Banking Amendment (Covered Bonds) Bill 2011

Scott Kompo-Harms
Economics Section

Contents

Purpose ........................................................................................................................................................................... 3
Background ........................................................................................................................................................................ 3
  Basis of policy commitment ......................................................................................................................... 7
  Committee consideration ............................................................................................................................ 7
  Policy position of non-government parties ........................................................................................... 8
    Coalition ......................................................................................................................................................... 8
    Greens ......................................................................................................................................................... 9
  Position of major interest groups ............................................................................................................. 10
    Australian Bankers Association ........................................................................................................ 10
    Abacus-Australian Mutuals ..................................................................................................................... 10
  Financial implications ............................................................................................................................... 11
  Main issues ..................................................................................................................................................... 11
    Increased reliance on deposit insurance – a positive or negative development? .................................. 14
      The theoretical debate .......................................................................................................................... 14
      Previous examinations of the Australian Financial System ............................................................... 15
      Is there a case for a new financial sector inquiry? .............................................................................. 17
  Key provisions ............................................................................................................................................... 18
    Issuance of covered bonds ...................................................................................................................... 19
    Restriction on issuance of covered bonds .......................................................................................... 19
    Cover pools .............................................................................................................................................. 20
    Protection of certain contractual rights ............................................................................................... 21
    Prudential standards relating to covered bonds .................................................................................. 23
APRA’s powers in respect of the cover pool ................................................................. 23
Concluding comments .................................................................................................. 24
Banking Amendment (Covered Bonds) Bill 2011

Date introduced: 15 September 2011
House: House of Representatives
Portfolio: Treasury
Commencement: On Royal Assent

Links: The links to the Bill, its Explanatory Memorandum and second reading speech can be found on the Bill's home page, or through http://www.aph.gov.au/bills/. When Bills have been passed and have received Royal Assent, they become Acts, which can be found at the ComLaw website at http://www.comlaw.gov.au/.

Purpose

The Bill seeks to amend the Banking Act 1959 to allow the issuance of ‘dual-recourse’ secured debt instruments, commonly known as ‘covered bonds’, by Australian Authorised Deposit-taking Institutions (ADIs).

Background

When an institution sells a bond (debt instrument), it issues a piece of paper undertaking to pay interest and to buy back the paper (redeem the bond) at some future time (known as the maturity date). In this way, it is like a bank taking a deposit. Bonds are different, however, in that they can be bought and sold in secondary markets without involving the issuing institution. These secondary market transactions can occur at any time up until the point of maturity.

Covered bonds are bonds that are secured against particular assets that the institution holds for that purpose. The bond holder would have recourse to those assets if the institution cannot pay back the cash. The covered bonds that are dealt with in this Bill are dual recourse bonds: the bond holder has recourse first to the institution, then to the assets and if for some reason the assets are insufficient they have recourse back to the financial institution for the remainder of their claim.

These bonds would probably be sold to overseas investors, so they could be a way to bring extra funds into Australia for lending to businesses and home buyers. They could also possibly be sold to investors that require or desire ‘safe assets’ to invest in, such as superannuation funds.

Covered bonds have been permitted to be issued in a number of jurisdictions for many years under a vast array of different legislative frameworks. The extent to which they have been issued and their relative importance as a source of funding varies significantly from country to country. Tables 1 and 2 below show the outstanding stock and annual issuance of covered bonds as at the end of 2010 (by type of assets used as security), respectively.

Warning: All viewers of this digest are advised to visit the disclaimer appearing at the end of this document. The disclaimer sets out the status and purpose of the digest.
Table 1: Covered Bonds - Stock Outstanding, end 2010 by country and asset type (% of 2010 GDP)

<table>
<thead>
<tr>
<th>Country</th>
<th>Public Sector</th>
<th>Mortgage</th>
<th>Ships</th>
<th>Mixed Assets</th>
<th>TOTAL</th>
</tr>
</thead>
<tbody>
<tr>
<td>Austria</td>
<td>6.83</td>
<td>2.67</td>
<td>0.00</td>
<td>0.00</td>
<td>9.50</td>
</tr>
<tr>
<td>Canada (a)</td>
<td>0.00</td>
<td>1.51</td>
<td>0.00</td>
<td>0.00</td>
<td>1.51</td>
</tr>
<tr>
<td>Czech Republic</td>
<td>0.00</td>
<td>5.52</td>
<td>0.00</td>
<td>0.00</td>
<td>5.52</td>
</tr>
<tr>
<td>Denmark</td>
<td>0.00</td>
<td>142.09</td>
<td>2.87</td>
<td>0.00</td>
<td>144.97</td>
</tr>
<tr>
<td>Finland</td>
<td>0.00</td>
<td>5.62</td>
<td>0.00</td>
<td>0.00</td>
<td>5.62</td>
</tr>
<tr>
<td>France</td>
<td>3.91</td>
<td>8.08</td>
<td>0.00</td>
<td>4.59</td>
<td>16.58</td>
</tr>
<tr>
<td>Germany</td>
<td>16.64</td>
<td>8.88</td>
<td>0.32</td>
<td>0.00</td>
<td>25.83</td>
</tr>
<tr>
<td>Greece</td>
<td>0.00</td>
<td>8.58</td>
<td>0.00</td>
<td>0.00</td>
<td>8.58</td>
</tr>
<tr>
<td>Hungary</td>
<td>0.00</td>
<td>6.51</td>
<td>0.00</td>
<td>0.00</td>
<td>6.51</td>
</tr>
<tr>
<td>Ireland</td>
<td>23.43</td>
<td>18.61</td>
<td>0.00</td>
<td>0.00</td>
<td>42.05</td>
</tr>
<tr>
<td>Italy</td>
<td>0.65</td>
<td>1.74</td>
<td>0.00</td>
<td>0.00</td>
<td>2.39</td>
</tr>
<tr>
<td>Latvia</td>
<td>0.00</td>
<td>0.35</td>
<td>0.00</td>
<td>0.00</td>
<td>0.35</td>
</tr>
<tr>
<td>Luxembourg</td>
<td>71.74</td>
<td>0.00</td>
<td>0.00</td>
<td>0.00</td>
<td>71.74</td>
</tr>
<tr>
<td>Netherlands</td>
<td>0.00</td>
<td>6.93</td>
<td>0.00</td>
<td>0.00</td>
<td>6.93</td>
</tr>
<tr>
<td>New Zealand (b)</td>
<td>0.00</td>
<td>1.17</td>
<td>0.00</td>
<td>0.00</td>
<td>1.17</td>
</tr>
<tr>
<td>Norway</td>
<td>0.59</td>
<td>22.50</td>
<td>0.00</td>
<td>0.00</td>
<td>23.09</td>
</tr>
<tr>
<td>Poland</td>
<td>0.04</td>
<td>0.14</td>
<td>0.00</td>
<td>0.00</td>
<td>0.18</td>
</tr>
<tr>
<td>Portugal</td>
<td>0.81</td>
<td>16.05</td>
<td>0.00</td>
<td>0.00</td>
<td>16.86</td>
</tr>
<tr>
<td>Slovakia</td>
<td>0.00</td>
<td>5.22</td>
<td>0.00</td>
<td>0.00</td>
<td>5.22</td>
</tr>
<tr>
<td>Spain</td>
<td>1.73</td>
<td>32.32</td>
<td>0.00</td>
<td>0.00</td>
<td>34.04</td>
</tr>
<tr>
<td>Sweden</td>
<td>0.00</td>
<td>54.42</td>
<td>0.00</td>
<td>0.00</td>
<td>54.42</td>
</tr>
<tr>
<td>Switzerland</td>
<td>0.00</td>
<td>15.56</td>
<td>0.00</td>
<td>0.00</td>
<td>15.56</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>0.21</td>
<td>12.10</td>
<td>0.00</td>
<td>0.00</td>
<td>12.31</td>
</tr>
<tr>
<td>United States</td>
<td>0.00</td>
<td>0.10</td>
<td>0.06</td>
<td>0.36</td>
<td>0.46</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>2.47</strong></td>
<td><strong>7.27</strong></td>
<td><strong>0.06</strong></td>
<td><strong>0.36</strong></td>
<td><strong>10.17</strong></td>
</tr>
</tbody>
</table>

Sources and notes: Data on value of covered bonds from *European Covered Bond Council Fact Book 2011*, p. 457. GDP data from Eurostat unless otherwise indicated.
(a) GDP data sourced from International Monetary Fund, *World Economic Outlook (WEO)* Database, September 2011.
(b) GDP data sourced from Statistics New Zealand, Quarterly National Accounts, current prices, table 4.2.

*Warning:* All viewers of this digest are advised to visit the disclaimer appearing at the end of this document. The disclaimer sets out the status and purpose of the digest.
### Table 2: Covered Bonds - issuance, 2010 by country and asset type (% of 2010 GDP)

<table>
<thead>
<tr>
<th>Country</th>
<th>Public Sector</th>
<th>Mortgage</th>
<th>Ships</th>
<th>Mixed Assets</th>
<th>TOTAL</th>
</tr>
</thead>
<tbody>
<tr>
<td>Austria</td>
<td>2.84</td>
<td>1.26</td>
<td>0.00</td>
<td>0.00</td>
<td>4.10</td>
</tr>
<tr>
<td>Canada</td>
<td>0.00</td>
<td>1.06</td>
<td>0.00</td>
<td>0.00</td>
<td>1.06</td>
</tr>
<tr>
<td>Czech Republic</td>
<td>0.00</td>
<td>0.48</td>
<td>0.00</td>
<td>0.00</td>
<td>0.48</td>
</tr>
<tr>
<td>Denmark</td>
<td>0.00</td>
<td>63.45</td>
<td>0.06</td>
<td>0.00</td>
<td>63.51</td>
</tr>
<tr>
<td>Finland</td>
<td>0.00</td>
<td>2.91</td>
<td>0.00</td>
<td>0.00</td>
<td>2.91</td>
</tr>
<tr>
<td>France</td>
<td>0.65</td>
<td>2.22</td>
<td>0.00</td>
<td>0.89</td>
<td>3.76</td>
</tr>
<tr>
<td>Germany</td>
<td>1.68</td>
<td>1.70</td>
<td>0.13</td>
<td>0.00</td>
<td>3.51</td>
</tr>
<tr>
<td>Greece</td>
<td>0.00</td>
<td>7.49</td>
<td>0.00</td>
<td>0.00</td>
<td>7.49</td>
</tr>
<tr>
<td>Hungary</td>
<td>0.00</td>
<td>0.56</td>
<td>0.00</td>
<td>0.00</td>
<td>0.56</td>
</tr>
<tr>
<td>Ireland</td>
<td>0.04</td>
<td>3.85</td>
<td>0.00</td>
<td>0.00</td>
<td>3.88</td>
</tr>
<tr>
<td>Italy</td>
<td>0.13</td>
<td>0.83</td>
<td>0.00</td>
<td>0.00</td>
<td>0.96</td>
</tr>
<tr>
<td>Latvia</td>
<td>0.00</td>
<td>0.00</td>
<td>0.00</td>
<td>0.00</td>
<td>0.00</td>
</tr>
<tr>
<td>Luxembourg</td>
<td>8.75</td>
<td>0.00</td>
<td>0.00</td>
<td>0.00</td>
<td>8.75</td>
</tr>
<tr>
<td>Netherlands</td>
<td>0.00</td>
<td>2.33</td>
<td>0.00</td>
<td>0.00</td>
<td>2.33</td>
</tr>
<tr>
<td>New Zealand</td>
<td>0.00</td>
<td>1.17</td>
<td>0.00</td>
<td>0.00</td>
<td>1.17</td>
</tr>
<tr>
<td>Norway</td>
<td>0.46</td>
<td>6.87</td>
<td>0.00</td>
<td>0.00</td>
<td>7.32</td>
</tr>
<tr>
<td>Poland</td>
<td>0.01</td>
<td>0.04</td>
<td>0.00</td>
<td>0.00</td>
<td>0.05</td>
</tr>
<tr>
<td>Portugal</td>
<td>0.14</td>
<td>6.72</td>
<td>0.00</td>
<td>0.00</td>
<td>6.86</td>
</tr>
<tr>
<td>Slovakia</td>
<td>0.00</td>
<td>1.79</td>
<td>0.00</td>
<td>0.00</td>
<td>1.79</td>
</tr>
<tr>
<td>Spain</td>
<td>0.56</td>
<td>4.89</td>
<td>0.00</td>
<td>0.00</td>
<td>5.44</td>
</tr>
<tr>
<td>Sweden</td>
<td>0.00</td>
<td>23.04</td>
<td>0.00</td>
<td>0.00</td>
<td>23.04</td>
</tr>
<tr>
<td>Switzerland</td>
<td>0.00</td>
<td>3.72</td>
<td>0.00</td>
<td>0.00</td>
<td>3.72</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>0.00</td>
<td>1.69</td>
<td>0.00</td>
<td>0.00</td>
<td>1.69</td>
</tr>
<tr>
<td>United States</td>
<td>0.00</td>
<td>0.00</td>
<td>0.00</td>
<td>0.00</td>
<td>0.00</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>0.31</strong></td>
<td><strong>2.10</strong></td>
<td><strong>0.01</strong></td>
<td><strong>0.07</strong></td>
<td><strong>2.49</strong></td>
</tr>
</tbody>
</table>

**Sources and notes:** Data on value of covered bonds from *European Covered Bond Council Fact Book 2011, p. 457*. GDP data from Eurostat unless otherwise indicated.

(a) GDP data sourced from International Monetary Fund, *World Economic Outlook (WEO)* Database, September 2011.

(b) GDP data sourced from Statistics New Zealand, *Quarterly National Accounts*, current prices, table 4.2.
The bonds can be secured against a variety of ‘quarantined’ assets (known as the ‘cover pool’), including, but not limited to, residential mortgages, shipping loans and government securities. In the event of a default by a financial institution on its obligations to covered bondholders, the covered bondholders first have recourse to the financial institution itself and if the financial institution is unable to meet those obligations, then the covered bondholders have recourse to the cover pool. In the event that the cover pool is insufficient to meet the covered bondholders’ claims, they then have a residual recourse back to the financial institution. Covered bonds can achieve a higher credit rating than that of the issuing entity because of the dual recourse available to the covered bond holders and also because the assets that are set aside are deemed to be ‘high quality, liquid assets’.

Internationally, there appear to be two broad models for regulating the issuance of covered bonds. Issuance can either be under specific or general legislative authority. This Bill seeks to introduce covered bonds using a specific legislative authority.

Broadly speaking, the issuance of covered bonds has been prohibited in Australia up to this point in time because of the notion of ‘depositor preference’ that has been enshrined in Division 2 of the Banking Act 1959 (Cth). This means that ordinary depositors should have first claim on the assets of ADI. In the event of insolvency of an ADI, depositor preference ensured that depositors were paid out before bondholders and shareholders. The Australian Prudential Regulation Authority (APRA) has expressed in-principle objections to covered bonds in the past. The following extract from APRA’s 2007-08 annual report outlined the basis for APRA’s concerns:

> The legislative framework in Australia ... does not support covered bond issuance. The Banking Act 1959 requires that, if an ADI becomes unable to meet its obligations or suspends payment, the assets of the ADI in Australia are to be available to meet that ADI’s deposit liabilities in Australia prior to all its other liabilities. In substance, covered bond structures subordinate the interests of depositors of ADIs to the interests of the covered bond holders. For this reason, APRA has an in-principle objection to such structures...

> More generally, APRA has been advising ADIs to consider carefully the implications of any proposed new forms of financing. In the current market environment, it is unlikely that more complex, opaque or legally untested structures will ultimately increase an ADI’s funding resilience or meet with market or APRA acceptance.1

On 12 October 2008, at the height of the global financial crisis (GFC), the Australian Government announced that it would guarantee both deposits and wholesale bank liabilities (as well as certain liabilities of general insurers).2 Prior to this, there was no explicit deposit insurance for ADIs in Australia. These guarantees were subsequently delineated into two separate parts. The first was the Financial Claims Scheme (FCS) which covered ADI deposits up to $1 million free of charge and the

---


**Warning:** All viewers of this digest are advised to visit the disclaimer appearing at the end of this document. The disclaimer sets out the status and purpose of the digest.
second was the Guarantee of Large Deposits and Wholesale Funding, which covered ADI deposits of over $1 million and eligible wholesale funding liabilities for a specified fee (dependent upon the credit rating of the deposit-taker/issuer). The Guarantee of Large Deposits and Wholesale Funding was closed to new liabilities as of 31 March 2010 although around $118 billion worth of ADI liabilities were still covered as at the end of August.\(^3\) As flagged when the *Competitive and Sustainable Banking System* package was announced\(^4\), the Australian Government confirmed on 11 September 2011 that the FCS would become a permanent feature of the Australian Financial System and as of 1 February 2012, the limit for coverage by the FCS would be reduced to $250 000. In addition, coverage for deposits held in Australian ADIs overseas will be removed.\(^5\)

The confirmation that the FCS is a permanent feature of the Australian Financial System means that APRA’s in-principle objections to the issuance of covered bonds are now less significant.

### Basis of policy commitment

The introduction of covered bonds was announced on 12 December 2010 as an element of the Government’s *Competitive and Sustainable Banking System* reform package. This reform package is divided into three broad streams and these are:

- empower consumers to get a better deal
- support smaller lenders to compete with the big banks and
- secure the long-term safety and sustainability of the Australian Financial System.

Each stream contains a number of elements that are being progressively implemented. The introduction of covered bonds is an element of the third stream.

### Committee consideration

The Bill has not been referred to any committee for inquiry.

---


*Warning*: All viewers of this digest are advised to visit the disclaimer appearing at the end of this document. The disclaimer sets out the status and purpose of the digest.
Policy position of non-government parties

Coalition

On 25 October 2010 in a speech to the Australian Industry Group annual national forum, the Shadow Treasurer, the Hon. Joe Hockey, MP, put forward a 9-point plan which indicated that the Coalition might support allowing the issuance of covered bonds. Specifically, points 8 and 9 of the plan say:

8. Let’s commission a resolution to the debate about whether the banks should be able to issue “covered bonds”, in the same way other jurisdictions allow their banks to, which provides a more affordable line of credit;

9. And let’s wrap up all of this work into a full review of the financial system—a Son of Wallis, or Grandaughter of Campbell, whatever you will.6

After the Government announced their Competitive and Sustainable Banking System package, the Shadow Treasurer offered the following remarks:

In particular, we welcome the adoption of the Coalition’s price signalling legislation and the introduction of covered bonds...

While there is much in this package we could support, it’s important to acknowledge the government’s plan is a piecemeal approach which hasn’t been fully thought through...

It confirms the need for an overall root and branch review of the banking system as called for by the coalition7

Thus, it appears that the Coalition supports the issuance of covered bonds but would also like to see a broad Financial System Inquiry to accompany this development.


Warning: All viewers of this digest are advised to visit the disclaimer appearing at the end of this document. The disclaimer sets out the status and purpose of the digest.
Greens

The Greens spokesperson on banking, Mr Adam Bandt, MP, has indicated that the Greens have reservations about allowing the issuance of covered bonds by Australian ADIs. Mr Bandt has raised a number of concerns relating to asset encumbrance, funding costs, market dominance by larger ADIs and the extent to which wholesale ADI funding is sourced from offshore.

Mr Bandt is quoted as saying:

Covered bonds will effectively shift risk from the large banks to the public purse and uninsured depositors...

Australian depositors are expected to feel secure about covered bonds because of the Government’s Financial Claims Scheme. But this is simply asking the taxpayer to carry a risk currently borne by the banks...

Covered bonds will not benefit small and community banks to the same degree as the big banks.

Covered bonds may in fact entrench the large banks’ market dominance, as smaller banks are unlikely to be able to access the covered bond market on the same scale, if at all.

I remain to be convinced that this will make home loans cheaper. Diversification of bank funding sources won’t in and of itself result in cheaper products. In fact, the cost of lower-ranking securities may become more expensive as they become riskier...

It would come as no surprise if covered bonds ultimately resulted in banks borrowing more money from overseas for the purpose of expanding the domestic property sector...

Covered bonds are instruments issued by banks to bondholders and secured by high quality assets. Part of their attractiveness to bondholders is that they will outrank depositors in any claim on bank assets. This would involve a fundamental change to Australian banking laws: currently depositors have the highest claim on assets. 8

---


Warning: All viewers of this digest are advised to visit the disclaimer appearing at the end of this document. The disclaimer sets out the status and purpose of the digest.
Position of major interest groups

Australian Bankers Association

The Australian Bankers’ Association (ABA) has expressed support for the Bill. In the covering letter to the ABA’s submission as part of the consultation process on the exposure draft of the current Bill, Mr Tony Burke states:

The ability to issue covered bonds in Australia will be a key means of diversifying and broadening funding sources and will improve the competitive position of our banks and other financial institution [sic] in the funding markets, and enhance their capacity to continue providing reasonably priced credit to Australian households and small businesses.  

Abacus-Australian Mutuals

Abacus-Australian Mutuals is the peak industry representative for non-bank ADIs such as credit unions and building societies. The Chief Executive Officer of Abacus Australian Mutuals, Ms Louise Petschler, expressed qualified support for covered bonds as a potential funding mechanism for some non-bank ADIs, although she did not consider this to be of much significance in terms of lowering funding costs. In particular, Ms Petschler commented that deposits are the most important funding source for smaller non-bank ADIs. She stated:

We welcome the Government’s commitment to covered bond issuance structures using pooled or aggregated models to accommodate smaller banking institutions...

Although big banks stand to gain the most from covered bonds, some credit unions and building societies aim to be able to access this new form of funding as the market develops.  

Ms Petschler went on to say that deposits were a more important source of funding for smaller ADIs and so the level of deposit insurance coverage under the FCS was a more decisive factor in helping credit unions and building societies to compete effectively with banks, particularly the larger ones. She cited the case of ‘larger’ depositors, such as local councils and community organisations as being important sources of funding for smaller ADIs.

As stated earlier, the cap on deposits eligible for the FCS will be reduced, effective 1 February 2012, from $1 million to $250 000.

---


**Warning:** All viewers of this digest are advised to visit the disclaimer appearing at the end of this document. The disclaimer sets out the status and purpose of the digest.
**Financial implications**

The Bill has no direct financial implications for the Commonwealth Budget.

**Main issues**

The benefits of allowing the issuance of covered bonds are laid out in the Explanatory Memorandum (EM) for this Bill. Briefly, they may improve system Financial System stability in the following ways:

- covered bonds may allow ADIs to diversify sources of funding:
  - covered bonds may be attractive to investors who wish to (or are mandated to) bear less risk in their portfolios relative to other forms of bank funding. Covered bonds can, in theory, achieve higher credit ratings than the issuing entity and so this may broaden the range of potential investors

- covered bonds may result in a lower overall cost of funding for ADIs
- covered bonds may allow ADIs to raise wholesale funds with longer maturities and
- covered bonds are usually structured as ‘bullet securities’:
  - bullet securities are securities where the principal is repaid in full at the maturity date, which contrasts with the typical arrangements used by securitisation vehicles such as residential mortgage-backed securities (RMBS). This can result in more predictable returns to investors.11

Generally speaking, these advantages would accrue more readily to larger ADIs because they already have a presence in international wholesale funding markets, which smaller ADIs (particularly credit unions and building societies) do not. The Bill does allow smaller ADIs to combine assets into a single cover pool which would then allow them to issue covered bonds, however, the extent to which this option would be viable is unclear. In a recent speech, the General Manager of the Financial System Division of the Markets Group in Treasury, Mr John Lonsdale, stated that the likelihood of smaller ADIs utilising this option immediately after the passage of the Bill was very low, but he did expect it to become a realistic funding option in the medium- to long-term.12

In relation to the second point about lowering ADI funding costs, the European Covered Bond Council makes the following observation about covered bonds and ‘asset encumbrance’ generally:

> Even though a higher share of covered bonds in issuers’ funding mix could reduce default probabilities, and, thus, lower funding costs, the implied structural subordination resulting from sizable encumbrance of high-quality assets is prejudicial to unsecured creditors’ interest

---


**Warning:** All viewers of this digest are advised to visit the disclaimer appearing at the end of this document. The disclaimer sets out the status and purpose of the digest.
by reducing the debt recovery value of residual assets to support their credit claims. In this regard, depositors and deposit insurers will have a smaller pool of unencumbered and possibly lower quality assets to fall back on in the event of a default depending on adverse asset selections. Furthermore, to the extent that covered bond funding replaces unsecured funding, the effectiveness of bank failure resolution frameworks will be adversely impacted.

In addition, there could be a negative feedback effect on the issuance costs of both funding vehicles, because covered bond spreads are generally anchored to those on issuers’ senior unsecured obligations...All else equal, a larger share of covered bonds in the funding structure increases the loss-given-issuer default to unsecured senior creditors due to the smaller set of residual assets available outside the cover pool to meet their claims. Lower recovery rates on unsecured senior unsecured debt could in turn increase the relative funding cost of this instrument and result in still heavier reliance on covered bonds, whose privileged position (regarding the seizure and foreclosure of collateral assets) only further weakens unsecured debt credit strength and so on.13

The 8 per cent cap on the amount of ADI assets that can be encumbered in a cover pool would limit the transfer of risk from covered bondholders to other unsecured creditors. It also limits the degree to which the issuance of covered bonds can lower ADI funding costs. In addition, the Bill limits the type of assets that can be included in the cover pool. They are, broadly speaking, restricted to cash, short term bank Bills that are eligible for RBA repurchase transactions, government securities, and residential and commercial mortgages (as well as a few other specified high-quality, liquid assets).

In relation to the third point above about lengthening the maturity profile of wholesale funding the EM states:

...any shift towards long-term funding has stability benefits for the Australian banking system and will assist ADIs to meet the international regulatory reforms to bank liquidity requirements.

While the first part of this statement may be true, the second part about helping banks to meet international regulatory reforms to bank liquidity requirements appears, at least at this stage, to be premature. The proposed ‘Basel III’ reforms to international prudential regulation are due to come into effect over the next few years (with a significant period of transition). One particular aspect of this is the introduction of a ‘liquidity coverage ratio’ or LCR. The LCR is designed to provide a buffer for financial institutions of high-quality liquid assets that would last at least one month in the event of an ‘acute stress’. The Basel Committee on Banking Supervision (BCBS) has defined two levels of assets that would qualify for the LCR. In February, APRA interpreted the two levels of eligible assets as follows:

**Level 1** assets are limited to cash, central bank reserves and highest-quality sovereign or quasi-sovereign marketable instruments that are of undoubted liquidity, even during stressed market conditions; and

---


**Warning:** All viewers of this digest are advised to visit the disclaimer appearing at the end of this document. The disclaimer sets out the status and purpose of the digest.
Level 2 assets (which can comprise no more than 40 per cent of the total stock) are limited to certain other sovereign or quasi-sovereign marketable instruments, as well as certain types of corporate bonds and covered bonds, that also have a proven record as a reliable source of liquidity even during stressed market conditions.  

APRA has conducted a review of marketable instruments denominated in Australian dollars and determined that, at this point in time, there are no qualifying level 2 assets. The factors APRA took into account are:

- the amount of the instrument on issue
- the degree to which the instrument is broadly or narrowly held and
- the degree to which the instrument is traded in large, deep and active markets.

APRA also considered the liquidity of particular asset classes during the GFC.

The LCR does not come into effect until January 1 2015 and so the situation regarding qualifying level 2 assets may change in future. However, presumably until covered bonds have established some sort of track record in the Australian Financial System, they would not assist ADIs to meet liquidity requirements. Given that there is no experience in this asset class during stressed market conditions, there is uncertainty as to whether APRA will decide that Australian covered bonds will qualify for level 2 status or not during or after the transition to implementation of the LCR.

As discussed earlier in the digest, the introduction of the FCS and the confirmation that it will remain a permanent feature of the Australian Financial System is a development that neutralises, to some extent, the reasons for APRA’s in-principle objection to the issuance of covered bonds. However, the fact that deposit insurance is now a central plank of the Financial System raises some much broader issues in relation to overall Financial System stability. The removal of ‘depositor preference’ is a big change to the overall Financial System and so it could be argued that the significance of this legislation goes well beyond just the introduction of a new form of wholesale bank funding.

The current proposed legislation would entrench deposit insurance as a core feature of the Australian Financial System. As will be argued below, increased reliance on deposit insurance could potentially have systemic implications, particularly around the issue of ‘moral hazard’. There are strong arguments for the establishment of a broad inquiry into the Australian Financial System to examine the systemic consequences of such a change before this is allowed to take place. At this stage, it is worth reviewing some banking theory and a bit of history.

---


**Warning:** All viewers of this digest are advised to visit the disclaimer appearing at the end of this document. The disclaimer sets out the status and purpose of the digest.
Increased reliance on deposit insurance – a positive or negative development?

The theoretical debate

The idea that deposit insurance provides stability to the Financial System is suggested in a seminal article in the Journal of Political Economy in 1983 by Douglas W. Diamond and Phillip H. Dybvig. This article (along with an earlier article by John Bryant in the Journal of Banking and Finance) spawned what has become known as the Diamond-Dybvig model of bank runs. This is now the standard model for analysing banking issues.

A central idea embedded in the Diamond-Dybvig model is that, at the most basic level, deposit insurance can prevent bank runs from occurring and therefore, makes the Financial System more stable. The conclusion from this is that deposit insurance is unambiguously good. This is contrasted with the view expressed in a 1978 article in the Journal of Business by John H. Kareken and Neil Wallace. Kareken and Wallace compare two scenarios. The first deals with a banking sector that has no government deposit insurance, while the second scenario examines a banking sector that has deposit insurance. The authors focus on the effect of deposit insurance on the size of banks and the riskiness of their portfolios. The point of interest in the analysis is the incentives that depositors, bank shareholders and bank management face in both cases. Kareken and Wallace argue that the provision of (inadequately priced) deposit insurance removes the incentives for depositors to monitor the riskiness of their banks’ lending and other activities, removing the threat of ‘punishment’ in the form of a bank run. Thus, the incentives for bank shareholders and bank management is to make their bank as large and as risky as possible, so as to maximise shareholder value. These are, in essence, the problems of moral hazard and ‘too-big-to-fail’ or ‘systemically important’ financial institutions.

It should be noted that the Bryant-Diamond-Dybvig and Kareken-Wallace models represent the extremes of this debate and ignore the political realities of the threat of failure of financial institutions. In the view of the first group of authors, deposit insurance is a purely positive policy...

---


Warning: All viewers of this digest are advised to visit the disclaimer appearing at the end of this document. The disclaimer sets out the status and purpose of the digest.
that acts to stabilise the Financial System, whereas the second group of authors view deposit insurance as being purely a negative thing. Deposit insurance has the effect of destabilising the Financial System by creating moral hazard and providing an incentive for financial institutions to become big enough to qualify, in the minds of regulators, as being systemically important, or ‘too big to fail’. There is a vast secondary literature that relaxes a number of assumptions made by both authors. It is beyond the scope of this Digest to cover that literature. However, the key point to be taken from the brief examination of the original papers here is that the introduction of covered bonds into the Australian Financial System would create difficulties in making changes to deposit insurance, if it is decided at some point in future that it is a bad idea. The debate above shows that deposit insurance is not unanimously perceived to be positive and can potentially create its own problems.

Previous examinations of the Australian Financial System

Another point to make in this broader debate is that the last serious examination of the Australian Financial System, the ‘Wallis inquiry’, was held in 1996-97. The final report was very wide-ranging and covered many issues, including regulation of banking, insurance and the payments system. Its recommendations formed the basis of the current Australian financial regulatory structure (for example, APRA was formed as a result of the Wallis inquiry).

Chapter 8 of the final report was titled: ‘Financial safety’. The first key finding of the chapter was:

The intensity of prudential regulation should be proportional to the degree of market failure which it addresses, but it should not involve a government guarantee of any part of the financial system.19

In addition, one of the key recommendations was:

The current arrangements for depositor protection through depositor preference should be retained but clarified and extended to all regulated [deposit-taking institutions]. On balance, the benefits of a scheme of deposit insurance are not considered strong enough to warrant its introduction.20

In March 2004, Professor Kevin Davis was commissioned to undertake a technical study into a limited explicit guarantee scheme in parts of the Australian Financial System. The study was undertaken in response the Royal Commission into the financial collapse of the HIH Insurance Group. The final report of this study (the ‘Davis report’) was quite vague in the sense that it made no policy recommendations, as per the terms of reference, but did examine (among other things) the relative merits of a system of deposit insurance in Australia. It was written in the context of no explicit deposit insurance existing in Australia and no particular model of deposit insurance having

20. Ibid. p. 298.

Warning: All viewers of this digest are advised to visit the disclaimer appearing at the end of this document. The disclaimer sets out the status and purpose of the digest.
been publicly considered or proposed up to this point. Professor Davis and his taskforce were unable to quantify the relative costs and benefits. However, the Davis report did raise many salient points in relation to the arguments for and against a deposit insurance scheme. Briefly, the Davis report noted:

Limited explicit guarantees on financial products can be preferable to implicit guarantees or to a *caveat emptor* approach (which in any event, may not be politically feasible), or to a ‘discretionary’, or case-by-case, response to failures. Explicit guarantees may contribute to the stability of the financial system, improve the allocation and pricing of risk and provide individuals a greater degree of financial security.

The advantages of an explicit guarantee over a discretionary approach may include timeliness of response, greater certainty for consumers as to product coverage and greater certainty also about the possible scale of compensation.

 Appropriately targeted guarantees remove at least some of the risks for those who are exposed to financial institution failure but are least able to assess, and therefore do not voluntarily bear, that risk. Explicit guarantees may also distribute the burden of risk more equitably than implicit guarantees.

The ability of retail consumers to assess counterparty risk associated with financial institutions is limited. Guarantees which are correctly priced (which, together with prudential regulation, mitigate ‘moral hazard’ concerns) may be warranted in this case. Consumers are generally more aware of ‘market risk’ associated with investments and there is no case for protecting consumers who voluntarily take on such an exposure.

If poorly designed and priced, explicit financial guarantees can (like implicit guarantees) distort economic behaviour and lead to inefficient outcomes.

Guarantee schemes cannot solve the problems of a systemic crisis where other government responses are necessary.21

The report also contained some suggestions as to how to manage the tradeoffs between various objectives and mitigate some of the potential negative consequences of deposit insurance:

Designing a scheme necessarily involves tradeoffs between multiple objectives. The challenge is to balance concerns about safety with objectives such as efficiency, equity, minimum complexity and minimum cost.

Scheme design features which can assist in meeting these objectives include coverage limits, coinsurance and means testing.22

---


**Warning:** All viewers of this digest are advised to visit the disclaimer appearing at the end of this document. The disclaimer sets out the status and purpose of the digest.
Is there a case for a new financial sector inquiry?

The EM for the Bill does not seem to adequately discuss the potential negative consequences of allowing the issuance of covered bonds. The arguments against covered bonds are:

- they could potentially entrench the market dominance of the larger ADIs and
- the issuance of covered bonds would entrench deposit insurance in Australia by making it much more difficult to reverse or alter and so this legislation may actually contribute to increased financial systemic risk in Australia.

There is a case for the establishment of a broad Financial System Inquiry to consider the changes that have occurred in Australia since the GFC and investigate in detail whether the changes have resulted in a more or less stable Financial System. This is particularly so when changes to the Financial System proposed in the current Bill is taken into account.

In brief, the following major changes have been observed since 2008:

- the temporary introduction of deposit and wholesale guarantees (with permanent retention of some deposit insurance coverage)
- significant government purchases of residential mortgage-backed securities (RMBS) and
- significant consolidation in the financial sector, particularly with the acquisitions of St George and BankWest by Westpac Banking Corporation and the Commonwealth Bank of Australia respectively.

Whether or not a Financial System Inquiry is established, the following questions need to be asked:

- should deposit insurance be entrenched as a permanent feature of the Australian Financial System and if so, is the current structure appropriate?
- is deposit insurance appropriately priced?
- are there any improvements that can be made to the current system of deposit insurance?
- does the introduction of covered bonds undermine the concept of ‘depositor preference’ in practice and what implications, if any, does this have for depositor protection and financial system stability?
- and is the current Australian system of deposit insurance a sufficient cure and does it create its own problems?

The primary risk with this Bill is that the notion of ‘depositor preference’ (that has served Australia well in the past) is jettisoned for the sake of reductions of, at best, a few basis points on the interest rates charged on retail loans from ADIs. To do this without a full and proper assessment of the costs

---

of doing so being undertaken is to take a substantial risk that the stability of the Australian Financial System would be compromised.

It should be noted that the Bill seems to be drafted in a conservative manner relative to other jurisdictions. There are significant safeguards built into the Bill, such as the 8 per cent cap on issuing covered bonds (as a proportion of total ADI assets), maximum loan-to-valuation ratio weightings and overcapitalisation requirements. However, these are untested in Australia and the implications for the Financial System as a whole are unclear. Furthermore, given the variety of different regulatory frameworks and Financial System structures under which issuers of covered bonds operate internationally, it is difficult to determine the relevance of experiences in other jurisdictions to the Australian debate.

Key provisions

Clauses 1 to 5 of the Bill would have the effect of inserting new definitions into subsection 5(1) of the Banking Act 1959 (Cth). The new terms are: covered bond; covered bond liabilities; covered bond special purpose vehicle; cover pool; and issuing ADI. The terms are not explicitly defined here, but rather, references are made to various subclause in the proposed section 26 contained later in the Bill.

Clauses 6 to 8, 10 to 17 and 20 to 21 make minor amendments to the Banking Act 1959 (Cth) in order to insert references to other proposed clauses contained in the Bill.

Clause 9 inserts proposed subsection 11CA(2AA). Subsections 11CA(1) and (1AA)²⁴ of the Banking Act set out the circumstances in which APRA may issue a direction to an ADI or an authorised non-operation holding company (NOHC), while subsection 11CA(2)²⁵ specifies the kinds of directions APRA may give in respect of an ADI, an authorised NOHC and any of their subsidiaries.

The Explanatory Memorandum notes that:

This means that APRA may have the power to issue directions in respect of assets in the cover pool held by a covered bond special purpose vehicle (which could be a subsidiary of an ADI).²⁶

This power is limited by proposed subsection 11CA(2AA) which provides that APRA must not direct, or give a direction, that would cause the covered bond special purpose vehicle to make a payment or not make a payment, or to deal or not deal in an asset which secures covered bond liabilities of the ADI.

The Explanatory Memorandum states that the overall result would be that:

²⁵. Ibid.
²⁶. Warning: All viewers of this digest are advised to visit the disclaimer appearing at the end of this document. The disclaimer sets out the status and purpose of the digest.
APRA [would have] no direction making powers over assets held by the special purpose vehicle for the benefit of covered bondholders and service providers. However, APRA [would have] a power to provide a direction in respect of assets held by the covered bond special purpose vehicle which are not for the benefit of covered bondholders and service providers.27

Clauses 18 and 19 would have the effect of inserting the proposed subsections 13A(3A) and 13A(4A). The insertion of these proposed subsections would have the effect of removing assets committed to a cover pool from the assets available to secured and unsecured creditors that were not covered bondholders. It is these two proposed subsections that would remove the concept of ‘depositor preference’ in the event of the insolvency of an ADI.

**Issuance of covered bonds**

Clause 22 is the most substantial portion of the Bill and would insert the proposed Division 3A into the Banking Act 1959 (Cth). The newly proposed Division 3A would provide for the issuance of covered bonds by ADIs.

Specifically, proposed section 25 establishes that covered bonds cannot be issued by foreign ADIs or against assets that do not reside in Australia.

Proposed section 26 provides the explicit definitions inserted by clauses 1 to 5.

Proposed section 27 provides for arrangements for multiple ADIs to aggregate cover pools and issue covered bonds jointly.

**Restriction on issuance of covered bonds**

Proposed section 28 establishes the ‘8 per cent rule’, which states that only 8 per cent of an ADI’s total assets can be committed to a cover pool for the purposes of issuing covered bonds. This regulatory cap is applied at the time of issuance rather than continuously through time. That is, an issuing ADI will be prevented from issuing new covered bonds if that issuance will cause the assets in the cover pool to exceed 8 per cent of the ADI’s total assets.

Proposed subsection 29(1) provides that APRA may direct an ADI not to issue a covered bond. The circumstances in which this may be done are set out in proposed subsection 29(2) and include where APRA:

- has reason to believe that the ADI has not complied with proposed Division 3A

---

27. Ibid., p. 9.

**Warning:** All viewers of this digest are advised to visit the disclaimer appearing at the end of this document. The disclaimer sets out the status and purpose of the digest.
has reason to believe that the ADI has not complied with any other legislative requirements in the Banking Act, a prudential regulation or prudential standard in respect of issuing covered bonds or

• has given the ADI with a direction under section 11CA of the Banking Act.  

Notices under proposed subsection 29(2) must be in writing.

Proposed subsections 29(3) to (9) relate to what the Explanatory Memorandum describes as ‘administrative matters’. Mirroring similar provisions in section 11CA, they provide:

• that a notice under proposed subsection 29(2) is not a legislative instrument (proposed subsection 29(3))
• that a direction may provide the time by, or the period during which, it is to be complied with (proposed subsection 29(4))
• that an ADI can comply with a direction despite anything in its constitution or any contract or arrangement to which it is a party (proposed subsection 29(5))
• for variation (proposed subsection 29(6)) and revocation (proposed subsection 29(7)) by APRA of a direction
• for the application of Part VI of the Banking Act to a decision to give a direction under proposed subsection 29(1) (proposed subsection 29(8))
• that information relating to directions and revocations of directions is subject to the secrecy requirements in Part 6 of the Australian Prudential Regulation Authority Act 1998, unless the information has been published in the Gazette under section 11CE of the Banking Act (proposed subsection 29(9)) and
• that the proposed section does not limit any other powers of APRA to give directions (proposed subsection 29(10)).

Cover pools

Proposed section 30 specifies that cover pools must have a cover pool monitor and sets out the requirements to be eligible as, and functions of, a cover pool monitor. Cover pool monitors must, under the Corporation Act 2001 (Cth) either:

• be registered as an auditor
• hold an Australian Financial Services Licence (AFSL) or
• be exempt from holding an AFSL for the purposes of being a cover pool monitor.

28. See 11CA of the Banking Act, op. cit.
29. Explanatory Memorandum, op. cit., p. 19, [1.51].
30. Part VI of the Banking Act relates to the reconsideration and the review, including by the Administrative Appeals Tribunal, of decisions by APRA under the Act.
31. This Part relates to secrecy.

Warning: All viewers of this digest are advised to visit the disclaimer appearing at the end of this document. The disclaimer sets out the status and purpose of the digest.
An issuing ADI cannot be its own cover pool monitor (nor can any associated entities). The function of the cover pool monitor is basically to keep a register of assets in the cover pool, provide regular reports to stakeholders, provide reports to APRA when requested to do so and to assess the compliance with the requirements as to the nature and value of assets in the cover pool.

**Proposed section 31** specifies the types of assets that can be included in cover pools. These include:

- at call deposits held with an ADI and convertible into cash within 2 business days
- bank accepted Bills or certificates of deposit that fulfil all of the following conditions: they mature within 100 days; are eligible for repurchase transactions with the RBA; and were not issued by the ADI that issued the covered bonds secured by the assets in the cover pool
- bonds, notes, debentures or other instruments issued or guaranteed by the Commonwealth, a state or a territory
- loans secured by mortgage, charge or other security interest over residential property in Australia
- loans secured by mortgage, charge or other security interest over commercial property in Australia
- mortgage insurance policies or other assets related to residential or commercial loans as defined above
- contractual rights relating to the holding or management of another asset in the cover pool
- derivatives that are held to protect the value of another asset in the cover pool or to hedge risks associated with assets held in, and liabilities secured by assets in, the cover pool and
- other assets as prescribed by Regulations.

**Proposed section 31A** outlines the requirements for maintenance of the cover pool. This proposed section includes an over-collateralisation requirement in that the value of the assets in the cover pool must at all times equate to 103 per cent of the face value of covered bonds secured by the cover pool. In addition, bank accepted Bills/certificates of deposit must not exceed 15 per cent of the face value of covered bonds secured by the cover pool (this test is applied continuously through time). Finally, the proposed section 31A states that if the loan-to-valuation ratio (based on the most recent valuation for the property concerned) exceeds 80 per cent for residential property (or 60 per cent for commercial property), then the value of the loan is only counted towards the total value of the cover pool at either 80 (or 60) per cent.

**Protection of certain contractual rights**

**Proposed subsection 31B(1)** provides that subsection 11CD(1A) of the Banking Act does not apply if the ADI has failed to make payments to the holders or representatives, that it would have been

---

32. **Subsection 11CD(1A)** of the Banking Act provides that:

   - The fact that the ADI or authorised NOHC is subject to a direction by APRA under Subdivision A or B does not allow the contract, or a party to the contract, other than the ADI, NOHC or subsidiary, to do any of the following:
   - deny any obligations under that contract;

**Warning:** All viewers of this digest are advised to visit the disclaimer appearing at the end of this document. The disclaimer sets out the status and purpose of the digest.
required to make if a direction under subdivision A or B of Division 1BA, or section 27, had not been given.

The Explanatory Memorandum explains that:

In these circumstances, covered bondholders or their representatives could invoke acceleration against assets in the cover pool.\(^{33}\)

**Proposed subsection 31B(2)** provides that section 15C(2) of the Banking Act\(^ {34}\) does not apply if the ADI has failed to make payments to the holders or representatives that it would have been required to make if the ADI statutory manager was not in control of the business of the ADI.

The Explanatory Memorandum explains that this means that:

...the appointment of a statutory manager by itself does not permit a covered bondholder to accelerate debt and claim security but will permit this to occur should the statutory manager prevent the ADI meeting its payment obligations to covered bondholders. In these circumstances, the covered bondholders could also invoke acceleration against assets in the cover pool including the exercise of their security interest in those assets.\(^ {35}\)

The Explanatory Memorandum further explains that without these two proposed amendments, subsections 11CD(1A) and 15C(2):

...could prevent covered bondholders accelerating their claim against the covered bond special purpose vehicle in circumstances where APRA has issued an ADI a direction not to make payments to covered bondholders, or where an ADI statutory manager prevents the ADI making payments to covered bondholders.\(^ {36}\)

**Proposed section 31C** has the effect of separating the resolution processes of a failing ADI and a covered bond special purpose vehicle (SPV). This means that an ADI statutory manager or an external administrator has no powers (apart from contractual powers) in relation to assets held by the covered bond SPV to the extent that the assets held by the SPV secure covered bond liabilities.

**Proposed section 31D** specifies how prudential standards will be applied to issuing ADIs and covered bond SPVs.

---

(b) accelerate any debt under that contract;
(c) close out any transaction relating to that contract.

33. Explanatory Memorandum, op. cit., p. 28, [1.90].
34. Subsection 15C(2) of the Banking Act provides that:
   - The fact that an ADI statutory manager is in control of the ADI’s business does not allow the contract, or a party to the contract, to do any of the following:
     (a) deny any obligations under that contract;
     (b) accelerate any debt under that contract;
     (c) close out any transaction relating to that contract.
35. Explanatory Memorandum, op. cit., p. 28, [1.91].
36. Ibid., [1.89].

**Warning:** All viewers of this digest are advised to visit the disclaimer appearing at the end of this document. The disclaimer sets out the status and purpose of the digest.
Prudential standards relating to covered bonds

Proposed subsection 31E(1) provides that a prudential standard made under section 11AF\(^{37}\) of the Banking Act may provide for any matter relating to covered bonds, including their issue, assets in cover pools and the maintenance of cover pools.

The Explanatory Memorandum explains that the underlying reason for this proposed provision arises from the fact that otherwise:

... APRA’s direction making powers set out in Division 1BA of the [Banking Act] may not apply to the covered bond special purpose vehicle.\(^{38}\)

Proposed subsection 31E(2) sets out examples of the requirements that may be specified in prudential standards with respect to covered bonds.\(^{39}\) The proposed section does not limit the prudential matters with respect to which APRA may make standards under section 11AF.

APRA’s powers in respect of the cover pool

Proposed subsection 31F(1) enables APRA to direct a covered bond special purpose vehicle to return assets to the issuing ADI to the extent that such assets are not securing covered bond liabilities (that is, assets relating to voluntary over-collateralisation and trust back assets).

Proposed subsection 31F(2) limits this power of direction to the circumstances set out in subsection 11CA(1).

Proposed subsections 31F(4) to (11) relate to a range of matters, including administrative matters in connection with directions issued by APRA with respect to covered bonds. They reflect similar provisions elsewhere in the Banking Act.

The matters dealt with are the same as those dealt with in section 11AC, and therefore also reflect the matters dealt with in proposed subsections 29(3) to (10), detailed earlier in this Bills Digest. In particular however, proposed subsection 31F(11) provides that if a direction is given under proposed subsection 31F(1), the Banking Act applies in relation to the direction as if the covered bond special purpose vehicle were an ADI, and the direction were given under section 29 of the Banking Act.

This would mean, for instance, that:

---

38. Explanatory memorandum, op. cit., p. 21, [1.71].

**Warning:** All viewers of this digest are advised to visit the disclaimer appearing at the end of this document. The disclaimer sets out the status and purpose of the digest.
The penalty if the covered bond special purpose vehicle does not comply with any direction issued by APRA [would be] the same penalty that would apply to an ADI not complying with a direction as set out in section 11CG of the Banking Act 1959. 40

Concluding comments

The Banking Amendment (Covered Bonds) Bill 2011 is being put forward by the Government as a measure to ‘secure the long-term safety and sustainability of the Australian Financial System’ as part of their Competitive and Sustainable Banking reform package. In particular, the issuance of covered bonds is being described as a relatively simple change to the Banking Act 1959 (Cth) that would enable ADIs to access a new source of wholesale funding, which would lower costs for ADIs and these cost reductions would presumably be passed on to consumers, in the form of lower retail interest rates. As argued in this Digest, there are reasons to think that the impact of the Bill would have a limited impact on funding costs and interest rate margins charged by ADIs. There are significant limitations built into the Bill, in terms of the percentage of an ADI’s assets that can ‘cover’ the issuance of covered bonds, restrictions on the types of assets that can be included in cover pools and ‘over-collateralisation’ requirements. These measures provide a degree of protection for both secured and unsecured creditors in the event of an ADI becoming insolvent. However, the safeguards would also serve to limit the degree to which covered bonds can reduce ADI wholesale funding costs, which is one of the key objectives of the Bill.

Embedded in the Bill is a fundamental change to the overall Australian Financial System – the removal of the concept of ‘depositor preference’. The removal of depositor preference would mean that depositors with deposits of $250 000 or less would be dependent on deposit insurance (known in Australia as the Financial Claims Scheme or FCS) for protection of their funds in the event of an ADI becoming insolvent. For depositors with deposits greater than $250 000, who would not have access to deposit insurance, their interests would be ranked below those of covered bondholders. They would potentially be dependent on lower quality assets securing their claims. In particular, this would affect holders of larger deposits such as local councils and community organisations, as well as other unsecured creditors. The potential for unintended consequences of this Bill needs to be considered.

The academic literature is quite divided on the positive and negative effects of deposit insurance, however, the Treasurer has indicated that it will continue for domestic deposits of $250 000 or less. This Bill could create political and policy difficulties in removing or reducing deposit insurance coverage in future if that was deemed to be a sound idea.

The absence of deposit insurance (and general conservatism on the part of Australian financial regulators) in the years leading up to the GFC is an underexplored possibility as to why the Australian financial sector held up so well during the crisis. The FCS and other deposit/wholesale

40. Ibid., p. 24, [1.74].

Warning: All viewers of this digest are advised to visit the disclaimer appearing at the end of this document. The disclaimer sets out the status and purpose of the digest.
funding guarantees introduced at the height of the GFC were done quickly and without much consideration for unintended consequences. This may have legitimately been deemed necessary in the circumstances policy makers found themselves at the time, however, it would be prudent to have some sort of broader examination now that the emergency has passed. It would certainly be a good idea to have more debate over these issues during the parliamentary debate on this Bill.
Members, Senators and Parliamentary staff can obtain further information from the Parliamentary Library on (02) 6277 2455.