

Treasury Report: Deposit Guarantee Scheme: Additional Issues

Date:	13 October 2008	Report No:	T2008/2008
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Action Sought

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Minister of Finance (Hon Dr Michael Cullen)	<p>Note the contents of this report regarding processes to implement the deposit guarantee scheme.</p> <p>Agree to offering coverage under the scheme to collective investment schemes that invest solely in the debt securities of the New Zealand government or institutions subject to a government guarantee, subject to conditions.</p> <p>Agree to the scheme covering senior debt only (as is the case with the Australian scheme).</p> <p>Sign the delegation to the Secretary to give authority for writing, managing and administering the Crown's Deposit Guarantee Scheme.</p>	8am, 14 October 2008 (overnight).

Contact for Telephone Discussion (if required)

Name	Position	Telephone	1st Contact
Peter Bushnell	Acting Secretary	04 9176176 (wk) <i>[deleted – privacy, OIA s9(2)(a)]</i>	✓
Joanna Gordon	Manager, Regulation and Market Performance	04 9176939 (wk) <i>[deleted – privacy, OIA s9(2)(a)]</i>	

None.

Enclosure: Yes

Treasury Report: Deposit Guarantee Scheme: Additional Issues

Executive Summary

This report covers the following issues associated with the deposit guarantee scheme announced on 12 October 2008.

- As discussed with you today two policy issues have arisen during the day as a result of questions about the scheme coming from institutions:
 - Coverage of collective investment schemes that invest solely in the debt securities of the New Zealand government or institutions subject to a government guarantee. This offer would be subject to a limitation that no collective investment scheme could increase its economic exposure to any non-bank guaranteed institution above the level prevailing as at 12 October 2008.
This issue was raised with you earlier today.
 - Clarification that the scheme covers senior debt only (as is the case with the Australian scheme announced on 12 October 2008). Subordinated debt is more like equity than debt and we expect that, while there are potentially going to be complaints about this clarification at the margins, informed investors will understand the nature of their investment is different from that the scheme is covering.
- Processes that will be undertaken to implement the scheme are outlined for your information.
- In order for us to manage and administer the guarantee scheme on your behalf, a delegation will be required to The Secretary to the Treasury. A letter of delegation is attached for your signature.
- We have made some clarifications to definitions of “deposit taker” and “financial institutions” which are included for your information. The clarifications are important although they do not involve any policy decisions.
- A draft “policy guidance” note will be developed further to assist in clarifying questions around coverage and policy intent. We will exercise our delegated discretion in line with the policy guidelines document. We will finalize the document to you and provide you with a copy.

Recommended Action

We recommend that you:

- a **note** the contents of this report regarding processes to implement the deposit guarantee scheme;

b **confirm your agreement** to:

- a. offer coverage under the scheme to collective investment schemes that invest solely in the debt securities of the New Zealand government or institutions subject to a government guarantee.
- b. make this offer subject to a limitation that no collective investment scheme could increase its economic exposure to any non-bank guaranteed institution above the level prevailing as at 12 October 2008.

Confirm/Not confirm.

c **confirm your agreement** to the scheme covering senior debt only (as is the case with the Australian scheme).

Confirm/Not confirm.

d **sign** the delegation to the Secretary to give authority for writing, managing and administering the Crown's Deposit Guarantee Scheme

Agree/disagree.

e **note** that the draft policy guidelines, for our internal use only, will be used to guide the exercise of any discretion under the delegation and will need to be finalized and with your office tomorrow.

f **refer** to this report to the Prime Minister.

Agree/disagree.

Peter Bushnell
Acting Secretary
The Treasury

Hon Dr Michael Cullen
Minister of Finance

Treasury Report: Deposit Guarantee Scheme: Additional Issues

Purpose of Report

1. This report covers a number of issues arising from the announcement and implementation of the New Zealand depositor guarantee scheme announced on 12 October 2008.

Policy issues

2. Two policy issues have arisen. The first, related to coverage of collective investment schemes is the most substantive and has been raised with you in discussion today. We are seeking confirmation of your decision as well as providing a little more background on this issue. The second policy issue is less substantive. However, it is likely to cause some comment as it draws a line between who is covered or not covered by the scheme at the margins. At any point where we draw the line for coverage, there will be people affected by such a decision.

Clarifying the coverage of Fixed Income Collective Investment Schemes

3. As originally approved yesterday, the scheme was intended to apply only to fixed income collective investment schemes (CISs, of which PIEs are a subclass, along with other superannuation schemes, managed funds, unit trusts) sponsored by guaranteed institutions and investing in the paper of those institutions.
4. As discussed with you earlier today, further reflection has lead us to conclude that this is not the appropriate line of demarcation. To avoid adversely impinging on deposit-like CISs sponsored by non guaranteed institutions such as funds managers, we are proposing that the guarantee offer be extended to all CISs, provided that they invest in either New Zealand government securities or debt securities issued by guaranteed institutions. Because we are concerned about the risk of funds flowing to government-guaranteed higher-risk non-banks (who are not subject to a full prudential supervisory regime) we are proposing that no guaranteed CIV will be able to extend its economic exposure to any guaranteed non-bank above the level applying yesterday. Were a CIV to extend its exposure beyond that level, the CIV concerned would no longer be eligible for the guarantee.
5. As with other guaranteed financial institutions, guaranteed fixed income CISs would not be guaranteed in respect of any claims held by financial institutions and/or related parties.
6. There are a number of fixed income CISs that hold moderate amounts of corporate or offshore paper. *[Information deleted under section 9(2)(b) to protect information where the making available of the information would be likely unreasonably to prejudice the commercial position of the person who supplied or who is the subject of the information]*
7. A separate guarantee contract will be developed for CISs. The contract will need to be with the actual collective investment vehicle, not its parent. That is we do not contract with "XYZ" (and cover that institution with the guarantee), we contract with XYZ's Unit Trust (or whatever the collective investment vehicle itself is).

8. We expect that the contingent liability associated with the extension of the guarantee should be about the same as before as, without this clarification and extension, we would have seen considerable switching of funds from the collective investment vehicles into guaranteed institutions.

Clarification that the Scheme Covers Senior Debt

9. The current definition of debt used in the draft contract is broad and could cover subordinated debt. This form of debt is more like equity and is not debt. On this basis, we are proposing to exclude subordinated debt (as is the case with the Australian scheme announced on 12 October 2008). This will be done by referring to debt in the documentation as senior debt.
10. Subordinated debt is more like equity than debt and we expect that, while there are potentially going to be complaints about this clarification at the margins, informed investors will understand the nature of their investment is different from that the scheme is covering.

Administrative Issues

Internal Processes for Managing the Guarantee Scheme

11. Attached, for your information, is a draft outline of the process we have outlined for handling the guarantee scheme. This draft will be finalized over the next couple of days. However, the initial phases of managing the guarantee are further developed and in effect operating (that is, applications that have come in are being processed).

Delegation of Authority: Policy Guidelines

12. A delegation will need to be made to the Secretary of The Treasury to manage and administer the scheme on your behalf. A letter of delegation is attached for you to sign.
13. In addition, we are preparing policy guidelines. These will cover areas where we will need to exercise discretion under the delegation. This draft is incomplete at this point and will be finalized tomorrow. However, we anticipate that the intervention goals that include 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. In addition, a key criteria would be whether the action is in the public interest. We also expect that we will be required to assess applicants eligibility for coverage. The draft process document attached indicates the processes that would be used to do this.

Definition Changes

14. Two important definitions in the contract have been revised – the definition of “deposit taker” and of “financial institutions”. Neither involve a change in policy but clarify the policy intent. We will have a second draft of the contract ready tomorrow with these and other changes (eg to reflect the policy decisions you confirm) included.

ANNEX 1

Processes for Implementing the Crown Deposit Guarantee Scheme

Draft processes for handling applications for the guarantee and for paying guarantees in the event of default are set out below. Areas where the RBNZ are involved are identified.

We anticipate up to 200 applications, most to be received this week. In terms of handling applications a prioritised approach is proposed with the largest institutions at the top of the list as delays could negatively affect the process:

- Registered banks 2-3 working days;
- Building societies/credit unions – 3-5 working days;
- Others 5-7 working days.

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 perspective;
- monitoring requirements to be placed on successful applicants; and
- monitoring and reporting requirements to be placed on the Treasury.

When paying out on the guarantee the key uncertainties are:

- time taken to satisfy requirements for payment to occur; and
- what actions the Crown takes to recoup the guarantee from the defaulting company

Process for Handling Applications

Application received by Treasury	Communications	Role of RBNZ
Establish Register of Applications		To be kept by RBNZ
Check details of applicant against register of companies and other relevant details		RBNZ to assist in confirming these details are complete and accurate
Check other information and seek further information where required		
Confirm eligibility – ie is within scope, assess aggregate indebtedness for fee		For institutions covered by the RBNZ Act, seek RBNZ agreement on eligibility. For institutions beyond the Act, RBNZ to be consulted.
TSY send invitation to enter scheme and Contract		RBNZ informed
TSY receive contract back and confirm authority of those signing Contract		
Treasury Secretary (or delegate) sign Contract and send to applicant (Execution Date and 14 days for payment of fee)	Publish info on RBNZ website	

Ongoing Monitoring

Monitoring by Treasury	Actions reported by Treasury	Role of RBNZ
TSY write to/receive from all approved applicants after 12 months to assess aggregate indebtedness and liability for fee.	Changes in eligibility reported on website. Line item in government account for fees received. Line item for liabilities covered by the scheme.	RBNZ to assist in verifying information.
Additional monitoring can be imposed under the contract eg quarterly reporting or copies of usual reports (eg to trustee companies to be provided to Treasury).	Changes in eligibility reported on website.	RBNZ to undertake monitoring for those under the Act (could extend beyond that) and advise Treasury of any issues etc.
TSY to provide regular monitoring reports to Minister of Finance.		Assist in preparation.

Process Claims under the Scheme

Claims received by Treasury	Actions reported by Treasury	Role of RBNZ
Notice of Assignment received by Treasury from Creditor.		RBNZ informed.
Check register for eligibility		
Confirm meets criteria (default event) for guarantee.		RBNZ to agree.
Assess sum for payment (could involve audit opinion).		
Recommendation to Secretary to make payment	Treasury to publish on website	
Payment made from Crown account.		Could have system liquidity impacts.

Resolution

Treasury and Reserve Bank to agree on processes for recovery of any claims.

DELEGATION BY THE MINISTER OF FINANCE – CROWN GUARANTEE OF RETAIL DEPOSITS

Date: 13 October 2008

From: Minister of Finance

To: Secretary to the Treasury

1. CROWN GUARANTEES

1.1 Delegation

Pursuant to section 28 of the State Sector Act 1988 and section 65ZD of the Public Finance Act 1989, I, the Honourable Dr Michael John Cullen, **MINISTER OF FINANCE**, delegate to the **SECRETARY TO THE TREASURY** (and any person acting in such role from time to time) the authority to give in writing guarantees as part of the management and administration of the Crown's Deposit Guarantee Scheme, such guarantees to be in such form as the Secretary to the Treasury may from time to time determine.

Pursuant to section 28 of the State Sector Act 1988 and section 65ZD(3) of the Public Finance Act 1989, I, the Honourable Dr Michael John Cullen, **MINISTER OF FINANCE**, also delegate to the **SECRETARY TO THE TREASURY** (and any person acting in such role from time to time) the authority to publish in the *Gazette* details of all guarantees given as part of the management and administration of the Crown's Deposit Guarantee Scheme.

This delegation shall come into effect on the date of its execution and shall continue in force until revoked.

1.2 Consent to sub-delegation

Pursuant to section 41 of the State Sector Act 1988, I, the Honourable Dr Michael John Cullen, **MINISTER OF FINANCE**, consent to the sub-delegation of all or any of the authority and powers delegated by me in this instrument.

1.3 Secretary to Provide details of Guarantees

The Secretary to the Treasury shall provide me with details of all guarantees entered into in accordance with this delegation.

SIGNED by the **MINISTER OF FINANCE**,
the Honourable Dr Michael John Cullen

Signature

In the presence of:

Signature of witness

Name of witness: _____

Occupation: _____

Address: _____