"Clayton's" Deposit Insurance

The announcement by the Treasurer that Australia will shortly have a Financial Claims Scheme (FCS) is welcome, although it will not be welcomed by all those it affects – and most particularly the large banks.

The Treasurer (and the Council of Financial Regulators) have been at pains to describe the proposed scheme as an "early access" mechanism. The arrangements would enable depositors or policy holders in a failed financial institution covered by the scheme to get virtually immediate access to their funds, up to a specified cap – of $20,000 in the case of deposits.

The emphasis on early access is important – and is a characteristic of deposit insurance schemes operating in all OECD countries (other than Australia and New Zealand). As well as limiting the disruption to depositors' finances if a failure occurs, it can work to reduce the likelihood of a run on an institution by retail depositors.

Of course, by limiting the amount covered to $20,000, depositors with larger amounts may still get nervous, and be susceptible to withdrawing funds if there is any hint of trouble. But that is the natural consequence of trying to maintain a role for market discipline as an important part of ensuring that bank management acts prudently.

Indeed, it can be argued that the proposal enhances market discipline, although some will argue that any such protection scheme promotes moral hazard among those covered by causing them to take less care in choosing where to place their (now protected) deposits.

The first response to such an argument is that its proponents overestimate (very substantially) the financial sophistication of the average retail depositor. Who among us, even well qualified accountants, is able to understand and interpret the financial statements of a bank in order to assess the risk of its deposits?

The second response is that placing a limit on coverage can be interpreted as removing an implicit government guarantee on bank deposits which the general populace believes already exists. Market discipline by those not covered under the early access arrangements would then increase.

As a digression, those who believe that there needs to be greater market discipline should perhaps be arguing for removal of the depositor preference arrangements, which place depositors ahead of all other (including secured) creditors of a bank. Those arrangements (not found extensively overseas) make it highly unlikely that Australian depositors would lose money in the event of a bank failure, and thus reduce the incentives for depositors to expend effort in assessing bank risk.

One reason why the Australian banks will not cheer the announcement of the FCS is that currently they are the beneficiaries of a widespread public perception that all bank deposits are guaranteed. Such a perception, I would argue, has existed despite repeated denials by both Government and regulatory officials. The “bail-out” of policy holders of the failed HIH by the previous Government could only have served to reinforce this perception.

A second reason why they will not cheer, is because of the potential competitive effects within the deposit taking industry. To the extent that depositors equate bank size and longevity with safety, the larger, older, banks possess a competitive advantage over smaller, newer, rivals. The FCS removes this competitive advantage (of perceived safety) in dealing with smaller, retail, customers.

Although the language surrounding the introduction of the FCS is that it is an early access arrangement, the reality is that it is a deposit insurance scheme. It does differ somewhat from many overseas schemes in terms of its being post-funded by possible levies on other institutions if required. It does have a relatively low “cap” – although at $20,000, the vast majority of retail depositors are fully covered.

Perhaps because the scheme also applies to general insurance policy holders, there are grounds for avoiding the use of the more specific term of deposit insurance. But, just like the old ads for “the drink you have when you’re not having a drink” the FCS might best be described as a “Clayton’s” deposit insurance.

Kevin Davis is the Commonwealth Bank Chair of Finance at the University of Melbourne and Director of the Melbourne Centre for Financial Studies. He led the Study of Financial System Guarantees commissioned by the former Treasurer to examine issues involved in alternative options for depositor and policy holder protection.