Paying for the Financial Claims Scheme:

Expanding the Options

FRDP 2013 – 2

September 2, 2013

In this ACFS Financial Regulation Discussion Paper, Professor Kevin Davis puts forward a proposal to allow ADIs to pay the proposed fee for the Financial Claims Scheme (FCS) by cancellation of accumulated franking credits as an alternative to cash payment. Introducing this option, which would be available to all ADIs, would offset some existing distortions in the financial system perceived to exist by mutual financial institutions arising from the dividend imputation tax system. It would also offset further distorting effects of the FCS fee that the mutual sector has suggested may reduce their competitive ability. The budgetary effects are relatively small and involve a reduction in the fee income to be gained from introduction of the fee.

On 1 August 2013 the Australian Treasurer announced that Australian ADIs (banks, credit unions and building societies) will in future be charged a fee for the protection provided to depositors by the Financial Claims Scheme. The proposed fee is to be in the order of 5 to 10 basis points per dollar of deposits covered by the scheme (which protects a depositor's balances up to a cap of $250,000 at a failed ADI). It is estimated that the fee will generate around $500 million per annum which is to be paid into the Federal budget and credited to a Financial Stability Fund.

It is generally assumed that the fee would be paid in the form of cash - but there is another option which could reduce one existing tax distortion in the financial system perceived to be significant by one group of ADIs. Specifically, if payment could also be made by way of cancellation of franking credits, this option would be of value to mutual ADIs who cannot distribute accrued franking credits, and perceive that as a competitive disadvantage vis a vis banks. Assessing whether it is, in fact, a competitive disadvantage is a complicated, empirical, matter, but to the extent that the option to pay the fee by way of franking credit cancellation is available to all ADIs, this could not be viewed as introducing a new distortion, and would at least reduce mutual ADI's perceptions of inequities. It could also reduce potential adverse competitive effects upon that group which the fee itself may create, as explained later.

One consequence of allowing payment by way of franking credits is budgetary. To the extent that undistributable franking credits of the mutual ADIs are cancelled, the government would receive less cash and gain nothing by way of those franking credits having been cancelled. On the other hand, if non-mutual ADIs (banks) chose to pay by way of cancellation of franking credits rather than by cash, the difference in effect on the budget position would be minimal. Less franking credits (attached to dividends) would be claimed by bank shareholders, implying a net increase in tax revenue. The offset would not be 100 percent (due to foreign shareholders not being able to use franking credits), but for the Australian banks it could be anticipated that around 80 per cent of franking credits distributed are used.

Given the attraction of franked dividends to Australian shareholders, it would seem unlikely that the Australian banks would elect to pay by way of franking credit cancellation. Hence, since they have the bulk of insured deposits, the budgetary effect seems likely to be minimal. Mutual ADIs have around $70 billion of total deposits and, assuming (because public information is not readily available) that 75 per cent of that amount is covered by the FCS, a 10 basis point p.a. fee would imply a fee income amount of around $50 million p.a. The government would be giving up that amount (10 per cent of the anticipated revenue) of cash receipts in exchange for cancelling a contingent liability in the form of currently unusable franking credits held by mutual ADIs.

There is one other potential budgetary cost arising from insured deposits held at Australian subsidiaries of foreign owned banks. For these institutions, franking credits are also unusable, and they could be expected to pay by way of franking credit cancellation. The amount is relatively small: there are eight such banks and they hold around $34 billion of household deposits. (Again, public figures are not available on what proportion of these deposits is covered under the $250,000 FCS cap, but a guesstimate might put the total amount at less than $20 billion, and the fee income involved at around $20 million p.a.). To the extent that the imputation system puts foreign owned banks at a competitive disadvantage, the consequent stimulus to competition with domestic banks in retail markets would be welcome.

One reason, apart from offsetting the existing perceived distortion arising from the imputation tax system, for considering the franking credit cancellation option is that the mutual ADIs have suggested that introduction of the FCS fee will harm their competitive ability against the larger banks. There are several possible reasons for this, and the relevance of each depends on whether the fee is ultimately borne by depositors (lower deposit rates), borrowers (higher loan rates), or the owners of ADIs (lower profits). The outcome will depend upon the degree of competition and demand and supply conditions in loan and deposit markets.

One argument advanced by the mutuals is that a larger proportion of their overall funding takes the form of insured deposits, probably in the order of 75 plus per cent, compared to less than 30 per cent for the major banks. It is thus a larger average fee per dollar of assets for the mutuals, so that if the market outcome was that the fee were to be passed on to borrowers the required increase would be higher for the mutuals reducing their competitive ability in loan markets. Alternatively, if the cost were borne by owners in the form of lower profits, the impact on the rate of profit (return on equity) would be greater for the mutuals, because more would be paid in fees per dollar of equity. That effect would be amplified by the tendency for mutuals to have significantly higher equity/assets ratios than the banks. Only if the outcome was that depositors bore the levy (such that the new deposit interest rate plus fee equals the old deposit interest rate) would it not be to the competitive disadvantage of the mutuals. In practice some mix of these outcomes might be expected.

It appears unlikely that the fee would, in fact, be borne by depositors. Basel 3 regulatory changes, and greater attractiveness to ADIs of more "sticky" retail deposits has meant increased competition in the market for insured deposits. That militates against lower retail deposit interest rates being an outcome, and that is reinforced by the fact that a significant proportion of insured deposits are in transaction accounts paying no, or derisory, interest rates, in exchange for subsidised transactions services.

If the fee is borne by owners, it would have a significant impact on return on equity (roe). Assume, for example, a fee of 10 basis points which applies to 50 per cent of the ADI's liabilities (ie assume insured deposits are half of the ADI's non-equity funding). This would reduce the return on assets by around 5 basis points. With ADIs having high leverage of assets/equity of around fifteen to one, the impact on roe would be around 75 basis points. That is significant, but with the major banks posting roe results in the upper teens the reduction would certainly be manageable, and would have political appeal given public concerns about excessive bank profits.

That outcome would be particularly negative for the mutual ADIs, since their only substantial source of increased capital for growth is retained earnings. Without external capital, their natural rate of asset growth (a growth rate that keeps their capital ratios constant) is equal to their roe. A reduction in roe of 75 basis points or so would significantly hamper their ability to grow.

However, it also seems unlikely that the fee impost would be ultimately borne by ADI owners. Rather, Australian ADIs have already demonstrated their ability and willingness to pass on to retail borrowers any increase in their funding costs. With borrowers having few options for loans outside of the ADI sector, it can be expected that this increase in bank costs will also be passed on to borrowers. As outlined above, this seems likely to adversely affect the mutual ADIs because of their larger reliance on insured deposits. Hence, providing the option to pay the fee via cancellation of franking credits would work to offset this adverse effect.

In conclusion, there would appear to be merit in considering a policy which allows for the FCS fee to be paid by ADIs either by cash or by cancellation of undistributed franking credits. Since this option would be available to all ADIs it could not be argued to be discriminatory. To the extent that payment by franking credit cancellation was favoured by particular types of ADIs (mutuals and Australian subsidiaries of foreign banks), this would suggest that the effect is to reduce competitive distortions arising from the imputation tax system. And doing so could counterbalance potential adverse effects of the FCS fee itself on competitive ability of those ADIs. While there is a potential cost to budgetary revenue from providing the franking credit cancellation option, it appears likely to involve a relatively modest reduction in the amount of new revenue to be obtained from the FCS fee, and a small price to pay for improving competitive conditions in the ADI sector.

This FRDP was prepared by Kevin Davis, Research Director of the Australian Centre for Financial Studies.

Disclaimer: Professor Davis is a former director of a small credit union, and also owns shares in Australian banks.

The ***ACFS Financial Regulation Discussion Paper Series*** provides independent analysis and commentary on current issues in Financial Regulation with the objective of promoting constructive dialogue among academics, industry practitioners, policymakers and regulators and contributing to excellence in Australian financial system regulation.

For more in this series, please visit our website at
australiancentre.com.au/tags/financial-regulation-discussion-paper-series/

FRDP 2013 – 2: Paying for the Financial Claims Scheme: Expanding the Options

About the Australian Centre for Financial Studies

The Australian Centre for Financial Studies (ACFS) facilitates industry-relevant and rigorous research, thought leadership and independent commentary. Drawing on expertise from academia, industry and government, the ACFS promotes excellence in financial services. The Centre specialises in leading edge research, aiming to boost the global credentials of Australia's financial sector, facilitate industry-relevant academic finance related research, and supports Australia as an international centre for finance research, practice, and education.

The ACFS engages academics, finance practitioners and government in knowledge creation, transfer and thought leadership related to the financial sector, developing strong linkages between these groups. Through its activities, partnerships and network, the Centre provides insights and influences policy, practice and thought across sectors and industries.

The Australian Centre for Financial Studies is a not-for-profit consortium of Monash University, RMIT University and Finsia (Financial Services Institute of Australasia).

www.australiancentre.com.au