OPINION

Climate change insurance

Greenhouse gas emissions can be cut at a moderate cost to the nation, say *Philip Adams* and *Peter Dixon*.

Recently, a petition was circulated among senior academic economists seeking endorsement for a statement on climate change. Key points were that warming of the world's climate through human activity is undeniable; that preventive policies, such as carbon taxes, are urgently needed; and that developed countries such as Australia should demonstrate leadership by being involved in international efforts to cut emissions. We signed the petition for the following connected reasons.

First, compelling advice from the scientific community, including CSIRO, suggests that a sharp cut in world greenhouse gas (GHG) emissions would substantially reduce the risk of catastrophic climate change over the next century.

Second, 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. It is on this second point that economists have particular expertise, justifying the presentation of an economists' petition.

Cutting GHG emissions is like buying an insurance policy: we incur a cost (a loss in GDP) to reduce a risk (catastrophic climate change). In any insurance decision, the cost matters. If a worthwhile reduction in risk costs 50 per cent of income, then living with the risk may be preferable. But if it costs 1 per cent of income, then taking the insurance policy may be the best option. So what will it cost?

For the last 20 years, we have undertaken economic modelling exercises for Australian and overseas organisations on the costs of GHG reductions. Our modelling and that of other quantitative economists around the world supports the claim in the petition that:

"Credible estimates suggest that a 50 per cent emissions reduction is achievable for less than one year's economic growth."

Exactly what this means can be explained in terms of the report by the Allen Consulting Group to

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AUSTRALIAN BANKS

Risk reporting

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Operational risk (OR) is a key risk faced by banks, but traditionally it has not been a focus for markets or for regulators. Even defining OR has proved a challenge for both the industry and its regulators. The disclosure of key areas of risk is important for both market discipline and effective bank regulation. Financial industry estimates suggest that operational risk contributes approximately one quarter of total bank risk. OR has also been the source of substantial bank losses – a recent example occurred in 2004 when the National Australia Bank lost $360 million as a result of operational risk in its foreign exchange options trading area. This study of voluntary operational risk disclosure in Australian bank annual reports was undertaken between 1998 and 2003 during a period in which substantial regulatory change had been foreshadowed, but not yet formally implemented. The research offers the first empirical investigation of whether Australian banks have changed their level of OR disclosure.

During the period of this study, the Basel Committee on Banking Supervision (BCBS) formulated a standard definition for OR and announced a new Basel Capital Accord (Basel 2) on OR disclosure and minimum capital requirements. Thus, banks had an incentive to reveal their level of operational risk as it would help prepare them for the formal requirements of Basel 2. There was also an incentive to show that formal requirements were unnecessary by implementing high levels of disclosure.

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

Bankers 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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