
POST-IMPLEMENTATION REVIEW AND
REGULATION IMPACT STATEMENT

FINANCIAL CLAIMS SCHEME

THE TREASURY

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Post-Implementation Review and Regulation Impact Statement — Financial Claims Scheme

Introduction

1. This document is a combined post-implementation review (PIR) and regulation impact statement (RIS). The PIR relates to the Financial Claims Scheme (FCS) for authorised deposit taking institutions (ADIs)¹, which was introduced in October 2008. The RIS relates to changes which are currently proposed for the FCS. A RIS was not conducted when the FCS was first introduced, as the global financial crisis required immediate action from the Government to restore confidence.
2. The combined PIR and RIS commences with a description of the FCS. It then reviews the FCS as introduced in 2008, including the problems it was intended to address, the Government's objectives in implementing it and the impact of the scheme. The document then sets out the problems the recommended changes are designed to address, sets out options for government in addressing them, and analyses the impact of those changes.
3. The discussion considers only the FCS for depositors of ADIs. Although an FCS for general insurance policyholders also exists, it will be the subject of a separate PIR.
4. The PIR and RIS do not consider the impact of the Government's Guarantee Scheme for Large Deposits and Wholesale Funding ('Guarantee Scheme'), which was introduced at the same time as the FCS, but which closed to new liabilities in March 2010.² Although the schemes were announced at the same time, they are different in substance. The FCS is a permanent feature of Australia's depositor protection arrangements, established in the Banking Act 1959 (Cth) ('Banking Act'). It applies only to deposits up to \$1 million per depositor, per ADI. The Guarantee Scheme was a temporary emergency

1 ADIs are banks, building societies and credit unions prudentially regulated by the Australian Prudential Regulation Authority.

2 The Government introduced the Guarantee Scheme in October 2008, which, for a fee provided a guarantee of deposits over \$1 million, and wholesale debt. It was administered by the Reserve Bank of Australia (RBA). After improvements in financial market conditions, the Guarantee Scheme was closed to new liabilities on 31 March 2010. The last deposits and wholesale liabilities covered under the Guarantee Scheme will expire in 2015. Further information is available on the [Guarantee Scheme website](#).

arrangement which closed to new liabilities in March 2010. It applied to deposits above the \$1 million FCS cap and to ADIs' wholesale funding liabilities.³ The Guarantee Scheme will be the subject of a separate PIR.

5. The PIR section of this document relates to the FCS with a \$1 million cap. The initial announcement of the FCS on 12 October 2008 did not include this cap; the cap was announced by the Treasurer on 24 October 2008. This means that there were only twelve days in which markets did not take an FCS cap into account. The brevity of this period means that there is insufficient data available to make meaningful observations. Therefore, the PIR section considers only the impact of the \$1 million cap.

6. It is worth noting that the \$1 million cap provides a very high level of coverage, at over 99 per cent of deposit accounts and a majority of deposits by value. This means that the impact of an unlimited cap is likely to have been similar to that of the \$1 million cap, but stronger.

BACKGROUND

What is the FCS?

7. The FCS is a key element of Australia's deposit protection arrangements established in the Banking Act. The FCS pays out depositors under a closed resolution of an insolvent ADI. If an ADI becomes insolvent, the FCS provides depositors with guaranteed access to their deposits up to a cap (currently \$1 million per depositor, per ADI).

8. The FCS applies to deposits held in ADIs incorporated in Australia, including their overseas branches. It does not apply to foreign ADIs, which operate in Australia as branches of overseas-incorporated entities, or to non-ADIs which provide deposit-like products. It covers all types of depositor, regardless of their citizenship or residency status, or whether they are natural persons or not.

9. The FCS currently applies to funds held in Australian dollars and foreign currencies. Foreign currency coverage will expire on 12 October 2011. The sunset of this provision was established anticipating it would no longer be required in a post-crisis environment.

3 Both the [FCS and the Guarantee Scheme](#) were announced by Prime Minister Rudd on 12 October 2008. Further details of the programs were [provided by the Treasurer](#) on 24 October 2008, including the creation of a \$1 million cap for the FCS and the structure of the Guarantee Scheme fee. The [final announcement](#) regarding the commencement of the FCS and the Guarantee Scheme was made on 28 November 2008, when the fee regime for deposits came into effect.

10. The deposits to which the FCS applies are ‘protected accounts’ under the Banking Act. These consist of generic deposit products and any account products which are specified by the *Banking Regulations 1966* (‘Banking Regulations’) or by a declaration of the Treasurer. A non-exhaustive list of deposit products covered by the FCS is set out in the *Declaration of Covered Financial Products*, made under s. 5(8) of the Banking Act on 27 October 2008.⁴ This includes deposits held in savings accounts, call accounts, transaction accounts, cheque accounts, cash management accounts, farm management deposits, pensioner deeming accounts, retirement savings accounts and term deposits. The FCS does not apply to certificates of deposit, as these are not account-based products.

11. If a depositor holds more than one account with the relevant ADI, their deposits are aggregated. Depositors receive one FCS payment per ADI, rather than one FCS payment per account.

12. The FCS is invoked at the discretion of the Treasurer. Before the Treasurer can activate the FCS, APRA must have applied to the Federal Court for an order that the ADI be wound up. Before this request can be made, APRA must first have appointed a statutory manager to the ADI, and be of the view that the institution is, or shortly will be, insolvent. The Treasurer may request that APRA, ASIC or the RBA provide information to assist in his decision whether to activate the FCS, and these agencies must respond.

13. The FCS is a post-funded scheme. If an ADI fails, the Government will provide funds to depositors through APRA. The Government would then recover funds through a priority claim on the assets of the insolvent ADI in the liquidation process. If the assets were insufficient to meet the Government’s claim, the Government could levy the ADI industry to meet the shortfall.

14. The FCS supplemented Australia’s main existing depositor protection arrangements. APRA has a broad responsibility to protect the interests of depositors. In addition, depositor preference, as established by the Banking Act, gives depositors a prior claim on the assets of an ADI that has become insolvent.

15. It should be noted that neither depositor preference, nor the FCS has ever been called upon in relation to ADIs.

The Objectives of the FCS

16. The FCS is a form of deposit insurance. Deposit insurance is a measure implemented in many countries to protect bank depositors, in full or in part, from losses caused by a bank’s inability to honour its deposit

4 comlaw.gov.au/Details/F2008L04298

liabilities. It aims to provide depositors with confidence that their funds are safe even in crisis situations. This is intended to maintain confidence in the banking system and reduce the potential for damaging runs. In the event that an ADI does fail, they minimise economic disruption by providing rapid access to funds.

17. The FCS has three main objectives:

- to protect Australian retail depositors, by providing them with certainty of recovery of their protected deposits;
- to support depositor liquidity, by providing depositors with prompt access to their protected deposits; and
- to support the stability of the Australian financial system.

18. The FCS was intended to support the stability of the Australian financial system, as opposed to the global financial system.

19. These three objectives were the goals of the FCS in its development and have remained so, through its implementation during the financial crisis and now, as it is being adapted to the post-crisis environment. These three objectives are the ongoing goals of the scheme.

20. The FCS focuses particularly on the protection of retail depositors. 'Retail' depositors are defined as those depositors with the least capacity to assess the soundness of individual ADIs, and the least capacity to manage their risk by spreading deposits across a number of ADIs. They are primarily individuals and unincorporated entities. Under the categories of deposit data collected by APRA, the best proxy for 'retail' depositors is the 'household depositors' category (see the discussion at paragraph 118).

21. 'Non-retail depositors' encompass all other classes of depositor, including non-financial corporations, financial corporations and the general government sector.⁵ In addition, \$250,000 is the current dividing line used by APRA to distinguish 'retail' from 'non-retail' deposits in the regulation of foreign ADIs.⁶

22. While the primary role of the FCS is to protect retail depositors, the FCS also contributes to financial stability by limiting the propensity for a destabilising 'run' on deposits, and promoting confidence in the Australian ADI sector more generally.

5 More detail may be found in the discussion at paragraph 115.

6 Foreign ADIs are not allowed to accept initial retail deposits below \$250,000 as a condition of their licences.

23. As Australia's deposit insurance scheme, the FCS is an element of Australia's framework protecting depositors and supporting financial stability. The government has a range of mechanisms available to it to manage financial crisis, including: a macroprudential approach to financial system regulation; a tough prudential regulation regime requiring ADI compliance with a range of standards, including the forthcoming Basel III capital and liquidity standards; depositor preference arrangements; a range of crisis management powers and tools; and constant monitoring by the regulatory agencies. Australia continues to engage internationally with forums such as G20 and the Financial Stability Board (FSB) to participate in the development of the international financial regulatory system and strengthen its own framework.

The Development of the FCS

The Wallis and Davis Reports

24. The 1997 *Financial System Inquiry* (the Wallis Report) set out the framework for Australia's financial system. The Wallis Report considered the merits of deposit insurance in Australia, but argued that it would not provide a substantially better protection for depositors than the existing depositor preference mechanism.

25. Following the collapse of the HIH Group of Companies the subsequent 2003 Royal Commission recommended that '... the Commonwealth Government introduce a systematic scheme to support policyholders of insurance companies in the event of the failure of any such company'.⁷

26. In response, the Government commissioned the *Study of Financial System Guarantees* (the Davis Report), which reported in 2004.⁸ The Davis Report argued that the community expected government support in relation to failed prudentially regulated financial institutions and 'critical' financial products. These included ADIs and deposits. The report also stated that the time between the failure of an institution and its resolution could be significant, which could create significant costs for stakeholders.

27. The Davis Report found that correctly-designed explicit guarantees could contribute to the stability of the Australian financial system, improve risk allocation and pricing, provide greater financial security to individuals and support more timely access to funds.

7 HIH Royal Commission, [*The Failure of HIH Volume 1: A Corporate Collapse and its Lessons*](#), 2003, Recommendation 61.

8 K. Davis, [*Study of Financial System Guarantees*](#), 2004.

The Council of Financial Regulators Report

28. After receiving the Davis Report, the Council of Financial Regulators (CFR)⁹ published an outline of a proposed FCS for industry consultation.¹⁰ Given the rarity of bank failures¹¹ in Australia and the strength of Australia's ADI regulation framework, the FCS was designed as a minimalist scheme, to complement depositor preference.

29. As part of its focus on retail depositors, the FCS cap considered before the financial crisis was in the range of \$20,000 to \$50,000. This was thought to strike an appropriate balance between protecting retail depositors and avoiding excessive moral hazard.

30. After the CFR report, the Government and the CFR consulted on the scope and design of the FCS. In June 2008, the Government announced that it would legislate to establish the FCS.¹²

The Financial Crisis

31. At the peak of the financial crisis in 2008, market confidence and global financial stability were severely disrupted. In September and October 2008, G20 nations responded with extraordinary policy measures, including enhanced protections for depositors, guarantees of financial institutions' wholesale fundraising, recapitalisations of major financial institutions and injections of liquidity into financial markets.

32. In this context, the Government introduced the FCS and the Guarantee Scheme in October 2008. The large deposit component of the Guarantee Scheme complemented the FCS by providing protection for larger depositors. Under the Guarantee Scheme, the Government guaranteed deposits over the \$1 million FCS cap and wholesale funding instruments on application, for a fee. After improvements in financial market conditions, the Guarantee Scheme was closed to new liabilities on 31 March 2010. The last deposits and wholesale liabilities covered under the Guarantee Scheme will expire in 2015.

33. The timing of its introduction meant that the FCS' settings, which were originally designed to protect retail depositors, were modified

9 The CFR comprises the Reserve Bank of Australia, the Australian Prudential Regulation Authority, the Australian Securities and Investments Commission and the Treasury.

10 Council of Financial Regulators, *Failure and Crisis Management in the Australian Financial System*, 2005.

11 There have been few deposit-taking institution failures in Australia by international standards. None has failed since the state-supervised Pyramid Building Society in 1990, well before the current system of uniform national prudential regulation was introduced.

12 *New Protections for Depositors and Policyholders*, Treasurer Media Release 061/2008.

for a crisis environment, with an emphasis on upholding the stability of the Australian financial system. This was reflected mainly in the setting of the cap at \$1 million, well above the level previously considered. Aware that these settings might not be appropriate in the long term, the Government committed to review the FCS parameters three years after its introduction. Despite this commitment, the FCS was always intended to remain in place as a permanent addition to Australia's depositor protection and crisis management framework.

34. Despite the crisis, no Australian ADI failed, and so the FCS has never been used.

Post-Crisis

35. On 12 December 2010, the Government confirmed the FCS as a permanent element of Australia's financial safety net. The Government has been working with the CFR to review the parameters of the FCS.

36. The CFR review considered Australia's experience of the financial crisis, the structure of its financial system, changed expectations on the part of depositors and the market in the wake of the crisis and international regulatory developments.

37. The CFR advised that the architecture of the FCS was sound and that no major changes were required. The CFR recommended refinements to tailor the FCS to a post-crisis environment and improve the efficiency of the scheme. In May 2011, the Government released a discussion paper seeking feedback on the CFR recommendations. These recommendations address the longer-term stability concerns that may arise if the cap is maintained at its current high level, and build on improved international understandings and established expectations of deposit insurance systems.

38. The CFR recommendations are discussed in detail in the 'Government Options and Impact Analysis' section at paragraph 117 onwards. In summary, the CFR recommended that:

- the FCS cap should be reduced to a level between \$100,000 and \$250,000 per depositor, per ADI, from October 2011, with a grandfathering mechanism;
 - coverage of foreign currency accounts should expire from 12 October 2011, as provided by the current legislation;
 - the FCS should no longer apply to deposits held in the foreign branches of Australian-incorporated ADIs;
 - the FCS should 'look-through' certain pooled trust accounts, so that the cap would effectively apply to
-

individual beneficiaries rather than the account as a whole;

- the FCS should be able to be activated by the Treasurer when APRA appoints a statutory manager to an ADI, before APRA applies to wind up an ADI;
- the FCS should automatically be activated either at the time APRA applies to the Federal Court for an ADI to be wound up, or when the Court makes the winding up order; and
- the FCS should include an additional payment mechanism, to enable APRA to make payments to beneficiaries by transfer of deposit funds.

POST-IMPLEMENTATION REVIEW OF THE FCS

39. This section sets out the problems which the FCS was intended to solve, its effectiveness in doing so and its regulatory impact.

Defined problems

40. The FCS was designed to address three problems:

- *Depositor protection*: consumer expectations of Government assistance in the event of the failure of an ADI did not correlate with the protections set out by the regulatory framework. For example, in 2006, the RBA commissioned a survey on public attitudes regarding what would happen if an ADI were to fail. This found that 60 per cent of respondents believed either that their deposits were guaranteed by the government, or that the government would step in to protect them in the event of a failure. This was despite the fact that no deposit guarantee existed.
- *Depositor liquidity*: in the event of a failure, depositors would face delays before accessing their funds in the liquidation process. The CFR's November 2005 report found that this could take 'many months, or even years'.¹³ This could cause undue hardship for vulnerable depositors, and the lack of a pre-existing

13 Council of Financial Regulators, [Failure and Crisis Management in the Australian Financial System](#), 2005, p1.

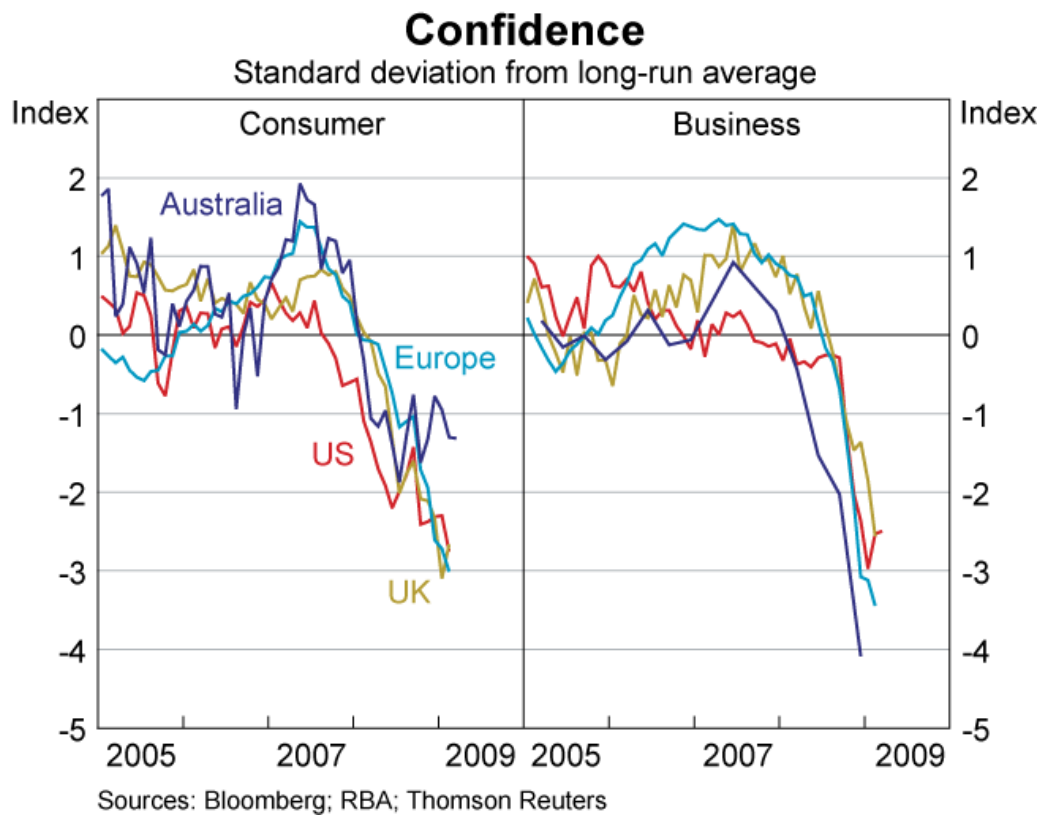
mechanism to deal with this problem could lead to a sub-optimal response at the time of a failure.¹⁴

- *Financial stability*: the above concerns could undermine depositor confidence in the ADI sector, which could lead to runs on ADIs and reduce the stability of Australia's financial system. As conditions deteriorated, concerns about the stability impact of consumer and investor confidence increased. Over the course of 2008, financial market conditions deteriorated significantly and consumer and investor confidence — both internationally and in Australia — declined markedly (Graph 1).¹⁵ While Australia's financial system was relatively well placed to withstand the turbulence, international events and the actions of international governments meant that measures were necessary to bolster the confidence of investors and depositors in Australian ADIs.

14 Council of Financial Regulators, [Failure and Crisis Management in the Australian Financial System](#), 2005, p1.

15 Reserve Bank of Australia, *Financial Stability Review – March 2009*, 2009, p14.

Graph 1: Consumer and Business Confidence



41. In early October 2008, there were signs that depositors were starting to withdraw funds from a number of smaller ADIs, indicating a loss of confidence in these institutions despite the fact that they were in a relatively healthy position. The RBA and the APRA described this situation as ‘potentially destabilising.’¹⁶ If left unmanaged, these depositor concerns had the potential to cause a run on smaller ADIs, create panic and trigger contagion, resulting in instability to the Australian financial system. On the basis of the evidence, it appears likely that the introduction of the FCS contributed to preventing runs on smaller institutions, and therefore promoted the stability of the Australian financial system. It is worth noting that part of this effect is likely to be due to the Guarantee Scheme, which was announced at the same time as the FCS.

Objectives of Government action

42. At the establishment of the FCS in October 2008, objectives of the FCS were as set out at paragraph 15: to protect depositors, provide prompt access to deposit funds in the event of an insolvency and to uphold the stability of the Australian financial system. The risks posed to financial stability at the time of the introduction the FCS were very unusual, and resulted in FCS coverage being set at a very high level, to ensure the stability objective was met. The practical result of this was to expand protection beyond Australian retail depositors, the usual target of deposit insurance schemes.

Impact analysis

43. This section assesses the impact of the FCS on the main affected groups. However, it is often difficult to disentangle the effects of the FCS from the Guarantee Scheme, as both programs were announced at the same time and were available to the same institutions. Additionally, in relation to entities which were not eligible for the FCS, it can be difficult to distinguish the impacts of the FCS from those of the crisis itself.

Depositors

44. In combination with the Guarantee Scheme, the FCS succeeded in the goal of restoring depositor confidence in ADIs.

45. As the RBA and APRA have noted, the most immediate impact of the announcement of the FCS was to halt movements in deposits. In early October 2008, outflows of deposits from a number of smaller ADIs had commenced, indicating that depositors had concerns over these ADIs. Following the announcement of the FCS and the Guarantee Scheme, these

16 Reserve Bank of Australia and Australian Prudential Regulation Authority, *Inquiry by the Senate Economics References Committee into Bank Funding Guarantees – Joint Submission from the RBA and APRA*, 24 July 2009, p5.

outflows were halted, indicating a restoration of confidence (see also Graph 2 below).¹⁷

46. This is consistent with industry feedback on depositor behaviour. In his appearance before Senate Estimates in October 2008, the Chair of APRA, Dr Laker stated, 'feedback from our regulated institutions is that the government's deposit and term funding guarantee [the FCS and the Guarantee Scheme], has calmed what was a growing disquiet on the part of some depositors'.¹⁸

47. This is also consistent with the published survey data. The Westpac and Melbourne Institute Survey of Consumer Sentiment (March, 2009) showed that the introduction of the FCS and the Guarantee Scheme led to a jump in the proportion of survey households who viewed bank deposits as the 'wisest place for savings'. In December 2008, the proportion was around one third of surveyed households, the highest level in over 15 years.¹⁹

48. Subtler changes in depositor behaviour have also emerged. Since the introduction of the FCS in October 2008, the value of household deposits larger than \$1 million has fallen, while the value of deposits less than \$1 million has increased. This indicates that household depositors are spreading their funds more thinly across more institutions, in order to maximise guarantee coverage. Business and other wholesale deposits did not show a similar change.

ADIs

49. The FCS applies to all Australian-incorporated ADIs. Together with the Guarantee Scheme, it succeeded in stabilising confidence in the ADI sector and in maintaining access to deposit funding for institutions.²⁰ As discussed at paragraph 45, at the peak of the financial crisis in early October 2008, there was evidence of deposit outflows from some smaller ADIs to the big banks. The introduction of the FCS and the Guarantee Scheme halted these outflows (see Graph 2).²¹

17 Reserve Bank of Australia and Australian Prudential Regulation Authority, *Inquiry by the Senate Economics References Committee into Bank Funding Guarantees – Joint Submission from the RBA and APRA*, 24 July 2009, p5.

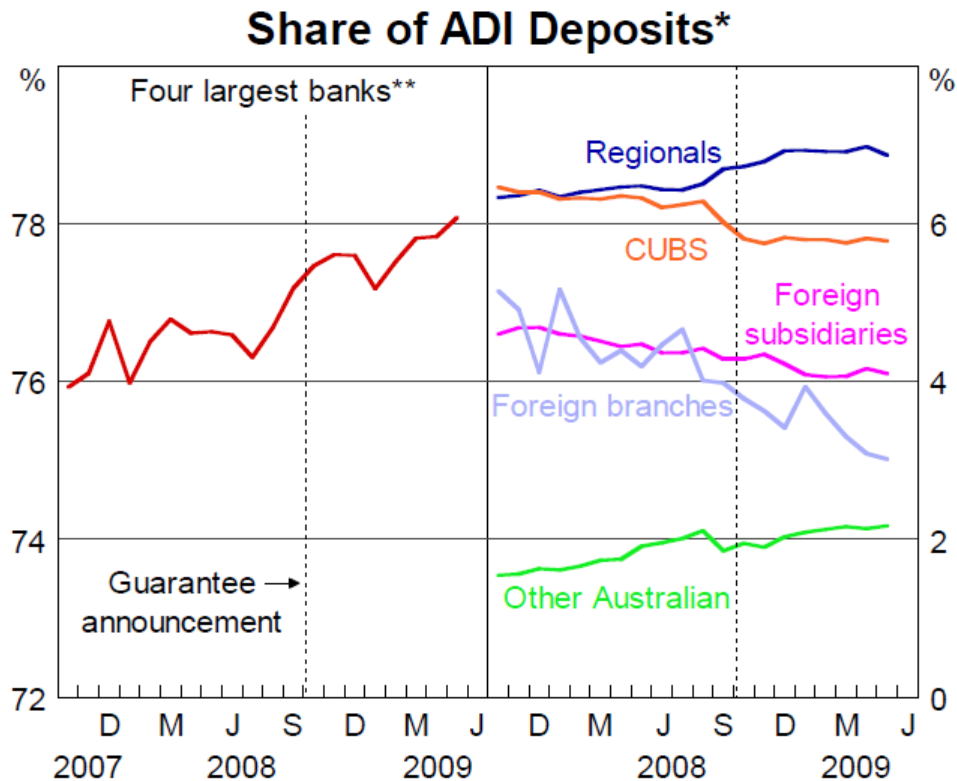
18 Dr John Laker, Chair, Australia Prudential Regulations Authority, *Estimates Hansard*, 23 October 2008, p5.

19 Melbourne Institute and Westpac, *Survey of Consumer Sentiment*, March 2009, p 7.

20 The benefits which flowed to ADIs from the FCS also accrued to their shareholders, as the owners of the ADIs.

21 Reserve Bank of Australia and Australian Prudential Regulation Authority, *Inquiry by the Senate Economics References Committee into Bank Funding Guarantees – Joint Submission from the RBA and APRA*, 24 July 2009, pp5-7.

Graph 2: Share of ADI Deposits by Class of Institution²²



* Excludes certificates of deposit and foreign currency deposits. Adjusted for reporting changes.

** Includes St George and BankWest.

Source: APRA

50. Following the introduction of the FCS, the deposit bases of non-major ADIs have grown at a faster rate than those of the four major banks, as shown in Graph 3 below.²³ The fall in deposits held in foreign bank branches — the only group of ADIs not covered by the FCS — suggests that the FCS was the cause of this change.

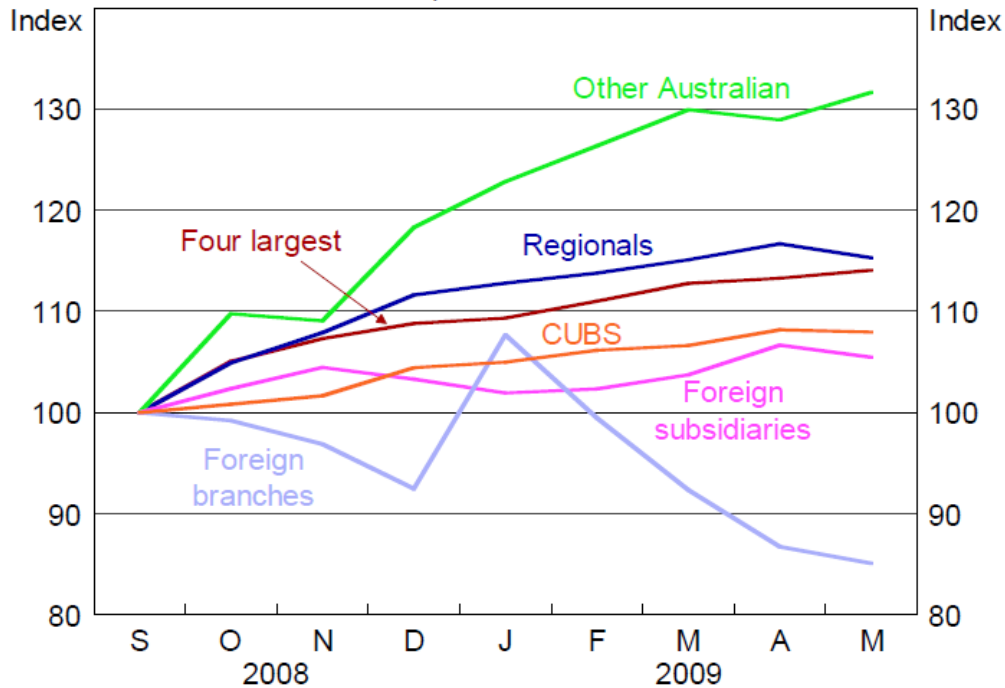
22 'CUBS' refers to credit unions and building societies. The 'Guarantee announcement' refers to the 12 October 2008 announcement of the FCS and the Guarantee Scheme.

23 Reserve Bank of Australia and Australian Prudential Regulation Authority, *Inquiry by the Senate Economics References Committee into Bank Funding Guarantees – Joint Submission from the RBA and APRA*, 24 July 2009, p6.

Graph 3: Total Deposits by ADI Group²⁴

Total Deposits by ADI Group*

Index, September 2008 = 100



* Excludes certificates of deposit and foreign currency deposits. Data are break-adjusted for some series breaks. BankWest is included in the 'foreign subsidiaries' until December, after which it is included in 'four largest'. 'Four largest' includes St George.
Source: APRA

51. This evidence is consistent with feedback from the banking industry, which indicates that the FCS succeeded in stabilising the ADI sector and restoring depositor confidence. For example, Abacus — Australian Mutuals (the peak body for Australian credit unions and building societies) has stated that the introduction of the FCS 'was timely and decisive in ensuring the stability of the ADI sector' and that the Guarantee Scheme 'also played an important stabilising role'.²⁵ Similarly, the Australian Bankers' Association (ABA) argued that the FCS 'had the effect of maintaining depositor confidence in ... prudentially regulated deposit-taking institutions' and that the Guarantee Scheme

24 'CUBS' refers to credit unions and building societies.

25 Abacus – Australian Mutuals, *Inquiry into the Bank Funding Guarantees – Submission 19*, 31 July 2009.

increased the probability that the domestic banks would continue to access overseas funding to support domestic lending'.²⁶

52. The FCS was not intended to be a competition mechanism. However, it did have some competition effects. The FCS guaranteed a large proportion of total deposits. This allowed smaller ADIs — which are largely funded by deposits²⁷ — to continue to access funding during the crisis, which allowed them to continue to compete with larger ADIs. As smaller ADIs rely more heavily on deposits as a source of funding than larger ADIs²⁸, smaller ADIs received a greater proportionate benefit from the FCS than larger ADIs.

53. The FCS has not imposed additional costs on the ADI industry through the financial sector levies. While APRA has initiated some implementation strategies in relation to data collection and supporting a single customer view, these are subject to a separate regulatory impact statement.

Non-ADIs

54. Non-ADIs are non-prudentially-regulated financial institutions, such as finance companies. These institutions do not have access to the FCS as they are not permitted to accept deposits and are not subject to prudential regulation. Non-ADIs offer investment products rather than deposit products, in which market risk is involved and the return of capital is not certain.

55. The non-ADI sector comprises a very broad spectrum of products and entities, from finance companies operating cash management trusts to fund managers offering equity investments. Those areas of the sector which provide the closest substitutes for deposit products covered by the FCS are mortgage trust and cash management trust products, and finance companies. Entities and products such as unit trusts operated by superannuation funds do not compete directly with deposits offered by ADIs.

56. ASIC data indicates that the first mortgage trust fund was frozen in January 2008, well before the introduction of the FCS. The RBA and APRA have noted that the 'trend of outflows from mortgage trusts was well established from early in the year'.²⁹ An October 2010 ASIC review suggests that a significant amount in fund assets was frozen before the announcement of the FCS.

26 Australian Bankers Association, *Inquiry into the Bank Funding Guarantees – Submission 24*, August 2009.

27 See the discussion at paragraph 128.

28 See the discussion at paragraph 128.

29 Reserve Bank of Australia and Australian Prudential Regulation Authority, *Inquiry by the Senate Economics References Committee into Bank Funding Guarantees – Joint Submission from the RBA and APRA*, 24 July 2009, p6.

57. Assets held in cash management trusts declined slightly in the lead-up to the FCS, from \$47.4 billion in June 2008 to \$46.3 billion at the end of September 2008. However, the value of the assets of these trusts did not change significantly following the introduction of the FCS. In fact, at the end of the March quarter 2009, total assets of cash management trusts were \$45.8 billion.³⁰

58. After the FCS was introduced, the asset levels of finance companies, relative to ADIs, declined. This is consistent with the increased attractiveness of the ADI sector, as a result of its FCS eligibility, but also with the security offered by prudential regulation. According to RBA data, the aggregate assets of finance companies fell relative to ADI assets, from around 5.3 per cent in September 2008 to 4.2 per cent in September 2009.³¹

59. However, investors' reduced appetite for instruments issued by finance companies was already evident prior to the introduction of the guarantees, as a result of the broader financial crisis. RBA data indicates that the assets of finance companies relative to ADIs were falling before the FCS was introduced, from 5.5 per cent in September 2007 to 5.3 per cent in September 2008.³² This trend is likely to have continued in the absence of the FCS, given the reduction in investor confidence and increased risk aversion following the collapse of Lehman Brothers in September 2008.

60. Overall, the effects of the FCS on the non-ADI sector are difficult to assess. The FCS would have increased the attractiveness of deposits relative to their substitutes. However, it is almost impossible to distinguish between a decision to move funds to the prudentially regulated sector, and accept lower returns for lower risk, and a decision to deliberately seek coverage by the FCS. As discussed at paragraph 73, non-ADIs and some consumer groups have argued that the introduction of the FCS had a negative impact on the sector, particularly on mortgage trusts. Nevertheless, many of the difficulties in the non-ADI sector appear to have pre-dated the introduction of the FCS. It is likely that the FCS caused some detriment to the sector and its ability to compete with ADIs, but it also seems likely that many of the sector's difficulties were caused by the crisis and increased risk aversion on the part of investors.

30 Reserve Bank of Australia, [Assets of Financial Institutions](#), accessed 05 August 2011.

31 Reserve Bank of Australia, *Banks Assets B2 and Finance Companies & General Financiers Selected Assets and Liabilities B10*, accessed 08 July 2011.

32 Reserve Bank of Australia, [Banks Assets B2 and Finance Companies & General Financiers Selected Assets and Liabilities B10](#), accessed 08 July 2011.

Financial markets

61. Even with a \$1 million cap, the level of coverage of the FCS was not high enough to impact on the wholesale fund raising activities of ADIs and other bodies, such as States and Territories.

62. Apart from its impact on deposit outflows from ADIs (see paragraph 49), the FCS has not had a measurable impact on the cost of non-deposit funding sources and the movement of funds between jurisdictions, although there is likely to have been some impact on non-ADIs (see paragraph 54). Funding costs were affected more by the introduction of the Guarantee Scheme, which allowed ADIs to continue to access wholesale funding markets.

63. It is not feasible to use financial models, such as the Capital Asset Pricing Model or the Multi-Factor Model, to examine the impact of the FCS on financial instruments such as bonds. These models are generally used to describe optimal portfolios of risky assets. They also assume liquid markets and constant risk premiums. However, during the crisis, wholesale debt markets faced significant liquidity difficulties and the switch from risky assets to safer assets reflected both an increase in volatility and an increase in the risk premium. The changing risk premium makes it difficult to use these models in crisis conditions with sufficient precision.

64. These factors make it difficult to apply these models to crisis conditions.

65. It is unlikely that the FCS had any effect on cross-border currency flows or the exchange rate. The quantum of protection offered by the FCS is too low to provide international investors with an incentive to choose Australian guaranteed deposits over wholesale debt issuances. The largest amount of protection the FCS could afford to any one international investor would be \$135 million, and only then if they spread their deposits across every eligible ADI, incurring considerable transaction costs on the way (based on 135 registered ADIs excluding foreign branches).³³ By contrast, bank issuances of debt tend to be within the range of around \$500 million to \$6 billion. If an investor were seeking a Government guaranteed asset, they would have the option of purchasing Commonwealth Government Securities. Additionally, deposits are generally not internationally mobile instruments, as depositors — particularly retail depositors — have a strong home bias. The existence of the FCS is therefore unlikely to impact on the international flow of deposits.

33 Transaction costs are likely to be high as banks discourage wholesale investors from placing funds in deposit accounts.

The general public

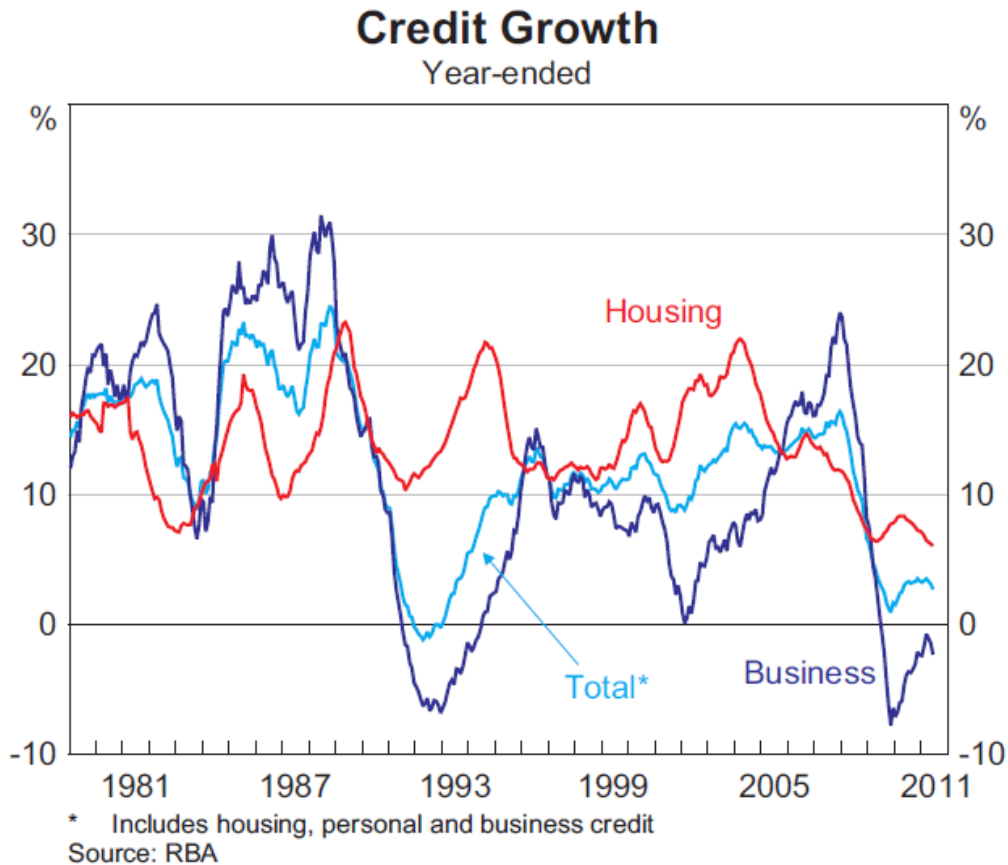
66. The FCS, as one of a wider suite of financial sector stability measures, has benefited the general public by contributing to the stability of the ADI sector. It formed part of a wider suite of financial sector stability measures, including the government's Guarantee Scheme; \$16 billion in Government funding for the residential mortgage-backed securities program, and a number of RBA liquidity support measures. This support allowed the financial sector to fulfil its function of intermediation, providing credit to the real economy. This can be measured by the flow of credit to the banking system and to the housing and business sectors and the economy as a whole.

67. As shown in Graph 4, the financial crisis caused a significant reduction in credit growth, including negative growth in business credit. After the establishment of the FCS and the Guarantee Scheme, total outstanding credit increased at an annualised rate of around 4 per cent over the six months to January 2009.³⁴ Most recently, total outstanding credit grew at an annualised rate of around 6 per cent in the 2011 March quarter. This reflected increased business lending and moderate growth in household credit.³⁵

34 Reserve Bank of Australia, [Financial Stability Review](#), March 2009.

35 Reserve Bank of Australia, [Statement on Monetary Policy](#), May 2011.

Graph 4: Credit Growth



APRA

68. APRA, as Australia's prudential regulator, administers the FCS. Since the introduction of the FCS, APRA has published consultation papers on various aspects of its implementation (such as the available payment mechanisms) and developed draft data reporting forms and standards. As the implementation of the FCS continues, APRA may need to seek additional funding as its administrative responsibilities increase.

69. To date, the development of the FCS implementation options has been funded within APRA's existing financial sector levies. There are no specific elements of the annual financial sector levies which account for FCS activities, and APRA has not imposed any specific charges on ADIs in relation to the FCS.

The International Reputation of Australia's Financial System

70. The positive impact of Australia's guarantee arrangements (the combination of the FCS and the Guarantee Scheme) on confidence,

financial stability and economic growth has been recognised internationally. For example, the International Monetary Fund (IMF) noted that the Government's ADI guarantees have bolstered confidence in the Australian financial system and allowed credit to continue to flow to the economy during the crisis.³⁶

CONSULTATION

71. The FCS consultation paper released in May 2011 sought feedback on the current operation of the scheme and any impacts on industry and consumers. Broadly, submissions stated that the introduction of the FCS during the crisis appropriately balanced protection of consumer deposits with the stability of the Australian financial system. One submission stated that the FCS is a good example of an arrangement that is working well, delivering both confidence and competition benefits to Australian consumers. Only one submission opposed the FCS, arguing that its introduction, along with market events at the time, had an adverse impact on mortgage funds and cash management trusts.

72. Additional stakeholder views on the FCS were provided in response to Senate inquiries into competition in the banking sector, and the FCS and the Guarantee Scheme, in 2011 and 2009 respectively. These generally commented positively on the combined impact of the FCS and the Guarantee Scheme. It should be noted that commentary does not often distinguish between the two schemes.

73. Broadly, ADIs have accepted that ongoing deposit insurance arrangements are necessary and supported the FCS. The ABA argued that the Federal Government should retain the FCS³⁷, whilst the Australia and New Zealand Banking Group argued that '... banks in Australia would have survived without the scheme. However, they would have found it difficult to maintain an adequate supply of affordable credit in the economy'.³⁸ By contrast, the non-ADI sector has argued that the introduction of the FCS damaged the non-ADI sector, particularly in relation to mortgage trusts.³⁹ There has been some agreement from

36 International Monetary Fund, *Australia - 2009 Article IV Consultation, Concluding Statement*, 23 June 2009.

37 Australian Banks' Association, *Submission 53*, p32, cited in Economics References Committee, *Competition within the Australian banking sector*, p 238.

38 ANZ Bank, *Submission 94*, p 97, cited in Economics References Committee, *Competition within the Australian banking sector*, p 233.

39 Investment and Financial Services Association, *Submission 8*, Senate Economics References Committee Inquiry into the Bank Funding Guarantees, p2.

consumer groups for this proposition, though they have supported retaining the current \$1 million cap.⁴⁰

74. There has also been academic support for the FCS. As Professor Harper commented 'I would far rather that the government erred on the side of too big a hit than too small a hit, because you only get one chance to do that in those circumstances. Fortunately, the government's invention worked and I do not know if it would have worked at \$500,000 or \$250,000. If it had not worked, the chances of a second round working would have been much lower and we would have been in a much more difficult situation'.⁴¹

Conclusion

75. The FCS has achieved its design objectives in relation to the crisis. In combination with the Guarantee Scheme, it restored depositor confidence and helped maintain the financial stability by providing depositor protection and liquidity in the event of an insolvency.

76. However, the crisis has now passed and market conditions have improved significantly. The FCS was always intended to be a permanent scheme (as opposed to the Guarantee Scheme, which has since closed), with the same three goals of protecting depositors, supporting depositor liquidity and upholding the stability of the financial system. Now that the crisis has passed, it is opportune to consider what settings of the FCS are required to fulfil these goals in the future. With the experience of the crisis, there is also merit in assessing how the FCS operated more generally, and whether it is possible to increase its efficiency.

77. Therefore, the CFR has reviewed the FCS, to assist in the Government's consideration of these matters. The CFR's recommendations are set out at paragraph 38. In summary, the CFR found that the framework of the FCS was appropriate for the future, in both crisis and non-crisis contexts. The CFR recommended that some of the FCS settings, such as the cap, be amended to adapt the scheme to the new post-crisis environment. It also recommended various refinements to the scheme, to increase its operational efficiency.

78. As discussed at paragraph 23, the FCS forms just one part of a broad range of deposit protection and stability tools, which can respond to a crisis. It also does not preclude the use of supplementary crisis management tools. If a future crisis were to eventuate, the Government has access to a range of stability and crisis management tools, including

40 Mr Richard Lloyd, International Policy Adviser, Choice, Committee Hansard, 14 December 2010, p 29; see also paragraph 328.

41 Professor Ian Harper, cited in Senate Economics References Committee, *Government Measures*, p 7.

the FCS. The appropriate tool would depend on the scope and nature of the crisis.

PROPOSED CHANGES TO THE FCS: REGULATION IMPACT STATEMENT

79. The RIS component of this document will examine problems which may arise with the FCS now that the crisis has passed. These were identified by the CFR in its review of the FCS. The RIS will set out options for dealing with these problems, the impact of those options and the views of stakeholders gathered in the consultation process. It will then conclude by recommending options for action.

Defined problems

80. This section considers problems which may arise with the FCS. As discussed at paragraphs 75 and following, the FCS fulfilled its objectives in relation to the crisis. However, the FCS was always intended to be a permanent scheme and was planned several years before the crisis. Therefore, the CFR has reviewed the FCS to assess the appropriate settings for its ongoing operation.

81. The potential difficulties with the FCS arise from the following sources:

- *changes in domestic circumstances*: the current parameters of the FCS were set in response to crisis conditions. They may not be appropriate for the post-crisis environment;
 - *potential for moral hazard*: in particular, the emergency settings of the FCS could risk creating moral hazard if retained as the ongoing parameters of the scheme. It is important to ensure that moral hazard is avoided;
 - *compliance with international standards*: since the creation of the FCS, international standards on best practice in deposit insurance have been developed. Australia will be assessed in international fora on its compliance with these standards;
 - *taxpayer exposure*: the FCS involves a significant level of contingent liabilities for the Commonwealth and, ultimately, taxpayers. There is merit in ensuring that these liabilities are no higher than is necessary; and
 - *operational efficiencies*: it is important that the FCS operate in an efficient manner. There is merit in
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considering improvements which can be made to ensure this.

Changed domestic circumstances

82. The main issue for the FCS is how to ensure its settings fit the current environment and requirements.

83. Since the closure of the Guarantee Scheme in March 2010, the Australian banks have maintained good access to local and offshore bond markets. At the urging of both regulators and markets, Australian banks have taken significant steps since the crisis to increase their resilience to disruptions in wholesale funding markets, by increasing their use of deposit funding, lengthening the average tenor of their term funding and increasing their holdings of liquid assets.⁴² Nevertheless, and as highlighted by the most recent episode of volatility, global financial markets remain fragile.

84. Growth in total ADI deposits, from \$1.2 trillion in September 2008 to \$1.4 trillion in May 2011, indicates ongoing depositor confidence in the sector. In June 2011, more than 30 per cent of households in the Westpac-Melbourne Institute Survey of Consumer Sentiment nominated banks as the wisest place for their savings, well above the 10-year average of around 20 per cent.

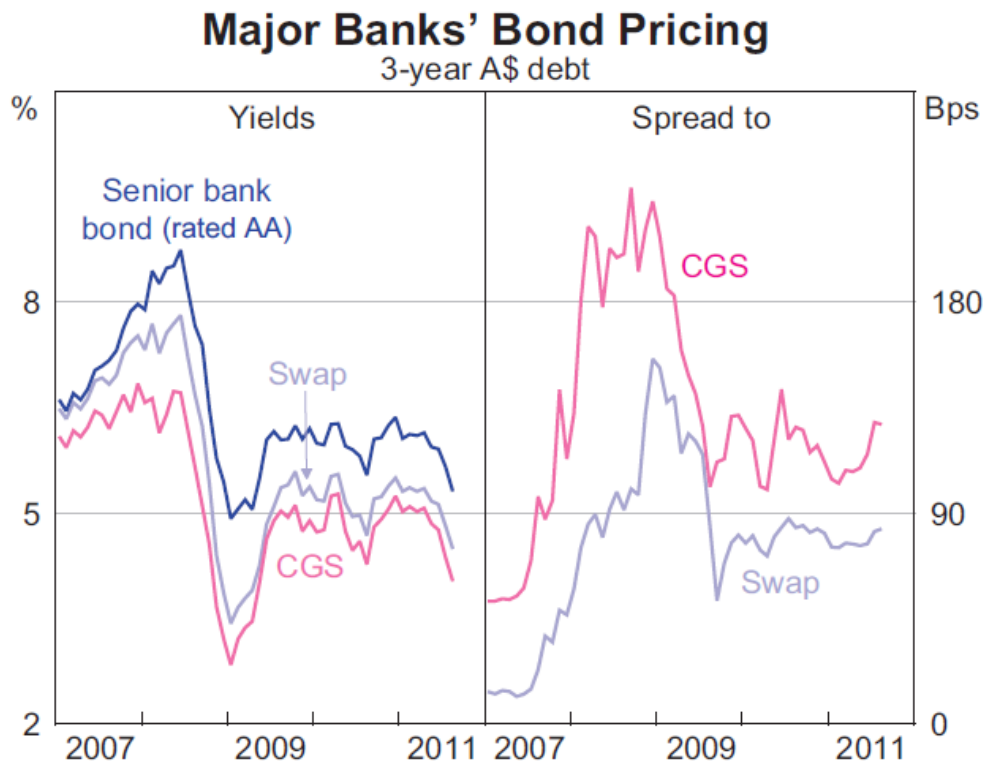
85. The profitability of the banking sector has improved. The four major banks' profits (or returns on equity) have recovered over recent periods, to be above (or near) their pre-crisis levels. The regional banks were more severely affected by the downturn than the major banks due to larger increases in bad debt charges and funding costs, while their profits (or returns on equity) have also recovered, they remain below their pre-crisis levels.

86. As rates of deposit growth have increased and credit growth has remained subdued, Australian banks have required less wholesale funding. Domestic secondary market spreads on the major banks' three-year debt have also narrowed since the crisis (Graph 5).⁴³

42 See, for example, Reserve Bank of Australia, *Financial Stability Review – March 2011*, pp21ff.

43 Reserve Bank of Australia, *Statement on Monetary Policy – August 2011*, p 47.

Graph 5: Major Bank Bond Pricing

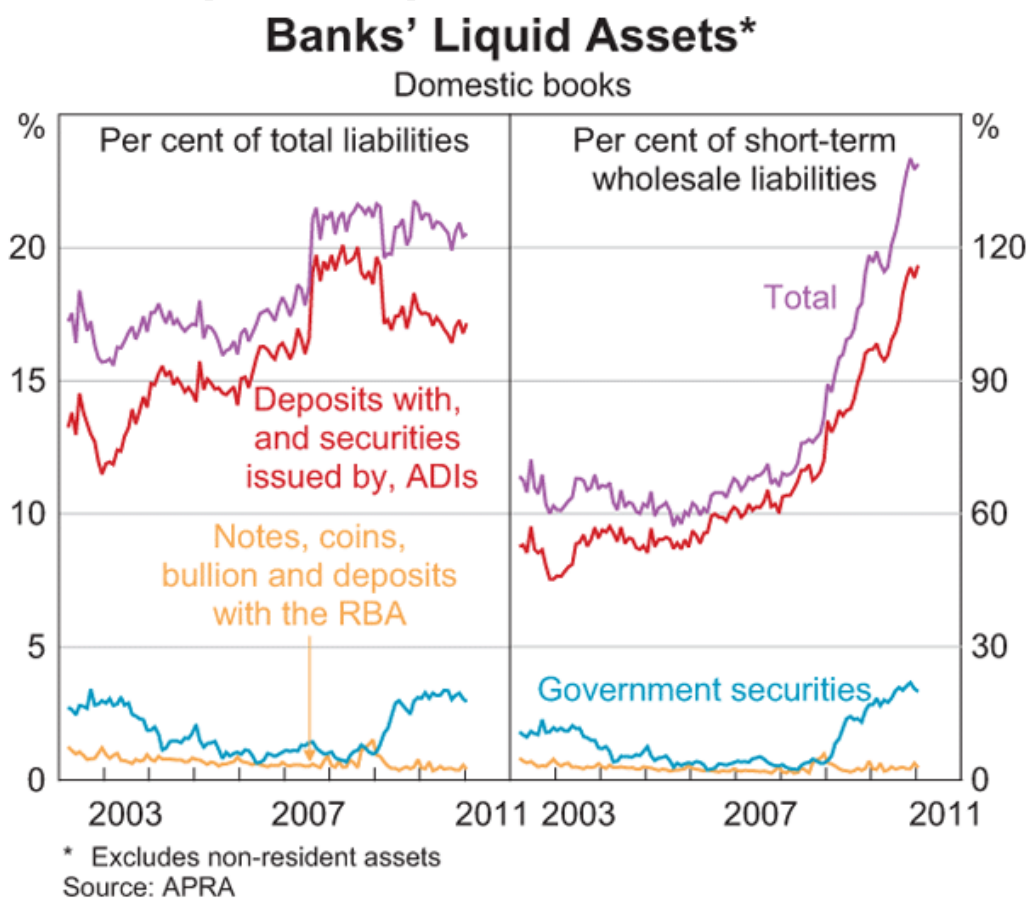


Sources: RBA; UBS AG, Australia Branch

87. Further evidence of improvements in market conditions is the repurchasing by ADIs of their guaranteed securities and their replacement with non-guaranteed securities. This indicates that non-guaranteed debt can be sold at prices and maturities which make it relatively more attractive than existing guaranteed debt. As at May 2011, around \$11.3 billion in guaranteed securities had been repurchased.

88. Banks have continued to improve their liquidity positions since the crisis. Their holdings of deposits, cash and highly marketable domestic securities have increased strongly over recent years as a share of their total short-term liabilities, as short-term wholesale liabilities have continued to decline (Graph 6).⁴⁴

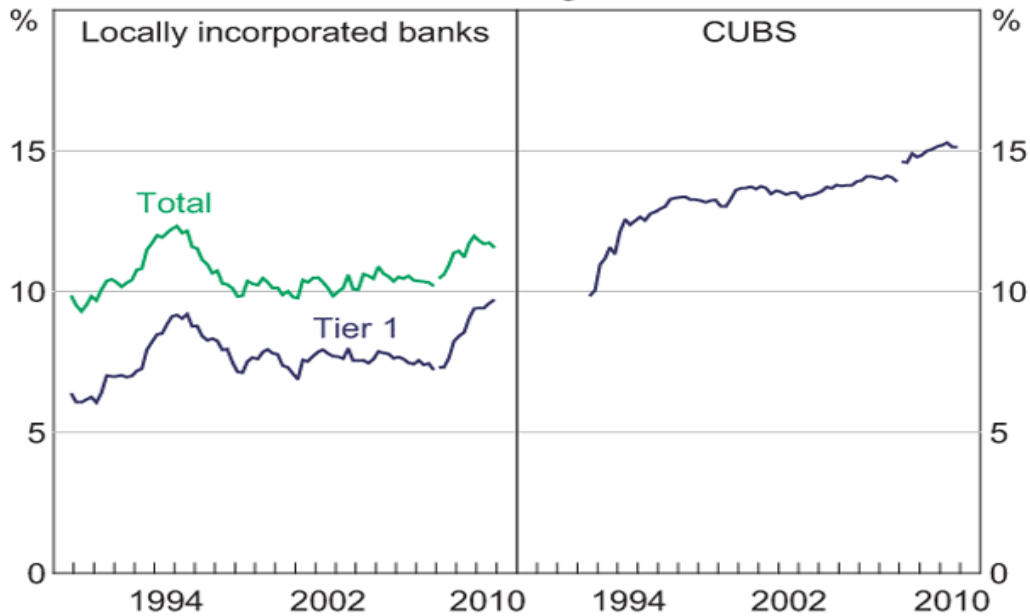
Graph 6: Banks' Liquid Assets



89. The Australian banking system is well capitalized and banks' capital positions have strengthened significantly since the onset of the financial crisis. As at December 2010, aggregate Tier 1 capital for the sector was 9.7 per cent compared with 7.3 per cent in mid 2008. The comparable aggregate ratio for credit unions and building societies was around 15 per cent, as at December 2010 (Graph 7).⁴⁵

Graph 7: ADI Capital Ratios
Capital Ratios

Per cent of risk-weighted assets*



* Break in March 2008 due to the introduction of Basel II for most ADIs
 Source: APRA

90. The improvements in ADIs' profits, funding conditions and liquidity positions have seen depositor and investor confidence in the soundness of Australia ADIs improve. Banks have been able to significantly strengthen their funding structures by increasing their share of the funding sourced from domestic deposits and long-term debt and reducing their reliance on short-term funding.

91. These improvements indicate that it is now appropriate to reconsider those settings of the FCS which were designed to respond to the global financial crisis.

[Confidential material]

Moral hazard: Entities failing to manage their own risk

92. Moral hazard occurs when an individual or a company has no incentive to manage their risk, because they are protected from the consequences of their actions. This is a problem endemic to any insurance arrangement. Ultimately, its effect is that the existence of a guarantee can increase the likelihood of risky behaviour and thus the events for which the guarantee provides protection.

93. There is a high level of consensus that moral hazard is an outcome of deposit insurance, particularly when high levels of coverage are maintained for substantial periods. In the banking sector, moral hazard brought on by deposit insurance can result in large, sophisticated depositors failing to monitor the stability of their banking provider, although they are in a good position to do so. This enables banks to make higher risk, higher return investments with depositor funds. Since the government is bearing the depositor's risk, and there is reduced scrutiny of the actions of the bank, there is no demand from the depositor for a higher return, to compensate for the higher risks to which their deposits are exposed.

94. Generally, the higher the monetary cap, the higher the moral hazard associated with the FCS, as larger and more sophisticated depositors with a greater capacity to manage risk fall within its ambit. Moral hazard associated with deposit insurance can be mitigated through a number of mechanisms, notably: a strong prudential regulation regime that requires sound risk management; a cap that is limited but credible; ensuring a blanket guarantee is not maintained for a substantial period; and ensuring that coverage does not remove the potential for market discipline. International standards (see paragraph 95) suggest that the mitigation of moral hazard should be a key design feature of a deposit protection scheme.

International standards and debate

95. Since the FCS was introduced, international guidance on the design of deposit insurance systems has been developed. The International Association of Deposit Insurers (IADI) and the Basel Committee on Banking Supervision (BCBS) released the Core Principles for Effective Deposit Insurance Systems ('Core Principles') in June 2009. Australia will be assessed against these standards through the IMF Financial Sector Assessment Program (FSAP) and FSB peer reviews.

96. It is important for Australia to comply with international financial sector standards, to maintain its international reputation as a safe jurisdiction for investment. As a net capital importer, Australia relies on foreign investment to finance the expansions in productive capacity that can drive future economic growth. Failure to comply with international financial sector standards would put at risk our attractiveness as a destination for foreign investment.

97. While Australia is broadly compliant with the Core Principles, overall compliance would be assisted by taking further steps to address the following principles:

- Principle 2 states that moral hazard should be mitigated by ensuring that the deposit insurance system contains appropriate design features, and through other elements
-

of the financial system safety net. For Australia, compliance could be improved by placing further limits on the amounts insured and excluding certain categories of deposits. Australia already has mechanisms in place to support good corporate governance and sound risk management, effective market discipline and has a sound framework for strong prudential regulation;

- Principle 9 states that a deposit protection scheme ‘should cover adequately the large majority of depositors to meet the public policy objectives of the system’ and that the level of coverage should be ‘limited but credible’; and
- Principle 10, which states that when transitioning from a blanket guarantee to a limited coverage deposit insurance system, the transition should be as rapid as a country’s circumstances permit. Blanket guarantees can have a number of adverse effects if retained too long, notably moral hazard.

98. Internationally, countries that increased protection under deposit insurance arrangements to a high degree have reduced them to levels more appropriate for a post crisis environment. Table 1 shows a comparison of Australia’s cap to those of Canada, the United Kingdom (UK), the United States (US) and the European Union (EU). The standard measure of cross-country deposit insurance caps is the ratio of the cap to the country’s per-capita GDP.

Table 1: International comparison of deposit insurance caps — selected countries

Country	Cap in Local Currency	Cap in AUD Equivalent ⁴⁶	Ratio to Per-capita GDP
Canada	CAD \$100,000 ⁴⁷	\$108,000	2.0
Japan	JPY ¥10,000,000	\$127,000	2.7
Norway	NOK 2,000,000	\$348,000	3.6
Singapore	SGD \$20,000	\$17,000	0.3
UK	GBP £85,000	\$155,000	3.5
USA	USD \$250,000 ⁴⁸	\$287,000	5.1
Select EU ⁴⁹	EUR €100,000	\$158,000	2.3-3.2
Australia	AUD \$1,000,000	\$1,000,000	15
CFR	AUD \$100,000-\$250,000	\$100,000-250,000	1.5-3.9
Recommendations			

Sources: IADI and IMF data (World Economic Outlook, April 2011).

99. Continuing to offer a substantially higher level of protection than other countries against the background of a sound financial sector could result in negative comment about Australia's compliance with international standards.

Taxpayer exposure

100. As at April 2011, approximately \$737 billion in deposits are guaranteed by the FCS. This is 58 per cent of total eligible ADI deposits of \$1.3 trillion. This constitutes a significant contingent liability for the Government. The rest of total eligible ADI deposits balance are over the \$1 million cap and are not covered by the FCS.

101. The strength of Australia's prudential regulation regime means that the likelihood of an ADI insolvency is low. However, even though FCS payout and administrative costs are recoverable, the FCS does constitute an exposure for government, which should not be set at a higher level than is needed to protect the intended beneficiaries of the scheme.

46 Exchange rates are 3-year average of 01/07/2008 - 01/07/2011 (RBA exchange rates). The exchange rate for NOK is an average of 1/01/2011 – 30/06/2011. The caps are rounded to nearest \$1,000 AUD equivalent.

47 Under certain circumstances, depositors may be eligible for more than one payment per institution.

48 Under certain circumstances, depositors may be eligible for more than one payment per institution.

49 Selected EU countries include Denmark, France, Germany, Netherlands and Sweden.

Operational issues

102. As flagged at paragraph 81, it is important to ensure that the FCS operates as efficiently as it can. The CFR has identified three aspects in which the operation of the FCS can be improved. These relate to:

- coverage of pooled trust accounts;
- the activation mechanism for the FCS; and
- the payout mechanisms available.

Pooled Trust Accounts

103. A pooled trust account (PTA) is an account held by a trustee of two or more trusts, which holds the trust funds of two or more of those trusts (Banking Act s 16AF(3)). Examples of PTAs range from the trust funds held by solicitors and real estate agents to those held by the trustees of superannuation funds and managed investments. The beneficiaries of a PTA may change frequently (for example, as clients of a real estate agency deposit and withdraw the proceeds of sale of real property) and the ADI with which the account is held generally will not know their identities.

104. At present, the FCS applies to PTAs in a limited manner. If the FCS is activated, then the trustee receives a single FCS payment, which is shared between all the beneficiaries whose funds are held in the account. Consequently, a beneficiary may receive only a very small proportion of their balance in a PTA under the FCS. It is likely that they will need to wait for an extended period before receiving any funds through the liquidation process.

105. By contrast, if the funds of each beneficiary were held in separate trust accounts, with the same trustee for each account, each trust would be treated as a separate entity and the trustee would receive a separate FCS payment for each account. The difference in structure results in beneficiaries in similar circumstances being treated differently, which raises fairness concerns. These may be magnified where PTAs temporarily contain large deposits of retail depositors, such as the proceeds of house sales.

Activation Mechanisms

106. At present, the FCS cannot be activated until certain preconditions have been satisfied (Banking Act s 14F(1), s 16AD(1)). These are that:

- a statutory manager is in control of the ADI's business;
 - APRA considers that the ADI is insolvent and cannot be restored to solvency within a reasonable period; and
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- APRA has applied to the Federal Court of Australia to wind up the ADI.

107. The current precondition enables action before a court has made a decision that an ADI is insolvent. It recognises that there may be delays between applying to the Court for liquidation and the Court making a winding-up order — if it were necessary to wait for a winding-up order, there could be delays to the timely implementation of the FCS and a reduction in certainty for depositors.

108. However, an application for winding up occurs relatively late in the lifecycle of a distressed institution. The existing preconditions preclude the FCS from being declared at an earlier point in the ADI's distress, such as where it is severely under-capitalised and it likely to become insolvent. While APRA can appoint a statutory manager and suspend the ADI from the payment systems, thus preventing a run on the institution, this will not prevent depositor anxiety, nor address the risk of contagion. The very appointment of a statutory manager is likely to cause depositor anxiety, and potentially detriment to the ADI's financial position.

109. The Treasurer would be constrained in the comment he could provide on the likely application of the FCS should the ADI fail. This could create an undesirable 'state of limbo' — even if it lasts for only a few hours or days — where an ADI's distress is known to the public with the appointment of a statutory manager, but the Government cannot announce or implement the FCS.

110. The continuing public distress of the ADI would likely impact on financial market confidence and financial system stability. This could be accompanied by possible disruptions to the payments system, and in the worst case, runs on ADIs.

Payment Mechanisms

111. Payments to FCS claimants may currently be made by several methods including enabling depositors to withdraw funds via the failed ADI's payment channels, paying depositors by cheques drawn on the RBA or a designated ADI, electronic transfers and establishing new accounts for depositors at designated ADIs. The current arrangements are suitable for a wide range of scenarios. However, several deposit protection schemes in comparable countries allow the making of deposit insurance payments by the transfer of deposits from one institution to another. These include the US and the UK.

Changing the cap

112. In the event the Government decides to lower the FCS cap from October 2011, in line with the CFR recommendations, transition

arrangements will be needed to smooth implementation and reduce any impact on consumers and industry.

113. Depositors holding term deposits could, in particular, be adversely affected by a reduction in the cap without a transition period. Should these depositors wish to change arrangements mid-term, following an announcement of a change to the cap, they could be subject to penalties for early termination.

114. If a pattern emerges whereby large depositors terminate current term deposits in order to split their accounts across a range of ADIs to maximise coverage under the new cap, this could lead to a bunching of maturities of term deposits: firstly just prior to October 2011, and then a year hence, given the most common term for term deposits is 12 months. This concentrated movement of funds could be of concern to some ADIs.

Objectives of government action

115. The objectives of the FCS remain the same as when the FCS was introduced. That is, the FCS objectives are:

- to protect Australian retail depositors, by providing them with certainty of recovery of their protected deposits;
- to support depositor liquidity, by providing depositors with prompt access to their protected deposits; and
- to uphold the stability of the Australian financial system.

116. The objectives of government action are to ensure that:

- Australian retail depositors continue to be protected;
- depositor liquidity continues to be supported;
- the stability of the Australian financial system continues to be upheld; and
- in doing so, market efficiency is upheld and distortions are minimised.

Government options and impact analysis

117. This section will consider how the main options for each parameter of the FCS would further the government's objectives and the impacts of implementing each option.

118. In several places, the impact analysis discusses the classes of depositor which could be affected by different options. The relevant classes of depositors considered are households, non-financial corporations and other non-household depositors. The impact analysis is structured in this way so as to align with the categories under which

APRA publishes deposit data. The classes of depositors are defined as follows⁵⁰:

- ‘household’ depositors are individuals, or groups of individuals, resident in Australia whose dealings with other sectors are for personal or household purposes. They do not include sole proprietors, partnerships or other unincorporated businesses owned by households — these are covered under the non-financial corporations category;
- ‘non-financial corporations’ include private trading corporations (whose main activity is producing goods or non-financial services for sale); private unincorporated businesses, such as unincorporated farms, professional practices (such as legal practitioners) and tradespeople; and government trading enterprises. Most small and many large businesses will be included in this category. The category excludes finance sector entities such as banks, which would be expected to be more familiar with financial risk management; and
- ‘other non-household’ depositors are a grouping of the APRA categories of financial corporations and the general government sector, grouped together to distinguish them from private entities outside the finance sector. These categories include financial sector corporations such as banks, money market corporations and insurance companies, and government departments.

119. Deposit data broken down into individuals, small businesses and larger businesses is not available. In matching these categories to the data categories, individuals will fall into the ‘household’ category. Most small businesses will fall into the ‘non-financial corporation’ category. Large non-financial businesses will fall into the ‘non-financial corporation’ category; large finance sector businesses and governments will fall into the ‘other non-household’ category.

The FCS cap

120. The Government considered five options in setting the cap for coverage of the FCS:

- retaining the current cap of \$1,000,000;
- increasing the cap to make FCS coverage unlimited;
- reducing the cap to \$250,000;

50 Australian Prudential Regulation Authority, [*General Overview of the Reporting Framework for Collection of the Statements of Financial Position*](#).

- withdrawing the FCS completely; and
- imposing a fee for FCS coverage.

121. The main impacts of these options are set out below. The full set of impacts is summarised in Table 4.

122. The discussion of the different options is informed by FCS coverage at different cap levels. This is set out in Table 2, below.

Table 2: Estimated coverage of FCS at various caps (per cent)

Cap	<i>Household deposits</i>		<i>Total deposits</i>	
	Value paid out	Accounts fully covered	Value paid out	Accounts fully covered
100,000	65.2	97.4	36.3	96.3
250,000	81.7	99.2	46.2	98.6
1,000,000	94.6	-	58.2	99.7

Sources: industry data, Treasury estimates.

123. The discussion is also informed by the total amounts covered by the FCS at different cap levels. These are set out in Table 3, below.

Table 3: Estimated total guaranteed deposits, April 2011

Threshold (\$)	100,000	250,000	1,000,000	Unlimited
Guaranteed amount (\$ billion)	460	586	737	1,268
Guaranteed amount (percentage of total deposits)	36	46	58	100

Option 1: Retain the Current \$1 Million Cap

124. The first option is to retain the status quo: that is, to retain the current \$1 million as the ongoing cap for the FCS.

Australian Retail Depositors

125. At a \$1 million cap, the FCS would cover almost 100 per cent of household deposit accounts in full and almost 95 per cent of the value of household deposit accounts. This is an extremely high level of coverage.

126. FCS coverage at these and other cap levels considered in this document is set out at Table 2. Coverage of the unlimited cap considered at Option 2 is 100 per cent of each category).

Non-Retail Depositors

127. At a \$1 million cap, the FCS would go well beyond coverage of Australian retail depositors, the intended beneficiaries of the scheme, and provide protection for larger and more sophisticated depositors. As Table 2 above shows, a \$1 million cap covers over 99 per cent of total eligible deposit accounts in full and pays out around 58 per cent of the value of total eligible deposits. More specifically, the \$1 million cap covers around 98 per cent of the deposit accounts of non-financial corporations (and around 61 per cent by value) and around 95 per cent of other non-household deposit accounts (and around 52 per cent by value).

128. This is a very high level of coverage. If this level of coverage is retained, significant moral hazard may arise — a cap at this level would reduce incentives which these larger depositors have to assess and manage their own risk levels.

The Commonwealth

129. At a \$1 million cap, the Government has a high initial financial exposure under the FCS. The total FCS contingent liabilities of the Commonwealth are around \$737 billion (as at April 2011). It is extremely unlikely that the Commonwealth would need to pay out an FCS figure at any level close to this. A payout at this level would require the simultaneous failure of every ADI in Australia, and Australia's strong prudential regulation regime means that the risk of the FCS being activated for any ADI is low. However, the quantum of the contingent liability is still very significant.

130. A \$1 million cap would see ordinary taxpayers bearing the risk of sophisticated depositors, as it covers, by value, approximately 61 per cent of non-financial corporations and 52 per cent of other non-household depositors' deposits. As non-retail depositors, these depositors are in a position to manage their own risk. Further, less than one per cent of household accounts hold more than \$250,000.

ADIs

131. Generally, the higher the cap, the easier it is for ADIs to attract depositors. While not the purpose of the FCS, the scheme has, as noted above, had an impact on competition. The \$1 million cap supports the capacity of some smaller ADIs to compete for deposits. Generally, smaller ADIs source a larger proportion of their funding from deposits than larger ADIs; for example, around 82 to 83 per cent of mutual ADIs' assets are estimated to be funded by deposits⁵¹, while the corresponding figure for banks is around 55 per cent.⁵² Therefore, any deposit guarantee

51 *Quarterly Credit Union and Building Society Performance Statistics*, Australian Prudential Regulation Authority, March 2011.

52 *Quarterly Bank Performance Statistics*, Australian Prudential Regulation Authority, December 2010.

will protect a higher proportion of smaller ADIs' funding than of larger ADIs' funding, and a higher cap will guarantee a higher proportion of smaller ADIs' funding.

132. At a \$1 million cap, it is not impossible that the assets of a failed ADI would be insufficient to cover the costs of the FCS payout. This would require a levy on the ADI industry, which would have a negative cost impact on ADIs.

133. The FCS cap may have an impact on the capacity of larger ADIs to meet the Basel III liquidity rules as established by the BCBS, in particular the liquidity coverage ratio (LCR) requirements. The LCR will require affected ADIs to hold sufficient high-quality liquid assets to survive their expected net outflows over a thirty day period. This requires that deposits be classed as either 'stable' or 'unstable'. 'Stable' deposits are less likely to be withdrawn in the event of a crisis. A key determinant of stability is the coverage of a deposit by a deposit protection scheme, such as the FCS.

134. Therefore, the FCS cap is a factor in determining the level of high-quality liquid assets which ADIs are required to hold against their deposits. However, although the impact cannot yet be quantified, FCS coverage forms only one aspect of the LCR, and APRA has advised that the total cost of complying with the LCR as a whole 'will not be great'.⁵³

135. Maintaining the cap at this high level is likely to result in moral hazard for ADIs. In the longer term, it runs the risk of reducing rather than increasing the stability of the financial system, as it would likely undermine market discipline and encourage risky behaviour.

Non-ADIs

136. Maintaining the \$1 million 'crisis level' FCS cap beyond the crisis could cause distortions in the Australian financial system. In particular, term deposits can operate as close substitutes for lower-risk investment products, such as cash management trusts and mortgage trusts. The provision of a deposit guarantee reduces the attraction of these substitutes by altering the risk-reward ratio for deposit products, particularly at a time when ADIs are offering high interest rates. This would negatively impact the capacity of the non-ADI sector to compete with ADIs. This could result in reduced competition across the broader financial sector and reduced product innovation.

The General Public

137. Similarly, continuing the \$1 million 'crisis' level FCS cap beyond the crisis would have a negative impact on the general public by

53 C. Littrell, [What are the Costs of Australian Basel III Implementation, and What are the Benefits?](#), speech to the Annual Australian Financial Services Conference of UBS, 23 June 2011, Sydney.

increasing moral hazard in the Australian financial system. As discussed at paragraph 127, a \$1 million FCS cap provides significant coverage to non-retail depositors, who have greater capacity to assess and manage their own risk than retail depositors. Maintaining the current cap would undermine incentives for these depositors to manage risk, and may increase incentives for ADIs to act in riskier ways. This could result in instability in the longer term, as ADIs and depositors became accustomed to a high level of protection against their own risks.

138. Retaining the \$1 million cap would also have a negative impact on fairness. At its current cap level, the FCS would use taxpayer funds to guarantee the deposits of depositors who are more sophisticated and better positioned to manage risk than retail depositors. The use of taxpayer funds to protect the interests of parties that have the capacity to manage their own risk raises fairness concerns.

The International Reputation of Australia's Financial System

139. If the \$1 million is retained beyond the crisis, the FCS risks non-compliance with the relevant international standards, the IADI Core Principles. This would have a negative impact on the reputation of Australia's financial system. Australia is generally seen as having very strong prudential and crisis management frameworks, which are largely compliant with international standards. This enhances the capacity of Australian ADIs to access international funding markets.

140. Principle 2 of the Core Principles calls for mitigation of moral hazard, while Principle 9 requires that coverage be 'limited' and meet the objectives of the scheme. As discussed at paragraph 137, preserving the \$1 million cap would create a significant risk of moral hazard. As set out in Table 2, a \$1 million cap covers over 99 per cent of total deposit accounts in full and a majority of deposits by value. This is difficult to reconcile with the requirement of limitations on coverage. Finally, as discussed at paragraph 127, an FCS cap of \$1 million would provide coverage well beyond the primary scheme objective of protecting Australian retail depositors. These factors indicate that the FCS may be considered non-compliant with relevant Core Principles.

141. Additionally, Australia implemented the \$1 million cap as a crisis measure. At the time of the crisis, there was broad acceptance that unusual degrees of government support were required. However, as Table 1 indicates, a \$1 million cap in a post-crisis environment is very high and could be regarded as excessive. This may send negative signals internationally about the health of the Australian ADI sector, if ADIs require a crisis-level cap in the longer term.

Option 2: Increased Cap: Unlimited

142. A second option would be to increase the FCS cap. Given the lack of data for FCS caps above \$1 million, this option considers an unlimited FCS cap.

143. An unlimited FCS would cover all eligible deposits in the Australian financial system. This would protect not only retail depositors, but all depositors, no matter how large or sophisticated. This would carry even greater moral hazard risks than those set out above, and for that reason is likely to have a negative impact on financial stability in the longer term. Overall, the costs can be said to outweigh the benefits.

Australian Retail Depositors

144. An unlimited FCS would have a positive impact overall on retail depositors. Coverage of retail deposits would increase from almost 100 per cent of accounts and 82 per cent of deposits by value, to 100 per cent of each. This would provide retail depositors with a higher level of protection, although the current level is very high.

Non-Retail Depositors

145. An unlimited FCS would have a positive impact for non-retail depositors in increased deposit protection, but would create extremely high moral hazard.

146. Under an unlimited FCS, coverage would increase from over 99 per cent of total eligible deposit accounts and 58 per cent of the value of total eligible deposits to 100 per cent of each (Table 2). This means that the impact of the change would be to increase the coverage of very wealthy depositors: it would provide additional coverage for a very small number of deposit accounts holding a very large quantum of deposits. These deposits are sufficiently large that the depositors holding them should be sophisticated enough to be able to assess and manage their own risk. In shielding sophisticated depositors from the consequences of their risk management decisions, an unlimited FCS would create extremely high levels of moral hazard.

The Commonwealth

147. An unlimited FCS would have a negative impact on the Commonwealth. The Commonwealth's FCS contingent liabilities would increase from \$737 billion to \$1.3 trillion.⁵⁴ This would create a significantly increased financial risk for the Commonwealth in the unlikely event that the FCS was activated.

54 *Monthly Banking Statistics*, Australian Prudential Regulation Authority, May 2011; *Quarterly Credit Union and Building Society Performance Statistics*, Australian Prudential Regulation Authority, March 2011.

ADIs

148. An unlimited deposit guarantee would have a positive impact on ADIs in terms of funding, but would have a negative impact in terms of the potential costs of an industry levy.

149. An unlimited deposit guarantee would cover the entire deposit base of all ADIs. On current estimates, this would guarantee around 82 to 83 per cent of the funding of mutual ADIs and around 55 per cent of the funding base of banks. This would have a positive commercial impact on ADIs. Given the relatively greater reliance of smaller ADIs (such as mutuals) on deposit funding than larger ADIs, it would have a relatively greater impact on smaller ADIs. It would increase their ability to compete with larger ADIs, both for deposit funding and for the lending activity which it funds.

150. An unlimited FCS would likely increase the ability of larger ADIs to meet their LCR obligations under the Basel III framework. As noted at paragraph 133, a higher FCS cap could result in ADIs being required to hold fewer high-quality liquid assets against their covered deposits. An unlimited FCS would maximise the amount of covered deposits, and so have a positive impact on these larger ADIs relative to the current cap.

151. There would be one negative impact for ADIs. If the FCS cap is raised from \$1 million to an unlimited level, the likelihood that the assets of a failed ADI will be insufficient to cover FCS payout costs will increase. This would increase the probability of an industry levy, in the event of an ADI failure, relative to the current cap. This would have a negative impact on the ADI sector.

Non-ADIs

152. An unlimited FCS would have a strong negative impact on the non-ADI sector.

153. An unlimited FCS cap could cause significant distortions in the Australian financial system, by distorting the risk-return ratio for close substitutes for deposits such as cash management trusts offered by the non-ADI sector. The lack of a limit would increase the negative impact for non-ADIs, relative to the current \$1 million cap; investors with larger amounts to invest than the FCS cap would face different incentives than under a capped FCS.

154. An unlimited guarantee could also cause distortions in the market for more sophisticated instruments, such as short-term money market bills. With no limit on the FCS, it is possible that very large guaranteed term deposits could be seen as a substitute for these instruments.

The General Public

155. An unlimited FCS would have a negative impact on the general public, by significantly increasing moral hazard in the Australian financial system. As discussed at paragraph 146, an unlimited FCS will cover all depositors in the Australian financial system, including those with the greatest capacity to assess and manage their own risk. This will protect sophisticated depositors from the consequences of their risk management decisions and so undermine incentives for them to manage risk. This will create extremely high levels of moral hazard, relative to a \$1 million cap.

156. In the long run, an unlimited FCS will have an overall negative impact on the general public in its contribution to financial stability. In the short run, at higher FCS cap levels, the likelihood of runs on ADIs in a crisis will fall, as depositors' confidence in the security of their deposits increases. However, in the long run, the stability effect is likely to be negative. This is because the significant moral hazard involved in an unlimited cap is likely to undermine market discipline and the proper management of risk.

157. An unlimited FCS would have a negative impact in relation to fairness. At an unlimited cap level, the FCS would use taxpayer funds to guarantee the deposits of all depositors, including very sophisticated ones. Using taxpayer funds to protect parties which have the capacity to manage their own risk raises fairness concerns; increasing the cap will exacerbate them.

The International Reputation of Australia's Financial System

158. Creating an unlimited FCS cap would undermine the international reputation of Australia's financial system.

159. As discussed at paragraph 140, the IADI Core Principles require mitigation of moral hazard and limitations on coverage. An unlimited FCS would work directly against these. The Core Principles also require that coverage meet the objectives of the scheme. The main objective of the FCS is providing protection for Australian retail depositors. An unlimited FCS would provide protection levels well above those needed to meet these objectives.

160. Finally, increasing the FCS limit above its 'crisis' level, after the crisis has passed, would send negative signals internationally about the health of the Australian ADI sector.

Option 3: Reduced Cap: \$250,000

161. The CFR has recommended that the FCS cap be reduced to a level between \$100,000 and \$250,000. For reasons discussed at paragraph 162, a cap of \$250,000 is the best option in this range and will be the cap option considered in this document.

\$100,000 vs \$250,000

162. The CFR has recommended that the FCS cap be set at \$100,000 to \$250,000. This impact analysis considers \$250,000 as the relevant option, for consistency with the goals of the FCS.

163. The primary goal of the FCS is the protection of Australian retail depositors. A cap of \$250,000 would be consistent with the identification of retail depositors elsewhere in Australia's prudential regulation regime. Under conditions imposed in APRA's authorisation of foreign ADIs, branches of foreign banks in Australia are not permitted to accept initial deposits of less than \$250,000. This is to prevent retail depositors from accessing these institutions, as they are not primarily regulated by APRA and are not eligible for the FCS. This indicates that, in the ADI sector, \$250,000 is the dividing line between retail and non-retail depositors.

164. The cap range recommended by the CFR would meet the objectives of the scheme in targeting protection at retail depositors.

165. A cap of \$250,000 would limit coverage to retail depositors, consistent with the objectives of the FCS. This would provide significant coverage for retail depositors, at 99 per cent of household deposit accounts by number and 82 per cent of household deposits by value.⁵⁵

166. However, coverage of non-household deposits would be significantly lower. For non-financial corporations⁵⁶, coverage of deposit accounts by number would remain quite high, at 95 per cent. However, coverage of deposits by value would be reduced significantly, to 34 per cent. Similarly, coverage of other non-household depositors would remain quite high by number, but quite low by value. For these depositors, 91 per cent of deposit accounts would be covered, but only 24 per cent of deposits by value. The differences in the value of deposits covered indicate that the vast majority of the benefit of the FCS would accrue to retail rather than other depositors.

167. A cap in the recommended range would provide a very high level of coverage to Australian retail depositors. For other categories of depositor, the disparity between the coverage levels by number of accounts and by value covered indicates that this range will remove coverage from a small number of depositors with very large deposits. This is consistent with the goals of the FCS, in targeting coverage at retail depositors.

55 Coverage information is based on industry survey data and Treasury estimates. It does not allow for the effects of account aggregation, which will reduce coverage by number of accounts by a small amount. Aggregation data will be available by 2014.

56 The Monthly Banking Statistics define 'non-financial corporations' as 'private trading corporations, private unincorporated businesses, commonwealth, state, territory and local government non-financial corporations': Australian Prudential Regulation Authority, *Monthly Banking Statistics*, May 2011.

Australian Retail Depositors

168. If the cap is set at \$250,000, then there will be little impact on the vast majority of Australian retail depositors. At this level, 99 per cent of household deposit accounts will be covered in full by the FCS, a reduction of around one percentage point compared with the present FCS cap (see Table 2). This means that there will be a negative impact on retail depositors, but that it will only be very slight.

169. The negative impact will be limited to a small number of depositors with very large deposits. A \$250,000 cap will cover 82 per cent of the value of household deposit balances, compared to the 95 per cent covered by the current cap. This means that the cessation of coverage will apply only to the top one per cent of household deposit accounts, which hold between 13 per cent of household deposits by value.

Non-Retail Depositors

170. Reducing the FCS cap to \$250,000 will have a negative impact on non-retail depositors, reducing their levels of protection. However, this is consistent with the goals of the scheme.

171. At a cap of \$250,000, the FCS would cover 95 per cent of deposit accounts held by non-financial corporations in full. However, it would only cover 34 per cent of deposits by value. This compares with the current coverage of 98 per cent of deposit accounts by number and 61 per cent of deposits by value.

172. Similarly, for other non-household depositors, the \$250,000 cap would cover 91 per cent of deposit accounts, but only 24 per cent of deposits by value. This compares with coverage under the \$1 million cap of 95 per cent of deposit accounts and 52 per cent of deposits by value.

173. Consultation indicates that the types of depositors who hold deposits between \$250,000 and \$1 million include businesses, local councils, hospitals, schools and community organisations.

The Commonwealth

174. Reducing the FCS cap would have a positive impact on the Commonwealth. As set out in Table 3, a cap of \$250,000 would reduce contingent liabilities under the FCS by around \$150 billion, to \$586 billion. This will have a positive impact on the financial exposure of the Commonwealth. It should be noted that this figure could increase, as some depositors would split their deposits across ADIs to maximise guarantee coverage. However, the administrative inconvenience of splitting deposits, the strength of the Australian ADI sector and its prudential regulation framework and the small number of entities with account balances between \$250,000 and \$1 million, means that this effect is likely to be mitigated.

ADIs

175. Reducing the FCS cap to \$250,000 will have a small negative impact on some ADIs.

176. As Table 3 shows, a \$250,000 cap will cover almost half of total ADI deposits, at 46 per cent (compared to 58 per cent at the current cap). This is a significant level of coverage, but is below the current rate. As discussed at paragraph 131, mutual ADIs source around 82 to 83 per cent of their funding from deposits, compared to 55 per cent for banks. This means that a \$250,000 cap will guarantee around 38 per cent of mutual ADIs' funding, compared to 48 per cent under the current FCS. For banks, a \$250,000 cap will cover around 25 per cent of banks' funding, compared to 32 per cent at present. Given their greater reliance on deposit funding, the negative impact — whilst still small — will be greater for smaller ADIs than for larger ADIs.

177. However, some smaller ADIs anticipate that certain classes of depositors, such as local councils and schools, and self managed superannuation funds (largely organisations rather than individuals), may withdraw their deposits if the entirety of their deposits are not guaranteed. Concerned depositors may move their funds to larger institutions with credit ratings, they may split their deposits across a number of ADIs, or they may reconsider their investment options.

178. Consultation indicated that some depositors are receiving advice to hold deposits in ADIs with certain credit ratings, or which are Commonwealth guaranteed.

179. Many smaller ADIs do not have credit ratings as they do not raise funds on wholesale markets. Lack of a credit rating is not an indicator of an ADI's capacity to protect deposits. Further, deposits above the cap are still protected by the prudential regulation regime through APRA's responsibilities to protect deposits, and through depositor preference which gives depositors a prior claim against the assets of a failed institution.

180. It is very difficult to estimate the likely quantum of funds being moved, and indeed the destination of these funds. [**Confidential material**]

181. If the FCS cap is reduced to \$250,000, then there may be a small negative impact on ADIs in relation to the LCR requirements. However, as 46 per cent of total eligible deposits would still be covered by the FCS (compared to 58 per cent at the current cap), and FCS coverage forms only one component of the LCR, it is unlikely that any impact will be significant.

Non-ADIs

182. Reducing the FCS cap to \$250,000 is likely to have a positive impact on the capacity of non-ADIs to compete with the ADI sector for funding.

183. Reductions in the FCS cap are likely to alter the risk-reward calculation for depositors who are attracted to deposit substitutes, such as mortgage trusts and cash management trusts. This is likely to create incentives for some depositors to shift funds out of deposit products and into these slightly riskier products. This means that the reduction in the FCS cap is likely to have a positive impact on the non-ADI sector, increasing its ability to attract funds and so compete with the ADI sector.

The General Public

184. Reducing the FCS cap will have a positive impact on the general public, through the reduction in moral hazard. Reducing the cap to \$250,000 will cover a large majority of household deposits by value, whilst removing coverage from the bulk of non-financial corporations and other non-household deposits. This will target FCS coverage at retail depositors, who are least able to assess and manage their own risk. This will reduce moral hazard significantly.

185. Reducing the FCS cap to \$250,000 will have a fairness benefit for the general public. If the FCS cap is reduced, then taxpayer funds would be called on to guarantee deposits of a size that relates to retail depositors, rather than larger and more sophisticated depositors who can and should bear their own risk. The use of taxpayer funds to protect the interests of parties that have the capacity to manage their own risk raises fairness concerns, which a reduction in the cap will alleviate.

The International Reputation of Australia's Financial System

186. Reducing the FCS cap will have a positive impact on the reputation of Australia's financial system.

187. As noted at paragraph 140, the IADI Core Principles call for mitigation of moral hazard, limitations on coverage and aiming coverage at the objectives of the scheme. A cap of \$250,000 significantly reduces moral hazard and limits coverage to retail depositors, which is the main objective of the scheme. This will enhance Australia's compliance with international standards and, thereby, the reputation of the Australian financial system.

188. A cap of \$250,000 would also be reasonably comparable with deposit insurance caps in comparator countries. As Table 1 demonstrates, a cap at this level would be at the higher end of the international range, but would not be an outlier, whether measured by the ratio of the cap to per-capita GDP (the international standard) or in a currency equivalent. It

would be unlikely to cause adverse international comment or negatively affect the reputation of Australia's financial system.

189. As noted in the PIR, the FCS does not offer protection at a level that can impact on the international flow of funds, and deposits generally have a strong home bias. Therefore, it is not anticipated that a change in cap will impact on the flow of funds into Australia. Further, international investors seeking Government guaranteed assets have the option of purchasing Commonwealth Government Securities.

Option 4: Removal of the FCS

190. Under this option, no deposits would be protected by the FCS — there would be no FCS coverage at all.

Depositors

191. The removal of the FCS would not be consistent with the objectives of the scheme of depositor protection, liquidity provision and supporting financial stability. Without the FCS, no depositors — retail or otherwise — would have their deposits covered under the scheme.

192. The strength of Australia's prudential regulation framework makes a failure unlikely. Additionally, if an institution did fail, depositors would still be protected by depositor preference, which provides them with a priority claim for their deposits in the liquidation process. However, this arrangement would not support the goal of providing depositors with liquidity, as they would lose access to their deposits until at least some way into — or the completion of — the insolvency process. This process would depend on the complexity of the institution, but depositors could be deprived of access to their funds for a period of many months or a small number of years.

193. Similarly, the removal of the FCS would undermine the objective of supporting financial stability. Without the FCS, depositors may face a significant delay in accessing their deposits in the event of an ADI failure. This increases the likelihood that, if there are public perceptions that an institution is becoming distressed, depositors will run on that institution in order to preserve access to their funds. This could cause (or exacerbate) the very distress from which depositors are seeking to protect themselves.

The Commonwealth

194. Repealing the FCS would reduce the risk exposure of the Commonwealth significantly. As set out in Table 3, the contingent liabilities under the FCS are currently \$737 billion. With no FCS, this figure would fall to zero, which would substantially reduce the Commonwealth's risk exposure.

ADIs

195. The withdrawal of the FCS would have a negative impact on smaller ADIs' capacity to compete for larger deposits. With no FCS, risk-averse depositors may move their deposits from smaller ADIs to larger ADIs, under the perception that these institutions are more secure. It may also induce depositors to shift their funds to higher risk, higher-reward instruments.

Non-ADIs

196. Removing the FCS would have a positive impact on non-ADIs. It would strengthen their ability to compete with ADIs by offering deposit-like products, such as cash management trusts. Without the FCS, there would be stronger incentives to invest in these products, as their risk-return ratio would improve (relative to deposits).

The International Reputation of Australia's Financial System

197. The removal of coverage would not be consistent with the relevant international standards, the IADI Core Principles. Principle 9 calls for coverage to be credible and to be sufficient to meet the objectives of the scheme. At a zero level, coverage will not be credible and will not meet the FCS objectives (see paragraphs 191 to 193). Similarly, as Table 1 shows, the withdrawal of the FCS would be significantly out of step with international deposit protection levels.

Option 5: FCS with a Fee

198. Under this option, an up-front fee for access to the FCS would be imposed. This would replace the current system whereby the Government pays out depositors and is then reimbursed in the liquidation process and, if need be, by a charge on industry. The proceeds would be kept in a special purpose fund, for the payment of any claims under the scheme.

Impact on Depositors

199. Imposing a fee on the FCS would have a slightly negative impact on depositors. It is likely that ADIs would pass at least a portion of any FCS fee on to depositors, primarily in the form of lower deposit interest rates. This would raise costs to depositors.

ADIs

200. An FCS fee would have a negative impact on ADIs; the effect would be greater for smaller ADIs. If an FCS fee were charged, ADIs may not be able to pass on the full costs of the fee to their depositors; this means that they would face a negative cost impact.

201. ADIs will also face an opportunity cost in relation to the fees. In the absence of a fee, these funds remain on ADIs' balance sheets and can be used to support the flow of credit into the real economy or to bolster

ADIs' capital positions. The creation of a fee would reduce these benefits. By contrast, the special purpose fund would need to be invested conservatively, in assets which would remain liquid in the adverse market conditions which would likely accompany a failure. This means that the fees would likely be invested more efficiently by ADIs than by the fund.

The Commonwealth

202. A fee would have, on balance, a positive impact on the Commonwealth. The existence of an up-front fee would mean that FCS payments could be drawn from the special purpose fund, rather than from borrowings and cash holdings. This would reduce the financial risk to the Commonwealth.

203. This impact would be reduced to some extent by the administrative costs of maintaining a fund. Establishing a fund would require the creation of the fund infrastructure, the assessment and collection of premiums and the management of the funding pool. However, no institution in Australia has failed since the modern national prudential regulation framework was created; the last institution to fail was the state-supervised Pyramid Building Society, in 1991. Where failures are rare, as in Australia, the administrative costs of the fund may become disproportionate over time. However, the reduction in financial risk is likely to outweigh the administrative costs.

Non-ADIs

204. The creation of an FCS fee would have a positive impact on non-ADIs, as it would be likely to reduce the return on deposits, increasing the attractiveness of products which are close substitutes for deposits, such as cash management trusts. Imposing a fee for the FCS would reduce this distortion. This would have a positive impact on the non-ADI sector.

The International Reputation of Australia's Financial System

205. Imposing an up-front FCS fee would have a neutral impact on the international reputation of Australia's financial system. A significant majority of countries have up-front fees for their deposit protection systems. Nevertheless, major financial jurisdictions such as Switzerland, Luxembourg, The Netherlands, Austria and Italy use a post-funded approach, as Australia does. Additionally, the post-funded system reflects the rarity of ADI failures in Australia.

206. Imposing an up-front fee will not alter Australia's compliance with international standards. The IADI Core Principles do not require countries to implement either up-front fees or post-funded systems. Therefore, imposing an FCS fee will not improve or reduce Australia's compliance with the Core Principles.

Practical Issues

207. There are practical difficulties in imposing an up-front FCS fee in Australia. The two basic factors underlying a fee are the probability of default and the loss given default. The rarity of failures in Australia generally, and the total absence of ADI failures under the modern prudential regulation system, means that there is little failure data to use to determine the likelihood that an institution would become insolvent.

A Voluntary Fee?

208. It would be possible to implement a voluntary rather than compulsory fee for FCS coverage. This would mean that only those depositors who wished to pay for coverage would be protected by the FCS. Other depositors would not have their funds guaranteed.

209. A voluntary fee would not further the objectives of the FCS. Those depositors who chose not to pay the fee would face reduced protection and the prospect of delays in recouping their deposits in the event of a failure, relative to depositors protected by the FCS. Those depositors who chose not to pay the fee would face increased incentives to run on their ADIs, should public perceptions of their safety decline. This would undermine the FCS objective of upholding the stability of the financial system.

210. A voluntary fee would also disadvantage smaller ADIs. Public perceptions of security may make depositors in larger ADIs more confident in the security of their deposits and so less likely to pay the fee than depositors in smaller ADIs. This would provide larger ADIs with a competitive advantage over smaller ADIs.

211. A voluntary fee would also be inconsistent with international standards. The IADI Core Principles call for membership of deposit insurance systems to be compulsory (Principle 8). Adopting a voluntary fee would impact negatively on the reputation of Australia's financial system.

Conclusion

212. The impacts of the different FCS options on the relevant groups are summarised in Table 4, below.

Table 4: Impacts of Cap Options on Stakeholders

<i>Group</i>	<i>Option 1: \$1 million Cap</i>	<i>Option 2: Unlimited Cap</i>	<i>Option 3: \$250,000 Cap</i>	<i>Option 4: No FCS</i>	<i>Option 5: FCS Fee</i>
<i>Retail Depositors</i>	<i>Status Quo</i> Current high protection Moral hazard	<i>Costs</i> Increased moral hazard <i>Benefits</i> Higher protection	<i>Costs</i> Lower protection level <i>Benefits</i> Reduced moral hazard Consistent identification of retail depositors across the ADI sector	<i>Costs</i> No protection <i>Benefits</i> No moral hazard	<i>Costs</i> Payment of some or all of the fee
<i>Non-Retail Depositors</i>	<i>Status Quo</i> Current high protection High potential moral hazard (with improving conditions)	<i>Costs</i> Extremely high moral hazard <i>Benefits</i> Much higher protection	<i>Costs</i> Lower protection level <i>Benefits</i> Reduced moral hazard	<i>Costs</i> No protection No protection of 'middle' depositors <i>Benefits</i> No moral hazard	<i>Costs</i> Payment of some or all of the fee

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<i>Smaller ADIs</i>	<i>Status Quo</i>	<i>Costs</i>	<i>Costs</i>	<i>Costs</i>	<i>Costs</i>
	Current high coverage	Very high moral hazard	Lower coverage of funding base	No coverage of funding base	Payment of some or all of the fee
	Current positive competitive position	<i>Benefits</i> Much higher coverage of funding base	Slightly worse competitive position	Much worse competitive position	Worse competitive position
	Risk of an industry levy if the FCS is activated	Better competitive position	Reduced moral hazard	Greatly reduced moral hazard	<i>Benefits</i> Reduced risk of levy
<i>Larger ADIs</i>	<i>Status Quo</i>	<i>Costs</i>	<i>Costs</i>	<i>Costs</i>	<i>Costs</i>
	Current moderate coverage	Very high moral hazard	Lower coverage	No coverage	Payment of some or all of the fee
	Risk of an industry levy if the FCS is activated	<i>Benefits</i> Much higher protection	Reduced moral hazard	Worse competitive position	<i>Benefits</i> Reduced risk of levy
		Slightly better competitive position	Neutral competitive position	Greatly reduced moral hazard	
			Reduced risk of levy	No risk of levy	
<i>Non-ADIs</i>	<i>Status Quo</i>	<i>Costs</i>	<i>Benefits</i>	<i>Benefits</i>	<i>Benefits</i>
	Current zero coverage High potential negative impact on competition (with improving conditions)	Much worse competitive position Extremely high market distortions	Improved competitive position	Improved competitive position	Minor improvement in relative competitive position

General Public	<i>Status Quo</i> High potential moral hazard (with improving conditions)	<i>Costs</i> Very high moral hazard Increased initial taxpayer exposure <i>Benefits</i> Increased financial stability	<i>Benefits</i> Reduced moral hazard Improved long-run financial stability Reduced initial taxpayer exposure	<i>Costs</i> Greatly reduced financial stability <i>Benefits</i> No moral hazard Reduced initial taxpayer exposure	<i>Costs</i> Inefficient use of funds Reduction in ADI funds available for credit provision
APRA	<i>Status Quo</i> No change	No change	No change	Reduced administrative responsibilities	No change
The Commonwealth	<i>Status Quo</i> Current high financial exposure	<i>Costs</i> Extremely high financial exposure	<i>Benefits</i> Significantly reduced financial exposure	<i>Benefits</i> No financial exposure	<i>Costs</i> Administration of fund <i>Benefits</i> Somewhat reduced financial exposure
International Reputation	<i>Status Quo</i> Current very high coverage levels by international standards High potential for non-compliance with international standards	<i>Costs</i> Extremely high coverage by international standards Extremely high potential for non-compliance	<i>Benefits</i> Coverage consistent with international standards. Very high compliance with international standards	<i>Costs</i> Extremely low coverage by international standards Very low compliance with international standards	No impact

213. The best option to choose is Option 3, the \$250,000 cap. This is the most consistent with the objectives of the FCS and, on balance, would provide the greatest benefit.

214. Options 1 and 2 (the current \$1 million cap and the unlimited cap) provide a very high level of protection for all depositors and guarantee a very high proportion of the funding of institutions. However, with improvements in market conditions, they also risk very high levels of moral hazard and significant negative impacts on the competitive positions of non-ADIs. There is also a strong likelihood of non-compliance with international standards and a very high degree of Commonwealth financial exposure. On balance, this would create a negative impact.

215. Option 4 (the removal of the FCS) will also have an overall negative impact. Although this proposal will significantly reduce moral hazard, and remove the Commonwealth's financial risk entirely, this will leave all depositors without timely access to their deposits in the event of an insolvency. This risks undermining the stability of the financial system. This is a significant negative impact.

216. In relation to Option 5, regardless of the cap level, it would not be appropriate to impose a fee on the FCS. A fee would impose costs on depositors and ADIs. Whilst it would reduce the financial exposure of the Commonwealth, it would also result in ongoing administrative and management costs. The funds stored in the fee pool would also not be available for ADIs to use to support lending or bolster their capital position. In a country where failures have been rare, the costs of a fee are likely to outweigh the benefits. A voluntary fee would have a particularly negative impact; it would affect smaller ADIs' competitive position and undermine the reputation of Australia's financial system.

217. Option 3 balances the costs and benefits in the most appropriate way. It will provide a degree of protection sufficient for Australian retail depositors, without the moral hazard difficulties of covering too high a proportion of the value of deposits of other depositors. It will reduce the Commonwealth's contingent liabilities and improve the competitive position of non-ADIs. There will be a negative impact on smaller ADIs' ability to compete for larger deposits but a positive impact on non-ADIs' ability to compete by providing deposit substitutes. Combined with the high degree of compliance with international standards, the overall impact will be positive.

Coverage of foreign branches of ADIs

218. The Government considered two options in determining coverage of foreign branches of Australian incorporated ADIs (for example, the branches of Australian ADIs in Vietnam and the UK):

- retaining the current coverage of these branches; or
- removing coverage.

Option 1: Retain Current Coverage

219. This option would see the FCS continuing to cover deposits held by the foreign branches of Australian-incorporated ADIs.

220. It is estimated that deposits held in these foreign branches account for approximately 8 per cent of total deposits. The majority of these accounts are already above the current cap of the FCS and so the bulk of these deposits are not currently covered by the FCS. This means that only a small portion of these deposits are protected by the FCS. While continuing coverage will not materially increase the exposure of the Government, covering them will neither add to stability (given the level of covered deposits is low) nor will it add significantly to the protection of Australian retail depositors. There is potential for the number of these accounts to grow. So if coverage is maintained, exposure of the Government could grow, without materially improving the extent to which the FCS fulfils its goals.

221. Covering deposits held in these branches is not consistent with the objectives of the FCS. The FCS is aimed at protecting Australian retail depositors. Providing coverage to deposits held outside Australia does not assist in meeting this purpose.

Australian Retail Depositors

222. Retaining the current coverage of foreign branches would have little impact on Australian retail depositors. Australian retail depositors are unlikely to hold deposits in the offshore branches of Australian-incorporated ADIs, and only a small portion of these funds are covered by the FCS.

Non- Retail Depositors

223. Maintaining the status quo will mean that non-retail depositors will continue to benefit from coverage foreign branches. However, the small portion of deposits held in foreign branches and covered by the FCS means that even for these depositors — who have greater access to foreign branches — the benefit which persists will be small.

Larger ADIs

224. Foreign branch coverage has a slightly positive effect on larger ADIs, as only larger ADIs operate overseas branches. Again, the small size of FCS-eligible deposits in these branches means that the benefit to larger ADIs is limited.

Option 2: Ceasing Coverage

225. The CFR has recommended the removal of FCS coverage of foreign branches of Australian ADIs. Ceasing to cover these deposits would better target FCS coverage at Australian retail depositors, who are the intended beneficiaries of the FCS.

Australian Retail Depositors

226. Ceasing coverage will have little to no impact on retail depositors. Australian retail depositors are unlikely to hold deposits in the offshore branches of Australian-incorporated ADIs, and only a small proportion of these funds are covered by the FCS.

Non-Retail Depositors

227. Removing coverage may affect non-retail depositors more than their retail counterparts, but the effect is unlikely to be significant. As discussed at paragraph 230, deposits held in foreign branches are a very small proportion of total eligible deposits, and FCS-eligible deposits are a small subset again of these. This means that even for non-retail depositors as a whole, a change in coverage is unlikely to have a great impact.

Larger ADIs

228. Withdrawing foreign branch coverage will have a mildly negative effect on larger ADIs. Only larger ADIs operate overseas branches, and so the reduction in FCS coverage will be limited to these ADIs. This means that there will be a relative negative impact on larger ADIs and a relative positive impact on smaller ADIs. However, the small size of the FCS-eligible component of these deposits, and the cessation of foreign currency coverage in October 2011, means that the reduction in coverage will be minor. This means that the impact of withdrawing coverage will not be significant.

APRA

229. There will be a moderate benefit for APRA in removing foreign branch coverage. The proposed change will reduce the potential administrative burden of providing FCS payouts to depositors with funds in these branches, which will reduce the cost of making payments. These depositors often reside in other jurisdictions, which could complicate the payout process.

The Commonwealth

230. Withdrawing coverage will have a small positive impact on the Commonwealth, by reducing the contingent liabilities under the scheme. However, given the small quantum of FCS-eligible deposits held in these accounts, this is unlikely to be significant. Additionally, foreign currency deposits will cease to be covered under the FCS from 12 October 2011

under a sunset clause in the Banking Act. This will further reduce the level of foreign branch deposits which would be affected by a change.

The International Reputation of Australia's Financial System

231. The Core Principles do not deal explicitly with the issue of whether deposit insurance schemes should cover deposits held with the foreign branches of domestic deposit-taking institutions. In the EU, many deposit insurance schemes cover these deposits; however, this seems to reflect the special arrangements which apply to the EU, rather than a design preference for foreign branch coverage more generally. Beyond the EU, the US, Canada and Japan do not provide coverage of deposits held in the foreign branches of locally-incorporated ADIs. Removal of coverage will have no impact on Australia's compliance with the Core Principles.

Conclusion

232. The impacts of retaining and ceasing coverage of foreign branches are summarised in Table 5.

Table 5: Impacts of Foreign Branch Coverage on Stakeholders

<i>Group</i>	<i>Option 1: Retaining Current Coverage</i>	<i>Option 2: Ceasing Coverage</i>
<i>Retail Depositors</i>	<i>Status Quo</i> Current very low protection	<i>Costs</i> Slight reduction in protection
<i>Non-Retail Depositors</i>	<i>Status Quo</i> Current low protection	<i>Costs</i> Slight reduction in protection
<i>Smaller ADIs</i>	<i>Status Quo</i> No coverage	No change to current arrangements <i>Benefits</i> Small improvement in competitive position relative to larger ADIs
<i>Larger ADIs</i>	<i>Status Quo</i> Current low coverage	<i>Costs</i> Small reduction in coverage
<i>Non-ADIs</i>	<i>Status Quo</i> No coverage	No change to current arrangements
<i>General Public</i>	<i>Status Quo</i> Slight moral hazard (as depositors of foreign branches are likely to be more sophisticated than Australian retail depositors)	<i>Benefits</i> Slight reduction in moral hazard
<i>APRA</i>	<i>Status Quo</i> Moderate administrative costs	<i>Benefits</i> Moderate reduction in administrative costs
<i>The Commonwealth</i>	<i>Status Quo</i> Moderate to extremely high financial exposure (depending on the cap chosen)	<i>Benefits</i> Small reduction in financial exposure
<i>International Reputation</i>	<i>Status Quo</i> No standard position on foreign branch coverage	No change to current compliance with international standards

233. The best option is Option 2, the removal of foreign branch coverage. This focuses the scheme more tightly on its objectives, with little impact on any group.

234. Compared with the Option 1 (the status quo), Option 2 will have a very small negative impact on Australian retail depositors, a small

negative impact on non-retail depositors and a small negative impact on larger ADIs. It will have a small positive relative impact on small ADIs, a small positive impact on the Commonwealth and a moderate positive impact on APRA. There will be a small positive impact on the general public through the reduction in moral hazard. These outweigh the small negative impacts on some depositors and larger ADIs.

235. Ceasing coverage will have a small and positive impact overall. It will further the primary FCS objective of protecting Australian retail depositors, with little impact on stability (given the small amounts quantum of FCS-eligible deposits held in foreign branches). Therefore, it is the best option.

Pooled trust accounts

236. The Government considered three options in determining coverage arrangements for PTAs:

- retaining the current coverage arrangements for PTAs;
- enabling an expansive PTA look-through; or
- enabling a narrow PTA look-through.

237. The main impacts of these options are set out below. The full set of impacts is summarised in Table 6.

Option 1: Retain current coverage arrangements

238. The first option is to retain the status quo: that is, to retain the current FCS treatment of PTAs, whereby only a single payment is made regardless of the number of beneficiaries. The current approach promotes prompt payout and administrative ease.

Retail Depositors

239. The current approach would not relieve the disadvantage faced by PTA beneficiaries who have no choice where their deposits are placed. These beneficiaries will in many cases receive only very limited protection under the FCS, particularly if the FCS limit is reduced.

240. Retaining this option may also cause significant public concern, given the low level of protection which beneficiaries may receive. These concerns may be acute where PTAs temporarily contain large deposits of retail depositors, such as the proceeds of house sales or superannuation lump sums.

Option 2: Expansive PTA Look-Through

241. A second option would be to provide a 'look-through' arrangement for all PTAs. This would include not only those PTAs where a legal requirement to hold the funds exists, such as those used by legal

practitioners and conveyancers, but also those used as financial structures by providers of superannuation and managed investment products.

Non-retail Depositors

242. An expansive revision to PTA coverage would move the FCS beyond its objectives of protecting Australian retail depositors. By covering the cash components of managed funds and superannuation products, which are managed by professional investment advisers, the FCS would move towards covering retail investors. Investment products involve a very different and less intense financial promise from that involved with a deposit. An investment may involve risk to capital, and there is no certainty of return unlike a deposit. Even where an investment is held in a cash product, the involvement of a professional investment manager means that an entity with the capacity to assess and manage risk is making the decision about the institutions with which funds should be placed. By contrast, the FCS is intended to protect those depositors who do not have the capacity to assess the risk level of a particular institution and who do not have deposits of a sufficient size to spread them across institutions.

ADIs

243. This option could result in increased reporting requirements for ADIs, if APRA requires ADIs to report on the division of their PTAs. This would require ADIs to gather information from their clients, which would administratively difficult.

Non-ADIs

244. An extended treatment of PTAs would improve the competitive neutrality across all savings products which are used to hold deposits in ADIs. This will benefit investment platforms, managed funds and superannuation funds that have a holding in an ADI deposit.

APRA

245. The introduction of an expanded approach will substantially increase the administrative burden for APRA. Currently, FCS payouts are based on the entity in whose name an account is held. This means that all of the information which APRA requires to make FCS payments is contained within an ADI's records. However, if the PTA changes are introduced, then APRA will need account-holders to provide evidence of the holdings of beneficiaries within the pooled account, as the ADI will not have this information. This will add an additional step to the payout process for this class of account-holders.

The Commonwealth

246. An expansive revision to PTA coverage would increase the contingent liabilities of the Commonwealth significantly. For example,

the total level of deposits held by managed funds institutions⁵⁷ was \$183.7 billion at March 2011.⁵⁸ Although a portion of these deposits would already be covered by the existing FCS, expanding PTA coverage arrangements would bring a significant additional segment of these funds under coverage.

Option 3: Narrow PTA Look-Through

247. A narrow approach arrangement would limit the class of PTAs for which a look-through was used to those required to be held by a law of the Commonwealth, a State or Territory for the purpose of holding monies on trust for another party. This would largely be confined to PTAs established as part of a professional service, such as the holding of client funds in solicitors', real estate agents' and conveyancers' trust accounts. It would not apply to family trusts or trusts used for investment purposes (such as superannuation funds and managed investment products).

Retail Depositors

248. This approach would be consistent with the FCS goal of providing protection for retail depositors as it would increase coverage for beneficiaries whose funds are held in affected PTAs. For these depositors, the holding of the deposit in a PTA is an ancillary feature of accessing a service, such as legal advice, rather than an investment. The trustee is not aiming to provide a return to the beneficiary nor is it providing financial advice; there is no intervening entity which changes the nature of the retail depositor to a sophisticated depositor.

The Commonwealth

249. It is difficult to estimate the amounts held in statutorily mandated types of PTAs — neither APRA, the RBA, nor the ABS compiles directly relevant statistics. Industry estimates in December 2008 suggest that the legal industry is one of the largest users of these PTAs, with total deposits estimated at \$2.6 billion.⁵⁹ Other significant users are likely to include real estate agents, conveyancers and stock and station agents. Even if all the other affected industries used PTAs to the same extent as the legal industry — which seems unlikely — the total amount in PTAs is unlikely to be over \$15 billion. The increased contingent liability will be quite small.

57 The [Australian Bureau of Statistics](#) defines these to include life insurance corporations, superannuation funds, public offer (retail) unit trusts, friendly societies, common funds and cash management trusts. Funds of a speculative nature which do not offer redemption facilities (such as agriculture and film trusts) and funds not established for investment purposes (such as health funds) are excluded.

58 [Managed Funds, Australia](#), Australian Bureau of Statistics, March 2011, Catalogue No. 5655.0.

59 Estimates provided by the Law Council of Australia, December 2008.

ADIs

250. As discussed at paragraph 244, additional PTA coverage could lead to an additional administrative burden on ADIs, through a need to gather information from clients. This burden would be reduced under this option, relative to the expansive look-through, because of the narrower range of clients from whom it would be necessary to gather PTA information.

APRA

251. As discussed at paragraph 245, the introduction of a look-through will increase the administrative burden on APRA. The extent of the increase is likely to be smaller for the narrow look-through option than for the expansive look-through option. This is because the range of account-holders from whom it will be necessary to gather and verify information will be much smaller than would be the case for the expansive look-through option.

252. This option could result in increased reporting requirements for ADIs, if APRA requires ADIs to report on the division of their PTAs. This would require ADIs to gather information from their clients, which would be administratively difficult.

Conclusion

253. The impacts of the different PTA options on the relevant groups are summarised in Table 6, below. Some categories were not included in the table, such as the general public and international reputation as there are no impacts.

Table 6: Impacts of PTA Coverage Options on Stakeholders

<i>Group</i>	<i>Option 1: Status quo</i>	<i>Option 2: Expansive PTA look-through</i>	<i>Option 3: Narrow PTA look-through</i>
<i>Retail Depositors</i>	<i>Status Quo</i> Limited protection	<i>Benefits</i> Much higher protection	<i>Benefits</i> Higher protection
<i>Non-Retail Depositors</i>	<i>Status Quo</i> No protection	<i>Benefits</i> Higher protection	<i>Costs</i> No protection
<i>ADIs</i>	<i>Status Quo</i> No change	<i>Costs</i> Increased reporting requirements	<i>Costs</i> Increased reporting requirements
<i>Non-ADIs</i>	<i>Status Quo</i> Possible market distortions	<i>Benefits</i> Competitive neutrality across savings products	<i>No change</i>
<i>APRA</i>	<i>Status Quo</i> Low administrativ e burden	<i>Costs</i> Higher administrative burden	<i>Costs</i> Moderate administrative burden
<i>The Commonw ealth</i>	<i>Status Quo</i> No financial exposure	<i>Costs</i> Higher financial exposure	<i>Costs</i> Moderate financial exposure

254. The best option is Option 3, the narrow PTA look-through. This is the most consistent option with the objectives of the FCS and, on balance, would provide the greatest benefit.

255. Option 1 (status quo) would be the most administratively simple, and would not contribute to growth in the Government's contingent liabilities. However, it will not contribute to the protection of retail depositors.

256. Option 2 (expansive treatment) will not overall, contribute to the achievement of the FCS objectives. An expansive coverage of PTAs is likely to increase protections for more sophisticated parties than Australian retail depositors, and will increase the Commonwealth's contingent liabilities markedly. It would also increase the administrative burden for APRA.

257. Option 3 balances the costs and benefits in the most appropriate way. It will contribute best to the protection of retail depositors. It would reduce the potential for inequitable outcomes under the current PTA structure and avoid providing the benefit to more sophisticated entities, with only a small increase in contingent liabilities. The overall impact will be strongly positive.

FCS activation

258. The Government considered four options in determining appropriate activation arrangements for the FCS:

- retaining the current activation arrangements;
- one combination of discretionary then automatic activation;
- a second combination of discretionary then automatic activation; and
- a third combination of discretionary then automatic activation.

259. The main impacts of these options are set out below. The full set of impacts is summarised in Table 7.

Option 1: Retain the Current Arrangements

260. As noted in the background discussion, the FCS can only currently be activated at the discretion of the Treasurer. Before the Treasurer can activate the FCS, APRA must have applied to the Federal Court for an order that the ADI be wound up. Before this request can be made, APRA must first have appointed a statutory manager to the ADI, and be of the view that the institution is, or shortly will be, insolvent. The Treasurer may request APRA, ASIC or the RBA for information to assist in his decision whether to activate the FCS, and these regulators must respond.

The General Public

261. Because the Treasurer cannot declare the FCS until APRA has sought a wind-up order, this option constrains the Treasurer from being able to make a precise statement of intent in relation to the application of the FCS to a failing institution while the institution is in distress. This could result in an ADI's distress being known to the public as a result of the appointment of a statutory manager, with subsequent confidence and possibly contagion issues, without the Government having the capacity to announce or implement the FCS.

The Commonwealth

262. Retention of the current arrangements would ensure the government retained discretion over the commitment of a substantial amount of funds.

Depositors

263. The FCS is currently activated at the discretion of the Treasurer. The existence of a purely discretionary trigger contributes to uncertainty. This is inconsistent with the purpose of the FCS in providing depositors with certainty that their deposits will be protected (up to the FCS limit). The FCS requires certainty in order to underpin depositor confidence and reduce the risk of retail deposit-based runs on ADIs.

Option 2: Discretionary then Automatic Activation (1)

264. The second option would be for the Treasurer to have discretion to activate the FCS from the time of the appointment of a statutory manager by APRA. Activation would be automatic on APRA's application to a Federal Court for an ADI to be wound up.

265. The appointment of a statutory manager is a public act and may be the first public statement of an ADI's distress. Appointment of a statutory manager would occur fairly late in the distress cycle of a failing ADI — at the point that the ADI advises APRA that it is likely to be unable to meet its commitments and is likely to suspend payment, or when APRA forms the view that this is the state of affairs, or when the ADI suspends payment. APRA is obliged to both brief the Treasurer and advise the market of its action in appointing a statutory manager. Thus, this step is a strong public signal that an ADI is in trouble.

266. The automatic activation point here would be the same as the current discretionary activation point. That is, the FCS would be activated automatically when APRA applies to the Federal Court to wind up the ADI. As with the current activation arrangements, there would be no requirement for a court order before the FCS is activated.

The General Public

267. This option would have a positive impact on the general public. It would support public confidence if the Government were able to announce the intended resolution for the ADI should it fail, and the status of deposits and other elements of the ADI's business, at the time when its distress became public. This would assist in preventing, to the extent possible, further deterioration in the value of the assets of the ADI, and could reduce the risk of contagion in the Australian financial system, as it would allow the government to reassure depositors at the point at which they discovered the ADI was in distress.

The Commonwealth

268. Under this option, the Commonwealth has no input on a decision to commit a substantial amount of funds. There is no requirement to make payments in a particular timeframe under the FCS, and so automatic activation need not alter the timing of any payment.

Depositors

269. This option has the advantage of providing depositors with absolute certainty that the FCS would be invoked in the event of an ADI insolvency. Bringing the discretionary trigger point forward will have a mildly positive impact on depositors; if it is exercised, they may receive their funds sooner than would otherwise have been the case.

ADIs

270. This option is likely to have a positive impact on smaller ADIs. There may be public perceptions that smaller ADIs are less secure than their larger counterparts. The changed activation arrangements will increase depositor confidence in the security of their deposits.

Option 3: Discretionary then Automatic Activation (2)

271. This option includes the same arrangements for discretionary early activation by the Treasurer. However, instead of activation being automatic on the application for a wind-up order, it would be automatic on the granting of a wind-up order by the Court.

272. This would retain the flexibility of Option 2, in the ability to activate the FCS at the time an ADI's distress becomes public. Making automatic activation contingent on the Court's issuance of a winding-up order, however, would make automatic activation contingent on the concurrence of two entities — APRA and the Federal Court — rather than only one. This would make the governance mechanisms for automatic activation more robust.

General Public

273. As with Option 2, it would support public confidence if the Government were able to announce the intended resolution for the ADI should it fail, and the status of deposits and other elements of the ADI's business, at the time when its distress became public. Taking this step would be with the intent of preventing, to the extent possible, further deterioration in the value of the assets of the ADI, and could reduce the risk of contagion in the Australian financial system, as it would reassure depositors at the point at which they discovered the ADI was in distress.

Commonwealth

274. Similar arguments to those set out at paragraph 268 apply in relation to this option. Under Option 3, the Commonwealth ultimately does not decide whether to commit a substantial amount of funds.

However, there is no requirement to make payments in a particular timeframe under the FCS, and so automatic activation need not alter the timing of any payment.

Depositors

275. There could be concerns that waiting for the Court to issue a winding-up order might cause delay in activation, and so in the payment of depositors. However, there would be nothing to prevent the Treasurer from using discretionary powers to activate the FCS, and so this concern is manageable.

276. As discussed at paragraph 269, the changed activation arrangements will increase depositor confidence in the security of their deposits. Moving the discretionary trigger point forward will have a mildly positive impact on depositors. If it is employed, then depositors may receive their funds sooner than would otherwise have been the case.

ADIs

277. As noted at paragraph 270, the changes to the activation arrangements are also likely to have a positive impact on smaller ADIs.

Option 4: Discretionary then Automatic Activation (3)

278. This option includes the same arrangements for discretionary early activation by the Treasurer, and automatic activation on APRA's application for an ADI to be wound up. The difference from Option 2 is that APRA would be required to consult with the Treasurer prior to making its wind-up application to the Federal Court.

279. This would retain the flexibility and speed of Option 2, in the ability to activate the FCS at the time an ADI's distress becomes public, and the certainty for depositors through the automatic trigger. It would also retain a role for the government in the processes leading to the activation of the FCS. As with Option 3, the involvement of a second entity would improve the robustness of governance arrangements and enhance accountability arrangements.

General Public

280. As discussed in relation to Options 2 and 3, it would support public confidence if the Government were able to announce the intended resolution for the ADI should it fail, and the status of deposits and other elements of the ADI's business, at the time when its distress became public. Again, this would assist in preventing further deterioration in the value of the assets of the ADI and could reduce the risk of contagion in the Australian financial system, as it would provide depositors with reassurance at the point at which they discovered the ADI was in distress.

Commonwealth

281. Under this option, the Commonwealth has some input on a decision to commit a substantial amount of funds. As with Options 2 and 3, the automatic trigger means that the ultimate decision will be in the hands with APRA, unless the Treasurer decides to activate the FCS during the discretionary period. However, the requirement to consult with the Treasurer means that, whilst APRA will remain the final decision-maker, the process will involve a second perspective. This will strengthen the governance arrangements around the automatic trigger.

Depositors

282. As with Options 2 and 3, the changed activation arrangements will increase depositor confidence in the security of their deposits. Moving the discretionary trigger point forward will have a mildly positive impact on depositors. If used, depositors may receive their funds sooner than would otherwise have been the case.

ADIs

283. As discussed above, the changes to the activation arrangements are also likely to have a positive impact on smaller ADIs.

APRA

284. Using Option 4 would involve APRA engaging in additional consultation than is currently required under the Banking Act. However, if an ADI did become distressed, it is likely that there would be close consultation between APRA, the other CFR agencies and the Treasurer in any event. Additionally, APRA is currently required to inform the Treasurer if it appoints a statutory manager over an ADI; the additional impact of also informing the Treasurer of the activation of the FCS would be very low.

Conclusion

285. The impacts of the different activation options on the relevant groups are summarised in Table 7, below. Some categories were not included in the table, such as distinguishing between depositors, non-ADIs, and international reputation as there are no impacts.

Table 7: Impacts of Activation Options on Stakeholders

<i>Group</i>	<i>Option 1: Status quo</i>	<i>Option 2: Discretionary then Automatic Activation (1)</i>	<i>Option 3: Discretionary then Automatic Activation (2)</i>	<i>Option 4: Discretionary then Automatic Activation (3)</i>
<i>Depositors</i>	<i>Status Quo</i> Uncertainty	<i>Benefits</i> Certainty	<i>Benefits</i> Certainty	<i>Benefits</i> Certainty
<i>ADIs</i>	<i>Status Quo</i> No change	<i>Costs</i> No change <i>Benefits</i> Certainty for smaller ADIs	<i>Costs</i> No change <i>Benefits</i> Certainty for smaller ADIs	<i>Costs</i> No change <i>Benefits</i> Certainty for smaller ADIs
<i>The General Public</i>	<i>Status Quo</i> Uncertainty	<i>Benefits</i> Certainty	<i>Benefits</i> Certainty	<i>Benefits</i> Certainty
<i>APRA</i>	<i>Status Quo</i> No change	<i>Costs</i> Minor additional consultation	<i>Costs</i> No change	<i>Costs</i> Minor additional consultation
<i>The Common wealth</i>	<i>Status Quo</i> Discretion	<i>Costs</i> No discretion or consultation	<i>Costs</i> No discretion or consultation	<i>Benefit</i> Consultation on decision

286. The best option is Option 4, which involves a combination of discretionary and automatic triggers. There would be discretionary activation while an ADI was in statutory management, with the automatic activation occurring when APRA applies to the Court for a winding-up order. APRA would be required to consult with the Treasurer before it makes this application. This provides the greatest overall benefit.

287. Option 1 (retaining current activation arrangements for the FCS) is not the best option, because the lack of an automatic trigger does not address depositor confidence and potential contagion issues. The FCS requires certainty in order to underpin depositor confidence and reduce the risk of retail deposit-based runs on ADIs.

288. Option 2 is not the best option as its governance arrangements are weaker than those of the other options. Option 2 does provide greater certainty for depositors than Option 1, but it involves only a single entity in the activation of the FCS.

289. Option 3 addresses the governance concerns of Option 2, but leaves the government with no input at all into the decision to commit

funds under the FCS. It is not the best option as it leaves the Commonwealth with no role in a decision which will involve the commitment of potentially significant levels of government funds. It may also result in depositors receiving their funds at a later point than is the case with Option 2.

290. Option 4 is the best option, as it incorporates the strengths of Options 2 and 3. Like Options 2 and 3, it will expand the Government's capacity to use the FCS to maintain consumer confidence and limit contagion. However, Option 4 will also preserve appropriate governance arrangements, by involving a second entity in the automatic activation mechanism, and provide the Commonwealth with a role in the automatic commitment of potentially substantial Commonwealth funds. The recommended changes to the activation arrangements will have also a positive impact on depositors. By allowing an FCS resolution to be announced at the time an ADI's distress becomes public, they will reduce the prospect of a run on the institution, which will avoid further damage to the institution and reduce the prospect of depositors suffering a loss in the liquidation process.

FCS payment mechanism

291. The Government considered two options in determining appropriate beneficiary payment arrangements for the FCS:

- not enabling a new payment option; and
- enabling the proposed new payment option.

292. The main impacts of these options are set out below. The full set of impacts is summarised in Table 8.

Option 1: Not Enabling a New Payment Mechanism

293. There would be no additional costs in taking no action. However, failing to enable a payment mechanism that is available in other countries may reduce the future efficiency and effectiveness of the FCS.

Option 2: Additional Payment Mechanism

294. The proposed additional payout option is that the FCS be given the capacity to transfer protected deposit accounts from the failed ADI to an ADI that had agreed to assume the liabilities. The account numbers and BSB numbers would be transferred with the accounts.

295. Under this option, the transfer provisions would operate simply as a mechanism for paying FCS claimants — payments would be limited to the FCS cap. Depositor funds exceeding the cap would remain as a liability of the failed ADI, to be dealt with in the liquidation process. There would be complexities to resolve before this option could be enabled.

ADIs

296. Once enabled, the feasibility of the additional mechanism in a particular instance will depend in part on whether it will be possible to vest ownership of the supporting IT platform in the acquiring ADI and retain key staff, such that the acquiring ADI would be able to run the failed ADI's relevant systems. APRA would determine whether this provided an effective and efficient option based on the circumstances in each case.

Depositors

297. This option may not always be feasible, but where circumstances allow its deployment, it would provide depositors timely access to their transaction funds without interruption to the direct debits and credits used by their accounts. This would reduce the existing payment facilities in their existing accounts. This would reduce the disruptive effect of a failure, both for individual depositors and, by improving affected depositors' ability to meet commitments and transact, the Australian financial system as a whole. With sufficient pre-positioning, a transfer could provide depositors with access to their funds more quickly than would be the case under the current mechanisms.

298. As with any significant transfer events, this option could have competition implications which would need to be addressed in implementation.

Conclusion

299. The impacts of the different payment options on the relevant groups are summarised in Table 8, below. Some categories were not included in the table, such as distinguishing between depositors, non-ADIs, the Commonwealth, the general public and international reputation as there are no impacts.

Table 8: Impacts of FCS Payment Mechanism Options on Stakeholders

<i>Group</i>	<i>Option 1: Status Quo</i>	<i>Option 2: Additional payment mechanism</i>
<i>Depositors</i>	<i>Status quo</i> No change	<i>Benefits</i> Timely access to deposits Account number portability
<i>ADIs</i>	<i>Status quo</i> No change	<i>Costs</i> IT challenges Increased reporting requirements
<i>APRA</i>	<i>Status quo</i> No change	<i>Benefits</i> Additional payment mechanism

300. The best option is Option 2, the additional payment mechanism. On balance, this would provide the greatest benefit.

301. Option 1 (status quo) does not contain additional costs, but may reduce the future efficiency and effectiveness of the FCS

302. Option 2 will have a positive impact on depositors, where it is technically feasible to employ it. Making payments by deposit transfers could allow depositors to retain their BSB and account numbers, and so retain access to their direct credits and debits. This would reduce disruption for affected depositors. The overall impact will be positive.

Transition arrangements

303. The Government considered three options in determining transition arrangements for the FCS:

- no transition mechanism;
- a progressive reduction in the cap; and
- a single-stage reduction in the cap, with grandfathering for existing term deposits.

304. The main impacts of these options are set out below. The full set of impacts is summarised in Table 9.

Option 1: No Transition Mechanism

305. One option is to move directly to any new cap, with no transitional mechanism. This would avoid administrative complications, but could disadvantage term depositors and ADIs.

306. Implementing a new cap with no transition mechanism will allow a swift transition from the emergency cap setting, and would be administratively simple. To the extent that the \$1 million cap provides effectively unlimited coverage, this would be consistent with IADI Core Principle 10, which states that the transition from blanket to limited coverage should be as rapid as a country's circumstances permit.

307. However, moving directly to a new cap would not address the bunching issues nor the potential disadvantage faced by term depositors, as discussed at paragraphs 112 to 114.

Option 2: Progressive Reduction in the Cap

308. One option would be to reduce the FCS cap in stages. For example, if the new cap were to be \$250,000, then it would be possible to set interim caps at \$750,000 and \$500,000.

ADIs

309. This would allow ADIs and depositors more time to adjust to the reduction in coverage. It would smooth any movements in deposits

between institutions over a longer period, through these would still be likely to cause some concentration of maturity dates of term deposits around the cap adjustment dates.

310. A phased reduction of the cap is also likely to increase administrative costs for ADIs.

Depositors

311. A progressive reduction would also create significant difficulties. It would not be consistent with IADI Core Principle 10, which recommends moving from unlimited coverage — which the \$1 million FCS cap effectively provides — to limited coverage as quickly as circumstances permit. It would also risk creating confusion for depositors, who may not be certain which FCS cap applies at a particular time to a particular deposit.

Option 3: Grandfathering

312. The CFR has recommended a single-stage move to a new cap with a grandfathering arrangement, to be in effect for twelve months from the day of announcement of any change to the cap. This is consistent with the fact that a significant majority of term deposits have a maturity of twelve months or less, and with the requirement of the Core Principles that the transition from 'blanket' guarantees to limited guarantees take place as quickly as a country's circumstances permit (Principle 10). It is also quite generous, given the Government has been clear about its intention to review the cap as of October 2011.

313. Grandfathering involves exempting existing arrangements from new legislative requirements. In this case, it would involve maintaining existing coverage for existing term deposit accounts until maturity or for twelve months, whichever came sooner. If grandfathering is implemented, then grandfathered term deposits will mature at different dates. There is likely to be some concentration towards the end of the grandfathering period, as depositors may try to anticipate the date any changes will be announced.

Depositors

314. Grandfathering would avoid disadvantaging depositors with term deposits, who had expectations that their deposits would be guaranteed until maturity. It would also reduce concentrations of movements of funds in response to changes in the cap, as depositors would not be able to change their term deposit arrangements after the date of the announcement, and retain access to the \$1 million cap protection.

315. Grandfathering would allow the vast majority of depositors with maturities of under three years to have certainty about the guarantee status of their deposits and reduce the prospect that they will need to break their terms, and suffer financial loss, to maintain guarantee coverage.

ADIs

316. Grandfathering may also give ADIs more time to manage the adjustment to the new limit.

317. It would provide industry — particularly smaller ADIs which have a greater dependency on deposit funding — with a substantial adjustment and planning period. The Government is also currently working closely with industry through its *Competitive and Sustainable Banking Package* to support smaller lenders to compete with the big banks.

APRA

318. Grandfathering may complicate administrative arrangements in the event of an FCS payout, as different FCS limits would apply to different depositors. However, this is not an insurmountable problem, particularly if grandfathered deposits are paid out after any initial FCS payout. A grandfathering mechanism was successfully established as part of the closure of the Guarantee Scheme, although it was never used.

Conclusion

319. The impacts of the different transitional arrangements on the relevant groups are summarised in Table 9, below. Some categories were not included in the table, such as the general public and international reputation as there are no impacts.

Table 9: Impacts of Transition Options on Stakeholders

<i>Group</i>	<i>Option 1: No transition mechanism</i>	<i>Option 2: Progressive Reduction in the Cap</i>	<i>Option 3: Grandfathering</i>
<i>Depositors</i>	<i>Costs</i> Reduced protection	<i>Costs</i> Increased confusion <i>Benefits</i> Much higher protection	<i>Benefits</i> Higher protection for term depositors
<i>Smaller ADIs</i>	<i>Costs</i> Much worse competitive position	<i>Benefits</i> Much higher coverage of funding base <i>Costs</i> Increase administrative costs	<i>Benefits</i> Higher coverage of funding base <i>Costs</i> Increase administrative costs
<i>Larger ADIs</i>	<i>Benefits</i> Slightly better competitive position	<i>Benefits</i> Much higher protection <i>Costs</i> Increase administrative costs	<i>Benefits</i> More time to manage the adjustment <i>Costs</i> Increase administrative costs
<i>Non-ADIs</i>	<i>Benefits</i> Improved competitive position	<i>Costs</i> Much worse competitive position High market distortions	<i>Benefits</i> Slightly improved competitive position
<i>APRA</i>	<i>Benefits</i> No administrative burden	<i>Costs</i> Higher administrative burden	<i>Costs</i> Moderate administrative burden
<i>The Commonwealth</i>	<i>Benefits</i> Reduced financial exposure	<i>Costs</i> Higher financial exposure	<i>Costs</i> Moderate financial exposure

320. The best option is Option 3, a twelve month grandfathering arrangement for existing term depositors. This is the most consistent option with the objectives of the FCS and would, on balance, provide the greatest benefit.

321. Option 1 (no transitional mechanism) is not the best option as it could result in a concentrated movement of funds and would disadvantage term depositors.

322. Option 2 (progressive reduction) is not the best option as despite giving ADIs and depositors more time to adjust to the reduction, it would risk creating confusion. It is also likely to increase administrative costs for ADIs.

323. Option 3 balances the costs and benefits in the most appropriate way. A grandfathering period will allow time for ADIs to make plans to mitigate the impact of any outflows. The transition arrangements are also likely to impact positively on depositors. The overall impact will therefore be positive.

Consultation

324. Treasury released a consultation paper on 27 May 2011 to seek views from industry and the general public on the proposed FCS arrangements. A total of 54 submissions were received from industry stakeholders and the general public, of which six were confidential. Of these, 16 were letters using substantially the same text, coming from individual members of self managed superannuation funds.

325. The main themes arising from the submissions are outlined below.

Revised cap

326. The main issue raised in submissions was the FCS cap. Most industry submissions argued that the current cap should be reduced in light of the improvement in market conditions since the financial crisis. The most common cap figure nominated was \$250,000.

327. 39 of those supporting a reduction in the cap, the majority supported setting the cap at the higher end of the proposed range, at \$250,000. These submissions were made by small and medium-sized banks, along with an ADI and non-ADI industry group, a self-managed superannuation fund advisor and a number of individuals. These argued that \$250,000 would allow provide a higher level of protection than \$100,000 and was consistent with the division between retail and non-retail depositors for the purposes of foreign bank branch deposits. A less common argument was that a \$250,000 cap would align well with forthcoming the Basel III LCR requirements.

328. Around one quarter of submissions called for the retention of the \$1 million cap. These were primarily made by smaller ADIs, including the peak body for mutual ADIs, a peak consumer group, the real estate industry peak body and a number of individuals. These submissions argued that global uncertainty meant that changes to the FCS would be inopportune and could trigger a ‘flight to safety’, of larger depositors to the major ADIs. The other main argument of these submissions was that reducing the FCS cap would cause disruptions to the funding base of smaller ADIs, which would reduce competition and increase the market share of the four major banks. Some submissions noted that forthcoming regulatory changes had intensified competition for deposit funding, resulting in increased funding costs, and that retention of the \$1 million cap would reduce this intensity by providing an ongoing incentive for depositors to hold their money in deposits.

329. Two submissions, including one from a large ADI, argued that a \$100,000 cap would be appropriate, as this would adequately protect the majority of retail depositors and be consistent with international standards. One submission, from a non-ADI peak industry group, called for a cap of \$50,000. This submission argued that the FCS created distortions across the financial sector and reduced the capacity of the non-prudentially-regulated sector to compete with ADIs.

330. The submissions confirmed Treasury’s view that the nominated cap range strikes an appropriate balance between the competing FCS cap considerations.

Coverage of foreign branches of ADIs

331. Few submissions engaged with the question of coverage of the foreign branches of Australian ADIs. All the non-confidential submissions — from the mutual ADI peak body, a large ADI, a peak consumer group and a superannuation advisor — argued for the removal of coverage of foreign branches, arguing that the rationale of the FCS is the protection of Australian retail depositors, and that foreign branch coverage was not consistent with this goal. These submissions also argued that removing coverage of these branches would remove the cost and complexity of complying with APRA reporting requirements.

332. Ultimately, Treasury’s recommendation matches those of the majority of the submissions: that the coverage of foreign branches is not necessary to protect Australian retail depositors. The concurrence of the submissions reinforces this view.

Pooled trust accounts

333. Ten stakeholders engaged with the PTA recommendation of the consultation paper. Seven submissions supported a look-through arrangement as set out in the consultation paper, as being consistent with

the protection of retail depositors, but sought further clarity as to how this would work. It was suggested that consumer organisations be consulted in the development of a list of eligible accounts, with an appropriate test being whether or not the deposit was required by statute or regulations. These submissions were made by the mutual ADI peak body, a large ADI, financial advisors and the real estate industry peak body.

334. Three submissions argued that the look-through mechanism should be applied to a wider range of accounts than those required by statute, such as the cash components of managed investment products held through investment platforms, superannuation and managed funds. These submissions argued that this would support competitive neutrality — that the funds were ultimately held in ADIs on behalf of depositors, and that the fact that an intermediary existed should not affect FCS eligibility. Parties which made these submissions included a non-ADI sector peak industry group and a sophisticated ADI.

335. Treasury agrees with the majority view of the submissions, that eligibility for a PTA look-through should be confined to a relatively narrow set of accounts required to be held by law.

FCS activation

336. Eight submissions engaged with the issue of FCS activation arrangements. These were made by the mutual ADI peak body, small, medium and large ADIs, a consumer group and a financial advisor. These all supported the discretion to activate the FCS at the proposed early stage, and all approved of automatic activation at a later point. However, none of the submissions commented on the merits of the two suggested automatic activation points.

FCS payment mechanism

337. Nine submissions supported the creation of an additional payment mechanism for the FCS, with none opposed. These were made by the mutual ADI peak body, small, medium and large ADIs, a consumer group and a financial advisor. However, most submissions pointed out that there could be significant IT challenges in allowing the transfer of BSB and account numbers between institutions. These challenges related to working with ADIs to support interoperability between IT systems and the severability of the IT functionality of the failed ADI; it would be necessary for the IT functions supporting the transferred deposits to be transferred to a new ADI, whilst leaving the failed ADI with sufficient records of non-transferred deposits. The system work would need to have been done in advance of any use of this payment mechanism.

338. It has not been possible to calculate the cost of changes required to support these amendments. Nevertheless, the Australian Payments Clearing Association, the industry body responsible for managing ADIs'

payments systems has stated a willingness to work with regulators to identify feasible implementation options. If a decision is made to introduce deposit account transfer as a possible FCS payment mechanism, then its implementation would be included in APRA's ongoing work with industry on implementation issues, which includes a stream on making FCS payments. In determining the nature of the FCS payment option to be applied in any particular circumstance, APRA will seek to ensure that the method chosen is cost-effective.

339. These submissions reinforced Treasury's view that the mechanism should be permitted, but not mandated.

Transitional arrangements

340. Twelve stakeholders commented on the merits of a transitional arrangement in the event that the FCS cap was lowered.

341. Seven submissions broadly supported a twelve-month grandfathering period for existing term deposits entered into before the announcement of the cap, as this would allow sufficient time for ADIs and depositors to make appropriate adjustments to their affairs. These were received primarily from small, medium and large ADIs. None of the submissions raised operational issues. These submissions agreed that any reduction in coverage should take place in a single stage, to limit the administrative impact on industry and reduce confusion for depositors.

342. Five submissions argued for an extended approach to grandfathering. These came from the mutual ADI peak body, an ADI and non-ADI industry body, a peak consumer group and a financial advisor. Some argued for a multi-stage reduction — for example, moving the cap to \$500,000 in October 2011 and to \$250,000 in October 2012. This was seen as assisting in managing the liquidity impact of a lower cap and allowing an assessment of competition effects as the cap was reduced. Others submissions argued that twelve months was an insufficient period for grandfathering, suggesting periods between three and five years. These submissions argued that term depositors had deposited their funds in the expectation that they would be guaranteed to maturity. One submission argued that if grandfathering remained at twelve months, then ADIs should waive penalty fees if depositors broke their terms. Some others argued that at-call deposits should also be covered at the current \$1 million cap for a further twelve months, to reduce any instability from the announcement of the cap change.

343. One submission, from the peak consumer body, argued that the cap should not be reduced until a comprehensive education campaign regarding the safety and security of smaller ADIs had been conducted. All stakeholders agree that a transitional mechanism should apply if to lower the cap. Most of them agree with the proposed transitional period of twelve months. However, several stakeholders raised concerns that if

the grandfathering period were less than the term of the existing deposit, some customers may restructure their large term deposits (even with a break fee), which could lead to liquidity problems for ADIs. Longer transitional periods are suggested, such as 24 and 36 months.

344. Treasury has retained its initial view, supported by the majority of submissions. It is inappropriate to include at-call deposits in a grandfathering mechanism, as these are not restricted from moving to maintain guarantee coverage. A phased reduction in the cap would be inconsistent with the IADI Core Principles and risks causing public confusion about the level of protection available during the transition period. A twelve-month grandfathering mechanism is appropriate, as it covers a significant majority of deposits and, consistently with the Core Principles, allows a relatively swift transition between caps.

Conclusion and recommended option

345. Treasury recommends that the best options for the post-crisis FCS are as follows:

- a reduction in cap to \$250,000;
- cessation of coverage of foreign branches of Australian-incorporated ADIs;
- the implementation of a twelve month grandfathering period for term deposits, to smooth the transition to the new cap;
- the discretion for the Treasurer to activate the FCS when an ADI enters statutory management, with automatic activation to result from APRA's application to the Federal Court for a winding-up order. APRA will be required to consult with the Treasurer prior to making this application;
- an additional payment option, to transfer protected deposit balances from the distressed ADI to a healthy ADI; and
- a 'look-through' mechanism for PTAs which are required by law to be held, with the list to be finalised following further consultation with industry bodies and consumer groups.

346. Implementing these changes will refine the parameters of the FCS to the post-crisis environment and increase the efficiency of its operation.

Implementation and review

347. If the Government proceeds with changes to the FCS, they will be implemented in two main stages.

348. The FCS cap and transitional arrangements will be implemented by amendments to the Banking Regulations. The Banking Act provides that the Banking Regulations can limit the amounts which account-holders can be paid under the FCS (s 16AG(1)). Reg 5 of the Banking Regulations sets out the current \$1 million limit. Any changes to the new cap and transition arrangements would be made by amending these regulations. It is anticipated that these would take effect from 12 October 2011.

349. The other changes would require amendments to the Banking Act. Some, such as the identification of appropriate PTAs, would also require additional consultation. It is anticipated that these would be progressed on a longer timeframe, with legislation passed in around May 2012 to take effect from 1 July 2012.

350. In the immediate term, the CFR will monitor the impact of any change in the FCS cap, particularly on the ability of smaller ADIs to compete. In the medium term, the CFR has recommended that the FCS cap be reviewed regularly, every five years. This would ensure that coverage levels remain appropriate, but that changes are not so frequent as to cause confusion for depositors.
