FEES FOR BANK GUARANTEES

Is a fee for perceived and actual protection provided to depositors by Government warranted? Probably, yes. Should it relate only to deposits less than the cap (currently $250,000) covered by the Financial Claims Scheme? Not necessarily. Should money raised be paid into a special fund rather than into the budget? No.

The Financial Claims Scheme (FCS) has been in operation in Australia since October 2008, with the current cap on deposit amounts guaranteed of $250,000 applying since February 2012. That cap is at the upper end of amounts covered internationally – and well in excess of the $20,000 amount which the banks were arguing for prior to the Global Financial Crisis.

Unlike deposit insurance arrangements in most other countries, there has been no fee charged for provision of the FCS guarantee, with an *ex post* funding model applying. Should a bank or ADI fail and APRA be unable to recoup amounts paid out to insured depositors from remaining assets of the ADI, then the Treasurer may impose a levy on other ADIs to cover any shortfall.

But because APRA then stands at the head of the queue of the claimants on the failed bank's assets, it is extremely unlikely, that APRA will not get its money back such that that taxpayers would bear the cost, or a levy on other banks would be required. It is thus uninsured deposits and other creditors that are the insurer of first resort. There is little need for a pre-financed "fund" to avoid taxpayer risks by deposit insurance under the Australian scheme.

But to the extent that they perceive that, despite government disavowals, government will not let banks fail, those other uninsured depositors and creditors will not see their implicit insurance role as a cost requiring higher returns. Banks then gain a competitive advantage in fund raising relative to other financial institutions.

This also generates a competitive advantage in loan and investment markets where banks can use funds raised at a risk free (or near risk free) rate to invest in risky assets such as loans and other investments where returns are higher.

It is this competitive advantage which gives rise to the argument for imposing a fee, rather than there being government/taxpayer exposures as a result of the FCS. If there is a taxpayer exposure it is primarily from the implicit guarantees due to "too big (or politically unacceptable) to fail", and is related to all deposit, rather than just insured deposit, funding.

Nevertheless putting a fee on insured deposits would be the politically simple thing to do, justifiable by bringing us more into line with international practice (even though our system is different). But by how much? In countries like the US and Canada, fees range from a few basis points up to as high as 40 basis points for "high risk" banks. But there is no "right" number based on assessing the value of insurance provided given that our FCS does not involve the same type of insurance underwriting.

Imposing a fee on guaranteed deposits would lead to some mix of three outcomes: banks would reduce deposit rates paid, they would increase loan rates, or shareholder returns would fall. Either of the first two outcomes would improve the relative position of non-guaranteed competitors in funding and loan markets – arguably moving the system towards a more level playing field, although it is so twisted, pitted and pock marked by taxes and regulation that it is hard to be definitive about consequences. The outcome regarding the last possibility would provide some evidence on the extent to which there is adequate competition in banking.

What should government do with revenue raised from such a fee – establish a specific fund, or pay it into general budget revenue? Provided that APRA can meet the costs of effectively resolving a bank failure by access to a budget provision (which it already has) there is nothing to be gained by having a separate fund which could grow without limit if APRA supervision (and good bank management) retains Australia's unblemished reputation for bank safety.

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