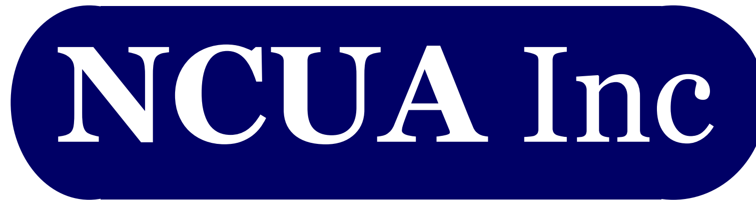

GOVERNMENT DISCUSSION PAPER ON FINANCIAL SYSTEM GUARANTEES DAVIS REPORT

SUBMISSION BY NATIONAL CREDIT UNION ASSOCIATION INC

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A. Introduction

NCUA is responsible for representing the interests of its member credit unions and in order to put our submission into context, it is important to address the history of credit unions in Australia. Credit unions are financial co-operatives, owned and controlled by their members. Credit unions operate by predominantly borrowing from, and exclusively lending to their members. Credit unions are a significant alternative to the major banks. They are non-profit organisations, with any surplus arising out of their operations being allocated to capital reserves to meet capital adequacy requirements and to reduce cost of services to members.

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 enshrined in legislation and in 1992 when the Financial Institutions Scheme was implemented, funds were established in each of the states and were called contingency funds. These funds, as with their forerunners, were capital funds holding approximately 1% of credit unions assets. 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 a fund in the event of a credit union failing.

History shows that although some credit unions caused claims on the funds, various strategies were devised 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.

In the early 1970's there were over 800 credit unions while today there are less than 180. 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.

This submission will focus only on the study on financial system guarantees as they relate to credit unions. It also includes responses to questions presented in the Government Discussion Paper on Financial System Guarantees.

B. Current Regulatory Environment

At present there are various safeguards in place to protect the position of the deposit holder. These mechanisms are largely the result of legislation, and industry responses. Details of some of the protective mechanisms are outlined below:

1. The *Banking Act 1959* provides depositor preference for customers of Authorised Deposit Taking Institutions (ADIs). These provisions will apply equally to credit unions as they do to banks. Depositor preference arrangements provide a significant degree of protection to deposit holders of credit unions since the proceeds from liquidation of an ADI are available to first meet the liabilities of depositors in priority to other creditors.

2. Since July 1999, credit unions were corporatised and brought under the *Corporations Act*. The *Corporations Act* incorporates the *Corporate Law Economic Reform Program,* the *Financial Sector Reform Act 2001* and the *Financial Services Reform Act 2001*. Protective measures such as financial requirements of an AFSL licensee, disclosure rules, director's duties and corporate governance are all relevant to ultimately protect deposit holders.

3. With the implementation of the Wallis reforms, credit unions have been prudentially regulated by APRA since mid 1999. Prudential standards applying to banks apply equally to credit unions. These prudential standards cover matters such as capital adequacy, liquidity management, and risk management.

   APRA also has extensive powers at its disposal for dealing with a range of circumstances, including actual or prospective breaches of the *Banking Act*, its prudential standards or prudential regulations. This may range from:
   - directions to a failing institution with the objective of returning it to a prudentially sound position;
   - full assumption of control; or
   - directions to transfer whole or part of the business.

4. APRA's capital standards meet the international capital standards of Basel I. APRA has given a commitment to ensure that the prudential standards meet the revised capital and risk management standard of Basel II.

5. Credit unions are required to comply with accounting standards set down by the Australian Accounting Standards Board, and will need to comply with international accounting standards next financial year.

Australia currently has a strong regulatory framework to deal with financial institutions failures, and it is with this backdrop that an introduction of an explicit guarantee system needs to be judged. In the *Review of the Outcomes of the Financial System Inquiry 1997* by the *Financial Sector Advisory Council (FSAC)* released by Treasury in August 2004, it was reported that, "Australia should resist excessive re-regulation of the financial sector, which could be an 'overreaction' to scandals such as the HIH collapse. The Government should be careful not to make knee-jerk responses".

C. Alternatives

The Government has sought comments on what general approach Government should adopt to reduce the consequences for consumers of financial institution failures. In particular 3 alternatives were offered for consideration. We make comments on each consideration as follows:

1. **Caveat emptor** – a response that insists that customers and other stakeholders should bear the consequences of a financial institutions failure.

   Certainly efficient market theory would suggest that such an approach be a preferable one. Essentially with the introduction of any external influence on a system, one could take the view that expectations and decisions of consumers would be undesirably influenced. "Moral Hazard" concerns, one could argue, will always be a by-product of external influence on the system.

   However pressures in balancing deposit holder's interests and the efficient operation of the financial market, as well as political pressure attached to loss of funds in deposit accounts could make it unpalatable for Government to reject deposit insurance. This will be particularly so where deposit holders are not well placed to assess the counterparty risk involved.

In reality, where community expectations of the safety of their savings is extremely high, Government will need to adopt a strategy to deal with the consequences of financial institution failure.

2. **Case by case, discretionary response** – that any assistance should be tailored to the circumstances of each instance of failure.

   NCUA's preferred option is for a case-by-case approach. There are a number of reasons why this approach is the most desirable. The following comments support this option:

   - Credit unions (as noted in the introduction) are mutual organisations whose objective is not one of profit maximisation or shareholder return, but rather to provide low cost deposit and lending alternatives for members.

     The ideals of the credit union movement do not lend themselves to some of the risks that may result from taking commercial, business and expansionary risks that other ADIs may do.

     The products that are offered by credit unions are fairly simple, and will generally comprise at call deposit accounts, term deposits, home and personal loans, and non-cash payment products such as EFTPOS or credit cards. Credit unions do not generally have extensive treasury operations aimed at increasing their own profits. Accordingly the risks involved in say, derivative trading, currency options or international investments are minimal.

   - Consequences for financial institution failure will vary greatly for consumers. It is interesting to note that statistics indicate that more than 80% of households hold less than $60,000, and more than 60% hold less than $15,000 in deposit accounts (NATSEM 2002). This is in contrast to the average sum insured for all household policies in force at the time of $201,650 (ICA 2002).

     This suggests that Government should not look to imposing one explicit guarantee system across the entire financial system. It also suggests that Governments should focus on perhaps areas where financial institution failure will have a more significant impact on consumers. It is relevant to note that the study of financial system guarantees had its roots from a royal commission into the collapse of an insurance company.

     In circumstances where there are considerable issues with design elements such as pricing and funding (which we expand on below), we do not believe that an explicit guarantee scheme covering deposit accounts should be introduced.

   - We acknowledge that solvency cannot be guaranteed by prudential supervision, but we would argue that a prudential system should not be designed such that the solvency of all participants is guaranteed. Such an approach would have implications for the competitiveness and efficiency of a financial system and would not be desirable.

The current system, which is regulated around capital adequacy requirements, has served Australia well. With credit unions maintaining risk-weighted capital ratios of around 14% and the intense supervision provided by APRA, it is difficult to see these deposit taking institutions in Australia failing to a point where depositors balances are severely diminished in value.

Given the extent of APRA's powers, supervision and the prudential standards applied to deposit taking institutions, it must be rated as unlikely that an ADI will fail, without significant advance indication. Further, the capacity for actual loss should be extremely limited, due to the level of reserves and capital.

Certainly the history of such a dramatic reduction in credit union numbers makes a compelling argument in favour of the industry's failure management process and transfer of business provisions. We know that consolidations, where handled appropriately, can result in good outcomes for deposit holders and other stakeholders. Certainly this approach is far more preferable to liquidation.

- Depositor preference provisions in the *Banking Act* when coupled with APRA's failure management powers provide a significant degree of protection to consumers.

  Although we believe that these provisions remain largely untested, we believe that they have the capacity to significantly protect deposit holders.

  The scope and range of activities of credit unions are limited to substantially retail deposit taking and lending. The capital adequacy requirements set by APRA should go a long way in ensuring that there is sufficient capital (especially in the case where it is risk weighted to the nature of the security) to meet liabilities.

  A failure during time of severe economic downturn, with dramatically reduced housing and commercial property values may limit the ability of these measures to protect deposit holders. However this must be considered in light of the risk weightings applied in calculating the adequacy requirement.

- It is conceded that deposit holders do assume, when dealing with financial institutions, that Government provide implicit guarantees, particularly in the case of deposit accounts. This, as Professor Davis notes, gives rise to "moral hazards" for both the institution and the deposit holder.

  However we do not support the view that a limited explicit guarantee scheme will mitigate "moral hazard" concerns. Ultimately, the ability of any explicit guarantee scheme to mitigate moral hazard concerns will come down to how well designed the scheme is. If poorly designed and priced, explicit guarantees can (like implicit guarantees) distort economic behaviour and lead to inefficient outcomes.

  There are significant issues with scheme design, which we will highlight below. These issues lead us to conclude that difficulties such as pricing, and funding may result in increasing moral hazard concerns. International experience on this issue has shown that this can cause significant

economic loss (for example, the US savings and loans crisis), and increase Government exposure in those circumstances.

3. **Limited explicit guarantees** – that the extent of some limited assistance should be defined up-front

   Whilst this is not NCUA's preferred option, we acknowledge that it needs to be considered as part of the exercise to strike a balance between protection of deposit holders and taxpayers' funds, and the efficient operation of the financial system.

   Some of the advantages of an explicit guarantee scheme may be timeliness of response, greater certainty for consumers as to product coverage and possible scale of compensation.

   However we believe that there are significant issues with the design of a scheme that outweigh the arguments for an explicit guarantee for deposit products. We will explore these issues further below.

D. Design of the Scheme

We propose to make comments regarding design characteristics as they relate to the ADI sector and credit unions in particular.

As noted by Professor Davis, design of the scheme in the broader sense will impact largely on whether the scheme can be successfully integrated into the existing financial system, without causing other unanticipated economic consequences.

Our views on design features of a scheme stems from several important principles as follows:

1. The design of the scheme must be such that the scheme is able to perform adequately in the most extreme adverse conditions, given that the likelihood of financial institution failures are more likely to occur during this time.

2. A guarantee scheme must have its pricing mechanism calibrated appropriately to take account of differences in risk, to avoid altering the incentives facing financial institutions. This will be relevant if Government is interested in reducing "moral hazard" concerns. Moral hazard will be as much a feature of a poorly designed system as it is with an implicit Government guarantee.

3. A scheme must be designed such that it will operate efficiently, with sustainable costs. As the beneficiaries of a scheme will be deposit holders and the public (taxpayers), there should be minimal costs to the ADI. We will comment on the costs of a scheme in section E below.

4. The costs of the scheme must be sustainable. Issues like the maximum limit of the guarantee, limits on currency and nationality will be relevant. Further the coverage of the scheme, i.e. whether it is on a per consumer basis or a per account basis, will need to be designed in such a way as to minimise any changes to behaviour and conduct of the consumer.

General Design Issues

One design question relates to how consumers should be covered. Providing compensation on the basis of each account rather than a per consumer basis may give rise to incentives to hold multiple accounts just below any threshold. Alternatively, providing compensation on a per consumer basis may create incentives to diversify across institutions. We feel that in either case, or even where a model like the US or Canada is adopted (i.e. per consumer, per institution basis), a scheme will impact on the behaviour of consumer and affect the outcomes and efficiencies of the system. Notwithstanding we feel that a 'per consumer per institution basis' will provide the most efficient outcome for deposit holders.

Monetary limits for the scheme will be essential, as an unlimited guarantee scheme may well prove too expensive to be funded, irrespective of the mix or funding base. In terms of the appropriate monetary limit, we believe that whatever limit is selected, it will be arbitrary. No doubt a number of factors will contribute to this limit, but it is important for Government to realise that there may be adverse funding and cost consequences in getting the limit wrong. Concentration of the ADI sector towards the four major banks (in terms of number of deposit holders) may result in a relative larger cost to smaller deposit taking institutions like credit unions.

We also feel that the currency that should be protected under a guarantee scheme should be limited to Australian dollars, and recommend that restrictions based on nationality be incorporated. We also suggest that any scheme not have an additional criterion based on the residency of a deposit holder, as this would increase the administrative costs for credit unions.

Funding

The viability of any scheme will depend initially on how it is funded. NCUA's preference is for such scheme to be compulsory.

A dilemma exists in relation to questions of one or more schemes covering ADIs. Should banks be subject to a separate scheme from credit unions and building societies? We believe there are arguments for perhaps two separate schemes for ADIs – one covering the banks and the other covering credit unions and building societies. This will certainly reduce the cross-subsidisation of different ADIs and also appropriately reflect the different risks in the operations of banks (being a profit organisation generally exposed to greater risks outside of deposit taking and lending) than credit unions or building societies.

This preference is based on the viability of a separate scheme for credit unions and building societies. Actuarial studies will need to be conducted before any decision is made regarding an ADI group's ability to sustain a scheme, however we suspect that in Australia's situation all ADIs may need to be in one scheme.

An issue of concentration arises in the situation of one scheme. The dominance of the four major banks in deposit accounts may cause a problem for funding and pricing of the scheme. The failure of a large institution may well exhaust the funds in the scheme, and depending on the pricing methodology used, may well be excessive for credit unions.

We accept that having a limited guarantee scheme, capped to some maximum amount per deposit holder, may go some way to alleviating this problem, but the

difference in concentration of assets is also translated to substantial differences in deposit holder numbers. A scheme encompassing credit unions and banks could prejudice credit unions and provide a further advantage to the major banks, at the expense of smaller deposit-taking institutions.

A key design question for any limited guarantee scheme is whether to have pre or post funding.

We accept that in theory there should be little difference between pre and post funding as the present value of funds accumulated under each approach should be the same. NCUA believes that the disadvantages of applying pre or post funding methods are significant especially for the concentrated ADI sector.

Whilst we accept that there can be a degree of science applied to determining probabilities and size of institutional failures, we do not accept that the timing and cost of the failures can be predicted to any degree of certainty. This is especially the case in the Australian experience, where there have been relatively few institutional failures. Reliance on international experience is unlikely to provide guidance, as Australia's existing regulatory environment is particular to it. The risk of pre-funding a scheme may result in funds never being needed (which will result in foregone earnings) or under funding when there is a failure. These factors will lead to inefficiencies in the financial sector and would be undesirable. We also suggest that where there is over funding that there be mechanisms in place to return funds to contributors. This should reduce any inefficiencies, as credit unions will be able to utilise those funds more efficiently.

Post funding poses different issues of fairness, and timing. A post-funded guarantee will mean that the failed institution will not have made some prior contribution to the scheme. Moral hazard concerns on the part of the failed institution will not be ameliorated in such situations.

A further disadvantage of post funding is the timing. An institution may fail as a result of a difficult economic environment. To levy contributions from other participants at such time may have a knock on effect for other institutions. This will be particularly the case where the institution failing is a large institution. Post funding, assessed in this light may well have the capacity to exacerbate an already difficult economic environment for credit unions.

Pricing

It is fairly uncontentious that pricing of the contributions to a scheme, based on risk is fairer and more efficient than flat-rate pricing and may ameliorate some practical problems of a concentrated ADI sector. Risk based pricing is however complex.

The benefits of risk pricing, being its ability to better ameliorate moral hazard concerns and being more equitable to participating institution, are attractive. This needs to be examined in light of the complexities. Professor Davis examined various ways in which risk can be measured, from option pricing techniques, to using existing APRA measures such as PAIRS and SOARS. Other techniques such as yield spreads, ratings, and credit scoring models were also discussed.

Ultimately risk rated premiums are a highly desirable feature of any guarantee system, but practicality issues do require a more streamlined list of risk indicators. Risk is hard to measure and it is likely that any streamlined list of risk indicators will not be accurate in reflecting the true risk of failure of an ADI. Designing an

appropriate risk based premium system could be difficult. NCUA's preference is for a risk based approach, but we suspect that irrespective of a whether a flat-rate or risk based approach is adopted, no pricing system will be able to fully resolve moral hazard concerns. Guarantee pricing arrangements which do not appropriately reflect risk of failure (whether flat rate or risk based pricing is used) is likely to involve an unfair allocation of costs among participants.

Correct pricing is crucial in ensuring that there is an appropriate balance between the benefits of an explicit guarantee – financial stability, against the cost of moral hazard. The magnitude of the problems, which is evident from the US experience, must surely be a reminder on how important it is to find that right balance. There is extensive commentary on the causes of the Savings and Loans crisis in the 1980's. We do not propose to examine the causes in detail in this submission except to say that a combination of altered behaviour of institutions resulting from regulatory forbearance, a downturn in asset values, and moral hazard all contributed to the problem.

NCUA has concerns that inappropriate pricing methodologies may contribute to moral hazards and result in adverse consequences for the sake of attaining a further level of financial stability beyond what, we would argue, is already a fairly stable and efficient system.

E. Costs of the Scheme

The issue that arises in respect to costs is "how much is the scheme going to cost". This question is not at all an easy question to answer but no doubt its answer bears a direct relationship to:

- the funding base: who and in what proportions should the loss be redistributed to taxpayers, industry, and deposit holders;
- pricing: how the premiums for industry are to be calculated;
- priority arrangements that are currently provided for in the *Banking Act* on a liquidation; and
- co-insurance: to what extent should the deposit holder share in the loss.

NCUA's position is that none of the methods of estimating costs as discussed by Professor Davis can provide a definitive estimate of the scheme's total costs. As discussed above, there are uncertainties in estimating the probability, magnitude and timing of any financial institutions failure, given Australia's relative lack of experience with financial institutions failure.

On the issue of funding our view is that the funding by industry for a scheme should be kept to a minimum given that the main beneficiaries are deposit holders and taxpayers. As such, partial funding from taxpayers as well as co-insurance of some form would be desirable and essential.

Given the complexity of estimating the costs accurately, we feel that the Government needs to give more weight and consideration to the indirect costs, which such a scheme might impose on the financial system. The problems of getting it wrong could result in changes in behavioural responses of industry participants, deposit holders and regulators, which may contribute to the frequency and/or cost of failure.

The cost to industry in complying with various regulatory responses of Government to safe guard consumers is not immaterial. As these costs are fairly obvious, we will not expand on this, except to say that further costs to ADIs who already comply with

APRA's prudential standards in terms of capital adequacy and liquidity requirements appear unwarranted. We feel that any further cost would reduce the competitive advantage, in terms of pricing, which credit unions currently have over banks.

F. Governance Arrangements

In relation to possible governance arrangements of a scheme, the administration of a guarantee scheme must, by its very nature, be undertaken by the party responsible for prudential supervision of the sector, in our case APRA. However, in addition to APRA, Federal Government, as well as industry interests should be represented on any overseeing body, given the difficulties which will no doubt be present in funding and pricing the scheme.

An overseeing body could have APRA with a majority of representation in order to undertake the role in a rational and accountable way, but in order to achieve the perspective which Government and industry can bring and also in order for openness and transparency, Government and industry should be adequately represented.

Any new statutory authorities purposely established to operate such a scheme is likely to cost taxpayers, as well as industry, more in terms of setup and establishment costs. Further, issues of duplication of prudential regulation, supervision and sharing of information may arise and create further inefficiencies. NCUA does not support the formation of a separate body to administer an explicit guarantee scheme.

G. Regulatory Implications

Under a pre-funded model, NCUA believes that it is essential that there be sufficient flexibility in the scheme to achieve a least cost resolution for a failed credit union. We believe that this is essential to firstly ensure that the protection of deposit holders is undertaken in the most economical way possible. However we see certain problems with a least cost resolution model that will need to be considered carefully before the parameters of how a scheme is to operate are set. There may also be practical problems of scheme governance, which this preference throws up.

Our preference is for the current regulatory safe guards to be exhausted before funds from the scheme are dissipated. Accordingly our position is that existing depositor preference rules in the *Banking Act* should continue to apply unchanged. This would mean the any guarantee scheme would benefit from the priority arrangements to the same extent as non-guaranteed depositors, and importantly the liquidated funds of the failed institution would continue to be applied unchanged.

The existence of the current depositor preference rules would have been factored into the commercial decisions of various stakeholders of an ADI, and to change this may result in unintended consequences for them.

We would recommend that the scheme be called upon once the failed institution's liquidated proceeds indicated a shortfall to guaranteed deposit holders.

H. Other Suggestions

In reviewing the matter we suggest that Government also investigate alternatives ways to provide extra safeguards against financial institutions failure. Government's focus should be to reduce the likelihood of loss through perhaps enhancing current safeguard mechanisms rather than the redistribution of loss.

Promotion of financial stability and reduction of bank runs have been often quoted as arguments for an explicit guarantee scheme. There is no doubt about the importance of liquidity management and in particular, having appropriate strategies to combat liquidity imbalance (i.e. the existence of liquid liabilities verses relatively illiquid assets), which ADIs face.

Although APRA has prudential standards on liquidity management, the availability of a liquidity support facility, whether within a deposit insurance scheme or as a stand alone facility to troubled ADIs can be an effective measure in staving off potential failures.

Perhaps Canada provides us with a good case study in point. It is understood that in the Canadian province of Alberta, 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.

Although the Reserve Bank has made it clear that its balance sheet is not available to prop up insolvent institutions, Government should look at polices to perhaps setting strict criteria for some “lender of last resort” facility to be available in lieu of implementing an explicit guarantee scheme.

Although APRA’s failure management powers are extensive, a detailed consideration of them with a view to further strengthening them may also be preferable to implementation of an explicit guarantee scheme.

Government currently provides assistance on a case-by-case or discretionary basis. We would certainly support Government setting out some predetermined criteria under which assistance would be provided to an ADI under stress. This coupled with an education program for the public may go some way to reducing any moral hazard concerns arising from the perception of an implicit guarantee scheme. In our view an explicit guarantee scheme will not reduce any moral hazard concerns, but rather has the potential to increase it, due to the many variables in scheme design.

The US, following the Loans and Savings scandal in the eighties, continues to fine tune the scheme to strike the balance between financial stability and moral hazard. The Australian financial landscape and how participants in it will react, will be unique to Australia; so merely duplicating the features of another country’s scheme (which has been fine tuned to a significant degree) may not strike the same balance that the Government may desire for Australia. Ultimately if we go down the route of introducing an explicit guarantee scheme, there will necessarily need to be continual review of the operation of the scheme to ensure that a balance continues to be maintained.

I. <u>Conclusion</u>

NCUA’s position is that Government should continue with a case-by-case or discretionary model in dealing with the failure of ADIs. Some of the more cogent arguments in favour of this approach are:

- The existing strong regulatory and prudential regulation of ADI’s;
- Depositor preference arrangements under the *Banking Act*;

- The limited nature and scope of activities of credit unions;
- The relatively more limited consequence of financial institutions failure for deposit holders vis a vie insurance policy holders;
- Difficulties in scheme design without the necessary certainty that an appropriate balance can be struck between financial stability and efficiency and competitiveness of the financial system; and
- The additional costs that credit unions will face in terms of reduction of capital resources, administrative and compliance costs.

Given the Australian context of financial institutions failure, we do not believe that the introduction of an explicit guarantee scheme is appropriate. We maintain the view that Government can address the issues of public funding of financial institutions failure by looking at other alternatives such as strengthening existing mechanisms.

Government Discussion Paper On Financial System Guarantees

This section answers questions presented in the Government Discussion paper on financial system guarantees designed to highlight the key issues identified in 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?

We hold the view that with the introduction of an explicit guarantee scheme, other perhaps more indirect consequences will arise. A guarantee scheme will come at the expense of reducing efficiency and competitiveness of our financial system. Government needs to be cognisant of the difficulties in scheme design that will lead to increased indirect costs for credit unions. Such costs are likely to be exacerbated by the concentrated nature of the ADI sector. We also anticipate further difficulties for credit unions relative to the larger banks, which will be able to absorb and defray the cost, ultimately to the detriment of credit unions and their competitiveness.

Moral hazard is a major concern. Although Government may argue that moral hazard already exists with an implicit scheme, we would submit that an explicit guarantee scheme may not necessarily mitigate moral hazard concerns. In fact we would argue that, given the issues surrounding scheme design, and the diverse risk characteristics of the participants in the ADI sector, an explicit guarantee scheme can also distort economic behaviour and lead to inefficient outcomes. Although it is difficult to predict the future risk behaviour of participants, we suspect that an explicit guarantee scheme may cause increased risk taking, particularly among those ADIs which are less competitive – thereby threatening the integrity of the sector.

Lessons form the US must be seen as a warning sign in this regard. Since the Saving and Loans crisis the US Government has amended the operation of their guarantee scheme to continually fine tune the balance between consumer protection and moral hazard concerns.

Q2. What general approach should government take to reduce the consequences for consumers of financial institution failure: caveat emptor; case-by-case; limited explicit guarantees; or alternative responses?

NCUA prefers **Option B – Case-By-Case, Discretionary Response**. Any assistance should be tailored to the circumstances of each instance of failure (refer to page 4 of this submission).

Australia currently has a strong regulatory framework to deal with financial institutions failures, and it is with this backdrop that the introduction of an explicit guarantee system will need to be judged. In the *Review of the Outcomes of the Financial System Inquiry 1997 by the Financial Sector Advisory Council (FSAC)* released by Treasury in August 2004, it was reported, "Australia should resist excessive re-regulation of the financial sector, which could be an 'overreaction' to scandals such as the HIH collapse. The Government should be careful not to make knee-jerk responses".

The Government should conduct rigorous research before any decision is made.

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?
Alternatively, you may wish to refer to relevant international experience in relation to some of the specific design issues.

In 'Deposit Insurance and Bank Intermediation in the Long Run', BIS Working Paper No. 156, by Robert Cull, Lemma Senbet and Marco Sorge (July 2004), which can be found at http://www.bis.org/publ/work156.htm, reference is made to the impact of deposit insurance programs on financial stability in a recent study by Demirgüç-Kunt and Detragiache (2002). Based on evidence for 61 countries between 1980 and 1997, they find that variations in coverage, funding or management of deposit insurance schemes are significant determinants of the likelihood of banking crisis, especially across countries where interest rates have been deregulated and the overall institutional framework is weak.

In order to determine how a scheme may be optionally designed, reference should be made to experiences in other parts of the world. The International Association of Deposit Insurers (IADI) website contains the Canada Deposit Insurance Corporation (CDIC) 'International Deposit Insurance Survey Questionnaire'. The information will help to draw on approaches being used elsewhere, to assist in the design of a deposit insurance system. This may be viewed at:
http://www.iadi.org/html/Default.aspx?MenuID=209.

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.

MODEL SCHEME DESIGN

BASIS OF PARTICIPATION

NCUA would prefer compulsory membership, and ideally the establishment of two schemes within the ADI sector. A combined scheme for building societies and credit unions, separate from the banks, is considered to be more equitable than the one scheme for all ADIs.

COVERAGE – DEPOSIT PRODUCTS GUARANTEED

The Davis Report (6.60) states the possible coverage that could be incorporated in the definition of an insured deposit, to be unquestionably clear as to what product is insured. This possible coverage is stated as follows:

"Australian dollar deposits of households, private unincorporated businesses and community service organisations repayable in Australia held in transaction, savings, cash management, term deposit and RSA's with locally incorporated ADI's. "

NCUA agrees with this proposed coverage.

COVERAGE LIMITS

Monetary Limits

An example of a coverage limit could be **$60,000 maximum per depositor per institution**. This amount is based on the fact that 80 percent of households hold less than $60,000 in deposit accounts. This figure should be subject to review or **indexed** (CPI). Interestingly more than 60 percent hold less than $15,000.

Downside of a limit

A downside of a limit of $60,000 per depositor per institution is the possibility of larger deposit holders withdrawing funds over the limit and spreading them across a number of institutions, to circumvent the limit**.**

Full or partial protection?

NCUA would prefer that a **'keep it simple' approach** be adopted. Some form of co-insurance would be desirable. There should be no floors based on severity of loss and means testing should not apply. 'Generosity of promise' features should be excluded. Special dispensation for real estate and legal agent trust accounts should be provided. Arbitrary limits on term deposits should not be applied.

Size of the Fund

Capping the size of the total fund, needs to be applied and amounts in excess should be returned to industry to prevent over funding.

In the past Australia's credit unions have operated **contingency / stabilisation funds**. 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 under the legislation in each of the states and were titled "contingency funds". These funds, as with their forerunners, were capital funds holding approximately 1% of credit union 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 a fund in the event of a credit union failing.

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

METHODS FOR ESTIMATING THE COSTS

- <u>Insurance or Guarantee Costs</u>

  We believe that methods for estimating the guarantee costs are problematic as Australia has a limited experience with ADI failure. To extrapolate from such limited history or overseas experience, as the underlying basis for determining the scheme's cost, is likely to be most inaccurate.

- Administration and Compliance Costs

  The costs associated with establishing, operating and maintaining the administration to support a scheme with industry interaction do not pose a significant issue. We do not envisage high costs for this given that all ADIs are already prudentially regulated and fund APRA.

- Indirect Costs (imposed on society - the impact on behaviour of the participants)

  We see this as the significant issue for Government. A poorly designed scheme is likely to increase the frequency and / or cost of failures due to behavioural responses of ADIs, deposit holders and regulators, although we cannot say to what extent.

  As with any introduction of an external influence on a system, there will necessarily be changes in risk appetite and behaviour of credit unions and deposit holders. To what extent such changes covered impact on the potential for financial institutions to fail is a matter for debate, but certainly the doubts surrounding these issues are not insubstantial and must certainly be fully evaluated.

Q6. Do you have further information or suggestions that might improve the accuracy and reliability of the results?

As the beneficiaries of such a scheme will be the consumers and Government, there should be no net cost imposed on ADIs in relation to creating such a structure.

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

A major portion of the cost of the current system is already being met by ADIs and other financial service providers in their levies paid to APRA. 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.

In the event of a notional fund existing, ADIs 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 ADIs 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 the Canadian province of 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.

Q7. To what extent do concentrated markets present challenges to the viability of any scheme?

DEPOSIT INSURANCE SCHEME - FEASIBILITY

The prospects for a deposit insurance scheme do not look promising in the Australian context. Actuarially the scheme may not be viable. The composition of the ADIs, in terms of the holdings of deposits, may be too concentrated in the big four and the aggregate number of institutions may be too small to cover the risk. Detailed actuarial studies would have to conduct modelling and assessment projects.

Actuarial studies would 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 (a separate scheme for credit unions and / or building societies is preferred) or, where it is possible in Australia for all ADIs to be in the one scheme.

Due to the size and structure of the ADI sector, a scheme could well be more expensive to operate and to fund than the deposit schemes in much larger countries, such as the United States, which has a very large number of smaller banks and credit unions. A country of similar size to Australia, with not dissimilar banking dynamics is Canada, which has deposit insurance.

Q8. The Davis Report explored some of the alternative approaches for funding explicit guarantees. Comments are invited on which approach should be favoured, and why.

- **If a pre-funded industry scheme should be preferred:**
    - **On what basis should the size of the target fund be set and over what period of time should the target balance be achieved?**

      We hold the view that the disadvantages of a post funded scheme, in particular the stresses, which may be placed on ADIs at times of most vulnerability and the concept of fairness of the affected ADIs contributing to the fund as well, make a compelling argument for a pre-funded scheme.

The question is a fundamentally difficult one to answer. In Australia's situation, we do not believe that there is sufficient experience with ADI failures to be able to predict to any degree of certainty the timing and cost of an ADI failure, both of which will be crucial in answering the question.

To rely on international experience will almost certainly result in inefficiencies in terms of idle capital for credit unions. Although there may be similarities between the credit union industry in Australia and other countries, the immeasurable differences in corporate culture and risk taking lead us to suspect that answers on size and timing are problematic. Needless to say we cannot offer any insight on the size of a target fund and the period in which it should be accumulated. Actuarial calculations will be necessary to provide the best estimate possible to minimise any inefficiencies that are likely to occur. In particular, processes should be provided to repay extra amounts.

- **What is the appropriate funding base and, in particular, should non-guaranteed products be included in funding base calculations?**

  At the broadest level, our position is that as the beneficiaries of any explicit guarantee scheme will necessarily be taxpayers and the individual deposit holders, the funding base should comprise a proportion of public as well as private funding. We also favour co-insurance to ensure that Government accrues for a percentage of future ADI failures as well as to provide a greater appreciation of risk for deposit holders. We believe that co-insurance may provide an adequate mechanism for deposit holders to make contributions to the funding of the scheme.

  It is submitted that separate schemes apply to banks and credit unions. This should ensure that any funding methodology in terms of estimation of timing and cost of ADI failures will be more likely to reflect an appreciation of the relative differences in the risk for banks vis a vie credit unions. This issue however must be examined from a mathematical / actuarial perspective, to ensure that separate schemes are viable and will not result in excessive costs for the participants.

  In the interest of matching contributions with beneficiaries, we believe that it is essential that contributions are collected on the basis of the total insured deposit base rather than total liabilities.

- **Should restrictions be placed on the type of assets in which the scheme can invest?**

  Certainly there need to be restrictions on the nature of investments which the scheme can invest funds in. It also goes without saying that the scheme funds should be invested in low risk products such as government and semi government bonds and other money market instruments.

- **Should the investment returns remain in the fund or be returned to participating institutions?**

  For reasons of efficient use of resources, we recommend that the scheme return any excess amounts to participating institutions. Actuarial assessments should determine the volume of funds required from time to time and any excess must be returned to participants.

- **What arrangements should be put in place to allow the scheme to borrow in the event of under-funding?**

  We believe that it is essential to allow the scheme to borrow, preferably from the Federal Government. We recommend that the situation of failures in Canada be studied further. As noted in the commentary, the issue of Government debt instruments to fund cash shortfalls in the case of financial stress should be a fundamental part of any scheme. As failures are likely to arise during times of economic stress, such measures may be better than adopting a quasi post funding methodology.

- **In the event of a failure, how should supplementary levies be applied?**

  It is suggested that Government investigate prospects for public funding and perhaps increasing the amount of co-insurance as alternatives, before supplementary levies be charged to participants.

- **If a post-funded industry scheme should be preferred, how should the following issues be dealt with?**

  - **Should the prudential framework require institutions to provision for their possible future contributions to a scheme?**

    In short, yes. However, if the scheme is funded on a capital basis, as opposed to expensed, the accounting treatment will differ.

  - **Should the scheme's governing body be able to borrow only from the market, only from the Government or a combination of both?**

    Priority should be for borrowing from Government, with a supplementary capacity to borrow from the market.

  - **Should a cap be set on how much the scheme can recover from institutions in a year? How would this cap be determined? What is the appropriate funding base?**

    It is considered essential that a cap be set for amounts required by an institution in any one year. Based on historical data, the cap should be limited to an amount that would enable an ADI to maintain its minimum capital requirement and not exceed 0.1% of total assets.

Q9. The Davis Report examined some general approaches to setting prices for industry funded explicit guarantees. Comments are invited on which approach should be preferred, and why.

- **If risk-based pricing is preferred:**

  - **What is the best way to determine premiums?**

    We believe that a risk based approach will be the most efficient method to determine premiums. Calculated properly, it has the ability to reduce moral hazard and behavioural aberrations.

    With credit unions, many of the risk measurement techniques which could be applied to banks will not be able to be used. We favour a "risk scoring model" developed for credit unions. This combined with an estimate of loss, will provide the most appropriate measure of risk to determine premiums.

    This option is not without difficulties. As highlighted in the commentary, estimating the timing and size of loss of financial institutions failure will not be easy in Australia's case, given the lack of experience.

  - **How often should re-rating take place?**

    For ease of operation of the scheme we favour ratings being undertaken each three years. However the system should have sufficient flexibility to re-rate annually if required. It would be desirable for criteria to be established to determine if an annual re-rating is required. Factors such as a significant change in the ADIs activities, or adverse balance sheet and profit and loss changes, or material changes affecting the overall risk profile of the ADI, as factors that may be considered which necessitate a re-rating.

  - **Who should be responsible for setting risk-based premiums?**

    A governing body, comprising representations from APRA, the Government and industry, should be responsible for setting such premiums. This will ensure that all participants have a say in the way premiums are calculated.

- **If flat-rate pricing is preferred:**

    This model is not supported

Q10. The Davis Report outlined some possible governance arrangements to support an explicit guarantee scheme if one were to be introduced. Comments are invited on which approach should be favoured, and why.

In the interest of keeping any administrative and compliance costs to a minimum, we do not believe that it would be appropriate for a separate body to be set up by Government to undertake this scheme.

We would recommend that the primary responsibility for ensuring the effectiveness of a guarantee scheme should rest with APRA. It is essential that there be input from Government and industry given our recommendation on the funding base.

Q11. What is the preferred allocation of functions among the relevant bodies?

The governing body, charged with the responsibility for administering a deposit insurance scheme, should comprise representatives of APRA, Government and Industry. It would address administrative decisions such as decisions on setting of premiums and when payments from the scheme should be made. The composition of the governing body could be 60% APRA, 10% Government, and 30% industry.

APRA would continue its current role of inspections and supervision as it does now. A governing body, as referred to above, is the only additional requirement envisaged, if a deposit insurance scheme were to be introduced.

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:

- **Under a pre-funded model, would it be feasible for the guarantee scheme funds to be available to achieve least-cost failure -resolutions (for example, a transfer of business) if that might be less expensive than compensating eligible customers in a liquidation?**

  - **What regulatory and governance arrangements might be necessary to support least-cost failure resolution?**

    We believe that it is essential that there be sufficient flexibility in the scheme to achieve a least cost resolution for a failed ADI. Rehabilitation programs and / or ‘transfers of engagement’ should be provided for.

- **Guarantee schemes and priority arrangements (for example, depositor preference) might be seen as alternative or complementary policy instruments to guarantees for protecting certain stakeholders in the event of financial institution failures.**

  - **What are your views on the existing arrangements for depositors in Australia?**

    NCUA’s preference is for current regulatory safe guards to be exhausted before funds from a scheme are dissipated. We therefore hold the view that the depositor preference rules in the *Banking Act* should be exhausted before any compensation from a scheme. We believe that this is essential to ensure that those persons who have previously acted in reliance on the depositor preference rules continue to be protected as anticipated. The Government has a vested interest in avoiding unintended consequences even though the other side of the equation is consumer protection.

- **What changes should be made to priority arrangements if a guarantee scheme were to be introduced?**

  We do not believe any changes should be made. Current regulatory safe guards should be exhausted first (covering in this case guaranteed and non-guaranteed deposit holders) before a claim on a scheme. An explicit guarantee scheme seen as complementing the depositor preference rules rather than replacing them.

- **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.**

  Deposit Insurance should be extended to deposits in domestic branches of foreign banks. Such deposits should be covered because they are part of the Australian Banking System. A deposit insurance scheme would not be effective if deposits with foreign banks in Australia are not protected. Many countries including the USA, Canada, and the UK extend protection to deposits in domestic branches of foreign banks. ADIs in countries with open financial markets are all subject to similar external risks and due to increasing globalisation it may not be justifiable to exclude deposits with foreign branches in Australia from protection.

  A guarantee scheme would provide an opportunity for removing or reducing restrictions on branches of foreign ADIs accepting deposits from retail customers. Globalisation, free trade, and competitive market forces demand this.

- **Would the introduction of a guarantee scheme allow or require changes to other financial sector regulations and arrangements?**

  We do not believe so.