THE TREASURY
Kaitohutohu Kaupapa Rawa

Treasury Report: Deposit Guarantee Scheme: Fiscal Implications and Accounting Treatment

Date:	15 October 2008	**Report No:**	T2008/2017

Action Sought

	Action Sought	Deadline
Minister of Finance (Hon Dr Michael Cullen)	**Note** the contents of this report	None

Contact for Telephone Discussion (if required)

Name	Position	Telephone		1st Contact
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Minister of Finance's Office Actions (if required)

None.

Enclosure: No

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Treasury Report: Deposit Guarantee Scheme: Fiscal Implications and Accounting Treatment

Executive Summary

This report provides more detail on the potential fiscal implications of the retail deposit guarantee scheme announced on Sunday. It also provides information on the expected accounting treatment and legislative basis for the scheme.

The potential fiscal implications comprise:

- **Direct costs of paying money out under the guarantees:** the total Crown exposure is estimated at around $180 billion. Our view is, of course, that the probability of the guarantees being called on is remote for the vast majority of funds covered. Based on information about the current deposit base, historical default frequency and a very subjective estimate of losses given a default, the following table gives a very rough sense of potential costs to the Crown from the guarantees across a range of institutions:

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

* Historical S&P default frequency based on credit ratings
** Banks: best 20%, mid 40%, worst 60%. Finance companies: best 40%, mid 60%, worst 80%.

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

- **Fees from the scheme:** these are estimated to be $119 million per annum; $238 million over the two year life of the scheme; and

- **Impact on servicing government debt:** issue yields around the world have increased by around 50 basis points following events in the last week. The bulk of this increase likely relates to investor sentiment about the improved prospects for world economies and the likelihood of the success of measures to stabilise the financial situation. Some of the increase for New Zealand issue yields may relate to the introduction of the deposit guarantee scheme. It is impossible to quantify how much of the increase in yields is attributable to these different factors. If the 50 basis points increase were to endure across the forecast period, this would add $53 million in debt servicing costs in 2009/10, and $478 million in total over the forecast period.

There will also be some reasonably minor costs for the Treasury and the Reserve Bank in terms of administering the scheme.

As mentioned previously, any fiscal implications should be considered against the costs that might have been faced by the Crown if a systemically important institution was to fail and a deposit guarantee was not in place.

Recommended Action

We recommend that you **note** the contents of this report.

Dr Peter Bushnell
Acting Secretary to the Treasury

Hon Dr Michael Cullen
Minister of Finance

Treasury Report: Deposit Guarantee Scheme: Fiscal Implications and Accounting Treatment

Purpose of Report

1. In Friday's report T2008/2000, *Responding to the Prospect of a Worsening Financial Crisis in New Zealand*, we advised you at a high level of potential fiscal implications of a deposit guarantee scheme. This report provides further detail and describes the expected accounting treatment and legislative basis for the guarantees.

Potential Fiscal Implications

2. There are broadly three areas of potential fiscal implications from the retail deposit guarantee scheme: the direct costs of paying money out under the guarantees; the fees from the scheme; and the impact on servicing government debt of higher issue yields. In addition, there is also the direct cost to the Treasury and the Reserve Bank of administering the scheme, which is trivial compared with the other potential implications.

3. Of course, any fiscal implications should be considered against the costs that might have been faced by the Crown if a systemically important institution was to fail and a deposit guarantee was not in place.

Guarantees

4. The estimated Crown exposure from the retail deposit guarantee scheme is around $180 billion. Our view is, of course, that the probability of the guarantees being called on is remote for the vast majority of funds covered.

5. The Reserve Bank has undertaken some analysis based on information about the current deposit base across a range of institutions; historical S&P default frequency based on credit ratings; and a subjective estimate of losses given a default (i.e. if an institution fails, what portion of the deposits would the guarantee be needed for). These factors can be put together, as they are in the table below, to give a very rough sense of the potential fiscal costs to the Crown from the scheme.

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

* Historical S&P default frequency based on credit ratings
** Banks: best 20%, mid 40%, worst 60%. Finance companies: best 40%, mid 60%, worst 80%.

6. In addition to the $166 billion of liabilities in the table above,

- The Crown guarantees would cover collective investment schemes that invest totally in New Zealand government securities or guaranteed institutions papers (i.e. including PIEs). We cannot quantify these at the moment, but they could add another $10-20 billion; and

- Some non-resident liabilities in bank branches, mainly HSBC, would be covered, which could add around another $1 billion.

7. The vast bulk of the potential costs would come from the lower-rated, higher risk entities, driven by the much higher historical default frequency from this class of investments.

8. Given the large degree of uncertainty at the moment, it should not be surprising that there are a number of caveats around this information, including:

- Default frequency information is based on historical trends; it is not clear whether these will be applicable in the current situation, or whether there would be a higher frequency. Current credit default swap spreads would suggest rates around ten times higher than this; although Treasury and the Reserve Bank consider these to be highly pessimistic;

- The information is based on retail liabilities at the end of August. It incorporates neither changes since then, nor potential behavioural changes in response to the announcement of the scheme, such as the risk of flight to lower-rated, higher risk entities;

- The percentage estimates of losses given a default are very subjective.

9. It is worth noting that under section 65ZF of the Public Finance Act 1989, any money paid by the Crown under one of the guarantees would constitute a debt to the Crown, which could be pursued through legal action, in addition to the exercise of any rights under the guarantee documentation.

Fees

10. Under the scheme, a fee of ten basis points per annum will be charged on total deposits above $5 billion. In addition, a fee of 300 basis points will be charged for growth in the covered liabilities of unrated finance companies.

11. At present, only five of the institutions eligible for a guarantee have total retail deposits of over $5 billion. The estimated fees that these institutions would pay under the scheme are set out below, based on liabilities reported at the end of August:

[Information deleted under section 9(2)(b(ii) 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; and 9(2)(ba) protect information which is subject to an obligation of confidence, or which any person has been or could be compelled to provide under the authority of any enactment, where the making available of the information would be likely to prejudice the supply of similar information or information from the same source and it is in the public interest that such information should continue to be supplied.]

12. At this point we cannot quantify the potential fees that will accrue from the 300 basis points charge for growth in the covered liabilities of unrated finance companies.

13. Fees under the scheme are to be paid in two instalments: the first within 14 days of the execution of the guarantee, and the second a year later.

Debt servicing

14. Issue yields around the world have increased by around 50 basis points following events in the last week. The bulk of this increase likely relates to investor sentiment about the improved prospects for world economies and the likelihood of the success of measures to stabilise the financial situation. Some of the increase for New Zealand issue yields may relate to the introduction of the deposit guarantee scheme. It is impossible to quantify how much of the increase in yields is attributable to these different factors.

15. This increase in yields will increase the costs of servicing government debt. While there is no impact in terms of the debt already issued, it will increase the costs of the future issuance path.

16. We have modelled the extra debt servicing costs from a 50 basis points increase in issue yields on the future bond and Treasury bill issuance path compared with the forecasts in the *Pre-election Economic and Fiscal Update*, as set out below:

	2008/09	**2009/10**	**2010/11**	**2011/12**	**2012/13**
Estimated increase in accrual debt servicing costs ($m)	22	53	88	134	181

17. These costs are based on an assumption of a 50 basis points increase in yields across the forecast period. It is unclear at this stage whether the increase would endure throughout the forecast period or whether it would reduce or disappear over time.

Accounting Treatment

Initial recognition and measurement

18. The proposed guarantees represent a financial guarantee contract as defined by NZ IAS 39.

    "A financial guarantee contract is a contract that requires the issuer to make specified payments to reimburse the holder for a loss it incurs because a specified debtor fails to make payment when due in accordance with the original or modified terms of a debt instrument" (NZ IAS 39.9).

19. Financial guarantee contracts can have various forms, including certain letters of credit, credit default contracts and insurance contracts. However, the legal form of such contracts does not affect their accounting treatment (NZ IAS 39.AG4).

20. If insurance accounting is not applied (and this is not recommended as the application of actuarially-based assumptions would not be expected to add value to the reporting) then the issuer of the contract must measure it initially at fair value. As the financial guarantee contract is being issued in a stand-alone arm's length transaction to an unrelated party, and there is no evidence to the contrary, its fair value at inception is the premium received.

21. Note that if there is no upfront payment then the fair value of a financial guarantee contract between unrelated parties is likely to be zero under NZ IFRS.

22. In the case of a contract where the premiums are paid in two tranches, one at inception and the second halfway through the two-year contract, in our view, to account for it as a single guarantee rather than two separate contracts, the contract should be measured at the total amount, and a debtor raised for the amount due in one year's time.

23. The above represents the accounting for the contract itself. The contract also creates a contingent liability for the Crown which does not affect the Operating Statement or Balance Sheet, but which requires disclosure in the notes. Disclosure requirements are discussed below.

Subsequent reporting and measurement

24. Subsequently, the financial guarantee contract (or unearned premium) shall be measured at the higher of:

- the best estimate of the expenditure required to settle the guarantee, or

- the amount recognised initially less, when appropriate, accumulated amortisation as the premium revenue is earned over the life of the contract (NZ IAS 39.AG4).

25. Therefore, as long as the likelihood of the guarantee being called is remote, and therefore the best estimate of any expenditure required by the Crown is effectively zero, the guarantee will be initially recognised as a liability at the amount of the premium received, this premium being transferred to revenue (and the liability reduced) over the life of the contract.

26. If however a payment under the guarantee becomes likely or crystallises, then an estimate will be required of the likely expenditure, and an expense and a provision should be recognised.

27. Any corresponding asset (i.e. debt due under section 65ZF of the Public Finance Act 1989) shall only be recognised if reimbursement of the expenditure is virtually certain. The liability and the asset shall not be offset, although the related expense and revenue items may be (NZ IAS 37. 53).

Disclosures

28. The financial statements must disclose information to enable users to evaluate the nature and extent of risks that the Crown is exposed to from such guarantees. (NZ IFRS 7.31) To that end, the Crown will be required to disclose the exposure to risk, how this contingent liability arises, its objectives, policies and processes for managing the risk, the method used to measure the risk, and any changes in the above from the previous period (NZ IFRS 7.33).

Authority to Undertake Transactions

29. Deposit guarantees will be made under section 65ZD of the Public Finance Act 1989.

30. Because the guarantees are contingent liabilities of the Crown and the exposure under a guarantee will exceed $10 million, the guarantee must be gazetted and presented to Parliament.

31. As noted above, 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.

32. As mentioned earlier, any money paid by the Crown under a guarantee constitutes a debt to the Crown. The Minister of Finance may write this debt down, but it may not be written down below its market value unless there is a separate appropriation or other authority for this.