

MEMORANDUM FOR CABINET

**Chair
CABINET**

CROWN WHOLESALE GUARANTEE FACILITY: IMPLEMENTING AND MONITORING THE FACILITY

Proposal

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

Executive Summary

2. On 1 November 2008 I announced the decision to offer a Crown wholesale funding guarantee facility in order to facilitate access by New Zealand banks to international financial markets, in a global environment where international investors remain highly risk averse and where many other governments have offered guarantees on their banks' wholesale debt.
3. This paper summarises for your information, the policy decisions I have taken in consultation with the Prime Minister to define the scope of the Facility I announced on 1 November 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 give authority for writing, managing and administering the Wholesale Guarantee Facility. Decisions to exercise discretion under this guarantee will be guided by policy guidelines.
4. It is difficult to estimate how heavily the facility will be used (that would depend largely on how quickly market access conditions improve). An assumption of \$40 billion of guaranteed issuance within six months would be a plausible estimate if conditions remain difficult. Wholesale guarantees will be recorded as contingent liabilities in the financial statements of the government.
5. The facility is likely to generate a significant amount of revenue from the up-front payment of guarantee fees. However, the guarantee fee has been set to cover the risk of losses under the guarantee facility itself, which would be very large should they occur. In addition, the guarantee facility is likely to increase the

Crown's own borrowing costs for a period. Therefore, it will be necessary to maintain considerable fiscal discipline over the next few years. In particular, it is important that the revenue from the guarantee facility be applied to debt reduction and not used to fund additional expenditure.

6. Significant legal, financial and administration costs will be incurred to establish and monitor the Facility. It is proposed that additional operating funding of \$5.060 million is provided to implement and operate the Facility.

Comment

Recent international events and backdrop to decisions taken

7. International funding markets are currently largely closed to New Zealand and Australian banks. Those markets are a key source through which New Zealand's substantial external financing needs are met, and if material volumes of maturing debt cannot be rolled over, the risk of a more severe economic dislocation over the coming months will be increased.
8. Many other governments have recently offered guarantees on their banks' wholesale debt. The traditional funding markets are likely to re-open gradually, and as they do there is likely to be a marked investor preference for some time for securities issued by banks that carry a government guarantee over those that do not.
9. In this context, in consultation with the Prime Minister, I took the decision to offer a Crown wholesale guarantee facility in order to support the re-entry by New Zealand financial institutions to international financial markets on a scale commensurate with our economy's overall financing needs.
10. At the same time, the facility is carefully structured to encourage issuers to withdraw from using the guarantee facility, and the Crown to withdraw from offering it, on new issues as soon as the international markets return to normal.

Characteristics of the Wholesale Guarantee Facility

11. The wholesale guarantee facility I announced has a number of characteristics, described in detail below, which I ask Cabinet to note. All the details below are subject to the overriding provision that the Crown will not be obliged to offer a guarantee facility to any particular issuer or on any particular debt issue.

The offer

12. A wholesale funding guarantee facility will be available to investment grade financial institutions which have substantial New Zealand borrowing and lending operations.
13. The facility will operate on an opt-in basis, by institution and by instrument. No financial institution would have to participate in the facility, nor would all new issues of debt have to be covered. This approach will facilitate institutions gradually withdrawing from using the guarantee on new paper, as market conditions allow.

Eligible issuers

14. Consistent with the approach taken to the retail deposit guarantee scheme, branches of foreign banks would be included among the investment grade institutions eligible for a wholesale guarantee facility, but only in respect of their New Zealand dollar issuance to avoid any risk of any New Zealand guarantee supporting the funding of the wider group.
15. The facility does not include non-financial (eg corporate and local authority) issuers. This focus on financial intermediaries is consistent with the approach to wholesale guarantee facilities which has been adopted in other countries.

Eligible instruments

16. All newly issued senior unsecured negotiable or transferable debt securities by eligible financial institutions would be eligible for coverage by the wholesale guarantee facility.
17. No instruments will be covered by both the wholesale facility and the deposit guarantee scheme. All newly issued wholesale securities issued by institutions participating in the wholesale facility will be excluded from coverage in the retail scheme.
18. The guarantee will cover all holders of these guaranteed debt securities, other than debt held by related parties (including parents) of the issuer. The retail deposit guarantee scheme excludes deposits held by financial institutions in order to minimise the extent to which wholesale holdings of financial instruments were covered by the highly concessional deposit guarantee scheme. An exclusion is not necessary under the wholesale facility. Consequently, all holdings of guaranteed debt securities held by unit trusts and other collective investment schemes, for example, would be covered.

Currencies covered

19. Eligible instruments in all major currencies would be eligible for cover. Specifically, the facility would cover NZD, AUD, USD, EUR, GBP, CHF, JPY, HKD, and SGD issuance.
20. Including domestic issuance should enable managed funds and other similar entities, over time, to transfer most of their claims on New Zealand registered banks into instruments that are eligible for coverage under a wholesale facility.

Fees

21. A guarantee fee would be charged for each issue, differentiated by the riskiness of the issuer and the term of the security being guaranteed, as follows:

| Credit rating of issuer ¹ | Fee (bps per annum) Term at time of issue | |
|--------------------------------------|--|------------------|
| | 1 year or less | More than 1 year |
| AA- and above | 85 | 140 |
| A- to A+ | 145 | 200 |
| BBB- to BBB+ | 195 | 250 |

22. The fee schedule has been designed to ensure that the facility is used while it is needed, but to encourage issuers to graduate from using the guarantee as market conditions permit. The guarantee fee will be reviewed regularly and may be adjusted in future for new issues, in light of market developments and experience with the facility. Adjustments would be made by the Secretary to the Treasury.

Term of the guarantee

23. Any paper carrying the wholesale guarantee would be covered to maturity or for up to five years from the time it is issued, whichever is the earliest.
24. The five year rolling term is longer than the fixed two year term on the retail deposit guarantee scheme. This reflects two considerations. First, most retail deposits are for terms less than two years. Second, it is important that wholesale funding is spread out over a range of maturities to avoid the risk of concentrated rollovers, with associated macroeconomic risks, at some point in the future.

Contractual

25. As with the retail guarantee scheme, the wholesale facility takes the form of a bilateral contractual agreement between the Crown and the individual financial institution in respect of a particular issue of debt securities. Legislation is not required for the Crown to enter into guarantees under section 65ZD of the Public Finance Act 1989.

Limitations and conditions of the guarantee

Limitation on the amount of debt covered by the guarantee

26. Issuers who joined the wholesale guarantee facility will not be permitted to have guarantees for debt in excess of 125 per cent of the total stock of eligible types of debt on issue prior to the intensification of the crisis².
27. This limit provides the Crown some additional cover against the risk of banks seeking to increase their funding activities solely on the basis of the guarantee. It also provides a cap on the risk that NZD issuance undertaken by New Zealand branches of wholesale banks under this guarantee would be used to fund the wider activities of the group.

¹ Standard and Poor's ratings, or the equivalent from Moody's or Fitch.

² For banks, as per the last published General Disclosure Statement, and for other issuers the last published set of annual accounts for a period prior to 12 October 2008.

28. No limit has been set on the total volume of paper guaranteed. Officials will be closely monitoring the overall use of the facility. The pricing of the facility could be adjusted, for future issues, if more debt is being issued under guarantee than is judged to be necessary in light of market access conditions.

Capital buffer

29. As a condition of continuing to receive guarantees on new issues, banks utilising the wholesale guarantee facility will be required to maintain an additional 2 per cent Tier 1 capital buffer, above the 4 per cent regulatory minimum.
30. Banks currently all hold at least this much additional capital, and ensuring that current levels of capital are maintained will help protect the interests of the Crown as guarantor. The capital buffer required for non -bank applicants will need to be treated on a case-by-case basis.

Foreign exchange risk

31. All issuers participating in this guarantee facility will be required to undertake that the foreign exchange risk associated with foreign currency borrowing will be hedged and managed.

The retail scheme

32. Deposit-taking financial institutions seeking to utilise the wholesale funding guarantee facility will be expected to have applied for a guarantee under the Crown retail deposit guarantee scheme.

Processes for Implementing the Wholesale Guarantee Facility

33. I have delegated authority to the Secretary to the Treasury to give authority for writing, managing and administering the Wholesale Guarantee Facility. The Treasury will use policy guidelines to guide the exercise of any discretion under the guarantee.
34. Draft legal documentation has been provided to several major institutions for comment. Officials expect to finalise documentation and be in a position to sign issuers up to the facility within the next week or so.

Financial Implications

Fiscal Implications of the Wholesale Guarantee Facility

35. The wholesale guarantee facility is likely to generate a significant amount of revenue. All guarantee fees will be paid up-front, so that in the first year perhaps as much as \$1 billion could be received in cash and up to \$2.3 billion over the life of the facility. In terms of revenue reporting, this income would be recognised over the life of the guarantee (up to five years on a rolling forward basis). However, the Crown's cash position would be materially improved.

36. However, the estimate of fee revenue is highly variable, being very dependent on how heavily the wholesale guarantee facility is used, which will depend largely on how quickly market access conditions improve.
37. The guarantee fee is set to cover the risk of losses under the guarantee facility itself, which would be very large should they occur. In addition, the guarantee facility is likely to increase the Crown's own borrowing costs for a period. The risks to New Zealand's credit rating from the deteriorating fiscal position and the offer of the retail guarantee scheme, combined with the weakening domestic and international economic environment, make it important that considerable fiscal discipline is maintained over the next few years. In particular it is important that the revenue from the guarantee facility be applied to debt reduction and not be thought of as an improvement in the fiscal position available to fund additional expenditure.

Accounting treatment

38. Wholesale 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 noted above, it is difficult to estimate how heavily the facility will be used (that would depend largely on how quickly market access conditions improve). An assumption of \$40 billion of guaranteed issuance within six months would be a plausible estimate if conditions remain difficult.
39. 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.
40. 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 wholesale guarantee facility

41. The implementation and administration of the wholesale scheme will be quite different from that of the retail deposit scheme as it will involve engagement with the relevant financial institutions on a general understanding of the guarantee being provided with each issue being covered by an eligibility certificate.
42. Implementation of the scheme will require:
 - policy guidelines to underpin the delegation of authority to the Secretary of the Treasury;
 - establishing and ensuring the soundness of the processes intended to be operated;
 - writing of understandings with each financial institution eligible and intending to use the facility.
43. The main areas of activity in administering the scheme include:
 - managing fees including:
 - managing the fee income

- managing foreign exchange issues;
 - calculating fees; and
 - charging monthly on the month's transactions.
 - Writing of individual certificates and signing off on the necessary documentation.
44. The Treasury estimates that additional operational funding of \$5.060 million will be required to implement and operate the Facility. This consists of two elements.
45. It is estimated that \$4.760 million will be required over the estimated seven year period of the Facility for the significant legal, financial and administration costs that will be incurred to establish and monitor the Facility. The Facility is expected to be utilised by financial institutions for up to two years and any paper with maturities up to five years will be covered. Therefore, the overall life of the Facility is estimated to be up to seven years.
46. We have assumed that financial institutions will not require the facility beyond 2 years and therefore costs (and revenues) over the remaining 5 years will be lower as guaranteed paper matures.
47. The Treasury will contract the Reserve Bank of New Zealand to perform the ongoing monitoring and administration of the Facility. This arrangement will take advantage of the Reserve Bank's established expertise and systems' resulting in costs being significantly less than alternative options, such as establishing a new unit in the Treasury.
48. Existing legal resources within The Treasury will need to work on the implementation of the deposit guarantee scheme and the wholesale guarantee facility. To ensure other core business at risk, the necessary funding for additional in-house legal resource is also being sought. The duration of this contract is expected to run for 24 months at a cost of \$0.300 million. At this stage this additional funding will be appropriated to the new Multi-Class Output Expense - Crown Wholesale Guarantee Facility. Costs associated with the Crown Deposit Guarantee Scheme can be transferred within the Multi-Class Output Expense appropriation.
49. The role of these legal and financial staff will be to reduce the Crown's exposure to the wholesale guarantee by performing regular monitoring of the financial institutions and debt issues to ensure they meet the necessary guarantee criteria. The budget is summarised in the following table.

Wholesale Guarantee Facility: Operating Budgets

| Operating Expenditure & Fees | 2008/09 \$m | 2009/10 \$m | 2010/11 \$m | 2011/12 – 2016/17 | Total \$m |
|---|--------------------|--------------------|--------------------|--------------------------|------------------|
| External Legal advice & services | 1.170 | 0.780 | 0.260 | - | 2.210 |
| Professional legal and | 0.260 | 0.390 | 0.270 | 1.000 | 1.920 |

| | | | | | |
|-----------------------------|----------------|----------------|----------------|------------------|------------------|
| financial personnel | | | | | |
| Administration | 0.070 | 0.100 | 0.035 | 0.125 | 0.330 |
| Contingency | 0.140 | 0.120 | 0.040 | - | 0.300 |
| In-house legal services | 0.100 | 0.150 | 0.050 | - | 0.300 |
| Total Operating Expenditure | 1.740 | 1.540 | 0.655 | 1.125 | 5.060 |
| Fee Revenue | 300.000 | 450.000 | 400.000 | 1,150.000 | 2,300.000 |
| Net Revenue | 298.260 | 448.460 | 399.345 | 1,148.875 | 2,294.940 |

50. The above expenditure and revenue are best estimates and may change as details of the guarantee facility are finalised and the amount of debt guaranteed known.
51. The expenditure budget above does not include litigation costs and further funding may need to be sought if litigation costs are incurred.

Human Rights, Gender Implications and Disability Perspective

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

Legislative Implications

53. The Treasury is assessing whether a Securities Act exemption is required for issuers of eligible debt securities.

Regulatory impact analysis

54. 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

55. The Treasury and the Reserve Bank have publicised the availability of the Facility, its features and any variations.

Recommendations

56. It is recommended that Cabinet:

1. **note** that on 1 November 2008 I announced that the Crown will offer a wholesale funding guarantee facility to investment-grade financial institutions in New Zealand in order to facilitate access by New Zealand banks to international financial markets.

Key features of the wholesale guarantee

2. **note** that the wholesale guarantee facility has the following characteristics and features:

Contractual

- 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 on an issue by issue basis.

Eligible institutions

- ii) The guarantee is available to investment grade financial institutions which have substantial New Zealand borrowing and lending operations;
- iii) Branches of foreign banks will be eligible for the wholesale guarantee facility in respect of their New Zealand dollar issuance;

Eligible instruments

- iv) All newly issued senior unsecured negotiable or transferable debt securities by eligible financial institutions would be eligible for coverage by the wholesale guarantee facility.
- v) No instruments will be covered by both the wholesale facility and the retail deposit guarantee scheme;
- vi) The guarantee will cover all holders of these guaranteed debt securities, other than debt held by related parties of the issuer;

Currencies covered

- vii) Eligible instruments in all major currencies would be eligible for cover by the guarantee.

Fees

- viii) a guarantee fee would be charged for each issue, differentiated by the riskiness of the issuer and the term of the security being guaranteed as follows:

| Credit rating of issuer ³ | Fee (bps per annum) Term at time of issue | |
|--------------------------------------|--|------------------|
| | 1 year or less | More than 1 year |
| AA- and above | 85 | 140 |
| A- to A+ | 145 | 200 |
| BBB- to BBB+ | 195 | 250 |

- ix) The guarantee fee will be reviewed regularly and may be adjusted in future for new issues.

Term of the guarantee

- x) Any paper covered by the guarantee would be covered to maturity or for up to five years from the time it is issued, whichever is the earliest.

Capital buffer requirement

- xi) Banks utilising the wholesale guarantee facility will be required to maintain an additional 2 per cent Tier 1 capital buffer, above the 4 per cent regulatory minimum.

Foreign exchange risk

- xii) All issuers participating in this guarantee facility will be required to undertake that the foreign exchange risk associated with foreign currency borrowing will be hedged and managed.

Retail Scheme

- xiii) Deposit-taking financial institutions seeking to utilise the wholesale funding guarantee facility will be expected to have applied for a guarantee under the Crown retail deposit guarantee scheme.

3. **note** that applications, offers and claims for guarantees will be administered by the Treasury;

Financial Implications

4. **note** that while it is difficult to estimate how heavily the facility will be used, an estimated Crown exposure from the wholesale guarantee facility of around \$40 billion within six months is regarded as a plausible estimate if market conditions remain difficult. Wholesale guarantees will be disclosed in the financial statements of the government as a contingent liability;
5. **note** that fees from the facility could be up to \$1 billion in cash in the first year of the facility and up to \$2.3 billion of revenue spread over the life of the guarantee facility;
6. **note** that the estimate of fee revenue is highly variable, being very dependent on how heavily the wholesale guarantee facility is used, which will depend largely on how quickly market access conditions improve.

³ Standard and Poor's ratings, or the equivalent from Moody's or Fitch.

7. **note** that the guarantee fee has been set to cover the risk of losses under the guarantee facility itself, which would be very large should they occur.
8. **Agree** that revenue from the guarantee facility should be applied to debt reduction and not used to fund additional expenditure.
9. **note** that the Treasury estimates that operational funding of \$5.060 million will be required to implement and operate the wholesale guarantee facility;
10. **note** that the Associate Minister of Finance (acting as the Minister of Finance) has agreed to add a new Output Class: "Crown Wholesale Guarantee Facility" 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 wholesale guarantee facility is outside the appropriation scopes of existing departmental output expenses in Vote Finance;
11. **agree** that the scope of the new Output Class "Crown Wholesale Guarantee Facility" be "this output class is limited to the implementation and operation of the Crown's wholesale guarantee facility";
12. **approve** the following changes to appropriations to implement and operate the Crown wholesale guarantee facility, 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 |
| Departmental Multi-class Output Expense: State Sector and Economic Performance Policy Advice and Management | | | | | |
| Crown Wholesale Guarantee Facility (funded by revenue Crown) | 1.740 | 1.540 | 0.655 | 0.225 | 0.225 |
| | 2013/14 | 2014/15 | 2015/16 | 2016/17 & Outyears | |
| | 0.225 | 0.225 | 0.225 | - | |

13. **note** the following changes to non-tax revenue associated with anticipated Crown wholesale guarantee facility fees, 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 |
| Non-Tax Revenue | | | | | |

| | | | | | |
|---|---------|---------|---------|--------------------|---------|
| Crown Wholesale Guarantee Facility Fees | 300.000 | 450.000 | 400.000 | 330.000 | 330.000 |
| | 2013/14 | 2014/15 | 2015/16 | 2016/17 & Outyears | |
| | 250.000 | 160.000 | 80.000 | - | |

14. **note** that the net impact from Facility fees revenue less expenses, as described above, is to increase the operating balance as follows:

| | \$m – increase/(decrease) | | | | |
|-----------------------------------|---------------------------|---------|---------|--------------------|---------|
| | 2008/09 | 2009/10 | 2010/11 | 2011/12 | 2012/13 |
| Net increase in Operating Balance | 298.260 | 448.460 | 399.345 | 329.775 | 329.775 |
| | 2013/14 | 2014/15 | 2015/16 | 2016/17 & Outyears | |
| | 249.775 | 159.775 | 79.775 | - | |

15. **agree** that the proposed changes to appropriations for 2008/09 above be included in the 2008/09 Supplementary Estimates and that, in the interim, the increases be met from Imprest Supply;
16. **note** that the above expenditure and revenue figures are best estimates and may change as details of the wholesale guarantee facility are finalised and the amount of debt guaranteed is known.
17. **note** that litigation costs have not been included in the above budget, and that further funding may therefore need to be sought if litigation arises.
18. **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 facility are known, and that changes to appropriations may be proposed at that time.
19. **note** that Treasury will review its Vote Finance departmental appropriation structure for both the Crown Deposit Guarantee Scheme and the Crown Wholesale Guarantee Facility prior to Budget 2009 to reflect the final operating structures of these schemes.

Hon Dr Michael Cullen
Minister of Finance

Date: