The $1 Million Cap No Longer Fits

The only surprise in the proposed changes to the Financial Claims Scheme (FCS) is why the Government took so long to reach, and announce, those plans. The existing cap of $1 million had to be reviewed by October 2011, and procrastination has done little other than adding the slight complexity of how to deal with term deposits which run over that date.

Various groups will respond to the Government's consultation paper, seeking to influence the changes in particular ways. Perhaps the most surprising of these will be the absence of proposals by banks and other ADIs to lower the cap on insured deposits below the $100 thousand to $250 thousand range suggested by the Council of Financial Regulators.

My how times change! When the FCS was originally mooted with a suggested cap of $50 thousand, the banks lobbied hard to have the cap reduced to $20 thousand. In the event, the Global Financial Crisis intervened and the scheme was introduced with a cap of $1 million.

There is also likely to be arguments advanced that the *ex-post* funding of the scheme is inappropriate, due to moral hazard concerns, and that an *ex-ante* risk-based fee scheme should be used. These arguments have limited weight.

First, the moral hazard concern is that depositor protection reduces depositor monitoring of bank risk taking and enables excessive risk taking by ADIs without the penalty of needing to pay higher deposit interest rates.

Really! The notion that retail depositors have the expertise and ability to assess the riskiness of even small ADIs is laughable – and even sophisticated analysts who might provide such information to depositors do not have a good track record. The main effect of protection is to reduce uninformed runs and panics. This is clearly a benefit to those ADIs covered by the scheme, to which we shall return shortly.

The second concern – that an *ex-ante* risk-based fee scheme is needed – ignores how the FCS operates. First, it is a *closed resolution* scheme, meaning that it only comes into operation when APRA applies to wind up an ADI (or, under the revised proposals, when a statutory manager has been appointed and all hope lost of an alternative to winding-up).

Who believes that APRA and the Government will ever let a bank or other ADI, fail in that way, rather than finding some method of open resolution (via take-over or merger) for troubled institutions? In other words, the FCS book of procedures is highly unlikely to ever be taken off the shelf and the FCS activated.

Second, even if the scheme is activated, it is extremely unlikely that *ex-post* levies on other institutions will be necessary. The reason is that, upon failure, APRA pays out insured depositors and then stands at the very front of the queue for compensation from the liquidation of the failed ADI's assets. It is the uninsured deposits and other claimants

who lose. Only if total assets were not enough to cover the insured deposits would APRA need to impose a levy.

In general, this is extremely unlikely – although it obviously depends on the size of the cap. If all deposits were insured (an unlimited cap) and there were no other creditors, then APRA could face a shortfall. But that is clearly not the case with large banks (who have substantial other funding sources), and a modest cap ($100 – 250 thousand) would ensure that smaller ADIs have a buffer of uninsured deposits.

So, a risk-based *ex-ante* fee has little to justify it. But there is, arguably, a case for some form of charge – not as a typical insurance fee, but as a requirement of competitive neutrality. Because the FCS provides an aura of government protection for retail deposits not available to other financial institutions, ADIs benefit from the reduced likelihood of depositor runs and ability to raise retail funds at lower interest cost than their competitors.

Banks and ADIs will, no doubt, argue that they do already pay via capital and liquidity requirements and other regulation and supervision (which, incidentally, serves to limit moral hazard issues). That may be so, but whether it is, on balance, adequate to offset the competitive advantages of explicit and implicit government protection is far from obvious.

Kevin Davis
Research Director, Australian Centre for Financial Studies
Professor of Finance, University of Melbourne
31 May 2011