CHAPTER 1: INTRODUCTION

1.1 The Royal Commission (the Commission) established to examine the circumstances surrounding the failure of the HIH Group of Companies (HIH) reported to Government in April 2003.

1.2 In his report, Justice Neville Owen recommended that the Australian Government introduce a scheme to support policyholders of general insurance companies in the event of the failure of any such company (Recommendation 61).[1]

1.3 On 12 September 2003, the Treasurer announced the Government's final response to the recommendations of the Commission. In regard to Recommendation 61, the Treasurer noted that the appropriateness of government intervention following financial institution collapses should be considered in terms of its financial system-wide impacts and the consequences for the regulatory framework. He added that the precise design of any support or guarantee arrangements for persons affected by the failure of financial institutions, incentive properties and associated financial costs warranted close consideration.

1.4 These are all complex matters. With that in mind, the Treasurer announced that the Government would commission an independent and comprehensive Technical Study, led by Professor Kevin Davis, to examine the issues. The Study was undertaken in accordance with the Terms of Reference set out at Appendix 1.1.

1.5 The Study was undertaken by Professor Davis with assistance from the Australian Prudential Regulation Authority (APRA), the Reserve Bank of Australia (RBA) and The Treasury. However, this Study should not be assumed to reflect the views of the Australian Government or any of the agencies that offered assistance.

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1 The Failure of HIH, Volume 1 A corporate collapse and its lessons, The HIH Royal Commission, April 2003, p lxxv.

Conduct of the Study

1.6 The Study drew extensively on the large volume of academic and other literature available on financial sector guarantees; reviewed the nature of, and experience with, schemes which operate in (most) other developed economies; and consulted extensively with stakeholders and experts in the field, both in Australia and overseas. The Study also benefited from the views expressed in a number of public submissions received from interested parties. A brief summary and lists of submissions received and of persons and organisations consulted in the course of the Study are at Appendix 2.2.

1.7 To assist in the conduct of the Study, the following public policy objectives were identified as relevant to assessing the appropriateness or otherwise of adopting an explicit financial sector guarantee in Australia:

- to promote an appropriate spectrum of risks and rewards in the financial system, both within and across sectors, and maintain incentives for self-management of risks;
- to promote transparency and clarity about the risks associated with promises made by financial institutions and provide for adequate consumer protection;
- to limit or effectively manage the financial exposure of government/taxpayers to financial institution failure;
- to ensure a regulatory structure which facilitates efficiency and competitive neutrality in the financial system; and
- to promote system stability, including through effective management of 'moral hazard' and of financial institution failure.

1.8 The extent to which adopting explicit guarantee arrangements may enhance or detract from achieving these policy objectives is likely to be critical to determining the future position of the Government on the issue. Of course, the pursuit of these objectives underpins the existing financial sector regulatory framework in Australia and in other countries. The essential issue that this Study explores, therefore, is the extent to which explicit guarantees might offer limited 'safety net' support to the core regulatory framework. Implications for changes to the regulatory framework are also considered.

Context of the Study

Financial System Inquiry findings

1.9 The 1997 Financial System Inquiry (FSI) provided a comprehensive assessment of policy measures necessary to enhance the safety, efficiency and competitiveness of Australia's financial system. Its report, which was generally embraced by the Government, provided the blueprint for the ongoing reform of Australia's financial system.

1.10 One critical element of the FSI relevant to this Study was its finding 'on balance, that the benefits of a scheme of deposit insurance are not considered strong enough to warrant its introduction'.[2]

1.11 Another key finding, expressed in relation to the philosophy of regulation, was that 'Governments should not seek to impose safety regulation across the entire financial system. The assurance provided by prudential regulation should not extend to a government guarantee of any financial promises.'[3]

1.12 The recommendations of the FSI have provided the basis for ongoing reform of Australia's financial system. The FSI recommended a principles-based model for reforming and modernising Australia's regulatory framework, balancing safety, efficiency and competition.

1.13 The design of this framework has been improved over time to embrace modern regulatory practice and to reflect developments in the constantly evolving financial system. As is common elsewhere, Australia's prudential framework is anchored by prudential regulation and complemented by a limited 'safety net' (notably depositor/policyholder preference arrangements). A perspective on the interaction between prudential regulation and safety net arrangements is given in Box 1.1. (Appendix 2.1 provides an overview of Australia's financial system structure.)

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2 Financial System Inquiry Final Report, March 1997, p. 298. The FSI appeared to consider a United States-style deposit insurance model in greater detail than possible alternative models of deposit insurance, and did not appear to consider the potential applicability of guarantee schemes to the insurance sector.

3 Financial System Inquiry Final Report, March 1997, p. 175.

Box 1.1: Prudential regulation and financial safety nets[4]

Berger, DeYoung, Genay and Udell (1999) describe the interrelationship between financial safety nets and prudential regulation in the following way:

'Governments typically provide a safety net for at least some of their nations' financial institutions, which absorbs some of the losses or provides liquidity in the event of the failure or distress of the institutions. The safety net may include deposit insurance, unconditional payment guarantees, access to the discount window, help in arranging private-sector funding or M&A [merger and acquisition] partners, forbearance, or other explicit or implicit government guarantees.

It is often argued that the safety net provides moral hazard incentives to take on more risk than would otherwise be the case, and that this incentive to risk-taking becomes stronger as an institution's equity capital or charter value gets very low (for example, Merton 1977, Marcus 1984, Keeley 1990). However, prudential regulation/supervision works in the opposite direction, imposing costs on risk-taking and giving incentives for value maximizing institutions to reduce risk to avoid penalties.

Prudential regulations designed to deter risk-taking include risk-based capital requirements, risk-based deposit insurance premiums, prompt correct action rules and legal lending limits. Prudential supervision includes regularly scheduled examinations backed by threats of cease-and-desist orders, withdrawal of deposit insurance, closure, limits on growth and prohibition of dividend payments.'

What has happened since the Financial System Inquiry

1.14 The failure of HIH and other failures that preceded it, have demonstrated that financial hardship almost inevitably results in public demand for governments to provide some compensation for losses suffered. Australian and State government decisions to compensate some policyholders of HIH, and government responses to other recent failures, raise questions

4 Some commentators use the term 'safety net' more broadly to encompass prudential regulation.

about whether in Australia there now exists an 'implicit guarantee'[5] of some financial promises extended by financial institutions, especially those of institutions which are APRA-regulated. More generally, it can be asked whether many retail customers of those institutions fully understand the limits to protection provided by the prudential framework and thus act as if there were implicit guarantees in place.

1.15 Amongst its Organisation for Economic Cooperation and Development (OECD) counterparts, Australia is distinguished by not having an explicit guarantee scheme for deposits as part of safety net arrangements. Fewer countries have explicit guarantee schemes in place for other products offered by prudentially regulated financial institutions (such as life insurance companies, general insurance companies and superannuation funds or their equivalents), although such schemes are growing in number.

Examining the rationale for change

1.16 Governments are likely to continue to face difficult choices in the wake of financial failures, unless it is believed that a credible *caveat emptor*[6] policy can, and will always, be pursued. This may be a sensible starting point for considering policy options available to Government. However, a reasonably broad base of community understanding of financial risks associated with mainstream financial institutions and products would appear necessary to support a credible *caveat emptor* policy — unfortunately, many consumers are not well-placed to assess counterparty/agent risk.

1.17 Given this, one option is for governments to respond in case-specific, 'discretionary' ways to mitigate the consequences of financial institution failure. A concern is that uncertainty as to the timing and scale of any response may lead to unrealistic community expectations about interventions aimed at resolving failure and protecting consumers. Another alternative is to establish an explicit framework which lays out mechanisms for dealing with such events, and identifies the limits of protection beyond which a credible *caveat emptor* policy can reasonably be followed. Even that approach, however, is

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5 The term 'implicit guarantee' refers to a situation where a government operates with an unstated practice, or succumbs to pressure to provide assistance in the event of failure even though it may claim it will never do so. An 'explicit guarantee', on the other hand, would involve a pre-determined level of assistance. In compiling a database of deposit insurance practices worldwide, Demirguc-Kunt and Sobaci (2001) assume that any country without an explicit scheme has an implicit or de facto scheme. The term 'discretionary response' might be equally applicable.

6 The axiom or principle in commerce that the buyer alone is responsible for assessing the quality of a purchase before buying (source: www.dictionary.com).

complicated by the problems which can emerge when failures are not isolated events or are of sufficient scale or breadth to threaten systemic stability.

1.18 The purpose of this Study is to present a balanced framework in which the general arguments in favour of, and against, limited explicit guarantees in Australia's financial system can be considered.

1.19 This Study identifies a number of central themes relevant to considering the issues.

- The existing regulatory framework serves to reduce the probability and consequences of a financial institution's failure. The framework is not intended to prevent the failure of a financial institution; however, its existence may be the kernel of community expectations of government assistance in the event of failure. Any explicit guarantee should require prudential supervision of the covered institutions. Therefore, the Study considers the issue only in relation to APRA-regulated institutions rather than contemplating changes in the coverage of prudential regulation.

- For a number of reasons, the existing regulatory framework provides uneven consumer protection across firms and industry sectors. In the event of a failure, this may prove to be inconsistent with community expectations and perceptions of fairness.

- The failure of a financial institution resulting in losses to consumers is a hopefully rare, but inevitable, event in a competitive market. Financial institution failures will often have far-reaching consequences. A limited, explicit guarantee would be one means of mitigating some of the consequences for some consumers. It could serve to mitigate losses, provide more rapid restitution than the insolvency process and provide governments and regulators with the benefit of drawing upon a better-defined, pre-determined response to failures.

- APRA-regulated financial institutions typically provide a range of retail financial products, broadly classified as deposit, insurance and superannuation products, that could be considered necessary for participation in a modern economy. The relative importance of these financial products to individuals varies across the spectrum of products on offer and according to a number of demographic factors. The range of products which might appropriately be covered by a guarantee is limited. The Study examines some principles that might be used to determine coverage of any guarantee.

1.20 Also relevant for a decision on whether to implement an explicit guarantee is the likely cost of a scheme, its pricing, governance arrangements and implications for the existing prudential framework.