



INTERNATIONAL  
BANKS AND SECURITIES  
ASSOCIATION OF AUSTRALIA

## **Submission to the Department of the Treasury**

### **Study of Financial System Guarantees**

**9 December 2003**



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## **Executive Summary**

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

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

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

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

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## 1. Introduction

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

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

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

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

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

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

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

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<sup>1</sup> Financial System Inquiry, Final Report (Chapter 8).

## 2. Existing Regulatory Safety Net is Satisfactory

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

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

### *Australia is Well Served by the Existing Arrangements*

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

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

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

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

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

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

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

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

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

### *An Evolving Framework*

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

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

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

### *No Weakness for Deposit Insurance to Cover*

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

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

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

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

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

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

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

#### *Moral Hazard*

The concept of moral hazard in the context of deposit insurance is well understood<sup>4</sup> – the more investors are protected from risk, the riskier their behaviour is likely to become as they know they will be rescued from the consequences of their mistakes. In short, deposit insurance weakens the normal risk-reward relationship that is fundamental to rational decision making in financial affairs by depositors.

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

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

#### *Deposit Runs and Wholesale Depositors*

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

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

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<sup>4</sup> See for example, Basle Core Principles for Effective Banking Supervision, Appendix II.

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

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

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

### *An Increase in Regulatory Capital*

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

### *A New Risk Exposure for the Government*

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

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

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

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

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

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

#### *Spillover of Retail Regulation into Wholesale Markets*

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

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

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

#### **4. Scheme Design**

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

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

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

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

- *Funding method* - Overseas schemes operate by either collecting a premium from banks based on a percentage of assets and building a pool of funds to repay deposits should the need ever arise; or by imposing a levy on banks in the event of a failure. The first approach entails costs for banks, and their customers, for a purpose that may never be realised. The second raises the spectre of unknown future liabilities for banks and their customers for which some provision would need to be made, again tying up capital unproductively. In the event of a failure, the failed institution would have made no contribution to the cost of protecting its customers with that burden falling on better-managed institutions.
- *Coinsurance* – To reduce the risks posed by a weakening of market discipline and the cost of the associated moral hazard, it would be necessary for the scheme to include an element of coinsurance by depositors; that is depositors would only be covered for a maximum percentage of their deposits. Thus, retail depositors might not receive full protection for their deposits.
- *Range of liability coverage* – Assuming that protection would be afforded to bank deposits rather than total bank liabilities, it would be unrealistic to protect all \$600 billion in deposits. A judgement will have to be made about the scope of the scheme, including the range of deposits covered and matters like the treatment of non-resident depositors. In this context, IBSA is of the strong view that wholesale deposits should be excluded from a deposit scheme, as outline above.
- *Claim limits* - The Government will have to set a claim limit which is likely to be modest given the scheme would be starting from scratch. This would entail political judgements on whose deposits would be fully protected.
- *Size of the insurance pool* - There would still be difficult questions to answer, even if the scope were to be limited to retail deposits. For instance, should the size of the pool of funds and associated premiums be set at a point that would cover the collapse of a major bank or a regional bank or a credit union? Why should depositors in one type of institution be more protected than depositors in others?
- *Cross-subsidies* - If inefficient and discriminatory cross-subsidies are to be avoided, the government would have to set different premium rates according to the risk rating of the type of deposit between institutions. Risk rating for deposit insurance purposes is untested<sup>8</sup> and could send signals to depositors and possibly have the effect of undermining confidence in institutions with a higher risk rating – defeating the purpose of depositor protection. On the other hand, if universal premium rates were to apply, the system would penalise strong and well-managed institutions (and their customers) and favour weaker and less well-managed ones.
- *Customer cost* - Under the user pays principle, the cost of deposit insurance will be passed on to customers. It is doubtful they would see value in paying more for an extra, unnecessary layer of protection, which may cover only part of their deposit.

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

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

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

## **6. Conclusions**

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

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

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

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

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

## **Attachment – About IBSA**

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

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