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Association of Building Societies and Credit Unions

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By email: fcspolicy@apra.gov.au

Dear Mr Grummitt

FCS for ADIs: Proposed requirements for payment, reporting and communications

Thank you for providing Abacus with the opportunity to comment on APRA's Consultation Package, *Financial Claims Scheme (FCS) for ADIs: Proposed requirements for payment, reporting and communications.* Our submission also responds to the *Summary of Issues* paper prepared by APRA following the FCS Industry Workshop, and released on December 21.

The mutual model is the proven alternative to the listed model in the Australian retail banking market. Mutual ADIs have 4.5 million customers, a strong share of the household deposits and new home loan markets and are consistent market leaders in customer satisfaction and responsible lending.

Our comments in this submission largely deal with the proposed payment arrangements outlined by APRA in the consultation package, consistent with the focus of stakeholder feedback at the December workshop. In responding to APRA's consultation package, Abacus makes the following recommendations:

Recommendation 1: That APRA considers setting two-tiers of FCS obligations (for large and small ADIs), recognising that smaller ADIs face higher relative FCS pre-positioning costs and do not individually present a systemic risk.

Recommendation 2: That APRA not proceed with the Alternative ADI Account Facility, and instead investigate the feasibility of APCA's proposal for the use of a centralised data hub.

Recommendation 3: That deposit account transfers not be pursued as an additional payment option under the FCS.

Recommendation 4: That additional consideration be given to the possibility of payments via the failed ADI during an FCS event.

Recommendation 5: If a low cost solution to facilitating EFT payments cannot be developed, APRA should limit payments in an FCS event to cheques.

Recommendation 6: The Government should commit to reviewing the appropriate level of the FCS cap at regular intervals, with the objectives of ensuring that its value remains appropriate, and that its "real" value is not eroded over time.

Recommendation 7: Existing ADI business continuity planning should be accepted as sufficient to meet communication contingency obligations under APS 910.

The remainder of this submission provides further detail around our recommendations, however, the truncated consultation timeframes have prevented the collection of detailed data from members on the exact costs and implications of some of the proposals put forward by APRA. Stakeholders have only been given 17 working days to comment on APRA's Summary of Issues Paper (released on 21 December), and the challenge has been compounded by the absence of key staff over the Christmas break and skeleton staffing levels typically present during the Christmas shutdown period.

Given the number of issues that remain unresolved, and the range of options still being considered, we support APRA's suggestion of holding further workshops with stakeholders to discuss FCS implementation in greater detail.

Tailoring a low cost-solution to the ADI sector

We recognise and acknowledge the need for the Government to have a credible framework and process in place to manage an FCS event should an Australian ADI ever be FCS declared. However, it is also important to recognise that it is highly unlikely that such a situation will ever eventuate in practice. The Government's Budget papers list the likelihood of it ever facing a liability under the scheme as "remote,"[1] in part because Australia's financial system "is among the strongest and best regulated in the world."[2] In addition to the strong prudential framework, a number of mechanisms are in place which can be used to help resolve ADIs in difficult situations without resorting to the FCS.

Certainly the Australian ADI sector has been more reliant than the banking sectors of many other countries since the GFC. A 2012 review found that among the 21 members of the Financial Stability Board who currently operate a deposit insurance scheme, Australia was one of only five countries to not have activated their scheme in the past ten years.[3] In total, the 16 countries that had activated their deposit insurance schemes had done so on more than 1,000 occasions over this period.[4]

Given the frequency with which deposit insurance schemes are used in these jurisdictions, it is critical that they all have robust and effective frameworks in place to ensure the smooth management of their insurance systems. In contrast, the very low probability of the FCS ever being used to meet payments to ADI account holders in Australia warrants the development of a low cost solution, which minimises the impact on the day to day operations of ADIs.

APRA has also acknowledged the need to find a low cost solution, and has noted that their "consideration of payment options seeks to strike a balance between speed of payment, security of payment and convenience for depositors, while also seeking to minimise compliance and administrative costs and operational risks."[5]

In seeking to implement a low cost solution, Abacus believes there is compelling case for APRA to set differing FCS standards for ADIs of different sizes, recognising:

- The relative likelihood of the ADI triggering an FCS event;
- The relative cost to the ADI of implementing FCS pre-positioning; and
- The systemic importance of the ADI.

[1] Treasury, *2008-09 Mid-Year Economic and Fiscal Outlook,* Appendix C, p. 243.
[2] ibid.
[3] Financial Stability Board, *Thematic Review on Deposit Insurance Systems,* February 2012, p. 6.
[4] ibid., p. 55.
[5] APRA, *FCS for ADIs - proposed requirements for payment, reporting and communications,* Nov 2012, p. 13.

Some groups have suggested that a smaller ADI is more likely to fail and that therefore an FCS event is more likely to arise in this segment. However, Abacus does not believe this is a fair reflection on our members.

APRA has stated that "It is likely that the FCS would only be declared in a situation where other remedies for resolving an ADI's financial difficulties, such as transferring all of its deposits to another ADI or facilitating the recapitalisation of the ADI, are not feasible or cost-effective in the circumstances."[6]

A smaller non-systemic institution potentially suffering an idiosyncratic failure is significantly more likely to be the subject of resolution by merger with a larger ADI. This was demonstrated during the GFC with the mergers of St George with Westpac and Bankwest with the Commonwealth Bank. We also note that most mutuals are members of CUFSS, which provides the sector with an additional layer of liquidity support in times of crisis.

Abacus contends that mutuals, by virtue of their smaller size and existing contingency frameworks, are less likely to trigger an FCS event, face higher relative costs to implement pre-positioning, and individually are not systemically significant to the Australian ADI sector as a whole. Recognising the lower risk this sector presents, it would be appropriate for APRA to set less onerous pre-positioning requirements for these institutions.

Feasibility of EFT payments

APRA is currently proposing making payments during an FCS event through two channels, EFT and cheque. EFT would be the primary payment channel, with cheques only being used as a "back-up" option where payment through EFT is not possible. Abacus agrees that there is merit in facilitating payments through EFT in the event of an FCS declaration, however, it is critical that the costs and impact on the ADI sector be minimised. Should it not be possible to find a low cost solution which facilitates EFT payments, Abacus recommends that APRA limits payments to cheques.

APRA has acknowledged that payment by cheque entails lower pre-positioning costs,[7] but at the same time has expressed concerns about the practical capacity of the RBA to print the number of cheques required to facilitate an FCS event were this the sole form of payment.[8] While Abacus accepts that this would prevent cheques being used to resolve an FCS event with a major bank, RBA printing capacity should be far less of a concern in the case of smaller ADIs.

Consistent with the two-tier approach proposed earlier, APRA could engineer an EFT solution which large ADIs would implement, while at the same time allowing smaller ADIs to avoid these pre-positioning costs and use cheques as the sole payment channel in the highly unlikely event of a small ADI ever being FCS declared.

Facilitating EFT payments during an FCS event

Making payments via EFT requires account holders to have an account with another ADI, and a process in place to manage payment from the failed ADI. To facilitate this process, and maximise EFT utilisation, APRA has proposed that all ADIs be required to establish "alternative ADI account facilities," which would be activated in the event of an FCS declaration.

In contrast, APCA has proposed that alternative account details be managed through a centralised data-hub, which would be "a scaled up version of the APCA account-switching mailbox." While noting that the mailbox system is a manual system not currently designed

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[6] APRA, *FCS for ADIs - proposed requirements for payment, reporting and communications,* Nov 2012, p. 10.
[7] ibid., p. 15.
[8] ibid.

for the input of multiple transactions in one data entry process, a form of the mailbox could potentially be used by a "gaining" ADI to advise the failed ADI of alternative ADI deposit account details and thereby enable the failed ADI to generate an aggregated RBA EFT payment file. In effect, the alternative account details would be passed from the "gaining" ADI to the failed ADI via the mailbox.

Abacus believes that the proposed APCA solution presents a number of potential benefits when compared to the alternative account facility:
- It is a lower cost solution;
- It is more convenient for account holders;
- It reduces the risk of customer error; and
- It better aligns economic incentives between the "gaining" and "losing" ADIs.

Cost

APRA's proposed alternative account facility is a high cost solution. Service providers have advised our members that implementing such a facility would be very expensive, and members considering in house implementation of a solution have indicated establishment costs in the order of $50,000. APRA acknowledged cost concerns with the current proposal at the Industry Workshop on 6 December, and subsequently proposed two potential amendments to the facility designed to reduce costs:
- "building the facility on a low-volume capacity but with contingency arrangements for up-scaling to cope with high volumes."
- "the facility is activated on an ongoing basis, as opposed to being activated only at the time an ADI is declared to be subject to the FCS."[9]

Abacus does not believe that either of these options will significantly reduce the cost of implementation, and that they could in fact make the system more expensive.
- It is not clear how building the facility on a low-volume capacity would reduce costs. Members had already assumed that the facility would only need to be activated in the event of an FCS declaration, at which point the high-volume capacity would be required.
- Members have indicated that activating the facility on an ongoing basis will increase costs rather than reducing them. Customer apathy means that there is likely to be very little take-up of the facility in advance of an FCS declaration, and that there would only be a minimal reduction in peak demand. Any cost savings during the peak would be outweighed by the increased costs associated with running the facility on an ongoing basis. In addition to increasing costs, there are other drawbacks to this approach:
  - Telling customers that there is a facility available where they can register alternative account details in case their current ADI becomes insolvent runs the risk of undermining consumer confidence in the safety and stability of the sector.
  - An ongoing facility runs the risk of account holders not keeping their alternative ADI details up to date, increasing the likelihood of incorrect transfers and return payments, which are costly and time consuming to process.

In contrast, it is expected that the APCA proposal would provide a lower cost solution. It is inherently more efficient for the sector to produce a single centralised solution than to require more than 100 individual ADIs to each implement their own individual system to manage the same process.

Convenience for account holders

APRA's proposed alternative account facility provides limited customer convenience. The facility would only be available through electronic channels, and many account holders do not have electronic account access.

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[9] APRA, *FCS Industry Workshop – Summary of Issues Raised,* Dec 2012, p, 5.

Internet banking has far from comprehensive coverage, and this channel may not be a familiar or comfortable option for all account holders whose accounts are currently "ebanking enabled." For these reasons, many account holders would be unable or unwilling to make use of the alternative account facility in the event of an FCS declaration. This is a major drawback to use of the alternative account facility, and means that even where this system is put in place; it is still likely that the majority of account holders would have to be paid out via cheque.

APCA's mailbox approach is more customer friendly, with the process specifically designed to to "make it easier for consumers to switch their everyday transaction accounts from one financial institution to another."[10] Account holders wishing to receive payment via EFT could open an account with another ADI and then request that this ADI manage the process of transferring funds. In this way, all account holders have the capacity to make use of EFT payments, irrespective of whether they have pre-existing electronic access to their account with the FCS declared ADI. The APCA mailbox also resolves identification authentication issues, as the "gaining" ADI would carry out these checks as part of the account opening process.

The process of transferring accounts is also more straight-forward for account holders under the APCA model. Where account holders do not currently hold transaction accounts with multiple ADIs, to receive an EFT payment they must both open an account with another ADI and flag their intention for the funds to be transferred. Under the alternative account facility, this is a two-step process requiring two sets of interactions – the account holder must first open an account and then log-on to the alternative account facility to register the account details. In contrast, the APCA mailbox provides a single-step solution, where account holders simply open an account with another ADI and simultaneously request that this ADI manage the process of transferring funds.

Risk of customer error

APRA's proposed alternative account facility increases the risk of customer error leading to incorrect payment. As noted in the November 2012 Discussion Paper, making payments through the alternative account facility "relies on the account-holder providing correct account details for the alternative ADI into which funds are to be deposited."[11] This is a manual process which inevitably runs the risk of human error. Provision of incorrect account details has significant consequences – "Payments made to an incorrect account can be hard to retract. Returned payments would need to be reconciled and re-processed manually, which would entail cost and considerable delays in making the payments to the account-holders in question."[12]

APCA's solution addresses this risk by removing the need for the account holder to manually enter their account details, eliminating the possibility of their error leading to a failed EFT transfer. The reduced risk of customer error under the APCA model reduces double handling and delays, leading to reduced overall costs, faster payments and increased customer convenience.

Incentive to effect payment

Under APRA's proposed alternative account facility, the declared ADI is responsible for managing the collection of account details and the provision of this data to the RBA. In contrast, the alternative ADI (ie the "gaining" ADI) does not need to take any action to effect the transfer of funds.

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[10] http://www.apca.com.au/payment-systems/direct-entry/account-switching

[11] APRA, *FCS for ADIs - proposed requirements for payment, reporting and communications,* Nov 2012, p. 14.

[12] ibid.

This appears to be a misalignment of economic incentives, and was one of the weaknesses with the original account switching process introduced by the Government in 2008. As noted by the Fraser Review:[13]

> "Transaction accounts are valuable banking products, bringing with them low interest balances which make up a significant part of the overall funding needs of many institutions. Traditionally they are also 'anchor' accounts to which other accounts can be tied. It is appropriate, therefore, that the acquiring institution should shoulder most of the task of effecting individual switches – all the incentive is with that institution (and none with the losing institution) to nurture the potentially profitable new banking relationship which starts with a successful switch."

The APCA mailbox addresses this issue by ensuring that the "gaining" ADI is the institution with primary responsibility for managing the transfer.

Deposit account transfers as an additional payment option

Under this option, APRA proposes that existing deposit accounts could be transferred to another ADI in the event of an FCS declaration.

Abacus notes that this approach is really just a variation on APRA's existing merger policy. However, APRA's approach in the past has been to complete whole of business mergers, which is arguably more manageable than this proposal, which would only transfer the deposit accounts. From a practical perspective, we also note that an ADI would only be FCS declared where APRA had already determined that a merger was not feasible or cost effective. It is hard to see how a deposit account transfer under the FCS could subsequently be feasible in these circumstances.

In addition, Abacus has the following concerns about using this approach to resolve an FCS declared ADI:

- It is potentially more costly;
- It could reduce competition in the banking sector; and
- It undermines customer choice.

Costs

APRA notes that under the deposit account transfer option, residual amounts would continue to be transferred by EFT or cheque, meaning that it would act in parallel to APRA's alternative account proposal, rather than replacing it.

APRA also notes that this option would impose additional IT costs on ADIs:

- IT pre-positioning would be required to ensure transfers did not exceed the FCS limit; and
- Given that the accounts themselves will be transferred, an IT system would be needed to allow for the identification of residual balances by account holder name.[14]

On APRA's own assessment, it therefore appears that in aggregate, the introduction of deposit account transfers under the FCS would place additional cost obligations on ADIs, without removing any of the existing obligations imposed under the primary EFT/cheque transfer proposal.

Competition

Abacus is concerned with the competitive impact this may have on ADIs. If the transfer of accounts is focussed on a single ADI rather than being spread across a number of

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[13] B Fraser, *Banking Services – cost-effective switching arrangements,* 2011, p. 16.
[14] APRA, *FCS Industry Workshop – Summary of Issues Raised,* Dec 2012, p, 5.

institutions, this approach will result in a less competitive outcome than other options currently being considered.

Careful consideration should be given the types of ADIs that could have the capacity to absorb some of the transferred accounts, including the capacity for the mutual banking sector to play a role in this space. We are concerned that, in the event of an FCS declaration, the desire for financial stability and a swift resolution will see concerns about competition given little weight, and decisions taken which are not necessarily in the long term interests of consumers.

While APRA has proposed the establishment of a bridge bank to address this concern, unless processes are in place in advance of any crisis situation to ensure that competition is not undermined, the final outcome is unlikely to be any different. Should deposit account transfers be pursued, it is important that this does not simply result in accounts being transferred to a major bank in a crisis event.

Customer choice and convenience

Under this proposal, customers are automatically allocated to an ADI, and do not have the opportunity to select their new financial institution. While customers are free to subsequently choose to move to an ADI of their choice, history has demonstrated that customer apathy reduces the likelihood of this occurring.

The automatic transfer of accounts can also be problematic for account holders where Direct Entry payment system links are not transferred with the account. In this situation, account holders would need to go through the time consuming process of manually re-establishing these arrangements.

Payments via the failed ADI as an alternative payment option

Under this proposal, in the event of an FCS declaration, the failed ADI would reopen some payment channels for a transitional period to provide account holders with an opportunity to withdraw their funds.

The main advantage of this option is that it gives account holders an opportunity to draw down their account during the transitional period, avoiding the need to make arrangements with an alternative ADI. Indicative data from the mutual industry suggests that a significant majority of account holders would be able to withdraw their entire balance during this transitional period.

This approach could also be integrated with the APCA mailbox option outlined previously. In this scenario, customers would have 2-3 weeks to either empty their accounts or open an account with another ADI and request a fund transfer. Those that have not taken one of these actions during that period (only likely to be a small number of customers) could be paid out by cheque.

In theory, this payment option performs well when assessed against APRA's own criteria, providing greater convenience to account holders and faster payments. However, it also presents a number of difficulties, and further investigation is required to determine whether solutions to these challenges can be found.

Our views on the concerns raised in APRA's workshop paper are set out below. In addition to these specific comments, we would also note that, at a more general level, several of these concerns could be at least partially mitigated if this approach was combined with some form or APCA's proposed account mailbox replacing the alternative account facility.

- *"Complexities and IT costs associated with recalculation of the SCV."* Member feedback has indicated that recalculating SCV balances is not a significant additional cost.

- *"The probable need for IT pre-positioning to place a cap on the amount of funds that may be withdrawn, so that the FCS cap is not exceeded."* We understand that some members have already done some work on setting up the ability to set limits on payments across different channels in anticipation of such an event and there were no significant complications involved. We also note that daily withdrawal limits will already provide some protection against withdrawals exceeding the FCS cap during the transitional period, and that the risk of withdrawals exceeding the $250,000 cap would be low, particularly if the transitional period was limited to two weeks. It is arguable that the cost of completely eliminating this risk is higher than the cost of allowing withdrawals above the cap in these rare cases. We note that in the US, the most common form of resolution has been the transfer of deposit accounts, and this approach has at times seen the acquirer take on all deposits, providing an uncapped level of protection which was in excess of the publicly stated cap. In the past, the Federal Deposit Insurance Corporation (FDIC) has been able to take this approach where guaranteeing the additional amounts is the "least cost solution."[15]

- *"The ability to post account-based transactions back to the SCV and reconcile the first SCV run with the second SCV."* Any reconciliation would only be required for accounts that had a balance of more than $250,000 at the time of the first SCV run. The Government has previously estimated that around 99 per cent of deposit accounts would be fully covered by the guarantee.[16] Managing the reconciliation of the remaining 1 per cent of accounts is unlikely to be a significant additional burden. Individual members have indicated similar account size breakdowns, and noted that the reconciliation task for these larger accounts is therefore unlikely to be onerous.

- *"The need for the Government to provide appropriate protection to other ADIs' exposures to the declared ADI during the period in which the declared ADI remains in the payment system,"* and *"Potential technical complications with withdrawals via other ADIs' ATMs* Abacus agrees that Government protection would be required to provide assurance to other ADIs that the failed ADIs settlement obligations would be met.

- *"Potential system capacity issues associated with high volumes of use of internet and telephone banking channels."* This issue is not unique to this payment option. All of the potential payment channels discussed in the various APRA papers will inevitably lead to some spike in demand for banking services, through either online, telephone or over-the-counter channels. System capacity issues are likely to be less pronounced under this option than the alternative account facility option proposed by APRA, as making payments via the failed ADI spreads the increase in demand over 2-3 weeks instead of 2-3 days.

- *"Potential security risks if branch networks are reopened*." Abacus does not support reopening branch networks. The potential security risks associated with reopening branches would be significant and costly to manage. In addition, reopening branches presents a risk to staff, particularly given the heightened emotions of customers during this difficult period. These safety risks would be amplified where cash limits were placed on withdrawals to manage the flow of funds. However, it may be possible for this option to operate without reopening existing branches. The vast majority of account holders already have the capacity to access their accounts through at least one channel other than over the counter.

- *"Logistics issues – eg the supply of cash to ATMs in a period where higher-than-normal withdrawals may be made,"* and *"The possible risk of adverse "optics" associated with the possibility of queues at ATMs and branches."* If account holders are not able to make

[15] See FDIC resolution handbook, pp. 23-24.

[16] The Hon. Wayne Swan MP, *Media Release – New Permanent Financial Claims Scheme Cap to Protect 99 Per Cent of Australian Deposit Accounts in Full,* 11 Sep 2011

use of third party ATMs then logistical issues around cash supplies and ATM queues will present significant challenges. Where account holders are limited to using the ADI's own ATMs, cash supplies would be exhausted quickly, and a solution would need to be found which allowed an ADI to manage the supply of additional cash required to meet the spike in demand. However, many mutuals make use of third party ATM networks to service account holders (in particular the RediATM network). If account holders were able to continue using this ATM network during an FCS event, it could reduce the impact of the spike in demand by spreading it over a larger number of machines than would be the case if each mutual operated their own independent ATM network.

- *"Delays in account-holders receiving their full FCS entitlement."* While this option potentially delays full payment, it gives account holders more timely access to some money, providing individuals with the finances needed to meet day to day living costs. In addition, if this option was combined with some form of APCA's account switching solution, it would also gives consumers faster access to their complete balance. In this scenario, account holders would not have to wait for the failed ADI to be removed from the payment system to receive their full account balance, they would simply open an account with another ADI and request the funds be transferred.

In addition to the issues raised by APRA, Abacus also notes the following potential concerns with this payment option:

- Most smaller ADIs use service providers to facilitate payments settlement. Arrangements would need to be pre-positioned with these service providers to allow the failed ADI to be re-activated on payment systems. In addition, many of the contracts and service agreements with these service providers include termination clauses triggered by insolvency events, and pre-positioning would be required as part of the ADI's business continuity planning arrangements to manage this.
- In addition to the challenges associated with FCS declared account holders using other ADI's ATMs, prepositioning would be required to prevent foreign cards from being used on FCS declared ATMs.

Given the potential benefits of this payment option, Abacus believes APRA should give further consideration to whether the challenges associated with its use can be overcome, with a view to potential implementation in the longer-term.

Other issues

Setting the FCS cap

On 11 September 2011, the Government announced that the value of the deposit guarantee available under the FCS would be capped at $250,000. While Abacus welcomed the announcement, we also believe it is important that the Government review the cap on a regular basis to ensure its value remains appropriate. We note that this approach is already followed in other jurisdictions. For example, in the US the value of their deposit guarantee has been adjusted on 7 occasions since its introduction, with an increase in the cap occurring roughly once every decade, and the cap increasing at an average rate of around 6 per cent each year. In addition, the Boards of the FDIC and the National Credit Union Administration can review and adjust the value of the guarantee every five years.[17]

At a minimum, a similar framework in Australia for reviewing the value of the cap is needed to ensure its "real" value is not gradually eroded over time through inflation.

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[17] US Federal Register, *Rules and Regulations,* Vol. 71, No. 176, Sep 2006, p. 53547

Communications

Crisis communication already forms part of an ADI's business continuity planning. Existing crisis management plans could be used to manage communications during an FCS event, and it appears unnecessary to expect ADIs to put separate communications contingency plans in place specifically to deal with an FCS situation.

Existing ADI crisis communication processes and contingencies should be seen by APRA as sufficient to meet any communication obligations under APS 910.

Testing

Consistent with our overarching position on FCS implementation, it is important that the ongoing cost burden of any testing obligations is minimised. However, the exact nature of any testing requirements cannot be settled until APRA has reached a position on the preferred payment channel.

End of day balances

APRA has sought feedback on whether 72 hours provides sufficient time to establish cleared funds positions for all deposit accounts. Abacus notes that it is impossible to comment on this in an informed way until APRA has finalised its position on the processes required to generate end of day balances and cleared funds in an FCS event.

Please contact me on or Micah Green, Senior Policy Adviser, on to discuss any aspect of our comments.

Yours sincerely

LUKE LAWLER
Acting Head of Public Affairs