1 Margaret Street
Sydney NSW 2000
GPO Box 4720
Sydney NSW 2001

DX 10271
Sydney Stock Exchange
Internet
www.cu.net.au

Telephone
02-8299 9000
Facsimile
02-8299 9607

Credit Union Services Corporation
Industry Association

6 September 2004

Mr Matthew Crooke
Senior Adviser
Financial System Division
Department of the Treasury
Langton Crescent
PARKES ACT 2600

Dear Mr Crooke

Thank you for meeting with us in Sydney recently and for the opportunity to comment on the issues being considered by the Government in relation to Financial System Guarantees.

Please find attached our response to the Government's Discussion Paper on Financial System Guarantees. We have limited our comments to the protection of depositors within the banking services system.

In summary, CUSCAL makes the following comments:

- Authorised Deposit-taking Institutions (ADIs) in Australia operate in a highly regulated environment and are prudently managed;
- credit unions have a strong history in successfully safeguarding member deposits;
- due to the operation of a strong prudential framework, together with the depositor priority provisions in the *Banking Act* 1959 and the role and impact of industry liquidity support schemes such as CUFSS, CUSCAL and credit unions do not believe that there is a strong argument for the introduction of a deposit insurance scheme for ADIs;
- If a deposit guarantee scheme is established, CUSCAL favours a scheme that is:
    - Post-event funded;
    - Universal;
    - Limited and explicit.

We look forward to the outcomes from the Government Discussion Paper and would seek to be involved in any further industry consultation. In the meantime, if you would like to discuss this submission, please do not hesitate to contact either Mark Degotardi (tel: (02) 8299 9053) or myself (tel: (02) 8299 9046).

Yours sincerely

Louise Petschler
Head of Public Affairs

RESPONSE TO GOVERNMENT DISCUSSION PAPER ON FINANCIAL SYSTEM GUARANTEES

Credit Union Services Corporation (Australia) Limited
August 2004

TABLE OF CONTENTS

1. Executive Summary

PART A

2. Likelihood of Loss, Not Failure

    2.1. Possible Benefits
    2.2. Likely Costs
    2.3. Conclusion

3. Design Principles

PART B – RESPONSES TO SPECIFIC QUESTIONS IN DISCUSSION PAPER

1. EXECUTIVE SUMMARY

CUSCAL welcomes the Government's Discussion Paper on Financial System Guarantees and we look forward to further consultation with the Government on any policy proposals arising from the Discussion Paper.

For simplicity, we have split our submission into two parts – the first part is a summary of our views on the issues raised in the Discussion Paper and the Davis Report and the second responds directly to the questions raised in the Discussion Paper. Our comments are limited to the ADI sector and the insurance of deposits in that sector.

As noted in our submission to the Davis Report, CUSCAL remains of the view that no economic case has been made for the introduction of a deposit insurance scheme. Credit unions, like all ADIs, are subject to strong prudential regulation under APRA and the licensing requirements of the *Banking Act 1959*. The prudential regulatory system established after the Wallis Inquiry has developed into an extremely robust framework that continues to evolve. Corporate governance reforms and more sophisticated risk management standards will further improve this framework.

Whilst this prudential framework will never guarantee that an institution will not fail, it does provide a mechanism for averting failure or ameliorating the impact of such failure. The issue for Government when considering the implementation of deposit insurance is not the likelihood of failure, but the likelihood of loss for depositors as a result of that failure.

In CUSCAL's view, the likelihood of loss is extremely small, particularly in the credit union sector due to:

- The strong prudential supervisory framework;
- The existing depositor priority provisions, and
- The role played by the Credit Union Financial Support Scheme (CUFSS), an APRA-approved liquidity support scheme for credit unions.

In the event that the Government decided to implement a deposit insurance scheme, it is our view that the scheme should have the following attributes:

- Post-event funded;
- Compulsory for all ADIs;
- Coverage of retail deposits up to $60,000 per depositor per institution;
- Availability of Government loans to fund any call on the fund at the time of failure of an institution;
- Risk-based contributions in the event of a call on the fund – the assessment of risk should encompass both institutional and systemic risk.

CUSCAL is happy to provide further information as required and looks forward to the outcomes from industry consultation. If there are any questions in relation to this submission, please contact **Mark Degotardi, Senior Adviser, Policy and Public Affairs, Industry Association, CUSCAL on (02) 8299 9053 or mdegotardi@cuscal.com.au .**

PART A

2. Likelihood of Loss, Not Failure

When determining whether to implement a deposit insurance scheme, it is appropriate that the Government measure the benefits of any scheme against the costs of implementation.

The benefits of a deposit insurance scheme might include:

- Protection of small retail depositors who are not able to adequately assess the risks attached to deposits held by ADIs;
- Promotion of financial system stability by limiting contagion risk in the event of failure of a particular ADI;
- Establishment of a clear framework to compensate depositors for the loss of funds and identification of who is to fund that compensation.

The costs of the any scheme would include:

- The administrative costs of the scheme;
- The competitive distortions of any scheme, and
- The premiums or levies paid by participating institutions.

In terms of the costs, it should be clear that the costs borne by ADIs from any scheme are likely to be passed on to consumers either directly or indirectly. Credit unions will have little potential to absorb costs, therefore either depositors will face increased costs (most likely reflected in reduced interest rates) or reduced services. The costs incurred by larger listed ADIs would similarly be borne by depositors or shareholders.

2.1. Possible Benefits

When assessing the protection offered by deposit insurance, the key question is not just whether an institution will fail, but whether depositors will be exposed to losses as a result of that failure.

The current prudential regulatory environment under APRA significantly reduces the likelihood of failure by an ADI. ADIs operate under close supervision by APRA and must meet a range of requirements under the prudential standards, including minimum capital, liquidity and large exposure requirements. The standards to be met by ADIs are increasing, with draft fit and proper standards and business continuity standards currently in circulation.

These standards of themselves provide protection for depositors and are met by all ADIs, from the largest bank to the smallest credit union. In addition, APRA's supervisory role, including the PAIRS rating system, all provide "early warning" of financial institution difficulties and APRA is mandated to intervene when ADIs appear to fail to meet the minimum requirements. APRA also has a range of powers to force an ADI to close in the event that the ADI fails to meet the prudential requirements.

These powers and standards will not prevent the failure of an ADI, but they will limit the extent of losses suffered by the ADI in the event of failure. Coupled with the existing depositor priority provisions in the *Banking Act 1959* which provide that depositors have priority over other creditors in the winding up of an ADI, the existing regulatory environment provides significant protection for depositors.

Whilst a deposit insurance scheme may have some benefit in protecting against contagion risk, two aspects are critical. Firstly, any deposit insurance scheme would be likely to be limited to retail depositors and the amount covered would be capped. Large institutional and other depositors would therefore not be protected and, whilst it could be assumed that these depositors may be less prone to reactive and poorly informed decision-making, the Davis Report notes that deposit insurance may do very little to promote systemic stability[1].

Secondly, credit unions affiliated with CUSCAL participate in an APRA-approved liquidity support scheme, the Credit Union Financial Support Scheme (CUFSS). CUFSS is designed to promote financial stability in the credit union sector and monitors key liquidity, capital and profitability measures. Funded by credit unions, CUFSS is able, in specific circumstances, to provide liquidity support to participating credit unions. CUFSS therefore plays a proactive role in assisting and advising credit unions that goes beyond the safety net of last resort provided by deposit insurance. CUFSS therefore has an important role in managing financial difficulties and therefore in reducing the likelihood of failure and loss to credit union depositors.

Accordingly, CUSCAL believes that the benefits of a deposit insurance scheme, that is protecting depositors, are extremely limited given that the likelihood of loss is remote.

2.2. Likely Costs

The Davis Report suggests that the cost of a limited explicit guarantee scheme will be very low. Whilst we are not in a position to dispute this claim, the absolute costs are only one factor and are considerably affected by the design of any deposit insurance scheme and the participants in that scheme. Further comment is made on these factors in section 3.

Notwithstanding the relatively low costs, it is important to note that credit unions as mutuals may be unfairly impacted by any scheme that results in additional costs. Credit unions focus on returning value to their members by lower fees and higher levels of service than some other ADIs. This is clearly demonstrated by the high member satisfaction and considerably higher cost-income ratios in credit unions.

In addition, the different deposit taking profile of credit unions as demonstrated in the Davis Report means that credit unions are likely to have a higher proportion of retail deposits that would be covered by the scheme than other ADIs. Depending

[1] Professor Kevin Davis, *Study of Financial System Guarantees*, Commonwealth of Australia, 2004, p48

on the design of the scheme, this may result in higher premiums for credit unions relative to other ADIs.

Further, credit unions are less likely to have a diverse range of deposit and lending products across which to spread any costs arising from the implementation of a deposit insurance scheme.

These factors considered together may put credit unions at a disadvantage to larger ADIs because credit unions will be less able to absorb additional costs. As a result, any costs arising from a deposit insurance scheme will in most cases be directly passed on to our members.

This competitive distortion along with other potential competitive distortions such as spreading deposits between institutions to maximise an individual’s level of insured deposits, should be avoided if a deposit insurance scheme is to be implemented.

2.3. Conclusion

Most credit unions remain unconvinced that a case has been made for the introduction of a deposit insurance scheme. The existing regulatory system, coupled with CUSCAL-affiliated credit union membership of CUFSS, considerably reduce the risk for retail depositors. On a cost-benefit analysis, our view is that the costs are likely to outweigh the perceived benefits of any scheme.

3. Design principles

Notwithstanding our comments above, in the event that the Government decided to introduce a deposit insurance scheme, it is critical that the scheme be designed to minimise the costs of insurance and ensure that those costs are shared equitably.

For these reasons, we believe that a deposit insurance scheme should be:

- **Post-event funded** – whilst this would mean that failed institutions would not contribute to the cost of their failure, we believe for reasons outlined above, that there would be limited calls on any scheme. Accordingly, a pre-event funded scheme would be likely to accumulate large surpluses which may never be required and would need significant resources to be allocated to its management and administration.
- **Compulsory participation** – any scheme should be compulsory for all ADIs, although it is likely and preferable that different schemes be established for different sectors of the financial services industry.
- **Limited , explicit guarantee** – a maximum coverage limit should be applied for retail depositors only. Further information would be required to determine whether the scheme should apply per depositor, per institution or on some other basis.
- **Risk based premiums/levies** – contributions to the post-event scheme in the event of a call should be calculated with reference to the risk that ADIs pose to any scheme. This risk should be calculated by reference to

individual institution risk as well as systemic risk, in a similar way to the calculation of financial sector levies that is to apply from 2005/06. Minimal levies to cover administration costs should also be calculated in this way.

- **Government guaranteed** – for any scheme to be effective in reimbursing depositors in a timely and orderly way, the Government would be required to “guarantee” payments from the scheme. This would most likely take the form of the scheme having access to loan funds from the Government to pay out calls on the scheme initially with the loan being repaid from contributions to the scheme over an agreed period. The absence of such a loan arrangement would potentially impose a destabilising cost on participating institutions and may result in delayed access to compensation for depositors.

PART B – RESPONSE TO SPECIFIC QUESTIONS IN DISCUSSION PAPER

1. If a limited explicit guarantee were introduced, what implications might this have for the safety, efficiency, and competitiveness of the Australian financial system?

For the reasons outlines in section 2 above, CUSCAL does not believe that a deposit insurance scheme would have any significant impact on the safety of the Australian deposit-taking sector. The strong prudential regulatory system, the depositor priority provisions and the operation of industry liquidity support schemes such as CUFSS already provide significant protection to depositors.

2. Comments are invited on what general approach government should take to reduce the consequences for consumers of financial institution failure:

A - *caveat emptor* — a response that insists that customers and other stakeholders should bear the consequences of a financial institution failure;

B - case-by-case, discretionary responses — that any assistance should be tailored to the circumstances of each instance of failure;

C - limited explicit guarantees — that the extent of some limited assistance should be defined up-front; or

D - alternative responses — for example, facilitating, but not underwriting an industry-based compensation arrangement?

As noted previously, CUSCAL and credit unions do not support a formal deposit insurance scheme. However, if the Government decided to establish a scheme, our clear preference is that such a scheme should be limited and explicit, with the design features set out in section 3 above.

3. Are you aware of additional international experience that could add to the debate about whether explicit guarantees may be desirable in the Australian context, or how any scheme could be optimally designed?

Alternatively, you may wish to refer to relevant international experience in relation to some of the specific design issues.

CUSCAL provided information on international schemes in its original submission to the Study of Financial System Guarantees – this information was incorporated into the Davis Report.

4. Comments are invited on the design principles, the associated institutional, product and consumer coverage or the more specific design features outlined in the Davis Report.

Comments on design principles are covered in section 3 of this submission.

CUSCAL notes that the coverage suggested by the Davis Report at a maximum of $60,000 for retail deposits only appears a sensible limit if a scheme was introduced. To reduce complexity and administrative costs, it may be appropriate for this limit to apply per depositor, per institution. However, the competitive distortions and anomalies created by such a limit (through encouraging depositors to spread their deposits and therefore maximise their coverage) should be carefully considered.

5. Comments are invited on the methods, underlying assumptions, and cost projections presented in the Davis Report.

6. Do you have further information or suggestions that might improve the accuracy and reliability of the results?

CUSCAL has no comment on the methodology or accuracy of the technical aspects of the Davis Report.

Clearly however, if the Government were to proceed with the establishment of a deposit insurance scheme, CUSCAL and credit unions would seek further consultation on the design of such a scheme.

The design principles, coverage and membership requirements of any scheme have a direct impact on administrative and other costs and therefore should be subject to further industry input if required.

7. To what extent do concentrated markets present challenges to the viability of any scheme?

CUSCAL noted in its earlier submission that, despite the diversity and choice offered by credit unions in Australia, the banking sector should be regarded as highly concentrated. According to the RBA, as at the September quarter for 2003, there were approximately $625 bn[2] in deposits held by Australian ADIs. Of this amount, less than $24 bn was held by credit unions with approximately $187 bn[3] (nearly 30%) held by the National Australia Bank alone.

In addition, we noted a concern raised by the Financial Stability Forum in 2001 in its report *Guidance for Developing Effective Deposit Insurance Systems.* The Report stated that[4], *"in a concentrated system the capacity of a deposit insurance system to fund or cope with the failure of a large and complex bank may be problematic."*

Accordingly, the capacity for any system of financial guarantees for deposits to cope with the failure of our largest banking institutions is questionable and raises serious concerns about any proposal to implement a deposit insurance scheme in

[2] Reserve Bank of Australia, Statistical table B03 available at http://www.rba.gov.au/Statistics/Bulletin/B03hist.xls
[3] National Australia Bank, 2003 Annual Report, p49 available at http://www.nabgroup.com/vgnmedia/downld/NABFullFinancials03wCover_FINAL.pdf
[4] *Guidance for Developing Effective Deposit Insurance Systems,* Financial Stability Forum, BIS, September 2001, p13

Australia. This concentration is also a critical factor to be considered if a scheme is established and must be reflected in the premiums paid by those institutions posing the greatest systemic risk, that is, the largest banks.

8. The Davis Report explored some of the alternative approaches for funding explicit guarantees. Comments are invited on which approach should be favoured, and why.

If a pre-funded industry scheme should be preferred:

- **On what basis should the size of the target fund be set and over what period of time should the target balance be achieved?**
- **What is the appropriate funding base and, in particular, should non-guaranteed products be included in funding base calculations?**
- **Should restrictions be placed on the type of assets in which the scheme can invest?**
- **Should the investment returns remain in the fund or be returned to participating institutions?**
- **What arrangements should be put in place to allow the scheme to borrow in the event of under-funding?**
- **In the event of a failure, how should supplementary levies be applied?**

If a post-funded industry scheme should be preferred, how should the following issues be dealt with?

- **Should the prudential framework require institutions to provision for their possible future contributions to a scheme?**
- **Should the scheme's governing body be able to borrow only from the market, only from the Government or a combination of both?**
- **Should a cap be set on how much the scheme can recover from institutions in a year? How would this cap be determined? What is the appropriate funding base?**

CUSCAL and credit unions favour a post-event funded scheme for the reasons set out in section 3.

Whilst in principle provisioning for exposure to any scheme would appear sensible, it is difficult to understand at this stage how participants could adequately estimate an appropriate level of provisioning. Further work on the design of any scheme would be required before this issue could be properly determined.

In our view, the introduction of a deposit insurance scheme should be at the very least, capital neutral. In the event that provisioning is required, appropriate reductions in regulatory capital should be implemented to balance the cost of provisioning to ADIs. Provisioning for losses that cannot reasonably be estimated may also have perverse outcomes under the proposed International Financial Reporting Standards to be adopted in Australia from 2005.

It is critical that any scheme has access to Government funding in the event of depositor loss. This will ensure timely compensation for depositors, a crucial element in the prevention of contagion. An appropriate cap should be determined on recovery from financial institutions each year to ensure that the calls on ADIs do not exacerbate financial stress in the event of a significant economic downturn.

9. The Davis Report examined some general approaches to setting prices for industry funded explicit guarantees. Comments are invited on which approach should be preferred, and why.

If risk-based pricing is preferred:

- **What is the best way to determine premiums?**
- **How often should re-rating take place?**
- **Who should be responsible for setting risk-based premiums?**

If flat-rate pricing is preferred:

- **How should the scheme deal with the moral hazard problems that may result from flat-rate pricing?**
- **Is the prudential framework (in particular, capital adequacy requirements) sufficient to mitigate incentives for risk-taking?**

CUSCAL believes that the moral hazard arguments associated with pricing are less relevant in a strongly regulated financial system. However, CUSCAL believes it is appropriate that premiums or levies are determined with reference to risk. This risk calculation should consider both the risk of an individual institution failing and the systemic risk posed by the failure of an institution. The failure of a major ADI, such as the NAB, would have far wider ramifications than the failure of Australia's largest credit union. In our view, this should be reflected in the premiums/levies paid by large financial institutions. The model announced for the financial sector levies for 2005/06 provides good guidance in this respect (see http://assistant.treasurer.gov.au/atr/content/pressreleases/2004/028.asp for further information on this model).

10. The Davis Report outlined some possible governance arrangements to support an explicit guarantee scheme if one were to be introduced. Comments are invited on which approach should be favoured, and why.

11. What is the preferred allocation of functions among the relevant bodies?

CUSCAL favours a separate statutory authority to administer the scheme. Such a body should have clear authority to access information from APRA in the event of a collapse. However, caution should be taken to ensure that the statutory body does not assume or duplicate the responsibilities of APRA. In our view, the statutory body would have no role in monitoring ADIs – this responsibility clearly rests with APRA. The statutory body should only be empowered to act when certain factors are triggered and its key responsibility should be to protect depositors in the event of failure.

It may be useful for the APRA executive to have a governance role (say, as a Board member) however conflicts of interest would need to be closely monitored.

12. The Davis Report examined a number of possible regulatory implications that may arise from introducing any guarantee scheme. The Government invites comments on the following issues:

- **Under a pre-funded model, would it be feasible for the guarantee scheme funds to be available to achieve least-cost failure resolutions (for example, a transfer of business) if that might be less expensive than compensating eligible customers in a liquidation?**
    - **What regulatory and governance arrangements might be necessary to support least-cost failure resolution?**

CUSCAL does not support a pre-event funded model, however in our view failure management powers properly rest with APRA and various corporate governance requirements.

- **Guarantee schemes and priority arrangements (for example, depositor preference and insurance 'cut-through' provisions) might be seen as alternative or complementary policy instruments to guarantees for protecting certain stakeholders in the event of financial institution failures.**
    - **What are your views on the existing arrangements for depositors and policyholders in Australia?**
    - **What changes should be made to priority arrangements if a guarantee scheme were to be introduced?**
    - **Should general insurance policyholders receive priority above other creditors?**

As noted previously, the existing depositor priority provisions are an important part of the protections offered to depositors in ADIs and should be retained. However, some further clarity under the depositor priority provisions may be required – that is, do (or should) these provision apply to all depositors, including large institutional depositors.

CUSCAL has no comment on the operation of provisions in the insurance industry.

- **Could a guarantee scheme provide an opportunity for removing or reducing restrictions on branches of foreign ADIs accepting deposits from retail customers in Australia? Your views may differ depending on whether you think foreign ADIs would be within or outside of the scope of a guarantee scheme.**

In our view, policy decisions on the ability of branches of foreign ADIs should not be driven by the introduction of a deposit insurance scheme. Banking policy decisions need to consider broader economic issues. At the very least, the regulatory playing field should be level. If foreign bank branches are to accept deposits without restriction, they should be required to meet the same prudential and other regulatory requirements as domestically domiciled ADIs.

- **The Davis Report notes that certain conditions may need to be met before a national scheme could apply to statutory insurance classes. What implications would a national guarantee scheme have for existing State-based arrangements for compensating policyholders under statutory insurance classes for insolvency-related losses?**

  CUSCAL has no comment on the operation of any scheme for the insurance industry.

- **Would the introduction of a guarantee scheme allow or require changes to other financial sector regulations and arrangements?**

  No. However, the introduction of provisioning requirements would require amendments to the capital adequacy calculations under the prudential standards to ensure that the scheme has a neutral impact on capital requirements for ADIs.