

the Business Roundtable on Climate Change (March, 2006). Modelling we contributed to that report shows Australia's real GDP growing between now and 2050 at an annual rate of 2.2 per cent under the assumption of no new GHG policies. In this scenario, Australia's GHG emissions by 2050 are 80 per cent above their level in 2000.

In an alternative scenario, Australia introduces an Emissions Trading Scheme (ETS) to reduce its GHG emissions by 2050 to 60 per cent below their level in 2000.

### **As part of a worldwide effort, Australia could achieve deep cuts in its own GHG emissions at only a moderate cost in terms of reduced economic welfare.**

Even with this very deep cut in emissions, Australia's GDP grows between now and 2050 at an annual rate of 2.1 per cent. The implication is that a massive 60 per cent cut in GHG emissions (relative to the 2000 level) costs about 20 months growth – the level of GDP that we would have reached on 1 January, 2050 is not reached until 1 September, 2051. A lesser cut would incur a lower cost. Taking account of non-linearities (the first 1 per cent

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Basel 2 is due to be implemented in Australia on 1 January 2008. Over the six years of the study, only 10 Australian banks afforded access to full annual reports. Trends in the quantity and quality of disclosure were examined. The absolute data was then tabulated and ratios calculated relative to the relevant total risk report.

The initial response of the Australian banking sector was to increase the *quality* of reporting on OR. But in the absence of a formal requirement, there has not been a significant increase in the *quantity* of reporting and not all banks specifically discussed OR in their annual reports over the study period. This is surprising given the regulatory environment. However, when the formal regulatory requirements are in place in January 2008, substantial change should be expected. ■

#### **AUSTRALIAN BANKS**

## **Safety net**

**B**ankers say no thanks, supporters hope it will liberate Australia's financial system and the financial press sit somewhere in the middle.

Deposit insurance is a guarantee that if a bank or insurer goes down, insured depositors get something back. There are two types of insurance: explicit and implicit. Explicit deposit insurance is an unequivocal agreement that bank deposits or insurance policies are protected up to a limit. With implicit deposit insurance the public remain uncertain if the Government will step in and pay out deposit holders in the case of corporate failure. Australia has an implicit deposit insurance system although for political reasons most governments have eventually jumped in after a collapse such as in the case of Pyramid Building Society in Geelong and HIH Insurance.

A new proposed scheme for retail depositors only put forward by the Council of Financial Regulators (CFR) wants the Government to provide a certain percentage (90 per cent and up) of a prescribed amount (proposed \$20,000) of the money lost. When the bank is fully wound up, the liquidator reimburses the

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Government and if there's insufficient funds, other surviving authorised deposit-taking institutions (ADIs) would be levied.

At the moment, Australian depositors are protected by the 'depositor priority' rule or provision contained within the *Banking Act 1959*. This states that, "depositors in Australia have first claim on the assets of an ADI in Australia should it be unable to meet its obligation or should it suspend

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cut is much easier than the last 1 per cent cut), a reasonable estimate for the cost of the 50 per cent cut mentioned in the petition is 12 months growth.

This suggests that the national macroeconomic impacts of an ETS are moderate, but does this carry through at an industry level? The modelling cited above showed that potentially some industries will be adversely affected, but that those adverse affects could be mitigated by targeted allocation of permit revenue. There are two main alternatives for permit allocation: auctioning with the permit revenue retained by the government, or grandfathering in which the permits are given to emitters free of charge. In the scheme modeled for the Business Roundtable, a hybrid system was designed to lessen effects on areas of the economy likely to be most adversely affected by the scheme. Some permits were freely allocated to those affected owners of generators to ameliorate the impacts on their rate of return, while the remaining permits were auctioned. The auction revenue was then used, first, to compensate trade-exposed, energy-intensive industries such as metal manufacturers. The purpose here was to offset the impact of the ETS on energy costs and thereby neutralise the effects of the ETS on each industry's international competitiveness. The remaining auction revenue was used to fund assistance measures for households, regions or small businesses deemed to have been 'unfairly' affected by the scheme.

Why do modelling results suggest that GHG emissions could be sharply reduced at seemingly moderate cost in terms of lost real GDP for the nation? Are these results plausible?

The main GHG-emitting activities are fossil-fuel-based provision of electricity and motor fuels. In Australia, these account for about 5.4 per cent of GDP. Advice from scientists and engineers indicates that the adoption of current alternatives to fossil-fuel-based technologies would no more than double the costs of electricity and motor fuels. As a back-of-the-envelope calculation, this suggests that Australia could make a 50 per cent switch to alternative technologies at a cost of 2.7 per cent of GDP, a little over an average year's growth. But this is a pessimistic view of the costs of climate insurance. If the world embraced the need for deep cuts in GHG emissions, we would expect rapid technical progress in GHG-benign technologies which would reduce the costs of their adoption. ■

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payment". To support depositors' interests, the Banking Act requires ADIs that take Australian retail deposits to hold assets here equal to their deposit liabilities.

Some worthy facets of the CFR insurance scheme are that it helps protect small depositors and encourages them to save; it stabilises the banking system; and it forces individuals with deposits over the stipulated limit to more closely monitor their bank's activities.

However, the proposal has its problems. The insurance could cause banks and depositors to become more complacent. It may also create a 'moral hazard' – both ADIs and insured depositors may adopt more risktaking activities to maximise their returns knowing their funds are covered. The adverse effects of this could spread throughout the banking sector. However, this moral hazard is minimised by the CFR recommendations that do not entirely eliminate the risk for both ADIs and depositors.

A key difference between the current implicit and the proposed explicit system is how they are funded. The current system is taxpayer funded, but any excesses not covered under the proposed explicit system by asset sale fall on the surviving institutions in the same pool as the failing institution. Rather than obtaining funding from all financial institutions and general and life insurance companies when, say, a credit union fails, the scheme limits the pool source. If a failure occurred in one sector such as a credit union, only the ADI funding pool is liable.

The CFR has proposed an ex post-funding arrangement based on other institutions in each pool. The levy will be based on surviving institutions' share of total insured deposits. The other option for explicit deposit insurance would be a pre-funded arrangement where institutions pay a levy each year to add to the pool.

How much each institution should contribute is another contentious issue. Theoretically, riskier firms should contribute more, but the CFR applies funding levies based on the insurance deposit base as a percentage of the total pool of insured

funds. This means that the lower risk banks will be required to pay the deposit insurance costs incurred when a high risk institution fails. Effectively, the costs of deposit insurance fall more heavily on the low risk institutions – probably one good reason why the banks aren’t over the moon about it.

The use of post-funding means that funds are only raised as required. It could be argued that the riskiest players should bear a higher level of liabilities, but APRA’s assessment of risk via its Probability and Impact Rating Systems decrees that the regulatory requirements of each institution not be publicly disclosed so as not to create panic in the market. A risk-based levy approach is more appropriate for a pre-funded scheme where risky behaviour leads to higher premiums. Deposit insurance will cost money. The CFR proposal wants the banks to fund it and there are no premiums to be paid on an ongoing basis. The CFR proposal is a good way to implement an explicit Australian deposit insurance scheme that will minimise liquidity issues and uncertainty for private depositors and policy holders and limit moral hazard.

Incentive to monitor the behaviour of players will shift from individual small holders and policyholders to industry competitors. A trade-off of the funding of

the scheme is that it is based on insured deposits, rather than the riskiness of insured institutions. It’s fair enough that excessive risk should be afforded higher regulatory requirements but rather than make the market aware of the more risky players and perhaps incite panic, the CFR funding system is based on the size of insured deposits. In conclusion, the CFR explicit deposit insurance proposal delivers

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stability and efficiency to the Australian financial system, without being overly burdensome to surviving institutions. ■

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**LIGHT RELIEF**  
By Steven Moore

