

17 October 2008

MEMORANDUM FOR CABINET
Chair
CABINET

**CROWN DEPOSIT GUARANTEE SCHEME: IMPLEMENTING AND MONITORING
THE SCHEME**

Proposal

1. This paper updates Cabinet on the decisions taken to implement a Crown deposit guarantee scheme ("the Scheme") and seeks funding for implementing and operating the Scheme.

Executive Summary

2. I took the decision to offer a Crown deposit guarantee scheme in response to a worsening of the international financial crisis and a growing nervousness in New Zealand, including at the retail and household level, about the international financial situation and the risk facing New Zealand. This paper summarises, for your information, the policy decisions I have taken to define the scope of the Scheme I announced on 12 October 2008 under powers granted to me under section 65ZD of the Public Finance Act 1989. I have delegated authority to the Secretary to the Treasury to offer and approve guarantees to eligible institutions. Decisions to exercise discretion under this guarantee will be guided by policy guidelines that I have approved.
3. The total Crown exposure is estimated at around \$180 billion. Any fiscal implications need to be considered against the costs that might have been faced by the Crown if an institution was to fail and the deposit guarantee was not in place. There are significant legal costs to implement the Scheme and operating costs over the two year period of the Scheme.
4. It is proposed that operating funding of \$10.1 million and capital funding of \$0.800 million is provided to fund the establishment and operations of the Scheme. The Scheme, as currently formulated, is estimated to generate \$238 million in fees, however I have asked officials to revisit this issue. The estimated

Crown exposure from the retail deposit guarantee scheme is around \$180 billion, which will be disclosed in the financial statements of the government as a contingent liability. The probability of the guarantees being called on is remote for the vast majority of funds covered. However, if the contingent liability of the Crown under a guarantee were to crystallise, this would be recorded as an expense.

5. There are a number of further details and refinements that are being worked through, and I will advise Cabinet of any changes that arise.

Comment

Recent international events and backdrop to decisions taken

6. The international financial crisis has worsened rapidly in the last six weeks or so, spreading to a wider range of countries and institutions. There is clearly a growing sense of nervousness in New Zealand, including at the retail and household level, about the international financial situation and the risk facing New Zealand.
7. New Zealand domestic policy responses to date have focused largely on Reserve Bank initiatives to make liquidity more readily available. The thrust of these initiatives has been entirely consistent with the approaches adopted in a wide range of other countries. However, the experience of other countries over the last year also demonstrates that providing additional liquidity is not always sufficient to allay retail or wholesale market concerns about a financial institution's soundness. Although I have good reason to be confident in the quality of the assets of the banking system, I cannot assume that New Zealand will continue to avoid the effects of the crisis. The situation could also change quickly.
8. It is against that backdrop that on 12 October 2008 I announced, through powers granted to me as the Minister of Finance under section 65ZD of the Public Finance Act, that the government will introduce an opt-in retail deposit guarantee scheme.

Characteristics of the Crown Deposit Guarantee Scheme

9. The scheme I announced has a number of characteristics, described in detail below, which I ask Cabinet to note.

The offer

10. A two year Crown guarantee of retail deposits in eligible institutions offered on an opt-in basis. The guarantee would be called upon when the Crown is satisfied that the institution will be unable to meet its obligations as they fall due. There is no right to the guarantee.

Eligible institutions

11. Eligible institutions are:

- New Zealand-registered banks including unincorporated New Zealand branches of overseas banks;
- Non-bank deposit-taking entities (including building societies, credit unions and deposit-taking finance companies) who are fully compliant with the requirements of their trust deeds; and
- Collective investment schemes (CISs, of which Portfolio Investment Entities [PIEs], super schemes, managed funds and unit trusts are subclasses) that invest solely in the debt securities of the New Zealand government or institutions subject to a government guarantee.

12. New entrants¹ to the Scheme are required to be BBB- rated or better in order to be eligible to apply for coverage under the scheme.

Deposits covered

13. The Scheme protects those who hold debt securities issued by businesses who receive a guarantee. It includes deposits, term deposits, current accounts, bonds, bank bills and debentures

14. The Scheme covers senior debt only and does not include related party liabilities. Although credit unions and building societies do not hold senior debt, the depositors in these institutions will be covered through contracts specific to building societies and credit unions.

15. The Scheme covers the following deposits:

- New Zealand incorporated registered banks (which includes incorporated branches of overseas banks), including deposits from both residents or non-residents;
- unincorporated branches of overseas banks, non-residents deposits as at 12 October 2008 , to reduce the likelihood that these depositors will leave these branches for guarantee covered institutions;
- For non-bank deposit takers, deposits of New Zealand citizens and New Zealand tax residents will be covered.
- For Collective Investment Schemes, investments must be held either in NZ government securities or debt securities held by guaranteed institutions. To manage the risk of funds flowing to government guaranteed higher-risk non banks any guaranteed CIS that extends its exposure to a guaranteed non-bank entity beyond 12 October levels will invalidate its guarantee.

¹ Entities seeking to come into the scheme that were not in existence or ineligible on 12 October 2008.

16. Deposit liabilities will be covered regardless of the currency in which they are denominated. Deposits and other liabilities owed to financial institutions, whether in New Zealand or offshore, are explicitly excluded from this guarantee.

Contractual

17. The guarantee takes the form of a bilateral contractual agreement between the Crown and the individual financial institution which elects to take up the guarantee. Legislation is not required for the Crown to enter into the agreements as I, as Minister of Finance, have a general power to enter into guarantees under section 65ZD of the Public Finance Act 1989.

Fees

18. For covered liabilities in excess of \$5 billion a fee of 10 basis points per annum will be charged for the guarantee. The fee will be charged on the basis of the total covered liabilities, in excess of \$5 billion of the institution. For non-rated non-bank deposit takers, a fee of 300 basis points per annum will be charged monthly on growth in the deposit book. Further work on the fee structure still needs to take place.

Limitations and conditions of the guarantee

Limitation for non-resident depositors in branches of overseas banks

19. The guarantee is limited to the total amount of the non-resident deposit base as at 12 October 2008 for non-resident depositors in existing² New Zealand branches of overseas banks. The guarantee on these deposits will allow up to a further 10% per year of that deposit value to cover for interest and any variation in deposit level.

Limitation for collective investment schemes

20. As noted previously, the guarantee is offered to collective investment schemes that invest solely in the debt securities of the New Zealand government or institutions subject to a government guarantee. This offer is subject to a limitation that no collective investment scheme can increase its economic exposure to any non-bank guaranteed institution above the level prevailing as at 12 October 2008.

Conditions of coverage for non-bank deposit takers

21. The standard guarantee contract has been tailored for non-bank deposit takers to include tighter controls because of the potential risk that these institutions may present. These variations:
 - Preclude the potential for stripping out funds through, for example, dividends, or payments to related parties;

² That is, as at 12 October 2008.

- Increase reporting requirements so that, in addition to obtaining information, the information obtained can be verified by a third party such as an auditor; and
 - Enable an assessment to be made as to whether reckless business behaviour is taking place that would then result in breach of the terms of the guarantee.
22. These terms are given effect through personal undertakings required from directors.
23. I am exploring whether to impose other minimum conditions such as a capital ratio. As a medium-term measure, regulations for non-bank deposit takers under the recently-enacted Reserve Bank Amendment Act will be expedited for liquidity arrangements, capital requirements and related parties provisions.

Administration

24. The guarantees will be offered and administered by the Treasury.

Processes for Implementing the Crown Deposit Guarantee Scheme

25. I have delegated authority to the Secretary to give authority for writing, managing and administering the Crown's Deposit Guarantee Scheme. The Treasury will use policy guidelines to guide the exercise of any discretion under the guarantee.
26. Draft processes for handling applications for the guarantee and for paying guarantees in the event of default have been set out.
27. The Treasury and Reserve Bank anticipate that there may be between 200 – 1000 applications, many of which are expected to be received this week. Priority will be given to handling applications of large institutions.
28. The Treasury and Reserve Bank are continuing to work through other practical details including:
- Resourcing of the claims process (each application will require a legal and commercial review);
 - Monitoring requirements to be placed on successful applicants; and
 - Monitoring and reporting requirements to be placed on the Treasury.

Financial Implications

Fiscal

29. The potential fiscal implications comprise:

- **Direct costs of paying money out under the guarantees:** The total Crown exposure is estimated at around \$180 billion. Based on information about the current deposit base, historical default frequency and a very subjective estimate of losses given a default, the following table gives a very rough sense of potential costs to the Crown from the guarantees across a range of institutions:

| Institution | Number | Retail liabilities (\$m) | Default frequency* | Loss given default (\$m)** | | |
|---|-----------|--------------------------|--------------------|----------------------------|------------|------------|
| | | | | Best | Mid | Worst |
| Banks | | | | | | |
| Big four plus Kiwibank | 5 | 144,244 | 0.05% | 14 | 29 | 43 |
| Other | 10 | 13,235 | 0.27% | 7 | 14 | 22 |
| Building societies, credit unions, finance companies | | | | | | |
| Investment grade | 7 | 5,610 | 1.03% | 23 | 35 | 46 |
| Sub-investment grade/unrated | 56 | 3,002 | 34.73% | 417 | 626 | 834 |
| TOTAL | 78 | 166,091 | | 462 | 704 | 945 |

* Historical S&P default frequency based on credit ratings

** Banks: best 20%, mid 40%, worst 60%. Finance companies: best 40%, mid 60%, worst 80%.

In addition to the liabilities in the table above, the Crown guarantees would cover collective investment schemes that invest totally in New Zealand government securities or guaranteed institutions papers (i.e. including PIEs). We are unable to quantify these at present, but they could add another \$10-20 billion.

- **Fees from the Scheme:** These are currently estimated to be \$119 million per annum; \$238 million over the two year life of the scheme. However I have asked officials to revisit the fees structure, and I will advise Cabinet of any subsequent revisions; and
 - **Impact on servicing government debt:** issue yields around the world have increased by around 50 basis points in the last week. Risk aversion has retreated, reducing the demand for safe assets, and the supply of government bonds in New Zealand and around the world has increased with the recent government rescue measures announced around the world. If the 50 basis points increase were to endure across the forecast period, this would add \$53 million in debt servicing costs in 2009/10, and \$478 million in total over the period to June 2013.
30. As mentioned previously, any fiscal implications should be considered against the costs that might have been faced by the Crown if an institution was to fail and a deposit guarantee was not in place.

Accounting treatment

31. Deposit guarantees will be made under section 65ZD of the Public Finance Act 1989 and will be recorded as contingent liabilities in the financial statements of the government. As mentioned above the Crown's estimated exposure is \$180 billion.

32. The guarantees are contingent liabilities of the Crown and where the exposure under a guarantee exceeds \$10 million, the guarantee must be gazetted and presented to Parliament.
33. If the contingent liability of the Crown under a guarantee were to crystallise, this would be recorded as an expense. Section 65ZG of the Public Finance Act 1989 provides permanent legislative authority for any money paid by the Crown under a guarantee and any expenses incurred by the Crown in relation to a guarantee; i.e. no further appropriation would be required.

Costs of implementing the Crown deposit guarantee scheme

34. The Treasury estimates that operational funding of \$10.1 million and capital funding of \$800,000 will be required to implement and operate the Scheme over the two year period, (though the Scheme will span three financial years). The Scheme's implementation and operational costs are made up of legal fees, financial and legal salaries and operating costs.
35. Initially we estimate 18 additional legal and financial professionals plus two support staff will be required to implement the Scheme. After the first six months we expect that the number of staff required will reduce by five.
36. The role of these legal and financial staff will be to reduce the Crown's exposure to the Scheme by performing regular monitoring of the financial institutions to ensure they meet the necessary Scheme criteria. In addition, we anticipate there will be an increase in demand for regulatory advice which will require 2 policy analysts. The capital costs are largely for credit assessment software and computers. The budget is summarised in the following table.

Crown Deposit Guarantee Scheme: Operating and Capital Budgets

| Operating Expenditure & Fees | 2008/09 \$m | 2009/10 \$m | 2010/11 \$m | Total \$m |
|--|--------------------|--------------------|--------------------|------------------|
| Legal fees | 0.682 | 0.160 | 0.040 | 0.882 |
| Professional legal and financial personnel | 1.515 | 1.620 | 0.405 | 3.540 |
| EFA Policy Analysts | 0.180 | 0.240 | 0.060 | 0.480 |
| Support personnel | 0.131 | 0.175 | 0.044 | 0.350 |
| Operating | 1.272 | 1.225 | 0.361 | 2.848 |
| Litigation | 1.000 | 1.000 | | 2.000 |
| Total Operating Expenditure | 4.780 | 4.420 | 0.9000 | 10.100 |
| Fee Revenue | 89.250 | 119.000 | 29.750 | 238.000 |
| Net Revenue | 84.470 | 114.580 | 28.850 | 227.900 |

| Capital Expenditure | 2008/09 \$m | 2009/10 \$m | 2010/11 \$m | Total \$m |
|----------------------------|--------------------|--------------------|--------------------|------------------|
| Credit Assessment Software | 0.600 | - | - | 0.600 |
| IT & Workstations | 0.200 | - | - | 0.200 |
| Total Capital | 0.800 | - | - | 0.800 |

37. The above expenditure and revenue are best estimates and may change as details of the scheme are finalised and the number of financial institutions participating in the scheme are known.
38. The expenditure budget above includes litigation costs and further funding may need to be sought if litigation costs exceed this budget.

Human Rights, Gender Implications and Disability Perspective

39. This paper has no human rights, gender or disability implications.

Legislative Implications

40. The Treasury is assessing the need to amend legislation

Regulatory impact analysis

41. The proposal does not require a regulatory impact analysis as section 65ZD of the Public Finance Act allows me, as Minister of Finance, to issue guarantees or indemnities if it is in the public interest.

Publicity

42. The Treasury and the Reserve Bank have actively publicised the availability of the Scheme, its features and any variations.

Recommendations

It is recommended that Cabinet:

1. **note** that on 12 October 2008 a two year, opt in Crown guarantee of retail deposits was announced that can be called upon by participating institutions when the Crown is satisfied that the institution will be unable to meet its obligations as they fall due;
2. **note** that the Scheme covers those who hold debt securities issued by businesses who receive a guarantee. It includes deposits, term deposits, current accounts, bonds, bank bills and debentures;

3. **note** that only senior debt is covered (except for credit unions and building societies);
4. **note** that the Crown deposit guarantee Scheme has the following characteristics and features:
- (i) The guarantee takes the form of a bilateral contractual agreement between the Crown and the individual financial institution which elects to take up the guarantee. The guarantee is open to all the following (as at 12 October 2008):
- New Zealand-registered banks;
 - Non-bank deposit-taking entities (including building societies, credit unions and deposit-taking finance companies) who are fully compliant with the requirements of their trust deeds; and
 - Collective investment schemes (CISs, of which Portfolio Investment Entities [PIEs], super schemes, managed funds and unit trusts are subclasses) that invest solely in the debt securities of the New Zealand government or institutions subject to a government guarantee.

And;

- For those entering the market after 12 October 2008 institutions in the forms described above rated BBB- or better.

The Scheme covers all deposits in:

- New Zealand incorporated registered banks (which includes incorporated branches of overseas banks), including deposits from both residents or non-residents;
- unincorporated branches of registered overseas banks, for all residents and, for non-residents, deposits as at 12 October 2008, and
- non-bank deposit takers for New Zealand citizens and New Zealand tax residents
- Collective Investment Schemes where investments are held either in NZ government securities or debt securities held by guaranteed institutions.

(ii) Charges a fee of:

- 10 basis points per annum for covered liabilities in excess of \$5 billion; or

- a fee of 300 basis points per annum, charged monthly, on growth in the deposit book for below BB rated and non-rated non-bank deposit takers;
5. **note** that the standard guarantee contract has been varied to include: limitations of coverage for non-resident depositors in branches of overseas banks; coverage of collective investment schemes; and tighter conditions for non-bank deposit takers to help mitigate the potential risk these entities present;
 6. **note** that applications, offers and claims for guarantees will be administered by the Treasury;
 7. **note** The Treasury and Reserve Bank are continuing to work through other practical details and that I will advise Cabinet of any further changes to the scheme;
 8. **note** that the estimated Crown exposure from the retail deposit guarantee scheme is around \$180 billion which will be disclosed in the financial statements of the government as a contingent liability;
 9. **note** that fees from the scheme are estimated to be \$119 million per annum, \$238 million over the two year life of the scheme;
 10. **note** that the Treasury estimates that operational funding of \$10.1 million and capital funding of \$800,000 will be required to implement and operate the Scheme;
 11. **note** that the Associate Minister of Finance (acting as the Minister of Finance) has agreed to add a new Output Class: "Crown Deposit Guarantee Scheme" to the Multi-Class Output Expense "State Sector and Economic Performance Policy Advice and Management" in Vote Finance, because the implementation and operation of the Crown deposit guarantee scheme is outside the appropriation scopes of existing departmental output expenses in Vote Finance;
 12. **agree** that the scope of the new Output Class "Crown Deposit Guarantee Scheme" be "this appropriation is limited to the implementation and operation of the Crown's deposit guarantee scheme";

Agree/disagree

13. **approve** the following changes to appropriations to implement and operate the Crown deposit guarantee Scheme, with a corresponding impact on the operating balance:

| Vote Finance Minister of Finance | \$m – increase/(decrease) | | | | |
|---|---------------------------|---------|---------|---------|----------------------|
| | 2008/09 | 2009/10 | 2010/11 | 2011/12 | 2012/13& Outyears |
| Departmental Multi-class Output Expense: State Sector and Economic Performance Policy Advice and Management | | | | | |

| | | | | | |
|--|-------|-------|-------|---|---|
| Crown Deposit Guarantee Scheme (funded by revenue Crown) | 4.780 | 4.420 | 0.900 | - | - |
|--|-------|-------|-------|---|---|

14. **note** the following changes to non-tax revenue associated with anticipated Crown deposit guarantee Scheme fees, with a corresponding impact on the operating balance:

| | \$m – increase/(decrease) | | | | |
|---|---------------------------|----------------|----------------|----------------|----------------------------------|
| Vote Finance Minister of Finance | 2008/09 | 2009/10 | 2010/11 | 2011/12 | 2012/13& Outyears |
| Non-Tax Revenue Crown Deposit Guarantee Scheme Fees | 89.250 | 119.000 | 29.750 | - | - |

15. **note** that the overall impact from Scheme fees (revenue) less expenses, as described above, is to decrease the operating balance as follows:

| | \$m – increase/(decrease) | | | | |
|--------------------------|---------------------------|----------------|----------------|----------------|----------------------------------|
| | 2008/09 | 2009/10 | 2010/11 | 2011/12 | 2012/13& Outyears |
| Operating Balance impact | (84.470) | (114.580) | (28.850) | - | - |

16. **approve** the following capital injection to the Treasury for the implementation and operation of the Crown's deposit guarantee scheme with a corresponding impact on debt:

| | \$m – increase/(decrease) | | | | |
|---|---------------------------|----------------|----------------|----------------|----------------------------------|
| The Treasury | 2008/09 | 2009/10 | 2010/11 | 2011/12 | 2012/13& Outyears |
| Net Asset Schedule of the Treasury: Capital Injection | 0.800 | - | - | - | - |

17. **note** that as a result of the above, the projected net asset position of the Treasury will increase by the amount of the capital injection;
18. **agree** that the proposed changes to appropriations and projected balances of net assets for 2008/09 above be included in the 2008/09 Supplementary Estimates and that, in the interim, the increases be met from Imprest Supply;
- Agree/disagree.*
19. **note** that the above expenditure and revenue are best estimates and may change as details of the scheme are finalised and the number of financial institutions participating in the scheme are known.
20. **note** that, while litigation costs have been included in the above budget, further funding may need to be sought if litigation exceeds this budget;

21. **agree** that the Treasury will provide an update of forecast expenditure and revenue once final policy decisions and the number of financial institutions participating in the scheme are known.

Agree/disagree

Hon Dr Michael Cullen
Minister of Finance

Date: