BANKING

QUESTION

Capland is a first world country with a fully developed financial market. The capital required for banks is currently 12% of assets. All assets, excluding Capland Government Bonds are weighted at 100%. Capland Government Bonds are weighted at zero. Prior to the GFC the capital requirement was 8% of assets. After the GFC the Government raised the rate to 10% (with effect from 1 October 2011), and 18 months ago it was further raised to 12% (with effect from 1 October 2015).

When the rate was raised to 10% the bank industry generally raised their interest rates on all types of lending by 40 basis points and following the rise to 12% rates were further increased by 50 basis points. These rate changes happened independently of changes in general market interest rates. The vast majority of loans, of all types, are with variable interest rates.

As a result, there has been serious and growing anger at the banks' behaviour. Even bank shareholders are criticising them for "rapacious" behaviour. The banks' response has been to point to the government as the body which determines the capital required. They have also added that the supply of capital for banks is limited and without these interest rate rises they would have been constrained in raising the necessary capital.

The Government has faced mounting pressure, with a cross-party parliamentary committee now examining the issue.

You are the senior partner of Capland Capital Actuaries ("CCA") a firm of actuaries which has previously provided advice to the Government on capital requirements for a range of financial service companies. CCA does not work for individual financial services companies.

An internal Government Task Force, separate from the parliamentary committee, has looked at the idea of replacing the capital requirement with a Government guarantee of bank deposits in the event of default by the bank. It has pointed out that each bank would need to pay an appropriate price for this guarantee, to ensure that risk-acceptance behaviour remains acceptable.

The Treasurer has asked you to examine the implications for the Government, the banks and, very importantly, the banks' customers. She has asked you particularly to:

- address the points raised by the Task Force, including recommending a price for the Government guarantee,
- quantify the financial risk to the Government of such a guarantee,
- discuss the implications, and identify any action by the Government to mitigate adverse implications, and
- Provide an overall set of recommendations for Government action.

You have been provided with summary financial data for the banking industry, showing the Financial Performance for each of the past five financial years, and the financial position at each year end.

Task:

Prepare your report

Attachments:

Capland_Banking_Data.xlsx

END OF QUESTION

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