



Credit Union
Industry Association

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Dr Philip Lowe
Assistant Governor
Reserve Bank of Australia
GPO Box 3947
SYDNEY NSW 2001

Dear Dr Lowe

Financial Claims Compensation Scheme Submission from Credit Union Industry Association (CUIA)

Thank you for the opportunity to meet in December 2005 with yourself and representatives of Treasury and APRA regarding the Council of Financial Regulators proposals to introduce a compensation scheme for deposit and policy holders. Further to our meeting, CUIA is pleased to provide our comments on the proposed Financial Claims Compensation Scheme below.

Background

The Credit Union Industry Association (formerly the CUSCAL Industry Association) is the peak industry body for the vast majority of Australia's 156 credit unions. Credit unions are a significant part of the financial services industry with 3.5 million members and combined assets of more than \$34 billion.

As you know, CUIA and credit unions have been actively involved in the debate surrounding the introduction of deposit insurance for Authorised Deposit-Taking Institutions (ADIs). As for our previous submissions, our comments in this letter are confined to the ADI sector – other than in relation to avoiding cross-sectoral levy subsidies (see below), we have limited views on the merits of a compensation scheme in regard to the insurance sector.

In our August 2004 submission to the Government, CUIA and credit unions maintained that there was no strong argument for the introduction of deposit insurance for ADIs due to the fact that:

- ADIs in Australia operate in a highly regulated environment and are prudently managed;
- credit unions have a strong history in successfully safeguarding member deposits;
- depositors are well protected by the operation of a strong prudential framework, together with the depositor priority provisions in the *Banking Act* 1959 and the role and impact of industry liquidity support schemes such as CUFSS.

Our submission made clear however that if a deposit guarantee scheme was established, credit unions and CUIA favour a scheme that is post-event funded, universal, and limited and explicit in terms of coverage.

THE CURRENT PROPOSAL

The current proposal is largely consistent with the position noted in our 2004 submission on parameters Government should consider, if mandating a compensation scheme. For simplicity, this submission will deal with our sector's issues in two parts, being, firstly, the question of the need for a scheme and who should pay, and secondly, the appropriate design features of a financial claims compensation scheme.

The Need for Deposit Insurance

As noted by the Davis Report, Australia is not immune from the failure of financial institutions. It is also clear that in some cases those failures have had significant impacts on taxpayers and the community. In some cases, such as the failure of HIH, the impact of the failure has not been limited to the financial sector but had widespread and long term impacts on other industries as well.

Notwithstanding these failures, it appears from earlier submissions to Government and from our meeting that there is broad agreement within the ADI sector and amongst regulators that the likelihood of failure of an ADI remains reasonably low. Further, there appears to be consensus that, even if there was a failure of an ADI, there is an even lower likelihood that there would be a shortfall of assets to meet its obligations to depositors.

There also appears to be widespread confidence in APRA's ability to detect and if required manage the risk of failure in financial institutions. As noted in the Davis Report, APRA's powers are extensive and include the ability to give directions to ADIs, appoint an external administrator, require a transfer of business or wind up and ADI. APRA will soon also have a range of powers to remove directors and senior managers under the new corporate governance regime.

Listed ADIs are also clearly subject to the listing and disclosure requirements of the Australian Stock Exchange.

In addition to APRA's role, credit unions have also established an APRA-approved industry liquidity support scheme, the Credit Union Financial Support Scheme (CUFSS). CUFSS is owned by the majority of Australia's credit unions and was established to protect members of participating credit unions and to promote financial sector stability. CUFSS achieves these objectives through monitoring credit unions' liquidity, capital and profitability, providing liquidity support to member credit unions in certain circumstances, assisting the orderly exit of credit unions (through merger or transfer of engagements with other ADIs) and providing advice on liquidity and risk management. We understand that CUFSS has made a separate submission to the RBA in relation to the proposed scheme.

These regulatory arrangements for ADIs and the work of CUFSS in the case of credit unions do not guarantee against a failure of an ADI. However, they do ensure that the risk is very low and that the extent of any losses in the event of a failure is minimised.

Accordingly, credit unions and the CUIA remain of the view that no strong case has been made for the introduction of a deposit insurance scheme.

Who would benefit from the proposed scheme?

Given the extremely low likelihood of actual losses for depositors in the event of a failure of an ADI, there are only two potential benefits of the proposed scheme:

- to limit the impact of any liquidity runs on financial institutions, and
- to provide temporary relief to retail depositors who otherwise would have to wait some time to have their deposits refunded.

Preventing runs on financial institutions

There is some risk that the failure of an ADI would result in short term instability in the ADI sector. This has been the case in the past in respect to bank and non-bank failures (outside the credit union sector), eg in South Australia and Victoria.

Clearly if the proposed scheme was to provide an ameliorating effect on the impact of these liquidity runs, it could be argued that this would be a benefit to the ADI sector.

However, in our view, there are serious questions about the ability of the proposed scheme to have any significant effect on liquidity crises caused by failures of another institution, most particularly given the concentration of the ADI sector in Australia. For example, if one of the major banks failed, the flow-on effects for all other ADIs would be significant and the impact on the broader economy disastrous. A guarantee for small retail deposits may have some lessening effect on liquidity runs but would have little impact on institutional depositors and lenders and investors¹. These groups could all fundamentally impact either the liquidity or revenues/costs of the remaining major banks to the extent that those institutions would also become vulnerable. Clearly in the event of the collapse of a major bank, explicit Government intervention would be required well beyond the protections envisaged by the proposed compensation scheme.

Further, in the event of a catastrophic collapse of a major bank, the potential long term impacts on the remaining ADIs that would be responsible for compensating retail deposit losses would be debilitating, particularly for mutual institutions that rely on retained earnings for capital and growth.

In relation to credit unions, the likelihood of collapse is low and the threat of the spread of liquidity runs to other ADIs is low. Further, the credit union sector already has a liquidity crisis management scheme in place, so the potential benefit to the sector is minimal.

In our view, there is little benefit for credit unions and their members from the proposed scheme and accordingly, we cannot support a scheme where the burden for the failure of other institutions ultimately falls upon credit union members.

Temporary relief for retail depositors

Notwithstanding our view that the collapse of an ADI is very unlikely, CUIA and credit unions understand the advantages that may accrue from having a clear mechanism for the temporary relief for retail depositors caught by the failure of an ADI. The Government already plays a significant role in the provision of emergency or interim relief to the community (eg during and after natural disasters).

It is not clear however why the ultimate responsibility for covering the cost of this temporary relief should fall on regulated institutions such as ADIs. The beneficiaries of any relief or compensation scheme are the general community and the Government itself, not the regulated institutions.

It is our clear view therefore that if a compensation scheme is to be introduced, then any costs arising from that scheme are rightly borne by the Government, and therefore the taxpayer, rather than placing the burden, once again, on the regulated ADI sector.

This is particularly important for mutual credit unions where our customers are also our owners. As organisations driven by member services rather than profit, credit unions would need to pass on the costs of any compensation scheme directly to its members. It is

¹ For example, the Davis Report noted that retail deposits represented only 53% of total deposits held by major banks. A scheme covering retail deposits will have no impact on the volatility of these deposits in a financial crisis.

inequitable in our view that the cost of a failure of another ADI should fall upon this limited group of people. Inequitable in the sense that mutual members would bear more of the burden (eg for other ADIs, the costs may be borne by customers and/or shareholders) and inequitable in the sense that the benefit of the compensation scheme accrues to the community in general. Accordingly, the cost responsibility should be borne by that community rather than a limited and specific sector of the financial services industry.

Appropriate Design Features of a Compensation Scheme

Overview

In the event that a compensation scheme is to be introduced, CUIA and credit unions support a post-event funded, limited and explicit scheme. In our view, participation in the scheme should be compulsory for all regulated institutions providing the products proposed to be covered by the scheme.

More detailed comments on specific design elements of the scheme are provided below.

Cross-sectoral subsidies

It is critical that any compensation scheme rule out the possibility of cross-sectoral subsidies. The nature of the ADI sector and its financial promises on deposit products are vastly different to those of the insurance and other regulated sectors.

The Davis Report provided important analysis of the composition of household wealth. That Report showed that deposits with ADIs represented only 6.1% of total household wealth with the vast majority of wealth held in asset categories with market risk exposures (ie predominantly real property, shares and superannuation)².

The Davis Report also noted the vast differences in household exposures to deposits as opposed to the level of insured assets. Based on the Report, 80% of households had less than \$60,000 in deposits whilst the average value of assets protected by household insurance policies was more than \$200,000³ and the average value of life insurance policies was \$235,000.⁴

Accordingly, given the differences in the size and timeframe of exposures in the regulated insurance sector as opposed to the ADI sector, it is appropriate that any proposed compensation scheme have separate schemes for each regulated sector. In our view, the ADI sector should only be responsible for losses incurred within the ADI sector.

Maximum Coverage Limits

We note the scheme proposes a low maximum payout limit and suggests \$50,000 is appropriate. Credit unions and CUIA support the establishment of a maximum limit but believe that it should be set having regard to a number of factors, including:

- the principal purpose of the scheme, being to relieve immediate financial hardship,
- the existing levels of retail deposits, and
- the potential anti-competitive facets of a compensation scheme.

As noted above, one of the principal drivers of the compensation scheme is to provide immediate relief from financial hardship for retail depositors with the failed institution. This occurs by giving those depositors access to funds immediately that otherwise may take some time to recover. The scheme is not, and should not be, designed to eliminate risk.

² http://fsgstudy.treasury.gov.au/content/Davis_Report/07_Chapter5.asp

³ http://fsgstudy.treasury.gov.au/content/Davis_Report/02_Executive_summary.asp

⁴ http://fsgstudy.treasury.gov.au/content/Davis_Report/07_Chapter5.asp

Accordingly in our view, the proposed maximum limit of \$50,000 is too high. As noted in the Davis Report, more than 60% of households have deposits of less than \$15,000. CUIA's own analysis suggests that more than 95% of members have deposits of less than \$50,000. However the remaining depositors hold more than 65% of household deposits by value across the credit union sector.

These figures suggest that the primary objectives of the proposed scheme are being exceeded with the vast majority of depositors having access to full compensation. Whilst this may on the one hand be a highly satisfactory outcome for credit union members, it is unlikely to be competitively efficient and may in fact distort the market. By setting a limit too high, the scheme may in fact encourage splitting of deposits across institutions thus having a negative impact on competition and creating moral hazard issues. A lower maximum cap would ameliorate this impact for practical and commercial reasons (eg a depositor may be prepared to split a \$100,000 deposit into two \$50,000 deposits but not ten \$20,000 deposits due to the administrative costs and interest rate costs).

In the event that a scheme is introduced, we are strongly of the view that it should be designed to protect the most vulnerable members of the community and provide immediate short term relief. It appears to us that a limit closer to \$20,000 would be effective in this regard, particularly given the high likelihood that depositors would receive the balance of their deposits upon winding up of the ADI.

Coinsurance

CUIA notes the Council's comments regarding co-insurance and it proposed 10% co-insurance premium. Whilst supporting this level of co-insurance in the event that coverage limits are high, it is probably unnecessary and overly harsh on vulnerable members in the event that the coverage limit is at the lower level suggested above.

Funding principles and levy arrangements

In the event that a scheme is introduced, credit unions consider the appropriate funding basis is one which draws most fairly on beneficiaries (ie the general community).

In the event that Government were to mandate an industry funded scheme, CUIA prefers in principle the initial funding, repayment of scheme liabilities, the proposed recoverable costs and funding pool arrangements as outlined in the Council's paper.

In relation to the levy base, we note the Council's recommendation that the levy base for ADIs would be based on covered liabilities on a flat rate basis. It is not clear how the scheme intends to calculate the levy base, however CUIA and credit unions would support a levy based on the "share of wallet" subject to a few important conditions:

- that the calculation of the levy based is determined according to data already collected by APRA and does not require further compliance or data collection from ADIs;
- that a maximum levy is established in any one year proportionate to the size of the ADI so as to prevent financial hardship in the event of the failure of a very large ADI.

Governance and other issues

The proposal to make APRA responsible for the proposed scheme is supported – APRA clearly already has a role in supervising relevant institutions and collects data that would allow it to administer the scheme effectively. However, in our view, the administration of the proposed scheme should not require an additional administrative levy from ADIs in the first instance and should incur little or no costs until such time as an ADI failed.

In addition, care should be taken when designing the legislative and other framework for any scheme that the compliance requirements for ADIs are not significant. Indeed it would be preferable that there be no additional compliance requirements for ADIs as a result of the implementation of the scheme.

Prudential matters

CUIA and credit unions are also of the view that ADIs should not be required to hold any general provision or reserve for prudential purposes against contingent liabilities arising from the scheme.

Conclusion

As stated above, credit unions and the CUIA still believe that no strong case exists for the establishment of a deposit insurance system.

However, should the Government decide to proceed with the implementation of a compensation scheme, it is our view that the scheme should be funded from consolidated revenue rather than an industry specific levy.

It is also important that that scheme include the following characteristics:

- low limited and explicit guarantees;
- compulsory participation for all regulated institutions in the ADI and insurance sectors;
- the scheme should be administered by APRA;
- zero or minimal compliance impact on regulated institutions.

In the event that the Government decides to levy industry for the costs of the scheme, then the scheme should:

- be post-event funded;
- have no cross-sectoral subsidies;
- comprise proportional levies based on market share and with the annual maximum levy caps to reduce impact on remaining institutions;

Thank you again for the opportunity to comment on the proposed scheme. If you have any further questions in relation to this submission, please contact me on (02) 8299 9053 or mdegotardi@cuscal.com.au .

Yours sincerely,



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