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**Opinion** Investment



The Government guarantee on deposits was recently capped at \$250,000. **Tamara Radice** details the facts about the change and explores options available to investors under the new lower guarantee limit.

**O**n Sunday 11 September the Government guarantee on deposits (officially called the Financial Claims Scheme or FCS) was reduced to a \$250,000 cap, down from \$1 million provided since October 2008. The lower limit will be a blow to investors in that it reduces competitiveness between the big four banks and their smaller competitors, the regional banks and the mutuals (credit societies and building societies). Deposits larger than the cap are likely to drift back to the big four given their much higher credit quality. The big four will rightly capitalise on the move and as a consequence we expect term deposit rates for more than \$250,000 to fall in coming months.

However there are strategies available to retain the government guarantee and/or the higher rates of return.

**The facts**

From 1 February 2012, the new deposit guarantee 'permanent cap' will be \$250,000 and will continue to apply per person per authorised deposit-taking institution (ADI).

The FCS has been confirmed as a permanent feature of the Australian banking system. This was announced in the Government's banking competition package released back in December 2010. The announcement on 11 September 2011 now provides a 'permanent cap' of \$250,000 (effective from 1 February 2012).

In October 2008 the Government brought in the automatic deposit guarantee capped at \$1 million. The guarantee was set to expire on 11 October 2011. In the recent announcement, the Government has extended the \$1 million



limit until 31 January 2012.

However, there was one transitional concession provided in the announcement. Term deposits already in existence as at 10 September 2011 will continue to be covered up to \$1 million until the earlier of either the scheduled maturity date or 31 December 2012.

Accordingly, the following guarantee cap applies to the various scenarios:

- New or existing deposits that mature on or before 31 January 2012 will continue to be guaranteed up to \$1 million.

- Existing deposits that have a scheduled maturity after 31 January 2012 will receive transitional relief and are covered up to \$1 million until the earlier of the scheduled maturity date or 31 December 2012. Such deposits must have been entered into on or prior to 10 September 2011 and investors will not be able to roll over term deposits that mature prior to 31 January 2012 to avail themselves of the transitional relief.

- New deposits made from 11 September 2011 onwards that mature after 31 January 2012 will be guaranteed to \$1 million until 31 January 2012 and then revert to the new cap of \$250,000 from 1 February 2012.

The Government also announced some minor legislative changes it intends to make to the FCS framework. In essence the Government will remove the deposit guarantee for deposits made by foreign branches of Australian-incorporated ADIs. The charter of the Banking Act and the Australian Prudential Regulatory Authority (APRA) is to protect Australian depositors (and hence not foreign depositors in Australian ADIs offshore).

There will also be some amendments to improve flexibility for operating the FCS in the unlikely event an ADI is expected to fail. APRA will have the ability to transfer deposits to a new institution and the Treasurer will be able to activate the FCS before an ADI has formally reached the point of winding-up.

#### Investor options

A government guaranteed term deposit is an excellent investment. The guarantee gives the investor the same protection as those investing in Commonwealth government bonds, which are considered risk-free as the Government has the ability to raise taxes and print money. So, in Australian market terms a Commonwealth government bond and a guaranteed term deposit are the lowest risk investments investors can own. The difference between the Commonwealth government bonds and government-guaranteed term deposits is liquidity. The bonds are highly liquid and that means easily traded. A term deposit locks the investor into a set investment period, so investors should be rewarded for that loss of liquidity.

At the moment you can earn more than 100 basis points (bps) over the bank bill swap rate (BBSW) for a \$250,000 one-year term deposit. The best rate on offer from [www.termdeposit.com.au](http://www.termdeposit.com.au) was 5.9 per cent from a regional bank. However one of the major banks was offering a high 5.60 per cent, or 145bps over today's one-year BBSW rate of 4.15 per cent.

#### Option 1

If you or your clients have more than \$250,000 to invest, you could split the investment between institutions. At [www.termdeposit.com.au](http://www.termdeposit.com.au) they have relationships with around 60 ADIs, all of whom provide access to the \$250,000 government guarantee. If you were to deposit \$250,000 with each one of them you could potentially invest \$15 million and have the total sum government guaranteed. It would involve a bit of work to set up but if you're wanting a government guarantee, then it's worth the initial effort.

The negative with this strategy is that



if you lock in your funds you can't access them without incurring a break fee. But you can invest the funds for different terms to suit your cashflow needs. Remember that shorter investment periods will pay lower returns.

**Option 2**

Do some research, or find a third party that will do the research for you, and make a risk assessment of the ADI. Key measures you'll need to assess are:

- Size
- Geographical diversity
- Profitability
- Loan book or business risks of the ADI
- Deposits-to-loan ratio

The funny thing about the guarantee is that it has been implied but not explicit in Australia for years. Can you think of a financial institution in Australia that has gone into wind-up and as a consequence, depositors have lost money? Pyramid Building Society collapsed, but the Treasury eventually came to the rescue of depositors to the value of around \$900 million.

The point I'm making here is that the guarantee provides us with a degree of certainty that exists implicitly. I think the possibility of a depositor losing money in Australia is remote. However, it does exist. As an investor, if you want to invest more than \$250,000 in a single financial institution, you'll need to make a risk/reward assessment.

The top four banks are low risk as they

are diversified, have significant assets on their balance sheet, and are consistently profitable. The low risk nature of the institutions means they can pay lower rates to attract deposits. Smaller companies with higher risk will need to pay more to attract deposits. But if you are comfortable that they aren't going to go into liquidation, then you can potentially pick up a higher return.

If you also think the risk of loss is minuscule, you would opt to deposit your funds with the institution paying the highest rates.

**Option 3**

Consider putting part of your cash into bonds for added return. By investing lower in the capital structure in those well-known banks you are confident will continue to trade, you can pick up an additional return. While senior bonds are slightly higher risk than term deposits, the main benefit they have is that they are liquid (see the capital structure diagram below). Typically, you can sell at short notice without loss.

Yields on Australian dollar bonds continue to contract as market expectations for a low-growth economy become more widespread. Some of the bonds you might consider are the Westpac fixed rate bond maturing in February 2020, which currently has a yield to maturity of 6.20 per cent. While this bond is long-dated it is liquid. Should market perceptions about interest rates

continue to contract this bond's price will rise, providing investors with the possibility of a capital gain (remember you can also incur a loss if you need to sell prior to maturity). The other bond I would consider is one issued by National Wealth Management, a subsidiary of National Australia Bank. This bond is subordinated debt, so sits under senior debt and for that reason is higher risk. It has a June 2016 maturity date, has a fixed coupon and a current yield to maturity of 7.2 per cent.

For investors prepared to consider foreign bank issuers, the yields are higher than those offered by domestic issuers. Australian dollar issued senior debt is yielding over 7 per cent to maturity and some subordinated debt issues are paying close to 10 per cent.

**Conclusion**

It seems most of us are uncertain about the future and don't want to take on additional debt. The regulatory environment is changing at the same time as the banks are having difficulty lending. This means we're likely to see rates go lower still. By doing your own research and comparing what's available in the market you can make the deposit decision that's right for you.

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