Options-Stage Regulation Impact Statement (RIS) – Establishment of a Financial Stability Fund

Context

Failure of an authorised deposit-taking institution (ADI) may expose the Australian Government to significant financial costs. If the ADI is placed into liquidation, and the Financial Claims Scheme (FCS) is triggered, the Government will be required to fund payments to protected depositors (up to a cap of $250,000 per depositor per ADI). If the ADI is systemically important and there is a need to continue its operations to maintain financial stability, the Government may be required to provide financial support if necessary funding cannot be obtained from other investors (including, where appropriate, bail-in of regulatory capital instruments).

Problems

There are two issues with the financial arrangements that are currently in place to fund the FCS and other bank resolution activities.

The first is that the Australian Government does not have a dedicated and readily accessible pool of assets that could be used to fund resolution activities. If the FCS is triggered, the Government will likely have to borrow the necessary funds at the time to make payments to depositors within 7 days. This is because the Government maintains relatively small cash balances. It would then have to recover these funds from the liquidation of the failed ADI or, if these are insufficient, from a levy on other ADIs. This process may take some time to complete and the Government has limited capacity to recover its interest costs under the current model. The Government would also have to borrow any funds necessary to support open resolution of a systemically important financial institution (although it may have more time to do this under a recapitalisation scenario).

The second is that ADIs do not currently pay for the right to offer explicitly guaranteed deposit accounts under the FCS. They benefit from free insurance that is not available to other entities (such as finance companies and managed funds). This is in contrast to the wholesale funding guarantees provided at the height of the financial crisis, for which ADIs paid a fee of between 70 and 150 basis points. The Government is not compensated for the insurance it provides through the FCS. In addition, systemically important ADIs do not pay for the benefits they derive from the market-perceived implicit government support which, as the IMF noted in its report on Australia's 2012 Financial Sector Assessment Program, include lower funding costs than their competitors.

Objective

Establishing a Financial Stability Fund would serve two objectives.

First, it would act as a fiscal buffer by providing a ready source of assets that could be used to meet the costs of ADI resolution. This could reduce the need for the Australian Government to undertake a rapid program of debt issuance during a period of financial stress. While

Australia currently has a strong fiscal position, and its ADIs are well-capitalised, it cannot be taken for granted that this situation will persist in the future. The availability of a dedicated pool of funds could also strengthen depositor confidence in Australia's ADI resolution arrangements.

Secondly, imposition of a levy to build-up a Financial Stability Fund would partially compensate the Government for the insurance it currently provides to ADIs. Depending on its size, it would also off-set to some extent the benefit that ADIs receive from the capacity to offer FCS protected deposits (or, for those that are perceived by the market to be too systemically important to be wound-up, the benefit of lower funding costs).

Options

Option 1: No Financial Stability Fund

This option would maintain the status quo. The Government would remain in the position of having to borrow to meet its up-front costs and attempt to recover these funds at a later date (with limited capacity to recover interest costs). ADIs would continue to benefit from free availability of insurance under the FCS. It would be inconsistent with the advice of the IMF and the Council of Financial Regulators (as well as inconsistent with the Financial Stability Board's Key Attributes of Effective Resolution Regimes for Financial Institutions, particularly the statement that 'resolution regimes should not rely on public support and not create an expectation that such support will be available').

However, Option 1 would avoid the costs to Government and industry of establishing and operating a fund. It would also allow ADIs to retain the use of their resources to make investments in more productive assets than the low risk liquid assets that would be held in a Government fund. It would also avoid the cost of the levy being passed through by ADIs to their customers.

Option 2: Establish a small Financial Stability Fund

Under this option, a Financial Stability Fund would be established and grow to be worth 1 per cent of FCS protected deposits. The fund would be used to meet the costs of covering FCS protected deposits[1] and other ADI resolution activities that protect deposits. The fund would invest in high quality, low risk, relatively liquid assets (such as semi-government securities). The fund would be built-up though a flat rate levy on the FCS protected deposits of all ADIs.

This option would help to address two problems identified in relation to current funding arrangements. Assuming a levy of 10 basis points, after 15 years the Government would potentially have available around $19 billion to fund crisis resolution activities that support depositors. This would be useful in meeting the costs of triggering the FCS for small to medium-sized ADIs. A fund of this size would also be helpful in supporting open resolution of larger ADIs. Reduced Government borrowing would reduce interest costs associated with future crisis resolution activities.

[1] As at February 2013, FCS protected deposits were estimated to be $696.9 billion.

A small fund based on a levy of between 5 and 15 bps of FCS protected deposits would also provide some compensation to the Government for the insurance it currently provides to ADIs and go some way to offsetting the advantages ADIs currently enjoy over other institutions. A fund would be consistent with the recommendations of the IMF, the CFR and international practice.

However, Option 2 does have some disadvantages. Firstly, there is the cost involved in establishing and operating a fund. Secondly, the resources held in the fund could potentially be better used by ADIs compared to being held by the Government and invested in high quality, low risk, liquid assets. Finally, a fund of this size would not be sufficient to meet all contingencies (especially the failure of multiple systemically-important financial institutions). At the same time, after paying the implied levy systemically-important institutions would likely still receive a benefit from the market-perceived implicit government support.

Option 3: Establish a large Financial Stability Fund

This Option would involve establishing a fund that would mature to equate to 5 per cent of FCS protected deposits and be supported by a higher levy than under Option 2. Option 3 would more fully address the two problems with current funding arrangements and be consistent with international practice. It would ensure that the Government has sufficient funds earlier to meet potential cost of triggering the FCS for multiple medium-sized ADIs or for supporting open resolution of a major banking group. A larger levy is also more likely to better reflect the value of the guarantees provided by Government (or perceived to be provided by the Government) that are enjoyed by systemically important ADIs.

However, Option 3 would magnify the potential disadvantages associated with Option 2. It is not clear that it would be prudent for the Government to maintain a large Financial Stability Fund given the size of the potential deadweight costs involved (5 per cent of estimated FCS protected deposits in 2013-14 would be worth around $37 billion and worth around $93 billion in 15 years). There is also the possibility that a large levy may drive behavioural changes that could increase the riskiness of the financial system at a time when ADIs are being asked by regulators to increase their reliance on deposit funding. Also, the larger the fund, the more difficult it may be to invest without sacrificing necessary liquidity or causing other market distortions.

Industry Overview

The market is dominated by four major banks. The rest of the market, which has FCS protected deposits, is made up of 16 other ADIs, eight foreign owned bank subsidiaries and 97 Credit Unions and Building Societies.

As the four major banks make up around three quarters of ADI deposits, the major banks will contribute the most to the fund. However, the levy will have a higher proportionate impact on small ADIs. This is partly due to FCS protected deposits making up a higher proportion of small ADIs funding when compared to the major banks (which make substantial use of wholesale debt).

The levy could potentially be: absorbed by reducing dividends to shareholders; passed onto customers; absorbed by reduced retained earnings (a key source of regulatory capital for CUBS); or met by internal efficiencies. This will largely depend on the individual ADI's business strategy.

Announcing a decision in advance of establishing a fund would enable consultation with industry on the fund's implementation. We would envisage establishing a fund on 1 January 2016, which would give industry sufficient time to raise any concerns and prepare for its implementation.