RESERVE BANK OF NEW ZEALAND

THE TREASURY
Kaitohutohu Kaupapa Rawa

Joint Report: Responding to the Prospect of a Worsening Financial Crisis in New Zealand

Date:	10 October 2008	Report No:	T2008/2000

Action Sought

	Action Sought	Deadline
Minister of Finance (Hon Dr Michael Cullen)	Agree to recommendations	

Contact for Telephone Discussion (if required)

Name	Position	Telephone		1st Contact
Dr Alan Bollard	Governor, Reserve Bank	471 3673 (wk)	*Information deleted under s9(2)(a) to protect the privacy of natural persons, including deceased people.*	
Mr Peter Bushnell	Acting Secretary, The Treasury	917 6176 (wk)	*Information deleted under s9(2)(a) to protect the privacy of natural persons, including deceased people.*	

Minister of Finance's Office Actions (if required)

None.

Enclosure: No

Joint Report: Responding to the Prospect of a Worsening Financial Crisis in New Zealand

Executive Summary

The international financial crisis has worsened rapidly in the last six weeks or so, spreading to a wider range of countries and institutions. The pressures have been concentrated in wholesale markets, where trust and confidence have become increasingly fragile. Against that backdrop this joint report reviews options for policy responses should the situation, as it affects New Zealand, deteriorate further.

There is a 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. At present, however, New Zealand and Australia (home of the parents of most of our banks) have escaped the worst of the storm. Most domestic markets continue to function , and we not yet seeing widespread or substantial changes in depositor behavior in New Zealand. We are also not seeing any widespread wholesale or retail concerns about the health and safety of the Australasian banks.

However, although we have good reason to be confident in the quality of the assets of the banking system, we cannot prudently assume that New Zealand will continue to avoid the worst effects of the crisis. And the situation could change quickly. To put us in a position to respond effectively and decisively should the need arise, it is important to prepare possible policy responses now.

There are two, broadly separable, issues. The first is the loss of confidence by wholesale markets in the resilience of financial institutions. The primary response, including in New Zealand, has been the liberal provision of liquidity by central banks. Should the crisis in New Zealand develop so that liquidity provision was insufficient on its own, then the government would need to consider complementary measures. The most likely would be the use of a comprehensive guarantee of the liabilities of financial institutions. We have no reason to believe that we are at such a stage.

The second problem could be a loss of retail confidence reflected in retail runs. New Zealand is the only OECD country without either any sort of deposit insurance or statutory preference for depositors. Deposit insurance schemes, of themselves, even those with quite generous caps, have failed to prevent financial crises engulfing a wide range of countries, and have not always made much obvious difference in maintaining or restoring retail depositor confidence. Such schemes can help protect depositors' interests in the event of failure, but have only a limited role to play in averting a worsening of a crisis.

A retail oriented scheme could be implemented quite quickly. The key features of such a scheme would include the following:

i) offered to New Zealand registered banks and non-bank deposit takers;
ii) offered through an opt-in scheme by bilateral agreement between the Crown and individual financial institutions;
iii) apply primarily to retail deposits;
iv) probably cover both resident and non-resident depositors;
v) subject to a cap per depositor per institution of $250,000 for banks and other rated deposit-taking institutions, and $50,000 for non-rated non-bank deposit takers;
vi) subject to a risk based fee;

We are not recommending implementation of such a scheme yet. Market conditions do not at this point warrant such an initiative. It would also imply a material departure from the established New Zealand approach to financial supervision and regulation. Offering a guarantee would enduringly change expectations about government responses to financial stresses and institutional failures in the future. Offering a guarantee of this sort would involve assuming a large unquantified contingent fiscal liability.

Market conditions can change quickly. In evaluating whether to recommend further measures, key considerations would be likely to include evidence of one or more of the following:

- Material indications of a "retail run' on a major deposit-taking institution,
- A serious or sustained deterioration in, for example, credit default swap spreads for Australian parents,
- Significant evidence of a reluctance of key counterparties to deal with one of the major domestic financial institutions
- Significant evidence of wholesale or non-resident depositors withdrawing funds from one or more major institutions.
- A deep, sharp or highly disorderly fall in the exchange rate, especially if linked to any of the other factors above.

We will continue to monitor markets very closely, will continue to provide written briefings daily and will continue to advance planning, in conjunction with the Australians where appropriate in case the situation deteriorates further.

This paper has outlined the broad design of a deposit guarantee scheme but there are a number of details that still need to be resolved, including the details of coverage. We would advise against announcing such a scheme until these details have been determined. There are risks of increasing uncertainty in the market by talking publicly about such a scheme in advance. We anticipate that these issues could be resolved in the next week. International experience suggests that policy initiatives in response to financial crises are most likely to be effective and contribute to restoring confidence when they have broad bipartisan support.

Recommended Action

We recommend that you:

a **note** that our view is that as of today, it is not necessary or appropriate to take any further policy measures, including deposit guarantees, in response to the international financial crisis

Noted.

b **note** that conditions are moving very rapidly and that our advice could change quickly in light of those developments here and abroad..

Noted

c **agree** that if it was desired to make some further policy response we would recommend some form of crown guarantee of deposits of financial institutions as the best, most readily deployable instrument, to help maintain and enhance confidence in the financial system.

Agree/disagree.

d **agree** that if you wish to proceed at this time with a deposit guarantee scheme, the guarantee would have the following key features:

i) offered to New Zealand registered banks and non-bank deposit takers;
ii) offered through an opt-in scheme by bilateral agreement between the Crown and individual financial institutions;
iii) apply primarily to retail deposits;
iv) probably cover both resident and non-resident depositors;
v) subject to a cap per depositor per institution of $250,000 for banks and other rated deposit-taking institutions, and $50,000 for non-rated non-bank deposit takers;
vi) subject to a risk based fee;

Agree/disagree. Subject to change, and consideration of risk fee

e **agree** that officials continue to develop the operational detail of a guarantee scheme for deposits and other liabilities that could be announced and implemented very quickly should the need for urgent action arise. We expect to have details finalised by the end of next week.

Agree/disagree.

f **agree** that, if at all possible, no public announcements be made before the key details have been finalised.

Agree/disagree.

g **agree** that officials will continue to liaise with Australian officials on any future policy responses.

Agree/disagree.

h **note** the advantages of achieving broad bi-partisan support for any policy initiative in this area.

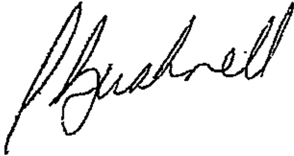
Noted

i **note** Treasury and RBNZ officials will continue to closely monitor developments in the financial sector for signs of material deterioration in the situation that might require further policy initiatives.

Noted.

j refer this report to the Prime Minister.

Referred.



Peter Bushnell
Acting Secretary to the Treasury

Alan Bollard
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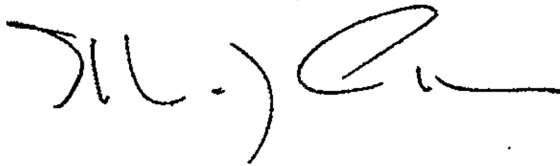
Reserve Bank of New Zealand



Hon Dr Michael Cullen
Minister of Finance

Treasury Report: Responding to the Prospect of a Worsening Financial Crisis in New Zealand

Purpose of Report

1. In the context of the rapidly worsening international financial crisis, this report advises on potential options which could be used in New Zealand if a response was to become necessary. It outlines the broad range of tools that has been used abroad, to provide a basis for determining whether, when, and how New Zealand might respond to a worsening of the crisis that affects New Zealand.

2. The report concludes that some form of Crown guarantee of deposits of financial institutions would be the most appropriate additional tool if further steps had to be taken quickly. Our advice is not to offer such a guarantee at this time. The paper aims to place the option of a deposit guarantee in the wider context of the full range of tools that could be available were the crisis, as it affects the New Zealand financial system, to worsen.

3. Notwithstanding that advice, the paper provides details of a limited retail depositor guarantee/insurance scheme that could be announced and implemented at short notice. More generally, it highlights the importance of advance preparation so that if the need for action arises we can move decisively and effectively.

Intervention goals

4. The international financial crisis, which has gathered pace in recent weeks, has been characterized by a growing and increasingly widespread loss of confidence in key financial intermediaries, and increasing disruption to the effective functioning of wholesale credit markets. The crisis internationally has largely taken the form of a loss of wholesale market confidence, with substantial retail depositor runs often becoming more apparent towards the very end when a particular institution is under extreme stress.

5. The successive waves of interventions, in different forms in different countries, have largely been designed to maintain or restore confidence in the financial system. The ultimate goal, of course, has been to avoid the serious economic costs that could result over time from widespread failures of significant financial institutions, especially if those failures disrupt commerce and result in material losses to depositors and other creditors.

6. We believe that the maintenance of confidence in the soundness and effective functioning of the financial system and credit markets would be the appropriate goal for any further policy responses adopted in New Zealand. For any particular financial institution, a wide range of parties' confidence is relevant, including domestic and foreign depositors, providers of wholesale funding, and those engaging in other wholesale transactions (including hedging transactions) with the institution.

The current New Zealand situation

7. So far, New Zealand has been affected only moderately by the international financial crisis. Foreign wholesale funding has become considerably more expensive, and also harder to obtain. Indeed, right at the moment it is very difficult for our major banks to raise funds abroad at all for terms longer than overnight. However, that is occurring not because of specific Australasian concerns, but because international commercial paper markets have largely closed to most borrowers. There has also been little sign of other creditors reducing their exposures to any of the major Australasian banks operating here, or of material pressures developing among retail depositors. Most domestic markets continue to function tolerably well, and domestic banks are continuing to deal with each other.

8. This relatively encouraging picture is consistent with our judgment that the overall asset quality of New Zealand banks (and their Australian parents) is sound and hence that there is no particular reason for creditors to be concerned.

9. Accordingly, 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.

10. 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. It is, therefore, prudent to be prepared with other tools that could help assure confidence and trust in the financial institution(s) concerned; preferably tools that could be deployed quickly.

11. As other countries have found, the situation can change very rapidly. It can change for reasons quite beyond the control of New Zealand authorities. A deterioration in the international situation, or a refocusing on a different class of countries or risk, could see confidence in Australasia come into question very quickly, with either individual institutions or the system as a whole in focus. At a retail level, the potential influence of media and other commentaries also cannot be taken lightly, despite the best efforts of officials working with journalists to ensure that they are well-briefed and understand the fundamental strengths of the Australasian banking system.

What would prompt us to recommend further action?

12. Our advice at present is that there is no need, nor material economic advantage, in announcing further measures at this stage. The crisis is moving quickly, however, and we cannot rule out the possibility of the pressures relating to New Zealand and Australian banks becoming more intense. That could mean that quick action could be needed at short notice.

13. It is not possible, or wise, to attempt to develop a formal decision rule in advance, as to when additional measures might be needed. However, key considerations would be likely to include evidence of one or more of the following:

- Material indications of a "retail run' on a major deposit-taking institution,
- A serious or sustained deterioration in, for example, credit default swap spreads for Australian parents,
- Significant evidence of a reluctance of key counterparties to deal with one of the major domestic financial institutions

- Significant evidence of wholesale or non-resident depositors withdrawing funds from one or more major institutions.
- A deep, sharp or highly disorderly fall in the exchange rate, especially if linked to any of the other factors above.

14. We will continue to monitor markets very closely, will continue to provide written briefings daily, and will continue to advance planning, in conjunction with the Australians where appropriate in case the situation deteriorates further.

Broad approaches

15. Three broad classes of policy response (not necessarily mutually exclusive) have been adopted internationally in an attempt to restore confidence in financial markets and institutions:

    - **Direct purchase of impaired assets** by the state from financial institutions (the prime example is the US TARP programme, signed into law last weekend).

    - The nationalization or **state recapitalisation** of individual institutions facing extreme losses of confidence.

    - **State guarantees** to some or all classes of creditors.

16. There is growing recognition that the most effective way to secure the confidence of depositors, wholesale investors, and counterparties, is by measures that place the direct weight of the state's balance sheet behind institutions that are being adversely affected by the crisis. That, of course, involves significant fiscal implications and risks. Any of these options also raises significant moral hazard concerns - not primarily in respect of how markets and investors behave right now, but about how behavior changes in future once the immediate crisis has passed. Significant state interventions that help shield depositors or other investors from loss are likely to have major implications for the future shape of supervisory and regulatory systems. That is a particular issue in New Zealand, where our regulatory system has placed considerable emphasis on the role of incentives and market disciplines.

Direct purchase of impaired assets

17. The United States approach of purchasing securitised impaired assets held on the balance sheets of financial institutions is irrelevant for New Zealand at present: there are few securitised assets on bank balance sheets; and there are no large losses or other impaired assets on bank balance sheets.

18. To the extent that credit concerns do arise in New Zealand, they are likely to relate to the prospect of a broad-based recession and a serious weakening in asset prices, particularly those for housing – in other words, the risks would go across the loan books. Broadly speaking, the situation is similar in the United Kingdom, and we are not aware that any serious or extensive consideration has been given to asset purchases as a way of resolving confidence issues in the United Kingdom financial system. We do not consider this option any further in this paper.

State re-capitalisation

19. In a number of countries in recent weeks, authorities have moved to take a large or 100 per cent state shareholding in financial institutions engulfed in the crisis. State ownership of the institution, combined with at least an implicit assurance that creditors will not be allowed to lose their money, has successfully ended pressures on the institutions concerned, and enabled them to continue functioning. This is the

approach that has been taken with the large European bank Fortis, and in the United States, for AIG and Fannie Mae and Freddie Mac. For institutions that are regarded as solvent, state recapitalizations also enable the Crown to share in the financial upside as confidence and stability returns.

20. This spirit of the approach is also broadly that taken by the UK in the package announced on Wednesday night. One of the key features of that package is that the Crown will be offering to take substantial, but non-controlling, shareholdings in affected banks and financial institutions.

Deposit guarantees

21. Faced with severe pressures in the wholesale funding markets (spilling over into share prices, and credit insurance costs), the Irish government announced a comprehensive guarantee of the liabilities of the six largest Irish deposit-taking institutions. This has been followed by a series of guarantees offered by a growing list of European governments. Some of these have been formal in nature and explicitly limited to retail deposits, others have more in the nature of statements of political intent - and hence less clear as to how far the guarantee would extend were a bank actually to fail.

22. Provided the creditworthiness of the state is not regarded as being materially impaired, a comprehensive guarantee, along the lines of the Irish one, is likely to be highly effective in staunching pressures on institutions and the system, and in assisting in restoring the functioning of markets. With the exception of Iceland, where the size of the banking system swamps the size of the economy, markets and rating agencies do not appear to have materially penalized governments which have moved to offer or extend guarantees. This may be in part because of strong prior implicit expectations of taxpayer support in the event of widespread financial crisis.

23. A guarantee will typically provide little effective ongoing leverage for the government over the guaranteed entity's behavior and does not provide the state with any of the gains if the guaranteed entity recovers soundly. Moreover, the cost of any guarantee fee is likely to be borne primarily by depositors/creditors, rather than by shareholders. It has been common ground in international debate around crisis resolution options that, wherever possible, shareholders and management should be exposed to the cost of choices they have made (for example regarding funding structures and levels of capital).

Application and options for New Zealand

Options now

24. **Equity recapitalization** is not an option. The local bank subsidiaries are not listed, and are wholly owned by the parents. Neither parents nor subsidiaries would welcome state approaches offering additional capital at this point.

25. If we were to need to act quickly the preferred option would be to offer a **guarantee of some or all liabilities of banks and other depositor-takers.** Such a guarantee could be provided unilaterally at any point in time, but because a scheme could not be legislated at present (Parliament having been dissolved), a government charge for a guarantee could only be applied if the scheme operated on a voluntary opt-in basis.

26. Were the financial crisis to engulf New Zealand, only a comprehensive guarantee would be likely to staunch the loss of confidence. The offer of a guarantee would all

but force institutions to take it up, but at present a high-priced guarantee might well not be well-received by the banks.

27. Although the position could move quickly, we do not believe that it would be appropriate to offer a full guarantee of all liabilities at present. We reach this conclusion for several reasons:

- There is no unmanageable pressure on New Zealand or Australian institutions at present;
- Announcing such a scheme, encompassing all creditors, could risk being taken by markets and investors as a sign that the situation is worse than it really is;
- Any sort of guarantee of this sort, used before it is absolutely needed, raises concerns about possible adverse behavioural responses. Specifically, if the Crown were now to guarantee all wholesale liabilities for the next two years, and the crisis never actually hit us, we would have turned New Zealand banks into risk-free borrowers for the next two years, distorting investment choices.
- At the margin, announcing a comprehensive guarantee at this stage could increase the risk of a downgrade in the New Zealand sovereign credit rating. Again, if the crisis is actually going to hit us, that risk may simply have to be run, but we do not need to take the risk just yet.

28. However, if the crisis should spread to New Zealand it is important to have a fully worked out scheme that could be announced and implemented, with certainty, very quickly. One of the lessons of international responses is that the effectiveness of (otherwise sensible) measures has been impeded when key details have not been worked out in advance, and hence market participants are not sure how the game has changed even after the announcement.

29. **Deposit insurance** would require legislation and would take some considerable time to develop and implement. New Zealand is the only OECD country without some form of explicit depositor insurance or statutory deposit or preference. However, it is clear that the standard retail deposit insurance model internationally is no guarantee against a loss of confidence (retail or wholesale) in a bank or financial institution. Each of the countries that has moved to fully guarantee deposits had deposit insurance systems in place. In Australia, the Banking Act provides explicit preference for retail depositors in the event of liquidation. Moreover, the Australian government is moving to implement a scheme which would provide immediate liquidity to bank depositors in the event of failure [see annex]

30. If desired, a voluntary (opt-in) retail-focused deposit guarantee could be developed and put in place quite quickly. With a suitably large cap, such a scheme might help to allay any retail concerns, and hence reduce the risk of a retail run on financial institutions. We have discussed this possibility with Australian officials, who regard their depositor preference as already providing that level of protection to retail depositors in the parent banks in Australia, and therefore see no need to adopt such a deposit guarantee themselves.

31. A serious financial crisis which involved the failure of major financial institutions would be likely to have significant and substantial fiscal implications for the Crown. However, any insurance or liability guarantee launched at this time would expose the Crown to additional fiscal risks. These cannot easily be quantified, but there is less than $10 billion of retail deposits held in non-bank financial institutions (less than $3 bn in unrated entities). The failure of institutions of this sort would not normally be expected to involve direct Crown involvement.

32. The second half of this paper explores the key design features of a retail-oriented scheme. It is also a basic structure which could be generalized to a much wider group of bank liabilities were that to be judged desirable at a later date.

Options at the point where the crisis was affecting us more severely

33. Options that involve Crown recapitalization of the banks ensure that any costs are sheeted home to existing shareholders, provides greater control for the Crown, and enables the Crown to share in any upside as and when the health of the bank(s) concerned recovered.

34. In practice, the fact that our largest banks are wholly-owned subsidiaries of Australian banks, makes this tool considerably less tractable and certain if used at short notice, at least until the situation had got so bad that the New Zealand government was able to credible wield the "big stick" of placing an institution concerned into statutory management.

35. Were a crisis to be affecting New Zealand and Australia in much the same ways, some sort of co-ordinated recapitalization model would be likely to play an important part in responding to the crisis. We propose to continue to work with our Australian colleagues on issues related to those options.

36. At this time, a move to a full guarantee of liabilities is likely to remain the tool that could be deployed most quickly and cleanly, should there be a marked deterioration in the situation, in particular one that was disproportionately affecting New Zealand relative to Australia.

Key characteristics of a Crown deposit guarantee

37. This section outlines the key design features of a Crown deposit guarantee scheme that could be announced and implemented at short notice. Any such scheme inevitably involves costs, risk and distortions. We have attempted to minimise and take account of these in designing the parameters of the scheme but they are still significant and would need to be weighed against the expected benefits of such a scheme. Such a guarantee would also imply a material departure from the established New Zealand approach to financial supervision and regulation. Offering a guarantee would enduringly change expectations about government responses to financial stresses and institutional failures in the future.

The offer

38. A Crown guarantee of retail deposits in eligible institutions, up to a maximum specified amount, offered on an opt-in basis subject to a risk-based fee. 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.

Eligibility

39. There are choices around how wide to extend coverage. Officials consider that this choice is essentially:
    i) New Zealand registered banks only; or
    ii) New Zealand registered banks and non-bank deposit takers (NBDTs) as defined in the Reserve Bank Act.

40. On balance, officials consider that any offer should include New Zealand registered banks and non-bank deposit taking entities (NBDTs) as defined in the Reserve Bank Act. This would include building societies, credit unions and deposit-taking finance companies.

41. Given the small size of the NBDT sector it is not necessary to include them to maintain confidence in the soundness and effective functioning of the New Zealand financial system. We consider that it would be desirable to include NBDT institutions within the offer to ensure competitive neutrality within the deposit taking sector and to prevent a government initiative triggering a flight from NBDTs to banks.

42. However, including the NBDT sector would significantly increase the fiscal risks to the Crown and heighten the moral hazard implications associated with offering a guarantee. The likelihood of a guarantee being called upon by some NBDT institutions is much higher than for banks. Further, guaranteeing NBDTs could potentially result in the government supporting institutions which it would otherwise have let fail.

43. This higher risk reflects: the less diversified, higher risk investment strategies and weaker funding lines of some NBDTs; the current absence of a robust regulatory regime the prudential regulatory regime for NBDTs (under which trustees rather than the Reserve Bank will remain the front line supervisor) progressively come into force over 2009-2010; and in the event of failure the Reserve Bank does not have the comprehensive failure management powers it has for banks.

44. In addition, equalising the risk to investors of investing in NBDTs and banks will incentivise the shifting of some deposits from banks to the higher rate of return offered by NBDTs, thereby increasing the fiscal risk to the Crown if the guarantee is called upon.

45. We propose a risk based fees structure and a lower guarantee cap which should mitigate to some extent the risks associated with including NBDTs. In addition, the guarantee would only be offered to those institutions which are fully compliant with their trust deed at the date of announcement. Officials will continue to consider any further measures which could mitigate the fiscal risks associated with offering a guarantee to NBDTs, such as more comprehensive reporting requirements.

46. There is a further choice of whether to include only New Zealand incorporated banks, or whether to extend this to all New Zealand registered banks. This latter option would include the branches of overseas banks, for example, HSBC. Our judgement is that it may be necessary to do so to avoid the risk of creating depositor runs on these New Zealand branches. This raises the risk that the parent shifts deposits into the New Zealand branch in order to take advantage of the guarantee. However we will do further analysis of options for minimising the risks associated with doing so, such as limiting the guarantee for those branches to the deposits of New Zealand residents.

47. To avoid barriers to entry the guarantee would need to apply to both banks and NBDTs in operation at the date of announcement and banks and NBDTs established after that date. This does create some risks that the guarantee will be used other than for its intended purpose. Officials will do further analysis of options for managing these risks in relation to new, non-rated institutions.

48. The guarantee would be limited to deposit products offered by these institutions and would not include equity instruments, including holdings in collective investment schemes, such as KiwiSaver, or portfolio investment entities (PIEs) (including deposit PIEs offered by banks). Including investment products of this nature could create distortions in financial markets by protecting those who seek higher returns through risk taking, or the tax advantages of these structures. This is consistent with the proposed

approach to be taken by the Australian Financial Claims Scheme. This is likely to result in some movement from non-guaranteed products into government guaranteed deposits, however this movement is likely to be around the margins.

What would be covered by the guarantee

49. The issue of coverage is a key strategic choice for the government if it were to offer a guarantee.

50. Our recommendation would be to limit the scope of the guarantee primarily to traditional retail depositors in the first instance, including both individual and business accounts. This approach is consistent with the objective of depositor protection and helping to avoid a retail run on deposits.

51. The guarantee could subsequently be extended to include all liabilities if this was considered necessary to facilitate access to wholesale funding. There is some risk however, that incremental extensions of a government guarantee may be perceived as indicating uncertainty over the nature and extent of problem in the financial sector.

52. Attempting to drawing precise boundaries between retail and wholesale deposits would be difficult in practice and we consider this would expose the Crown to significant risk of legal challenge from those depositors considered to be wholesale in nature and therefore not covered by the guarantee. Consequently, officials consider that providing a guarantee to all deposits (with the exception of related party liabilities as discussed below) but placing a cap on the value of the deposits guaranteed per depositor per institution, is the most effective way of ensuring appropriate coverage of retail deposits, while substantially excluding wholesale deposits from coverage.

53. Setting the level of such a cap is inherently a matter of judgement. Internationally, the level of a cap differs between established deposit insurance schemes (In Europe the cap has just been raised to NZ$100,000 and in the United States to about NZ$400,000) and the more extensive government deposit guarantees announced for example by Iceland, Denmark and Ireland (which have not announced a cap on the amount covered).

54. Officials consider that a cap of $250,000 for banks and those NBDTs with ratings of BB or higher, and $50,000 for non-rated NBDTs is likely to be effective in providing confidence to retail investors, minimising exposure to wholesale depositors and thereby limiting the Crown's potential liability. A cap in this range would also provide a realistic basis for moving from a temporary government deposit guarantee to a deposit insurance regime over the longer term.

55. A guarantee should not include related party liabilities. In respect of trans-Tasman banks inclusion of related party liabilities would extend the New Zealand government's risk to include the guarantee to the Australian parent bank. Many NBDTs are characterised by highly complex related party lending arrangements, significantly increasing the difficulty in estimating the Crown's contingent liability.

56. Non-resident retail depositors are at least as vulnerable to a decline in confidence in New Zealand financial institutions and are likely to be more mobile. Consequently, to achieve the objective of reducing the risk of depositor flight, officials would recommend that a guarantee cover both resident and non-resident retail depositors. Officials will undertake further analysis to determine whether the banks hold sufficient information to enable them to accurately determine in a timely manner whether a depositor is resident or non-resident, should you decide to exclude non-resident depositors.

How would the guarantee be provided

Contractual

57. The guarantee will be offered through an opt-in scheme and would take the form of a bilateral contractual agreement between the Crown and the individual financial institution which elects to take up the guarantee. Offering the guarantee on an opt-in basis enables the Crown to charge a risk-based fee in return for the guarantee. Legislation would not be required for the Crown to enter into the agreements as the Minister of Finance has a general power to enter into guarantees under section 65ZD of the Public Finance Act 1989.

58. Each time an agreement was executed a statement that a guarantee had been given would need to be gazetted and presented to the House of Representatives.

Fixed term

59. The guarantee would be offered for a fixed term. Officials consider that a two year term would be appropriate in the first instance. This would provide the financial institution and depositors with certainty, and provides the Crown with the flexibility to assess developments in international financial markets after one year to determine whether it is considered necessary to provide a further guarantee offer in order to continue to maintain and enhance investor confidence. The temporary deposit guarantee could be replaced with a deposit insurance regime over the longer term.

Fees

60. We consider it appropriate to charge a fee and would propose charging by the riskiness of the institution concerned to reflect the significant value being provided to depositors and to limit the distortions that a guarantee scheme creates. Some of the guarantees issued abroad are being charged for but few details are available (indeed, in some cases these have not yet been finalised).

61. There are market prices for credit insurance – for example, credit default swaps are traded for each of the parents of the Australian banks but these are distorted by the current turmoil. As a starting point, we use pricing on credit default swaps for an Australian parent bank in the two to three years prior to the international credit crisis beginning last year. These numbers may understate an appropriate price, given that risk generally was widely perceived to have been underpriced in the middle years of this decade. Illustrative pricing below is based on a price of 7.5 basis points for AA rated entities.

62. As noted already, we do not think it is feasible to envisage restricting a deposit guarantee to banks. We would propose to differentiate pricing by credit rating, with any unrated institutions in the highest priced tier. The big 4 banks all have a credit rating in the AA band.

63. The rating agencies provide data on the historical probability of default for institutions in different ratings bands. Illustratively, a BB rated entity has defaulted on average 15 times as frequently as AA rated entities.

64. We would need to further develop details regarding the frequency with which the premium was charged (some would no doubt balk at an upfront two year payment, and in any case the base of guaranteed deposits could change materially over the course of the two years. Further work will be undertaken over the next few days on refining pricing models.

65. The illustrative cost of two years cover for $1000 million of deposits is as follows:

Rating	Price per $1000m, for two years of coverage $m
AA (7.5bps pa)	1.5
A (20bps pa)	4.0
BBB (40bps pa)	8.0
BB and unrated (100bps pa))	20.0

66. This implies a cost of about $40 million for a typical large bank and about $10 million for a mid-sized ($500 million balance sheet) unrated NBDT.

67. For lower rated entities the prices may look relatively high. However, they apply to institutions that are typically considerably riskier. Moreover, those institutions are typically already paying deposit rates well above those offered by the big banks. A government guarantee of deposits could be expected to be followed by a material reduction in the deposit rates offered for terms of less than two years (ie those covered by the guarantee).

68. Reserve Bank data suggest retail deposits held in the banks of around $130 billion. Retail deposits liabilities of other institutions would add around another $10.billion. On these numbers, and the possible pricing schedule outline above, the total premium for two years cover would exceed $200 million.

Conditions

69. Other than the payment of the fee, and the requirement that the institution be fully compliant with the terms of its trust deed, it is not anticipated that the provision of the guarantee would be subject to many conditions. If too many conditions were attached to the guarantee the Crown would end up having to micro-manage each institution to ensure compliance. The more complicated the guarantee, the less likely institutions will be prepared to take up the offer reducing the effectiveness of the measure as a quick and temporary form of assistance.

70. With respect to Registered Banks the monitoring and information requirements in the Reserve Bank Act 1989 are viewed as sufficient to ensure that the Crown is kept informed of what each Bank's financial position is.

71. The contract would also require NBDTs to be subject to the monitoring and information requirements in the RB Act as if they were Registered Banks.

72. In addition, the guarantee contract would require each institution subject to a guarantee to report periodically to the Crown setting out the number of persons or organisations subject to the guarantee and the amount of the Crown's contingent liability under the guarantee.

Logistics

73. The first step following decisions on the form of the scheme is the preparation of a clear and concise government statement which announces the availability of the scheme, describes its key elements and the process that will be followed to implement the guarantee. Interventions by other governments such as the Northern Rock guarantee have shown the importance of a clear and concise announcement to avoid ongoing uncertainty.

74. Once the elements of the guarantee such as the coverage, cap and fee have been decided the government statement can be prepared very quickly and held ready.

75. If the government were to decide that a trigger point had been reached and it was necessary to announce the scheme the next step is signing the bilateral agreements. As previously discussed the agreements will not be overly complex. Once the elements of the guarantee have been decided the agreements could be finalised within a day and held ready.

76. Details on ongoing monitoring of the guarantee still need to be determined, but we would envisage this being administered by the Treasury.

Fiscal costs

77. Any guarantees would be recorded as unquantified, contingent liabilities of the Crown.

78. Retail deposits held in the banks currently total around $130 billion and those of other institutions would add around another $10 billion. Hence the contingent guarantee might well involve a sum equal to three quarters of GDP. This is an order of magnitude larger than all existing Crown Contingent Liabilities.

79. Of course, this is the total potential exposure and the actual fiscal cost would be only the amount the Crown ended up paying out in the event of a failure. This could be a very large sum. A back of the envelope calculation based on US Savings and Loan crisis experience is that this cost could be of the order of 0.1% of GDP or about $1.6 billion (although this is not strictly comparable in view of our judgement of the sound quality of the assets of New Zealand's financial institutions).

80. It should be noted however, that this cost should be compared with the costs that might be faced by the Crown if a systemically important institution was to fail even if a deposit guarantee were not in place.

Communications

81. This paper has outlined the broad design of a deposit guarantee scheme but there are a number of details that still need to be resolved, including the details of coverage. We would advise against announcing such a scheme until these details have been determined. There are risks of increasing uncertainty in the market by talking publicly about such a scheme in advance. We anticipate that these issues could be resolved in the next week. International experience suggests that policy initiatives in response to financial crises are most likely to be effective and contribute to restoring confidence when they have broad bipartisan support.

Appendix One

The number of entities eligible for a guarantee would be approximately:

	Number	Retail deposits $bn
New Zealand – incorporated banks	7	132
New Zealand branches of overseas banks	11	2
Building Societies – Rated	2	1
Building Societies – Unrated	6	1
Credit Unions (All unrated)	40	0.6
Finance companies – Rated	5	4
Finance companies – Unrated	62	1.3

Appendix Two

AUSTRALIA

What is the current situation?

No deposit insurance scheme currently exists. However depositors do receive priority over other creditors in the event of liquidation of a bank, building society or credit union.

What is proposed?

The Federal Treasurer, the Hon Wayne Swan, announced on 2 June 2008 that the Australian government will introduce legislation to create a *Financial Claims Scheme* (FCS).

The key features are:

- The Financial Claims Scheme will provide rapid access to funds by depositors following the failure of a bank, building society or credit union up to a proposed cap of A$20,000. Those with deposits which exceed the cap will seek to recover the remainder of their funds from the liquidation of the institution.
- It will also provide compensation to those with valid claims on a failed general insurer.
- Coverage will be limited to individuals, small businesses and not-for-profits.
- The scheme will be administered by the Australian Prudential Regulation Authority (APRA) and will be funded by the Crown, with costs to be recovered through liquidation. If the liquidation does not provide for full recovery of the Crown's costs, a levy may be applied to relevant financial institutions.
- The FCS will not cover life insurance, superannuation or market linked investment products not covered by the regulator, APRA.
- The scheme has deliberately excluded investment products as it could create distortions in financial markets by protecting those who seek higher returns through risk taking.

What is the motivation for change?

Under the current depositor preference funds arrangements funds are distributed following liquidation of the financial institution. Consequently, it could take many months or longer before funds are available for distribution to depositors. Consequently, the primary objective of the financial claims scheme is to provide a mechanism for quicker access for depositors to at least some funds.

In addition, Australia is a member of the Financial Stability Forum. In its April 2008 report "*Report of the Financial Stability Forum on Enhancing Market and Institutional Resilience*" the Forum urges authorities around the world "to review, and if necessary strengthen deposit insurance arrangements". Further, the Treasurer referred to the recommendations of the HIH Royal Commission in 2003 following the collapse of a major general insurer.