SUBMISSION TO THE FINANCIAL SYSTEM INQUIRY, REGARDING THE FINANCIAL CLAIMS SCHEME

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A. THE CURRENT POSITION

Currently in Australia depositor protection is addressed by the Financial Claims Scheme (FCS). This scheme provides funding *ex post*, initially funded by the Federal government, then through disposal of the failed bank's assets, and then if need be by way of a levy on ADIs.

This scheme is aimed at preventing contagion by introducing a government guarantee that depositor's funds are safe. Such guarantees, however, encourage three instances of moral hazard:

1. Depositors will have no incentive to take account of risk, only returns. This places pressure on ADIs to offer ever higher returns by increasing the risk profile of their asset allocations.
2. Depositor protection – effectively the ability to continue trading, must be viewed separately when examining systemically important banks. A systemically important bank, regarded as 'too-big-to-fail', will in all likelihood be recapitalised if it reached the point where depositor's funds were in jeopardy. This type of moral hazard encourages shareholders to 'bet the firm'. Recent investment columns in the Business sections of the Australia press, in discussing the value of owning shares in banks, reminded readers that shares in the 'big four' were effectively risk-less. Risk sensitive insurance against depositor losses would offer systemically important banks a transparent and potentially compelling incentive to avoid excessive risk.

3. The same argument can be made in the case of management of systemically important banks. There too a government guarantee to, effectively, recapitalise, would encourage moral hazard, and the perverse behaviour that flows from that. A price sensitive premium, sensitive to increased risk, would similarly dissuade management against excessively risky behaviour.

Some deposit protection schemes, like the IDIC in Indonesia and the FSLIC in the US, charge an *ex ante* fee by way of an insurance premium, but these are flat-rate premia. Such flat-rate premia do not punish risky behaviour with an increase in premium fees.

It is also of note that the establishment of an *ex ante* fee would address some of the current criticisms levelled by the IMF in this regard.[1]

B. A MARKET-MECHANISM PROPOSAL

This proposal would require banks to insure a certain percentage of each depositors funds against the bank's own collapse. What the ideal percentage would be is beyond the scope of this paper. For the sake of argument an arbitrary figure of 20 per cent will be used.

In order to provide this insurance, insurers would have to quantify the risk of the bank collapsing during the currency of the contract. The premium would rise and fall depending upon the risk profile and conduct of the bank. This would rely on the market to accurately price risk, and act as a deterrent against banks engaging in unduly risky behaviour. If the costs of the premia are passed on to the consumer, then they will be free to choose what risk to assume in their deposits, thanks to a transparent indicator of risk: the premium.

In order to assess the risk of collapse posed by an individual bank, the insurer would be at liberty to negotiate with the bank

[1] 'The gaps [in resolution powers] identified include: … no resolution or privately funded protection funds'. Anonymous, "Financial System Inquiry Interim Report", series edited by The Australian Government the Treasury, The Australian Government the Treasury, Financial System Inquiry, July, 2014, p. 3-13.

whatever indices it wished to assess. As a useful point of departure, insurers may wish to assess a bank against the Basel Core Principles.

Similarly, the ADI would be in a position to negotiate with the insurer whatever specific forms of conduct or asset allocation should be avoided, in order to reduce the premium further.

Whether ADIs would then seek to 'game the system' by changing their asset allocation after negotiating the insurance contract, would depend upon the transaction costs associated with changing the asset allocation both after the insurance is issued, and back again in time for the policy renewal. Notwithstanding this, insurers and ADIs could negotiate whatever arrangements they choose, to mitigate this problem.

In the event of a failed bank, the FCS would immediately reimburse depositors 80 per cent of their savings (in this example). The remaining 20 per cent would be disbursed by the relevant insurer shortly thereafter, allowing for the insurance claims process. In this way the role played by deposit insurance, and the need for immediate relief to affected depositors, in order to discourage bank runs, remains in force. The delay involved in a private insurer meeting claims would be ameliorated under this scheme. With the example of 20 per cent of funds insured, a depositor with $ 250,000, would be reimbursed $ 200,000 immediately. The remaining $50,000 a short time thereafter.

C. Advantages

Private insurers are more likely to accurately assess risk than is a government scheme.

The costs of increased risk and poor asset allocation will be borne by the bank in the form of higher premiums. This provides a transparent mechanism by which to incentivise better banking.

If consumers choose ADIs that offer higher returns, then they should be willing to shoulder their share of a higher premium, charged to guarantee a portion of their funds.

This scheme would also act as an early warning system: banks incurring higher than expected premiums could attract attention from the Regulator.

Anonymous, "Financial System Inquiry Interim Report", series edited by The Australian Government the Treasury, The Australian Government the Treasury, Financial System Inquiry, published by Financial System Inquiry, Canberra, ACT, July 2014, pp 1-460, http://fsi.gov.au/files/2014/07/FSI_Report_Final_Reduced20140715.pdf.