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**Introducing Low Cost Deposit Insurance
Kevin Davis**

Treasurer Costello's announcement that a limited guarantee scheme for depositor (and insurance policy holder) protection is to be introduced is welcome news. Although such schemes do have costs, careful design (such as implied in the Council of Financial Regulators proposal to which the Treasurer referred) can lead to a favorable benefit-cost ratio.

Local opposition (appearing to come more from banks than insurers) is based on a number of arguments. First, it is argued that there is a very small probability of a bank failure occurring of a magnitude which would lead to losses for retail depositors.

It is true that the current structure of the major banks' balance sheets (combined with depositor preference) mean that a failure involving loss to retail depositors is highly improbable.

But new types of banks, with different types of balance sheets, are emerging (and stimulating competition and innovation), and there is no certainty that major bank balance sheets won't look radically different in the future. It is important to have in place some mechanism for dealing with future potential problems, rather than assuming that the status quo will continue forever.

In this regard, the focus of the proposed scheme on providing mechanisms for timely resolution of a failed institution is particularly relevant. Without this, public pressure on Government to intervene in ad hoc (potentially undesirable) ways is likely to prove irresistible.

Equally important, the proposed *ex post* funding mechanism, and administration by APRA, counters a second argument – that an insurance scheme imposes excessive costs and regulatory burdens. If the probability of failure is so small, the likelihood of *any* costs being incurred (other than some legislative drafting costs and shelf space in APRA to house the procedures manual) is exceptionally small.

The third line of opposition is to cry *moral hazard* – that a limited guarantee scheme will induce wanton risk-taking by management no longer subject to depositor and policy holder scrutiny, and lead to an increased risk of failures.

A limited guarantee scheme provides an incentive for those (few) retail customers smart enough, and with large enough exposures, to monitor bank and insurance

company risk taking Admittedly, other retail customers won't engage in monitoring and assessing risk if their exposures are guaranteed (even only to 90 per cent as proposed) against loss.

But other parties, such as wholesale customers, institutional counterparties, and a regulator enforcing a minimum risk weighted capital requirement, seem a lot more likely sources of effective market discipline.

The scaremonger's scenario is one of a very high risk Pyramid type institution, attracting guaranteed deposits at high interest rates from retail customers oblivious to the underlying risk. But here, the merits of an ex-post industry funded scheme become apparent. Other institutions are more likely to bring the risks to the attention of the regulator (and demand action) when they are at risk of having to meet any shortfall following a failure, than in the case where the Government is the ultimate guarantor.

And while the Government doesn't currently provide a guarantee, there appears to be widespread public perception, influenced by past bail-outs, that an *implicit* guarantee exists.

Indeed, one benefit from introducing an *explicit* scheme is its potential to increase the credibility of Government commitments not to provide future bail-outs. An explicit scheme which provides limited guarantees and *caveat emptor* beyond, provides a line in the sand behind which a Government can stand firm in resisting demands for even greater compensation.

Following the Report of the Rethinking Regulation Task force, the need for proposals such as this to undergo some serious cost-benefit review is now generally accepted. Unfortunately, quantitative assessment of policies designed to deal with low-probability events such as failure of a prudentially regulated financial institution, is not particularly useful.

Instead, qualitative judgments and assessments must be made - ideally from the perspective of the public interest rather than those of private players more interested in protecting their competitive positions and existing advantages. Fortunately, much of that work has already been done by the Study of Financial System Guarantees commissioned by the Treasurer in 2003 which presaged the current proposal.

Kevin Davis is Commonwealth Bank Chair of Finance and Director of the Melbourne Centre for Financial Studies. The Davis Report on Financial System Guarantees is available at <http://fsgstudy.treasury.gov.au/content/default.asp>

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