Chapter 5

The transition to a permanent scheme

5.1 The global financial crisis constituted extraordinary circumstances calling for unusual responses. As Professor Harper put it:

> … the whole point of financial regulation is to achieve an appropriate balance between competitive efficiency and system stability. Something like the GFC obviously upsets that balance and raises the premium which a government should place on system stability at the expense of competitive efficiency, at least until things return to normal.[1]

5.2 While the Government has paid lip service to the need, once the global financial crisis eases (and evidence exists that it already is), for a transition to a more limited, permanent, scheme of depositor protection and no support for wholesale fundraising, it has done little to indicate how or when this might occur. This is despite calls by the Reserve Bank for the transition to start soon:

> For their part, banks will need to reduce their reliance on the extended guarantees and stand on their own feet before too much longer. The banks of the United States and Europe are starting down this path on their wholesale issuance, having recognised that it is in their own interests to do so. It would make sense for Australian banks, which have accounted for 10 per cent of global issuance of government‑guaranteed bank debt over the past nine months, to step up their efforts to do likewise.[2]

Removing the guarantees

5.3 Treasury is monitoring the situation:

> …I think it is a little premature to be thinking about exiting at this time…It may be that the second-tier banks will need the guarantee longer than, say, the majors.[3]

5.4 There are risks involved in leaving the guarantee in place too long:

> If you leave these things in place, you unduly strengthen the institutions that are inside the cordon, relative to their competitors on the outside of the cordon. The longer you leave it there, the more competitive strength they gather, which is really drawn on the strength of the guarantee rather than on competitive performance. In the worst case, you debilitate the system by

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1 Professor Ian Harper, Senior Consultant, Access Economics, *Proof Committee Hansard*, 4 August 2009, p 34.

2 Mr Glenn Stevens, Governor, Reserve Bank of Australia, Address to The Anika Foundation Luncheon, 28 July 2009.

3 Mr Jim Murphy, Treasury, *Proof Estimates Hansard*, 4 June 2009, p 26.

> making life so difficult for those outside the cordon that they eventually begin to fail or are absorbed by those inside the cordon and you create for yourself an inner core in the system which becomes certainly very stable but really too profitable for the long-term good of the efficiency of the system. [4]

5.5 An opinion poll conducted in June 2009 suggested the public still wanted the deposit guarantee in place then:

> Only 30 per cent of those surveyed said they would be comfortable keeping money in the bank with no guarantee. A guarantee of deposits up to $50,000 would satisfy 50 per cent of the population. A $100,000 guarantee finds two-thirds public support, while a $500,000 guarantee brings in 80 per cent.[5]

5.6 Of course, most Australians prior to the crisis thought their funds were already guaranteed!

5.7 The wholesale funding guarantee should be subject to a gradual phase-out, or what the RBA and APRA have called a 'natural exit mechanism':

> As market conditions normalise and funding markets 'thaw', it is expected that it will no longer be commercially viable for entities to rely on the guarantee.[6]

> …at some point investors will no longer be willing to accept the lower yields on guaranteed paper and banks will therefore no longer seek to insure their debt.[7]

> As the price and availability of credit normalises, non-guaranteed debt issues will become relatively more attractive, and at some point, paying the guarantee fee will become an uneconomic proposition.[8]

5.8 The Reserve Bank Governor was asked about this recently and commented:

> On the wholesale front, when the pricing of the fee for the guarantee was set it was set in a way that we hoped would be such that when market conditions normalised it would be too expensive to issue with the guarantee and would naturally therefore fall into disuse. We are probably not that far actually from that stage. I think that it would be good for our institutions to just start to issue in their own name anyway as much as they can. That is happening in other countries. I think that conditions have pretty much now sufficiently stabilised that it would be sensible for them to start doing that

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4 Professor Ian Harper, Senior Consultant, Access Economics, *Proof Committee Hansard*, 14 August 2009, p 35.

5 The poll was conducted for IFSA. *Australian Financial Review*, 7 August 2009, p 56.

6 Treasury, answer to question on notice sbt28, Supplementary estimates 2008-09.

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

8 Westpac, *Submission 6*, p 2.

> even if it did cost slightly more in the short term, and I have said that publicly.[9]

5.9 Professor Swan said that this might apply to some banks but perhaps not the weaker banks:

> I think that particularly the weaker banks who have trouble borrowing will want to go on relying on the guarantees as much as possible...[10]

5.10 One foreign bank emphasised the risks from uncertainty about the removal of the guarantees:

> Certainty as to the mechanisms and timing of any changes or removal of the Government Guarantee arrangements is critical to maintaining confidence and stability in both retail and wholesale funding markets.[11]

5.11 There have been calls for considerable notice of any phase-out:

> For the Wholesale Bank Funding Guarantee Scheme, the Government will provide a minimum notice period of 12 months prior to the closure of the Scheme to new issuance, and the Government will not provide such notice prior to the point in time that funding markets have normalised for all ADIs currently qualifying to utilise the Guarantee. (Investec believes that such “normalisation” is unlikely to be achieved prior to 1 January 2010).[12]

> …information about the removal of the bank funding guarantee should be clearly communicated to the market well in advance of its scheduled implementation.[13]

5.12 Even some critics of the guarantees believe it needs to be phased out gradually rather than abruptly:

> If the guarantee is now removed abruptly a flight of funds from small financial institutions to banks is likely which may endanger the very survival of these institutions. Consequently, the deposit guarantee roll back needs to be done with caution.[14]

5.13 Specific timetables for removal have been suggested:

> …a gradual reduction of the $1 million threshold to $50 000 over the next 12 to 18 months (and in line with market conditions) with that level being retained for a further 12 months before being closed.[15]

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9 Mr Glenn Stevens, Governor, RBA, *Proof House of Representatives Economics Committee Hansard,* 14 August 2009, p 34.

10 Professor Peter Swan, *Proof Committee Hansard*, 14 August 2009, p 4.

11 Investec, *Submission 5*, p 3.

12 Investec, *Submission 5*, p 4.

13 AFMA, *Submission 20*, p 7.

14 Professor Milind Sathye, *Submission 23*, p 4.

15 IFSA, *Submission 8,* p 5.

> I suggest that the government roll back the deposit guarantee scheme in stages: to $100,000 by December 2009, to $60,000 by June 2010 and to $20,000 by December 2010.[16]

5.14 The Tasmanian Government suggested that markets should have been regarded as 'normalised', and so the guarantees withdrawn, once most of the following conditions (Table 5.1) have been met for one to three months.[17]

Table 5.1: Tasmanian Government criteria for normality

Market criteria	Measurement
The price of bonds guaranteed by the Commonwealth, relative to comparable Commonwealth bonds, is consistent with risks faced by investors	• Material contractions in credit spreads between Commonwealth bonds and Commonwealth-guaranteed bonds
Market pricing suggests there should be no bias for authorised deposit-taking institutions between issuing guaranteed and non-guaranteed bonds	• Increased issuance of non guaranteed debt by ADIs • Cost of issuing guaranteed debt and unguaranteed debt are closely aligned
Consistent demand for primary issues of semi-government bonds	• Central financing authorities are able to issue long-term debt (guaranteed and non-guaranteed) at a time and method of their choosing
Liquid secondary markets for semi-government bonds	• Reduced bid/offer spreads
Other entities are able to access credit markets to raise funds	• Increased primary issuance of bonds and other securities by corporates and non-bank lenders

Source: Tasmanian Department of Treasury and Finance, *Submission 16*, p 2.

International co-ordination of the transition

5.15 The Committee was presented with a broad consensus that the removal of the guarantee should be related to similar action in other countries:

> …we need to have a globally coordinated approach to evaluating the application and then ultimate removal of guarantees.[18]

> …any exit from the Guarantee Scheme for Large Deposits and Wholesale Funding should be gradual and implemented in a coordinated way, with other countries, in an atmosphere of international cooperation.[19]

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16 Professor Milind Sathye, *Submission 23*, p 1.

17 Tasmanian Department of Treasury and Finance, *Submission 16.*

18 Mr Christopher Joye, *Proof Committee Hansard*, 28 July 2009, p 15.

19 Mr Mark Degotardi, Abacus, *Proof Committee Hansard*, 14 August 2009, p 60.

> We think that our banking system is strong enough to be a magnet for funds so long as they do not have to compete against other banks which have government guarantees. That is why the international agreement to remove them all is important for us.[20]

> …the issue of when the funding guarantee should be lifted is one that is going to take an awful lot of international coordination.[21]

> …the Government should also consider what international practice is… so as to protect against any potential for a significant outflow of funds from Australia that may seek to "chase the Guarantee" of other jurisdictions.[22]

> …given the interconnectivity of global financial markets, the wholesale funding guarantee can only be removed when other members of the G20 do so.[23]

> Australia could lead the way in discussions, but if Australia just made an announcement then there would be a rash of money running out of the country.[24]

> …the guarantees should be removed in an orderly way, coordinated with similar actions in the major European and North American economies.[25]

> …the removal of bank guarantee arrangements should be coordinated with similar actions in key overseas jurisdictions to ensure this is achieved in a smooth and non-disruptive manner.[26]

> …it is also important to ensure that some kind of coordination exists amongst countries for terminating the government backed debt program.[27]

5.16 Treasury and the Reserve Bank have referred to global co-ordination:

> Exit strategies from various actions that governments have taken are matters that are being discussed in the G20, the Financial Stability Board and other international meetings on these issues.[28]

> …it is important to have some degree of coordination. I would not say that everybody has to do everything all at once or that you need to have some formal agreement because I think countries do have scope to go their separate ways. What we do will partly depend on market conditions and what happens in other countries. All of these things are part of ongoing

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20 Mr Nicholas Hossack, Australian Bankers' Association, *Proof Committee Hansard*, 14 August 2009, p 23.

21 Mr Chapman, APRA, *Proof Committee Hansard*, 28 July 2009, p 34.

22 Investec, *Submission 5*, p 4.

23 Bank of Queensland, *Submission 10,* p 3.

24 Mr Porges, Chief Executive Officer, Aussie, *Proof Committee Hansard*, 28 July 2009, p 65.

25 ANZ, *Submission 18*, p 4.

26 Australian Financial Markets Association, *Submission 20*, p 1.

27 Professor Fariborz Moshirian, *Submission 25*, p 5.

28 Mr Jim Murphy, Treasury, *Proof Committee Hansard*, 18 August 2009, p 17.

> discussions through various international forums, particularly the FSB and the G20.[29]

5.17 Some other economies are planning to coordinate their measures. For example, the Hong Kong Monetary Authority, Bank Negara Malaysia and the Monetary Authority of Singapore announced recently the establishment of a 'tripartite working group to map out a coordinated strategy for the scheduled exit from the full deposit guarantee by the end of 2010 in their respective jurisdictions'.[30]

5.18 A recent press report warned that achieving global agreement will take time:

> …few expect a swift multi-lateral agreement given that some national banking systems are still on life support.[31]

5.19 Some countries have indicated termination dates for their schemes, although in a number of cases the original closing dates have already been extended (Table 5.2).

Table 5.2: Expiry dates for guarantee schemes

	Maximum maturity date / debt no longer covered		Final date for guaranteed issuance	
	Original	Change (if any)	Original	Change (if any)
Australia	Rolling 5 years	--	Unspecified	--
Belgium	31-Oct-11	--	31-Oct-09	--
Canada	30-Apr-12	31-Dec-12	30-Apr-09	31-Dec-09
Denmark	30-Sep-10	31-Dec-13	30-Sep-10	31-Dec-10
Finland	30-Apr-12	31-Dec-14	30-Apr-09	31-Dec-09
France	31-Dec-14	--	31-Dec-09	--
Germany	31-Dec-12	31-Dec-14	31-Dec-09	--
Ireland	29-Sep-10	--	29-Sep-10	--
Korea	30-Jun-12	31-Dec-14	30-Jun-09	31-Dec-09
Netherlands	31-Dec-12	31-Dec-14	31-Dec-09	--
New Zealand	Rolling 5 years	--	Unspecified	--
Spain	01-Jul-12	15-Dec-12	01-Jul-09	15-Dec-09
Sweden	30-Apr-12	31-Oct-14	30-Apr-09	31-Oct-09
UK	13-Apr-12	09-Apr-14	09-Apr-09	31-Dec-09
US	30-Jun-12	31-Dec-12	30-Jun-09	31-Oct-09

Sources: BIS; Treasury departments, central banks, debt management offices and guarantee administrators

Source: RBA & APRA, *Submission 7*, p 5.

29 Dr Malcolm Edey, Assistant Governor, Reserve Bank of Australia, *Proof Committee Hansard*, 28 July 2009, p 20.

30 Hong Kong Monetary Authority, *Press release*, 22 July 2009.

31 *Australian Financial Review*, 7 August 2009, p 56.

An ongoing deposit insurance scheme

5.20 There have been discussions about a possible deposit insurance scheme in Australia for a long time. In mid-2008 Australia and New Zealand were the only OECD countries not to have such a scheme.[32] There are around 100 deposit insurance schemes operating around the world, according to the International Association of Deposit Insurers.

5.21 Deposit insurance is regarded as a standard feature of the financial system in much of the world:

> Deposit insurance is a natural, optimal and permanent part of the financial system architecture in every country in the OECD for very good theoretical and practical reasons. It builds a firewall into the financial system that prevents large shocks to the banking system propagating to the household and business sectors.[33]

5.22 One reason deposit insurance had not been introduced in Australia is that the 1996 Wallis Inquiry recommended against it.[34] However the IMF supported such a scheme in its 2006 assessment of the Australian financial system.[35]

Committee view

5.23 The Committee considers such an alternative should be considered as part of the examination of options for an ongoing deposit guarantee.

The optimal cap for a permanent scheme

5.24 The Council of Financial Regulators advocated an Early Access Facility, which would provide early repayments of up to $20,000 per depositor in a failed institution.[36] In June 2008, the Government announced its intention to introduce a Financial Claims Scheme along these lines.[37]

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32 Mr Jim Murphy, Executive Director, Treasury, *Estimates Hansard*, 22 October 2008, p 188.

33 Dr Sam Wylie, *Submission 16*, p 1.

34 Professor Quiggin comments: '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'; *Submission 3*, pp 6-7.

35 RBA *Financial Stability Review*, September 2008, p 59.

36 RBA *Financial Stability Review*, March 2008, p 65.

37 RBA *Financial Stability Review*, September 2008, p 59. The scheme was to work as follows; 'the Scheme would be administered by APRA, with the necessary payments initially being funded by the Government. APRA, on behalf of the Commonwealth, would also be able to borrow from the Reserve Bank for the purpose of the Scheme. APRA would then have first claim over the assets of the failed entity. Only in the highly unlikely situation that APRA was unable to recover the full cost of the Scheme through the sale of the failed ADI’s assets, would an industry levy be required.'

5.25 However, with the introduction of the guarantee schemes, deposits are currently guaranteed up to $1 million under the Financial Claims Scheme. This is believed to cover 99 per cent of depositors.[38]

5.26 There are a range of views about the appropriate cap for a permanent deposit insurance scheme:

> The monetary cap on deposit protection under the permanent financial claims scheme should be set at a level well below $1 million. The $20,000 threshold that was originally proposed is low relative to the international standard.[39]

5.27 Some lessons for design of deposit insurance have been drawn by the run on Northern Rock in the UK, the first on a UK bank for 130 years. The Reserve Bank commented:

> One aspect of the UK arrangements that has featured prominently in the post-crisis evaluations is the design of the deposit insurance scheme. Prior to the run, depositors were guaranteed to receive repayment of the first £2 000 of any deposit in a failed bank, and 90 per cent of the next £33 000. There were, however, no arrangements in place to make these repayments to depositors in a timely fashion. The combination of the 10 per cent 'haircut' on repayments above £2 000 and likely delays in repayment are widely thought to have contributed to the scale of the run.[40]

5.28 A key lesson in this is the timing issue. Whatever is put in place must deliver quick access to a substantial portion of depositors' funds.

5.29 An IMF survey has referred to average coverage levels in (pre-crisis) deposit insurance schemes being around one to two times per capita GDP, although they note:

> That ratio, however, is only a statistical description of deposit insurance systems and is not meant to be considered as a desired design feature.[41]

5.30 Given Australia's GDP of over $1 trillion and population of over 20 million, in round terms, one to two times per capita GDP would translate into a range of $50 000 to $100 000 as a coverage limit.

5.31 Some features of pre-crisis deposit insurance schemes are given in Table 5.3. Many of the schemes are long-established and are generally compulsory. One way in which they attempt to reduce moral hazard is by having risk-related premia.

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38 RBA *Financial Stability Review*, March 2009, p 43.

39 AFMA, *Submission 20*, p 6.

40 Reserve Bank of Australia, *Financial Stability Review*, March 2008, p 65.

41 Hoelscher, Taylor and Klueh, The Design and Implementation of Deposit insurance Systems, IMF Occasional Paper 251, 2006.

Table 5.3: Pre-crisis deposit insurance schemes

	Enacted	Compulsory?	Risk-adjusted premium?	Coverage US$'000 (ratio to per capita GDP)
Austria	1979	√	x	22.6 (0.7)
Belgium	1974	√	√	22.6 (0.8)
Canada	1976	√	√	42.8 (1.2)
Finland	1969	√	√	28.3 (0.9)
France	1980	√	√	79.1 (2.8)
Germany	1966	√	√	22.6 (0.8)
Hong Kong	2006	√	√	12.8 (0.6)
Japan	1971	√	x	82.3 (2.6)
Netherlands	1979	√	x	22.6 (0.7)
Norway	1961	√	√	282.5 (5.8)
South Korea	1996	√	x	42.0 (3.4)
Sweden	1996	√	√	30.9 (0.9)
Switzerland	1984	x	√	22.3 (0.5)
UK	1982	√	x	57.2 (1.9)
USA	1934	√	√	100.0 (2.8)

Source: Secretariat, calculated from data in Hoelscher, Taylor and Klueh, *The Design and implementation of deposit insurance Systems*, IMF Occasional Paper 251, 2006.

Senator Alan Eggleston

Chair