

Treasury Report: Retail Deposit Guarantee Scheme: Further Issues

Date:	14 October 2008	Report No:	T2008/2013
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Action Sought

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Minister of Finance (Hon Dr Michael Cullen)	<p>Agree to the policy changes that:</p> <ul style="list-style-type: none"> • tighten the requirements upon non-bank deposit takers • introduce a fee for non-rated finance companies • require all new entrants to the scheme to be rated BBB- or better • cover non-resident depositors in New Zealand branches of overseas banks as at 12 October 2008 • modify the senior debt requirement to ensure coverage of credit unions and building societies <p>Note the attached policy guidelines that will guide discretion exercised under the delegation to the Secretary</p> <p>Note that the cost of implementing and monitoring the scheme over the two year guarantee period is estimated to be \$2.1 million but excludes litigation costs arising from applications being declined.</p>	

Contact for Telephone Discussion (if required)

Name	Position	Telephone	1st Contact
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Enclosure: Yes

Treasury Report: Retail Deposit Guarantee Scheme: Further Issues

Executive Summary

As the retail deposit guarantee scheme is being implemented, a small number of policy issues are arising that require a decision from you so that action can then be taken to address these. We have identified policy decisions that need to be taken around:

- Tightening up contractual and fee requirements to address risks of depositor flows to riskier institutions (mainly, to finance companies). In the absence of either a cap or fees, the options are limited. We are, however, recommending a fee be charged to non-rated finance companies.
- Addressing new entrant requirements to deal with problems associated with phoenix (or zombie) companies by introducing a blanket requirement that any new entrants must be BBB- rated or better in order to be eligible to apply to join the scheme.
- Coverage of existing non-residents in New Zealand branches of overseas banks. We are proposing that those non-resident depositors in branches as at 12 October 2008 be grand-parented into guarantee coverage to reduce the likelihood that these depositors will leave branches for guarantee covered other institutions.
- Introducing special requirements in relation to the senior debt requirements of the scheme to address the special cases of building societies and credit unions (whose members do not hold senior debt).

The report covers other issues, for your information, that have arisen including issues around collective investment schemes, coverage of brokers and accessing details of the Australian scheme.

The report also contains a synopsis of the process issues being managed and attaches guidelines the exercise of any discretion under the delegation to the Secretary to the Treasury. It also includes the Treasury cost of implementing and monitoring the scheme.

Recommended Action

We recommend that you:

- **agree** to a contract being tailored for non-bank deposit takers containing tighter controls around the following areas:
 - potential for stripping out funds through, for example, dividends, or payments to related parties;
 - increased reporting requirements so that, in addition to obtaining information, the information obtained can be verified by a third party such as an auditor; and
 - enabling an assessment can be made as to whether reckless business behaviour is taking place that would then result in breach of the terms of the guarantee

Agree/disagree.

- **note** that other tightened requirements may be explored including the possibility of imposing minimum standards such as a capital ratio.
- **note** that these terms would be given effect through personal undertakings required from directors.
- **note** that, 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.
- **agree** that for **non-rated finance companies**, a fee of 300 basis points could be charged monthly on growth in the book.

Agree/disagree.

- **agree** that only new entrants (that is, entities seeking to come into the scheme that were not in existence or ineligible on 12 October 2008) are required to be BBB- rate or better will be eligible to apply for coverage under the scheme.

Agree/disagree.

- **agree** that, for non-resident depositors in existing New Zealand branches of overseas banks (that is, at 12 October 2008), that the guarantee is limited to the total amount of the non-resident deposit base as at 12 October 2008 and up to a further 10% per year of that deposit value (to cover for interest and any variation in deposit level).

Agree/disagree.

- **agree** that, as depositors in credit unions and building societies do not hold senior debt, the senior debt policy decision be modified to enable these depositors to be covered by the scheme as originally intended (through a variation to the contract or contracts specific to building societies and credit unions).

Agree/disagree.

- **note** the attached policy guidelines incorporate all your decisions, setting them out with the principles underpinning the exercise of any discretion under the delegation to The Secretary to the Treasury for the deposit guarantee scheme.
- **note** that the cost of implementing and monitoring the scheme over the two year guarantee period is estimated to be \$2.1 million but excludes litigation costs arising from applications being declined.
- **refer** a copy of this report to the Prime Minister.

Agree/disagree.

Peter Bushnell
Acting Secretary
The Treasury

Hon Dr Michael Cullen
Minister of Finance

Treasury Report: Retail Deposit Guarantee Scheme: Further Issues

Purpose of Report

1. This report seeks your agreement to policy changes to the retail deposit guarantee scheme that have arisen as we work through the details of its implementation. We have also attached, for your information, the finalized process for managing the scheme, the policy guidelines that will guide use of any discretion under the delegation granted to the Secretary to the Treasury.

Policy Issues

Finance companies: flows of depositors to riskier institutions

2. Issues have arisen regarding the potential for flight to riskier finance companies who obtain guarantee coverage under the scheme. This was an expected result where a fee or cap does not apply.
3. As finance companies are likely to offer potentially higher interest rates, coupled with a guarantee which is not subject to a fee (which would be expected to be passed on to depositors in the form of lower returns), then depositors may choose to take money from other institutions and deposit it with finance companies. There is strong anecdotal evidence that this is already happening.
4. In addition to the concerns about the competitive neutrality of this situation, if such transfers do take place, then the risk to the Crown is also extended (that is, there are more deposits in riskier companies).
5. In the absence of a cap on deposit levels and as fees are not intended to be charged for total covered liabilities under \$5 billion, options are limited.
6. To address the issues arising around finance companies, we propose the following actions be taken:

At this point:

- A contract be tailored for non-bank deposit takers containing tighter controls around the following areas:
 - the potential for stripping out funds through, for example, dividends, or payments to related parties;
 - increasing reporting requirements so that, in addition to obtaining information, the information obtained can be verified by a third party such as an auditor;
 - an assessment can be made as to whether reckless business behaviour is taking place that would then result in breach of the terms of the guarantee.

We may also explore the possibility of other controls, such as imposing minimum standards such as a capital ratio – the ratio would need to be at a level consistent with acceptable minimum standards so that it could not be used capriciously by the Crown or the reserve Bank.

These controls would be given effect through personal undertakings being required from directors. If the terms of the guarantee are breached, the Crown

could give notice of termination (probably one month's notice) such that future liabilities incurred would not be covered.

Medium term:

- Regulations for non-bank deposit takers under the recently-enacted Reserve Bank Amendment Act can be expedited for liquidity arrangements, capital requirements and related parties provisions. This option would take about three months to implement and can occur irrespective of the decision taken today.

If there is still an option to review the decision not to charge a fee:

- For ***non-rated finance companies***, a fee of 300 basis points could be charged monthly on growth in the book. This would significantly change the dynamics for the industry without changing the stated policy of no fees – at least in respect of existing deposits.

We strongly recommend that such a fee be charged.

Phoenix (or Zombie) companies

7. The concerns in this area have been raised mainly in relation to finance companies who have failed, are currently in receivership or in moratorium who are not eligible for coverage under the scheme, but may reform (or recover) and become eligible.
8. While this issue may be manifest most prominently in the finance company sector, it is a more general issue for new entrants to the guarantee arrangement.
9. We propose that this be managed by a refinement to provisions covering all new entrants (that is, entities seeking to come into the scheme that were not in existence or ineligible on 12 October 2008) so that only new entrants that are BBB- rate (investment grade) or better will be eligible to apply for coverage under the scheme.

Non resident depositors in existing branches of overseas banks

10. There are about seven branches of overseas banks operating in New Zealand. The scheme currently excludes non-residents of these branches from coverage under the scheme. This was to limit the extent to which the Crown would be exposed to covering non-residents in the non-bank deposit taking area and in branches.
11. The implication for the branches of these overseas banks (some of whom have a substantial non-resident depositor base) may be more serious than initially believed. Depositors will very likely move to guaranteed institutions.
12. To address this problem but to prevent uncontrolled growth and movement of offshore deposits to New Zealand, we propose that, for non-resident depositors in existing New Zealand branches of overseas banks (that is, at 12 October 2008), that the guarantee is limited to the total amount of the non-resident deposit base as at 12 October 2008 and up to a further 10% per year of that deposit value (to cover for interest and any variation in deposit level).

Senior debt: coverage of building societies and credit unions

13. We understand that depositors in credit unions and building societies do not hold senior debt. We will need to modify the senior debt policy decision to enable these depositors to be covered by the scheme as originally intended. This will require a variation to the contract or contracts specific to building societies and credit unions.

Other issues that have arisen

Collective Investment Schemes

14. You agreed recently to include, with certain conditions, collective investment schemes (CIS) that invest solely in government debt or institutions subject to a government guarantee. Fund managers have noted that this excludes a large part of their CIS that they - and, they contend, the general public - perceive as being equivalent in nature to a fixed interest deposit. For example, there are some CIS that invest in government stock and high quality corporate Commercial Paper. In our view, we should resist moving the boundary to include these as such a move would go well beyond the intent of the scheme to cover deposits at financial institutions, but you should note the arguments of the fund managers.
15. NZX have raised the fact that brokers - as financial institutions - will not have their deposits, or their client accounts guaranteed under the scheme. They suggest that brokers' clients are moving funds to finance companies. Their concern is that this may put the brokers' business at risk and, separately, that the guarantee may make the stock market a less attractive place to invest. Again, we are asking you simply to note this issue, which we can work through and report back to you if it looks to be material.

Australia

16. The design details of the Australian scheme are still unclear. We are attempting to ensure that we are made aware as soon as the details have been finalised. We will then look to see what opportunities may exist for Trans Tasman arbitrage so that we can seek to close any loopholes.

Process and administration issues

Ongoing refinement of definitions and provisions

17. Where any policy issues arise, we are bringing these to your attention. There are a number of definitions and issue clarifications that are taking place as we work through the implementation process. Where these are significant, we will advise you.
18. Currently, we are refining definitions that are not substantive including those of related parties, financial institutions, and debt securities.
19. We are working on a separate contract for collective investment schemes, given the institutions being contracted with differ from those that are more generally covered by the guarantee.

Process for managing applications and monitoring contracts

20. In the report to you yesterday (T2008/2008), Treasury provided a draft of the process that the Treasury and Reserve Bank will be operating to. This is being finalized and implemented.
21. Treasury has set up a register of applications and are in the process of setting up physical facilities and administrative arrangements for undertaking the checking process. Priority will be given to processing the applications of large institutions

(registered banks, large non-bank deposit takers) while still seeking to turn over all applications in a matter of days wherever possible. Once contracts are signed, the approved institutions will be listed simultaneously on the Treasury and Reserve Bank websites.

Policy Guidelines

22. The attached policy guidelines incorporate all your decisions, setting them out with the principles underpinning the exercise of any discretion under the delegation to The Secretary to the Treasury for the deposit guarantee scheme. All decisions on applications for guarantees will be checked against these guidelines.

Fiscal Implications

23. Our initial assessment of the cost of implementing and monitoring the scheme are \$1.2 million in the first year and \$900,000 in the second year. This budget includes legal advice, monitoring and support services. These costs are initial assessments and we will refine them as further information becomes available. You should also note that this costing does not allow for any legal costs that may arise if applications are declined (e.g. judicial reviews).

POLICY GUIDELINES

These guidelines cover the exercise of discretion under the delegated authority granted to the Secretary to the Treasury by the Minister of Finance regarding the management and administration of the Crown's Deposit Guarantee Scheme.

Discretion

The decision to enter into a Crown Guarantee with any specific entity is at the sole discretion of the Crown.

Overarching Principle

The grant of a Crown Guarantee to an Entity must be "necessary or expedient in the public interest."

The key "public interest" factor when considering the provision of a Crown Guarantee is the maintenance of public confidence in New Zealand's financial system.

There appears to be no "public interest" in providing the Crown Guarantee to entities that fail to meet reasonable standards of business practice.

Entities Eligible to Apply for the Crown Guarantee

The Entities eligible to apply for the Crown Guarantee are:

- a Banks registered under the Reserve Bank of New Zealand Act 1989;
- b Building Societies as defined in the Building Societies Act 1965;
- c Credit Unions as defined in the Friendly Societies and Credit Unions Act 1982;
- d Other bank like entities (such as finance companies), existing on 12 October 2008, which issue Debt Securities [*to the public*].
- e Other bank like entities (such as finance companies), established after 12 October 2008, which issue Debt Securities [*to the public*] and have a BBB- rating or higher.
- f Qualifying Collective Investment Schemes.

Debt Securities mean any interest in or right to be paid money that is, or is to be, deposited with, or lent to any person (whether or not the interest or right is secured by a charge over any property); and includes—

- a Debenture, debenture stock, bond, note, certificate of deposit, and convertible note; and
- b An interest or right that is declared by regulations to be a debt security for the purposes of the Securities Act 1978; and
- c A renewal or variation of the terms or conditions of any such interest or right or of a security referred to in paragraph (a) or paragraph (b) of this definition;—

but does not include—

- d An interest in a contributory mortgage where the interest is offered by a contributory mortgage broker; or
- e Any such interest or right or a security referred to in paragraph (a) or paragraph (c) of this definition that is declared by regulations not to be a debt security for the purposes of the Securities Act 1978:

A Qualifying Collective Investment Scheme means:

- a an arrangement or scheme to which a participatory security (within the meaning of section 2(1) of the Securities Act 1978) relates;
- b a superannuation scheme (within the meaning of section 2A(1) of the Superannuation Schemes Act 1989); or
- c a unit trust (within the meaning of section 2(1) of the Unit Trusts Act 1960) that invests exclusively in:
- d NZ government securities; or
- e debt securities issued by an New Zealand registered bank that is covered by the Crown Deposit Guarantee Scheme.

Relevant Criteria

Entities applying for the Crown Guarantee should meet all of the following criteria:

- a issue Debt Securities or be a Qualifying Collective Investment Scheme;
- b be in the business of borrowing and lending, or providing financial services, or both;
- c carry out a substantial portion of their business in New Zealand; and
- d do not primarily provide financial services or lend to related parties and/or group members.

Other Factors to be considered in exercising discretion to offer, or refuse to offer, the Crown Guarantee

- a The size of the Entity;
- b The credit worthiness of the Entity, including any rating agency reports on the Entity;
- c The number of depositors in the Entity;
- d The related party exposure of the Entity;
- e The quality of the information provided by the Entity;
- f Whether the accounts of the Entity are audited;
- g That the business practices of the Entity meet reasonable standards;
- h That the individuals with control of the Entity are of good character;
- i That the individuals with control of the Entity have the business experience and acumen relevant to the operation of the Entity;
- j Whether, and the extent to which, the Entity's overall business is bank-like in nature;
- k The length of time the entity has been in business;
- l The track record of the entity with respect to such matters as whether it has met its payments as they fell due and maintained solvency;
- m Any other factors relevant to the maintenance of public confidence in New Zealand's financial system; and
- n The importance of the entity to the New Zealand financial system.