



Government Consultation on Financial System Guarantees A Response on the Merit of a Deposit Insurance Scheme

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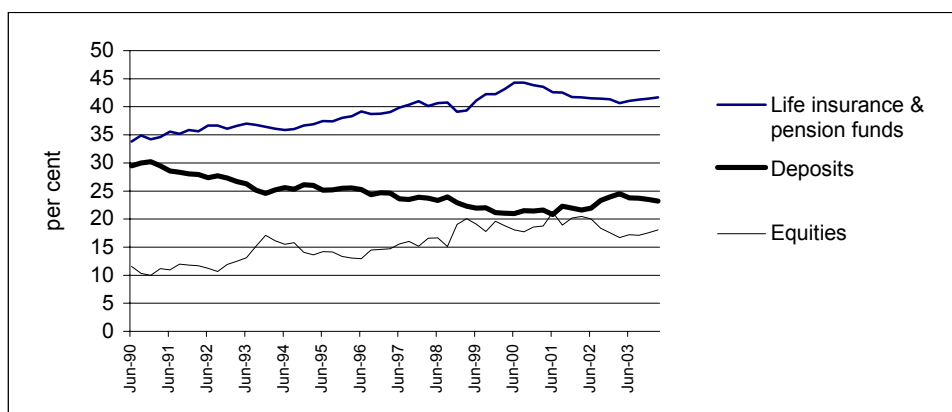
IBSA welcomes the opportunity to respond to the Government's Discussion Paper on Financial System Guarantees. Most of our members are authorised deposit taking institutions (ADIs) and their business is predominantly wholesale in nature. We focus on deposit insurance and do not reflect on matters pertaining to life or general insurance. We believe the quality and effectiveness of Australia's bank regulation is of a very high standard and, in part because of this, the cost of a mandatory deposit insurance scheme would exceed the associated benefits.

The Discussion Paper states "Australia has a strong regulatory framework and is regarded internationally as a leader in innovative, market based reform".¹ The introduction of a deposit insurance scheme would not be a market based reform and would present Australia as a follower rather than a leader in the design of regulation for the financial sector.

Having carefully considered the various arguments for and against a mandatory deposit insurance scheme, the "Wallis' Financial System Inquiry in 1997 decided against recommending the introduction of deposit insurance in Australia. The nature of the deposit taking market has not altered markedly since then, nor has new information come to hand that would justify a revision of the Inquiry's findings. If anything, the relative benefit from a deposit insurance scheme has declined as the proportion of household financial assets held in the form of deposits has contracted significantly since the 1990s and consumer protection has been enhanced through the Financial Services Reform (FSR) regulatory regime.

Figure 1

Distribution of Household Financial Assets



Base data are sourced from ABS 5232

¹ Paragraph 6 of the Discussion Paper.

At the request of the Treasurer, the Financial Sector Advisory Council (FSAC) conducted a review last year of the changes to financial system regulation arising from the Financial System Inquiry. FSAC identified a range of factors likely to impact on the future evolution of the financial system and identified a number of areas where further development of the regulatory system may be necessary. FSAC did not recommend the introduction of deposit insurance nor did it identify the potential need for deposit insurance.

The Study of Financial System Guarantees Report prepared by Professor Davis in 2004² is a detailed review of the issues that must be considered in an assessment of the net benefit from deposit insurance. The Report does not recommend that the Government should introduce a deposit insurance scheme, nor in our view does its analysis lead to a conclusion that such a scheme is necessary or desirable.

IBSA made a submission (see attachment 1) to Professor Davis during his consultations, in which we argued:

- The case for a deposit insurance scheme in Australia has not been made nor has evidence of a net public benefit from such a scheme been presented;
- Experience suggests that deposit insurance is unnecessary and it has not been shown that the costs generated by a deposit insurance scheme would be offset by the benefits that might flow from it;
- Australia has strong and effective safeguards through APRA's prudential supervision, depositor preference and the Reserve Bank's management of financial system stability, while exits from the industry have been managed on an orderly basis - this safety net is being actively enhanced as the markets develop and technology improves;
- The benefit to financial system stability from deposit insurance is questionable, as it would not avert runs by large, sophisticated depositors who would not be covered by a deposit insurance scheme;
- The moral hazard risk of deposit insurance, which involves a weakening of market discipline, is well understood and experience has shown that this can cause significant economic loss (eg the US Savings and Loan crisis) and increase the Government's exposure in the event of a failure;
- Retail deposit protection could spill over into the wholesale market, where depositors would not benefit from an insurance scheme but would be forced to bear costs associated with its operation. In particular, foreign ADIs that are restricted to wholesale banking should not be required to participate in a deposit insurance scheme.

Reflecting these and other issues, IBSA does not support the introduction of a deposit insurance scheme in Australia. Most importantly, if a deposit insurance scheme were to be introduced, then it should not apply to wholesale deposit taking business, given the associated moral hazard risk, the cost of compliance and the absence of a consumer protection need in the wholesale market.

² The "Davis Report".

Q1. If a limited explicit guarantee were introduced, what implications might this have for the safety, efficiency, and competitiveness of the Australian financial system?

Safety and Moral Hazard

It is universally accepted that deposit insurance schemes create a moral hazard, which in some circumstances can weaken the safety of the financial system.³ In effect, deposit insurance weakens market discipline, as insured depositors are indifferent to the level of risk taken by institutions that are insured. This can lead to deposit taking institutions adopting a riskier operating strategy than would otherwise be justified. Moreover, depositors may shift funds towards the riskier institutions, as they chase the highest returns, without any need to consider the underlying risks that are covered by insurance. The moral hazard problem was perhaps most notably evidenced by the Savings and Loan crisis in the US during the 1980s.⁴ Thus, to be effective and safe, it would be essential to design a deposit insurance scheme in a manner to minimise the potential adverse impact from moral hazard.

Safety and Consumer Protection

The case for deposit insurance hinges on the provision of greater consumer protection and not on enhancing systemic financial stability.⁵ In this context, it is relevant to note that the Government has only just completed a major and expensive revamp of the consumer protection regulatory system through the Financial Services Reform (FSR) Act 2001. The effect of this regime is that investors cannot be offered any financial product or service without being properly informed of the associated risks and other relevant factors, while being provided with adequate mechanisms to obtain redress in the event of a dispute.

Risk is an inherent feature of the financial system. The existing regulatory arrangements are not designed to ensure that depositors never lose money in the event that an ADI fails, nor would it be wise to insulate depositors in this manner. There are already significant measures in place to protect depositors' interests apart from the FSR regime (for example, the depositor preference arrangements and prudential regulation) that have proven to be effective over the years.

It is a matter of fact that individual consumers would be given a greater level of protection through a deposit insurance scheme, as their residual risk from holding a deposit with an ADI would be eliminated or greatly reduced.⁶ However, we do not believe that a deposit insurance scheme would materially increase the safety of the financial system in practice and consider this view to be consistent with the information provided in the Davis Report.

³ The Davis Report provides an overview of the relevant considerations.

⁴ "Deposit Insurance System Design and Considerations", Nicholas Ketcha, Bank for International Settlements Policy Papers, No.7, October 1999.

⁵ Paragraph 83 of the Government Discussion Paper on Financial System Guarantees; page xii and paragraph 4.45 of the Davis Report.

⁶ The residual risk is that remaining after the benefits of prudential regulation, depositor preference and the ADI's capital buffer have been exhausted.

The Davis Report notes that a deposit insurance scheme would assist consumers by curtailing the need for them to manage information asymmetry.⁷ However, it should be possible to place retail consumers in a similar position to sophisticated investors by providing them with information, like current bank credit ratings, in an accessible form.⁸ Moreover, APRA's prudential regulation of ADIs proxies the effect of financial monitoring conducted by sophisticated investors. Thus, the ultimate rationale for a deposit insurance scheme lies in the benefit of providing a risk-free asset to retail investors, rather than in placing them on the same footing as wholesale investors by closing the information gap.

If there is a desire to offer risk-free investments to retail consumers, then there are other alternatives to a mandatory deposit insurance scheme that might be considered; for example, a voluntary insurance scheme where investors actively make a choice about the riskiness of their deposit investment. The maintenance of choice in this manner, together with an active decision by a depositor about the level of risk they wish to hold, would represent a market based approach to the issue and should dilute the community expectations about government support in the event of a failure.

Safety – Are Deposits a Special Case?

Households typically hold a major part of their wealth in the form of their home (and in some instances rental properties), with deposits a relatively small part of their total wealth.⁹ Consumers are not required to insure their homes against risks, nor is a compulsory insurance scheme contemplated, even though they are subject to material risks that could result in very significant financial loss. Superannuation is partly an enforced saving that has a risk element and is a major component of household financial assets (see figure 1), but there is no broad guarantee. Against this backdrop, the justification for deposit insurance as a consumer protection measure seems weak.

This observation is especially relevant as the main difference between deposits and housing assets is that losses arising from the former could have a harmful *systemic* impact. However, both the Davis Report and the Discussion Paper suggest that enhanced financial system stability of itself would not justify a deposit insurance scheme, so the case for deposit insurance must hinge on its consumer protection benefits – and this case is not compelling.

Deposits may not be radically different from other assets, when it comes to community expectations of government assistance. It seems expectations of government assistance arise in the event of disasters that destroy a significant part of the housing wealth in an area, or a natural disaster like a drought that has widespread effect within a region. Thus, the management of community expectations is not an issue unique to deposits and does not distinguish deposits from housing (or indeed from many other assets). Further, a deposit insurance scheme may not ease public pressure for government action, as it would almost

⁷ Paragraph 4.30.

⁸ Information asymmetry still exists between an ADI and its wholesale clients, though these clients are better placed than retail clients to manage and assess this risk in the absence of measures (one of which is prudential regulation) to assist retail clients.

⁹ See Table 5.3 in the Davis Report.

certainly not cover retail depositors facing greatest hardship (for example, a person who sells their home and while waiting to settle on a new home, holds \$500,000 on deposit with a bank that fails).

In effect, a deposit insurance scheme would not manage community expectations about the Government's response to an ADI failure; rather, it would validate these expectations. A better alternative may be to endeavour to reshape expectations, so they more effectively reflect the Government's policy. For instance, the effect of the FSR regime should be to inform and educate consumers on the risks inherent in investment and alert investors to deposit risks.¹⁰

In summary, deposits are not different to many other assets in the risk they pose to investors, or to community expectations of government assistance. Deposits are a unique asset class to the extent that failure of an ADI could pose significant risk to the stability of the financial system and harm the economy. However, enhanced financial system stability is presented as a reason to introduce deposit insurance.

Efficiency and Capital Usage

In effect, deposit insurance would increase the amount of regulatory capital that is required to support insured deposit taking institutions. All banks would be required to maintain their existing capital and in addition there would be a 'banking system' capital requirement that must be met through the funds to support a deposit insurance fund.

In theory, a deposit insurance scheme should lead to a reduction in the amount of regulatory capital that banks themselves are required to hold. In practice, this is unlikely, as wholesale deposits that are the most sensitive to credit ratings would not benefit from deposit insurance protection. Thus, the additional capital embedded in the deposit insurance scheme would simply be an additional operating cost placed on the banking system that would have to be passed on to consumers.

Wholesale Deposits and International Competitiveness

For a variety of reasons, the competitiveness of the Australian financial system is tested most acutely in the wholesale financial markets. Matters that are relevant in this context include the scale of typical transaction size, the international nature of clients and their relative sophistication. The internationalisation of wholesale financial services has been extensive in recent decades. Domestic companies and financial institutions raise large amounts of finance on overseas capital markets and also look to invest in those markets. Multinational companies operate across multiple jurisdictions, including Australia, and prefer financial institutions that can service them on this basis.

Given the potential costs involved (including the moral hazard risk), it is not feasible to insure wholesale deposits, nor do we believe it is contemplated that they should be covered, as the Discussion Paper recognises the sophistication of

¹⁰ This may be complemented by other initiatives, like those arising from the Consumer and Financial Literacy Taskforce.

wholesale depositors. However, if a deposit insurance scheme were to be introduced, the scheme must be designed in a manner to avoid inadvertently covering wholesale deposit taking businesses (wholesale only ADIs and the wholesale business of full service ADIs). In particular, the operating cost of a scheme should not be imposed directly, or indirectly, on wholesale deposit taking businesses, as it would increase the cost of conducting this business in Australia.

Foreign ADIs, as a group, should be excluded from a deposit insurance scheme, as they are barred from the retail deposit market and the depositor protection provisions in the Banking Act do not apply to them.¹¹ Branch operations integrate seamlessly with operations offshore, so they are the most common structure through which international banks conduct global and regional business. An increase in the Australian cost base would reduce its competitiveness as a location for conducting international business.

Q2. Comments are invited on what general approach government should take to reduce the consequences for consumers of financial institution failure.

The Davis Report notes that the *caveat emptor* principle is that the buyer alone is responsible for assessing the quality of a purchase before buying.

In practice, the traditional concept of *caveat emptor* applies in a very limited way to authorised deposit taking institutions, as there is a high level of government intervention in the market for deposits and both the product on offer and the manner of the offer are vetted through the regulatory process. Because deposit taking is perhaps the most highly regulated financial activity, depositors are offered a product that is substantially stripped of the risk that would exist in it in an unregulated, or *laissez faire*, market.

Indeed, to a large degree given their relative unsophistication in financial affairs, retail depositors are required to place their trust in the effectiveness of regulation (especially prudential regulation) and the regulators, rather than having to judge the financial soundness of a particular deposit taking institution *per se*. In this sense, deposit insurance to some degree would represent coverage against a lapse in effective regulation.

The effect is that depositors obtain a low risk product and the *caveat emptor* principle can be applied to the retail deposit market in a sufficiently safe manner.

Q3. Are you aware of additional international experience that could add to the debate about whether explicit guarantees may be desirable in the Australian context, or how any scheme could be optimally designed?

In respect of deposit insurance, the Davis Report refers to the international experience that we are aware of.

We note that our reservations about deposit insurance find some support in an IMF Working Paper published in 2000, which claims to be the first

¹¹ See attachment 2 for relevant APRA regulatory requirements.

comprehensive study of the effects of deposit insurance on bank stability.¹² After modelling results from 61 countries during 1980-97, the authors conclude that explicit deposit insurance tends to be detrimental to bank stability. However, the authors also note their empirical results suggest that deposit insurance in a jurisdiction with a very good institutional environment may not lead to additional instability, perhaps because regulators can more effectively compensate for the weakening of market discipline.

Q4. Comments are invited on the design principles, the associated institutional, product and consumer coverage or the more specific design features outlined in the Davis Report.

If a deposit insurance scheme were to be introduced, it should cover only retail deposits. The scheme should not cover wholesale deposits, nor should it cover non-deposit liabilities of banks.

A deposit insurance scheme should not replicate coverage provided by overseas regimes. For instance, to the extent that a foreign ADI's deposits in Australia are covered by an overseas deposit insurance scheme, they should not be subject to an Australian scheme.

This conclusion follows naturally from the principles that underpin the existing foreign ADI regime and the FSR regime, through which the Government has decisively indicated that consumer protection regulation should only be applied to retail clients. Wholesale clients are sophisticated persons who have adequate resources to access information and the expertise to evaluate it, seek individual contractual protection and, if necessary, obtain redress through the courts.

More generally, there should be a presumption in favour of minimal regulation of wholesale markets, unless a higher level of regulation can be justified – which it cannot be in this case.

There are a number of alternative models to distinguish between retail and wholesale depositors. For example, the Corporations Act distinguishes between retail and wholesale clients and also between sophisticated and unsophisticated investors.¹³ Meanwhile APRA regulation limits foreign ADIs to the 'wholesale' deposit market.¹⁴ It seems likely that the retail/wholesale split for the purpose of deposit insurance would involve a cap on insurance payments to individual depositors in the event of an ADI failure and a limit on the range of persons eligible for insurance payments (for example, companies should be excluded).

However, the precise distinction between retail and wholesale clients for the purpose of deposit insurance is a secondary matter that involves both conceptual and practical issues. More detailed consideration of this complex matter should be deferred until the principal question about the merit of a deposit insurance

¹² "Does Deposit Insurance Increase Banking System Stability?", IMF Working Paper, WP/00/3, Demirguc-Kunt and Detragiache, 2000.

¹³ See Chapters 6D and 7 of the Act.

¹⁴ Foreign ADIs are not permitted to accept initial deposits (and other funds) from individuals and non-corporate institutions of less than \$250,000. They can, however, accept deposits and other funds in any amount from incorporated entities, non-residents and their employees.

scheme is answered. If it is decided that a scheme is desirable, then the detail of its design should be considered in consultation with industry, given the significant practical implementation issues involved.

Q5. Comments are invited on the methods, underlying assumptions, and cost projections presented in the Davis Report.

The Davis Report is a helpful summary of the issues and identifies the difficulty in determining the economic cost of deposit insurance with precision.

A matter that should also be considered in addition to the factors considered in the Davis Report is the additional amount of regulatory capital (discussed above) that is required to support insured deposit taking institutions, which would impose a new cost on the system.

We also note that even a well-designed guarantee scheme that avoids unacceptable moral hazard risk will involve some deadweight administration and monitoring costs, which would not be a mere redistribution of costs within the system. These costs would have to be passed on to consumers.

A proposal to introduce a deposit insurance scheme should be validated by a full cost benefit analysis by Treasury, before it is confirmed as a policy recommendation to government.

Q12. The Davis Report examined a number of possible regulatory implications that may arise from introducing any guarantee scheme. The Government invites comments on the following issues:

What are your views on the existing arrangements for depositors and policyholders in Australia?

The existing arrangements are adequate, for the reasons outlined in our submission to Professor Davis (see attachment 1).

Could a guarantee scheme provide an opportunity for removing or reducing restrictions on branches of foreign ADIs accepting deposits from retail customers in Australia? Your views may differ depending on whether you think foreign ADIs would be within or outside of the scope of a guarantee scheme.

Foreign ADIs as a class of entity should be outside the scope of a deposit insurance scheme, as regulation effectively permits them to deal only with wholesale depositors and they have structured their business on this basis (see attachment 2 for an outline of APRA regulation).

The restriction on foreign ADIs accepting retail deposits exists because APRA cannot provide the same level of depositor protection for foreign ADI deposits, as it can for deposits with locally incorporated banks. One reason for this is that foreign ADIs are not required to hold regulatory capital in Australia and as APRA does not regulate their solvency, under the Basle Accord. There is also concern about the ability to enforce a statutory priority in any distribution of a foreign

ADI's assets, amongst other things.¹⁵ A deposit insurance scheme would go a considerable way towards alleviating these concerns in relation to retail deposits, so it is possible that APRA might feel more comfortable about altering licence conditions to permitting foreign ADIs to accept retail deposits.

If a deposit insurance scheme were to be introduced, there would be merit in permitting foreign ADIs to participate in the scheme on an elective basis, provided those that make the election are permitted to accept retail deposits. That is, if a foreign ADI wished to conduct retail deposit taking business, it could elect into the deposit insurance scheme and, thereby, qualify as an authorised taker of retail deposits. Of course, amongst other things, this outcome would hinge on APRA accepting the adequacy of the deposit insurance scheme, which would largely depend on its design and coverage.

Foreign ADIs presently operate exclusively in the wholesale deposit market and they typically would not wish to alter their market strategy in this regard. An election would enable this class of entity to avoid the compliance costs associated with a deposit insurance scheme, while facilitating a business expansion by an individual foreign ADI into the retail market, if it so desired.

Concluding Comments

We remain of the view that deposit insurance is a matter of careful judgement, taking account of the institutional context and experience of the market for which it is being considered. In this regard, we do not believe that deposit protection for bank customers needs to be extended beyond the existing range of measures. Australia has a stable economy and an effective regulatory and legislative safety net for depositors that has been tested over the years and has been found to work.

It is recognised that deposit insurance, given its limited coverage, would not resolve the systemic problems that might be generated by an ADI failure. Thus, it is accepted that one of the key factors that underpins many international regimes would not apply in an Australian context. Moreover, the Australian regulatory system has operated more effectively than those overseas and a range of measures, including the new FSR regime which took full effect in March this year, have enhanced its performance.

As stated above, our comments on financial system guarantees are limited to the issue of bank deposit insurance. We are not in a position to comment on the merit of a guarantee scheme for other financial products, like life and insurance, and accept that it may be appropriate to introduce some form of protection scheme to cover those products.

¹⁵ On 18 June 1993, at the time of the introduction of the Foreign ADI regime, a banking policy statement by Treasurer Dawkins outlined the policy reasons for restricting foreign branch banks to wholesale banking business. Amongst other things, the Treasurer stated "Without locally dedicated capital, the solvency of branches cannot be adequately supervised by the Reserve Bank".



INTERNATIONAL
BANKS AND SECURITIES
ASSOCIATION OF AUSTRALIA

Submission to the Department of the Treasury

Study of Financial System Guarantees

9 December 2003



INTERNATIONAL
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ASSOCIATION OF AUSTRALIA

Executive Summary

IBSA appreciates the opportunity to offer comment on the Study of Financial System Guarantees. IBSA represents 37 investment banks operating in Australia. Most of our members are authorised deposit taking institutions (ADIs) regulated by APRA and their business is predominantly wholesale in nature.

We approach the issue of financial sector guarantees from a banking perspective and focus on deposit insurance and do not comment on matters pertaining to life or general insurance.

Having considered the various arguments, the 'Wallis' Financial System Inquiry decided against recommending the introduction of deposit insurance. In summary, IBSA agrees with this conclusion and we do not support the establishment of a deposit insurance scheme for the following reasons:

- Experience suggests that deposit insurance is unnecessary and it has not been shown that the significant costs and risks generated by a deposit insurance scheme would be offset by the benefits that might flow from it;
- Australia already has strong and effective safeguards through APRA's prudential supervision, depositor preference and the Reserve Bank's management of financial system stability, while exits from the industry have been managed on an orderly basis - this safety net is being actively enhanced as the markets develop and technology improves;
- The benefit to financial system stability from deposit insurance is questionable, as it would not avert runs by large, sophisticated depositors who would not be significantly covered by a deposit insurance scheme;
- The moral hazard risk of deposit insurance, which involves a weakening of market discipline, is well understood and experience has shown that this can cause significant economic loss (eg the US Savings and Loan crisis) and increase the Government's exposure in the event of a failure;
- Retail deposit protection could spill over into the wholesale market, where depositors would not benefit from an insurance scheme but would be forced to bear costs associated with its operation. By way of example, foreign ADIs compete strongly in the wholesale deposit market, even though the depositor protection provisions of the Banking Act do not apply to them. If deposit insurance were to be applied to their business, it would impose a cost without offering any offsetting benefit to their clients.

9 December 2003

1. Introduction

Financial system stability is central to the health of the national economy because it facilitates investment, growth and development by intermediating between lenders and borrowers and facilitating payments within the economy. Banks are particularly important, as they transpose liquid deposit liabilities into illiquid loan assets and are the fulcrum of the payments system. Ongoing depositor confidence is vital to the continued viability of these arrangements and the stability of the financial system.

The HIH Royal Commission report contemplated a compensation scheme limited to the general insurance industry. However the terms of reference for the Study have been expanded to cover other parts of the financial system generally; notably deposit insurance, which is the area of interest to IBSA.

The arguments in favour of a deposit insurance scheme are that it would provide explicit protection to depositors in the event of a bank's liquidation and, consequently, reduce the risk of a run on a bank. Thus, it would enhance both the consumer protection and system stability outcomes of financial sector regulation. However, a deposit insurance scheme would also impose an additional cost on users of the financial system that would need to be justified by the benefits.

The issue to be addressed by the Study is whether or not a deposit insurance scheme would in fact enhance the Australian regulatory framework and, if so, would it be worthwhile given the costs and risks involved? In order to do this, it is necessary to evaluate the effectiveness and weaknesses of the existing safety net for depositors and other users of the financial system.

Sound economic policy, prudent fiscal management, a strong legal system and effective regulation combine to form the fibre of an effective depositor safety net. In Australia, a stable, well-managed, growth orientated economy has produced a favourable macro-environment for the financial system. The introduction of a deposit insurance scheme would not assist in improving the macro-environment. Instead, the effect of a deposit insurance scheme would be to increase the range of regulatory instruments through which the Government intrudes in the normal operation of the banking market.

In 1997, the Financial System Inquiry (FSI) considered the case for a carefully crafted deposit insurance scheme and concluded that it would not improve on the existing arrangements. The FSI felt that depositor preference on liquidation of a bank would provide better protection than an explicit insurance scheme and would not unnecessarily hamper APRA's ability to manage exits.¹

We do not believe that the situation has changed materially since then. Indeed, if anything, depositors are now better protected following the structural regulatory reforms that flowed from the FSI Inquiry, including the Financial Services Reform Act, and measures to revamp the regulation of consumer protection and market integrity.

¹ Financial System Inquiry, Final Report (Chapter 8).

2. Existing Regulatory Safety Net is Satisfactory

Australia has strong and effective regulatory safeguards for deposits that have been designed to reflect the character of the Australian financial system. On the occasions when the system has been tested, it has performed well. IBSA believes that these characteristics obviate the need for a deposit insurance scheme.

The establishment of deposit insurance schemes generally reflects a concern about the potential for a bank run that could jeopardise the stability and efficiency of the financial system and disrupt economic activity. The role of deposit insurance would be to stabilise the financial system in the event of a bank failure by assuring investors that their funds will be secure, thus reducing the incentive for a run on a bank.² However, it is widely accepted that deposit insurance of itself plays a limited role in preserving financial system safety; indeed, in some circumstances it may actually weaken it, as outlined in section 3 below.

Australia is Well Served by the Existing Arrangements

The institutional framework for containing systemic risk in Australia is solid and includes elements of Reserve Bank and APRA regulation, as well as industry agreements.

The Reserve Bank has overall responsibility for financial system stability and has adequate capacity to contain contagion of financial distress that might impact on the real economy. Under the auspices of the Payments System Board, the Bank regulates the payments system, including clearing and settlements facilities. This is supplemented by industry measures; for example, through their Interbank Deposit Agreement, any one of the four major Australian banks can call on the other three for a cash injection of up to \$2 billion from each for 30 days.

It is especially pertinent to note in the context of deposit insurance that the Reserve Bank can use its balance sheet to maintain liquidity in the banking system and act as a lender of last resort for emergency liquidity support if needed. Support to individual institutions facing liquidity difficulties would be conditional.

APRA is a specialist prudential supervisor that closely monitors the risk profile of ADIs and has the power to intervene and direct ADIs to take certain actions and to appoint an administrator. APRA is highly regarded as a bank regulator and its governance and resources have recently been strengthened. As far as we are aware, the effectiveness of APRA's supervision of banks was not questioned throughout the HIH Royal Commission.

The Banking Act that is administered by APRA gives depositors absolute priority over all other creditors in the event an ADI cannot meet its obligations. ADIs are also required to maintain assets equal to or greater than their liabilities under the Banking Act. In addition, governments and the banking industry are capable of

² "What Deposit Insurance Can and Cannot Do", Ricki Tigert Helfer, Finance & Development, IMF, March 1999.

organising an orderly exit through a trade sale if necessary, as happened with state-owned banks in Victoria and South Australia in the 1990s.

Communication and co-operation between regulators is ensured through the Council of Financial Regulators and memoranda of understanding between the Reserve Bank, APRA and ASIC. Internationally, RBA and APRA are active participants in the Financial Stability Forum and the Basel Committee on Banking Supervision.

It is important to realise that banks themselves have perhaps the greatest interest in the preservation of a stable and secure banking system and, independently of formal regulation, would adopt measures to achieve this. The updated Basle Accord will recognise this by placing greater emphasis on banks' governance and internal risk management systems.

An Evolving Framework

The regulatory framework is continuing to improve as it evolves over time to reflect market developments, enhanced standards and technological developments. For example, APRA has settled the prudential rules for ADI conglomerates, the Basle Capital Accord is being updated to promote better management of financial risks, including operational risk, and continuous linked settlement of transactions in key foreign currencies has reduced payments risk. Parliament has recently passed new 'fit and proper' legislation for the directors and senior management of ADIs, with rules to be spelt out in a new APRA Prudential Standard. Further improvements to regulation are expected.

In addition, significant new consumer protection measures are being put in place with the full commencement of the Financial Services Reform regime in March 2004. This will place retail consumers of financial services in a much stronger position than ever before to understand and assess the risks in their investments. Placed against a backdrop where the retail client base has been growing in sophistication and the relative decline in the importance of deposits as a savings medium, there would be less of a role for deposit insurance as a consumer protection mechanism.³

Thus, while the regulatory system is well placed to protect depositor interests at present, we also expect this to be maintained into the future as the regulators and industry proactively respond to new developments and challenges.

No Weakness for Deposit Insurance to Cover

The key issue to be addressed by the Study is whether this suite of depositor protection measures needs to be augmented by deposit insurance and whether its cost to depositors is justified by any benefits it might give them.

In IBSA's view, the depositor protection arrangements outlined above would not be significantly enhanced by gold plating the system with deposit insurance as the

³ "Globalisation: the role of institution building in the financial sector", Department of the Treasury Economic Roundup, Summer 2003

existing measures already provide an adequate and effective level of protection. Given the existing safeguards, and Australia's history of dealing effectively with rare instances of failure by a regulated deposit taking entity, the cost of providing deposit insurance would not be justified.

Deposit insurance would make no difference to the need for an effective prudential regulator - indeed, arguably the need for a good prudential regulator would be even greater, given the weakening of market discipline associated with moral hazard.

A better approach is to place an obligation on investors, financial institutions and regulators to accept responsibility for making prudent decisions. In other words, prevention is better than the cure. This is the policy principle that has been adopted in Australia and it has worked well.

3. Problems with Deposit Insurance – Apart from the Financial Cost

Moral Hazard

The concept of moral hazard in the context of deposit insurance is well understood⁴ – the more investors are protected from risk, the riskier their behaviour is likely to become as they know they will be rescued from the consequences of their mistakes. In short, deposit insurance weakens the normal risk-reward relationship that is fundamental to rational decision making in financial affairs by depositors.

In this way, market discipline is weakened by deposit insurance, as insured depositors are indifferent to the level of risk taken by institutions that are insured. This can lead to deposit taking institutions adopting a riskier operating strategy than would otherwise be justified. Moreover, depositors may shift funds towards the riskier institutions, as they chase the highest returns, without any need to consider the underlying risks that are covered by insurance.

Moral hazard should not be taken lightly, as it can be very costly in economic terms, as evidenced by the Savings and Loan crisis in the US during the 1980s and problems in Scandinavia and elsewhere.⁵

Deposit Runs and Wholesale Depositors

Retail deposits are typically the focus of deposit insurance schemes. This is usually satisfied by some form of cap on deposit insurance payments, which is set at a low level relative to the size of deposits in the corporate and institutional market.

Thus, a deposit insurance scheme would not prevent or check a 'run' by wholesale depositors, as they would not be covered by the insurance on offer. This is important as wholesale depositors are more financially sophisticated than retail depositors and would be quickest to respond to potential liquidity or solvency

⁴ See for example, Basle Core Principles for Effective Banking Supervision, Appendix II.

⁵ "Deposit Insurance System Design and Considerations", Nicholas Ketcha, Bank for International Settlements Policy Papers, No.7, October 1999.

problems encountered by banks and, hence, a run would be more likely to occur here first. The cost of insuring wholesale deposits to eliminate this problem would be too great to bear and it would deal a critical blow to market discipline.

This suggests that deposit insurance could only play a quite limited role in the maintenance of financial system stability by halting bank runs. However, the consumer protection benefit of insurance for retail depositors would remain intact.

An Increase in Regulatory Capital

In effect, deposit insurance would increase the amount of regulatory capital that is held to cover banks. If a bank were to fail, then both its equity capital and the funds (or ‘system capital’) in the deposit insurance scheme would be available to act as a buffer to protect depositors. In theory, a deposit insurance scheme should lead to a reduction in the amount of regulatory capital that banks themselves are required to hold. In practice, this would be unlikely and the additional capital embedded in the deposit insurance scheme would simply be an additional operating cost placed on the banking system that would have to be passed on to consumers.

A New Risk Exposure for the Government

The commercial failure of a large bank in a relatively concentrated market like Australia’s would place intolerable pressure on a deposit insurance fund.⁶ Thus, there is a concern that deposit insurance may give the appearance of guaranteeing all qualifying bank deposits but in reality not doing so, as it would require premiums being set at an unacceptably high level. This could create a gap between public expectations of what an insurance scheme should do and what it can realistically deliver.

In the event of a major ADI failure or contagion across a number of small and medium ADIs, insured depositors are unlikely to accept that only part of their deposit is protected and would press government to make up the shortfall. Thus, a deposit insurance scheme could create a greater financial exposure for the Government based on higher community expectations of government protection. Indeed, the Savings and Loan episode in the USA demonstrates that the cost of institutional failure to government can be great, even if a deposit insurance scheme is in place.

The Government and prudential authorities in Australia have made it clear on many occasions that there is no government guarantee for bank deposits under the current system of bank regulation. The evidence over the years is that market behaviour has been predicated on this understanding, which has promoted careful market scrutiny of banks.

Notwithstanding the Government’s statements, there may be a view in some quarters that the largest banks are ‘too big’ for government to let them fail, given

⁶ In IMF Working Paper WP/99/54, “Deposit Insurance: A Survey of Actual and Best Practices”, Garcia reports that many developed countries have a deposit insurance fund size of 2% or less of deposits covered. For example, the fund in the USA was 1.4% of insured deposits. Australian household bank deposits were \$248 billion at mid-2003 (Reserve Bank, *Bulletin*).

the potential disruption to financial and economic activity, the loss to depositors and the associated political fallout. We doubt that a deposit insurance scheme would materially temper this view or would be a practical way to manage a major system problem. However, as discussed above, it could weaken the monitoring role of the market that disciplines bank behaviour, which of itself would increase risk.

Spillover of Retail Regulation into Wholesale Markets

IBSA's recent experience with regulatory reform in the financial sector leaves us with a significant concern that regulatory spillover would occur and a mandatory deposit insurance scheme designed to protect retail clients would be applied to wholesale markets.

The ability of participants in the wholesale market to manage their own risks is illustrated by the ability of foreign ADIs to successfully compete for business in Australia's wholesale markets, even though deposits placed with them are not covered by the depositor protection provisions of the Banking Act.⁷

In this instance, regulatory spillover would be a highly inefficient outcome, as wholesale depositors would not benefit significantly under a deposit insurance scheme, while being forced to bear part of the costs associated with its operation.

4. Scheme Design

A deposit insurance scheme would have to be designed to ameliorate the worst effects of the problems described in section 3, like moral hazard, and minimise the direct and indirect costs of the scheme. There is a difficult balance to be achieved here as, *ceteris paribus*, the greater the level of insurance protection the greater the weakening of market discipline, so this is a matter of very careful judgement.

It is clear that a policy decision to implement deposit insurance would require the government to make critical and difficult decisions on the design and operation of the scheme and we can comment on some of the framework issues here.

- *Responsible entity* - Management of a deposit insurance scheme would likely fall to either an existing government authority (e.g. the Reserve Bank) or a new one established for the purpose. While some countries (including the UK and EU economies) entrust deposit insurance to the private sector, most have opted for officially or jointly administered schemes.
- *Investment risk* – No matter how the scheme is set up, the Government would have to accept ultimate responsibility for the pool of funds created. These funds would need to be invested and the associated returns would be subject to market risk. In effect, through its ultimate responsibility to ensure prudent management of the deposit insurance scheme funds, the Government would be underwriting the scheme and guaranteeing bank deposits – something it has consistently said it will not do.

⁷ Foreign ADIs (i.e. the Australian branches of foreign banks) are effectively excluded from the retail banking market, as they cannot accept initial personal deposits for amounts less than \$250,000.

- *Funding method* - Overseas schemes operate by either collecting a premium from banks based on a percentage of assets and building a pool of funds to repay deposits should the need ever arise; or by imposing a levy on banks in the event of a failure. The first approach entails costs for banks, and their customers, for a purpose that may never be realised. The second raises the spectre of unknown future liabilities for banks and their customers for which some provision would need to be made, again tying up capital unproductively. In the event of a failure, the failed institution would have made no contribution to the cost of protecting its customers with that burden falling on better-managed institutions.
- *Coinsurance* – To reduce the risks posed by a weakening of market discipline and the cost of the associated moral hazard, it would be necessary for the scheme to include an element of coinsurance by depositors; that is depositors would only be covered for a maximum percentage of their deposits. Thus, retail depositors might not receive full protection for their deposits.
- *Range of liability coverage* – Assuming that protection would be afforded to bank deposits rather than total bank liabilities, it would be unrealistic to protect all \$600 billion in deposits. A judgement will have to be made about the scope of the scheme, including the range of deposits covered and matters like the treatment of non-resident depositors. In this context, IBSA is of the strong view that wholesale deposits should be excluded from a deposit scheme, as outline above.
- *Claim limits* - The Government will have to set a claim limit which is likely to be modest given the scheme would be starting from scratch. This would entail political judgements on whose deposits would be fully protected.
- *Size of the insurance pool* - There would still be difficult questions to answer, even if the scope were to be limited to retail deposits. For instance, should the size of the pool of funds and associated premiums be set at a point that would cover the collapse of a major bank or a regional bank or a credit union? Why should depositors in one type of institution be more protected than depositors in others?
- *Cross-subsidies* - If inefficient and discriminatory cross-subsidies are to be avoided, the government would have to set different premium rates according to the risk rating of the type of deposit between institutions. Risk rating for deposit insurance purposes is untested⁸ and could send signals to depositors and possibly have the effect of undermining confidence in institutions with a higher risk rating – defeating the purpose of depositor protection. On the other hand, if universal premium rates were to apply, the system would penalise strong and well-managed institutions (and their customers) and favour weaker and less well-managed ones.
- *Customer cost* - Under the user pays principle, the cost of deposit insurance will be passed on to customers. It is doubtful they would see value in paying more for an extra, unnecessary layer of protection, which may cover only part of their deposit.

⁸ The use of risk-weighted insurance premiums relies on an official scheme to replicate the market and this has yet to be tested through an entire banking cycle overseas, according to Ketcha (ref above).

In spite of the lack of a compelling case that depositors need additional protection, if the Government were to be attracted to the idea it would need to be on the basis that:

- The user pays principle applies and the cost of deposit insurance should be passed on to the customers who derive benefit from it. Depositors who do not receive protection should not have to pay for providing it to others who do.
- Banks should not be required to cross-subsidise other ADIs (credit unions and building societies) and other segments of the financial sector (insurance and superannuation).
- Deposit insurance should be limited to retail and perhaps small business deposits, and should not extend to wholesale depositors.

6. Conclusions

The case for deposit insurance is a matter of careful judgement to determine the balance of needs within the institutional context and experience of the market for which it is being considered. The fact that Australia has a stable economy and an effective regulatory and legislative safety net for depositors that has been tested over the years is important in this regard. Considering the issues raised in this submission, we see no reason to disturb this now.

Therefore, IBSA does not believe that deposit protection for bank customers needs to be extended beyond the effective range of measures the government already maintains. We are concerned that the introduction of a deposit insurance scheme would impose unnecessary cost on banks and their customers without generating additional public benefit.

Our reservations about deposit insurance find support in an IMF Working Paper published in 2000, which claims to be the first comprehensive study of the effects of deposit insurance on bank stability.⁹ After modelling results from 61 countries during 1980-97, the authors conclude that explicit deposit insurance tends to be detrimental to bank stability.

Thus, there are both conceptual and empirical reasons to be wary of deposit insurance proposals. While academic work is necessarily explorative, the IMF results are consistent with our qualitative assessment of the potential for deposit insurance in Australia, which is based on industry experience.

⁹ “Does Deposit Insurance Increase Banking System Stability?”, IMF Working Paper, WP/00/3, Demirguc-Kunt and Detragiache, 2000.

Attachment – About IBSA

- IBSA is the representative body for investment and international banks operating in Australia.
- Most of our 37 members are ADIs regulated by APRA and their business is predominantly wholesale in nature. All of our members are regulated by ASIC for financial services licensing, market integrity and consumer protection purposes.
- The majority of our members are branches or subsidiaries of foreign-owned banks and, thus, are also subject to direct or indirect regulation by their parent bank's regulator.
- IBSA's main task is to secure policy outcomes that assist our members to develop their business in Australia - consistent with the Government's pro-competition policy and its objective of positioning Australia as a global financial services centre.
- Investment banks make a substantial contribution to the economy, through competition, efficiency and innovation – as a consequence, business and consumers have access to a wider product range at a lower cost.
- The activities of investment banks include deposit taking and lending, corporate advice, capital raising, infrastructure finance, stockbroking, wealth management, trade finance, securitisation, custody and treasury services.
- IBSA's members employ over 20,000 people in high quality jobs throughout Australia and provide the basis for Australia to be a world-class financial centre.

Attachment 2

Extract from APRA Guidelines on Authorisation of ADIs

Restrictions on Deposit-Taking Activities

30. Authorities to carry on banking business in Australia are granted to foreign ADIs subject to a condition which specifically restricts the acceptance of retail deposits by their Australian branches. As mentioned above, foreign ADIs are not required to maintain endowed capital in Australia and are not subject to any capital-based large exposure limits. These are the responsibility of the home supervisor (though APRA monitors credit risk concentrations and other risk exposures borne by foreign ADIs as part of its prudential oversight of their local operations). Due to the difficulties in ensuring the same degree of protection for depositors with foreign ADIs as for those with locally incorporated ADIs, foreign ADIs are required to confine their deposit-taking activities to “wholesale” markets.

31. Foreign ADIs are not permitted to accept *initial* deposits (and other funds) from individuals and non-corporate institutions of less than \$250,000. They can, however, accept deposits and other funds *in any amount* from incorporated entities, non-residents and their employees. No other specific restrictions are placed on the sources of funding or on the use of funds by foreign ADIs. They may offer cheque accounts to customers, subject to the above requirements governing the nature and size of deposits they can accept. Where credit card accounts are offered, there should be policies and procedures in place to ensure that any credit balances are promptly identified and repaid.

Disclosure Requirements

32. Pursuant to Section 11E of the Act, foreign ADIs must disclose that they are not subject to the depositor protection provisions of the Act (Division 2 of Part II). Disclosure to customers should include the following:

- (a) prior to the opening of an account, the transfer of an account from an existing entity, or the lodgement of an initial deposit, foreign ADIs should provide a written statement to the prospective depositor which indicates that deposits are not covered by Division 2 of the Act and, as such, are not subject to depositor protection provisions of the Act;
- (b) foreign ADIs should obtain a signed acknowledgement from prospective depositors that they understand the status of deposits with the foreign ADI concerned. (The acknowledgement should contain the signature of all interested parties in respect of joint accounts.);
- (c) in the case of the transfer of an account from a foreign bank-owned subsidiary ADI to a foreign ADI (resulting in a change of the operating status of the foreign bank in Australia from a locally incorporated subsidiary ADI to branch operations), the depositor must formally consent to the transfer and consequent loss of protected status before the account is transferred;
- (d) foreign ADIs should have systems and procedures in place which ensure that depositors opening an account or making an initial lodgement of funds receive and acknowledge the disclosure statement; and
- (e) deposit slips or any other communication evidencing the creation of a deposit used by foreign ADIs should carry the statement “Deposits are not subject to Division 2 of the Banking Act – Protection of Depositors”. This statement should also appear on any certificates of deposit or other marketable securities issued by foreign ADIs in the Australian market. Such instruments should generally be issued with a minimum denomination of \$250,000.

33. External auditors of foreign ADIs will be asked to report to APRA on compliance with the disclosure requirements as part of the audit arrangements in relation to the observance of prudential standards by foreign ADIs (refer Prudential Standard on “Audit Arrangements” with respect to the required timing and frequency of such reporting).