

# The Financial Claims Scheme

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**An Assessment of the scheme's broader economic impact**

August 2013

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## Executive Summary

Government backed bank deposit insurance schemes have been globally accepted as a means for promoting financial stability and protecting deposits of households unable to assess bank default risk. Australia's deposit insurance scheme, the Financial Claims Scheme (FCS) which was introduced subsequent to the onset of the Global Financial Crisis, has been somewhat unique by international standards with a maximum insurable amount as large as any other offered without requiring an ex-ante fee for the protection - until the August 2013 announcement by the then Labor Government foreshadowed the introduction of an ex-ante fee. The FCS is also relatively unique in the priority afforded to APRA for recovery of amounts paid to insured depositors in the event of an ADI liquidation. This virtually eliminates the potential cost of the FCS to the taxpayer (although exposure to more general bail-outs remains) and removes much of the rationale for an ex-ante fee on "fair insurance" cost grounds. But such a fee may be motivated instead by the benefits which a guarantee of "rapid access" to funds which the FCS provides, together with the possible costs to APRA of facilitating an open resolution of a troubled ADI prior to failure (such as through a subsidised takeover).

The potential financial stability benefits provided by the FCS come at a cost. As well as the reduced level of market discipline of banks by retail depositors (from perceptions of safety), there is also an impact on demand for alternative investment products. While other factors have also played a role, the size of institutions like cash management trusts and finance companies which compete directly with banks for household funds have decreased significantly since the introduction of the FCS. During this time term-deposits held by households have increased considerably both on an absolute basis and relative to other forms of investments.

The scheme has also created competitive distortions between longer-term investments issued by institutions not covered by the FCS, and financially engineered products offered by ADIs which are economically equivalent and receive the government guarantee. For example, annuities offered by non-prudentially regulated organisations are at a clear disadvantage when the same investment can be created through a series of government guaranteed ADI term deposits. As demand for risk free income streams for retirement increases the potential size of the competitive distortions caused by the scheme grows.

The FCS also works against the development of a retail corporate bond market, since investors can, by diversifying across banks, invest large amounts in risk free term deposits. Regulatory changes and competition for funds has led to substantial increases in term deposit interest rates on offer, amplifying this effect. Competitive imbalances are also evident amongst retirement investment vehicles; while the large deposits of institutional superannuation funds (held indirectly on behalf of many individuals) are ineligible for the

guarantee, deposits held by a self-managed superannuation fund are covered by the scheme.

The potential distortions also affect lending markets. To the extent that the FCS means that ADIs are able to raise retail funding at lower rates than other intermediaries, they have a competitive advantage in competing for loan business and in investment markets. Unless regulators (APRA) or uninsured depositors and bond holders of the ADIs inhibit such actions, ADIs can engage in higher risk lending and investment activities – based on retail funding at “risk free” rates, whereas other intermediaries would find these higher risk activities reflected in their funding costs.

The competitive distortions caused by the FCS suggest that a case for an ex-ante fee for the guarantee can be made. However determining the appropriate size of the fee is problematic particularly given the likelihood that blanket guarantees provided during the GFC have entrenched a general belief that an implicit government guarantee extends beyond the FCS. A fee solely based on insured deposits would not offset this potential competitive advantage of (particularly large) ADIs.

There is also merit in reducing the maximum cap for insured deposits. Very few households have deposits above \$50,000, and the aggregate amount of insurance coverage can be increased by spreading deposits across ADIs. An alternative (but also using a lower cap), given the emphasis in the FCS on providing ready access to funds, would be limit coverage of the scheme to transactions (at-call) accounts of retail depositors. Providing the option of protection (for a fee up to some specified limit) for unsophisticated investors with temporary large balances or SME businesses with larger operating balances to meet payrolls etc., could be considered if that type of protection was seen as being within the scope of the scheme.

While a deposit insurance scheme such as the FCS can enhance financial stability and enhance transactional liquidity for households unable to assess bank default risk, the structure of the FCS requires a review to mitigate the competitive distortions created by the scheme in its current form.

## 1. Introduction

The Financial Claims Scheme (FCS) has been in operation in Australia since October 2008, with the current \$250,000 cap on deposit amounts guaranteed applying since February 2012. There has, to date, been no fee charged for provision of the guarantee, with an *ex post* funding model applying. Should an ADI fail and APRA be unable to recoup amounts paid out to insured depositors from remaining assets of the ADI, then the Treasurer may impose a levy on other ADIs to cover any shortfall. The FCS also provides for compensation of general insurance policy holders should a general insurer fail (See Appendix 1 for details). This has attracted less attention and appears to have less spillover effects to other parts of the financial sector, and is consequently not considered further in this report.

Absence of a fee for such deposit insurance, until the announcement of a planned fee of 5 - 10 basis points in early August 2013,<sup>1</sup> is relatively uncommon in an international context, and Appendix 2 provides recent information on fees charged for deposit insurance in other countries. The size of the cap is also relatively high by international standards, although many countries increased the level of coverage after the onset of the Global Financial Crisis (GFC). Appendix 3 provides comparative information.

In this report the extent of likely distortions to financial markets arising from the FCS, in terms of allocation of resources, competitiveness of non-bank providers of financial services, and financial product innovation is examined. In section 2 rationale for deposit insurance schemes (of which the FCS is the Australian example) is considered. In section 3, the history behind the introduction of the FCS in its current form is reviewed and reasons for its current design features are outlined. Section 4 then provides an analysis of the likely social and private benefits and costs which arise from the current FCS structure. The empirical relevance of these effects is considered in Section 5 which focuses upon household financial asset holdings and in Section 6 which examines the impact on competing financial products and institutions. Section 7 concludes by identifying potential changes to the design of the FCS which could be considered to reduce the financial sector distortions identified in the earlier sections.

In undertaking this analysis it is important to note that the FCS is only one factor creating distortions in financial markets, and also that empirical assessment of its effects is complicated by the disruptions to financial markets caused by the GFC and subsequent

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<sup>1</sup> "The Government will progress a recommendation from the Council of Financial Regulators, which includes the Reserve Bank of Australia and the Australian Prudential Regulation Authority, to establish a dedicated Financial Stability Fund to help meet any future cost of the Financial Claims Scheme (FCS), as well as the cost of other resolution activities that protect depositors. The dedicated Fund will build gradually over time to a target size of 0.5 per cent of total deposits protected by the FCS. Establishing the Fund is expected to have a net positive impact on the budget of \$733 million over the forward estimates, from 1 January 2016."  
[http://www.budget.gov.au/2013-14/content/economic\\_statement/download/2013\\_EconomicStatement.pdf](http://www.budget.gov.au/2013-14/content/economic_statement/download/2013_EconomicStatement.pdf)

regulatory changes. Financial decisions of the retail sector (to whom the FCS particularly applies) are also distorted by taxation arrangements which provide incentives for investments in owner-occupied and investment properties, equities, superannuation (where there is also a significant compulsory component), and the financing of investments by leverage. Financial sector adjustments since the introduction of the FCS have also been affected by changes in bank (and other financial) regulation together with a reassessment of the desired level and type of risk-taking by both financial institutions and investors.

## **2. Rationale for Deposit Insurance and the Financial Claims Scheme**

Deposit insurance involves (generally) government establishment and operation of a scheme which provides depositors in approved institutions with a guarantee of safety of funds invested up to some “capped” amount.<sup>2</sup> In some countries, guarantee schemes also operate to provide limited protection to investors in other financial products. In Australia, the FCS also provides for limited protection of policy holders with general insurance companies (but not life assurance companies).

Internationally, the provision of government guarantees over financial products other than deposits is infrequent. On the other hand deposit insurance has become common internationally, prompted in part by the views of international agencies about its importance as part of the core financial infrastructure for financial stability. Originally introduced in the USA on the 1<sup>st</sup> of January 1934<sup>3</sup>, but adopted by few other countries over the next forty years, it has since been adopted virtually universally.

The traditional rationale for government provided deposit insurance schemes is twofold. One is the perceived benefits in terms of financial system stability arising from the exposure of deposit taking institutions to runs by depositors and the potential for contagion (or spillovers) to other institutions. That exposure reflects the “first-come first-served” nature of the deposit contract such that “early withdrawers” obtain full value, but their actions can create a need for banks to liquidate assets at discounted prices threatening bank solvency and reducing the probability of “late withdrawers” receiving full value. Incentives exist for depositors to thus “join a run”, and potential spillovers arise from the inability of depositors to identify whether the cause of a run is specific to that institution or reflects more general issues also likely to affect other banks. The decline in the incidence of bank runs in countries such as the USA which had adopted deposit insurance no doubt contributed to its more widespread implementation in the latter part of the twentieth century.

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<sup>2</sup> Schemes are generally government run (or backed) because a private insurance scheme may itself be subject to risk of failure. Participation of designated types of depository institutions is also generally compulsory to avoid problems of adverse selection (participation only by institutions which turn out to be high risk) and free-riding (where poorly informed depositors incorrectly assume that all institutions are participants).

<sup>3</sup> <http://www.fdic.gov/about/learn/symbol/index.html>

The second rationale for such schemes is to provide uninformed retail investors with a “safe haven” for their savings. Deposit insurance removes the need for such investors to gather information about the risk of depositing with a particular bank, which they would be unable to adequately assess anyway. It also provides peace of mind about the safety of funds which have been deposited. The distinction between such retail depositors and more informed wholesale depositors, who should be better able to assess bank risk, is a major reason for placing a “cap” on the size of insurance of individual deposits. Depositors with large amounts of funds to place are assumed to provide “market discipline” over banks by demanding returns on their deposits commensurate with their assessment of the risk of the bank.

The rationale for government insurance of deposits rather than other forms of household savings (such as superannuation balances or life insurance company policies and annuities) reflects three factors. One is the historical context and the relative risk and disruption of bank failure compared to that of other institutions. A second factor is the role of (some) bank deposits in the payments system. A third is the complication that some, but not all, of those other savings forms involve exposure to market risk rather than having fixed contractual obligations of the product providers. As the demand by retirees for risk free income streams from investment of savings (outside of superannuation) grows, the anomaly of, and distortions arising from providing insurance over bank long-term term deposit-type products but not over other similar products provided by prudentially regulated non-banks becomes increasingly relevant. This is a clear example of where regulation on institutional classification basis rather than an economic function basis can induce competitive imbalances and market distortions.

A further consideration in the development of deposit insurance schemes has been the objective of providing depositors in a failing bank with *rapid access* to their funds. Because bank deposits also function as money, long delays in depositors being able to access their funds in a failed bank can, when they have few other liquid assets, have significant implications for individual consumption and welfare and for the viability of business customers with payment obligations to others. The consequent disruption to consumption and income streams can have deleterious consequences for economic activity and business continuity – even if the amounts owed are eventually paid in full. The importance of the Early Access Facility for Depositors (EAFD) was highlighted in the explanatory memorandum accompanying the introduction of the Financial Claims Scheme legislation on October 15, 2008.<sup>4</sup>

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<sup>4</sup>[http://parlinfo.aph.gov.au/parlInfo/download/legislation/ems/r3096\\_ems\\_7f78f6b6-bda4-4229-bd9f-7cd2bc99654a/upload\\_pdf/320519.pdf;fileType=application%2Fpdf#search=%22legislation/ems/r3096\\_ems\\_7f78f6b6-bda4-4229-bd9f-7cd2bc99654a%22](http://parlinfo.aph.gov.au/parlInfo/download/legislation/ems/r3096_ems_7f78f6b6-bda4-4229-bd9f-7cd2bc99654a/upload_pdf/320519.pdf;fileType=application%2Fpdf#search=%22legislation/ems/r3096_ems_7f78f6b6-bda4-4229-bd9f-7cd2bc99654a%22)

## 2.1 An Assessment

There are two problems with the traditional rationale for capped deposit insurance schemes. The first relates to their role in preventing bank runs. While retail depositors may still run on a bank where there are concerns about deposit safety, modern bank runs are likely to involve wholesale, relatively well informed, creditors and depositors refusing to roll-over short term funding or withdrawing deposits – generally via electronic transactions. Thus, while deposit insurance, capped at some level of deposits, is likely to reduce certain sources of bank runs (such as retail depositor uncertainty), it is not, of itself, a solution for preventing runs and achieving financial sector stability. Moreover, a relatively small cap covers most retail deposit amounts (as shown later) and thus removes incentives for virtually all retail depositors to run (unless concerns about disruptions caused by delayed access to funds are an issue).

The second problem is that the existence of an explicit cap may have little credibility if there is widespread belief that government will not countenance the failure of (at least some) banks. Investor decisions are then premised on the existence of implicit guarantees over all deposits in banks believed to be protected, removing or reducing the extent of market discipline – and providing a competitive advantage in fund raising to such institutions. Actions such as the temporary introduction of blanket government guarantees on all deposits during the GFC tend to reinforce such perceptions, reducing the credibility of government assertions that (uninsured) depositors are at risk in the future. This is particularly an issue in the case of large banks which are designated as systemically important either at the global level (G-SIBS) or the domestic level (D-SIBS).<sup>5</sup>

Designing policies to overcome distortions arising from perceived implicit guarantees is a difficult and ongoing policy task, including introduction of contingent liability and bail-in provisions for some forms of bank liabilities. However, the ability of governments to extend such loss-sharing arrangements to uninsured deposits as a means of returning institutions to solvency is politically limited – as experience in mid-2013 with such proposals in the case of Cyprus demonstrates.<sup>6</sup>

The possible existence of widespread perceptions of implicit levels of depositor protection extending beyond the boundaries of the explicit cap, make it difficult to analyze the implications, and desirable design changes, of the FCS in isolation. Thus, for example, investor portfolio readjustments during and after the GFC towards bank deposits may have reflected perceptions of implicit guarantees as much as the explicit protection provided by

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<sup>5</sup> G-SIB (D-SIB) stand for (respectively) Globally (Domestically) Systemically Important Bank.

<sup>6</sup> While large, uninsured, depositors in several Cypriot banks had part of deposits converted into equity, the fact that many such deposits were foreign-owned reduced the domestic political complications.



the FCS.<sup>7</sup> Nevertheless, in more normal times, the explicit cap does serve as a psychological signal which potentially influences retail investor portfolio decisions, and thus warrants explicit consideration. A further implication is that it may not be possible to consider government risk-bearing and appropriate pricing of fees of explicit guarantees separately from consideration of implicit guarantees.

More generally, however, the increased role of wholesale investors as potential sources of bank runs (particularly if it is believed that they do not perceive that implicit guarantees exist) means that it is more relevant to consider the design of deposit insurance schemes such as the FCS from the context of the “safe haven” role in conjunction with the objective of “rapid access” to funds, rather than in terms of prevention of bank runs and financial stability.

### **3. History and Design of the Financial Claims Scheme<sup>8</sup>**

Table 1 provides a timeline of important events in the lead-up to the introduction of the FCS in Australia. Australia (together with New Zealand) had been an outlier internationally in not having an explicit deposit insurance scheme (although relatively few countries had insurance policy holder protection schemes). The need for a deposit insurance scheme was considered by the Wallis Inquiry (1997) and rejected, based partly upon the existence of depositor preference arrangements in Australia. Because depositors have priority over other bank creditors in insolvency, the risk of there being a shortfall of assets sufficient to imply losses for bank depositors was seen as sufficiently low to obviate the need for a deposit insurance scheme.

The failure of HIH Insurance in 2000, the introduction of a compensation scheme for policy holders, and the recommendations of the subsequent Royal Commission, brought the issue of protection arrangements to a head. In particular, the credibility of Government statements that there were no implicit guarantees for depositors or policy holders was challenged. Concerns that an explicit scheme could create moral hazard concerns became of less import if there was widespread belief that implicit guarantees existed.

Following the Davis Report (2004), commissioned by the Treasurer to examine the case for, and potential design issues, of financial system guarantees, there was a long period of consultation and debate before legislation was eventually brought forward for planned introduction into Parliament in the week commencing 13 October 2008. That legislation with an insured deposit cap of \$20,000 (reduced from previously recommended \$50,000

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<sup>7</sup> The initial blanket guarantee effectively replaced any implicit guarantee with an explicit guarantee, and whether subsequent reductions in explicit coverage changed perceptions of implicit guarantee coverage is open to question.

<sup>8</sup> Turner (2011) provides an overview of the history of the Financial Claims Scheme

after lobbying by the banks) was overtaken by events following the failure of Lehman Brothers, widespread international introduction of bank guarantees, and concerns about depositor nervousness and financial system stability.

On 12 October 2008, the FCS was legislated, an unlimited guarantee of bank deposits introduced, with the guaranteed amount subsequently capped at \$1 million on 28 October 2008.<sup>9</sup> In late 2011, after a review of the scheme which was foreshadowed at the time of the schemes introduction, it was announced that the cap would be reduced to \$250,000 per depositor in a failed bank, and this was implemented in February 2012, and remains the case today.

**Table 1 A timeline of introduction and changes to the Financial Claims Scheme**

<b>Date</b>	<b>Action</b>
<b>April 1997</b>	The Wallis Report investigates the implementation of a deposit insurance scheme but deems it unnecessary due to alternative deposit protection mechanisms in place. <i>- Financial System Inquiry, 1997</i>
<b>May 2001</b>	Government introduces the HIH Claims Support Scheme, a compensation scheme for policy holders of the failed HIH insurance company
<b>September 2002</b>	APRA provides a submission to the HIH Royal Commission including an argument for consideration of a broad financial sector deposit insurance scheme. <i>- Future policy directions for the regulation and prudential supervision of the general insurance industry, 2002</i>
<b>April 2003</b>	HIH Royal Commission recommends introduction of a policy holder protection scheme. <i>- Report of the HIH Royal Commission, 2003</i>
<b>March 2004</b>	The Davis Report assesses the case for government support for individuals affected by the failure of prudentially regulated institutions and the potential design characteristics of any such scheme. <i>- Study of Financial System Guarantees, 2004</i>
<b>November 2005</b>	Council of Financial Regulators recommendation for introduction of a Financial Claims Scheme Council of Financial Regulators – Failure and Crisis Management in the Australian Financial System, 2005
<b>June 2008</b>	Announcement of planned introduction of a Financial Claims Scheme capped between \$20,000 and \$50,000
<b>September 2008</b>	The failure of US investment bank Lehman Brothers (which filed for chapter 11 bankruptcy protection) severely disrupted global financial markets and governments and regulators worldwide responded by introducing government guarantees over bank debt, enhancing

<sup>9</sup> A guarantee could be purchased for deposits over \$1 million on similar terms to the guarantee facility available to banks for the issue of new debt securities in wholesale markets. At its peak, \$24.1 billion of large deposits was insured under this scheme, with maximum maturities permitted of 5 years for term deposits and to October 2015 for at call deposits. At June 2013, \$2.4 billion still remained under guarantee.

	depositor insurance, and introducing other support and protection mechanisms.
<b>October 2008</b>	The Australian Government introduced the Financial Claims Scheme in conjunction with a guarantee scheme for bank debt. The guarantee of deposits was initially unlimited but reduced to a cap of \$1,000,000 on 28 November 2008.
<b>7 February 2010</b>	Government announces Guarantee scheme for new debt issues and large deposits to be closed on 31 March 2010
<b>December 2010</b>	Government announces that the Financial Claims Scheme is to remain as a permanent feature of the financial system
<b>May 2011</b>	The Council of Financial Regulators (CFR) releases their recommendations for the Financial Claims Scheme following a review of the scheme. The most significant recommendation stemming from the review is a reduction in the cap to between \$100,000 and \$250,000
<b>September 2011</b>	Government announces a reduction in the Financial Claims Scheme cap to \$250,000 to apply from 1 February 2012.
<b>August 2013</b>	Government announces plans to introduce a levy of 5-10 basis points on insured deposits at ADIs to be paid into a Financial Stability Fund

While the level of the guarantee cap has changed over time, other features of the FCS have remained unchanged until the recent announcement of a planned introduction of a fee on banks of 5-10 basis points per dollar of insured deposits. Prior to that announcement, there had been no fees charged for the guarantee, with the scheme being described as “ex post” funded. This meant that if a bank failed and APRA (the operator of the scheme) was unable to recover funds paid out to insured depositors from the assets of the bank in liquidation, the Treasurer could impose a levy on other ADIs to recoup those amounts.

The logic behind the absence of a fee was primarily that, on actuarial grounds, there was virtually zero risk of APRA not recovering amounts paid out from the assets of the bank. This reflects (a) the probability of an ADI being placed into liquidation (b) the balance sheet structures of ADIs and (c) priority rankings of claimants in liquidation. If an ADI fails, APRA pays out insured depositors and then stands at the head of the priority queue of claimants on the failed ADI’s assets.<sup>10</sup> Because banks (but to lesser extent mutual ADIs) have significant uninsured deposit and other debt liabilities, the probability that the value of assets of the failed bank would have declined to such an extent as to not cover insured liabilities (and thus enable full reimbursement of APRA) is extremely low. Also, the likelihood of an ADI being placed into liquidation, and thus triggering a payout to insured depositors, is also perceived as low. High capital ratios (with higher values for mutuals partially offsetting their lower use of other debt and uninsured deposit funding), APRA supervision and early action to effect an open resolution of a failing ADI (by takeover), and

<sup>10</sup> This priority ranking was introduced in the Financial System Legislation Amendment (Financial Claims Scheme And Other Measures) Bill 2008. Previously, all depositors ranked equally with first priority.

(ADI management would argue) prudent management of ADIs, all combine to suggest a low probability of failure. With these ingredients suggesting a low probability of failure, and extremely low loss to APRA (and thus the government) in the event of failure, an actuarially fair fee for insurance provided by government approaches zero.

In fact the provider of the first line of insurance is other claimants and stakeholders on the bank (uninsured depositors, debt holders, shareholders) who rank below APRA (standing in place of insured depositors) in the event of a bank liquidation, and would suffer larger losses if that priority ranking were not in place. In principle, this implicit provision of insurance to insured depositors, should be reflected in demands for higher promised returns on uninsured deposits and debt issued by ADIs. However, to the extent that such stakeholders perceive that there are implicit government guarantees of ADIs which reduce the risk of liquidation and thus losses to zero, this mechanism will not operate, with ADIs thus benefitting from the perception of implicit guarantees. Arguably, this effect is more relevant for those ADIs which are designated D-SIBs.

These considerations thus suggest four possible intertwined arguments for charging a fee for the FCS protection of insured deposits. One relates to the potential benefits of “rapid access” which the FCS provides to insured depositors in a failed ADI. Even though, without the scheme, depositors would still most likely receive their funds back in full, the liquidation process could take some considerable time. The benefits from avoiding such disruption are substantial and could warrant imposition of an *ex ante* fee for providing this benefit.

However, the probability of such an event (a liquidation) happening are, arguably, miniscule – but this reflects two other features of depositor protection which can justify fees. One is the role played by APRA in ensuring the smooth exit of a troubled ADI via takeover and thus avoiding its liquidation. Benefits to insured depositors (and other creditors) from such a process can be argued to exceed those from the “rapid access” arrangements which would otherwise come into play if the ADI were placed into liquidation. Hence, fees could be justified on the basis of both benefits to depositors and competitive advantages to ADIs relative to other financial institutions subject to different resolution and liquidation arrangements. A third argument relates to the benefits in the form of reduced likelihood of retail depositor runs resulting from the existence of the FCS. If the psychological effect of the FCS is to largely remove the probability of runs, banks benefit from the reduced cost of risk management (such as the need to hold higher liquid asset reserves).

The fourth argument relates to the possible role of implicit guarantees. If widely perceived to exist, these give a competitive advantage to the ADIs involved, and a fee could be justified on competitive neutrality grounds. Even though uninsured depositors and debt

holders are effectively the insurer of first resort in event of failure, they may not demand higher returns on funds provided because of a view that implicit guarantees mean that they will not be called upon to incur losses. But demonstrating that there are such perceptions and that they reduce bank funding costs below what they would be on a “stand alone” basis reflecting their low-risk basis is problematic.

#### **4. Distortions arising from the FCS**

Explicit provision of free (or underpriced) insurance to a major class of assets (such as provided to retail deposits via the FCS) would be expected to create distortions to investor portfolio preferences unless either (a) the assets were inherently risk free even in the absence of the insurance or (b) there existed widespread belief in implicit government insurance arising from unwillingness to let the issuing institutions (ADIs) fail – itself a major encompassing source of distortion.

The distortion arises from the competitive advantage provided to ADIs in raising funds in the form of retail deposits relative to other institutions raising funds in different forms from the same investor group. The potential distortion is not limited simply to deposit-like investments. It can distort loan and securities markets because guaranteed institutions can raise funds for risky lending and investment at a lower cost than competitors. Also, because the FCS affects risk-expected return characteristics of deposits it thus can alter the competitive position relative to other risky assets. Appendix 4 illustrates using standard textbook type analysis of portfolio choice. More generally, the competitive distortion may affect the risk-taking behavior of other competing financial institutions. For example, such institutions may respond to the fact that their lending-borrowing spreads are reduced relative to ADIs (who can raise funds at a lower rate) by adopting higher leverage in search of a comparable return on equity to ADIs. Also important is the extent to which ADIs can design guaranteed financial products which are very close substitutes for those produced by other institutions not covered by the FCS.

One important determinant of the extent and nature of distortion will be how competitive conditions between ADIs affect the pricing of guaranteed deposits. In this regard, a major issue is the existence of a somewhat segmented market. Institutional (wholesale) investors face an inelastic supply of risk free investment opportunities – in the form of bonds issued by the sovereign government.<sup>11</sup> Retail investors face a highly elastic supply of risk free investment opportunities in the form of guaranteed bank deposits. While there is a cap on guaranteed amounts per depositor at any one bank of \$250,000, retail investors can place

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<sup>11</sup> Financial engineering can extend the available supply of close substitutes to some degree, such as by using cross-currency interest rate swaps to convert cash flows from a bond issued by an overseas government into known domestic currency amounts, or by purchase of credit default swaps from a high ranking counterparty to provide default protection on a high quality bond investment.

funds with over 100 ADIs, enabling coverage of over \$25 million per investor under the FCS. While there is some scope for retail investors to access government bonds and for wholesale investors to hold risk-free investments in a large number of small amounts across ADIs, there would appear to be relatively limited linkages between the two markets. That lack of linkage is reinforced by the impact of Basel III liquidity requirements which treat short term deposits from financial and wholesale investors as being less stable for meeting liquidity regulation requirements.<sup>12</sup>

There are three potential outcomes regarding the pricing (ie interest rates) of guaranteed deposits. At one extreme, a lack of competition among ADIs for retail deposits and inability of retail depositors to readily access alternative risk free investments could lead to interest rates being set below the “true” risk free interest rate. That outcome seems unlikely, at least for term deposit products, because of the risk free arbitrage opportunity available to the ADIs (of attracting retail deposits and investing in higher yielding government debt or other low risk assets).<sup>13</sup> A second possible outcome is that deposits are priced at the “correct” risk free rate of interest. If that does occur, then other investments which carry (actual or perceived) default risk will need to provide a higher expected return commensurate with that risk. While that would not provide any competitive advantage to banks in fund raising, it would provide them with a competitive advantage in loan and investment markets. A risky asset portfolio could be held, implying some risk to depositors who, however, provide funds at the risk free rate due to the government guarantee.

In practice, in Australia, there are considerable difficulties in identifying what is the “true” risk free rate of interest. A relatively small supply of government debt, together with overseas and domestic demand for that debt for liquidity and collateral purposes has, arguably pushed observed yields below a “true” risk free rate reflecting time preference.<sup>14</sup> And it is readily observable, in Figure 1, that the third outcome of “risk free” interest rates on bank deposits being higher than risk free rates on government debt of equivalent maturity has occurred.<sup>15</sup>

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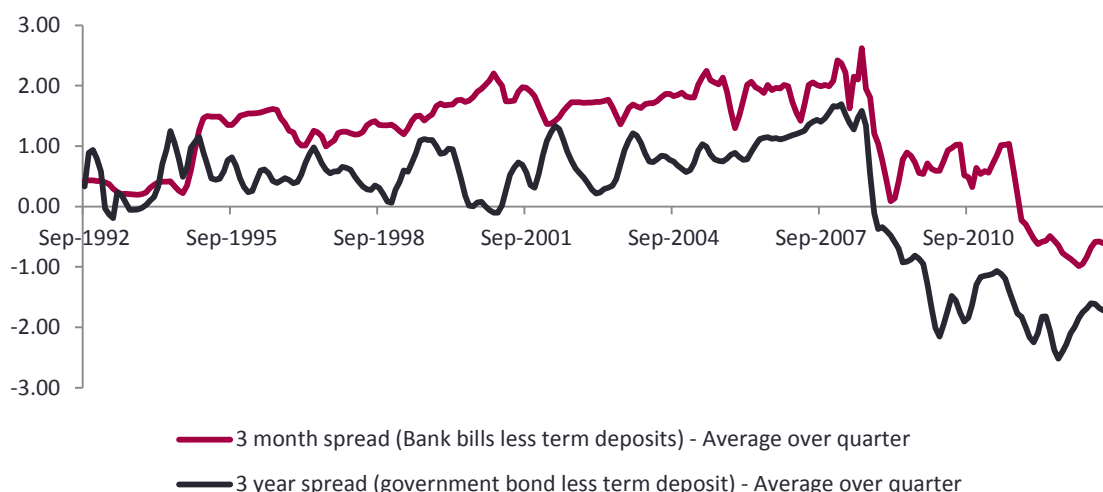
<sup>12</sup> There are also issues here related to the extent to which deposits by collective investment vehicles are treated as wholesale rather than on a “look through” basis as a collection of smaller retail deposits.

<sup>13</sup> For at call deposits, also offering transactions services, this argument is less applicable.

<sup>14</sup> There is no readily available risk free arbitrage strategy for retail investors to profit from the gap between risk free deposit rates and government bond rates, since that would involve short selling government bonds to invest in bank deposits.

<sup>15</sup> Given the absence of a continuous series for short term government treasury rates, 3 month bank bill rates have been used in the figure. Since bank bill rates will typically exceed treasury note rates, the short term yield spread shown understates the extent to which deposit rates now exceed treasury rates. Over the period May 2009 (when Treasury note issues recommenced) to May 2013, the 90 day bill rate exceeded the Treasury Note rate by an average of 23 basis points.

**Figure 1 Wholesale - Retail Deposit Spreads**



Source: RBA Bulletin Table F2

Although beneficial for depositors, this outcome has potentially significant adverse consequences for the Australian economy. Other institutions or borrowers seeking funds from the retail market will need to offer returns benchmarked against the risk free retail deposit rates on offer. Loan interest rates will reflect the rates paid on deposits by banks and other potential lenders will be constrained in their ability to compete due to their higher cost of funds.

This latter effect is related to, but not dependent upon, another form of distortion often cited in the literature on deposit insurance. This is the potential for *moral hazard* in the form of incentives for ADI owners (and managers) to increase the level of risk taking by the ADI. Free, or underpriced, insurance means that expected risk adjusted returns to ADI equity holders are increased when the ADI adopts a higher risk asset portfolio (even if there is no higher expected return on that portfolio). The reason is that the equity holders capture any upside if the investments are successful, while (a) their downside is limited to their amount invested and (b) the ADI cost of deposit funding is not increased due to higher risk taking. The potential for greater losses is borne by the deposit insurer. In the jargon of finance, the provision of deposit insurance by a government is akin to providing the equity holders with a put option giving them the right to put the assets of the bank to the government at a strike price equal to the amount owed to insured depositors.

Such risk-taking incentives can be realised in two main ways. One is to increase the leverage of the bank (ie operating with a lower capital ratio). The other is to increase the riskiness of assets acquired / loans granted by the bank. Risk weighted required capital ratios attempt to offset this moral hazard problem by linking required capital to the size of risk weighted

assets. While this moral hazard issue, and its control, is important, it is not considered further in this report.

It is possible to consider distortions arising from the FCS along a number of different dimensions. One is the impact on the size and competitive position of non-bank financial institutions and markets. Another is by consideration of the effect on particular types of financial products – including innovations in product design to exploit the guarantee. A third is the impact upon pricing of financial products. A fourth is in terms of the impact upon household demand for various financial products.



## 5. The Scheme's Impact on Household Asset Allocation

It is difficult to assess definitively the impact of the FCS on the financial investment decisions of the household sector because (a) there have been significant other disruptions in financial markets since the time of its introduction, and (b) there is a paucity of official statistics available providing adequate detail. For example, bank deposit figures published by APRA do not give a division of household deposits into at-call and term deposits, nor by size categories.<sup>16</sup>

However, one vitally important point needs to be noted. While it has been shown earlier that the FCS design enables individuals to obtain guarantees over very large sums of money by diversifying deposit holdings across ADIs, this is an option relevant only to quite wealthy investors. For the vast majority of households, actual and potential holdings of bank deposits are relatively small. The Davis Report (2004, Table 6.3) estimated that 94-98% of retail depositors had deposit balances in any one bank of less than \$50,000 and that a coverage limit (cap) of \$250,000 increased this coverage to 99.2 -99.8% of retail depositors. Subsequent studies have produced consistent information, and in announcing the reduction in the cap to \$250,000 in September 2011, Treasurer Swan indicated that this would provide full coverage of around 99 per cent of deposits. Connelly et al (2012) examine the HILDA data for 2010 and find that the median level of household bank deposits was \$9,000 and the average level was \$41,200. In the mid-year economic and financial outlook (Treasury, 2013) noted that at 31 August 2012 deposits eligible for coverage under the FCS were \$646.5 billion, which suggests an average level of deposits per capita of around \$30,000.

Further evidence can be found in data from the HILDA Survey, from which the RBA has extracted information on household financial asset holdings. As shown in Table 2, while most individuals have a bank deposit account, the median amount held even for the top percentile is only \$18,000. One relevant feature of that data is the small proportion of individuals with life insurance<sup>17</sup> – where a number of products such as annuities have similar characteristics to deposits

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<sup>16</sup> Much more detailed information is publicly available from APRA on characteristics of superannuation fund accounts.

<sup>17</sup> It would appear that these figures do not include group insurance provided through superannuation.

**Table 2 Distribution of household financial assets**

Percentile of income	Per cent of households holding assets			Median value of holdings for households holding assets (\$'000, September 2010 prices)		
	Deposits	Life insurance	Superannuation	Deposits	Life insurance	Superannuation
Less than 20	96	4	45	6	30	25
20-39.9	98	4	77	6	33	40
40-59.9	98	4	92	7	28	50
60-79.9	99	10	98	10	50	87
80-100	99	10	99	18	43	164

Source: RBA, Table B24

These figures suggest that the figures used in the Davis Report are still indicative of the distribution of retail deposits, and that very high levels of coverage could be achieved with a much reduced cap (eg of \$50,000). Reducing the cap would thus affect only a relatively small number of investors – but arguably the ones where most distortion in asset allocation from the FCS occurs.

Despite the paucity of useful data, some trends relevant to investor asset allocations can be discerned.

- a) The share of bank deposits in household financial asset holdings has increased since 2007, reversing the declining trend over the previous decades. Some part of this change reflects valuation effects – as the value of assets such as direct shareholdings and superannuation balances declined following the onset of the GFC. Table 3 illustrates. How much of the remaining effect is a result of increased bank competition for retail deposits in an attempt to alter funding mix, how much reflects portfolio reallocation due to risk aversion, and how much is due to the FCS is uncertain.

**Table 3 Household financial asset holdings (1990-2012)**

	Deposits	Shares	Super/Life	Unfunded Super	Other
Sep-90	29%	10%	36%	13%	11%
Sep-00	19%	19%	44%	9%	9%
Sep-07	15%	27%	46%	6%	5%
Sep-12	22%	16%	46%	11%	5%

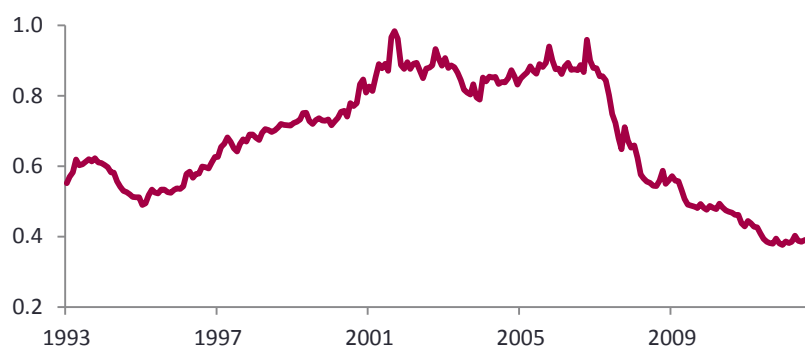
Source: ABS 5232.0 National Accounts: Financial Accounts

- b) The composition of deposits on the Australian balance sheets of banks has changed significantly since 2008. Figure 2 illustrates the growth of term deposits relative to current/at-call deposits since the GFC. The downturn in current/term deposits began in late 2007 and has continued since the introduction of the FCS in October 2008. While these figures relate to total (not just retail) deposits, it could be expected that the change would be even greater for retail deposits, given that business and institutional holdings of current deposits are likely to dominate that category by value. However, figures for mutual ADIs which cater almost exclusively to retail customers do not show

such a pronounced downturn (Figure 3) – although this may reflect the effect of increased competition by banks for term deposits attracting such funds away from the mutuals. Ellis et al (2012, Table 1) report that household direct holdings of deposits at June 2012 were \$232 million of at-call and \$470 million term deposits, and that the respective growth rates between 2007 and 2012 were 8 and 14 per cent p.a. They also report that indirect holdings of deposits via superannuation and investment funds were \$236 million.

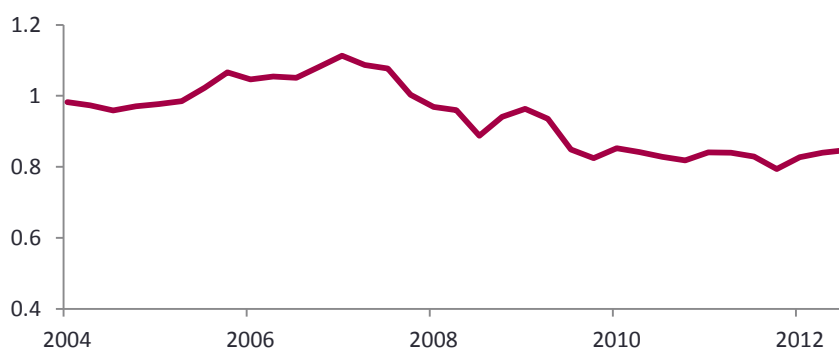
- c) Australian households appear to hold relatively little in the way of interest bearing assets outside of deposits in ADIs. Ellis et al (2012) note, based on HILDA data, that “In aggregate, households invest around two-fifths of their financial assets in interest-bearing assets. Household deposits have grown strongly over recent years, although there has been no growth in interest-bearing securities. Compared with other advanced economies, the share of interest-bearing assets in household financial assets remains low in Australia.”

**Figure 2 ADI at call deposit to term deposit ratio**



Source: Reserve Bank of Australia, Bulletin Table D3

**Figure 3 Mutual ADI at call deposit to term deposit ratio**

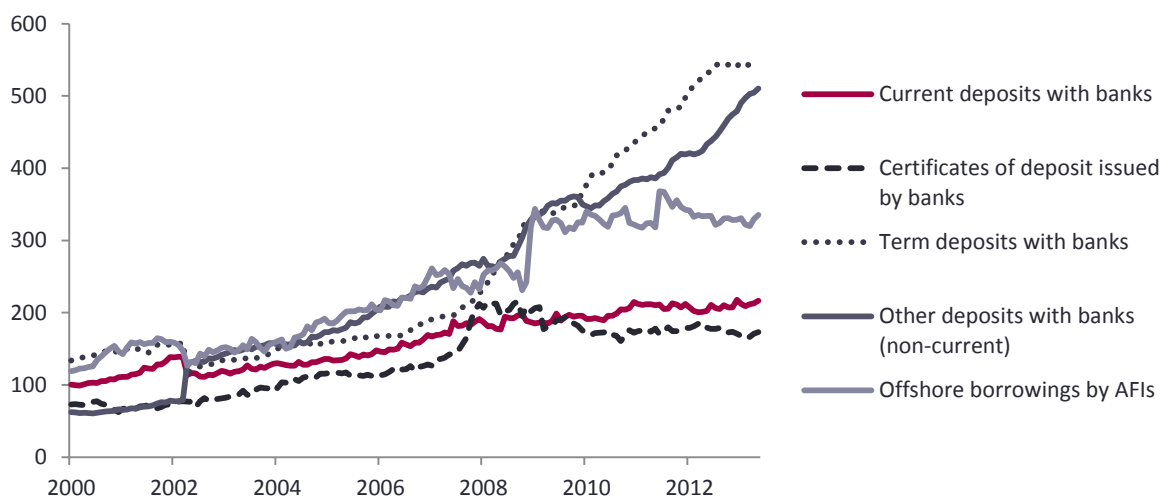


Source: Reserve Bank of Australia, Bulletin Table D3

It is worth noting that the introduction of the FCS has not enabled smaller mutual ADIs to gain a larger share of the deposit market – which may have been expected given public

perceptions of greater risk of mutuals relative to banks. It does appear, however, to have halted the downward slide in market share which had previously been occurring. The mutual ADI share of deposits (excluding foreign bank branches which cannot effectively compete for retail deposits) had fallen from 4.50% in December 2005 to 3.61% in December 2008, and at March 2013 was 3.54%.<sup>18</sup>

**Figure 4 Australian bank liability funding quantities**



Source: RBA, Table D3, 2013

## 6. The Impact of the FCS on other Financial Products and Institutions

As noted earlier, by changing the risk-return characteristics of bank deposits for retail investors, the FCS could be expected to affect household asset allocation decisions across a broad range of assets – but particularly those which are relatively close substitutes for deposits. As also noted earlier, separating the impact of the FCS from other developments in the financial sector is problematic

### 6.1 Money Market Funds (Cash Management Trusts)

It would be expected that money market funds such as cash management trusts would be one form of investment adversely affected by the introduction of the Financial Claims scheme – since they are a close substitute for at-call and term bank deposits. This does indeed appear to have been the case, with the size of the CMT sector declining markedly since 2008. One component of this decline was the decision of Macquarie Bank to close its (large) cash management trust and transfer customers' funds (subject to their approval) to a bank deposit product which would be eligible for coverage under the FCS. But even

<sup>18</sup> These figures are calculated by subtracting foreign bank subsidiary deposits from the total of all ADIs and comparing mutual ADI deposits to that figure found in APRA's quarterly banking statistics. Unfortunately the ADI deposit statistics do not distinguish between household and other deposits. (In principle, it would be possible to construct comparative series using the monthly banking statistics, but that is beyond the scope of this work).

excluding that change, the industry has suffered gradual decline. Another reason for the decline of the sector is the declining stock of short term high quality securities available for investment.<sup>19</sup>

During the mid-1990s money market funds grew in popularity as an alternative to bank deposit accounts. Money market funds invest in short-term highly liquid securities that generally have a maturity that is less than 1 year. ASIC provides the following table as guidance on the asset classes that money market funds generally invest in.

Asset Type	Examples
Cash	Cash receivables, bank deposits, time/call deposits, negotiable certificates of deposit, discount notes, bank bills, non-Australian dollar denominated cash, cash equivalent securities and other money market securities
Debt and fixed income securities	Government and semi-government securities, bills of exchange, promissory notes, notes, asset-backed bonds, corporate floating or fixed rate debts, commercial paper, treasury bills, and asset backed securities
Mortgage	Mortgage securities, collateralised mortgage obligations and mortgage-backed securities
Derivatives	Repurchase agreements and foreign exchange contracts. Derivatives are primarily used for hedging purposes

As collective investment schemes money market funds have traditionally held some advantages over bank savings accounts. These include:

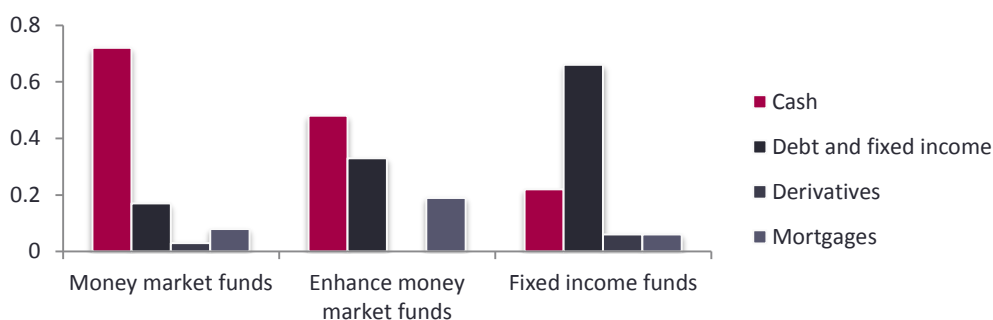
- Access to money market rates and other higher yielding OTC products unavailable to individual investors
- Expertise in assessing and managing short-term securities
- Offering a diversified portfolio of short-term instruments.

Money market funds by definition should hold a large proportion of their total portfolio in high quality, liquid, short-term securities and should not be mistaken for fixed income funds which generally have longer-dated and, depending on the fund, riskier underlying assets. A 2012 report by ASIC<sup>20</sup> investigated the holdings of Australian money market funds and found that the branding of money market funds generally provided an accurate indication of the nature of the funds underlying assets. (Figure 5)

<sup>19</sup> Not only has the stock of treasury notes on issue been low (or zero) for some time, but there has been a decline in the size of the bank accepted bill market and the commercial paper market. Banks have also reduced the relative interest rates offered on short term deposits from financial institutions.

<sup>20</sup> ASIC Report 324: Money market funds, December 2012

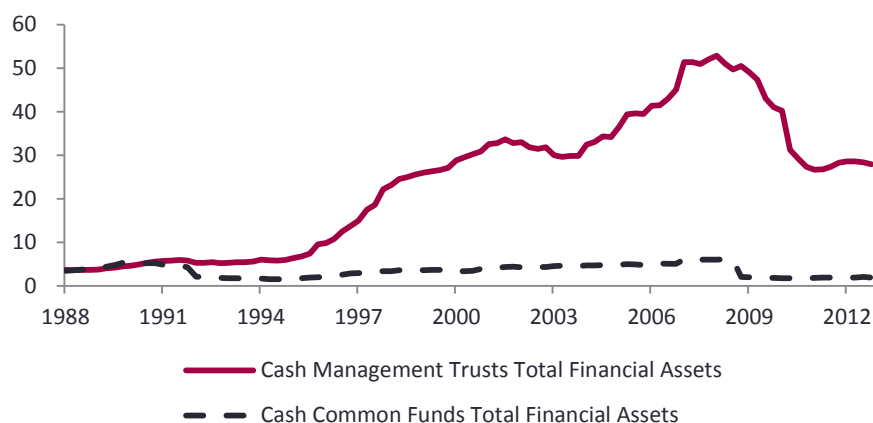
**Figure 5 Portfolio composition of money market, enhanced money and fixed income funds, 2012**



Source: ASIC Report 324: Money market funds, December 2012

Unlike savings accounts which can only be offered by APRA regulated banks, money market funds are collective investment schemes that are regulated by ASIC and therefore are outside the prudentially regulated perimeter. The ABS identifies the two largest sub-categories of money market funds as cash management trusts (CMTs) and cash common funds. Cash management trusts, as the name suggests, follow a trust structure whereby the funds of individual investors are pooled in exchange for units in the trust. These funds are then invested in relatively low-risk liquid assets. Cash common funds are similar to CMTs but are subject to additional state regulations. There has been a significant increase in total assets held by money market funds since the mid-90s however this growth has been solely in the CMT sub-category.

**Figure 6 Money Market Funds Total Financial Assets**



Source: ABS Cat 5655, Managed Funds, Mar 2013

While total assets managed by money market funds increased to almost \$60 billion by mid-2008. The global financial crisis brought with it a significant reduction in the total assets managed by money market funds. Macquarie Group who closed their \$10 billion dollar CMT in late 2008 cited the Financial Claims Scheme and improving the Group's balance sheet as

the two key reasons for closing the trust.<sup>21</sup> The largest currently active Australian money market funds as reported by Morningstar are listed below.

Fund name	Net assets (\$ million)
TPS Cash Management	900.45
Perennial Cash Enhanced Trust	871.77
Russell Australian Cash A	749.39
IIOF/Perennial Flex Cash & Income	672.83
UCA Cash Portfolio	517.74

The decline in the size of money market mutual funds since 2008 would appear to be largely due to the introduction of the FCS, and banks offering cash management account deposit products covered by the guarantee. While product specifications differ (the interest rate paid is determined by the bank rather than directly determined by investment earnings, and there may be tiered rates for different size balances rather than a pro rata entitlement) they are very close substitutes. In addition to the competitive disadvantage imposed on CMTs and money market mutual funds, there is also the potential for managers of such funds to adopt higher risk investment strategies (lower credit grade investments) in search of higher yields to offset the advantage given to bank deposits via the guarantee.

## 6.2 Finance Companies

Finance companies and general financiers (part of the “shadow banking” sector) offer bank like intermediation services and are mostly outside of the APRA regulatory perimeter. While some liabilities of this group are referred to as “deposits” these are typically provided by wholesale investors and not covered by the FCS. Additional funding is obtained from issuing debentures and unsecured notes to both retail and wholesale investors.

Debentures are fixed income securities generally issued by finance companies that are secured by the issuing company’s assets. The yield on a debenture security is a function of the underlying risk, term and liquidity of the security which is determined by the characteristics of both the issuing company and the security. Unlisted and unrated debentures should command a higher yield than comparable listed and rated debentures. Unlike debentures, unsecured notes are not collateralised by the issuing company’s assets.

<sup>21</sup> Macquarie steers \$10b from trust into deposit account, <http://www.smh.com.au/business/macquarie-steers-10b-from-trust-into-deposit-account-20100304-pltf.html#ixzz2ZNbcuKRg>

**Table 4 Face value of debentures on issue (\$ billion December 2008)**

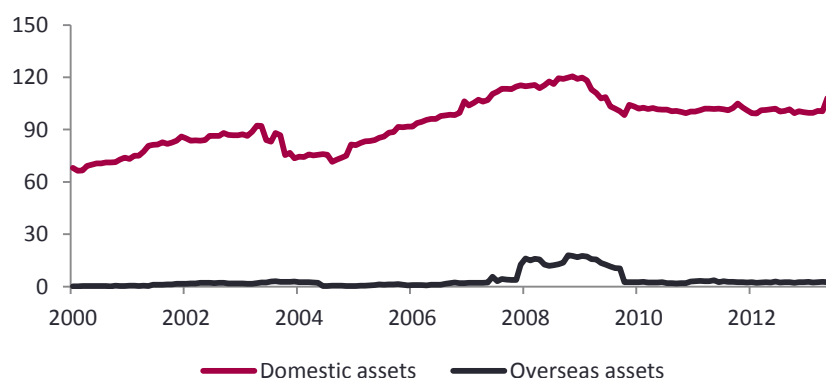
	Total issued	Number of issuers
Unlisted and unrated debentures	4.5	64
Unlisted and rated debentures	5.9	5
Listed and rated debentures	1.3	2
Listed and unrated debentures	5.2	39

Source: ASIC, Report 173

Finance companies typically provide finance for property investments and development, personal loans, leasing, equipment purchase, car financing etc. In this regard they are in competition with ADIs on both sides of the balance sheet.

Given the often short-term nature of debentures and unsecured notes, finance company securities have been a viable alternative to bank deposits for investors seeking additional yield. Prior to the GFC total assets of finance companies and general financiers grew strongly to a peak of \$138 billion in November 2008, but have since declined to \$108 billion as at June 2013. While “other borrowings” (which includes funds raised by debentures and promissory notes etc) had begun to fall from a peak of \$56 billion in October 2007, outstandings fell markedly from \$52 billion in October 2008 (when the FCS was introduced) to a low of \$36 billion in October 2009, and have recovered only marginally to \$41 billion in June 2013.

**Figure 7 Financial assets of Finance Companies and General Financiers: 2000-2013<sup>22</sup> (\$ billion)**



Source: RBA, Table B10, July 2013

There are a number of factors that may have contributed to the sharp reduction in financial liabilities of Finance Companies following the GFC including the default of a number of debenture issuing organisations at the end of 2008 (and subsequently). In response to these defaults, ASIC increased the disclosure requirements and implemented a benchmarking

<sup>22</sup> This chart is derived from data which comprises returns submitted by Finance Companies, General Financiers, Pastoral Finance Companies and Money Market Corporations.



reporting requirement for issuers of debentures.<sup>23</sup> Finally, because the liabilities of Finance companies are not covered by the Financial Claims Scheme, the relative risk premium required for finance company liabilities relative to bank deposits would have also increased.

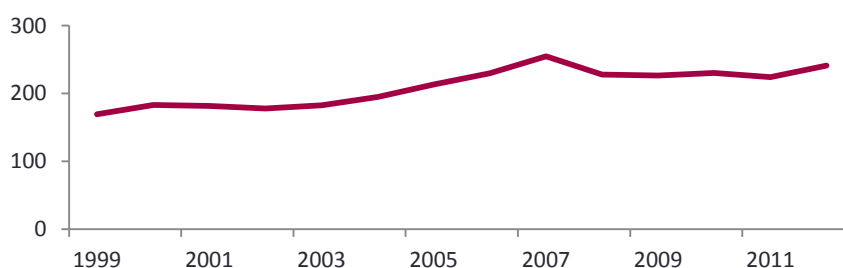
Reliable data on finance company debenture interest rates comparable with bank deposit rates is not readily available. However, at mid-August 2013, advertised rates by several finance companies for 3 year debentures were approximately 350 – 450 basis points higher than those advertised by banks for 3 year term deposits.<sup>24</sup>

It is likely that the FCS has been one contributor to the lack of growth of non-bank financiers such as finance companies which compete with banks for household savings, although recent failures of a number of finance companies are also relevant. The effect on ability to raise funds, implying a need to offer higher yields, also flows through into the ability of such institutions to offer viable competition in lending (and leasing) markets for households, small business.

### 6.3 Life Insurance Products

Currently there are 28 Life insurance companies operating in Australia with 4 of the larger insurers owned by the four major banks. The top 5 groups represent 88% of life insurance industry. The industry has grown slowly in terms of assets under management in recent years (see Figure 8) and become more concentrated over time (Figure 9). Life insurance risk business remains one of the few market segments to record growth during 2011/12, albeit at a slightly subdued aggregate level compared to previous years, and investment-linked business in life insurance is declining with risk and annuity based products being the principal areas of potential growth.

**Figure 8 Life Office Statutory Fund Assets (\$ billion)**

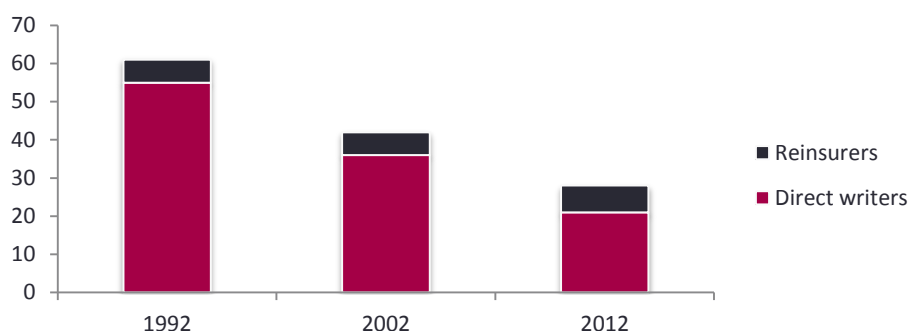


Source: *Life Insurance Trends, March 2008 and Quarterly Life Insurance Performance, June 2013*

<sup>23</sup> ASIC Regulatory Guide 69 – Debentures, improving disclosure for retail investors.

<sup>24</sup> Canstar.com.au, accessed 14 August 2013.

**Figure 9 Number of Life Insurers Operating in Australia**



Source: APRA Insight 2013 Issue 3

Traditionally the life insurance sector was a major provider of long term savings facilities (through endowment and whole of life policies) as well as a provider of insurance. Many of those traditional policies also involved investment linked returns, making them significantly different to bank provided savings products. The relative importance of the life insurance sector has declined over recent decades, partly reflecting the emergence of alternative forms of long term savings (superannuation) and investment opportunities (managed funds). The structure of life insurance contracts has changed to much greater emphasis on term (eg annual) contracts which provide risk protection without the savings element. The provision of life insurance within superannuation has also seen a relative increase in the significance of group insurance arrangements relative to sales of individual insurance products.

But another aspect of life insurance business which can be expected to grow in importance (in the absence of competitive disadvantages) is the provision of longer term income products such as annuities, catering for the running down (decumulation) of wealth to finance consumption by retirees. In general, these involve no investment risk for the purchasers, who are obtaining a fixed (or inflation linked) stream of cash flows promised by the product provider.

In examining which financial products might be appropriately covered by a guarantee scheme, the Davis Report (2004) drew a distinction between products which involved market (investment) risk and those which had no such risk, but where counterparty (default) risk existed. Products such as annuities fell into this category, and were viewed as being similar to bank deposit products – which are now covered by the Financial Claims Scheme.

That similarity is easily seen by noting that a term annuity of (say) ten years can be replicated by a package of term deposits of regular maturities ranging up to ten years. The annuity provides a regular (say) quarterly cash flow of \$X to the investor for an initial cash

payment amount. Purchasing a package of term deposits of appropriate size) which mature sequentially each quarter to deliver \$X each, gives the same future promised cash flow stream. Currently, that package of term deposits (if less than \$250,000 in total, and taking into account other deposits of the holder with the same ADI) is protected from default risk by the Financial Claims Scheme. However, the annuity provided by the life insurance company is not covered. Westpac, for example, is one bank which has recently provided an annuity style product which is covered by the Financial Claims Scheme because it is structured as a portfolio of term deposits covering a range of maturities.

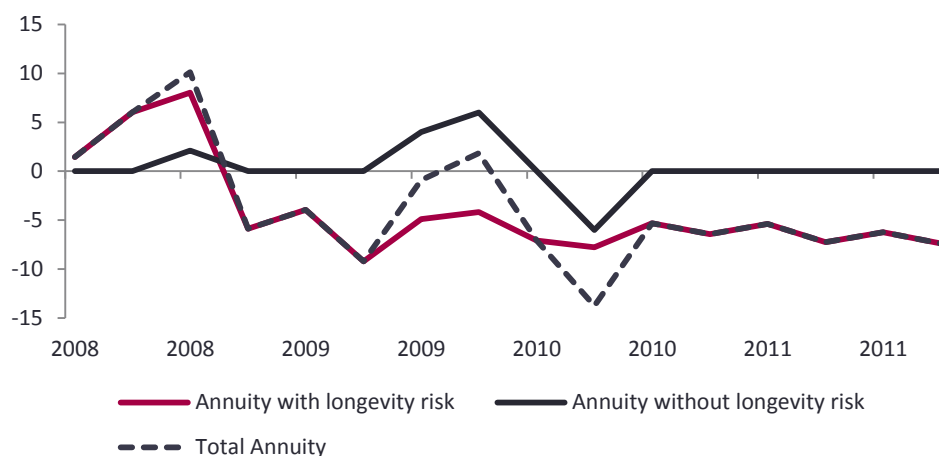
This is a clear distortion affecting the competitive ability of Life Offices to compete with banks. More generally, the exclusion of such annuity products from coverage by the Financial Claims Scheme appears anomalous given the potentially large impact of provider default on the holder. While retirees might diversify their retirement wealth across a number of financial products and providers, there are potential benefits from retirees making significant investments in annuity (and particularly lifetime annuity) products which are protected from default risk.

#### **6.4 Annuities**

Annuities are a close substitute for bank deposit products, in that an annuity stream of income can be constructed by a portfolio of term deposit contracts. Given the importance of annuity style products for retirees seeking a low risk cash flow stream, the FCS distorts investor choice towards guaranteed deposit products and away from annuities provided by other institutions such as life insurance companies.

This distortion reinforces other past policy measures which have reduced incentives for individuals to invest in annuity style products. In 2009, for example, there were less than 20 lifetime annuities written compared to nearly 2000 written in 2001. The removal of tax concessions for retirees converting superannuation balances into annuity products rather than taking lump sums or retaining a managed account (allocated pension) is relevant in this regard, as is the tax free status after age 60 of earnings on amounts retained inside a superannuation account in drawdown mode.

**Figure 10 Life insurers net policy revenue from annuity products (\$ million)**



Source: APRA, *Quarterly Life Insurance Performance*, March 2013

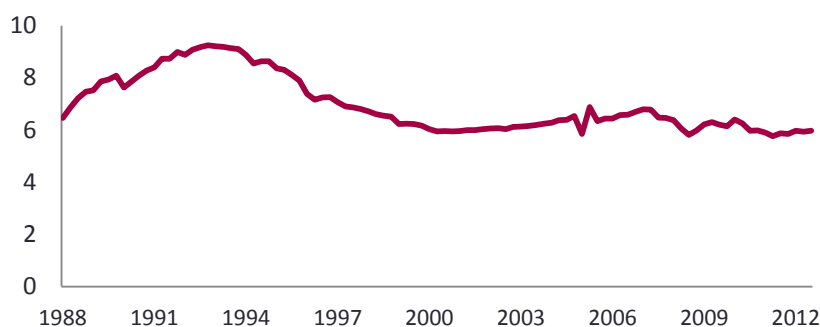
## 6.5 Friendly Societies

Friendly societies were originally member owned organisations that traditionally offered a suite of insurance and savings products (a number of those currently operating are no longer mutuals). Many of the long term investment products offered by friendly societies, including education and insurance bonds, are potential substitutes for bank savings accounts.

The friendly society sector has been in a steady decline from its peak in the early 1990s both in terms of assets under management and number of institutions in operation. The number of registered friendly societies has more than halved in the last decade and as of June 2012, only thirteen registered friendly societies remained active at June 2012. The reduction has been a result of a number of mergers, acquisitions and demutualisations in the sector.

Total funds under management by the sector have also decreased considerably from almost \$10 billion in 1993. Much of the decline can be attributed to the removal of tax concessions and a subsequent tax-disadvantaged position relative to superannuation as a long term investment option for individuals. While some products are structured to provide long term fixed interest type returns and thus potential substitutes for longer term bank deposits, others involve the policy holder bearing some degree of market risk. While the FCS could be expected to reduce the competitive position of the former product type vis a vis bank deposits, it is more likely that the lack of growth reflects the impact of superannuation.

Figure 11 Total Funds Under Management - Friendly Societies (\$ billion)



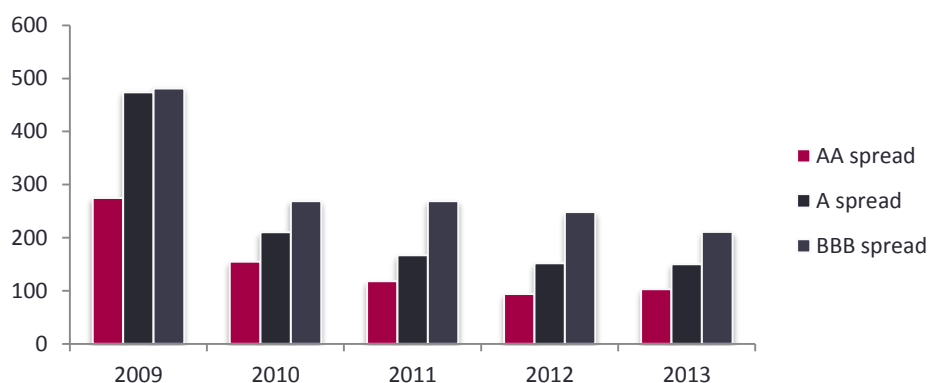
Source: RBA, Table 18, 2013

## 6.6 Corporate Bonds

There has been limited investment in corporate bonds by retail investors in Australia, although various hybrid products (such as convertible bonds and converting preference shares) have attracted interest at various times. In recent years, the Australian government has been attempting to promote the growth of a retail corporate bond market by, for example, changing issuance requirements.

The interaction of the FCS and relatively high yields on guaranteed bank term deposits must operate to reduce the potential for development of a retail corporate bond market. Since few retail investors have sufficient financial wealth to hold a diversified portfolio of corporate bonds, the credit risk associated with individual bonds implies a significant yield spread over bank deposit rates is required to attract interest. This is a disincentive for corporates to use this market as an alternative source of funding to bank loans. While banking regulation changes occurring as part of Basel 3 are likely to increase incentives for banks to promote corporate use of bond markets rather than on-balance sheet lending, the availability of guaranteed term investments at banks is likely to adversely affect the supply curve of funds for retail corporate bond issues. Liquidity regulation proposals in Basel 3 (the Net Stable Funding ratio) also provide banks with incentives to attract longer dated term deposits – which also has adverse supply consequences for a retail corporate bond market.

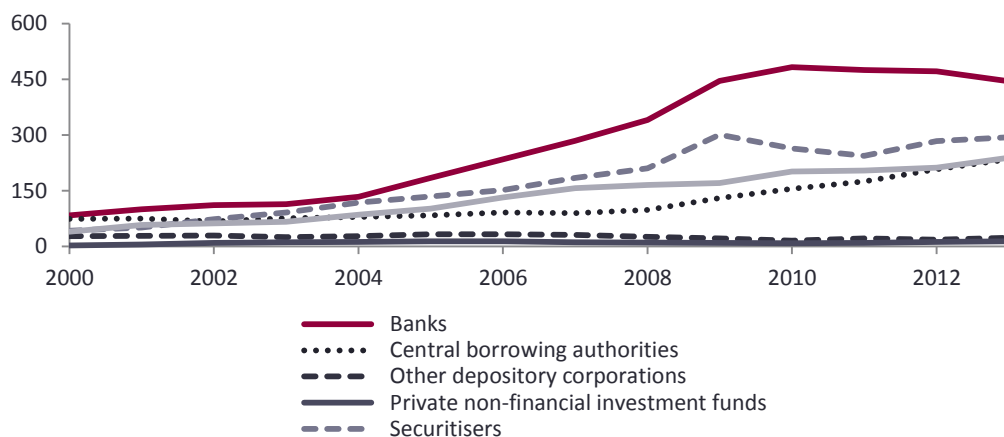
**Figure 12 Corporate Bond Spreads over Online Savings Accounts\***



Source: Derived from RBA tables F3 and F4 2013

\*All yields are computed in June of the corresponding year

**Figure 13 Australian bond issues outstanding by issuer, \$ billion (2000-2012)**

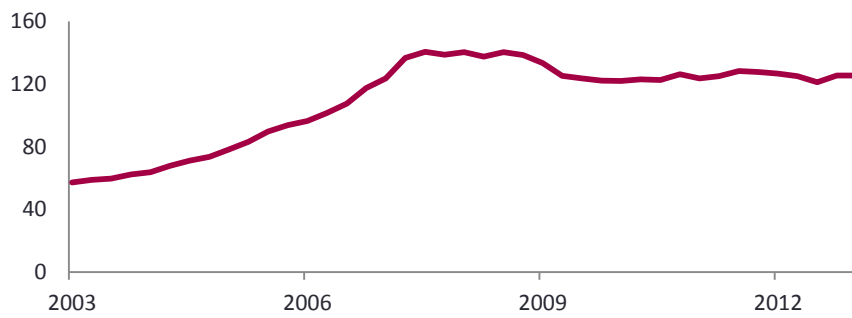


Source: Derived from RBA table 28. The Bonds Market (\$ million)

## 6.7 Mortgage and Property Trusts

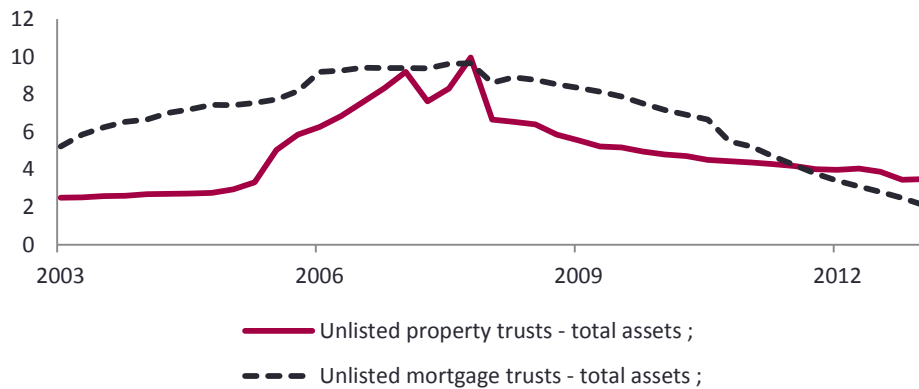
The introduction of the FCS in October 2008 reinforced the difficulties of mortgage and property trusts which were already experiencing outflows reflecting concerns over declining asset values. Many unlisted trusts were forced to suspend redemptions. The sector has continued to decline as shown in Figures 13-16. While some part of the decline may reflect valuation effects, most of it appears to reflect reduced investor interest in these types of investments, which compete with bank deposits. While listed real estate trusts have maintained their size, unlisted mortgage and property trusts have declined markedly in size. This has flowed through to their ability to provide funding for borrowers, with their holdings of mortgages, other loans and asset backed securities all declining substantially.

**Figure 14 Listed Property Trusts - Total Assets (\$ Billion)**



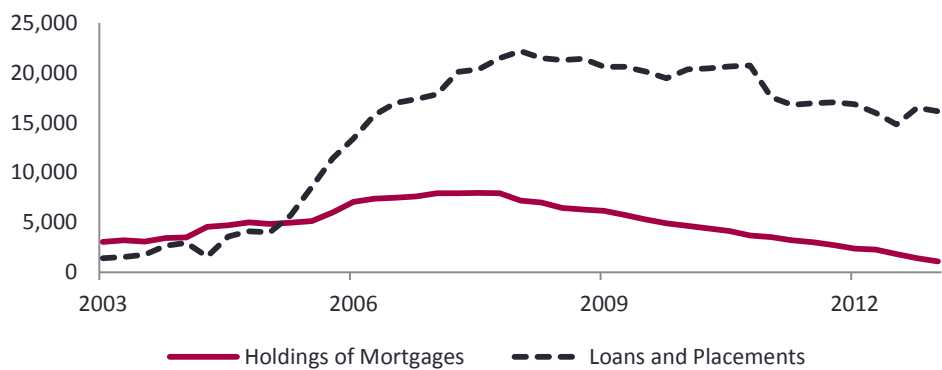
Source: ABS Cat No 5655.0 Table 5

**Figure 15 Unlisted Trusts: Total Assets (\$ Million)**



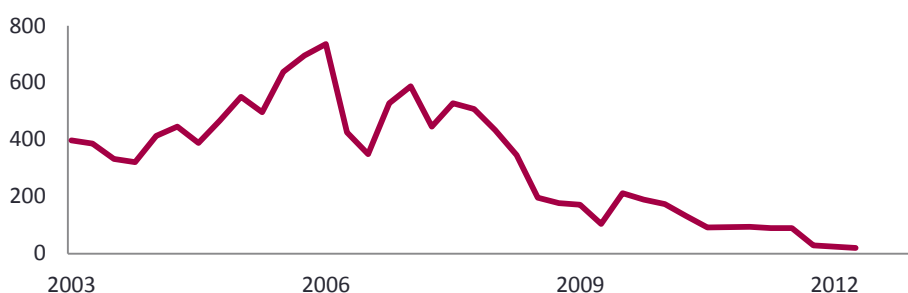
Source: ABS Cat No 5655.0 Table 5

**Figure 16 Public Unit Trusts: Mortgages and Loans (\$ Million)**



Source: ABS Cat No 5655.0 Table 5

**Figure 17 Public Unit Trusts: Holding of Asset Backed Securities (\$ million)**



Source: ABS Cat No 5655.0 Table 5

## 6.8 Self-managed Superannuation Funds

Self-managed superannuation funds (SMSFs) have grown significantly in size in recent years and now constitute around one-third of total superannuation assets. Investment strategies of these funds can vary quite markedly from those of institutional managers and many are heavily weighted towards investments in ADI deposits. This is reflected in the significantly higher average allocation to “cash” of this sector – which has also increased since 2008 (when the FCS was introduced). Also particularly noticeable is the miniscule allocation of “fixed interest”. SMSF trustees would appear to be allocating funds to term bank deposits rather than to other fixed interest products – partly in response to the guarantees provided over bank deposits. (Since the average size of SMSFs was just under \$500,000 at June 2012, a large proportion of assets can be placed in guaranteed deposits within a single institution and greater coverage obtained by diversifying across ADIs.

One complication arising from the operation of the FCS is the extent to which APRA will “look through” collective investments in bank deposits in determining coverage under the FCS. For example, a deposit of a large institutional super fund in a bank may represent relatively small amounts for a large number of members, which if invested in individual names would be covered by the FCS. This problem does not arise for SMSFs, enabling members of the SMSF to obtain a guarantee over bank deposits within the fund which is not available to members in large institutional funds.



**Table 5 Differences in asset allocation by super fund type: 2011**

	Not-for-profit	Retail	Small	Small 2008
Cash	3.0	3.4	29.3	26.4
Fixed interest	24.9	30.9	0.7	1.3
Aust equities	30.9	37.9	37.3	41.2
Other equities	17.2	17.9	0.3	0.8
Unlisted property	16.7	5.5	14.9	12.5
Other	7.2	4.5	17.0	17.8

**Table 6 Pension fund deposits as a percentage of total pension fund assets**

2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
3.83%	4.12%	3.83%	3.51%	3.20%	4.41%	5.84%	6.29%	8.10%	8.91%

*Source: derived from ABS and APRA data*

In aggregate the relative growth of SMSFs over time would appear to be one of the drivers of the increase in deposit holdings of the pension fund sector shown in Table 6.

## 6.9 Product Innovations and the Financial Claims Scheme

Banks and other ADIs have incentives to design financial products which fall under the FCS umbrella of protection.

Recently, Westpac has released a PDS for a Westpac Annuity Deposit which provides a guaranteed stream of income for a term of between one to fifteen years. This product can be replicated by a package of individual term deposits of different maturity, but also offers the option of an inflation protected income stream.

While there is no life assurance component to the product (although remaining funds are released on death of the deposit holder) this is otherwise a direct competitor to term annuity products offered by life insurance companies. Given the potential growth in retirees seeking investments giving long term low risk income streams, the extension of the FCS guarantees to such products provides a significant competitive advantage in this market.

In principle, the Government should also have incentive to design financial products which provide an alternative to providing a guarantee over bank term deposits. Providing access to government bonds in suitable parcel sizes for retail investors would provide a safe haven for longer term savings. This may require creation of special types of securities and issuance/registry arrangements (in addition to the depository interests in wholesale bonds now tradeable on the ASX), but would remove much of the contingent liability associated with the FCS from the budget.

## 7. Conclusions

Based on the preceding analysis and evidence, it is apparent that the FCS is distorting the structure of household financial decision making and the relative competitive position of ADIs versus other financial market participants in savings, lending and investment markets. The following questions can be posed about whether the current design of the FCS is optimal, and suggests options for policy changes.

- Given the distortions caused by the FCS, one policy option could be to remove it. As argued in the Davis Report (Davis, 2004) the case for a deposit insurance scheme in Australia was finely balanced due to the existence of depositor preference arrangements which provide protection to depositors by virtue of seniority of claims in liquidation. That remains the case, and depositor preference arrangements could be further strengthened to provide priority to particular types or amounts or holders of deposits even in the absence of the FCS. In practice, there are several impediments to removing the FCS. First, the international pervasiveness of deposit insurance and agreement on its role as part of the core financial infrastructure could make non-conformity with international norms an issue. Second, the GFC experience reinforced perceptions of the existence of implicit guarantees which would become explicit in situations of stress. It is unlikely that depositors would treat repeal of the FCS as removal of guarantees, and thus retention of an explicit scheme may be preferable. Nevertheless, removal is an option – although other provisions of the scheme including strengthening of APRA’s powers and ability to effect open resolution of troubled ADIs (by merger etc) rather than liquidation are valuable changes to failure resolution in Australia.
- An alternative approach would be to increase the size of the guarantee fee charged to banks to reflect the benefits obtained from the perceived lower risk of deposits, thereby restoring some measure of competitive neutrality for institutions not covered by the FCS. Unfortunately, determining an appropriate fee is complicated by two factors. First, information on perceived bank credit risk on non-covered products such as credit spreads on bank debt, relates to bonds and other securities which are lower in the preference ordering than deposits. Identifying what would have been the credit spread on uninsured deposits (and thus the interest rate benefit to insured deposits) is thus more complicated than would be the (already difficult) case where deposits ranked equally with debt. Second, spreads on bank bond instruments will be partially affected by perceptions of the existence of implicit guarantees (or likelihood of government assisted open resolution of troubled institutions) and the likelihood that bondholders will thus suffer loss in the event of bank failure.
- The current size of the cap at \$250,000 is far in excess of the amount required to protect the deposits of most investors. The number of retail depositors with deposit account balances greater than \$50,000 or \$100,000 is relatively small. Moreover, this latter group (who can get aggregate guarantee coverage of over \$25 million by diversified deposit

investments across ADIs) is most likely to be those who have discretionary investment funds which might otherwise be invested in products offered by non ADIs. The case for lower cap appears to have merit.

- With any cap, there will always be the possibility of special cases of depositors with temporarily higher amounts on deposit with a failed institution (such as proceeds of a house sale prior to a subsequent purchase, or small business prior to payroll). Providing depositors with the option of guarantee coverage, for a fee, for amounts in excess of the cap, would be one way of dealing with such circumstances and also providing a “user pays” service for those desirous of higher coverage. As shown following the introduction of the FCS, some depositors were willing to pay (quite substantial) fees to insure deposits of \$1 million or more. However, unless the fee charged were commensurate with wholesale market spreads on bank debt, it would be necessary to impose some upper limit on the amount which could be eligible for such coverage. It may also be appropriate to make coverage of such larger amounts the default option. This, in effect would be a two tier cap system, with the premium for amounts within the upper tier being higher than for the lower tier, and with depositors having the option to opt out of coverage for the upper tier. Such a scheme would need specification of eligible deposit types (eg term or non-payments accounts) to minimize complexity and administrative expenses, but would enable those concerned about risk on larger deposit sums (either temporary or being invested for longer duration) to choose to buy protection. As well as generating budget revenue, the decision by some depositors to opt out of offered protection would also provide greater scope for government to impose losses on such depositors in the event of the ADI failure.<sup>25</sup>
- The larger is the cap, the greater is the proportion of insured deposits in the bank’s liabilities (even though the number of insured depositors is much less changed). Consequently, the probability that remaining assets of a failed bank in liquidation will not be sufficient to repay APRA for its payout of insured deposits, and thus require a levy on other ADIs, is increased. While that probability is currently very small, it would be reduced further by a reduction in the deposit cap.
- The case for introduction of an *ex ante* fee for the FCS is stronger when considered as compensation for competitive advantages to the industry arising from explicit and implicit guarantees and avoidance of disruption from exit of a failing institution, rather than as a pure insurance premium. Because (a) APRA will endeavour to ensure open resolution of failing ADIs, thereby avoiding liquidation, and (b) in the event of a liquidation the structure of priority arrangements makes it highly unlikely that APRA would not be fully compensated for payments made to insured deposits from the failed ADI’s assets, the likelihood of taxpayer losses or need for a levy on other ADIs is extremely small. Assessing the appropriate size of an FCS levy based on competitive

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<sup>25</sup> To the extent that “bailing in” or “haircutting” uninsured depositors in the event of failure such as occurred in Cyprus become the norm, such a two tier scheme provides some degree of political protection for such actions.

neutrality grounds is made problematic by the question of whether implicit guarantees are generally perceived to exist and outweigh the effects of the FCS.

- While, in principle, the government has a maximum explicit contingent liability equal to the size of insured deposits (of \$646.5 billion at 31 August 2012) this would require the inconceivable situation where all ADIs failed and had no assets of value upon which claims could be made. Any sensible estimate (using realistic estimates of probabilities of ADI liquidation and recovery shortfalls) of the contingent liability arising from the explicit guarantees of the FCS is close to zero. Contingent government liabilities are more applicable to the situation where an impending failure of one or more large ADIs leads to implicit guarantees being triggered and government support required to maintain ongoing institution viability and system stability being provided. The size of such contingent liabilities is impossible to estimate with reliability, and depends upon the inherent soundness and supervision of the banking system and willingness of government to enforce losses upon (rather than bail out) various stakeholders in failing institutions. Nevertheless, the size of the costs to a number of governments internationally from actions taken to stabilise their financial systems in the GFC indicates that such contingent liabilities can be substantial.
- While contingent government liabilities from the FCS (rather than from implicit guarantees) are minimal, international observers and ratings agencies need not necessarily understand the specific features that give rise to this. Consequently, the previous absence of an explicit *ex ante* fee for protection of insured deposits is something which has been noted adversely by entities such as the IMF (2012).
- To the extent that the FCS is largely motivated by the desire to ensure ready access to deposit funds to prevent disruption to household and small business activities, the logic for the guarantee to apply to term deposits is not clear. Similarly, the rationale for a deposit guarantee to prevent bank runs is less relevant to the case of term deposits where access on demand is at the discretion of the bank. Whether this suggests that the FCS should be limited to at-call deposits, or whether other term-style products issued by other prudentially regulated institutions should be covered by the FCS is an open question. More generally the FCS needs to be reviewed from a perspective of the merits of providing guarantees to particular types of financial products on a functional basis to ensure that like products are treated equally, rather than on the current institutional basis.
- If the motivation for the FCS is to protect poorly informed / unsophisticated depositors and provide a safety haven for their investments, then the question can be asked of whether all depositors should be provided with a guarantee on amounts up to the deposit cap. Arguably, individuals who pass the test applied by ASIC enabling them to be designated as “sophisticated” investors and able to participate in wholesale market product offerings (or dealing in derivatives) could be excluded from coverage on these

grounds. This logic could be extended to the case of self-managed superannuation funds, whose trustees are assumed to have sufficient financial literacy to make prudent financial decisions regarding their superannuation savings.

There is undoubtedly a case for a review of the structure of the Financial Claims Scheme.

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## *Appendix 1 Financial Claims Scheme for General Insurance*

The Financial Claims Scheme for general insurers was announced on the 2<sup>nd</sup> of June and legislated in October 2008. The FCS covers the claims of eligible policyholders against insolvent APRA regulated general insurance providers. The scheme does not cover policies issued by life insurers. The scheme applies to all claims below \$5,000 and all claims from individuals, small businesses, family trusts and not-for-profit organisations.<sup>26</sup> The scheme has been instated to both ensure the claims of these policy holders against APRA regulated general insurers are upheld and to allow policy holders to receive payment without having to wait for the outcome of an (often lengthy) liquidation process. The FCS only covers claims by policy holders and does not reimburse policy holders for unexpired premiums.

The FCS for general insurers is administered by APRA and funded by the Australian Government. The process for applying the scheme is as follows:

1. APRA must determine that the general insurer is insolvent
2. The finance minister must determine that the FCS will be utilised. (The best resolution for the insolvency is determined to be liquidation)
3. After liquidation any recoverable funds are repaid to the government ex-post. Any shortfall is made up through a levy on the general insurance sector.

As noted in the step 3 above, in the event that the FCS is applied and the value of the Commonwealth Government payouts cannot be recovered through the liquidation process a cost-recovery levy will be administered ex-post to make up any shortfall. The levy can be applied to the entire general insurance industry or a specific class of general insurer as determined by APRA and is charged as a percentage of gross premiums received. The maximum charge is currently 5% of gross premiums received.

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<sup>26</sup> Claims in excess of \$5,000 by medium and large businesses are not covered by the FCS.



## Appendix 2 Deposit Insurance Scheme Price and Coverage: International Comparison

Jurisdiction	Premiums		Assessment Basis	Back-Up Funding
	Risk-based	Rate		
Argentina	Yes	0.015-0.3% 1/	Eligible deposits	Borrow in market and require advanced premium payments
Australia	N/A	N/A	N/A	FCS is a post-funded scheme with no ex-ante fee. Standing appropriation from Parliament for up to A\$20.1 billion per failure (A\$20 billion to meet payout costs and A\$100 million for administrative fees), supported by a power to borrow funds.
Brazil	No	0.0125% of average monthly balances	Covered deposits	Special premiums, advances, loans from private sectors
Canada	Yes	2.8 , 5.6, 11.1, and 22.2 basis points	Covered deposits	It can borrow CAD 17 billion from the Government or markets (the limit increases annually in proportion to the growth in insured deposits). Additional borrowing requires a special Act.
France	Yes		Eligible deposits	Borrowing in market and additional premiums
Germany	Yes	0.016%	Liabilities of protected depositors	Extraordinary contributions from institutions; borrowing in market
Hong Kong	Yes	0.0175-0.049%	Covered deposits	Stand-by credit facility of HK120 billion (US\$15.4 billion) from the Exchange Fund
India	No	0.1%	Eligible deposits	RBI supplementary financing INR 50 m
Indonesia	No	0.2%	Average monthly deposits	Government lending facility and recapitalization facility
Italy	N/A	N/A	N/A	
Japan	No		Eligible deposits	Borrowing from central bank, in market or issuing bonds
Korea	No		Eligible deposits	Borrowing from the market, or issuing bonds, borrowings from the government or the central bank
Mexico	No	0.4%	A proxy of total bank liabilities	Ability to impose extraordinary premiums up to 0.3% of total bank liabilities; the sum of ordinary and extraordinary premiums must not exceed 0.8 % of total bank liabilities. Borrowing up to 6 %, every three years, of total bank's liabilities.
Netherlands	N/A	N/A	N/A	The central bank apportions costs ex-post over the banks.
Russia	No	0.1% of average quarterly balances (~0.4% annually)	Eligible deposits	Bond issuance, authority to temporary increase premiums by 0.3% (per quarter); unlimited federal budget support
Singapore	Yes	0.02-0.07%	Covered deposits	Private sources or central bank
Spain	Yes	0.002 basis points	Eligible deposits	Central bank can provide funding but requires passage of a law

Switzerland	No			Banking sector sources; all banks are members. They are required to hold 50% of their contingent liability in liquid assets. The DIA can borrow from the market.
Turkey	Yes	11, 13, 15, or 19 basis points; 1-2 additional basis. Points may be imposed based on a firm's size	Insured deposits	Advance payments from banks can be sought; may borrow from the Treasury, central bank may give advances
United Kingdom	N/A	N/A	N/A	The initial primary source of funding for the FSCS is levies on other deposit takers. The FSCS can also borrow from the market, and has the ability to apply to the National Loans Fund for support.
United States	Yes	2.5 - 45 basis points	Average consolidated total assets minus average tangible equity	\$100 billion line of credit from Treasury. Authority to borrow from Federal Financing Bank, Federal Home Loan Banks and insured depository institutions

Source: Financial Stability Board, *Thematic Review on Deposit Insurance Systems*

**Appendix 3 Deposit Insurance Scheme Caps: International Comparison (Coverage Levels as of year-end 2010)**

Jurisdiction	Deposit Coverage Level (US\$)	Total Domestic Deposit Base (US\$ billion)	Deposit Value (% of total)		Number of Fully Covered Eligible Depositors / Accounts (% of total)	
			Eligible	Covered	Depositors	Deposit Accounts
Argentina	7,545	95	N/A	29	N/A	94.9
Australia	1,016,300	1,336	95	61	N/A	>99
Brazil	42,000	933	77	22	98.9	N/A
Canada	100,000	1,803	64	35	N/A	97
France	136,920	1,742	92	67	N/A	N/A
Germany	136,920	3,395	~40	N/A	N/A	N/A
Hong Kong	64,000	877	98	20	90	N/A
India	2,240	1,166	95	33	N/A	92.9
Indonesia	235,294	279	90	61	N/A	99.9
Italy	136,920	2,050	45	31	55.1	N/A
Japan	122,775	11,101	90	71	NA	98.9
Korea	43,902	951	68	27	95.4	N/A
Mexico	146,606	178	100	58	N/A	99.9
Netherlands	136,920	1,202	59	48	80	N/A
Russia	23,064	692	47	32	96.5	99.7
Singapore	38,835	456	70	19	91	N/A
Spain	136,920	1,963	65	47	64.1	N/A
Switzerland	96,830	1,481	73	24	N/A	N/A
Turkey	32,341	399	59	25	86.5	88.7
United Kingdom	133,068	N/A	N/A	N/A	N/A	98
United States	250,000	7,888	100	79	N/A	99.7

Source: Financial Stability Board, Thematic Review on Deposit Insurance Systems

#### *Appendix 4: The Financial Claims Scheme and Portfolio Choice*

The FCS effectively converts “risky” bank deposits into “risk free” deposits for retail savers and investors and consequently can be expected to affect the portfolio decisions of individuals affected. The effects may be felt along the entire spectrum of risky assets and not just very close substitutes for bank deposits – although the effects are likely to be stronger for close substitutes.

The figure below illustrates in a simple context where it is assumed that initially investors have investment possibilities of a risky bank deposit (A), another risky asset (B) and a risk free asset (O). The risky asset portfolio frontier they face is the curved line (AB) and their overall investment frontier (including the risk free asset) is OC.<sup>27</sup> As depicted, given their risk return preferences they initially choose portfolio Y.

Following the introduction of a guarantee on bank deposits, it is assumed that the return paid on bank deposits declines to the risk free rate (they become equivalent to the risk free asset, ie point A disappears), such that the choices available to the investor lie along the straight line OB. The investor choice is now at point X, involving a different risk return allocation and allocation to risky assets.

As drawn the investor now has lower utility, but this is purely an result of implicit assumptions about the pre- and post- guarantee expected returns on bank deposits and asset return correlations. Different assumptions would yield different results – including higher utility. Moreover, this is a partial equilibrium analysis, and the assumptions that the expected return on risky assets is unchanged, the risk free rate is unchanged, and that risky bank deposits pay a higher return than the risk free rate, may be inappropriate.

However, the objective of this analysis is not to predict likely changes, but simply to illustrate that it is not just investor choices regarding risk-free or near-risk-free assets which may be affected by the introduction of a guarantee on bank deposits. The entire risk return trade-off facing retail investors is affected such that portfolio decisions involving all risky assets may be affected.

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<sup>27</sup> The frontier AB is curved to reflect less than perfect correlation of returns of the two risky assets, and OC is the line from O tangential to AB, which indicates the best available risk-return combinations. The convex dotted curves represent investor indifference curves trading off expected return for risk.

Expected Return

