

# Depositor Protection in Australia

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Depositors in authorised deposit-taking institutions (ADIs) in Australia benefit from a number of layers of protection designed to ensure that their funds are safe. At the broadest level, Australia has a strong system of prudential regulation and supervision which, together with sound management at individual institutions, has meant that problems in ADIs have been rare. In addition, depositors benefit from strong protections in the unlikely event that an ADI fails. They have a priority claim on the assets of a failed ADI ahead of other unsecured creditors, known as ‘depositor preference’. Depositor protection arrangements were further strengthened in 2008 with the introduction of the Financial Claims Scheme (FCS), under which the Australian Government guarantees the timely repayment of deposits up to a predefined cap. This cap was temporarily set at \$1 million per person per ADI when the FCS was introduced and is scheduled to be set on a permanent basis at \$250 000 per person per ADI from 1 February 2012.

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## Introduction

An essential feature of a well-functioning financial system is its ability to channel funds from savers to borrowers. Banks and other deposit-taking institutions provide this function by accepting deposits and issuing debt into capital markets, and then lending these funds on to borrowers, typically at longer maturities. For this process of financial intermediation to work effectively, depositors and other creditors need to have a sufficient degree of confidence that their funds are safe. In the absence of depositor confidence, there is a heightened risk of deposit runs and contagion to other institutions given the limited scope for most depositors to differentiate between safe and unsafe banks. Confidence in the banking system is therefore important for financial system stability and, to this end, governments and regulatory authorities put in place various legal and regulatory arrangements to support confidence among bank creditors that their funds are secure.

There are a number of reasons why authorities may seek to provide greater protection to depositors than to other creditors of banks. First, deposits are a critical part of the financial system because they facilitate economic transactions in a way that wholesale debt does not. Second, they are a primary form of saving for many individuals, losses on which may result in significant adversity for depositors who are unable to protect against this risk. These two characteristics also mean that deposits are typically the main source of funding for banks, especially for smaller institutions with limited access to wholesale funding markets. Third, non-deposit creditors are generally better placed than most depositors to assess and manage risk. Providing equivalent protection arrangements for non-deposit creditors would weaken market discipline and increase moral hazard.

This article describes the various layers of protection for depositors of Australian ADIs: the governance and risk management arrangements within ADIs themselves; prudential regulation and supervision of ADIs by the Australian Prudential Regulation Authority (APRA); the FCS, under which the Australian Government guarantees the timely repayment of

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deposits in Australian ADIs up to a predefined cap; and depositor preference.<sup>1</sup>

## Governance and Risk Management at ADIs

Boards and senior management are ultimately responsible for the financial safety and soundness of the financial institutions that they manage. Central to this responsibility is the need to ensure the institution is able to meet its financial commitments to its depositors, non-deposit creditors and other stakeholders on an ongoing basis. To maintain the soundness of their institution, stakeholders expect boards and senior management of ADIs to put in place structures and policies for risk management, internal controls and incentives that are commensurate with the institutions' complexity and risk profile.

Risk management involves identifying, measuring, monitoring and managing the key risks facing the ADI. ADIs are exposed to a number of different types of risks, including credit risk, liquidity risk, market risk and operational risk. A critical aspect of an ADI's risk management is its assessment of its capital needs based on its risk profile. An ADI's capital, broadly defined as its assets minus liabilities, acts as a buffer against unexpected losses and thereby helps protect depositors and other creditors. An appropriate internal capital buffer should, at a minimum, allow an ADI to withstand severe adverse shocks to its operations without imposing losses on its creditors, and thereby enable it to continue operating as its problems are addressed. Risk management also encompasses a self-assessment of liquidity needs given an ADI's own liability profile. ADIs need to manage their liquidity risk carefully because their intermediation activities normally expose them to

maturity mismatches. An ADI should have enough liquidity to be able to meet its obligations (including deposit liabilities) as they fall due in a range of circumstances, including under stressed conditions.

Poor governance and deficient risk management practices prior to the 2008–2009 financial crisis were central to many recent cases of bank distress in the major advanced economies. Boards and senior management of some banks did not effectively establish or adhere to an acceptable level of risk, or have in place structures that adequately monitored and managed risk (Senior Supervisors Group 2009). Moreover, executive compensation practices in many of those banks encouraged excessive risk-taking that may have been in the short-term interests of some executives and shareholders, but was not in the broader interests of depositors, other creditors or stakeholders.

Australian banks did not have such governance problems or risk management deficiencies in the period leading up to the financial crisis; this was one of the factors that contributed to the resilience of the Australian banking sector during this period. Nonetheless, Australian banks and other local ADIs have been strengthening their governance and risk management arrangements in light of the crisis, including in the areas of board oversight of risk policies, funding risk management and stress testing practices.

## Regulation and Supervision of ADIs

Although boards and senior managements have primary responsibility for maintaining the soundness of ADIs, the capital buffers and risk management practices that they might choose in the absence of regulation may not fully account for the risks that they pose to depositors, the financial system and the economy. As with any firm that is leveraged and where shareholders have limited liability, ADI shareholders and executives receive asymmetric returns, involving substantial upside and limited downside. Furthermore, their risk management

<sup>1</sup> Authorised deposit-taking institutions (ADIs) include domestically owned banks, foreign-owned bank subsidiaries, foreign-owned bank branches, credit unions and building societies licensed by APRA to operate in Australia. The term 'Australian ADI' used in this article includes all ADIs except foreign-owned bank branches. Foreign-owned bank branches are not incorporated and capitalised in Australia, and are referred to as 'foreign ADIs'.

decisions will have effects beyond their own institutions. It is for this reason that authorities have widely established systems of prudential regulation and supervision that aim to ensure that deposit-taking institutions are able to honour their financial promises, including to depositors.

APRA is charged with the prudential regulation and supervision of ADIs in Australia.<sup>2</sup> Its mandate in relation to ADIs is to ensure that, under all reasonable circumstances, they meet their financial promises to depositors, within a stable, efficient and competitive financial system. This clearly defined mission helps ensure that APRA is not distracted, or conflicted, by other objectives, such as consumer protection or anti-money laundering work (Laker 2010).

APRA is responsible for the authorisation of institutions to carry out banking business in Australia, including the business of taking deposits and making loans. Authorised institutions that are locally incorporated and capitalised (that is, Australian ADIs) are able to accept deposits without restriction. However, foreign-owned banks operating in Australia via a branch (that is, foreign ADIs), which are not locally incorporated and capitalised, are prohibited from accepting initial deposits of less than \$250 000 from individuals and non-corporate institutions in Australia. This restriction provides additional protection to smaller retail depositors by ensuring that their funds are backed by capital in Australia.

ADIs must comply with various prudential standards set by APRA, which include standards in relation to acceptable governance, risk management and internal control arrangements. Locally incorporated ADIs are also subject to prudential standards that specify a minimum capital requirement depending on their risk profile. APRA's current risk-based capital requirements are based on the internationally agreed Basel II capital standard, although with a more conservative approach in several areas than

is required under the Basel II framework. APRA will be adopting the more rigorous Basel III international bank capital standard from 2013.<sup>3</sup>

In addition to setting prudential standards, APRA is also tasked with supervising ADIs. Supervision involves continuous monitoring and oversight of ADIs' behaviour to ensure that they comply with prudential standards, are in a sound financial condition and maintain effective governance and risk management systems. APRA follows a proactive and risk-based approach under which institutions that pose greater risks receive more intensive supervision. Although APRA has developed a constructive relationship with the ADI industry that helps it achieve its supervisory objectives through regular dialogue and consultation, it is able to respond to risks through direct intervention if necessary. For example, reflecting risks within individual institutions, APRA often imposes minimum prudential capital requirements for individual ADIs beyond the minimum requirements of the Basel II framework.<sup>4</sup>

APRA also has a wide range of legislated powers that enable it to take direct action if it identifies behaviour or financial distress that may threaten an ADI's ability to meet its financial obligations to depositors, or otherwise threaten financial system stability. These include powers to: obtain information from an ADI; investigate an ADI; give binding directions to an ADI (such as to recapitalise); and, in more extreme circumstances, appoint a statutory manager to assume control of a distressed ADI. It also has the power to prevent an Australian branch of a distressed foreign-owned ADI from moving assets

<sup>2</sup> APRA is also responsible for regulating and supervising insurance companies, friendly societies and most superannuation funds.

<sup>3</sup> The new Basel III capital standard sets out internationally agreed minimum requirements for higher and better-quality capital for banks and other deposit-taking institutions, better risk coverage and a new (non-risk-based) leverage ratio. It also includes measures to promote the build-up of capital that can be drawn down in times of stress. APRA (2011) has recently issued a consultation paper on the implementation of Basel III capital reforms in Australia.

<sup>4</sup> For a more detailed discussion of APRA's approach to supervision, see Byres (2011).

out of, or liabilities into, Australia.<sup>5</sup> The existence of these powers and APRA's willingness to use them (though it has rarely had to do so) means that they can be effective in controlling behaviour without needing to be regularly deployed.

APRA's depositor protection mandate is also supported by the activities of the other main financial regulatory bodies in Australia. The Australian Securities and Investments Commission (ASIC) plays an indirect role in protecting depositors by setting standards around the sale and distribution of deposits and other financial products and services provided by ADIs under Financial Services Licences, and by enforcing standards set by the *Corporations Act 2001* for the behaviour of boards and senior executives of financial institutions. The Reserve Bank of Australia (RBA) has an overarching mandate to promote financial stability, including through its role in providing liquidity support to ADIs as part of its market operations, and as regulator of the payments system. More generally, the Council of Financial Regulators (the Council) – a non-statutory body comprising APRA, ASIC, the RBA and the Australian Treasury – is a forum for these agencies to share views and coordinate policy actions aimed at ensuring the safety and efficiency of the financial system.

## Depositor Protection and Failure Resolution

Strong prudential regulation and supervision, and sound management at individual institutions, have meant that ADI failures in Australia have been very rare. A few smaller institutions failed in the late 1980s and early 1990s during a period of stress in the banking system that followed financial deregulation in the mid 1980s, but these failures were resolved without loss to depositors.<sup>6</sup>

In addition to this low failure rate, Australian depositors benefit from strong protections in the unlikely event that an ADI does fail. The principal mechanism for depositor protection has historically been the preferred status granted to Australian depositors over other unsecured creditors in the event of the insolvency of an Australian ADI. This legislative provision is referred to as 'depositor preference'. Depositor protection arrangements were considerably strengthened with the introduction of the FCS in 2008, under which the Australian Government guarantees the prompt repayment of deposits at a failed Australian ADI up to a specified cap (see below). Further details of the development of these depositor protection arrangements are provided in Box A.

5 These powers were all in place prior to the 2008–2009 financial crisis, although some have been strengthened over the past few years. In 2008, APRA's statutory management powers were widened to enable it to appoint a manager to an ADI prior to it becoming insolvent, and in 2010 APRA was explicitly provided with the power to direct an ADI to recapitalise.

6 These failures included the State Banks of Victoria and South Australia, and Pyramid Building Society, which at the time was the second largest building society in Australia. The most recent failure in which Australian depositors lost some portion of their deposit balances (and then only a minimal amount) was in 1931, the Primary Producers Bank of Australia (Davis 2004 and Fitz-Gibbon and Gizycki 2001). For a history of ADI failures prior to the introduction of prudential regulation and supervision in 1945, see Fitz-Gibbon and Gizycki (2001).

## Box A

## A History of Depositor Protection Arrangements in Australia

The principle of depositor protection in Australia was first enshrined in the *Banking Act 1945*. The legislation specified depositor protection as a function of the central bank (then the Commonwealth Bank of Australia) in accordance with its responsibility for prudential regulation of banks and the resolution of distressed banks (Cornish 2010). The *Banking Act 1959* transferred these responsibilities to the RBA upon its establishment as Australia's dedicated central bank. The RBA interpreted its depositor protection responsibility broadly to mean using its available powers in the interests of protecting depositors' funds, rather than implying that it should provide a blanket guarantee or protection against all failures (RBA 1997).

Depositor preference was also introduced in the *Banking Act 1945* but initially applied only to depositors in banks. The provision was extended to depositors in all Australian ADIs in 1998 following a recommendation from the Financial System Inquiry (1997). In addition, the responsibilities for prudential regulation and depositor protection were transferred from the RBA to APRA and broadened to encompass all ADIs, in accordance with the Inquiry's recommendations. Depositor preference arrangements were subsequently altered in 2008 upon the introduction of the FCS.

The number of countries providing explicit financial protection for depositors expanded noticeably in the 1980s and 1990s, partly in response to numerous banking crises internationally (Garcia 1999). There was little impetus to follow other countries in this regard given Australia's low rate of banking failure. As a result, apart from New Zealand, Australia was the

only industrialised country not to have introduced a deposit insurance scheme by the mid 1990s (Kyei 1995).

In considering the case for introducing deposit insurance in Australia, the Financial System Inquiry (1997) came to the view that, on balance, the existing regime of depositor preference on liquidation provided greater protection for depositors. This reflected concerns that introducing deposit insurance could weaken incentives to monitor and manage risk. However, in 2005, following a comprehensive review of Australia's failure and crisis management arrangements which drew on *Study of Financial System Guarantees* (Davis 2004), the Council of Financial Regulators recommended that the Government introduce a limited mechanism to provide depositors and general insurance policyholders with access to their funds on a timely basis. The Council's rationale was that the lengthy nature of the wind-up process for a failed institution could create financial hardship for households and businesses if they could not access their funds in the meantime (Australian Treasury 2005). If that occurred, the Government would be under pressure to make an ad hoc response, as was demonstrated by the failure of the general insurer HIH in 2001.

The international financial stress that began to emerge in 2007 gave added impetus to the Council's previous analysis that Australia's crisis management arrangements for depositors should be enhanced. In late 2007 the Council recommended that the Government establish a facility to provide prompt repayment of up to \$20 000 per depositor per institution; such a facility was also recommended

to the previous Government (RBA 2008). In June 2008, the Government announced that it would introduce legislation to establish a 'Financial Claims Scheme' (FCS) along these lines. In the event, the collapse of Lehman Brothers later in 2008 triggered an intensification of the international crisis, which needed to be taken into account in the implementation of the FCS and the temporary wholesale guarantees that were also introduced.

To reassure depositors and investors, and ensure Australian ADIs were not disadvantaged in their access to wholesale funding markets relative to banks in other countries, the Australian Government introduced guarantee arrangements for ADI deposits and wholesale funding in October 2008. The FCS provided a guarantee of deposit balances at Australian ADIs, up to a cap that was initially set at \$1 million per depositor per institution, based on the aggregated deposits held in the name of each account-holder.<sup>1</sup> No fee was charged for this guarantee. Deposit balances greater than \$1 million and wholesale funding instruments with a maturity of 5 years or less were eligible for a temporary government guarantee, for a fee, under a separate

Guarantee Scheme (GS) for Large Deposits and Wholesale Funding. Unlike the FCS, the GS was available, with some restrictions, to branches of foreign-owned banks. These two schemes were successful in supporting confidence in ADIs and ensuring they had continued access to funding during the global financial crisis, and therefore supported financial system stability and the flow of credit to the economy (RBA and APRA 2009).

The GS was closed to new funding liabilities in March 2010, by which time funding conditions had substantially recovered. The value of outstanding large deposits and wholesale funding covered by the GS has since been declining. In October 2011 there were \$118 billion of guaranteed large deposit and wholesale funding liabilities that were due to run off over the next four years.<sup>2</sup>

When the FCS was introduced, the Government committed to reviewing the Scheme's settings by October 2011. In December 2010, the Government confirmed the FCS as a permanent feature of the Australian financial system and changes to aspects of the Scheme's settings were announced in September 2011 (discussed below).

<sup>1</sup> At the same time the Government also established a separate scheme for general insurers, the FCS Policyholder Compensation Facility. Further details on this scheme are available on APRA's website.

<sup>2</sup> In regard to large deposits, \$3.4 billion was guaranteed under this scheme in October 2011, representing only 0.2 per cent of ADIs' total deposit liabilities. More details on the GS, including a discussion of its closure, are available in Schwartz (2010).

## The Financial Claims Scheme

The FCS is a form of deposit insurance that provides depositors with certainty that they will quickly recover their deposits (up to the predefined cap) in the event that an Australian ADI fails.<sup>7</sup>

The FCS is administered by APRA and operates as follows.

- The Scheme is activated at the discretion of the Australian Treasurer where APRA has applied to the Federal Court for an ADI to be wound up. This can only be done when APRA has appointed a statutory manager to assume control of an ADI and APRA considers that the ADI is insolvent and could not be restored to solvency within a reasonable period.
- Upon its activation, APRA aims to make payments to account-holders up to the level of the cap as quickly as possible – generally within seven days of the date on which the FCS is activated.
- The method of payout to depositors will depend on the circumstances of the failed ADI and APRA's assessment of the cost-effectiveness of each option. Payment options include cheques drawn on the RBA, electronic transfer to a nominated account at another ADI, transfer of funds into a new account created by APRA at another ADI, and various modes of cash payments.

When the FCS was introduced at the height of the global financial crisis, the Government committed to reviewing a number of aspects of the Scheme's initial settings by October 2011. To support this review, the Council undertook an assessment of whether the initial structure of the FCS was suitable for the post-crisis environment. Its advice informed the Government's revised arrangements, which were subject to a public consultation process prior

to being announced in September 2011. The main feature of the revised arrangements for the FCS is the reduction in the level of the cap from \$1 million to \$250 000 per person per ADI from 1 February 2012. Term deposits that existed on 10 September 2011 (the day before the revised arrangements were announced) will continue to be covered by the old cap until 31 December 2012 or until the maturity of the term deposit – whichever occurs sooner. Despite the reduction in the cap, it is estimated that the FCS will still cover around 99 per cent of deposit accounts in full, and about 50 per cent of eligible deposits by value. For household deposits, the estimated proportion of the value of balances covered is higher, at about 80 per cent. The revision to the FCS cap in Australia is consistent with developments internationally, with a number of other governments having taken the decision to change their deposit insurance limits to more appropriate post-crisis levels. At \$250 000 per person per ADI, the revised FCS cap is still at the higher end of the range of post-crisis deposit insurance caps relative to per capita GDP (Table 1).<sup>8</sup>

The Government also announced that it intends to make a number of legislative changes to the existing FCS framework to improve its effectiveness. These include: the removal of coverage of deposits in foreign branches of Australian-owned ADIs; enabling an additional payment option which would allow APRA to transfer deposits of a failed ADI to another institution; establishing a 'look-through' mechanism for deposits in pooled trust accounts; and enabling

<sup>7</sup> Deposit accounts that are eligible for coverage under the FCS, and are also protected by depositor preference, are those which meet the definition of 'protected accounts' in the *Banking Act 1959*. They include a wide range of deposit products offered by ADIs, such as transaction accounts, cheque accounts, savings accounts, term deposits, debit card accounts, cash management accounts and farm management accounts.

<sup>8</sup> However, at least two countries – Canada and the United States – allow depositors with funds in certain different deposit products to be eligible for more than one payment up to the cap per institution, which alters the comparison in these cases. Moreover, the United States has granted temporary unlimited insurance on non-interest bearing transaction accounts at Federal Deposit Insurance Corporation (FDIC) insured institutions until the end of 2012. Comparisons of coverage between the FCS and equivalent schemes elsewhere are also affected by differences in the eligibility of certain types of deposits. For example, a number of countries provide coverage of foreign currency deposits. In contrast, in Australia, one of the changes made in the revised FCS arrangements is that deposits denominated in foreign currency are no longer covered.

**Table 1: Deposit Guarantee Arrangements – Selected Jurisdictions**

	Deposit cap		Coverage		Funding <sup>(f)</sup>	Scheme functions <sup>(g)</sup>
	In local currency	Ratio to per capita GDP <sup>(c)</sup>	Foreign bank deposits <sup>(d)</sup>	Foreign currency deposits		
Australia	A\$250 000 <sup>(a)</sup>	4.1	No	No	<i>Ex post</i>	Reimbursement
Brazil	R\$70 000	3.1	No	No	<i>Ex ante</i>	Reimbursement, resolution
Canada	C\$100 000 <sup>(b)</sup>	2.1	No	No	<i>Ex ante</i> (risk-based)	Reimbursement, resolution
France	€100 000	3.3	Yes	Yes <sup>(e)</sup>	<i>Ex ante</i> (risk-based)	Reimbursement, resolution
Germany	€100 000	3.3	Yes	Yes <sup>(e)</sup>	<i>Ex ante</i> (risk-based)	Reimbursement
Hong Kong SAR	HK\$500 000	2.0	Yes	Yes	<i>Ex ante</i> (risk-based)	Reimbursement
India	Rs.100 000	1.6	Yes	Yes	<i>Ex ante</i>	Reimbursement
Italy	€100 000	3.9	Yes	Yes	<i>Ex post</i>	Reimbursement
Japan	¥10 million	2.7	No	No	<i>Ex ante</i>	Reimbursement, resolution
Malaysia	RM250 000	9.2	No	Yes	<i>Ex ante</i> (risk-based)	Reimbursement, resolution
Netherlands	€100 000	2.8	Yes	Yes	<i>Ex post</i>	Reimbursement
Singapore	SG\$50 000	0.9	Yes	No	<i>Ex ante</i> (risk-based)	Reimbursement
South Korea	KRW 50 million	2.1	Yes	Yes	<i>Ex ante</i>	Reimbursement, resolution, supervision
Spain	€100 000	4.3	Yes	Yes	<i>Ex ante</i> (risk-based)	Reimbursement, resolution
Switzerland	CHF100 000	1.4	Yes	Yes	<i>Ex post</i>	Reimbursement
United Kingdom	£85 000	3.6	Yes	Yes	<i>Ex post</i>	Reimbursement, resolution
United States	US\$250 000 <sup>(b)</sup>	5.3	No	Yes	<i>Ex ante</i> (risk-based)	Reimbursement, resolution, supervision

(a) Applies from 1 February 2012, subject to a transition period for term deposits in place as at 10 September 2011

(b) Depositors with funds in different deposit products may be eligible for more than one payment up to the cap per institution; in the United States, non-interest bearing transaction accounts at FDIC-insured institutions have been granted temporary unlimited insurance until the end of 2012

(c) Based on per capita GDP for 2010

(d) Refers only to deposits in foreign-incorporated deposit-taking institutions

(e) Only foreign currencies of countries in the European Economic Area

(f) 'Risk-based' schemes are those that determine their insurance fees based on an institution's assessed risk of failure

(g) Scheme functions include: reimbursement of depositors; involvement in other resolution options; and supervision of institutions' financial condition

Sources: IADI; IMF; RBA; national sources



the Treasurer to activate the Scheme earlier than the point of winding up.<sup>9</sup>

Payouts of deposits covered under the FCS are initially financed by the Government through a standing appropriation of \$20 billion per failed ADI (although it is possible that additional funds could be made available, if needed, subject to parliamentary approval). The amount paid out under the FCS, and expenses incurred by APRA in connection with the FCS, would then be recovered via a priority claim of the Government against the assets of the ADI in the liquidation process. If the amount realised is insufficient, the Government can recover the shortfall through a levy on the ADI industry.

This *ex post* method of funding FCS payouts contrasts with the *ex ante* approach that is more common in other jurisdictions. An *ex ante* approach involves charging deposit-taking institutions fees for the provision of the deposit guarantee, with the size of the fee typically determined either as a fixed proportion of an individual institution's insured deposits or based on an institution's assessed risk of failure. The fees received from insured institutions are usually pooled in a special purpose investment fund from which payouts can be made in the event of a failure.<sup>10</sup> In principle, this approach reduces the possibility that surviving institutions or taxpayers are burdened by a shortfall from the liquidation of a failed institution's assets. However, it may be difficult to accumulate adequate pre-funded resources in practice, as was demonstrated in a number of countries during the 2008–2009 financial crisis. In Australia's case, the adequacy of post-funding arrangements is supported by the historically low incidence of ADI failure and the priority claim the Government has on the failed ADI's assets in respect

of amounts paid out under the FCS, which makes it highly unlikely that the Government would be unable to recoup payouts from the liquidation of an ADI's assets. Pre-funding also introduces operational costs and opportunity costs, as compared with a post-funded scheme. A further consideration is the low stock of government debt in Australia, which means that there would be only a limited pool of low-risk investments available to a deposit insurance fund. While pre-funded schemes remain the most common around the world, a number of countries other than Australia have chosen post-funded arrangements, including Austria, Chile, Luxembourg, Italy, the Netherlands, Slovenia and Switzerland.

Another important aspect of the design of the FCS is that it is administered by APRA. APRA's role as prudential supervisor provides it with the information necessary to determine whether or not the FCS needs to be activated. This approach helps to limit the potential for costly additional monitoring of ADIs that may occur in a separately governed scheme and ensures that there are no coordination problems in the event the FCS is activated. In contrast, deposit insurance schemes in many other countries are separately governed corporations, likely reflecting that the scheme administrators are effectively tasked with managing a special purpose fund (although in some cases regulatory authorities have representatives on the scheme's Board).

The Australian FCS operates as a so-called 'paybox' scheme, meaning that its sole purpose is to reimburse depositors in a failed Australian ADI. Some deposit insurance schemes in other jurisdictions have broader mandates which allow them to finance other bank resolution options, including the creation of a bridge bank and recapitalisation (for example, in Japan and Korea). Although APRA has these broader resolution options available to it, these functions are separate from the FCS.

APRA is in the process of developing a new prudential standard that sets out minimum requirements that Australian ADIs must meet to ensure they are adequately prepared to implement the FCS

9 The Council has recommended that the Australian Treasurer be given discretion to activate the FCS as soon as APRA has appointed a statutory manager to an ADI. This would provide depositors with greater certainty over the status of their deposits and the arrangements with respect to accessing their deposits (Australian Treasury 2011).

10 Some deposit insurance funds also have backstop funding arrangements in place, such as the ability to issue debt or borrow from the central bank.

should it be activated. The draft prudential standard was issued in September 2011 after a period of consultation with industry. In order to minimise the risk of payment errors in the event that the FCS is activated, ADIs must be able to identify each unique account-holder in advance, as well as develop and implement an aggregated deposit balance for each account-holder, known as a 'single customer view'. ADIs are also required to be able to generate FCS data within 48 hours of a request being made by APRA (72 hours during the transition period) to ensure prompt payouts can be made to depositors. FCS systems and data will be subject to external audit, as well as sign-off by the ADI's chief executive officer. These requirements are expected to come into effect on 1 January 2012 and ADIs must be in compliance with them after a two-year transition period (unless granted an extension by APRA).

## Depositor Preference

While the existence of the FCS means depositors' funds are guaranteed up to the FCS cap, deposits above the cap in Australian ADIs also benefit from depositor preference. This means that Australian depositors have a priority claim on the assets of a failed ADI ahead of other unsecured creditors, after the Government has been reimbursed for any amounts paid under, and expenses incurred in relation to, the FCS. Section 13A of the *Banking Act 1959* states that if an Australian ADI is wound up, all of its assets in Australia are first made available to APRA (on behalf of the Government) to recover amounts paid out to depositors under the FCS, and then any other debts owed to APRA in relation to expenses incurred in operating the FCS. Thereafter, the failed ADI's remaining assets in Australia must be used to repay any deposits in Australia above the FCS cap before they can be used to repay other unsecured creditors. To further support depositors' interests, ADIs are required to hold sufficient assets in Australia at all times to meet their Australian deposit liabilities.

The existence of depositor preference in Australia has meant that Australian ADIs have historically been prevented from issuing covered bonds.<sup>11</sup> The reason was that covered bondholders would have preferential access to a specified pool of assets (the 'cover pool'), thereby subordinating the claims of other unsecured creditors, including depositors, over those assets. However, with the permanent FCS now providing full protection for nearly all depositors, the Australian Government recently passed legislation allowing covered bonds to be issued by ADIs, in order to give them additional flexibility in their mix of funding instruments. This has been accompanied by legislative safeguards to preserve the interests of depositors in addition to the protections provided by the FCS. In particular, to limit the degree of depositor subordination, the legislation provides for issuance of covered bonds by an ADI to be subject to a cap, such that the value of assets in the associated cover pools must not exceed 8 per cent of the value of the ADI's assets in Australia. The cap is designed to ensure that the ADI retains sufficient assets on its balance sheet to meet deposit liabilities in the event of default. The legislation also provides APRA with the power to prevent an ADI from transferring assets to cover pools if the ADI is in, or close to, default, as well as the power to prevent an ADI from issuing covered bonds in certain circumstances.

Australia is one of a minority of countries that have depositor preference, with most countries instead relying solely on deposit insurance. Other countries that have depositor preference include Argentina, China, Malaysia, Russia and the United States. In some other jurisdictions, depositor preference exists but only applies to insured deposits, including Chile, Hong Kong SAR and Switzerland. In addition, the introduction of preference for insured deposits was included in the recent recommendations of the UK Independent Commission on Banking (2011). Providing preference to insured deposits is primarily aimed at improving the recoveries of the deposit insurance scheme rather than protecting

<sup>11</sup> For background on covered bonds, see RBA (2011).

depositors beyond the insurance scheme limits. It may still benefit uninsured depositors to the extent that wholesale creditors are provided with incentives to better monitor ADIs, but not to the same extent as generalised depositor preference of the kind prevailing in Australia. ✎

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