

REGULATORY IMPACT STATEMENT EXTENDING THE RETAIL DEPOSIT GUARANTEE SCHEME

EXECUTIVE SUMMARY

1. On 12 October 2008 the current retail deposit guarantees scheme (DGS) was put in place to stabilise the financial system as result of extreme international stresses in financial markets. The temporary scheme is due to lapse on 12 October 2010, one year earlier than the Australian scheme.
2. The decision being made is not whether a retail deposit guarantee scheme should be introduced or not, but how to exit from the scheme in a way that balances the government's economic, financial stability, and fiscal objectives. A range of options were assessed ranging from no change from the status quo (12 October 2010 end date) through to extending the scheme for a further period; and within this option the terms on which the scheme would be extended. The key terms of the extended scheme are the length of the extension, whether it is voluntary or compulsory, the fees that are charged, institutional eligibility, the cap on the amount of deposits that are covered, and what management and resolution levers are available to the Government.
3. Having assessed each of these options against the objectives, the option that best meets the overall objectives (economic, financial stability, and fiscal) is to extend the scheme on tighter terms for a period ending 31 December 2011. However, this option is finely balanced with the status quo option of letting the scheme cease on 12 October 2010.
4. Extending the scheme on tighter terms reduces likely fiscal costs of guaranteed institutions failing. This is because by extending adjustment over a longer but definite period it is more likely to improve recoveries, avoids depressing an already fragile asset market, and provides greater opportunity for a viable non-bank sector going forward. It provides more time for financial markets to stabilise and aligns the end of the New Zealand guarantees more closely with that of Australia.
5. The tighter terms also improve on the economic costs associated with the existing scheme from under pricing risk. Also, it puts an emphasis on managing risk and the enhancements allow for better control of the actions of financial institutions that could be potentially detrimental to the Crown and wider economy.
6. The status quo stops economic distortions from under pricing risk, but does so at potentially high fiscal and medium-term economic cost, in so far as it reduces recoveries from failed institutions and it means that otherwise sound institutions are unable to survive the disorderly exit of other financial sector firms.
7. Given the time imperative, implementation is to be through urgent legislation for some or all of the stages with a limited select committee process.

ADEQUACY STATEMENT

8. Treasury's Regulatory Impact Analysis Team has reviewed this Regulatory Impact Statement and considers it to be adequate according to the adequacy criteria.

STATUS QUO

Reasons for introduction of current deposit guarantee scheme

9. The current retail deposit guarantee scheme (DGS) was put in place on 12 October 2008 to maintain depositor confidence in New Zealand given, at the time, the extreme stresses in international financial markets and the actions being taken internationally to introduce broad deposit guarantees, including by Australia.
10. Given the strong financial sector and corporate interconnections between New Zealand and Australia, Australia's policy reaction to these financial market stresses was very important as potentially significant parts of New Zealand's retail deposit base might have moved to Australian banks to take advantage of the Australian guarantee. This would have made New Zealand banks more dependent on wholesale markets which, also at that time, had been severely disrupted.
11. A wholesale funding guarantee facility (WFGF) was introduced in November 2008 to help improve access to international funding markets for investment grade New Zealand financial institutions. The WFGF has no explicit end date and is outside the scope of this RIS.
12. New prudential regulations for non-bank deposit taking institutions (NBDTs) were due to be phased in during 2009-2010 to promote the maintenance of a sound and efficient financial system and avoid damage to the financial system that could result from the failure of a NBDT. These regulations were not considered sufficient at the time to address the perceived risks to depositor confidence. The regulations will continue to be implemented throughout the current scheme and any extension. Clearly the regulations are not the means of exit from the scheme: they help to create and shape the environment into which firms will be required to manage long term. However they will encourage firms to take actions to reduce their own riskiness or to exit the sector.

Key features of existing DGS

13. The DGS is voluntary and will lapse on 12 October 2010. Eligible financial service providers pay a fee to enable their depositors to be covered by the scheme. Features of the current DGS are:
 - **Eligibility:** The current DGS covers retail deposits up to \$1 million per depositor per institution (including deposits, term deposits, current accounts, bonds, bank bills and debentures) in banks and non-bank deposit taking institutions (building societies, credit unions, finance companies, the PSIS and collective investment schemes who meet the eligibility criteria). For the purposes of the Scheme, retail deposits include deposits made by anyone other than financial institutions, related parties and in the case of

non-banks people who are neither New Zealand citizens nor New Zealand tax residents. Policy guidelines set out the types of institutions eligible for the DGS and what criteria and other factors may be considered by officials when assessing an application, including whether the inclusion of an institution meets the relevant public interest test.

- **Fees:** Institutions which choose to opt in to the current DGS pay risk based fees depending on their credit rating, the size of their deposit book (if over \$5 billion), or the expansion of the deposit book (if under \$5 billion). The fee structure involves an element of subsidy from taxpayers to guaranteed depositors and deposit taking institutions, particularly in the non-bank sector.

14. Annex 1 shows the coverage of institutions at the moment.

Costs of existing DGS (sunk costs)

15. [Withheld - commercial sensitivity

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16. [Withheld - commercial sensitivity

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17. To date, fees collected under the current fee structure are approximately \$87.4 million per annum (\$81.9 million from banks and \$5.5 million from non-banks).

18. However, the net costs of the Scheme extend beyond just fiscal: there are also economic costs. As a result of under-pricing of risk due mainly to the subsidised fee schedule, the current DGS has created distortions in financial and capital markets. Economic distortions include encouraging guaranteed depositors and deposit taking institutions to make riskier investment decisions since the gains from these riskier decisions will be accrued by the depositors and deposit taking institutions, while potential losses to depositors (of up to \$1 million per depositor per institution) will be borne by the taxpayer. This is referred to as a “moral hazard” problem.

19. An example of this “moral hazard” problem within the current DGS is that finance companies, which tend to be involved in higher-risk and higher-return lending, have grown their deposit books by approximately \$880 million (19%) since the guarantee was introduced in October 2008. Before the guarantee, the deposit

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books of many finance companies were shrinking.² In some cases, finance companies have used retail funding to replace their bank funding lines.

Objectives

20. The Government seeks a stable and economically efficient financial sector that supports growth in economic activity by minimising economic distortions while not exposing the Crown (and thus, taxpayers) to undue fiscal costs or risks. This requires a diversity of innovative financial service providers that are prudent in their lending decisions, can adapt to changing circumstances, and investors in these institutions that understand the risks involved and can price these risks accordingly. This reduces moral hazard, ensuring well-priced credit markets. Ensuring a viable non-bank sector in the future is important to this end, particularly as it provides competitive pressures upon banks and provides services in areas not otherwise provided.

Costs of exiting DGS

21. The current DGS was put in place for a period of two years, expiring on 12 October 2010 to provide time to see how well international financial markets stabilise.
22. This is one year shorter than the Australian scheme. [Withheld – prejudicial to our international relations

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23. Decisions need to be taken as to what will happen after October 2010 so that firms and depositors can make informed reinvestment and business decisions. A prompt announcement about the future of the Scheme will:
 - Provide greater certainty to investors, and enable them to make sensible reinvestment decisions.
 - Enable NBDTs to make more rational decisions in terms of strategy, pricing and lending. Due to uncertainty, NBDTs are increasing their holding of liquid assets, which in turn is having an impact on profitability, the efficient allocation of resources, and the ability to strengthen capital levels. NBDTs are also reluctant lend for term beyond October 2010. We expect banks to also want certainty about future arrangements sooner rather than later.
24. To provide this certainty these decisions need to be taken as soon as possible; at the latest one year out from the expiry of the Scheme - that is, before October 2009.

² Growth in finance company deposit books has been flat since December 2008. Growth, like finance company deposits, is concentrated in a few entities.

25. As assessment of the pros and cons of letting the DGS cease in October 2010 to achieving the objectives (economic efficiency, stability and fiscal) are provided below.

Pros

Economic efficiency

26. Blanket retail deposit guarantees are generally undesirable because of the economic distortions they create. Economic distortions include encouraging guaranteed depositors and deposit taking institutions to make riskier investment decisions since gains are privatized and losses are socialised (referred to as a “moral hazard” problem); lessening the market incentives on firms to restructure, merge, exit the industry etc; and creating an artificial shortening of terms offered by firms if depositors are not willing to invest beyond the guarantee period. Allowing the DGS to lapse avoids the additional period of economic distortion. Moreover, the DGS ceasing in October 2010 would avoid the possibility of firms using the longer DGS period to imprudently growth their retail deposit books, increasing the Crown’s exposure.

Stability

27. Stability is aided to the extent that moral hazard is reduced, thus decreasing the likelihood of more failure in the long run through imprudent lending. However, there are more likely short term stability detriments, which are considered in the cons section. It can be expected that individuals would take actions that would reduce their own risks, which would also have systemic benefits, but in aggregate may not be sufficient.

Fiscal

28. Letting the DGS cease in October 2010 would avoid the direct costs associated with the Treasury continuing to operate the DGS for an additional period, but forgo the fees currently collected. Also, retail guarantees expose taxpayers to risks of default. Allowing the scheme to lapse removes this risk. However, in the transition it could create larger expected fiscal costs if it causes institutions to fail at a time when asset markets are still weak. This is covered in the cons section.

Cons

Economic efficiency

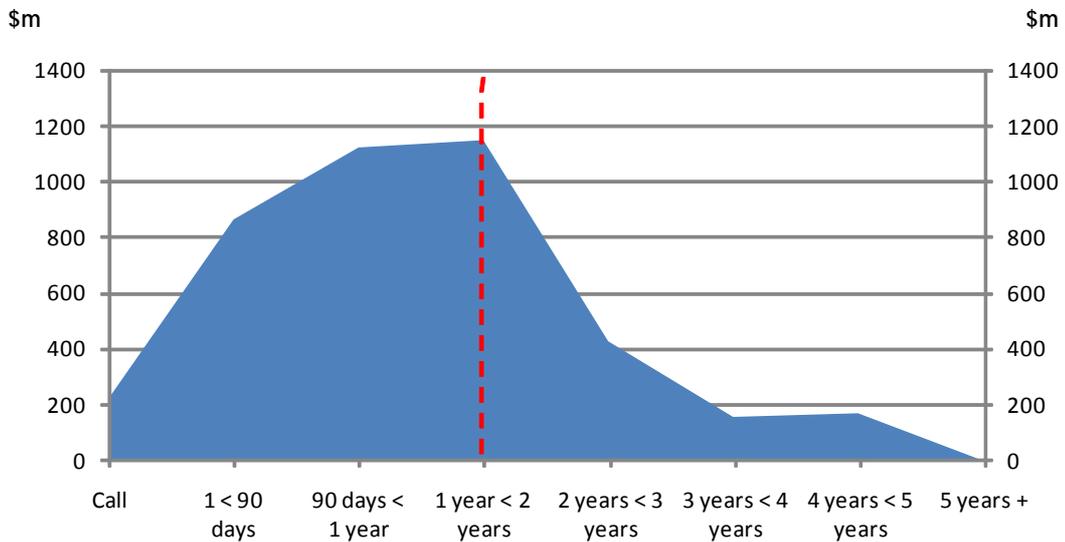
29. Despite its relatively small size, a viable non-bank sector provides competition and domestic capability in the financial sector, particularly in regional New Zealand, where larger banks are less active, and for certain specialised forms of lending, such as SME, vehicle, consumer and property financing. The Scheme lapsing could come at the expense of the longer term viability of the non-bank sector, which may take some time to recover, but generally economic efficiency is enhanced, hence the discussion in the pros.

Stability

30. The current DGS appears to have achieved the objective of promoting depositor confidence in New Zealand deposit taking institutions during a period of financial turmoil, although the counterfactual is difficult to determine. Funding sources have stabilized for banks since the DGS was introduced, although they remain reliant on the wholesale funding guarantee facility in international markets. Funding sources remain vulnerable for non-banks due, in part, to the impact of the recession on their asset quality.
 31. While confidence in international and domestic financial institutions has improved substantially from late 2008, and individuals are likely to respond in the absence of the Scheme by taking risk mitigation actions, it would be imprudent to assume that a full return to 'normal times' has occurred and the stability gains from the Scheme are insignificant.
 32. While it is difficult to be precise about the extent to which a loss of deposit confidence will impact significantly on financial system stability, it is worth bearing in mind that:
 - The Australian guarantee remains in place until October 2011. Although ex ante we cannot be certain about the size of the flow to Australian guaranteed banks if the New Zealand Scheme ceases in October 2010, anecdotal evidence from the period around October 2008 suggests some flow could occur, particularly by corporate and high net worth individuals. However, a large flow of retail funds is not expected.
 - [Withheld – to avoid prejudice
-].
- Relatively high levels of non-performing loans are currently affecting the profitability of some deposit takers. This situation is not expected to improve in the near term and will impact on the ability of affected institutions to absorb any additional unexpected pressures.
33. While these risks are low, it would be imprudent to rule them out or to assume international markets are no longer an area of risk. Extending the DGS could avoid the downside risks of a loss of depositor confidence on system-wide financial stability by allowing more time for financial markets to stabilise and aligning the end of the Scheme better with that of Australia's.
 34. Moreover, the impending expiry of the current DGS has resulted in short-term "hot money" seeking higher returns, and a dramatic "wall" of maturities is building up for many NBDTs as investors wait to see if the guarantee will be extended post October 2010 (see figure 1 showing the funding wall affecting finance companies). In general this wall of maturities is making it difficult for NBDTs (includes finance companies) to lend for term, and could result in liquidity

problems for some NBDTs if they find it difficult to attract retail funding after the guarantee expires.

Figure 1: Funding maturity profile for active finance companies



Source: RBNZ estimates based on returns from financial institutions. Data as at 31 March 2009.

35. Failures particularly of significant entities could also result in the disruption of financial services and credit markets, particularly in regions and sectors where the entities operate.

Fiscal

36. Calls on the DGS remain a possibility throughout the remainder of the current DGS due to devaluation of assets, liquidity issues and the foreseeable removal of the guarantee which has enabled some deposits to be attracted or retained when they might not have been otherwise. The government is monitoring this risk closely to assess the likelihood of further defaults by any individual deposit-takers and the Crown's likely loss given a default³. [Withheld – to avoid prejudice

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37. If the DGS ceases in October 2010 some non-bank entities may find it difficult to find new equity investors and depositors which could lead to both capital and liquidity shortfalls. [Withheld – commercially sensitive

] It still remains possible that firms will default during either the current guarantee or

³ A loss given default is the gross payments that the Crown would be required to make to deposit-holders, less net assets subsequently recovered from the deposit-taker.

extension period. A number of firms are beginning to change their strategies by looking to raise additional equity, focusing on their core business, exiting property development and working out ailing assets, in preparation for the end of the guarantee period.

38. If the DGS ceasing in October 2010 resulted in concentration of defaults in the lead up to the end of the guarantee period, then that could also lead to assets being realized over a short period, depressing asset prices and reducing recovery rates and so increasing the net cost to the Crown of the default event. This is because the gross payments to deposit-holders, less net assets subsequently recovered from the deposit-taker could be expected to be higher, than if the default event occurred when asset prices had stabilised, or were recovering. However, this would be offset to some extent by the additional fee revenue that would be collected during the additional period, from firms in the DGS.
39. [Withheld – under active consideration

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PROBLEM DEFINITION

40. The problem the government needs to address in relation to the DGS is how to now exit from it. That is, should exit take place as is currently the case in October 2010 or should there be an extension of the DGS and if so, on what terms. Exit needs to be managed in a way that enables the financial system to carry forward avoiding as far as possible any unnecessary damage (economic, financial stability and fiscal) along with enabling the required amount of adjustment, including firm exits and mergers, necessary for a stronger financial (namely non-bank) sector going forward.

OPTIONS AND ASSESSMENT

41. The broad options available to the Government are:
- Option 1 – Let the current DGS cease on 12 October 2010 (status quo option).
 - Option 2 – Extend the DGS for a given period of time. Within this option an assessment is needed as to the design features of the extended scheme.
42. There are also other interventions that the government could consider on a case-by-case basis, such as providing liquidity support to firms⁴, putting a firm in statutory management, or buying firms' bad assets through commercial transactions. These intervention options could be used in addition to, and

⁴ The retail DGS and wholesale funding guarantee facilities are forms of liquidity support. Other forms of liquidity support could be direct lending to firms (via the Crown or the RBNZ), or the government guaranteeing bank lending to non-banks for example.

independently of options 1-2 above that would need to be considered on a case-by-case basis depending on the entity in question.

Baseline assumptions

43. There is a significant degree of uncertainty associated with what could happen if the current DGS is left to expire on October 2010. This reflects uncertainty about whether and how quickly the economy will recover over the next 18 months, whether financial markets will continue to stabilize, and what will happen to asset prices. It also reflects uncertainty about the position of entities in the scheme, the extent of likely contagion resulting from the failure of any entities in the scheme, and the extent of any possible deposit flight to Australian guaranteed banks due to the mismatch of guarantee periods. The impact will also depend in a large part on depositor sentiment, which is very difficult to predict.
44. The option assessment is based on the following baseline assumptions about economic conditions, which are consistent with the Budget Economic and Fiscal Update (BEFU) 2009 and the RBNZ Financial Stability Report (FSR), May 2009:
- The economy is expected to be recovering in October 2011, relative to October 2010, but residential property prices are not expected to be recovering until October 2012.
 - Credit conditions have tightened somewhat which is likely to have implications for the real economy.
 - Financial markets have stabilised. Funding sources have stabilized for banks since the DGS was introduced, although they remain reliant on the wholesale funding guarantee facility in international markets. Funding sources remain vulnerable for non-banks due, among other things, to the impact of the recession on their asset quality. There is expected to be a further increase in impaired assets of banks and NBDTs, but they are not expected to reach levels experienced in the 1990s.

Option 1 – Status quo

45. The assessment of option 1 is provide in the status quo section of the RIS and is not repeated here.

Option 2 – Extend the DGS

46. Table 1 assesses the high-level terms upon which the scheme could be extended (on looser, existing, tighter, or fully commercial terms) and summarises the economic, stability and fiscal effects against the status quo. The key design features involved are: price, cap, coverage, whether the scheme is voluntary or not, and the length of extension.
47. The terms and how they combine is important. As it is neither feasible nor sensible to go through each combination of features possible for the four broad variations of the extend option, the following assumptions have been made:

- Length of extended term to 31 December 2011 and the end date is fixed. This date has been chosen as end of the fiscal quarter which includes October 2011, when the Australian scheme expires. Any extension shorter than one year be less desirable as it does not provide time for the sector to adjust, and is less likely to be at a point where asset recovery rates are more likely to be seen as rising. An extension for significantly more than a year would be getting to be more permanent in nature and further removed from the crisis response roots of the initial intervention. The scheme would risk becoming “business as usual”.
- The scheme is voluntary for eligible institutions to join. Membership of the WFGF is also not dependent on being a member of the retail scheme. The economic and stability pros and cons of delinking the retail and wholesale scheme are finely balanced, including a possible variant of making it compulsory for some groups only (e.g. banks). The main reason for making the current scheme voluntary and to remove the linkage to the WFGF is to reduce the fiscal exposure and to encourage firms to move into a non-guaranteed environment as early as possible. The current scheme is voluntary with few potentially eligible firms deciding not to join, while some join in order to access the WFGF. If the scheme was to be compulsory for all eligible institutions (while continuing to exclude those firms that are currently ineligible – i.e. those in moratorium or default), then it would mean all risk profiles (aside from those already in some form of default) are covered, it would potentially be more difficult for non-eligible institutions to compete for investor funds with a wider population of guaranteed firms, and it may signal that there are prevailing conditions that require it (when they do not). On the other hand, it would mean that the scheme would include all risk profiles across eligible institutions, which is closer to a compulsory insurance arrangement.
- If terms are “loose” (or more generous), then caps would be high with, crudely, low risk sharing and greater economic and fiscal costs. If terms are “tight” (less generous), then caps would be low with high risk sharing and lower economic and fiscal costs. The cap for the status quo was set in line with other crisis level caps at the time reflecting the concerns about depositor confidence and depositor flight to guaranteed institutions in Australia. [Withheld – under active consideration
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- Based on similar arguments used for caps, if terms are loose, then coverage is open to all eligible institutions irrespective of their ratings. If terms are tight, the coverage is limited to more highly rated institutions.
- Price is one of the most influential features in a voluntary scheme as this affects incentives to join. The extent to which fees are subsidised affects the extent to which risk is underpriced (distorting decisions by firms and investors, and increases moral hazard), makes it more difficult for non-guaranteed institutions to compete and for covered institutions to adjust to a non-guaranteed environment.

Table 1: Assessment of extension options against objectives

	Looser terms	Current terms	Tighter terms	Full commercial terms
Description	Highly subsidised fee schedule (possibly no fees), high cap of at least \$1M per depositor per institution; coverage to all banks and non-bank deposit takers who are not in moratorium or default.	Fees over \$5B, fees on growth if under \$5B, based on credit rating; high cap of \$1M per depositor per institution (in line with similar crisis responses at the time); coverage to all banks, non-banks and limited CISs as long as not in default or moratorium and it is in the public interest to include.	Fees on total book based on credit rating and expected loss to Crown if default; fees not full commercial pricing but based on market averages in normal times, Treasury bill minus Bank bill differentials and the average rates applying over the 5 years before the crisis with a risk premium attached (see Table 3 in Annex 2); cap lowered to \$500K for bank depositors per institution and \$250K for non-bank depositors per institution (heading in the direction of pre-crisis, normal time levels); coverage to BB rated and above; CISs excluded to limit coverage.	Fees on total book at full commercial rates (although not entirely clear at this point what rates would be for October 2010 – December 2011); [Withheld - under active consideration]; only investment grade (or at least credit rated) banks and non-banks eligible.
Economic	Increases the economic costs associated with underpricing risk, makes it harder for non-guaranteed institutions to compete, makes exit harder as it is distant from real market conditions.	Economic costs associated with underpricing risk. Difficult but not impossible for non-guaranteed to compete: some firms chose not to join the scheme even though they would have been eligible; non-eligible institutions have tended to keep their customer base but some switching has occurred into guaranteed products. Finance company growth likely to have reached its limit and not continue to expand. However, pre-DGS their	As fees are not fully commercial (considered to be overpricing risk currently) it will be continuing to underprice risk, but to a lesser extent relative to the status quo. Fees are also charged across the book reducing the level of subsidy relative to the status quo and would be in line with what would happen under commercial terms. Exit decision is easier as the cliff into a non-guaranteed environment is not expected to be as steep.	While there would be no distortions created by any subsidy or ease of other terms, currently risk is overpriced, and rates are unaffordable by most and virtually no, if any at all, demand for the scheme. Even if firms could afford the rates, overpricing of risk has economic costs in that an appropriate level of risk is not taken, with opportunities missed. As the commercial price is expected to be unaffordable,

	Looser terms	Current terms	Tighter terms	Full commercial terms
		deposit base was contracting and a better reflection of risk. Buys time for restructuring. Exit decision is just as hard as it is now but pushed out.	Less risky firms go forward into an environment where NBDT sector provides competition to banks and services in area of lending and niche lending not covered by banks.	then no demand means the option becomes, in effect, the status quo and firms behave as if the scheme ends on 12 October 2010.
Fiscal	Fee revenue decreases due to low or no fees, contingent liability increases. Possible that asset markets have more of a chance of starting to pick up by end of 2011, and so recovery rates in default situations may be higher. There may be a disorderly exit and higher fiscal costs as the extension has not promoted adjustment, and pushed out the liquidity wall. However, the new NBDT prudential regulations will mitigate that to some extent.	Fee revenue higher than under looser terms, but still involves a large amount of subsidy. Coverage of unrated and lower rated entities continues the risk to the Crown. Possible that asset markets have more of a chance of starting to pick up by end of 2011, and so recovery rates in default situations may be higher. There may be a disorderly exit and higher fiscal costs as the extension has not promoted adjustment, and pushed out the liquidity wall. However, the new NBDT prudential regulations will mitigate that to some extent.	Fee revenue higher than under current terms. [Withheld to avoid prejudice] Banks may opt out as access is not longer factor considered for access to WFGF, but there still may be depositor and competitive pressure to join the scheme. Contingent liability is reduced by excluding lower rated firms and CISs. Overall fiscal costs are not expected to increase relative to the status quo and may decrease as some firms that would have exited under the status quo will still exit, with some taking the additional time to reduce their overall riskiness via mergers and restructuring [Withheld – to avoid prejudice]. Less likely to have good firms taken down with disorderly exit of firms with no long-term future. May make more recovery in	Same as for the status quo as fees not affordable. [Withheld – to avoid prejudice].

	Looser terms	Current terms	Tighter terms	Full commercial terms
			default situations as defaults are spread and it is possible that asset markets have more of a chance of starting to pick up by end of 2011.	
Stability	<p>Relative to the status quo, investor flight is less likely. Scheme will cover institutions that do not comply with NBDT regulations that will be introduced and put into effect over this time. Non-guaranteed firms are likely to struggle and moral hazard is significantly increased, so there are still some stability problems present. Liquidity wall gets pushed out another year, and increased in amplitude, with RB regulation beginning to have an effect for non-banks.</p>	<p>Relative to the status quo, investor flight is less likely. Scheme will cover institutions that do not comply with NBDT regulations that will be introduced and put into effect over this time. Non-guaranteed firms are likely to struggle and moral hazard is increased, so there are still some stability problems present. Liquidity wall gets pushed out another year with RB regulation beginning to have an effect for non-banks.</p>	<p>Relative to the status quo, investor flight is less likely. Liquidity wall is eased with RB regulation beginning to have an effect for non-banks.</p>	<p>Liquidity wall does not resolve. Same as for the status quo where stability concerns would be minor. Less restructuring occurs as no additional time has been gained. Sector to October 2010 remains as risky as it is currently.</p>

PREFERRED OPTION

48. If the scheme is extended, the preferred option, based on the above analysis, is to extend the scheme in tighter terms in order to achieve a less disruptive and potentially less costly exit from the DGS. The decision of whether to extend the DGS until 31 December 2011 on tighter terms or proceed with the status quo of exiting in October 2010 is finely balanced.
49. The gains to system-wide financial stability from continuing the scheme, or detriments of the scheme lapsing are not large because it is only the relatively small institutions that are materially at risk. However, the risk of deposit flight to Australia is lower under the extended DGS, as it more closely aligns the end date of the DGS with that of the Australian guarantee scheme, although this overall risk is considered low. Given possible enhancements to an extended scheme, the economic efficiency arguments are finely balanced. The strongest argument is that extending the scheme reduces likely fiscal and economic costs of guaranteed firms failing by extending adjustment over a longer period, so it is more likely to improve recoveries and avoid depressing an already fragile asset market.
50. The risks with the options assessed have been considered in making a final decision, and are reflected in the cost benefit analysis.
51. The preferred option, based on the above analysis is to extend the DGS on revised terms until 31 December 2011. A more detailed description of the design features of the extended DGS is provided in Annex 2.

IMPLEMENTATION AND REVIEW

52. Although it is possible to introduce the extended DGS using the Minister of Finance's existing Public Finance Act powers, this paper proposes introducing new legislation to give effect to the extended DGS. New legislation has the following advantages:
 - Greater certainty for the end date of the DGS.
 - More appropriate from a constitutional perspective, considering the size of contingent liability under an extension and given that Parliament is in session.
 - Enables better management of Crown risk in respect of the guarantees.
53. Urgency is required for such legislation in order to give certainty to financial markets. Support from key support and opposition parties will be necessary.
54. This proposal is that legislation:
 - Confirm the establishment of the current DGS and enable an extension of the DGS only until 31 December 2011, on terms and conditions including eligibility criteria the Minister of Finance considers fit.

- Provide permanent legislative authority for the cost of undertaking investigations, to make payments under guarantee and expenses incurred administering those claims.
 - Ensure that any payments to creditors under the guarantees are debts due to the Crown from the guaranteed entity.
 - Ensure such payments will be given the same priority as that held by the relevant creditor. The reason for this is that if the Crown does not pay out to depositors in full (e.g., if the individual has a deposit in a non-bank in excess of the \$250,000 cap), this can have the result of the Crown losing the priority it would otherwise have.
55. Given the urgency required, the Minister of Finance would seek authority from Cabinet to make further decisions on the detail of the legislation. If significant policy issues arise in drafting, the Minister of Finance will refer these back to Cabinet.
56. Provided the proposed legislative reform receives assent during the week of 14 September 2009, entities will be eligible to apply for the temporary extended DGS from late September 2009. This lead time will:
- Allow time for The Treasury to manage the re-application process, and issue deeds of guarantee for the extended DGS well in advance of the current DGS expiring. It is anticipated that applications could be made for entry into the extended DGS from late September 2009, and new deeds would be issued from late September/ early October 2009.
 - This would provide most entities and depositors with certainty about whether they are in the Scheme approximately a year out from the current DGS's expiry.⁵
57. The DGS will be extended for fourteen and a half months until 31 December 2011. It is our very strong presumption that it will not be extended beyond this period of time.
58. The Treasury will monitor and evaluate the overall performance of the extended DGS and whether it is meeting the government's fiscal, economic and stability objectives. The main information sources for monitoring are the monthly monitoring information from NBDTs in the DGS, letters to Treasury and Ministers, and media reporting. The RBNZ is contracted to monitor NBDTs in the DGS.
59. The monitoring of NBDTs focuses on asset quality, liquidity, the regulatory environment and general business practices. The RBNZ provides three types of standard report to the Treasury on a monthly basis based on the information collected from NBDTs:

⁵ Most large entities already have credit ratings. Entities in the process of getting a credit rating will not have certainty until they have received their rating, since a credit rating of BB or above is a requirement to be eligible for the extended DGS. Under the new prudential requirements for NBDTs credit ratings are required by 1 March 2010 for entities with liabilities greater than \$20 million.

- Monthly portfolio report.
 - Individual high risk entity report.
 - Sector based reporting (for finance companies, credit unions, building societies and the PSIS).
60. This monthly reporting would continue during the DGS extension period.
61. The Treasury will provide advice to the Minister of Finance of any issues with its performance and options for addressing any issues. The criteria that will be used to make this evaluation are whether the scheme is meeting the government's fiscal, economic and stability objectives. This will be done as part of The Treasury's regular economic reporting to the Minister of Finance (e.g. in the Trimester reporting to the Minister, and in the monthly customer focus report), during the fortnightly meetings with the Minister on Financial System Issues, and on an as needs be basis outside of those regular opportunities, for example through Treasury Reports.
62. The Crown currently has levers to manage risk to the Crown under the guarantee. Under the current deeds of guarantee the Crown is able to prevent or to require firms to remedy particular transactions such as distributions, material non-commercial transactions, and related party transactions; and remove the guarantee to limit potential future increases in the nominal exposure.
63. However, changes to be made under the new deeds under the extended scheme (not requiring legislation) would make improvements as follows:
- More active management levers: Considering restricting undesirable asset acquisition and deposit growth by introducing a requirement to seek authorization with contractual penalties for non-compliance (such as withdrawal of guarantee or financial penalty). This will need to be carefully defined and considered taking into account the risks to the Crown, and the capability and role of Government to make these decisions.
 - Redefining trigger events for default so institutions entering statutory management would not necessarily be in default. This would mean the institution could potentially continue to trade to allow more time to consider resolution options. This change cannot be introduced into the current deed so will not be available prior to the extended DGS coming into affect.
 - Change of control authorization requirement: Where a firm is in wind-down under the guarantee, there is a risk of a buyer entering the market with the aim of using the guarantee to rapidly build a deposit book. An explicit power could be granted to authorize (or provide 'no objection' to) change of control under the guarantee, or else require re-application before change of control occurs. This could prevent firms being able to enter the market to exploit the guarantee.
64. These terms can also be introduced into the current guarantee deeds to have effect before October 2010. The Crown is also able to ensure appropriate contingency planning is undertaken to respond effectively to a default under the Scheme. However, an extended scheme provides a natural opportunity to issue revised deeds.

CONSULTATION

65. The proposals for policy changes to the retail DGS were developed by The Treasury and the Reserve Bank of New Zealand in consultation with the Ministry of Economic Development (including the Companies Office), and the Securities Commission. These views have been reflected in the policy development. Annex 3 provides further detail on the issues raised in consultation and how these were dealt with.
66. The decision was made not to consult proactively on the proposals with the public. This is due to:
- Officials already having a reasonable amount of information about stakeholder views from regular interactions (summarised in Annex 3).
 - Desirability to make an announcement soon, limiting the time available for any consultation. A period of consultation would make timing significantly worse and may not make us any better informed.
 - Commercial sensitivity of the policy decision.
 - Concern that public consultation could create further uncertainty in the market.
 - The proposed course of action is temporary.
67. For these same reasons, we recommend the some or all of the stages of legislation to enact these changes, be passed under urgency with support from key support and opposition parties. There could also be a limited (one-two day) select committee process.
68. [Withheld – under active consideration

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ANNEX 1: COVERAGE OF INSTITUTIONS

The current DGS has covered the majority of the financial institutions in New Zealand, by asset size⁶. Namely:

- 50% to 60% of the finance company sector. Most of those not included are either in moratorium or receivership;
- More than 95% of the credit unions;
- More than 95% the building societies; and
- 85% to 90% of the banks.

The current DGS guarantees \$128 billion of New Zealand deposits with approximately 93% in banks, and 7% in non-bank deposit taking institutions (NBDTs)⁷ and Collective Investment Schemes (CISs) (see Table 2).

Table 2: Details of entities in the current DGS (as at March 2009)

Type of institution	Entities in scheme (number)	Guaranteed deposits (\$billion)	Guaranteed depositors (number)
Bank	12	[Withheld – commercially sensitive]	[Withheld – commercially sensitive]
Finance company	27	[Withheld – commercially sensitive]	[Withheld – commercially sensitive]
Credit union	20	[Withheld – commercially sensitive]	[Withheld – commercially sensitive]
Building society and PSIS	8	[Withheld – commercially sensitive]	[Withheld – commercially sensitive]
PIEs (stand alone)	1	[Withheld – commercially sensitive]	[Withheld – commercially sensitive]
Total	68	\$127.4	[Withheld – commercially sensitive]

⁶ KPMG Financial Institutions Performance Survey

⁷ The NBDT sector is comprised of finance companies, credit unions, building societies and the PSIS.

- The financial services typically offered by finance companies are at the higher-risk, higher-return end of the market and include SME financing, motor vehicle and vendor finance, property development and commercial finance, consumer finance and other retail lending activities. Deposits with finance companies tend to be on term, rather than transactional accounts.
- Savings institutions (credit unions and building societies) tend to raise funds from its membership to provide common financial services to its members. They tend to be involved in retail financial services, residential mortgage lending, commercial lending and personal secured lending. Some building societies have evolved over time to a business model more akin to a finance company than a savings institution. Savings institutions tend to offer transactional services to a greater extent than finance companies.

ANNEX 2: CHANGE IN FEE STRUCTURE, ELIGIBILITY AND COVERAGE

Detailed design features of DGS extension

This section summarises the design of the extended DGS and the judgements used in making these amendments:

- Extended the Scheme until 31 December 2011, with a clear end date;
- Tougher eligibility criteria (firms rated BB- or below, or unrated are ineligible; CISs not eligible);
- Voluntary scheme (institutions will need to apply);
- More risk sensitive fees, paid on the whole deposit book; and
- Reduced and differential coverage for banks and non-banks (up to \$500,000 for banks, and up to \$250,000 for non-banks, per depositor, per institution).

Length of extension – extend until 31 December 2011, with a clear expectation it will be removed

The current DGS runs for a total of two years until 12 October 2010. The extended DGS is proposed to run for an additional fourteen and a half months and expire on 31 December 2011. This provides time for organisations to improve their business in advance of the withdrawal of the guarantee while not allowing the market to become dependent on the guarantee. Expiry in December 2011 will align more with Australia's guarantee, which expires in October 2011. An expiry date at the end of the quarter will assist firms to manage their liquidity, since many firms take deposits that expire at the end of the quarter.

It is critical that the market views the expiry date as certain and credible. This is essential to ensure that institutions take the actions needed to ensure their long-term viability following the removal of the guarantee. For example, some institutions may need to merge, owners may need to inject additional equity, and some institutions will need to offer higher return deposits past the end of the guarantee to prevent the build-up of another deposit maturity wall. If the market is not provided with absolute certainty then there is the risk that the necessary adjustment does not occur and there is pressure to extend the scheme further.

Institutional eligibility – minimum quality-based eligibility criteria for all institutions

Under the current DGS, deposit taking institutions were eligible for the guarantee if they met general eligibility criteria. New entrants after a certain date were required to have a credit rating of BBB- or above to be eligible to join the DGS.⁸ To be eligible for the WFGF consideration is given as to whether, if the institution takes deposits, the institution is a member of the retail scheme.

⁸ They must be in the business of borrowing and lending money, and carry on a substantial proportion of their business in New Zealand.

The extended DGS would have a higher eligibility threshold than the current DGS by only being available to institutions covered by the current guarantee which have a credit rating of BB or higher⁹. Tighter eligibility criteria are proposed to help to meet the transitional objectives of the DGS. Credit ratings are simple and objective criteria. However, it will take time and cost for entities to obtain ratings, especially smaller entities. However, under the new prudential requirements for NBDTs, entities are required to have ratings by 1 March 2010, unless they have liabilities less than \$20 million. [Withheld – commercially sensitive

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The extended DGS would again be voluntary for all institutions. Access to the WFGF will not be conditional on also being in the extended DGS after October 2010. This will reduce the incentives for institutions to join the extended DGS. This is in order to encourage firms to opt out of the scheme to encourage transition. However, firms are likely to gain a competitive advantage from being in the scheme, if their depositors value the government guarantee, and so it is not clear that all banks (say) would chose to opt out.

The Crown would have the discretion to allow new institutions into the DGS where it is a newly merged entity and its inclusion lowers Crown risk by improving the long-term viability of guaranteed institutions, or it is a newly registered bank¹⁰.

Collective investment schemes (CISs) are currently covered by the DGS to the extent that they solely invest in guaranteed retail deposits and/or Government stock. This is to recognise that the risk characteristic and substance of these investments is no different to a retail deposit that would be guaranteed if made by an eligible institution. However, CISs are legally different from deposits covered by the DGS in that units in these funds do not represent deposits or other liabilities, and are subject to investment risk, including possible delays in repayment and loss of income and principal invested.

As the CISs covered by the DGS invest solely in guaranteed institutions and/or Government stock, they do not pay fees as they invest in institutions already paying fees on eligible deposits.

Removing this limited category of CISs from the extended DGS's coverage would be consistent with the core coverage of the DGS. It would also reduce one of the boundary issues that has arisen between CISs and other institutions (such as mortgage trusts) with similar legal structures (but different investment approaches) that are not covered by the present DGS, and result in slightly reduced administration costs associated with managing separate deeds of guarantee. There may be some shifting of investors from CISs to guaranteed deposits, but this would be minimal.

⁹ Note that there is no exception for entities without a rating, whereas the Reserve Bank Act only requires NBDTs with liabilities over \$20 million to have a credit rating by March 2010. The credit rating requirement may help provide impetus for consolidation, for entities to lift their credit rating, and for credit unions to join the credit union cross-guarantee (private sector risk-sharing initiative). This means smaller and potentially more risky organizations will transition off the guarantee more quickly. Also note that once accepted into the transitional DGS institutions would not necessarily have the guarantee withdrawn solely due to a credit downgrade.

¹⁰ A newly registered bank would be considered and as it is part of a stricter prudential regime, it is likely to be low risk, and would increase market competition. However, a newly registered bank is unlikely over this period.

Retaining CISs in an extended DGS would not cause any particular issues, other than potentially raising again the boundary issues with non-guaranteed schemes. The extended DGS proposes excluding CISs, in order to assist with moving toward tighter and more limited coverage.

Fees – pricing to reflect probability of default and likely loss

Fees in the current DGS involve a strong element of subsidy from taxpayers to shareholders and depositors, as fees are only charged on growth in guaranteed deposits of more than 10% or in excess of \$5 billion¹¹. All classes of institutions are charged on a less than expected cost recovery basis. Subsidised fees have led to economic distortions. For example finance companies have substituted bank funding with a growth in guaranteed deposits of \$880 million since October 2008.

The extended DGS attempts to reduce economic distortions with pricing that reflects risk as much as possible. This will help to reduce moral hazard, minimize distortions of investment decisions between equity, bonds, non-guaranteed and guaranteed deposits, and to ease the transition out of the guarantee.

The proposed fee schedule (see table 3) would apply to all guaranteed deposits and better reflect risk (based on credit ratings) and likely loss given default. The proposed fee structure is based on average US market spreads during the 20 years prior to the financial crisis. Current market spreads are higher than this, and so depending on how markets stabilise, it is possible that firms could exit into an environment where they have to pay higher rates to attract market funding than they do under the DGS.

The proposed fees will aid transition off the guarantee by providing less of a subsidy to guaranteed institutions which will help to ensure institutions have a real choice about whether to opt into the Scheme, or to opt out of the Scheme and offer higher, but unguaranteed deposit accounts. The fees may also encourage firms to undertake measures to improve their credit ratings where they think that it is possible over the next two years. This will also improve their chance of long-term survival.

Higher fees are expected to lead to some market adjustments with guaranteed depositors offered lower interest rates, borrowers charged higher interest rates, and a decrease in the return to the firms' equity where the fee cannot be passed on to depositors or borrowers.

A comparatively lower fee structure is recommended for banks, credit unions and building societies compared to finance companies as generally, finance companies with the same credit rating (reflecting the same probability of default) have a higher loss given default than other institutional types.

In determining the fees, some consideration has also been given to affordability issues for non-bank deposit takers (although the primary consideration was to reduce economic distortions). A risk here is that non-bank deposit takers are unable to afford the fees (or attract and retain deposits without the guarantee). While viable in the long-run, some institutions may struggle to be viable in the short run as they adjust to the new prudential requirements and are subject to the more commercial fees schedule. The proposed fee structure takes this concern into account, but the risk that some

¹¹ Fees on growth of over 10% by credit rating: AA- or higher, 10bpts; A+/- 20bpts; BBB+/- 50 bpts; BB or BB+ 100bpts; no credit rating or BB- or lower 300bps on all growth.

institutions that are viable in the long-run will experience considerable difficulties in the short-run remains, particularly in respect of building societies.

Table 3: Proposed fee schedule

Credit rating	Recommended option		Historical market rates			Current market rates
	Finance Companies (bpts)	Banks, Credit Unions, Building Societies, PSIS (bpts)	B-bill minus T- Bill (for AA at 20bp) scaled up based on current market prices for US financials	10 year median option adjusted spreads	Historic US commercial rates (6 mths)	Current US commercial rates (6 mths)
AAA +/-	15	15	20-30	50-60	30	140
AA +	15	15		60-70		
AA	15	15				
AA-	20	15	40-60	70-80	40	250
A+	25	20				
A	30	20				
A-	40	20	70-100	80-150	60	490
BBB+	60	25				
BBB	80	30				
BBB-	100	40	120-150	-	100	630
BB+	120	50				
BB	150	60				

[Withheld – commercially sensitive

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Depositor coverage cap – reduced and differential coverage for banks and NBDTs

The current DGS has a cap on guaranteed deposits of up to \$1 million per depositor per eligible institution. This is relatively high by international standards.

The extended DGS proposes reducing coverage per depositor, per institution to \$250,000 for NBDTs, and \$500,000 for banks. Reduced coverage signals the temporary and transitional nature of the DGS, reduces Crown contingent liability, and could reduce fiscal costs of any future default events (to the extent that depositors do no spread deposits across institutions). It also reduces NBDT reliance on a few large depositors, but balances these objectives against not setting the cap on NBDTs so low as to be likely to trigger failure. The lower cap for NBDTs compared to banks reflects the higher risks in this sector compared to the lower risk of banks that by-and-large are covered by a tighter prudential regime.

Table 4 summarises the proposed design features of the extended DGS.

Table 4: Proposed design features of extended DGS

Design parameter	Current DGS	Extended DGS	Rationale for difference (if any)
Length of extension	Expiry on October 2010.	Expiry with definite end date on 31 December 2011.	Less disruptive and potentially less costly exit from DGS.
Fees	Heavily subsidised. Fees only on growth and guaranteed deposits in excess of \$5 billion - somewhat risk based.	Reduced subsidy. Full book pricing. More risk-based (see Table 3 above).	Manage Crown risk better, facilitate adjustment and minimise distortions.
Institutional eligibility	Voluntary. General eligibility criteria later restricted to BBB- or above for new entrants. Membership of retail DGS one factor taking into account to gain access to Wholesale Facility.	Voluntary. Minimum credit rating BB. Only open to institutions currently guaranteed (except new entrant registered banks, or merged entities, at the Crown's discretion). CISs excluded from scheme. Access to the Wholesale Facility will no longer take into account membership of the retail DGS.	Tighter criteria to assist transition from the scheme.
Depositor coverage cap	Up to \$1 million per depositor per institution.	Up to \$500,000 for banks and \$250,000 for non-banks per depositor per institution.	Signals transitional nature. May reduce Crown contingent liability.
Management tools	Limited tools, but can introduce amended deed to cover the desirable changes to the current DGS, including restrictions on undesirable asset acquisition and deposit growth, and change of control authorization.	These additional provisions can also be included in the deed for extension. Provides a natural opportunity to update deeds to include stronger management tools.	Attempt to better manage the exposure by using existing tools more actively.
Resolution tools	Statutory management triggers payout under the DGS.	Redefine default event so that statutory management can be used without immediately triggering requirement to payout.	Institution may be able to continue to trade under statutory management. Time to consider resolution options.

ANNEX 3: DETAILS ABOUT CONSULTATION

The Treasury and the Reserve Bank regularly engage with stakeholders in the sector, which have provided their views on the DGS and its possible extension. This includes financial institutions, trustee corporations, unions and professional services companies. The key issues raised by these groups were:

- Distortions being created by the DGS - many non-banks are finding it difficult to attract deposits after the end of the guarantee period (creating a “wall” of maturities). A business grouping has expressed concerns about the distortions to financial markets created by the DGS.
- Timing of future arrangements - non-banks in particular require clarity about future arrangements as soon as possible.
- Extending the Scheme – mixed support for extending the Scheme to match the Australian scheme (October 2011). Banks tend to think it is not necessary for them and risk of depositor flight to Australia is low. Finance companies tend to support extension. Some Credit Unions have chosen not to opt into the DGS because they have a relatively sticky depositor base. Entities operating outside of the DGS (e.g. fund managers) are concerned about the competitive disadvantage that the Crown guarantee puts them at.
- Conditions on institutions’ behaviour – it has been suggested by a workers union and an economic think tank that there should be conditions added to firms that are part of the DGS, e.g. employment protection/ mortgage holiday provisions.
- Fee structure – fees should be more risk-based, and not involve cross-subsidisation of non-banks by banks.
- Eligibility criteria – concerns were raised in the media about whether Mascot Finance should have been eligible for the DGS, given that it was in wind down.

Stakeholder views have been considered when developing the policy proposals as summarised below.

- The extended DGS is designed to minimise economic distortions by having much more risk sensitive pricing. It is designed with a definite end date, to help reduce the risk of another wall of maturities forming before the end of the guarantee period.
- It is recommended that an announcement be made soon to give depositors and deposit taking institutions certainty about the future of the DGS, and make informed planning decisions. It is also recommended that changes be passed under urgency, with cross-party support to provide the market with certainty.
- On balance, it is recommended that the DGS is extended until 31 December 2011. The Scheme will be voluntary to join, and will be on more risk sensitive firms to help to minimise distortions between entities and products within and outside of the guarantee. The fees charged to banks, credit unions, building societies and the PSIS are lower than finance companies to reflect the higher loss given default of finance companies compared to these other entities.

- We have assessed the idea of introducing conditions on the guarantee, but consider such conditions may undermine the objectives of the guarantee, e.g. it may stop firms downsizing, when that sort of change is necessary to ensure their future viability.
- The fees will be more risk-sensitive and based on the probability of default and expected loss given default. Fees will apply to the whole deposit book of both banks and non-banks (previously, they effectively just applied to growth of non-banks, and deposits in banks over \$5 billion).
- The eligibility criteria for entry to the extended DGS will be set at a minimum BB credit rating or above. The current DGS did not have such an eligibility criteria when it was introduced.

The DGS operational team focuses engagements on the larger and relatively riskier entities in the DGS, and meets with entities on an ad hoc basis. Over the last month, the DGS team has met with these larger entities on several occasions to discuss the DGS.