Government Discussion Paper

on Financial System Guarantees

May 2004

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Treasurer's introduction

The final report of the HIH Royal Commissioner, 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).

In response to Recommendation 61, I announced that the Government had decided to commission a Technical Study to consider the general merits and possible design of such a (guarantee) scheme in the Australian financial system. This decision was taken in order to consider guarantees across the prudentially regulated sectors: deposit-taking, life and general insurance and superannuation, rather than in relation to the general insurance sector alone.

The Government considered that the appropriateness of any guarantee scheme needed to be assessed more generally in terms of its possible financial system-wide impacts and consequences for the design of the regulatory framework. Moreover, the precise design of any guarantee scheme, its incentive properties and associated financial costs warrant close consideration.

The Government appointed Professor Kevin Davis, one of Australia's most experienced academics in this field, to lead the Technical Study. Professor Davis' Report provides an independent appraisal of the relevant issues and will serve as a critical resource for those interested parties wishing to contribute to the public discussion of these issues. On behalf of the Government, I would like to thank Professor Davis for his important and comprehensive contribution.

Professor Davis' Report does not make recommendations but concludes that the costs and benefits of adopting a guarantee scheme in Australia appear finely balanced. His Report also catalogues the broad range of issues that would need to be considered in designing any such scheme to suit Australia's circumstances.

Internationally, guarantee schemes have been widely implemented, serving as complements to a country's prudential framework. However, while providing benefits, particularly in reducing the exposure of taxpayers and some consumers in the event of a financial institution failing, they also give rise to potential costs and can weaken private incentives to manage risk.

At this stage, the Government has not decided whether any form of guarantee scheme should be introduced in Australia. The input received through this public consultation process will assist the Government to make an in-principle decision on whether to implement a financial system guarantee scheme and, if so, to determine appropriate design parameters.

The Government believes a decision cannot be made without a clearer understanding of the costs and benefits that would be associated with any guarantee scheme, bearing in mind that the costs may well outweigh the benefits. Further, the Government is interested in receiving public views on the model which might be best suited to Australia's circumstances; and how a limited guarantee might work in practice.

The purpose of this Discussion Paper is to provide all stakeholders with a suggested framework for commenting on the issues raised by Professor Davis in his Report which will in turn assist the Government in making a decision.

The Government welcomes all views on the question of the appropriate government response to financial institution failure as well as suggestions on the design of a guarantee scheme if it was considered desirable to add such a 'safety net' to the existing prudential framework.

The Government's overall objective remains one of encouraging a financial system that appropriately balances financial system safety, efficiency and competitiveness. The diverse needs of the industry and consumers need to be adequately addressed. The system must contain appropriate incentives for participants to manage risk and to bear its consequences. Importantly, the regulatory framework should not entail an open-ended financial commitment from governments or taxpayers.

Whether or not a guarantee scheme is ultimately considered to be in the public interest, the process of engaging in consultation should deepen community understanding of the Australian financial system. I encourage you to participate actively in this public consultation process.

The Hon Peter Costello MP
Treasurer
Parliament House
Canberra

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Introduction

1. This Discussion Paper is designed to highlight the key issues identified in the Davis Report and to focus attention on those questions which would benefit from further consideration in public submissions.

2. Further information on the timetable for submissions and associated processes is provided at http://www.fsgstudy.treasury.gov.au.

Existing policy on financial system guarantees

3. In 1997, the Financial System Inquiry (FSI) reported to the Government on its assessment of the measures necessary to enhance the safety, efficiency and competitiveness of Australia's regulatory framework. The FSI considered the merits of guarantees for deposits and recommended against their introduction.

> 'On balance, the benefits of a scheme of deposit insurance are not considered strong enough to warrant its introduction.'[1]
>
> '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.'[2]

4. At that time, the Government adopted in general the findings of the FSI, including its findings with respect to financial system guarantees.

5. The ***safety net*** supporting the prudential framework includes depositor preference arrangements for authorised deposit-taking institutions (ADIs), the requirement for life insurance statutory funds, priority arrangements for insurance policyholders and compensation arrangements under Part 23 of the *Superannuation Industry (Supervision) Act 1993*.

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1 *Financial System Inquiry Final Report*, March 1997, p. 298.
2 *Financial System Inquiry Final Report*, March 1997, p. 175.

Should the safety net be extended to include a limited explicit guarantee?

6. Australia has a strong regulatory framework and is regarded internationally as a leader in innovative, market-based reform.

7. Improvements to further strengthen the prudential framework have been on-going.

8. The Government has taken a number of steps in recent years to improve the regulatory regime that applies to financial institutions. This includes implementation of the FSI reforms, the Corporate Law Economic Reform Program, revision of the *Insurance Act 1973*, *Financial Sector Reform Act 2001*, and Superannuation Safety legislative amendments along with other discrete financial sector reforms. In addition, following the HIH Royal Commission recommendations, the governance arrangements of the Australian Prudential Regulation Authority (APRA) have been enhanced.

9. Australia's prudential framework balances a desire for efficiency and concern for the safety of consumers and the stability of the financial system. The framework is designed to reduce to very low levels the probability that a financial institution will fail. At the same time, it allows financial markets to operate competitively in a risk/reward environment which encourages efficiency and provides business and consumers with the greatest possible choice.

10. Australia's prudential framework is designed also to facilitate the external management of a financial institution which is in difficulty or threatened with insolvency. Australia's prudential regulators have played a key role in reducing the incidence of failures and managing the smooth exit of troubled institutions.

11. Compared to other countries, Australia has had limited experience with financial institution failure. Financial sector consolidation and evolution have generally occurred through relatively uneventful mergers and well-managed exits rather than by spectacular failures.

12. However, the failure of HIH highlighted the severe consequences of a large scale financial failure for consumers (in this case policyholders), and how failure led to widespread disruptions within the insurance market. Significant financial institution failures may also cause wider disruption to the financial system and the economy as a whole.

13. Well-informed consumers can limit their risk exposure by choosing relatively safer institutions and financial products. Many consumers, however, are not financially sophisticated and not sufficiently well-placed to assess a financial institution's creditworthiness or the soundness of its board's and management's strategic and operational decisions.

14. Where financial institution failures have occurred, pressure has been brought to bear on governments to intervene and offer compensation to consumers. This has particularly been the case where the financial institution is prudentially supervised and where the products, such as at-call deposits or general insurance, are critical to everyday life.

15. The Davis Report examines whether there is merit in adding to the existing ***safety net*** a ***limited explicit guarantee*** for those consumers most affected by the failure of a financial institution.

Possible alternative policy responses

16. The Davis Report outlines a number of possible Government responses to financial institution failure, ranging from a ***caveat emptor***, or no intervention approach, to the introduction of a limited explicit guarantee.

Option A — *caveat emptor*

17. The Davis Report recognises that the Government may take the view that there is not a strong case for an expanded safety net and that any assumed willingness to introduce a safety net could influence, undesirably, the expectations and decisions of guaranteed consumers.

18. Governments could be portrayed as taking this approach in the past, at least as a starting point, in carefully assessing the individual circumstances of particular failures.

19. This may be a reasonable and prudent response, particularly where there is a concern to limit ***moral hazard*** and to protect taxpayer funds.

> *Moral hazard exists when people take risks because they expect they are being protected against a financial loss. This increases the probability of loss.*

Option B — case-by-case, discretionary responses

20. If, however, the Government felt that there was a community expectation of support in the event of the failure of a financial institution it could indicate that it will respond on a ***discretionary***, or ***case-by-case***, basis offering limited assistance to, say, those consumers holding particular financial products who have limited capacity to monitor the performance of the financial institution.

21. A case-by-case, discretionary approach also provides the Government with flexibility to consider the very different nature and scale of possible failures — the failure of a small credit union for example would raise different issues than those following the HIH collapse.

22. The disadvantages of a discretionary approach to the provision of safety net assistance include:

- the possible delay in a Government response;
- the lack of certainty as to who will be eligible for support;
- how the support will be paid for — in the first instance at least, taxpayers will carry the burden; and
- consumer expectations that Governments will step in may create the perception that an ***implicit guarantee*** exists at least for some categories of (and, particularly large/systemically important) institutions.

Option C — limited explicit guarantee

23. An alternative approach would be for the Government to facilitate a ***limited explicit guarantee***.

24. Such a guarantee reduces the extent of losses which consumers could suffer on a limited range of financial products.

An example is deposit insurance — a system in which bank deposits are protected up to a pre-determined monetary limit.

25. These arrangements could be applicable for a limited range of other financial products, including some insurance products.

26. The Davis Report assesses the relative merits of introducing a limited explicit guarantee to parts of the Australian financial system and examines the costs and benefits associated with explicit guarantees.

27. An explicit guarantee provides for a pre-defined framework of support and, ideally, less disruption of economic activity. The possible benefits of an explicit guarantee scheme include:

- providing a ready-made mechanism to address the impact of failures when they inevitably occur;
- providing a clearly defined level of protection and greater transparency as to the extent of assistance;
- potentially providing more rapid restitution for consumers than occurs under the insolvency framework or discretionary compensation arrangements;
- improving competition by removing some of the perceived advantages of larger institutions considered 'too big to fail'; and
- where there is industry funding, offering some protection to the budget (and thereby taxpayers) from exposure to future financial institution failure.

28. Compared to case-by-case, discretionary approaches, a credible explicit guarantee scheme would usually involve pre-determined financing arrangements, including industry financing, which can serve to lessen the burden on the taxpayer.

29. That said, a limited explicit guarantee cannot prevent all of the consequences of the failure of a financial institution — this reflects the uncertainty surrounding the nature, timing and scale of any such failure. Inevitably, there will be stakeholders who suffer following a financial institution failure; delays associated with identifying the remaining net worth and restitution options (if any) of the institution; and delays also in making compensation payments.

30. Moral hazard can exist both when an explicit guarantee scheme is in place or when there is no formal commitment but participants in the financial system believe that, in the event of failure, the government will provide compensation for losses. Accordingly, an explicit guarantee would need to be designed with a view to limiting moral hazard. Of course, a badly designed scheme may exacerbate any moral hazard problems that currently exist.

31. The Davis Report notes that an explicit guarantee may also contribute to the overall stability of the financial system, although this is a welcome consequence rather than a compelling case in support of extending the safety net.

Q1. If a limited explicit guarantee were introduced, what implications might this have for the safety, efficiency, and competitiveness of the Australian financial system?

Q2. Comments are invited on what general approach government should take to reduce the consequences for consumers of financial institution failure:

A *caveat emptor* — a response that insists that customers and other stakeholders should bear the consequences of a financial institution failure;

B case-by-case, discretionary responses — that any assistance should be tailored to the circumstances of each instance of failure;

C limited explicit guarantees — that the extent of some limited assistance should be defined up-front; or

D alternative responses — for example, facilitating, but not underwriting an industry-based compensation arrangement?

International experience with financial system guarantees

32. The Davis Report considers relevant international experience with explicit guarantee arrangements.

33. International experience shows that providing assistance following the failure of a financial institution may potentially involve very large costs. Ultimately, these costs would need to be met by taxpayers, industry or consumers. Spending public money on such assistance might come at the expense of other government programs or result in higher taxes. Government intervention might also interfere unduly with industry and consumer incentives to manage risk.

34. Amongst OECD countries, 28 of the 30 now have in place, or are implementing, explicit deposit insurance schemes.[3] Twenty-one OECD countries are reported to have in place, or are implementing, schemes for insurance products. Many of these schemes focus on compulsory classes of insurance (for example, Workers' Compensation and liability insurance) while 9 of the 21 schemes extend beyond compulsory classes of insurance.[4]

35. A number of countries also have implemented guarantee schemes to cover situations where an employer, who has occupational superannuation commitments, becomes insolvent or cannot meet these commitments. However, Australia's superannuation and private retirement income arrangements differ from those in many other countries making direct international comparisons difficult.

36. The composition and strength of regulatory frameworks and safety nets varies considerably across countries. A key lesson is that guarantee schemes must be carefully designed to limit moral hazard.

37. Further, the effectiveness of a guarantee scheme as a safety net component depends upon the underlying strength of the prudential framework.

38. Overseas experience suggests a guarantee scheme, no matter how carefully designed, will be ineffective where the core prudential framework is weak. A guarantee scheme in these circumstances can add to moral hazard and aggravate system stability problems.

Q3. Are you aware of additional international experience that could add to the debate about whether explicit guarantees may be desirable in the Australian context, or how any scheme could be optimally designed?

Alternatively, you may wish to refer to relevant international experience in relation to some of the specific design issues discussed below.

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3 World Bank Deposit Insurance Database 2000.

4 Yasui, T., 'Policyholder protection funds: Rationale and structure' in Insurance and Private Pensions Compendium for Emerging Economies, OECD 2001. <http://www.oecd.org/dataoecd/39/57/1813504.pdf>.

How might any limited explicit guarantee scheme be designed?

39. The Davis Report notes that the success of a limited explicit guarantee scheme depends crucially on its design features. It must be designed in a way that:

- preserves the spectrum of risk in the financial system;
- does not add to, and if possible reduces, moral hazard in the financial system;
- is not so generous that it excessively reduces the efficiency of the financial system;
- keeps administrative costs to a minimum; and
- does not result in duplication of activities or conflicts of interest among the relevant regulatory and supervisory agencies.

40. The potential costs of a poorly designed explicit guarantee are considerable. A poorly designed scheme can:

- create confusion as to who is and is not covered in the event of a financial institution failure;
- lead to sector and product 'creep' adding to the costs of any guarantee(s);
- undermine market discipline and add to moral hazard concerns for key stakeholders — including wholesale consumers and managers of financial institutions;
- unduly constrain desirable risk-taking behaviour and financial market competition and development;
- encourage regulatory 'forbearance' where regulators take unreasonable comfort in the knowledge that a 'safety net' exists; and
- add to, rather than ameliorate, any emerging systemic stability problems.

41. The following sections outline some of the major design issues discussed in the Davis Report.

Institutional, product and consumer coverage

42. The Davis Report identifies that institutions covered by a guarantee would need to be prudentially regulated to ensure that they continue to manage appropriately their overall risk and the risks they present to a guarantee scheme.

43. Effective regulation and supervision would limit the cost of a guarantee by reducing the incidence and severity of failure and, in hopefully most cases, resolving failures in ways that avoid net claims on the guarantee scheme. The Davis Report suggests that:

- A guarantee scheme could be limited to only those products that are ***capital certain*** or ***guaranteed income stream*** promises backed by the assets, and protected by the capital, of financial institutions.

- Consumers should only be protected against ***counterparty*** and ***agent risk*** — that is, the risks that those making financial promises may default and the risk that management of the institution may fail to protect the interests of depositors or policyholders — these are risks which are difficult for consumers to assess.

- It is generally not appropriate for a guarantee to be provided for products whose capital value is exposed to ***market risk*** in the pursuit of higher investment returns — that is, products with a lower ***intensity of promise*** (most consumers would have some experience of market risk, for example, through home or share ownership).

- Broadening coverage beyond a limited range of financial products could compromise the ability of the financial sector to provide the appropriate spectrum of risk/expected return choices necessary for efficient functioning of the economy. Too comprehensive coverage may inappropriately remove risk assessment responsibility from individuals in cases where they should and are able to perform that function.

- Beneficiaries of the guarantee should only include those consumers who could not be expected to have the ability or resources to be able to assess the creditworthiness of their financial institution.

- Consideration should also be given to the use of a degree of coinsurance — this would require consumers to bear some part of any potential or realised loss as a result of the failure of a financial institution.

- Thought might also need to be given to the practicalities of 'means testing' any guarantee — against consumer income or wealth — particularly where a guarantee is funded, initially at least, by taxpayers. This could, however, add to delays and administrative complexity.

Possible product coverage

44. Financial products that would be included in a guarantee scheme if the design principles proposed by the Davis Report are adopted would be:

- deposit products and other capital-guaranteed savings products offered by ADIs and life insurers;
- risk protection products offered by general and life insurers, such as house and contents insurance, motor vehicle insurance and term life insurance; and
- guaranteed income stream products, such as some forms of annuities offered by life insurance companies and some forms of pensions offered by superannuation funds.

45. Additional design features could limit the application of a guarantee to target beneficiaries, for example, individual and small business policyholders or third-party beneficiaries of insurance policies.

46. One of the more significant implications of the Davis Report's design criteria is that most superannuation products in both the accumulation and draw-down phases would not be covered by a guarantee.

47. This would seem appropriate given that the vast bulk of superannuation savings in Australia is exposed to market risk and the value of a consumer's superannuation fluctuates with changes in the price of the assets purchased by their superannuation trustees with their contributions.

48. The regulatory framework for superannuation contains a range of provisions addressing the counterparty and agent risks faced by consumers — such as the non-payment of contributions, breach of duties by trustees, funds that are facing financial difficulty — together with a range of regulatory, civil and criminal remedies.

49. The regulatory regime applying to superannuation trustees is aimed at ensuring that trustees prudently manage investments (and manage funds in

the member's best interests). This regime is significantly more rigorous than for other types of investment managers. This is important because of the long-term and compulsory nature of superannuation and the limited ability of some members to transfer investments from a poorly performing fund.

50. The regulatory framework also includes a mechanism for the Minister to grant compensation to superannuation fund members who have lost money as a result of fraudulent conduct or theft by the trustees.

51. The Davis Report identifies two types of ***capital certain*** superannuation products to which a guarantee could potentially apply. These are (deposit-like) Retirement Savings Accounts and guaranteed pensions or guaranteed annuities provided by prudentially regulated institutions.

52. The rationale for this coverage is that consumers purchasing these products are not seeking an exposure to market risk. In exchange for lower investment returns, on average, the consumer gains certainty over the value of the accumulated superannuation funds or retirement income stream. A guarantee scheme would provide consumers of these products with compensation if their financial institution cannot meet its obligations.

53. Where consumers have a choice in deciding where to place their superannuation contributions, these products would provide a relatively risk-free option.

Q4. Comments are invited on the design principles, the associated institutional, product and consumer coverage or the more specific design features outlined in the Davis Report.

Cost of a guarantee

54. Well-designed guarantee schemes need not impose significant additional costs on the financial system. A guarantee scheme, like any insurance scheme, can be seen as a mechanism for ***pooling of risks*** and ***redistribution of losses*** among various parties. The losses arising from a particular financial institution failure will have already been incurred.

55. The funding needed to meet the obligations of a guarantee scheme depends on a number of factors, including the design features (coverage) of the guarantee, the creditor preference arrangements that may exist for each

industry sector, and the probability and magnitude of losses associated with financial institution failure in the future.

56. It is important to ensure that the funding requirements do not reduce the efficiency of the financial system or the stability of individual institutions and the system as a whole.

57. This could be achieved, in part, by limiting the size of the claims against the scheme. This can be done by:

- ensuring that the guarantee provided by the scheme is extended only to those consumers not in a position to adequately assess risk; and
- designing the scheme in a way that does not increase the probability or magnitude of failure — that is, does not significantly increase moral hazard, particularly among sophisticated stakeholders.

58. The Davis Report examined a number of methods for estimating the costs of any explicit guarantee scheme. However, any estimates of the costs must be strongly qualified, given uncertainties about the probability, magnitude and timing of financial institution failures in the future.

59. That said, the estimates produced by the different methods do produce broadly consistent results and show that the costs of providing a guarantee vary considerably across sectors of the financial system. These findings have implications for both the level of funding and the desirable extent, if any, of pre-funding.

Q5. Comments are invited on the methods, underlying assumptions, and cost projections presented in the Davis Report.

Q6. Do you have further information or suggestions that might improve the accuracy and reliability of the results?

Q7. To what extent do concentrated markets present challenges to the viability of any scheme?

Funding and pricing

60. The key design questions for any limited guarantee scheme(s) are whether to have a pre- or post-funded scheme; and, whether to have risk-based or flat-rate pricing. There are also choices to be made about the appropriate level and timing of industry, consumer and taxpayer contributions.

61. The ***cost*** of a guarantee is determined by the total amount of losses to be redistributed.

- ***Funding*** issues relate to the appropriate base from which to collect contributions.

- ***Pricing*** issues relate to the determinants of the relative share of contributions from each contributor.

62. The Davis Report indicates that a scheme which is at least partly funded by industry with the funds partially accumulated in advance may be preferable. A pre-funded arrangement would:

- add credibility and stability to the scheme;

- better allow risk-sensitive pricing to affect behaviour and so contain moral hazard; and

- be perceived to be fairer because contributions will have been made by the failed financial institution.

63. The Davis Report concludes that there is little difference between pre- and post-funding in terms of the expected cost impost on financial institutions. Under either approach, it is argued, it is in fact the rate at which contributions bring the scheme's funding base to a target level (pre-funding) or allow the repayment of borrowed monies (post-funding) that determines the impost.

64. Some may feel, however, that a guarantee scheme would impose additional costs on financial institutions which must either provision for failure of an institution in their sector or contribute directly to a government sponsored and/or supervised scheme. This would seem to assume (perhaps unreasonably), however, that the better alternative would be for the Government, and ultimately taxpayers, to fund any compensation through the Budget without eventual repayment through industry levies. Some of the

concerns about industry funding might be lessened under a post-funded model when recoveries are made once the costs of actual failure are known.

65. The Davis Report also finds little difference between pre- and post-funding in terms of the impact of the business cycle.

66. There is a concern, however, that a post-funded scheme could be pro-cyclical and impose an additional burden on institutions at a time of stress in the sector. This would depend in part on how quickly any taxpayer-funded interim assistance is re-couped by the Government.

67. As mentioned above, the uncertainty associated with failure means that the costs for a guarantee scheme are impossible to accurately predict. It appears desirable that any scheme would involve a combination of pre- and post-funding.

68. Under such arrangements, a scheme would need capacity to borrow to cover a funding shortfall. Requiring the scheme to borrow from the market, with a government guarantee, could be an appropriate model. Funds could then be recovered from the industry over a manageable period of time.

69. If it is accepted that even pre-funded models require post-event funding, the level of pre-funding might then be set to at least match the costs of maintaining any borrowing facilities and associated administrative costs.

70. In terms of pricing, a risk-based pricing mechanism for a guarantee scheme is, in principle, preferable, although the costs and feasibility of doing so need to be carefully considered.

71. Risk-based pricing would help ameliorate the moral hazard problems that are commonly associated with guarantee schemes and would be more equitable to the participating institutions.

72. At a practical level, differences in risk characteristics could warrant consideration of either different schemes or different pricing structures for various sectors or products. For example, all ADIs could be grouped together within a single scheme, with different premia set to reflect the risks of different categories of institution. This might be broadly equivalent, but more efficient, than creating separate schemes for the various categories of ADIs.

73. There are, however, benefits in having broad funding bases and simplicity in pricing structures. This can be complicated where there are

differences in the sizes of institutions and differences also in balance sheet structures.

74. The Davis Report acknowledges that risk-based pricing is complex and that considerable effort would be required to ensure that appropriate risk-ratings are applied.

75. Flat-rate pricing might nonetheless be designed to draw some distinctions between various categories of financial institution, products and risks.

Q8. The Davis Report explored some of the alternative approaches for funding explicit guarantees. Comments are invited on which approach should be favoured, and why.

- If a pre-funded industry scheme should be preferred:
  - On what basis should the size of the target fund be set and over what period of time should the target balance be achieved?
  - What is the appropriate funding base and, in particular, should non-guaranteed products be included in funding base calculations?
  - Should restrictions be placed on the type of assets in which the scheme can invest?
  - Should the investment returns remain in the fund or be returned to participating institutions?
  - What arrangements should be put in place to allow the scheme to borrow in the event of under-funding?
  - In the event of a failure, how should supplementary levies be applied?

Q8. (continued)

- If a post-funded industry scheme should be preferred, how should the following issues should be dealt with?
  - Should the prudential framework require institutions to provision for their possible future contributions to a scheme?
  - Should the scheme's governing body be able to borrow only from the market, only from the Government or a combination of both?
  - Should a cap be set on how much the scheme can recover from institutions in a year? How would this cap be determined? What is the appropriate funding base?

Q9. The Davis Report examined some general approaches to setting prices for industry funded explicit guarantees. Comments are invited on which approach should be preferred, and why.

- If risk-based pricing is preferred:
  - What is the best way to determine premiums?
  - How often should re-rating take place?
  - Who should be responsible for setting risk-based premiums?
- If flat-rate pricing is preferred:
  - How should the scheme deal with the moral hazard problems that may result from flat-rate pricing?
  - Is the prudential framework (in particular, capital adequacy requirements) sufficient to mitigate incentives for risk-taking?

Governance arrangements

76. The Davis Report examines a range of possible governance arrangements that might support the establishment of a limited guarantee scheme in Australia. In broad terms, the following arrangements appear appropriate in the Australian context:

- prudential regulation and supervision, enforcement and failure management should remain the responsibility of APRA;
- a new statutory authority could be established to establish premiums and/or set levies and conduct asset and/or debt management; and
- claims assessment and payments could draw heavily on established industry systems and expertise.

77. In the Australian context, it would be important to ensure that there is not a duplication of prudential regulation, supervision and failure management functions. Options could also be explored for using existing public sector expertise in asset and debt management. Effective information sharing arrangements among relevant agencies would also be crucial.

Q10. The Davis Report outlined some possible governance arrangements to support an explicit guarantee scheme if one were to be introduced. Comments are invited on which approach should be favoured, and why.

Q11. What is the preferred allocation of functions among the relevant bodies?

Regulatory implications

78. The Davis Report makes a number of observations about the linkages between the prudential framework and any safety net that includes a limited explicit guarantee. These include the need for the prudential framework to appropriately assess risks to any scheme and to manage the failure of participants and the possibility that scheme resources could complement the powers of the prudential supervisor. Implications for existing guarantee arrangements, such as those which exist for statutory classes of insurance, were also noted in the Davis Report.

79. If a guarantee scheme were to be introduced, the Davis Report envisages that the arrangements that currently exist for prudentially regulating and supervising financial institutions or managing failing or insolvent financial institutions would not need to be significantly altered. Given the linkage to scheme costs, however, there would appear to be a case for considering closely the adequacy of APRA's failure management powers.

Q12. The Davis Report examined a number of possible regulatory implications that may arise from introducing any guarantee scheme. The Government invites comments on the following issues:

- Under a pre-funded model, would it be feasible for the guarantee scheme funds to be available to achieve least-cost failure resolutions (for example, a transfer of business) if that might be less expensive than compensating eligible customers in a liquidation?
  - What regulatory and governance arrangements might be necessary to support least-cost failure resolution?
- Guarantee schemes and priority arrangements (for example, depositor preference and insurance 'cut-through' provisions) might be seen as alternative or complementary policy instruments to guarantees for protecting certain stakeholders in the event of financial institution failures.
  - What are your views on the existing arrangements for depositors and policyholders in Australia?
  - What changes should be made to priority arrangements if a guarantee scheme were to be introduced?
  - Should general insurance policyholders receive priority above other creditors?
- Could a guarantee scheme provide an opportunity for removing or reducing restrictions on branches of foreign ADIs accepting deposits from retail customers in Australia? Your views may differ depending on whether you think foreign ADIs would be within or outside of the scope of a guarantee scheme.
- The Davis Report notes that certain conditions may need to be met before a national scheme could apply to statutory insurance classes. What implications would a national guarantee scheme have for existing State-based arrangements for compensating policyholders under statutory insurance classes for insolvency-related losses?
- Would the introduction of a guarantee scheme allow or require changes to other financial sector regulations and arrangements?

Conclusion

80. The Government remains committed to achieving the appropriate balance between safety (consumer protection), efficiency and competitiveness in the financial system. The Government recognises that no prudential framework and no supporting 'safety net' can or should prevent failure of financial institutions in a competitive and rapidly evolving and globalised financial market.

81. The arguments for implementing a limited explicit guarantee over a limited range of deposits, life insurance, general insurance and superannuation products appear finely balanced.

82. Australia stands out among developed countries in not having a system of deposit insurance. Insurance sector schemes are less common but growing in number. However, this does not necessarily mean that guarantees are appropriate in the Australian context. This turns critically on whether the benefits outweigh the costs given our prudential framework arrangements and market structure.

83. The clearest arguments in favour of implementing a guarantee are in providing greater certainty as to the extent and timing of consumer protection, creating a ready-made response to failures of financial institutions and possibly providing some protection to the Budget and taxpayers in such cases.

84. The clearest arguments against include that the scope of guarantee schemes may be difficult to constrain and too comprehensive a system can undermine market discipline and private incentives to manage risk.

85. The purpose of the public consultation process is to generate public debate about whether the introduction of a limited guarantee scheme would be appropriate and, if so, to determine what the broad design parameters for any such scheme might be.

86. Should a decision be made to undertake such a significant reform to financial system policy, the Government would consider the detailed design of any scheme in consultation with the financial services industry, consumer groups and regulatory agencies.