

\$250K Deposit Guarantee Cap: Who Wins, Who Loses?

The entrenchment of deposit insurance, aka the Financial Claims Scheme (FCS), with a \$250,000 cap was largely a “no-news” event. Even though the cap is at a high level by international standards, there have been few voices raised against the FCS arrangements.

That is a far cry from the banks’ strident opposition to its introduction before mid 2007. It was unnecessary (due to depositor preference legislation and good supervision and bank risk management), and that it would weaken market discipline and distort competition. What a difference a global financial crisis makes!

More interesting than the details of the FCS are its likely effects, particularly in the context of other policy changes affecting banks and the household investor/consumer of financial services.

The first, obvious, point is that the FCS provides banks and (even more so) other ADIs (building societies and credit unions) with a significant competitive advantage - that of customer perceptions of safety over other competitors for shorter-term household savings. Arguably, this tilting of the competitive playing field suggests that ADIs should pay some fee to offset the benefits gained.

Two responses can be expected. One is that ADIs are safe anyway, such that the FCS really doesn’t add anything. That may be so, and if a “fair” deposit insurance premium is calculated it would be very close to zero for most ADIs. But that is separate to the consequences for competition where, as the GFC demonstrated, perceptions are what matters.

The second response is that ADIs are subject to a plethora of regulation imposing additional costs and offsetting any competitive advantage. Yes, but while the regulatory intrusions seem to be continually increasing, it is not clear where the net balance of costs and benefits lies.

Recent and proposed measures such as banning exit fees, prohibiting unsolicited credit card limit increases, increased responsible lending requirements etc., clearly limit bank flexibility, but the extent of the actual costs imposed is far from clear. Arguably, if depositors accept lower interest rates due to perceived greater safety, the net effect of all changes on costs to lenders may be minimal.

A second competitive consideration is the effect of recent budget changes which will (ultimately) reduce the tax rate on the first \$1,000 of interest by 50 per cent. While this applies to all fixed interest investments and not just bank deposits, it does somewhat reduce the tax advantage of superannuation (where funds invested are locked away till retirement).

A third consideration is the adverse consequences for the development of a local retail bond market, which has been an objective of policy makers for some time, with actions

such as allowing simplified prospectuses designed to help market development. But retail bonds – even if issued by banks – involve default risk, such that deposit guarantees reduce their appeal and imply payment of higher yields (with consequently higher cost of funds to the corporate issuers) to become competitive.

Fourth, continuation of the FCS with a high cap, will facilitate banks meeting the new funding liquidity requirement (the Net Stable Funding Ratio) being introduced by APRA, because retail deposits (generally) are regarded as stable funding.

Finally, it must be asked what the consequences of the FCS will be for our Trans-Tasman neighbours? Because the FCS applies to deposits by both Australian residents and non-residents in banks in Australia, New Zealanders are able to take advantage of the guarantee by depositing in Australia rather than with the subsidiaries of the Australian banks operating in New Zealand.

At the moment, that does not matter, because the Kiwis have a guarantee scheme operating until December 2011. But they have announced that after that date there will be no deposit insurance scheme. Under their Open Bank Resolution proposals depositors in a failing bank will be exposed to some loss (a “haircut” they call it – although recipients will no doubt think of it as a “scalping”!)

On balance, there are lots of pluses from the FCS for the Australian ADIs (if not their NZ subsidiaries) in terms of deposit-taking consequences which should at least lessen the pain from other regulatory imposts of which they have been complaining. Whether it will help the development of non-bank competitors and capital markets is another question.

Kevin Davis
Research Director, Australian Centre for Financial Studies
Professor of Finance, The University of Melbourne

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