonably cause depositors to split their investments across as many institutions as it takes to place individual amounts of $100,000.

This could have the effect of significantly impacting on the economics of deposit takers as depositors who are presently content to maintain significant account balances far in excess of any future guaranteed amount. It could also have the effect of limiting the extent of their business connection with financial institutions as a result of available funds being scattered across a number of institutions. This latter aspect could be significantly counter to the best interest of consumers.

The implications of having an unlimited guarantee are probably best left to expert economic analysis, however it is understood that such a proposal would render any scheme difficult to structure.

c) In the event of a financial institutions failure, there can be extreme repercussions for the depositors with that institution in that they may not have access to their funds for an extended period of time and subsequently, may only recover a portion of those funds.

As the Banking Act depositor priority is, to our knowledge, untested, it must be considered somewhat doubtful that the depositor priority provision will ultimately protect consumers to 100 cents in the dollar.

Beyond that however, is the capacity of the failure of one institution to have a knock on effect to other institutions, which may be limited to the same type, but not necessarily so.

It was the experience of credit unions, particularly in Victoria, that the failure of the Pyramid Building Society had an immediate and substantial adverse impact on them, as the perception of the greater proportion of the community seemed to be that it was a deposit taker, without any great distinction between the different type of institution and the facilities that existed to protect depositors interests.

As structured today, it is highly likely that the failure of a medium to large financial institution, without any other steps being taken, would result in significant dislocation for most of the customers of the institution and with the high probability that they would not recover 100 cents in the dollar.

A transfer to another ADI, or the injection of funds to rehabilitate is far preferable to liquidation.

Given the extent of APRA's powers, supervision and the prudential standards applied to deposit taking institutions, it must be rated as unlikely that a deposit taker will fail, without significant advance indication. Further, the capacity for actual loss should be extremely limited, due to the level of reserves and capital. The exception to this scenario would be a failure during the time of severe economic downturn, with dramatically reduced housing and commercial property values.

The one particular aspect that could be the exception in that regard is in the event of a liquidity crisis, particularly one which was to be caused by, or fuelled by media coverage.

Prior to considering the actual guarantee scheme for deposits, it is considered that liquidity support mechanisms be viewed as a fundamental frontline defence against a potential financial institutions failure. The provision of additional liquidity support could avert the actual closure/failure of the institution and in certain circumstances, under direction of the authorities if there was a fundamental failing of the business, to perform adequately, it could be restructured and restored to profitable operations.

There is no questioning that the level of supervision intensity by APRA on Australia's ADI's, together with the prudential standards applied, result in relatively low risk balance sheets, significant levels of capital and reserves to protect against any potential failure.

The likely incidence of a failure under that scenario must be considered relatively remote and it is considered that the Pyramid collapse could not be replicated under the APRA prudential regime.

Most importantly, it is considered that any form of guarantee scheme is a waste of time, if it could not perform to the level required under the most extreme ADI failure conditions. It is pointless if a scheme looks good in good times but does not have the financial resources to overcome broad systemic failure.

In other words, substantial financial backup resources need to be available to such scheme/s, ie. Federal Treasury lines or the like.

d) We have no wide range of views to present in relation to design variables, other than to stipulate three important principles.

   (i) Any deposit guarantee scheme should not generate additional cost to ADI's, particularly as the beneficiaries of such a concept are consumers and Government.

   (ii) In view of the dynamics involved in the concept, it is fundamental that a capping needs to be applied, however it is considered that whatever cap is selected will be of an arbitrary nature and capable of derision on a wide range of factors.

   (iii) As stated earlier in this submission, it is fundamental to such a scheme that it perform adequately in the most extreme adverse conditions and therefore any form of private underwriting and co-insurance arrangements, in addition to support from Federal Treasury, are considered both necessary and fundamental to the delivery of an adequate system.

e) As the beneficiaries of such a scheme will be the consumers and Governments, there should be no net cost imposed on ADI's in relation to creating such a structure.

   In view of the above, Government should not be adverse to contributing some portion of the costs of implementing and maintaining such a scheme, particularly in view of the significant political benefits which would accrue as a result.

   As the beneficiaries primarily are the depositing consumers, there should be capacity for them to make contributions to the cost, on the grounds that a fee for service concept should ensure their appreciation of this significant benefit.

   A reasonable portion of the cost of such a guarantee is already being met by ADI's and other financial service providers in relation to their levies paid to APRA in relation to the cost of supervision.

   This comment is made in the context of the guarantee scheme and fund needing to be administered by the supervisor, on the basis that the provider of the guarantee needs to have the power and authority to influence activities in order to protect the resources of the guarantee scheme. It is considered completely inappropriate that separate bodies undertake the roles of supervision and administration of the guarantee scheme.

   The additional costs of the guarantee scheme directly, could very well be determined by whether there is a notional fund in support of the scheme, or

whether a physical monetary fund is created. This is considered the most substantial determinate which would contribute to a variation in cost. All other aspects are considered relatively minor in this regard.

In the event of a notional fund existing, ADI's will be able to maximise earnings on the indicative portion of assets attributed to being in support of the scheme. The transfer of a portion of ADI's assets to a physical fund managed by APRA would result in a significant reduction in the earning yield, simply because of the investment options available and therefore this, in certain respects, is a less desirable concept.

In raising the matter of Treasury or equally substantial support lines in relation to the operation of such a scheme and the need for liquidity support facilities in order to stave off potential failures, it is considered that commercial costs should apply in such regard and that all and any funds advanced through such a system would invariably be repaid. It is understood that in a Canadian provence, understood to be Alberta, that a collapse of the economy in the late eighties and early nineties resulted in that provincial Government issuing bonds to cover advances required by the deposit guarantee scheme in operation. It is understood that that mechanism enabled the system to withstand that maximum stress placed on it and that, as of today, all such provincial Government monies that were advanced, have been repaid. It is recommended that that example of a liquidity and subsequent solvency crisis on a mini scale compared to the Australian financial system, be studied in detail in order to obtain the best possible model.

f) The fundamentals of funding such schemes can only be around the notion of industry funding, with an interesting debate to be conducted as to whether pre or post funding is the most applicable.

It is unrealistic to believe that consumer funding could apply.

However, whilst debate needs to be conducted in relation to pre or post funding, it is considered realistic that the funding must by nature be undertaken by industry, with the extensive support of public funding via Government, in relation to not only the deposit guarantee facility, but most importantly, in relation to a liquidity support capacity. In our opinion, the matter of liquidity support facilities cannot be overstated as control of difficulties in this arena are considered absolutely essential in order to minimise what could otherwise become significant guarantee funding issues.

g) In relation to governance and accountability arrangements, we have already stated that the administration of the guarantee scheme must by its very nature be undertaken by the party responsible for the supervision, or vice versa. In our context that confers that function on APRA. However, in addition to APRA, we believe that some Federal Government representation should occur, as well as considerable industry representation, given the high stake that it will have on the assumption that it largely funds the scheme.

In our view, this would see APRA with a majority of positions in order to undertake the role in a rational and accountable way, but in addition there-to, in order to achieve the perspective which Government and industry can bring and also in order for openness and transparency, that Government and industry are adequately represented.

h) General Matters – Actuarial studies need to be undertaken in relation to the various ADI groups, in order to ascertain whether they are capable of sustaining guarantee schemes in their own right or, as is suspected, the only appropriate methodology in Australia will be for all ADI's to be in the one scheme.

   - the cost to ADI's for participation (irrespective of how "cost" is arrived at) requires equal payment, based on total assets held. The only concession in this regard should be a scientifically graded scale, based on superior prudential standing, ie. representing a lower risk of claiming against the scheme.