16 December 2003

Professor Kevin Davis
Chair
Study of Financial System Guarantees
c/- Department of the Treasury
Langton Crescent
PARKES ACT 2600

Dear Professor Davis

Thank you for meeting with us in Sydney recently and for the opportunity to comment on the issues being considered by the Study of Financial System Guarantees.

Please find attached our comments on the technical aspects of financial system guarantees. We have limited our comments to the protection of depositors within the banking services system – this is not a reflection of any view about the potential importance of financial system guarantees outside of the banking system, but merely a reflection of our expertise.

In summary, CUSCAL makes the following comments:

- the technical review of financial system guarantees is welcomed;
- Authorised Deposit-Taking Institutions (ADIs) in Australia operate in a highly regulated environment and are prudently managed;
- credit unions have a strong history in successfully safeguarding member deposits;
- a clear rationale must be developed for the introduction of any deposit insurance scheme – that rationale must analyse the effectiveness of the existing regulatory framework, highlight any gaps in that framework that may put depositors funds at risk and consider whether a deposit guarantee scheme is the most effective (from cost and other perspectives) way to increase protection for depositors (if required);
- the role and impact of industry liquidity support schemes such as CUFSS should be carefully considered, and

- the most significant importance of a deposit insurance scheme would be the promotion of financial sector stability (ie guarding against contagion risk).  If a deposit guarantee scheme is warranted, the design of the scheme should consider:
    - the concentration of the banking sector in Australia and whether any scheme could adequately cover those institutions in the so-called “too big to fail” category, and
    - the pricing of premiums to reflect risk, however that risk must be assessed in terms of the impact of an institution’s failure on financial sector stability. CUSCAL argues that the collapse of small ADIs such as credit unions is unlikely.  Further, any collapse would present virtually no risk to financial sector stability.

CUSCAL believes that the case for a deposit guarantee scheme has not yet been made and therefore we would not support the introduction of such a scheme at this time.

However, we look forward to reviewing the findings of the Study Team next year and would like to work with you in ensuring good outcomes for our credit union members from this important debate.

If you would like to discuss this submission, please do not hesitate to contact either Mark Degotardi (tel: (02) 8299 9053) or myself (tel: (02) 8299 9046).

Yours sincerely

Louise Petschler
Head of Public Affairs

# SUBMISSION TO THE STUDY OF FINANCIAL SYSTEM GUARANTEES

**Credit Union Services Corporation (Australia) Limited**
**December 2003**

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# 1. EXECUTIVE SUMMARY

CUSCAL welcomes the Government's technical review of financial system guarantees and we look forward to the report of the Study Team.

In our view, it is important that the any technical review carefully consider the nature and effectiveness of the existing legal and regulatory environment for Authorised Deposit-Taking Institutions (ADIs). In particular, CUSCAL makes the following comments:

- ADIs in Australia operate in a highly regulated environment and are prudently managed;
- credit unions have a strong history in successfully safeguarding member deposits;
- a clear rationale must be developed for the introduction of any deposit insurance scheme – that rationale must analyse the effectiveness of the existing regulatory framework, highlight any gaps in that framework that may put depositors funds at risk and consider whether a deposit guarantee scheme is the most effective (from cost and other perspectives) way to increase protection for depositors (if required);
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However, we look forward to reviewing the findings of the Study Team next year and would like to work with you in ensuring good outcomes for our credit union members from this important debate.

If there are any questions in relation to this submission, please contact **Mark Degotardi, Senior Adviser, Policy and Public Affairs, Industry Association, CUSCAL on (02) 8299 9053 or mdegotardi@cuscal.com.au .**

# 2. OVERVIEW

The Credit Union Services Corporation (Australia) Limited (CUSCAL) is the representative body for 158 of the 180 credit unions in Australia. Credit unions play an essential role in Australia's financial services sector, providing banking and financial services to more than three and a half million members, and offering a genuine and community based alternative to the major banks.

Credit unions in Australia:

- are the main financial institution for 9% of the population;
- are mutuals, where members own the credit union in which they are customers;
- are focussed on delivering benefits to members and a common set of values and ethics which govern credit union operations; and
- have strong records of protecting depositors' funds;
- continually report strong service outcomes – research in 2003 showed more than eight out of ten members rated satisfaction with their credit union as "excellent" or "very good" compared with less than four in ten customers of major banks.

# 3. ESTABLISHING THE RATIONALE FOR A DEPOSIT GUARANTEE SCHEME

## 3.1 The Study of Financial System Guarantees

Whilst CUSCAL notes that the Government has requested the Study Team to undertake a technical review of explicit guarantee mechanisms across the financial sector, the comments in this submission are restricted to the issues surrounding the introduction of any scheme to guarantee deposits taken by ADIs including credit unions.

CUSCAL is supportive of the Government's decision to establish a review of financial system guarantees. It is important that an open and robust debate occur on this issue, particularly in light of the impact of the failure of HIH on consumers, policyholders and taxpayers.

CUSCAL believes that the Study Team should seek to establish whether there is a clear and defendable rationale for the introduction of a scheme to guarantee deposits in Australia. If a scheme is supportable, then the Study Team should consider what characteristics such a scheme might have in the Australian context and then consider the costs and benefits of each of these design elements.

In this context, CUSCAL believes that any policy decision on financial system guarantees should be cautiously made having regard to the risk of financial institution failure to consumers and the economy, the effectiveness of the current system of consumer protection and prudential regulation and the likely costs of any guarantee mechanism.

### 3.2 What does deposit insurance do?

*"The principal objectives of a deposit insurance system are to contribute to the stability of a country's financial system and to protect less-financially-sophisticated depositors from the loss of their deposits when banks fail."*[1]

This was the view of the Financial Stability Forum (FSF) in 2001. Interestingly, the FSF noted that the first step in establishing a deposit insurance system was to specify *"appropriate public-policy objectives"*[2] and that a number of factors should be taken into account, including:

- the state of the economy;
- current monetary and fiscal policies;
- the state and structure of the banking system;
- public attitudes and expectations;
- the strength of prudential regulation and supervision;
- the legal framework, and
- the soundness of accounting and disclosure regimes.

It is important to recognise that the most significant role of deposit insurance is not to protect depositors in the case of the failure of their financial institution, but to reassure depositors in the event of the failure of other financial institutions, that is, to prevent or ameliorate contagion risk.

This approach, which is supported by the Canada Deposit Insurance Corporation (CDIC)[3], is predicated on the view that financial institutions are regarded as so important to the effective operation of the financial system (and their failure so damaging) that financial support should be provided for institutions (or deposit protection for their customers) when the institution encounters difficulties. This approach seeks to promote confidence in the financial system by protecting the system against systemic risk. Additionally, deposit insurance schemes may have the effect of dispelling an implicit perception that the government guarantees deposits – this was one of the primary concerns of the Wallis Inquiry.

If the protection of financial system stability is accepted as the prime role of a deposit guarantee scheme, CUSCAL believes the Study Team should consider what the contagion risk might be. Again, CUSCAL does not have sufficient economic expertise to adequately assess this risk, although there is a range of published material on contagion risk based on the US experience of bank failure. For example, an article appearing in the Journal of Economics and Finance entitled *FDICIA and Bank Failure Contagion: Evidence from the Two Failures of First City Bancorporation*[4] suggests that the extent of contagion is dependent on the size of the failing institution and the nature of the causes of failure (eg through fraud and mismanagement or through external economic factors). It also suggests that

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[1] *Guidance for Developing Effective Deposit Insurance Systems,* Financial Stability Forum, September 2001, p3
[2] ibid, p3
[3] *Taskforce on the Future of the Canadian Financial Services Sector,* Discussion Paper, 1997, http://finservtaskforce.fin.gc.ca/disce/discuss.htm
[4] *Bank Failure Contagion: Evidence from the Two Failures of First City Bancorporation,* Weignand, Fraser and Baradwaj, Journal of Economics and Finance, Vol 23, Number 1, Spring 1999

contagion may be geographically limited or more common in institutions with similar risk profiles to the failed institution.

Accordingly, CUSCAL suggests that the Study Team consider the factors that influence the risk and extent of contagion within the financial sector, in addition to economic and regulatory factors outlined by the FSF in the Australian context.

### 3.3 The Australian regulatory and legal framework

Authorised Deposit-Taking Institutions (ADIs) operate in an extremely regulated environment. Since the Wallis reforms, all ADIs operate in a harmonised prudential environment under the supervision of the Australian Prudential Regulation Authority (APRA) – this means that credit unions meet the same requirements under the *Banking Act 1959* as other ADIs such as banks and building societies. All ADIs currently comply with the international capital accord known as the Basel Accord and APRA has indicated that all ADIs will be subject to the revised capital accord, Basel II.

Further, ADIs are also subject to regulation by the Australian Securities and Investments Commission (ASIC) under the *Corporations Act 2001* which includes the extensive reforms under the Financial Services Reform (FSR) regime. In addition, listed ADIs are subject to the various compliance and disclosure requirements of the Australian Stock Exchange.

A number of other players have a role in regulating ADIs in one form or another, including the Reserve Bank of Australia (RBA), the Australian Competition and Consumer Commission (ACCC) and various levels of Government in terms of consumer credit and fair trading. In addition, all ADIs also comply with the accounting standards set down by the Australian Accounting Standards Board (AASB) and will comply with the International Accounting Standards (IAS) when they are introduced in 2005.

Accordingly, it is clear that on the basis of the factors set down by the FSF (listed above), Australian ADIs operate in a highly developed and effective legal and regulatory framework. Given the soundness of this environment, CUSCAL suggests that it is necessary to clearly define what role a financial guarantee mechanism for deposits might be expected to play in Australia. Providing the required technical information should be a key role for the *Study of Financial System Guarantees*.

### 3.4 Is failure of financial institutions likely?

Credit unions have an extremely sound history of protecting depositors' funds. This is not to say that credit unions are without risk; all financial institutions present some level of risk.

However, there are some unique characteristics of credit unions that make failure of individual credit unions less likely. First among these is the fact that credit unions are mutual and therefore are less likely than other ADIs to be exposed to imprudent risk-taking behaviour by their management or moral hazard concerns (which is discussed below). Providing member value, not shareholder returns, drives credit unions, therefore it is arguable that credit union management and directors are less likely to be exposed to those pressures that may encourage risk-taking behaviours.

In addition, credit unions generally have less complex business lines, they typically do not invest internationally and have extremely low levels of commercial lending. These commercial attributes operate to limit the exposure of credit unions to large losses that can accrue from commercial failures or international exposures.

CUSCAL affiliated credit unions are also members of the APRA endorsed Credit Union Financial Support Scheme (CUFSS). CUFSS is a liquidity support scheme that protects the interests of credit union depositors and promotes the stability of the credit union sector. CUFSS monitors individual credit unions to identify, detect and track significant risk exposures in a range of areas.

CUSCAL believes that the loss of depositors' funds as a result of the failure of a credit union is unlikely for three reasons as follows:

1. credit unions are ADIs and subject to full harmonised prudential regulation;
2. the role of CUFSS in promoting sector stability and guarding against individual institution failure, and
3. the protections of the depositor priority provisions under the *Banking Act 1959* apply to credit unions (as well as to other ADIs).

Additional advantages accrue to those credit unions affiliated with CUSCAL. These credit unions benefit from the increased earnings and cost savings resulting from the aggregated service delivery model provided by CUSCAL. This allows affiliated credit unions to compete effectively in the marketplace and contributes to the overall financial stability of affiliated credit unions.

As a result, the loss of credit union depositor funds continues to be extremely low.

There are others better placed to measure the risk of failure in other ADIs. However, the greatest risk to credit unions resides in the potential impact on financial sector stability from the failure of ADIs outside the credit union sector.

The question for the Study Team is, therefore, whether any real threats to financial institutions exist and whether a system of financial guarantees would be effective in ameliorating the impact of financial institution failure on financial sector stability.

### 3.5 The Wallis Inquiry

The Wallis Inquiry considered the issue of deposit insurance less than a decade ago and concluded that it was *"not convinced that such a scheme would provide a substantially better approach or additional benefits compared with the existing depositor preference mechanism."*[5]

Does the failure of HIH alter this view? Clearly, CUSCAL acknowledges the widespread impact of the failure of HIH. However, it is not clear that some form of

[5] Final Report of the Financial System Inquiry, p355 available at http://fsi.treasury.gov.au/content/FinalReport.asp

explicit guarantee mechanism for policyholders would have had any ameliorating effect on the systemic impacts of that collapse. Certainly, individual policyholders with ongoing or pending claims may have been better served in the short term if they had access to financial guarantees. However, it is not clear that the wider impacts (eg the collapse of the building insurance market) would have been avoided. Nor is it certain that the actions of various Governments in the wake of the collapse (such as the Commonwealth's HIH Claims Support Scheme) were less efficient than any formal mechanism that could now be established. Indeed, it is arguable that only Governments in Australia would be in a position to respond to a collapse of such magnitude.

Would a system of financial guarantees have provided any incentives within HIH to behave differently and therefore avoid failure? This seems unlikely. Justice Owen attributed the failure of HIH to a calamitous range of issues including poor management, under reserving, appalling corporate governance and accounting procedures, some poor practices by APRA, lack of independence of external advisers and possible individual misconduct.[6]

The Government has acted quickly to respond to the recommendations of the HIH Royal Commission – this Study is an example of that. Changes at APRA and other legislative and remedial actions are in place or underway. CUSCAL is not an expert in the field of insurance and hence will leave commentary on the effectiveness of these changes to others. It is important to note, however, that the plight of depositors and insurance policyholders in the event of institutional failure is completely different, insofar as the potential extent (and in certain cases unknown quantity) of the losses, the timeframes in which loss can occur or be realised and the way in which depositors are already protected under the legislative framework now in place.

Therefore, any discussion of a system of financial guarantees should assess:

- any differences in the effectiveness of the existing regulation of ADIs and other types of financial institutions (including insurance companies, superannuation, etc); and
- the nature and extent of potential losses of depositors as against policyholders or other investors in financial institutions.

CUSCAL strongly believes that it is critical that a clear and defendable rationale for a deposit guarantee system is established before the various elements of any mechanism are considered.

At this time, CUSCAL believes that no such rationale has been identified.

### 3.6 Concentration within the banking sector

An additional concern relates to the issue of concentration within the banking sector in Australia. As noted by the FSF[7], *"in a concentrated system the capacity of a deposit insurance system to fund or cope with the failure of a large and complex bank may be problematic."*

[6] *The Failure of HIH Insurance*, Justice Neville Owen, Volume 1, pp xiii - lxiii
[7] *Guidance for developing effective deposit insurance systems*, op cit, p13

Clearly, despite the diversity and choice offered by credit unions in Australia, the banking sector should be regarded as highly concentrated. According to the RBA, as at the September quarter for 2003, there were approximately $625 bn[8] in deposits held by Australian ADIs. Of this amount, less than $24 bn was held by credit unions with approximately $187 bn[9] (nearly 30%) held by the National Australia Bank alone.

Accordingly, the capacity for any system of financial guarantees for deposits to cope with the failure of our largest banking institutions needs to be considered carefully.

### 3.7 Existing Liquidity Support Schemes – the role of CUFSS

As the Study Team may be aware, credit unions affiliated with CUSCAL have established a self-regulatory system – the Credit Union Financial Support System (CUFSS) – as an additional protection for depositors.

CUFSS is an industry funded and operated liquidity support scheme certified by APRA under s11CB of the *Banking Act 1959*. CUFSS' objectives are to protect the interests of credit union depositors and to promote financial sector stability, particularly in relation to credit unions. The system involves a range of support and advisory services for participating credit unions. CUFSS monitors member credit unions to identify, detect, gauge and track significant risk exposures in the following areas: Liquidity Risk; Market Risk; Operations Risk; Credit Risk; Data Risk; and other special risks.

As an industry support vehicle, this supervision is independent from, and additional to, that undertaken by APRA. Credit unions participating in the system are required to enter into an Industry Support Contract (ISC) which sets out their obligations, rights and responsibilities. The contract between credit unions, CUFSS and CUSCAL is certified by APRA under the *Banking Act 1959*. APRA is empowered to enforce compliance of all participants to the contract.

Credit union participation in CUFSS and the continuance of an industry support scheme continue to provide a valuable additional protection to credit union depositors. In addition to the certification of the ISC under the *Banking Act 1959,* APRA has confirmed that it recognises membership in the industry support scheme as a factor taken into account in the formal capital requirement setting for ADIs.

*CUFSS Objects and Functions*

CUFSS is a special purpose company limited by guarantee, funded and supported by credit unions**.** ***CUFSS'*** primary objects are to:

- protect the interests of members of credit unions; and
- promote financial sector stability.

[8] Reserve Bank of Australia, Statistical table B03 available at http://www.rba.gov.au/Statistics/Bulletin/B03hist.xls

[9] National Australia Bank, 2003 Annual Report, p49 available at http://www.nabgroup.com/vgnmedia/downld/NABFullFinancials03wCover_FINAL.pdf

CUFSS key functions are to:

- administer the industry support system;
- monitor credit union liquidity;
- assist in the orderly exit of credit unions;
- advise about liquidity and risk management;
- investigate and assess credit union liquidity support needs;
- decide whether to offer financial support and terms.

Liquidity support extended directly to credit unions by CUSCAL, through loan, standby and overdraft facilities continues to be assessed and provided by CUSCAL as part of the normal operations of CUSCAL.

In the rare circumstances where a credit union requires support beyond that available from CUSCAL, CUFSS can determine that such support be provided directly from the balance sheets of all participating credit unions. This decision is based on CUFSS review and circumstances, and is not a guarantee of support.

CUFSS has the capacity to decide whether the support is in the form of a market rate loan, a concessional loan or a permanent loan (the latter category would only be provided in circumstances where a credit union is to merge or transfer).

CUFSS can provide advice to a credit union before or when deciding to provide financial support. Investigations and monitoring processes are included in CUFSS operations.

CUFSS decides the terms and conditions applying to financial support. CUFSS' determination that support should be provided, if accepted by the 'assisted' credit union, will bind all participating credit unions to contribute.

Conditions applying to the provision of support will be stringent and may require the assisted credit union to appoint an external administrator or cease certain business activities.

*CUFSS Operations*

To date, no credit union has required CUFSS support through a call on the balance sheet of participating credit unions.

CUFSS has, however, conducted reviews and on-site assessments on a number of credit unions, and has established a cooperative relationship with APRA on the monitoring and investigation function which CUFSS performs.

The members of CUFSS have recently approved constitutional amendments giving CUFSS a broader range of supervisory and investigatory powers.

CUSCAL suggests that the role of industry liquidity support schemes be closely considered by the Study Team, both in terms of the need for a deposit guarantee scheme and in setting premiums for such a scheme should it be considered necessary.

# 4. DESIGN ELEMENTS OF A DEPOSIT GUARANTEE SCHEME

## 4.1 Elements of a guarantee for depositors

Notwithstanding our preliminary view that the case for deposit guarantees has yet to be made, CUSCAL believes it is worthwhile to make some observations of some common elements of deposit insurance or similar mechanisms.

A large amount of literature is available on deposit insurance schemes as they operate internationally. The most common desirable elements of deposit guarantee schemes typically include:

- an explicit guarantee limited to non-commercial depositors;
- risk based premiums;
- complementary strong prudential and other regulation;
- universality;
- access to sufficient funding to allow prompt repayment of lost funds, and
- appropriate governance and other structures.

The question of whether the fund should be privately run or run by a Government agency is also clearly a key consideration.

*Limited Coverage*
CUSCAL supports the view that any scheme to guarantee deposits should be limited in nature. The precise quantum of that limit should be subject to further discussion once the desirability of a deposit guarantee scheme is established.

In CUSCAL's view, it is important that any guarantee be limited to a maximum amount per depositor and should exclude non-private and interbank deposits. Limiting the amount of funds guaranteed and extending protection to only a per depositor basis helps to ensure that the scheme is only applicable to small depositors who would normally be unable to adequately monitor a bank's performance (and therefore make sound investment decisions).

One important reason often advanced for the limitation of coverage of deposit insurance schemes is that universal coverage distorts the operation of the market – this is the moral hazard argument in deposit insurance (discussed below).

CUSCAL agrees that it is important to avoid moral hazard in the design of any scheme. In this regard, we note the US Federal Deposit Insurance Corporation's[10] (FDIC) comments regarding the factors to be considered when setting the coverage limit. These factors include:

- ensuring that coverage applies to a depositor not to a deposit with a particular institution;

[10] *Reform of Deposit Insurance – A Report to the FDIC,* Alan Blinder and Robert Westcott, March 2001 available at http://www.fdic.gov/deposit/insurance/initiative/reform.html

- determining what constitutes a "large" depositor versus "small" depositor – this could be determined not by median account balances, but by a determination of the level at which a depositor could be expected to monitor the performance of a financial institution;
- the rules for determining the limitation for coverage – for example, the rules under the FDIC scheme permit coverage for individuals, for individuals and their partners and for the minor children of individuals. This clearly has the potential to significantly distort the intention of the limited coverage; and
- indexation of coverage limits.

*Pre- or Post-Event Funding*

Pre-event funding provides some certainty of cost for members of the scheme and allows the smoothing of premiums over the course of a business cycle. It also ensures that financial institutions that subsequently fail have contributed to the cost of their failure[11], which arguably minimises the moral hazard concern by allocating costs to the beneficiaries of the scheme.

Additionally, it is possible to provide a scheme with the ability to levy members for shortfalls in the fund that might arise after an institution's failure. The impact of such a call needs to be carefully considered, particularly with respect to how it is calculated and its impact on smaller institutions.

In any event, the designers of any scheme need to consider the implications of establishing a fund on which no or limited calls will ever be made. For example, the US National Credit Union Share Insurance Fund (NCUSIF) requires members to maintain 1% of their deposits in the NCUSIF. The NCUSIF is also able to levy a premium on members in the event of a failure. Since 1995, member credit unions have received dividends from the fund and it has not been necessary to charge a premium since 1992.[12]

Whilst it is obviously a positive outcome for credit unions in the US (in that the losses incurred by credit unions are extremely low), the moral hazard impacts of not paying premiums need to be considered. These issues are discussed further below.

*Risk Based Premiums*

One of the most significant arguments used by opponents of deposit insurance schemes is the moral hazard inherent in those schemes. Deposit insurance, no matter how carefully crafted, will always distort market forces and therefore market discipline.

[11] *Guidance for developing effective deposit insurance systems,* op cit, p26
[12] *Fact Sheet,* National Credit Union Share Insurance Fund available at http://www.ncua.gov/about/ncusif.html

Some commentators suggest that one way of reducing the moral hazard inherent in those schemes is to ensure that premiums paid by members are risk based and therefore influence financial institution behaviour.[13] Whilst acknowledging the influence that risk based premiums may have, CUSCAL suggests that three additional issues be considered:

- how the risk may be quantified in setting the premiums – in our view, risk should be calculated according to the risk of institutional failure <u>and</u> the risk that an individual institution's failure poses to the financial system;
- risk based premiums alone will have limited effect – they must be complemented by strong supervision and disclosure policies[14], and
- the desirability of levying higher premiums on financial institution under pressure.

It must be recognised that the costs of any deposit guarantee scheme will have a greater impact on small institutions, including some credit unions. It is critical that this issue be carefully considered because:

- a deposit guarantee scheme should not be introduced at the cost of reducing diversity and choice in an already highly concentrated banking market place, and
- the allocation of costs via premiums must be equitably distributed to ensure that:
  - credit union members do not pay a disproportionate amount compared to customers of other financial institutions, and
  - premiums are allocated according to the risk that a particular institution poses to financial system stability – in the case of individual credit unions, this risk is negligible.

*Complementary Effective Prudential Regulation*

As noted above, CUSCAL strongly agrees with the importance of effective prudential regulation as a complementary feature of any deposit guarantee scheme. CUSCAL urges the Study Team to consider each element of the prudential regime as they act together to regulate financial institutions and to prevent and ameliorate financial difficulties. Any consideration of deposit insurance should also extend to an assessment of the entirety of the prudential supervisory approach.

For example, the Federal Reserve Bank of Minneapolis[15] suggests that a regime that included a deposit insurance scheme with effective market disclosure requirements offers financial institutions a tool for differentiation. These measures enable participants to emphasise financial strength and soundness, while the market continues to exert discipline on institutions. However, a deposit insurance scheme on its own, which is without an accompanying disclosure regime, provides little incentive for financial institutions to make such a case.

However, the starting point must be establishing the rationale for the introduction of a deposit guarantee scheme. If a rationale is established, it must clearly be considered

[13] *Guidance for developing effective deposit insurance systems,* op cit, p28

[14] *Can Risk-Based Deposit Insurance Premiums Control Moral Hazard?,* Economic Quarterly, Federal Reserve Bank of Richmond, Volume 88/2, Spring 2002

[15] *Top of the ninth: Market discipline as bank regulator,* Stern G., Federal Reserve bank of Minneapolis, 1998, http://www.minneapolisfed.org/pubs/region/98-06/top9.cfm

in the context of the “negative” aspects of deposit guarantee schemes, including the cost of such schemes and the impact on market discipline and risk-taking behaviour.

*Universality*
CUSCAL believes that should a deposit guarantee scheme be established, the scheme should apply to protect the depositors of all ADIs on a compulsory basis. However, this would not necessarily preclude the establishment of sub-sectoral funds that could apply to different types or sizes of financial institutions. Sub-sectoral funds may allow the insurers to set different premiums based on the risk to financial sector stability and individual institution risk more easily if, for example, the largest institutions (being those that posed significant threats to financial sector stability) had a separate fund from low risk smaller institutions such as credit unions. However, the additional administrative costs or other issues may make separate schemes inefficient.

CUSCAL suggests that the Study Team consider the equity, efficiency and simplicity of establishing separate sub-sector guarantee schemes.

*Access to Funds and Governance Arrangements*
A clear point made in much of the international literature on deposit insurance schemes is the importance of ensuring that funds from the scheme are made available to depositors quickly. This is considered to be the most effective way of ameliorating the impact of contagion risk. This aspect should be carefully considered in designing any guarantee scheme and when considering how such a scheme should be funded and particularly who funds losses in the event that institutional failure occurs early in the life of the scheme.

It is also clear from international experience that a strong governance and disclosure regime is put in place should a deposit guarantee scheme be introduced. Whilst supporting this view, CUSCAL highlights the extensive governance and disclosure requirements already in place (and, in some cases, on the way) for ADIs. Any requirements of a deposit guarantee scheme should not unnecessarily add to the significant compliance burden already faced by ADIs.

### 4.2 Possible effect of deposit insurance on behaviour

Some critics of deposit insurance schemes suggest that these schemes can contribute to financial failures by artificially propping up trouble institutions thereby exacerbating the impact of financial failure on the financial sector. Others suggest deposit insurance schemes add needed confidence to the financial system by providing depositors with certainty.

*Moral hazard*
There is an inherent paradox associated with deposit insurance schemes, which is that by making financial institutions safer for individual depositors, the financial system as a whole may be rendered less secure. This is because it may be that where an individual depositor is insured against loss, this may lessen that insured’s incentive to act to prevent or minimise loss from occurring. This moral hazard may arise in connection to deposit insurance because depositors are relieved of the need to pay close attention to the safety of their institution, which in turn alleviates the

pressure of market discipline on those institutions. This market pressure would usually operate to prevent financial institutions from engaging in unsound practices[16]. That is, a deposit insurance scheme could end up providing assistance to those financial institutions engaging in reckless activities, at the expense of other institutions and the will of the market.

In these circumstances, deposit insurance schemes may shift the burden of ensuring financial institutions make considered decisions (that do not expose deposits to unnecessary risk) from financial institutions and to the scheme fund and ultimately onto regulators and governments that administer or supervise the scheme. In these circumstances, deposit institutions would be risk-free in the eyes of the public, disrupting the working of the market. This appears to have been the view of the Wallis Inquiry , which asserted that *government should not provide an absolute guarantee in any area of the financial system*[17].

CUSCAL suggests that the Study Team should consider what the potential moral hazard risks might be if a deposit insurance scheme were to be introduced in Australia. Generally, CUSCAL believes that the extent of this risk may be dependent on the regulatory regime within which the deposit insurance scheme operates and, in particular, the design of any scheme.

## 5. CREDIT UNION DEPOSIT DATA

As requested by the Study Team, CUSCAL has attached some data on deposits held by credit unions as at 30 September 2003. The data is based on a database of approximately 120 credit unions held by CUSCAL. The table (attached as Appendix 1) shows total deposits (by deposit type) across a range of age cohorts together with average account balances by age cohort by deposit type.

It should be noted that the data is analysed on a "per account" not a per member basis. It is possible (indeed likely) that a member would have more than one account.

More complete aggregated data for all credit unions would be available from APRA – unfortunately this information is no longer publicly released.

CUSCAL would be happy to provide further information on credit union deposits where possible.

[16] *The future of deposit insurance: An analysis of the alternatives*, Kuprianov A and Mengle D, Economic Review, Federal Reserve Bank of Richmond, May/June 1989, available at http://www.rich.frb.org/pubs/ereview/pdfs/ER750301.pdf
[17] *Final Report of the Financial System Inquiry*, Chapter 5 available at http://fsi.treasury.gov.au/content/downloads/FinalReport/chapt05.doc