AAPBS RESPONSE TO THE GOVERNMENT DISCUSSION PAPER ON FINANCIAL SYSTEM GUARANTEES

Australian Association of Permanent Building Societies, Inc

July 2004

EXECUTIVE SUMMARY

1. We agree with the proposition that solvency cannot be guaranteed by prudential supervision.

2. Except where there are strong reasons for believing that the overall stability of the financial system would be impaired, non-viable financial institutions should be allowed to fail to preserve efficiency and competition within the financial system.

3. It does not follow, however, that an explicit guarantee scheme (Option C) is appropriate. We have provided detailed reasons in our submission as to why such a scheme should not be imposed on building societies.

4. We appreciate that the caveat emptor approach (Option A) may not be entirely appropriate either, since it is premised on consumers understanding financial risks and products when in fact many consumers are not well-placed to assess these.

5. Clearly, an ADI failure in the absence of a guarantee scheme can result in a loss of depositor funds to the extent that these are not recoverable under the depositor preference provisions of the Banking Act.

6. In view of this, we support Option B. Australia has a strong regulatory framework which is designed to reduce to very low levels the probability that a financial institution will fail. That regulatory framework is funded by levies on industry. If, despite this regulatory framework, an ADI were to fail, the responsibility must then be on the government to respond in a case-specific discretionary manner to mitigate the consequences of that failure.

Introduction

We support the proposition that consumers of financial services, particularly retail depositors, should have adequate protection and be made aware of this so that there is no loss of confidence in the capacity of viable financial institutions to meet their obligations.

We believe that, in relation to building societies and other ADIs, adequate protection for retail depositors is provided by:

- ADIs being prudentially supervised by APRA at the highest level;
- depositors having the benefit of the depositor preference provisions of the Banking Act 1959; and
- the existing and prospective regulatory environment in which they operate.

While solvency cannot be guaranteed by prudential supervision, the possibility of ADIs becoming insolvent are presently far more remote than may be the case for other participants in the financial sector.

We note that Professor Kevin Davis' Report acknowledges that in practice, a financial institution facing financial difficulty would normally be identified by APRA as having breached requirements under legislation or prudential standards before it reaches the point of insolvency or illiquidity.

In certain circumstances, particularly for ADIs, APRA has the power to assume control of an ailing institution. There are also specific legislative provisions (eg transfer of business) that allow for a financial institution's business to be restructured or transferred without significantly impacting on customers.

The degree of ADI supervision undertaken by APRA and their compliance with extensive prudential and operating standards have resulted in improved risk management standards and significant levels of capital and reserves to protect against any potential failure.

For these and other reasons, we would suggest that, for example, the Pyramid collapse would not have occurred in the present regulatory environment – there would more likely have been a well-managed exit rather than by spectacular failure. (The Farrow group was found to have fuelled its growth and caused its ultimate demise by adopting highly risky lending policies, misstating its accounts and deliberately breaching the regulations that applied to building societies.)

We have confined our comments to the protection of depositors within the banking system.

Existing and prospective regulatory environment

Building societies are presently subject to a wide range of regulatory controls. The following are some of the more pertinent ones which clearly demonstrate that building societies operate in a highly developed and effective regulatory framework:

(a) On 1 July 1999, building societies, after more than 100 years under State legislation, were corporatised to become companies. As companies, they comply with the Corporations Act 2001 which imposes strict requirements in relation to, inter alia, corporate governance, disclosure and director duties. The Corporations Act also incorporates the Corporate Law Economic Reform Program, the Financial Sector Reform Act 2001 and the Financial Services Reform Act 2001.

(b) Since the implementation of the Wallis reforms, building societies have been prudentially regulated by APRA to ensure they have sufficient assets to carry on their business of banking. They are required to meet the same prudential standards as banks under the Banking Act 1959, such as those relating to capital structure, management policies and risk management.

APRA's proposed fit and proper person test (albeit modified, we hope) will raise the bar even further by ensuring that directors, senior officers and auditors of ADIs meet the highest standards of fitness and propriety.

(c) By virtue of APRA supervision, building societies comply with the international capital standards (Basle I) and will be subject to the revised capital and risk management standard of Basel II.

(d) Building societies comply with accounting standards set down by the Australian Accounting Standards Board and will comply with the International Accounting Standards (IAS) when they are introduced next year.

(e) As cash dealers, building societies, like banks and credit unions, comply with the reporting and other requirements of the Financial Transaction Reports Act 1988. Likewise, as financial services providers, societies will need to implement the proposed global anti-money laundering and counter-terrorist financing standards which involve, inter alia, customer due diligence and reporting obligations.

All of the above play a significant role in enhancing ADI institutional stability in the financial system.

Apart from these, there are other compelling reasons that further support the proposition that there should not be imposed on building societies an explicit guarantee scheme:

Other compelling reasons

1. There are particular attributes of building societies that operate to significantly limit their exposure to large losses that can accrue from commercial failures or international exposures.

   The majority of building societies, by number and size, are mutuals whose objectives are not profit maximization or shareholder returns. There is therefore less pressure on management and Boards to take commercial risks designed to maximise profit.

2. In relation to building societies generally, only three types of financial services are offered: taking deposits, selling general insurance as intermediaries and providing credit. Since the sale of general insurance products is performed only as agent for a principal insurer, any possibility of failure will necessarily be confined to their deposit-taking and lending activities.

   Building society products are straight-forward and are at the lower end of the risk spectrum. Deposit products are capital assured and capital is not at risk as it is, for example, with equity securities. Societies are not involved in currency option and derivative trading activities, nor do they invest internationally. They are conservative in their lending practices and have very limited exposure to commercial lending, which generally entails larger risk exposure.

3. The provision in the Banking Act 1959 providing for depositor preference applies equally to building societies as it does for banks. Depositor preference arrangements provide a significant degree of protection to customers of ADIs since the proceeds from liquidating the assets of an ADI are available to first meet the liabilities to depositors in priority to other creditors.

4. Although Professor Kevin Davis was not required to make a recommendation, his Report concludes that the costs and benefits of adopting a guarantee scheme appear finely balanced.

   On the other hand, the Financial System Inquiry found that, on balance, the benefits of a scheme of deposit insurance are not considered strong enough to warrant its introduction. Specifically, it was not convinced that such a scheme would provide a substantially better approach or additional benefits compared with the existing depositor preference mechanism contained in the Banking Act.

5. Guarantee schemes can promote poor management and risk taking activities (as they did in the Savings and Loan industry in the United States), thereby undermining market discipline by wholesale consumers and managers of financial institution.

6. There will be cross-subsidisation of poorly managed financial service providers by well-run ADIs.

7. The Government Discussion Paper on Financial System Guarantees ("Discussion Paper") suggests that the introduction of an expanded safety net could influence, undesirably, the expectations and decisions of guaranteed consumers. Moral hazard is inherent in guarantee schemes – consumers may take risks because they expect they are being protected against a financial loss. (Paradoxically, this increases the probability of loss.) Explicit guarantees may therefore distort the spectrum of risk, by increasing the range of financial assets that are deemed risk-free.

   The Davis Report provides the following example: A guarantee can encourage retail investors to target products with the highest promised return, irrespective of the inherent risks. Providers competing for funds can only satisfy this preference for maximum nominal return by undertaking more risky business.

8. The Discussion Paper acknowledges that a limited explicit guarantee cannot, in any event, prevent all of the consequences of the failure of a financial institution, such as delays in identifying the remaining net worth and restitution options. We think that in the case of HIH, it is likely that, even had a form of explicit guarantee scheme been available to its policy-holders, the broader consequences would still have occurred (for example, the collapse of the building insurance market).

Competitive issues

Federal and State legislation as it affects the financial services sector has grown greatly in recent years. The cost burdens of compliance with prescriptive legislation and regulation fall squarely on institutions irrespective of their performance and reputation. Smaller ADIs feel these costs (per customer) more than the majors. In a competitive environment, building societies accept their fair burden. However, the mounting imposition of costs originating from government regulation will necessarily impede their ability to provide choice and diversity.

Differing risks as between financial institutions

If the Government concludes that a guarantee scheme is warranted for other participants in the financial sector, it should not follow that the scheme should be extended, whether or not in a modified form, to ADIs. Indeed, the Financial System Inquiry found that "Government should not seek to impose safety regulation across the entire financial system".

There is after all no rational reason why there should not be differing approaches to accommodate the different ways that business is done across the financial services industry, the different risks involved and the recognised segments of the industry.

The Davis Report itself suggests that, in relation to an ADI failure, more than 80 per cent of households hold less than $60,000 in deposit accounts and more than 60 per cent hold less than $15,000. On the other hand, the amounts involved on the failure of an insurer can be quite significant - as at 31 December 2000, the average value of assets protected for all household policies in force at that time was $201,650.

Our preference- Option B

We acknowledge that solvency cannot be guaranteed by prudential supervision.

The Campbell 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.

(Furthermore, although in principle a lender-of-last-resort loan could be made to any institution supervised by APRA, the Reserve Bank has made it clear that its balance sheet is not available to prop up insolvent institutions (Macfarlane 1999)).

It does not follow, however, that an explicit guarantee funded by industry (Option C) is appropriate, having regard for the reasons referred to above.

We appreciate that the caveat emptor approach (Option A) may not be entirely appropriate either since it is, according to the Davis Report, premised on a "reasonably broad base of community understanding of financial risks associated with mainstream financial institutions and products" and that, "unfortunately, many consumers are not well-placed to assess counterparty/agent risk".

Clearly, an ADI failure in the absence of a guarantee scheme can result in a loss of depositor funds to the extent that these are not recoverable under the depositor preference provisions of the Banking Act.

In view of the above, our preference is for Option B. The Discussion Paper asserts quite correctly that Australia has a strong regulatory framework which is designed to reduce to very low levels the probability that a financial institution will fail. That regulatory framework is funded by levies on industry. If, despite this, an ADI were to fail, the responsibility must then be on the government to respond in a case-specific discretionary manner to mitigate the consequences of that failure. We agree that one way of negating unrealistic community expectations that governments will step in may be to commit to some pre-determined criteria for providing assistance.

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