Chapter 2
The deposit guarantees

The introduction of the deposit guarantees

2.1 The Government developed the deposit guarantee in consultation with Treasury, the Reserve Bank of Australia (RBA) and APRA, following discussions going back to early 2008.[1] The Government had announced in June 2008 its intention to introduce a 'Financial Claims Scheme' with a cap of $20,000 per depositor.

2.2 On 11 October, the Coalition called for the proposed cap to be raised from $20,000 to $100,000 in response to the deterioration in the international financial environment.[2]

2.3 On Sunday 12 October, after a meeting with the Secretary of the Treasury, the Treasurer announced a package of changes to Australia's financial system, including an uncapped guarantee for three years on all deposits of Australian authorised deposit-taking institutions.

2.4 The immediate aftermath of the announcement saw a run on redemptions for those institutions not benefiting from the proposed guarantee, together with controversy surrounding the extent to which the Government fully consulted on the proposed changes with the appropriate agencies, specifically the RBA.

2.5 From there the chronology was as follows:

> The Australian Government also moved to reassure depositors and investors in Australian ADIs, and to ensure that Australian ADIs were not disadvantaged compared to banks in other countries, by announcing guarantee arrangements for deposits and wholesale funding. This was announced on 12 October, with further details – including a guarantee fee on large deposits – announced on 24 October following advice from the Council of Financial Regulators. The Government noted in its announcement that the guarantee scheme arrangements would be reviewed on an ongoing basis and revised if necessary. The guarantee arrangements became fully operational on 28 November after a period of close co-ordination between Council agencies – in consultation with ADIs – to establish the necessary rules, processes, documentation and architecture.[3]

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1 Dr Ken Henry, Secretary, Treasury, *Estimates Hansard*, 22 October 2008, pp 10-11; Dr John Laker, Chair, Australian Prudential Regulation Authority, *Estimates Hansard*, 23 October 2008, p 7.

2 The Hon Malcolm Turnbull MP, 'Responding to the international financial crisis', *Media Release*, 11 October 2008.

3 RBA & APRA, *Submission 7*, p 1.

2.6 Although it remains unclear to what extent the Government consulted and fully considered the impact and potential intended and unintended consequences of these measures, prior to first announcing them, what is evident from this chain of events, is that the Government was struggling in terms of its response to the financial crisis and that it found it frustrating that the Leader of the Opposition was calling for needed reforms prior to their announcing them.

2.7 Nevertheless, the Australian government eventually moved further than many other governments – even those facing more serious problems – in jumping from no guarantee or deposit insurance to an unlimited scheme.[4] This decision clearly increased the impact on non-bank financial institutions outside the scheme, a matter taken up in Chapter 4.

The fee for deposits over $1 million

2.8 While the deposit guarantee as eventually implemented was not subject to a cap, the guarantee offered for non-deposit forms of wholesale funding had a fee. The Government's position is now that that it was therefore necessary to impose a corresponding fee on very large deposits or there could be distortions in the financial markets as wholesale funding became reconfigured as very large 'deposits' to benefit from the free guarantee. The Government set $1 million as the threshold over which the fee would be payable, at the same rate as that applying to wholesale funding.

2.9 As the Treasury Secretary put it:

> A large deposit could in fact be a source of wholesale funding for a financial institution…If we continue with an unlimited guarantee for deposits, for which there is no charge, there is no insurance premium charged, but at the same time for short-term wholesale funding, we say, ‘Yes, there is a guarantee but there is a charge,’ then we will distort the short-term money markets.[5]

2.10 For large deposits, there has been relatively little demand for this guarantee, with the guarantee fee being paid on around $20 billion of deposits, around 2 per cent of total deposits.[6] The Reserve Bank and APRA report:

> Liaison with ADIs suggests that most depositors with over $1 million are not seeking the guarantee when they have to pay for it. The major exception is depositors with very conservative mandates, such as trustees and councils.[7]

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4 Professor Sathye notes 'Australia has the unique distinction of announcing an ‘unlimited guarantee’ from a ‘no guarantee’ situation'; *Submission 23*, p 2. Dr Ken Henry, Secretary, Treasury, gave evidence that, notwithstanding some media reports to the contrary, Treasury and the Reserve Bank were in agreement that the guarantee should be unlimited; *Estimates Hansard*, 22 October 2008, pp 16, 27 and 28.

5 Dr Ken Henry, Secretary, Treasury, *Estimates Hansard*, 22 October 2008, p 32.

6 RBA & APRA, *Submission 7*, p 10.

7 RBA & APRA, *Submission 7*, p 10.

2.11 APRA-regulated foreign bank branches are eligible to apply for a guarantee for liabilities from Australian residents with maturities up to the end of 2009 but they have to pay a fee for all these liabilities.[8]

The threshold for the fee

2.12 The $1 million threshold above which the guarantee is no longer free is essentially arbitrary. It was designed to be dramatically different to the $20,000 cap envisaged for normal times and to provide sufficient assurance to prevent bank runs.

2.13 It is hard to know whether $1 million was the 'right' amount to choose. As Professor Harper put it:

> …could they have done that with a guarantee of $250,000 or $500,000 or $100,000? I do not know the answer to that. In a sense, what I am saying is that I would far rather that the government erred on the side of too big a hit than too small a hit, because you only get one chance to do that in those circumstances. Fortunately, the government's intervention worked and I do not know if it would have worked at $500,000 or $250,000. If it had not worked, the chances of a second round working would have been much lower and we would have been in a much more difficult situation.[9]

2.14 Contrary to a view that bank runs result from small, less sophisticated and informed, investors (whose concerns could be addressed by a relatively small threshold), Professor Harper argued:

> These things start in the wholesale markets. The irrationality that you are talking about was amongst wholesale investment funds. Frankly, the banks, including our major banks, stopped lending to each other…you are not talking about ordinary Herald Sun-reading folk on the train…The ones who ought to have known better were frightened to the point of closing their balance sheets, not lending and hoarding cash—the whole lot. That is why, in my view, the best thing to do was to convince people who had a lot of money that it was all safe rather than the mums and dads with not that much.[10]

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8 Treasury, answer to question on notice sbt28, Supplementary estimates 2008-09. There are also further conditions; The amount guaranteed is limited to 110 per cent of the combined average value of short-term wholesale liabilities and deposits held by Australian residents in the 30 days up to and including 24 October 2008; branches cannot use guaranteed liabilities to directly support the parent bank or group (of which they are part) outside Australia; and the guarantee is only available if the liabilities are not guaranteed by the home authorities and the branch provides additional information about the parent bank's prudential compliance. AFMA makes the case for allowing foreign banks to participate; *Submission 20,* p 4. See also Treasury, *Submission 22*, p 9.

9 Professor Ian Harper, *Proof Committee Hansard*, 14 August 2009, pp 43-4.

10 Professor Ian Harper, *Proof Committee Hansard*, 14 August 2009, pp 44.

Criticism of the fee tiering

2.15 The fee structure matches that applying to the wholesale funding guarantee. A controversial feature of both fee structures is the relation between the fee and the credit rating of the ADI concerned. This is discussed in the following chapter.

International comparison

2.16 Many comparable countries extended the coverage of their deposit insurance schemes in the face of the crisis (Table 2.1 and Chart 2.1).

2.17 Comparing the Australian arrangements with those overseas, the Reserve Bank and APRA comment:

> The Australian arrangements share many common features with those introduced in other countries although, on balance, the range of parameters are generally at the more supportive end of those internationally.[11]

Table 2.1

Table 2: Changes in Selected Countries' Deposit Guarantee Arrangements

	Previous Limit	Current Limit	Termination Date
Australia	--	Unlimited: first $1 million is free, then voluntary access via Guarantee Scheme	12-Oct-11
Austria	€20 000	Unlimited	31-Dec-09
Belgium	€20 000	€100 000	--
Denmark	DKK300 000	Unlimited	30-Sep-10
Finland	€25 000	€50 000	Until further notice
Germany	€20 000	€50 000*	--
Greece	€20 000	€100 000	30-Oct-11
Hong Kong	HKD100 000	Unlimited	31-Dec-10
Ireland	€20 000	€100 000 (Unlimited for selected institutions)	28-Sep-10
Netherlands	€40 000	€100 000	--
New Zealand	--	NZ$1 million	12-Oct-10
Singapore	SGD20 000	Unlimited	31-Dec-10
Spain	€20 000	€100 000	--
Sweden	SEK250 000	The higher of €50 000 or SEK500 000, depending on exchange rate	--
Switzerland	CHF30 000	CHF100 000	--
United Kingdom	£31 700	£50 000	--
United States	US $100 000	US$250 000	31-Dec-13

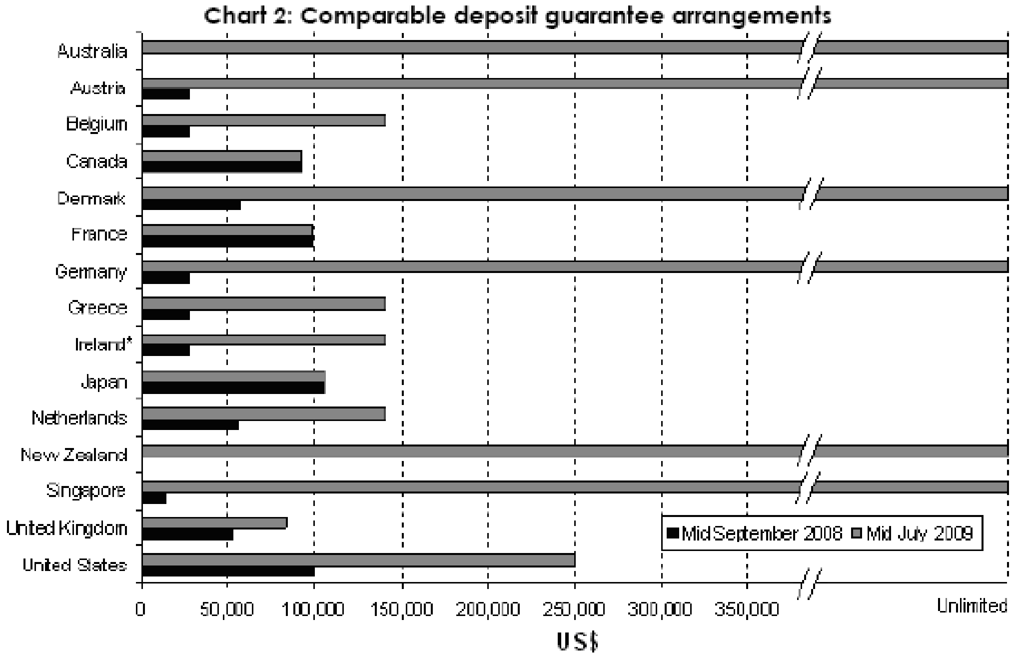
* Intended to increase to €100 000 in January 2011

Source: BIS; Countries' deposit insurers and regulators

Source: RBA & APRA, *Submission 7*, p 3.

11 RBA & APRA, *Submission 7*, p 2.

Chart 2.1



Sources: Bank for International Settlements (BIS); Bloomberg; RBA; Treasury departments, central banks, debt management offices and guarantee administrators., XE.com.
Coverage limits converted into US dollars using bilateral exchange rates as at 1 August 2009.
* The Irish Government has also provided a 100 per cent guarantee for seven of its credit institutions and subsidiaries.

Source: Treasury, *Submission 22*, p 12.

2.18 The Committee questions whether, in a country where banks have remained well capitalised, highly profitable and well regulated, it was necessary to take action 'at the more supportive end of those internationally' to achieve the desired stability of the system, given some of the consequences discussed in this report.

Corresponding obligations

2.19 Some witnesses argued that the provision of a deposit guarantee should be associated with some increased obligations on banks:

> …such conditions should include measures to safeguard Australian jobs against practices such as off-shoring, maximise Australian employment, lend responsibly and effectively to all market segments and require the observation of social obligations ensuring that banks do not withdraw services to disadvantaged communities or groups.[12]

2.20 There have also been suggestions that banks should be restrained in their ability to increase housing loan interest rates (especially if the Reserve Bank has not made a corresponding increase in its policy rate), charge high interest rates on credit

12 Finance Sector Union, *Submission 11*, p 2.

cards and pay executive salaries exceeding $1 million when they are benefiting from funding guarantees.[13]

2.21 As these matters are currently being examined by the Economics Legislation Committee's inquiry into the Banking Amendment (Keeping Banks Accountable) Bill, they are not pursued further here.

13 *Herald-Sun*, 17 June 2009, p 33.