

Terms of Reference

Background

In contrast to many other countries, Australia's financial regulatory framework does not include an explicit guarantee over the deposit or insurance policy liabilities of financial institutions.

The 1997 Financial System Inquiry was not in favour of a government guarantee over any part of the financial system. It believed that the benefits of *deposit insurance*¹ were not considered strong enough to warrant its introduction in light of Australian *depositor preference*² arrangements. The two arrangements are, however, not mutually exclusive.

In broad terms, the Inquiry favoured depositor preference arrangements, believing that they provided a stronger level of consumer and systemic protection, superior behavioural incentives and a preferred means of managing failure. The Inquiry also identified that, from international experience, poorly designed guarantees were probably worse than not having one at all.

While deposit insurance schemes are common in developed countries, far fewer have implemented such arrangements for insurance policyholders and other investors. Where they have, such schemes are generally targeted towards life insurance and annuity products.

The Government has supported the development of a safe and efficient financial system by implementing path-breaking reforms to the prudential regulation and corporate governance frameworks. Underlying these frameworks is the principle that the health of a financial institution, and its capacity to meet its promises, is primarily the responsibility its board and management. Prudential regulation and market discipline reinforce this responsibility.

The Government cannot, and should not, be responsible for the financial promises of these institutions. The Government recognises, however, that when failures occur the community can suffer extreme financial hardship. At the time of the collapse of HIH, the Government moved quickly to establish a support scheme.

Reasons for Commissioning the Study

The final report of the HIH Royal Commission, prepared by Justice Neville Owen, recommended that "the Commonwealth Government introduce a systematic scheme to support the policyholders of insurance companies in the event of the failure of any such company" (Recommendation 61).

The Government considers that the appropriateness of such arrangements needs to be considered in terms of their possible financial system-wide impacts and consequences for the design of the regulatory framework. Moreover, the precise design of any

guarantee, its incentive properties and its associated financial costs warrant close consideration.

The Government has decided to commission a technical study to consider the merits of introducing an explicit guarantee of part or parts of the Australian financial system and the merits of possible coverage and design options. At this stage, the Government has not made a decision whether any form of guarantee should be implemented in the Australian context.

Scope of the Study

The Government requests that the following issues be addressed by the technical study, drawing upon relevant international experiences:

- a. the economic rationales for and against explicit guarantees over certain retail financial products including the implications of explicit guarantees for financial stability and private incentives for monitoring the financial health of financial institutions;
- b. the implications of introducing a limited explicit guarantee for the general design of the Australian prudential framework and any existing compensation mechanisms (eg. state-based arrangements);
- c. the consequences of a financial institution's failure (which may vary by the sector or sectors in which it operates and the kinds of products that it offers) and the current level of consumer protection provided by the Australian prudential framework;
- d. the merits of possible guarantee design variables (whether or not a scheme appears warranted) including general and sectoral applications, private underwriting, product application, capping, benefit limits and co-insurance arrangements;
- e. the potential cost of a guarantee and the impact of key design variables on the cost;
- f. funding arrangements, exploring pre-and post-funding, public funding, industry funding, consumer funding, and co-funding models (and the possibility of purchasing financial reinsurance cover for any guarantee);
- g. governance and accountability arrangements, including the relationships between the various functions (eg. claims assessment, investment management, prudential regulation) and other arms of government; and
- h. other matters considered relevant.

The purpose of preparing the technical study is to provide a balanced analytical framework against which interested parties can consider the issues and formulate their views. It is not intended to result in specific recommendations to Government at this stage.

Following receipt of the report, the Treasury will conduct a public consultation process on possible policy options.

Key Dates

The consultant is required to provide a final report to the Treasurer by 26 March 2004.

¹ Using pre-paid contributions, public or industry funding to meet unpaid deposit liabilities of a failed bank.

² Liquidating the assets of a failed bank to meet depositor liabilities above all other liabilities.