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The Economic Case for the Bank Levy

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FINANCIAL POLICY BRIEF

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Can a feasible economic case be made for the levy on the big banks announced in the budget? Yes.

Is that case consistent also with the government not charging insurance for sub-\$250,000 deposits? Also, yes.

Is the levy preferable to some alternatives? No, but is probably politically more feasible.

No Economic Case Given

In announcing the levy on certain liabilities of the big banks, the Treasurer eschewed attempting to provide an economic case to justify the new charge. Politically, that is probably sensible. The banks won't get much public sympathy and the complexity of the economic argument will not be grasped by many.

Nevertheless, for credibility of our economic policymaking, the argument still needs to be made.

It starts with the principle that those who provide insurance should be paid for the costs, and those that receive insurance should pay for the benefits from this transfer of risk.

Yet no levy will be paid to the government insuring sub-\$250,000 deposits under the Financial Claims Scheme. Why? The answer is simple – it is not the government that bears the ultimate risk of paying out those depositors in a failed bank.

A stylised example may help explain.

Most Australian banks would be insolvent if the value of their assets fell (due to bad loans or investments) by 15 per cent – from, for example, initially \$100 to \$85, because total liabilities would be higher, say \$90 (assuming \$10 initial equity).

If APRA liquidated the bank it would pay insured depositors their claims of, let's say, \$30. But APRA would then have first claim on the proceeds of the sale of the whole \$85 of assets. It would recover all it paid out – so the government does not incur a cost – and shouldn't receive a fee for insurance it will never have to pay out.

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Big Creditors Bear the Risk

Who is bearing the risk in that case? It's the other uninsured creditors of the bank – wholesale funders and uninsured (large) depositors, who will not get back full value of their claims. (In the example above, there's only \$55 of assets left, while they are owed \$60). Because such creditors realise such credit risk, they charge the banks a correspondingly higher interest rate. In that way the banks effectively pay their uninsured creditors for the insurance received by insured depositors.

But is that the likely scenario? Many would argue, validly in my view, that the response of government would instead be to take actions, such as injecting funds or providing guarantees, to prevent the bank from failing – particularly for large banks. This is typically referred to as the Too-Big-To-Fail problem (TBTF).

If that is the likely response of government, uninsured bank creditors will (arguably) take the view that they are in fact protected from loss from a bank failure. The government is providing implicit insurance to them. They will thus not require a higher interest rate from the banks to compensate for possible default risk.

The Implicit Government Guarantee

In this scenario, the banks benefit from not having to pay an “insurance premium” built into higher interest rates on uninsured liabilities. It is the government that is ultimately providing this insurance to the banks via taking on the risk of making uninsured creditors whole in the event of looming bank failure.

If that scenario is credible, it provides an economic case for a levy on uninsured bank liabilities. But is it credible?

There is certainly a widely held view that TBTF exists. Many researchers have produced studies indicating that, in banking systems around the world, large bank borrowing costs are lower as a result of perceived implicit guarantees. Those studies can, of course, be challenged – but it should be noted that for many years the ratings agencies have included an “uplift” to bank ratings to reflect perceived government support.

If this argument is accepted, is the bank levy the appropriate approach? An alternative is higher capital ratios and other prudential measures to ensure that banks are “unquestionably strong”. That would remove the value of implicit guarantees, since they are then redundant.

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My view is that higher capital ratios would be preferable – but banks have resisted this and now face the consequences of the politically attractive alternative.

This Financial Policy Brief was prepared by Professor Kevin Davis, Research Director of the Australian Centre for Financial Studies

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