EXECUTIVE SUMMARY

The Royal Commission into the collapse of the HIH Group of Companies (HIH) recommended that '…the Commonwealth Government introduce a systematic scheme to support policy holders of insurance companies in the event of the failure of any such company'. On that basis Professor Davis was appointed to lead a Technical Study into the merits of a limited explicit guarantee system for the Australian financial system.

In establishing the Study the Government took the view that 'the appropriateness of government intervention following financial institution collapses should be considered in terms of its possible financial system-wide impacts and consequences for the design of the regulatory framework'.

In accordance with the Terms of Reference, therefore, the Study considers the merits of introducing guarantee schemes in various sectors of the financial system. This Study has not been undertaken with one particular financial sector in mind. The interrelationships between any guarantee scheme and the existing regulatory and prudential framework, and consequences for the latter, are a fundamental concern of the Study.

The purpose of the Study is to '…provide a balanced analytical framework against which interested parties can consider the issues and formulate their views.' It was not within the scope of the Terms of Reference to provide recommendations to the Government.

Australian and international experience with failure

The incidence of significant financial institution failure in Australia has been relatively low by international standards. However, even with best practice prudential regulation, failures will occur from time to time.

Government responses have rarely involved attempts to prevent insolvent institutions from failing or to shield creditors or shareholders from loss. Rather, they have sought generally to mitigate the impact of failure for certain consumers.

A number of lessons are evident from experience:

- community expectations of government support appear widespread, particularly where failed financial institutions have been prudentially regulated and 'critical' financial products (such as deposits and insurance) are involved;
- the causes of failure are diverse and the impact on consumers depends upon the type of institution and financial 'promises' involved;
- the probability, extent and associated consequences of a failure can be difficult to predict in advance; and
- the time between failure and resolution can be significant, and create significant costs for stakeholders even if restitution ultimately occurs.

Internationally, deposit insurance and insurance policyholder protection schemes are becoming widespread. Australia is one of only two Organisation for Economic Cooperation and Development (OECD) countries without some form of explicit deposit insurance.

Explicit guarantee schemes for other products offered by prudentially regulated financial institutions are growing in number throughout the world.

Australia's existing regulatory framework

Australia's existing regulatory framework and financial 'safety net' aim to balance efficient risk-taking by financial institutions with protection for consumers of financial products.

At present, the prudential framework is supported by a limited safety net offering depositor preference for customers of authorised deposit-taking institutions (ADIs) and policyholder preference for some insurance products.

To promote efficiency, the current regulatory framework presumes that consumers knowingly bear the consequences of 'counterparty risk' (default) associated with their chosen financial institutions.

However, the prudential framework recognises that many consumers will not be in a position to assess and monitor the risks in dealing with financial institutions. Instead, the Australia Prudential Regulation Authority (APRA) plays an important role as their delegated monitor in the case of prudentially regulated financial institutions. Prudential regulation is the foundation of the overall policy approach to achieving public policy objectives such as financial system stability, efficiency and equity. Other components include fostering market discipline, corporate and market regulation, and consumer protection.

Consumers can purchase a range of financial products from non-prudentially regulated suppliers which may be close substitutes to many of those offered by prudentially regulated institutions. Consumers willing to bear the counterparty risk associated with such suppliers in pursuit of higher returns are able to do so — and this is a desirable feature of an efficient financial system.

The existing prudential framework is not designed to ensure that consumers will not lose money in the event that their prudentially regulated financial institution fails. Losses incurred will be affected by such characteristics as preference arrangements which vary across sectors and provide different levels of protection for customers of different types of institutions. Depositor preference arrangements and policyholder priority over statutory fund assets, however, can provide a significant degree of protection to customers of deposit-taking institutions and life insurance companies respectively.

Australia's prudential framework exhibits differences between deposit-taking, life insurance, general insurance and superannuation products in terms of the 'intensity of capital' and other risk management requirements; the powers that APRA may exercise; and the protection provided to consumers in insolvency.

There are some existing compensation and guarantee arrangements in place, applying to superannuation, compulsory insurance classes, financial advisers and financial exchanges, that are relevant in assessing the merits of limited explicit guarantees.

The economic rationale for explicit financial guarantees

Financial institution failures will occur even in an efficiently regulated financial system. When failures occur, there is generally strong pressure on governments to underwrite at least some of the financial promises made by some types of failed institutions, regardless of whether there was any prior commitment to do so. Consumers may assume, in dealing with some financial institutions, that governments provide 'implicit' guarantees.

Limited explicit guarantees on financial products can be preferable to implicit guarantees or to a *caveat emptor* approach (which in any event, may not be politically feasible), or to a 'discretionary', or case-by-case, response to failures. Explicit guarantees may contribute to the stability of the financial system, improve the allocation and pricing of risk and provide individuals a greater degree of financial security.

The advantages of an explicit guarantee over a discretionary approach may include timeliness of response, greater certainty for consumers as to product coverage and greater certainty also about the possible scale of compensation.

Appropriately targeted guarantees remove at least some of the risks for those who are exposed to financial institution failure but are least able to assess, and therefore do not voluntarily bear, that risk. Explicit guarantees may also distribute the burden of risk more equitably than implicit guarantees.

The ability of retail consumers to assess counterparty risk associated with financial institutions is limited. Guarantees which are correctly priced (which, together with prudential regulation, mitigate 'moral hazard' concerns) may be warranted in this case. Consumers are generally more aware of 'market risk' associated with investments and there is no case for protecting consumers who voluntarily take on such an exposure.

If poorly designed and priced, explicit financial guarantees can (like implicit guarantees) distort economic behaviour and lead to inefficient outcomes.

Guarantee schemes cannot solve the problems of a systemic crisis where other government responses are necessary.

Consequences of financial institution failure

Assessing the composition of households' and individuals' exposure to risk arising from their financial asset holdings provides some insight into the possible consequences of a financial institution failure. This can assist in consideration of the possible scope of explicit guarantees.

The available data suggest:

- Australian households hold the majority of their wealth in assets involving an exposure to market risk;

- Australian households hold around two-thirds of their financial wealth in the prudentially regulated sector;
- deposit balances are generally quite small, even for high wealth households; and
- the value of assets or income protected by insurance policies is significantly higher than deposit balances.

The consequences of failure of financial institutions vary considerably for consumers.

- An ADI failure would involve a loss of savings. While some households may have very large exposures at certain times, more than 80 per cent of households hold less than $60,000 in deposit accounts and more than 60 per cent hold less than $15,000.
- Failure of an insurer would mean that consumers might not receive compensation for claims lodged under life or house and contents insurance policies. The amounts involved can be quite significant. As at 31 December 2000, the average value of assets protected for all household policies in force at that time was $201,650.
- Similarly, third-party beneficiaries of liability insurance might not receive compensation. For example, in the year-ended June 2002, the average claim size under these categories of insurance exceeds $50,000.
- In extreme circumstances, the failure of one or more large financial institutions could also pose systemic risks.

Guarantee scheme coverage

A criteria-based approach has been used to explore the possible coverage of a guarantee scheme and allow cost estimates for any scheme to be modelled.

The criteria proposed for determining coverage involve restriction to:

- products that are supplied by prudentially regulated institutions;
- ‘capital certain’ and ‘critical’ financial products issued by financial institutions; and

- consumers who are least able to assess product risk.

Applying these criteria leads to specific classes of institutions and products that might be covered by a guarantee. These include, primarily, deposits of ADIs, policy liabilities under general and life insurance, and some income products offered by prudentially related institutions. Maximum coverage limits aim to focus protection on retail consumers and preserve incentives for well-informed stakeholders to exert market discipline.

Designing a scheme necessarily involves tradeoffs between multiple objectives. The challenge is to balance concerns about safety with objectives such as efficiency, equity, minimum complexity and minimum cost.

Scheme design features which can assist in meeting these objectives include coverage limits, coinsurance and means testing.

The vast majority of superannuation products would not be covered under the criteria proposed because they do not involve exposure to counterparty risk. Concerns about compulsory contributions being exposed to market and agent risk can be addressed by other means.

Cost of a guarantee

Guarantee schemes involve a redistribution of losses due to financial institution failures. This redistribution is not of itself a cost to society, but some participants may perceive that private costs exceed the likely benefits.

Scheme design variables determine the coverage of any guarantee. The scheme costs depend on the proportion of total liabilities covered. The incidence of guarantee scheme costs depends on the capital structure of the industry, particularly where preference arrangements are in place.

There are considerable practical problems involved in estimating scheme costs, particularly given the relatively limited experience with financial institution failure in Australia.

Estimation of scheme costs in the insurance sectors is made more difficult by the fact that the value of insurance liabilities is more prone than deposit liabilities to uncertainty.

Further industry data would be required to allow the appropriate calibration of model parameters. Estimates that have been derived for the purpose of the

Study do, nevertheless, fall within the (broad) range of estimates derived from international experience.

Subject to a number of important caveats, on the basis of the evidence and theory available, the 'insurance costs' of a limited explicit guarantee in Australia are expected to be very low.

The size of compliance and administration costs depends upon scheme design.

Comparison with costs in other countries should take into account that deposit insurance and insurance guarantee premiums often involve a component for prudential supervision — a cost which Australian institutions already bear through supervisory levies.

Funding and pricing

International practice in funding and pricing guarantees varies according to the industry and products in question.

Whereas the cost of a guarantee derives from the total amount to be redistributed, funding issues relate to the appropriate base from which to collect contributions and pricing issues relate to the determinants of the relative share of contributions from each contributor.

Schemes can be pre-funded to varying extents. Internationally, pre-funding is more common than post-funding in deposit insurance and is becoming more widespread. There is more use of post-funding in insurance policyholder guarantee schemes.

Under both pre- and post-funding, arrangements can be made in advance to ensure scheme access to lines of credit (or interim taxpayer funding) if needed following failure; and to define the limits to government guarantees of initial support. Explicitly identifying such arrangements should provide better protection also for the budget/taxpayers.

The Study concludes that the theoretical differences between pre- and post-funding are minor. Pre-funding involves building up the scheme's capital position from premiums to some positive target level able to provide compensation following failures.

Post-funding generally relies on the scheme borrowing initially (from government or the market) with some or all of this funding recovered through industry/consumer levies.

There is a view, however, that there is a difference between pre- and post-funding in terms of the cyclical impact on the economy. That is, pre-funding allows at least some accumulation of reserves in buoyant times whilst post-funding calls for industry and possibly budget contributions at times of greatest stress. The speed at which the capital position of the scheme is restored or borrowings are repaid from subsequent setting of premium rates is a key consideration in assessing the relevance of that view.

There are some practical differences between pre- and post-funding. The existence of a pool of funds (under pre-funding) may adversely affect perceptions and behaviour both of market participants and managers of the scheme although this may be mitigated by risk-based pricing of contributions. Post-funding enables deferral of the decision about required premium rates until failures occur and costs are known. Applying risk-based pricing under post-funding may, because of uncertainty about when it might occur, have less effect in preventing moral hazard. The fact that failed institutions have not contributed under a post-funded scheme could be seen as unfair and weaken industry support.

A mix of pre- and post-funding is possible.

Some schemes price according to the risk of the provider. This acts to deter moral hazard and is fairer and more efficient than flat-rate pricing. But risk-based pricing is complex, and the probability of mistakes is considerable. Nevertheless, the arguments in favour of some degree of risk-related pricing are strong, and accounting, regulatory and market information can be used to assess risk.

Most deposit insurance schemes tend to be industry-funded and do not discriminate according to the risk of the deposit-taking institution. Pre-funded deposit insurance schemes with risk-sensitive pricing are becoming more common, and Australia could implement such a scheme if necessary.

Insurance guarantee schemes tend to make greater use of post-event funding partly reflecting the difficulty in measuring the quantum and timing of the liabilities of a failed insurer. The incidence of risk-sensitive pricing among these schemes is low.

Many of the inputs required for pricing decisions in any type of scheme can be inferred from financial market prices, accounting and regulatory reporting data, or based on APRA's monitoring activities.

Risk-based pricing, coverage limits and preference arrangements help to overcome concerns about the fairness and viability of a guarantee scheme operating in a concentrated sector with a skewed size distribution of participants.

Governance and accountability

Introducing a limited explicit guarantee would necessitate explicit articulation of the degree of separation, governance arrangements and allocation of powers and functions between the guarantee scheme and existing regulatory authorities.

Key objectives would include:

- avoiding duplication and establishing clear lines of responsibility and accountability;
- avoiding the more serious potential conflicts of interest;
- minimising the administrative costs of the scheme;
- minimising the compliance costs for industry;
- harnessing industry expertise and involvement, where appropriate; and
- ensuring an appropriate incentive structure for regulatory authorities.

Choices concerning appropriate governance arrangements and the allocation of functions probably should flow from decisions about the scope of any guarantee, particularly the question of whether it will extend across a number of prudentially regulated sectors, and whether it is pre- or post-funded.

There does not appear to be merit in creating a scheme which has or needs supervisory powers which duplicate those of APRA. The main options consistent with the objectives outlined above include:

- establishing a scheme under the umbrella of APRA but possibly with an independent charter; or

- creating a separate statutory authority with responsibilities limited primarily to setting premiums/levies, managing funding and compensation arrangements.

Such a statutory authority could be created but remain inoperative until failure necessitated its activation.

Use of private sector capabilities to manage claims assessment and payment may be desirable.

Regulatory implications

The viability of any guarantee scheme depends heavily on the prudential framework and its ability to avoid and manage failure. Introducing a guarantee would appear to warrant some reconsideration of APRA's failure management powers. Regulatory definition of the scope of the guarantee's application would be necessary.

A guarantee scheme may, in certain circumstances, complement the prudential framework by providing the resources necessary to implement resolution strategies other than closure of a troubled institution. This would need to be considered carefully and, if pursued, would have implications for the choice of governance arrangements of the scheme.

The cost of any guarantee scheme, and its distribution between internal and external stakeholders of a failed firm, is directly related to the priority in insolvency of insured consumers. More effective targeting of stakeholder preference arrangements could be analysed.

There is merit in exploring the question of whether the State-based insurance regulatory framework could move towards a national approach over time.

An associated issue is what general rules or principles might need to be satisfied before any guarantee could extend to products associated with statutory classes of State insurance.

It may be possible for administration of the existing compensation arrangements under Part 23 of the *Superannuation Industry (Supervision) Act 1993* (covering fraudulent conduct and theft) to be vested in any independent body administering a guarantee scheme.