Australia-New Zealand Shadow Financial Regulatory Committee

Managing Bank Failure in Australia and New Zealand: Rapid Access Matters

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In stark contrast to other OECD countries, Australia and New Zealand do not have explicit deposit insurance schemes, despite their increasing popularity. Now both countries are reviewing the way they would manage and respond to bank failure, but progress has been slow. In Australia, the issue has been on the agenda since 2001, and proposals for change surfaced in New Zealand as early as 2002.

The proposed changes are still being formulated and a number of details remain unresolved. Nevertheless, the broad outlines are clear. In Australia, deposit holders would have immediate guaranteed access to their funds up to some pre-specified level in the event of a bank failure, with no protection for amounts greater than this level. In New Zealand, by contrast, deposit holders would receive access to some proportion of their entire funds, although this proportion will not be known prior to failure.

In the view of the ANZSFRC, improved mechanisms for timely resolution of bank failures and provision of rapid access to depositors' funds are highly desirable.

Why are these changes being considered? One reason is the need to provide a mechanism for rapidly responding to bank failure. Another is the need to alleviate potential political pressure to bail out depositors in the event of bank failure. Yet another is the so-called moral hazard problem. The lack of any definite failure management policy may encourage depositors to believe that their funds are implicitly guaranteed by governments. This weakens incentives for effective monitoring of bank behaviour. An explicit statement of what will happen in the event of a bank failure will make investors aware of the risks they are taking.

Nevertheless, both countries are reluctant to be seen as offering traditional deposit insurance schemes, viewing these as cumbersome, inefficient and expensive. Such schemes have two principal objectives: to stop a single bank failure from escalating into a multi-bank crisis, and to protect individual depositors from significant loss. In formulating their proposals, regulators in Australia and New Zealand have downplayed the protection role focussing instead on financial system stability.

To achieve this objective, the key feature of both schemes is their emphasis on depositors obtaining rapid access (e.g., within 1-2 business days) to funds following failure of their bank. The underlying idea is that by providing such access, deposit holders are able to carry out their "everyday business", thereby reducing economic and social disruption.

In the view of the ANZSFRC, ensuring rapid access to depositor funds is an important component of bank failure management policy. We urge both countries to finalise, formalise, and implement their respective plans as soon as possible.

The regulatory environment for financial regulation is quite different in Australia and New Zealand resulting in contrasting elements in the proposals. While in both countries, the regulations surrounding financial institutions emphasize financial stability, the Australian arrangements also provide a degree of depositor protection through the preferential treatment of domestic depositors. In New Zealand, the onus for assessing and bearing risk is placed on the individual depositor.

The proposed Australian compensation scheme would guarantee retail depositors immediate access to a maximum of $20,000 of their deposits at a failed deposit-taking institution. The scheme would be operated by the Australian Prudential Regulation Authority (APRA), drawing initially on a line of credit at the Reserve Bank of Australia. The scheme would then become the most senior claimant (ahead of all other depositors) on the assets of the failed bank. Remaining claims would be met over time as the value of the failed bank's assets are realised.

Should the failed bank's assets be inadequate to meet the scheme's claims (in which case the remaining depositors receive nothing) the shortfall would be met by a levy on other deposit-taking institutions. In practice, given the structure of deposit-taking institution balance sheets, depositor preference arrangements, and prompt action by APRA in closing distressed institutions, the likelihood of a failure of the magnitude that depositors suffer severe losses and a levy being necessary is quite small.

We note that during the consultation process the maximum deposit size was reduced from $50,000 to $20,000. The scheme's claim was also promoted in seniority such that deposit-taking institutions will have effectively achieved their objective of avoiding levies when another institution fails.

Since over 80% of depositors' balances are less than $20,000, most households would effectively have complete protection but small businesses may be faced with liquidity problems. However, a higher maximum risks greater moral hazard.

The New Zealand proposal involves no guarantee of immediate access to a specific amount, but aims to provide access to some proportion of claims to a wider range of depositors and other creditors. It does so by applying a percentage 'haircut' to all liabilities such that the value of total adjusted liabilities becomes less than a conservative estimate of the value of assets. The percentage haircut will vary depending on the estimated losses of the deposit-taking institution and could differ across claimant categories. The adjusted liability value would be guaranteed by government and immediately available. Over time claimants may get access to more of their funds as the amounts available for distribution are realised. In this scheme, creditors remain exposed to losses due to bank failure.

In contrast to the Australian scheme, the New Zealand scheme links creditor liquidity access to the size of deposit balances, which may be beneficial for small businesses. However, depositors are treated the same as all other creditors.

Finally, we also note:

- Any failure mechanism scheme involving limited depositor protection is only as good as a government's resolve to implement its stated intentions.
- In Australia, development of policy regarding failure resolution of insurance and deposit-taking institutions has been linked. There is merit in separating the discussion.
- The different proposals reflect different approaches to prudential regulation in Australia and New Zealand and both have merit for their respective countries.

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