FINANCIAL REGULATION DISCUSSION PAPER SERIES

No Financial Claims Scheme Levy – A Good Decision

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In this FRDP, Professor Kevin Davis explains why the Government decision announced today to not impose an upfront fee on banks, based on insured deposits, to fund the Financial Claims Scheme is correct on both logical and practical grounds. While a case could be made for imposing a fee based on total bank liabilities to finance a resolution fund, a better option is ensuring unquestionably strong bank equity capital positions.

After much speculation, the Australian Government has announced that it will not follow through with the proposal of the previous government to impose an upfront fee on insured bank deposits (perhaps 5-10 cents per $100 of deposits) to pay for the insurance provided to those depositors by taxpayers via the Financial Claims Scheme (FCS). This is a triumph of logic over the hunt for budget revenue.

An upfront fee has no basis in logic, because Australia's depositor preference arrangements mean that the risk of loss to taxpayers from the FCS is negligible. While a case might be made for imposing a fee based on total bank liabilities (which could be used to finance a bank resolution fund, such as those introduced in some other jurisdictions), a better option is to remove the rationale for such a fund by ensuring that banks have unquestionably strong capital ratios overseen by a strong prudential supervisor. This was the position advocated by the Financial System (Murray) Inquiry.

The reason why an FCS levy makes no sense is because of APRA's super priority in the liquidation of a bank or other ADI (building societies and credit unions). If a bank is liquidated, APRA pays out insured depositors and stands above other depositors and creditors, such as bond holders, in priority of claims on the failed bank's assets. Given the structure of bank and ADI balance sheets, the likelihood that APRA would not fully recoup all it has paid out is negligible. For the major banks, such an outcome would require a fall in asset values of around 70 per cent – an event which would make the Global Financial Crisis look like a mild hiccup. Consequently, the "fair value" fee for "providing" insurance is essentially zero. Even for small organisations such as credit unions with more reliance on insured deposits, the "fair value" fee is also essentially zero.

APRA's service, via the FCS, to insured depositors is essentially to ensure rapid (ideally uninterrupted) access to their funds if a bank is to be liquidated. More generally, an important component of APRA's services is, if possible, to facilitate the orderly exit of a troubled institution via an arranged merger with a stronger partner – to the benefit of all depositors and creditors.

It is the uninsured depositors and other creditors who "provide" insurance to insured depositors by having lower priority to them (via APRA's priority) in a liquidation situation. In principle, the bank will already be paying for the deposit "insurance" through the higher interest rates these stakeholders require because of their greater exposure to potential loss.

In practice, however, the existence of implicit government guarantees (the expectation of "bail-out" of troubled banks) means that this mechanism does not always operate fully. Banks then benefit from lower funding costs due to such implicit guarantees – as evidenced by the "uplift" in bank credit ratings assigned by the ratings agencies in recognition of expectations of sovereign support for troubled banks.

If there is a case for a levy, it is based on the exposure of the taxpayer to loss from such government "bail-out" of troubled banks – which benefits all depositors and creditors. Consequently, such a levy would be logically based on the total liabilities of the bank (not the insured deposits). How large such a levy should be is problematic, since it is difficult to assess the precise benefit to banks from implicit guarantees. While it would be much better, and logical, to raise a desired amount by a levy on total bank liabilities rather than a levy on insured deposits alone, a better option is to ensure strongly capitalised banks and robust supervision which prevents "bail-out" situations arising.

Several overseas jurisdictions have imposed such levies on banks to build up a "resolution fund". Why might government, other than in the hunt for revenue, want to raise funds in this way? One valid argument (in addition to receiving compensation for costs of potential bail-outs) is that it may be useful for regulators to have access to a resolution fund which can be drawn upon to facilitate the exit of a troubled bank via an assisted merger with a stronger entity. That would reinforce the case for a levy on all bank liabilities (rather than insured deposits alone), because such a process protects all depositors and creditors. But providing APRA with pre-authorised access to funds from the government budget to facilitate needed exits with *ex post* levies on industry to recoup such costs is another, arguably better, way to achieve this.

But ideally, what makes better sense is to ensure that banks have unquestionably strong capital ratios such that there is no general expectation of implicit government guarantees or potential for "bail-out". Proposals for additional "bail-in" debt requirements are relevant here, but high common equity capital requirements, and diligent supervision by APRA, are a much preferred approach.

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This FRDP was prepared by Professor Kevin Davis, Research Director of the Australian Centre for Financial Studies, who was also a member of the Financial System (Murray) Inquiry.

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