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Deposit Insurance – Getting the Financial Claims Scheme Settled

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In this Australian Centre for Financial Studies Financial Regulation Discussion Paper, Professor Kevin Davis reviews the proposed changes to the Financial Claims Scheme which were released in May 2011. He argues that the absence of an ex-ante risk based insurance fee is justified given the "closed resolution" nature of the scheme, and the priority given to APRA in the unlikely event that the scheme is activated. However, the existence of the scheme arguably generates competitive benefits for ADIs, relative to other non-ADIs competing for retail funds, due to perceptions of greater safety. Whether such benefits are offset by costs to ADIs from prudential regulation, or whether some fee is warranted on competitive neutrality grounds is an unanswered question.

The only surprise in the proposed changes to the Financial Claims Scheme (FCS) is why the Government took so long to reach, and announce, those plans. The existing cap of $1 million had to be reviewed by October 2011, and procrastination has done little other than add the slight complexity of how to deal with term deposits which run over that date.

Most of the suggestions by the Council of Financial Regulators for changes to the FCS are relatively straightforward and uncontroversial. But the proposed size of the cap and the financing of the scheme will no doubt evoke debate.

The straightforward changes include the following.

First, deposits in foreign branches of Australian banks are not covered by the scheme. International practice varies on this score, but the recent Icelandic experience cautions against countries taking on such exposures. More generally, international regulatory pressures seem likely to lead to most international expansion being by way of separately capitalized subsidiaries (covered by the host country deposit insurance scheme). In that case, deposit insurance arrangements for foreign branches become a non-issue.

Second, coverage will not apply to foreign currency deposits. Individuals holding such deposits are presumably not unsophisticated investors whom the scheme is designed to protect.

Third, foreign bank branches will not be covered, unlike Australian subsidiaries of foreign banks which are incorporated, separately capitalized and supervised by APRA). Since their licenses are premised on them not dealing with typical retail customers (they are not permitted to accept deposit accounts with initial balances of less than $250,000), exclusion from a scheme which involves a cap on insured deposits of no greater than that amount is again, a non-issue.

Fourth, since the insured cap is meant to apply to total deposits of an individual at one bank, a coverage issue arises when an agent (such as a trustee) operates one account on behalf of a number of individuals. The proposals, sensibly, advocate “looking through” the account to identify the ultimate owners, with the proposed cap applying to each.

The first issue which will generate debate relates to the proposed size of the cap. Perhaps the most surprising aspect of the debate will be the absence of proposals by banks and other ADIs to lower the cap on insured deposits below the $100,000 to $250,000 range suggested by the Council of Financial Regulators.

My how times change! When the FCS was originally mooted with a suggested cap of $50,000, the banks lobbied hard to have the cap reduced to $20,000. In the event, the Global Financial Crisis (GFC) intervened and the scheme was introduced with a cap of $1 million. At $50,000, almost all retail depositors are fully covered, but the GFC has led to a general increase in coverage levels internationally, and the proposed range is not inconsistent with that found elsewhere.

Smaller institutions, such as credit unions, can be expected to lobby for retention of the $1 million cap. Explicit government protection removes some of the competitive disadvantage they feel they face from the perceived implicit government protection which, it can be argued, the large banks gain from their size. Since no up front fees are proposed as part of the scheme, the larger the cap the better from their perspective.

The issue of fees will no doubt generate some debate. An ex-post funding approach is to be maintained, whereby levies on other ADIs would be made should APRA pay out depositors of a failed ADI and not recoup those funds from the realization of the failed ADI’s assets.

Some will argue that ex-post funding of the scheme is inappropriate, due to moral hazard concerns, and that an ex-ante risk-based fee scheme should be used. These arguments have limited weight given the specific nature of the scheme.

First, the moral hazard concern is that depositor protection reduces depositor monitoring of bank risk taking and enables excessive risk taking by ADIs without the penalty of needing to pay higher deposit interest rates reflecting that risk.

Really! The notion that retail depositors have the expertise and ability to assess the riskiness of even small ADIs is laughable. Even sophisticated analysts who might provide such information to depositors do not have a good track record in this regard. Risk-based capital requirements and APRA supervision (and its flexibility to adjust capital (and liquidity) requirements for individual ADIs) are one reason to think that moral hazard concerns are not a major issue. Another is that market discipline by wholesale providers of funds to banks, who are not covered by the scheme, is unaffected by the nature of the deposit insurance arrangements. Arrangements which create moral hazard need to be avoided, but this is not one of them. In fact, it can be argued that since the alternative to an explicit, limited cap, insurance scheme is depositor perceptions of a complete implicit government guarantee, such a scheme reduces moral hazard.

The main effects of protection are to reduce uninformed runs and panics, and enable ADIs to raise funds at “risk-free” interest rates. Hence this is clearly of benefit to those ADIs covered by the scheme, and to which we shall return shortly.

The second concern – that an ex-ante risk-based fee scheme is needed – ignores how the FCS operates.

First, it is a closed resolution scheme, meaning that it only comes into operation when APRA applies to wind up an ADI or, where under the revised proposals, a statutory manager has been appointed and all hope lost of an alternative to winding-up).

Who believes that APRA and the Government will ever let a bank or other ADI, fail in that way, rather than finding some method of open resolution for troubled institutions such as a take-over or merger? In other words, the FCS book of procedures is highly unlikely to ever be taken off the shelf and the FCS activated.

Second, even if the scheme is activated, it is extremely unlikely that ex-post levies on other institutions will be necessary. The reason is that, upon failure, APRA pays out insured depositors and then stands at the very front of the queue for compensation from the liquidation of the failed ADI's assets. It is the uninsured deposits and other claimants who lose. Only if total assets were not enough to cover the insured deposits would APRA need to impose a levy.

In general, this is extremely unlikely – although it obviously depends on the size of the cap and the structure of the ADI's balance sheet. If all deposits were insured (ie. an unlimited cap) and there were no other creditors, then APRA could face a shortfall. But that is clearly not the case with larger banks who have substantial other funding sources. A modest cap ($100,000 – 250,000) would likely ensure that smaller ADIs have a buffer of uninsured deposits which bear the losses.

(It might be argued that not giving APRA priority in liquidation would increase APRA's incentive to resolve troubled institutions before a liquidation situation is reached. In practice, the reputational cost to APRA of not monitoring ADI capital positions and acting rapidly enough to prevent a liquidation situation would appear to make the priority issue one of second-order importance).

So, a risk-based ex-ante fee has little to justify it. But there is, arguably, a case for some form of charge as a requirement of competitive neutrality between ADIs and other institutions seeking to raise funds from retail customers. Because the FCS provides an aura of government protection for retail deposits not available to other financial institutions, ADIs benefit in two ways. One is the reduced likelihood of depositor runs which enables them to undertake greater liquidity creation than would otherwise be the case (ie. by using short term deposits to make long term loans while holding lower levels of liquid assets). The second benefit is the ability to raise retail funds at lower interest cost than their non-ADI competitors.

Banks and other ADIs will no doubt argue that they do already pay via capital and liquidity requirements and through other regulation and supervision imposts. That may be so, but whether it is on balance adequate to offset the competitive advantages of explicit and implicit government protection is far from obvious. Whether the cap should be set at the proposed lower end of $100,000 or the upper end of $250,000 should perhaps be considered primarily in the context of how much it distorts competition in the market for retail funds between ADIs and other non-prudentially regulated institutions.

On the other hand, if individuals perceive that their deposits in ADIs have an implicit government guarantee regardless of their size, the size of the cap is largely irrelevant. It will be interesting to see if researchers can answer that question about perceptions by analysis of the behavior of depositors with $1 million or more over the last few years.

This FRDP was prepared by Kevin Davis, Research Director, Australian Centre for Financial Studies and Professor of Finance, University of Melbourne.

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