The end of quasi-guarantees and the case for a narrow banking model of prudential regulation:

Submission to Senate Economics Committee Inquiry into the Bank Funding Guarantees

John Quiggin

Australian Research Council Federation Fellow

School of Economics and School of Political Science and International Studies

University of Queensland

http://www.uq.edu.au/economics/johnquiggin

Summary

Until October 2008, retail depositors in and wholesale lenders to Australian banks were protected by a quasi-guarantee. Governments sought to assure both the general public and wholesale lenders that our major banks are completely safe, while simultaneously denying that their liabilities were guaranteed. This system failed when confronted with the global financial crisis, and was replaced by an explicit guarantee.

The current situation, where a wide range of financial institutions receive the benefit of an explicit guarantee, but remain subject to 'light-handed' prudential regulation, is not sustainable. However, a return to quasi-guarantees is probably impossible and certainly undesirable.

Instead of a return to quasi-guarantees, Australia should move to a system of narrow banking. In such a system, banks and other institutions providing a specified range of low-risk investments and financial services would be explicitly guaranteed. Higher-risk investments would be subject to regulation to ensure investor protection, along the lines of the protection currently provided to stock market investors, but would be explicitly excluded from any guarantee.

To prevent high-risk investments from threatening systemic stability, institutions providing those investments should be completely separate from publicly guaranteed banks. Publicly guaranteed banks should not be permitted to own, invest in or lend to, high-risk, non-guaranteed financial institutions.

To ensure that guaranteed low-risk banking services are universally available, government should consider the establishment of a publicly-owned savings bank similar to the New Zealand Kiwibank. The role of co-operative financial institutions such as credit unions would also be expanded under the proposed model.

The end of quasi-guarantees and the case for a narrow banking model of prudential regulation

On Sunday 12 October 2008 the Australian Federal Government announced it would guarantee deposits of Australian banks, building societies and credit unions and Australian subsidiaries of foreign-owned banks that are regulated by the Australian Prudential Regulation Authority (APRA). This announcement followed a strongly critical reaction to a proposal announced several days earlier to provide a guarantee limited to $20 000 per depositor. It was part of a worldwide shift of policy, taken in response to the global financial crisis. New deposit guarantees were introduced by many governments and previously limited guarantees were greatly expanded.

The guarantee represented an abandonment of the long-standing position of Australian banks and regulators that no explicit guarantee of deposits was desirable or necessary. This position was expressed in strong terms when the Wallis Committee sought to examine the possibility of deposit insurance and remained strongly held until the possibility of a catastrophic failure of the banking system was clearly imminent.

The guarantee was presented as temporary and was not accompanied by plans for the development of a new regulatory system appropriate to institutions fully guaranteed by government, and therefore ultimately, by the Australian public. It is therefore necessary to consider the options for removal of the guarantee or for a sustainable system in which the guarantee is retained in whole or in part.

Guaranteed, quasi-guaranteed and non-guaranteed investments

Until the 2008 crisis investments available to Australian households fell into three classes.

First, there were investments explicitly guaranteed by governments, such as government bonds. These were once made directly available to retail investors, and widely held by the public. In recent times, however, this option has been withdrawn, and bonds have been placed with financial institutions through tenders or direct negotiations.

Second, there were quasi-guaranteed investments such as bank deposits. Governments sought to assure investors that, thanks to the system of prudential regulation, bank deposits and other quasi-guaranteed investments were completely safe. However, they refused to state that such investments were guaranteed, and sought to avoid any public discussion of the issues.

Finally, there were non-guaranteed investments, such as shares and managed investment schemes. Governments undertook a variety of regulatory measures to protect investors against fraud and market manipulation. However, investors who incur losses either through poor performance of the investments or through the failure of financial intermediaries such as stockbrokers have no recourse to a government guarantee.

The vague and undefined nature of a quasi-guarantee means that the scope of such guarantees is rarely clear. This problem regularly created difficulties during the period in which quasi-guarantees operated.

The first problem is that, if a large sector of the public is given the impression that an investment or institution is safe, it is very difficult for governments to resist calls for a bailout. In 2002, for example, a range of insurance businesses got into difficulties and government was forced to provide substantial financial support.

Another set of problems arises when guaranteed (and regulated) banks are allowed to own financial institutions in the in the non-regulated sector. In the 1970s, for example, the Bank of Adelaide owned a finance company which ran into difficulties. To avoid allowing the bank to fail, the Reserve Bank organised a rescue which effectively bailed out investors who had bought securities issued by the finance company. At around the same time investors in other failed finance companies lost their money.

Similar problems arise when quasi-guaranteed banks engage in large scale lending to speculative financial institutions. There have been numerous cases of this kind from the 1980s to the present. The effect is that the exposure of banks to the unsound activities of speculators has been allowed to threaten the stability of the financial system as a whole.

As has been demonstrated by the current crisis, quasi-guarantees inevitably become explicit guarantees when they are actually needed. The effect of offering quasi-guarantees is to expand, without careful consideration, the range of institutions the government is effectively obliged to protect.

The debate over quasi-guarantees

The problems with quasi-guarantees have been pointed out repeatedly. In this section, I draw on an article written for the *Australian Financial Review* at the time of the 2002 insurance crisis.

The apparent rationale for a quasi-guarantee is twofold. First, it appears to preserve maximum discretion for the authorities to manage any future banking crisis as they see fit. Second, there are a range of objections to any alternative policy, such as deposit insurance.

The insurance crises were among many instances showing that the idea of preserving discretion is nonsense. In the panic that necessarily accompanies a crisis, the absence of an ironclad guarantee naturally leads the public to focus on the worst-case scenario. The difficulty the government had in persuading surgeons to keep operating after the collapse of United Medical Protection illustrates this point.

Once a panic is under way, any equivocation on the government's part is fatal. The disastrous experience of state regulated building societies provided an example. When the Pyramid group got into trouble in Victoria in the early 1990s, the Cain Labor government tried to hedge its bets on whether deposits would be guaranteed. The resulting climate of panic helped to bring down both the government and the Victorian economy. And, in the end, the government had to pay out anyway.

Even with a prompt and unequivocal response, situations like this raise the question of where lines are to be drawn. If ordinary bank deposits are guaranteed, what about certificates of deposit? If certificates of deposits are included, what about the share parcels marketed by banks? What about the 'Mum and Dad' shareholders of the bansk themselves? The only way to prevent panic is to spread the safety net as wide as possible, and far wider than would have been required with an explicit, and explicitly limited, guarantee.

Many of these problems would arise to some extent even in the presence of an explicit system of deposit insurance. But nearly of the problems with deposit insurance, such as moral hazard, apply in spades to the implicit insurance in force in Australia.

The real reason we do not have deposit insurance is that the big banks are unwilling to pay for it. The main cost is not the premium but the more intrusive regulation that would obviously be justified once the government was explicitly identified as an insurer.

One might ask how such a situation could arise, given that the whole system of prudential regulation was reviewed by an eminently-qualified commitee (the Wallis committee) as recently as 1997. In fact, the Committee's 1996 Discussion

Paper did suggest looking at deposit insurance, but the idea was howled down so effectively that it made no appearance in the final recommendations.

In principle, a deposit insurance scheme could be run either by the government, as in the United States, or by a private insurer, as in Germany. For expert advice on the options, I spoke to Ian Harper of Melbourne University, Australia's leading banking economist and a member of the Wallis committee. Harper's view was that private deposit insurance could play a useful role as a 'front-line' of defence against minor problems, particularly those affecting smaller institutions. However, the Big Four banks are too big for reinsurance, and too few in number for mutual insurance on the German model. Hence, the system must ultimately be guaranteed by government.

My 2002 conclusion was borne out by recent experience

> In the current atmosphere of global financial crisis, a banking panic could emerge with very little warning. **The sooner Australia moves to an explicit system of deposit insurance, the better** (emphasis added

The introduction of the guarantee

The debate over the response to the guarantee in October 2008 revealed the inadequacy of the analysis offered by the banking industry and government policymakers. On 4 October, I called for an immediate guarantee of bank deposits (http://johnquiggin.com/index.php/archives/2008/10/04/time-to-guarantee-oz-bank-deposits/). Responding to the initial proposal for a $20 000 guarantee, I made the following observations, which formed the basis of letters to the government calling for an unlimited guarantee (http://johnquiggin.com/index.php/archives/2008/10/12/a-bit-more-on-deposit-guarantees/)

> Until the recently announced proposal to guarantee bank accounts up to $20 000, the security of Australian bank deposits rested on two main presumptions

(i) the Reserve Bank would act to maintain stability. While this has always excluded an explicit guarantee of deposits, it was generally understood to mean that anyone who had a standard bank account (not precisely defined) with a bank complying with APRA regulations would be fully protected against default either through the lender of last resort facility, an RBA-facilitated rescue by another institution or in the worst case by the RBA taking over the bank and assuming its liabilities to depositors

(ii) the fact that depositors rank ahead of all other creditors, and account for only about 50 per cent of liabilities meant that, even if the Reserve Bank decided to let an institution fail, depositors would almost certainly recover their money in a liquidation

The second of these defences no longer seems adequate in the light of overseas bank failures in which losses far exceeded 50 per cent of the capital value of the bank concerned.

The general acceptance of the Reserve Bank as implicit guarantor has remained strong (if shaken by recent events). However, this can scarcely be combined with an explicit and limited guarantee of deposits up to some fixed amount.

In this context, the proposal to guarantee bank accounts up to $20 000 is worse than useless. According to statements made in support of the proposal, the result would be to protect 85 per cent of depositors, or equivalently, to withdraw protection from 15 per cent of depositors. The proportion of deposits left unprotected is presumably larger.

Under a scheme in which individual accounts are protected to a fixed amount, depositors have an obvious incentive to diversify, holding a number of accounts in separate institutions, each of which falls below the statutory limit.

The process of diversification would require large-scale withdrawals. While the money withdrawn would be rapidly deposited in new accounts, such a churn process might not be symmetrical, and would in any case be likely

> to generate considerable alarm. The possibility of this turning into a run is far from remote.
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> The Opposition response, suggesting a guarantee of $100 000 is an improvement. But this is still below the level guaranteed in most other deposit-insurance jurisdictions (the US level was recently increased to $US 250 000). More importantly, most jurisdictions are abandoning limited insurance in favour of unlimited guarantees. In the current environment, only an unambiguous guarantee appears sufficient to avoid the risk of panic.
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> The financing of an insurance or guarantee scheme is straightforward in principle, though the calculation of premiums will be a difficult task in the absence of any historical failures, but in the presence of greatly increased risks in the immediate future. However, at this point it is more important to get an adequate guarantee in place than to get the details of financing correct.

An unlimited guarantee was announced on 12 October and remains in place.

A return to quasi-guarantees?

The unlimited guarantee announced on 12 October 2008 was stated to apply for a period of three years. Subsequent policy debate has largely been premised on the presumption of a return to the previous system of quasi-guarantees. But such a return is unlikely to be possible. The quasi-guarantee system rested critically on ambiguity. Governments did not guarantee that deposits would be guaranteed in the event of a failure, but neither did they specify any circumstances under which such a guarantee would not apply.

Supposing that the financial system is reasonably stable by 2011, could the government simply announce that the guarantee had expired, and that the previous policy was to be restored. From the viewpoint of depositors, this would amount to the replacement of an explicit guarantee with no guarantee at all. Some at least, would surely seek to move their money from smaller institutions perceived as more vulnerable to larger institutions perceived as both more financially stable and 'too big to fail'. Thus, the government would immediately be faced with the choice between maintaining the guarantee for these small institutions, or risking the failure of one or more as the result of a loss of investor confidence.

The alternative of withdrawing the guarantee for the major banks while protecting smaller institutions is even more problematic. Given the widespread perception that the big banks are 'too big to fail' (a perception bolstered by such events as the near-failure of Westpac in the early 1990s crisis and the clear evidence that the Reserve Bank was willing to act to present such a failure), the result would be to give the big banks all the benefits of a guarantee with none of the costs.

The system of implicit quasi-guarantees was proved worthless by the financial crisis and cannot be restored. The only replacements for an explicit, unlimited guarantee are guarantees that are explicitly limited (or completely removed).

As argued above, there is little value in limiting the amount guaranteed, at least as far as retail deposits are concerned. So, the only effective way to limit guarantees is to fully guarantee some investments and institutions while excluding others.

The case for narrow banking

Post-crisis financial regulation must begin with a clearly defined set of institutions (such as banks and insurance companies) offering a set of well-tested financial instruments with explicit public guarantees for clients, and a public guarantee of solvency, with nationalisation as a last-resort option. Financial innovations must be treated with caution, and allowed only on the basis of a clear understanding of their effects on systemic risk.

In this context, it is crucial to maintain sharp boundaries between publicly guaranteed institutions and unprotected financial institutions such as hedge funds, finance companies, stockbroking firms and mutual funds. Institutions in the latter category must not be allowed to present a threat of systemic failure that might precipitate a public sector rescue, whether direct (as in the recent crisis) or indirect (as in the 1998 bailout of Long Term Capital Management). A number of measures are required to ensure this.

First, ownership links between protected and unprotected financial institutions must be absolutely prohibited, to avoid the risk that failure of an unregulated subsidiary will necessitate a rescue of the parent, or that an unregulated parent could seek to expose a bank subsidiary to excessive risk. Second, banks should not market unregulated financial products such as share investments and hedge funds.

Third, the provision of bank credit to unregulated financial enterprises should be limited to levels that ensure that even large-scale failure in this sector cannot threaten the solvency of the regulated system.

In the resulting system of 'narrow banking', the financial sector would become, in effect, an infrastructure service, like electricity or telecommunications. While the provision of financial services might be undertaken by either public or private enterprises, governments would accept a clear responsibility for the stability of the financial infrastructure.

The role of public and co-operative financial institutions

One possible risk of a move to 'narrow banking' is that the range of options available to depositors seeking a publicly-guaranteed investment option would be limited. This would be the case if, for example, the major banks decided they could operate successfully without access to a deposit guarantee.

In this context, it makes sense to consider policy action to promote access to safe and convenient basic banking. To ensure that guaranteed low-risk banking services are universally available, government should consider the establishment of a publicly-owned savings bank similar to the New Zealand Kiwibank. The role of co-operative financial institutions such as credit unions would also be expanded under the proposed model.