Treasury Report: Possible Wholesale Funding Guarantee Facility: Issues & Options

Date:	17 October 2008	Report No:	T2008/2036

Action Sought

	Action Sought	Deadline
Minister of Finance (Hon Dr Michael Cullen)	**Note** and discuss with officials	

Contact for Telephone Discussion (if required)

Name	Position	Telephone		1st Contact
John Whitehead	Secretary, The Treasury	917 6040 (wk)	*[deleted – privacy, OIA s9(2)(a)]*	✓
Alan Bollard	Governor, Reserve Bank	471 3673 (wk)	*[deleted – privacy, OIA s9(2)(a)]*	

Minister of Finance's Office Actions (if required)

None.

Enclosure: No

17 October 2008

Treasury Report: Possible Wholesale Funding Guarantee Facility: Issues & Options

Executive Summary

In the last couple of weeks most developed countries, including Australia, have announced guarantee facilities covering wholesale bank funding and/or interbank lending. These facilities have been part of overall policy response designed to tackle the pervasive loss of confidence and trust in wholesale debt markets. That loss of confidence has meant that key funding markets used by New Zealand and Australia have been largely closed to all borrowers for the last couple of weeks.

The temporary closure of those markets does not pose any immediate domestic liquidity pressures. The Reserve Bank's enhanced liquidity facilities can readily meet the settlement cash needs of local banks for some time to come. However, bank foreign funding is also the prime means by which the current account deficit is financed. Taken together with the risk of further jeopardizing investor confidence in New Zealand if banks are perceived to become increasingly dependent on central bank liquidity support, this suggests it would be desirable to regain access to usual foreign funding sources as expeditiously as conditions permit.

Once it is operational the Australian wholesale guarantee scheme will have some benefits for New Zealand. New Zealand **branches** of Australian banks will benefit directly, and New Zealand **subsidiaries** may be able to borrow from their parents, at least up to the maximum levels allowed in Australian prudential regulatory standards. Some banks are closer to those limits than others, although in aggregate there is substantial headroom.

However, there will also be disadvantages for New Zealand. As a matter of policy, we have encouraged New Zealand banks to fund themselves directly from international markets rather than through their parents. Without a guarantee, New Zealand issuers themselves will have a harder time re-establishing a presence in the international markets even when general market conditions begin to improve. There is also some risk of New Zealand domestic wholesale funds being shifted to Australia to take advantage of their wholesale guarantee facility.

Our proposed response has a number of elements.

[Information deleted under section 6(a) "the making available of the information would be likely to prejudice the security or defence of New Zealand or the international relations of the Government of New Zealand"]

Accordingly, we plan to continue intensive and detailed planning for a possible wholesale facility of our own, along the general lines outlined here.

In designing a wholesale guarantee scheme, the most important parameter is price. The aim of the facility would be to assist financial institutions to re-enter markets on sufficient scale to re-establish their usual diverse range of funding channels. The fee cannot be set too high or the banks might simply choose to hold off re-entering markets. On the other hand, it needs to be set high enough to encourage borrowers to graduate from reliance on a government guarantee once market conditions permit. It also needs to be high enough so that when markets begin to re-open, this scheme would not disadvantage unduly any local corporate issuers looking to raise funds in international markets. A fee of perhaps 130 basis points per annum, for a bank with an AA credit rating (all our main banks), appears to us to be in the right ballpark.

Other key design features would include:

- The guarantee would apply only to new issuance, on paper of terms maturing up to three years from the announcement of the scheme,
- It would be an opt-in scheme,
- Only investment grade banks and deposit-takers would be eligible,
- A higher fee would be charged for any entities with a credit rating below AA.
- The fee structure would be reviewed regularly. Over time the fee could be adjusted for new issues, in light of market conditions, as part of exit strategy.
- The guarantee would no longer be offered on new issuance once market conditions had returned to something approaching normal.

The contingent fiscal risk associated with offering a wholesale guarantee facility would be significant. On a purely statistical basis, a fee structure along the lines outlined in this paper would more than cover the expected loss. However, in practice, with only four main banks the most likely outcome is to have either no claims at all, or a claim for billions of dollars.

We have concerns that a significant portion of bank wholesale funding could eventually find its way into the coverage of the (relatively cheap) deposit guarantee scheme. This risk will, in part, be addressed in a paper on the deposit guarantee scheme that will come to you early next week. In addition, if a wholesale facility was to be introduced we would envisage making any paper that was eligible for cover under the wholesale scheme explicitly not covered by the deposit guarantee scheme.

There are some types of domestic financial institutions' deposits (especially those of brokers' trust accounts and some mutual funds) that may not be covered by the deposit guarantee scheme. A wholesale guarantee scheme, if implemented, would allow most remaining concerns in this area to be addressed directly (most of the relevant funds could be held in guaranteed wholesale instruments).

Recommended Action

We recommend that you:

- **Note** that offshore wholesale funding markets remain largely closed, including to New Zealand banks.

  Noted

- **Note** that Reserve Bank liquidity facilities can handle any domestic liquidity pressures that might arise as a result over the next few months.

  Noted

- **Note** our view that it would highly desirable, nonetheless, to re-establish regular access to foreign funding markets as soon as reasonably possible.

  Noted

- **Note** that the Australian wholesale guarantee facility will, when implemented, have some advantages for New Zealand banks but will also pose some difficult challenges going forward.

  Noted

- *[Information deleted under section 6(a) “the making available of the information would be likely to prejudice the security or defence of New Zealand or the international relations of the Government of New Zealand”]*

  Agree/Disagree

- *[Information deleted under section 6(a) “the making available of the information would be likely to prejudice the security or defence of New Zealand or the international relations of the Government of New Zealand”]*

  Noted

- *[Information deleted under section 6(a) “the making available of the information would be likely to prejudice the security or defence of New Zealand or the international relations of the Government of New Zealand”]*

  Agree/Disagree

- **Agree** that officials should continue with detailed design work on a possible New Zealand wholesale guarantee scheme, which would have the following key features:

  - A fee sufficiently high to encourage issuers to graduate from dependence on a government guarantee as soon as market conditions permit;
  - Applying only to new issuance;
  - Applying to paper with maturity dates no more than three years from the announcement of the scheme;
  - An opt-in scheme;
  - Banks and deposit-takers with investment grade credit ratings would be eligible to have the paper they were issuing guaranteed;
  - The fee would be reviewed regularly and could be adjusted for new issues, including as part of an exit strategy;
  - The guarantee offer would be withdrawn once market conditions had returned to something like normal; and
  - Paper eligible for the wholesale guarantee would be made explicitly ineligible for cover under the current deposit guarantee scheme.

  Agree/Disagree

- **Note** that such a wholesale guarantee scheme, if implemented, would allow some of the major outstanding coverage issues (e.g. bank deposits of mutual funds and brokers' trust accounts) to be dealt with, as these funds could largely be invested in guaranteed wholesale instrument. There remains the possibility of further distortions or gaps in coverage becoming apparent over coming months.

  Noted

- **Note** that although the fees outlined this paper would more than cover the statistically expected loss, the concentration of exposures means that in the event of any failure of a bank the actual exposure would be likely to run to billions of dollars.

  Noted

John Whitehead
Secretary to the Treasury

Alan Bollard
Governor
Reserve Bank of New Zealand

Hon Dr Michael Cullen
Minister of Finance

Treasury Report: Possible Wholesale Funding Guarantee Facility: Issues & Options

Introduction

This joint Treasury and Reserve Bank paper reports on a number of issues and options associated with the possibility of offering a wholesale funding guarantee facility in New Zealand.

The report focuses on the way in which New Zealand should respond to the continued closure of international funding markets, and to the announcement by Australia of a wholesale funding guarantee facility. *[Information deleted under section 6(a) "the making available of the information would be likely to prejudice the security or defence of New Zealand or the international relations of the Government of New Zealand"]*
The remainder of the paper focuses on outlining the features of a possible New Zealand wholesale funding guarantee facility.

The current international situation

In the last couple of weeks, facilities which would make government guarantees available for bank wholesale funding and/or interbank lending have been announced by an increasing number of countries. Most developed countries have now announced such facilities (including the United States, the United Kingdom, Australia and most of the euro-area countries)[1].

These facilities, sometimes in conjunction with measures to recapitalise weakened banking systems, have been designed to tackle the pervasive loss of confidence and trust that has increasingly gripped wholesale debt markets over the last few months. As our report last week on a possible deposit guarantee scheme noted, this crisis is, at heart, primarily one about wholesale markets and the ability to raise funds.

Few, if any, of the wholesale guarantee facilities are yet operational. In many, or most, cases (including Australia's) authorities are still finalizing the details of the schemes. No doubt these details will be finalized shortly, but at present any beneficial effects on market-functioning of the wholesale guarantee facilities are more in the nature of "announcement" or "expectational effects". In any case, many experts expect that credit markets will improve only relatively slowly following the intense scares and disruptions of recent months. This prospect is made more likely by the apparent continuing economic deterioration in many countries as the accumulated imbalances are worked out of the system and as the real economic effects of the financial crisis itself come to be more fully apparent. For the time being, international funding and debt markets remain largely closed to most borrowers, at least for terms much longer than overnight.

The current domestic situation

The closure of those international markets also means that New Zealand and Australian banks are, at present, unable to tap most of the commercial paper and other international funding markets that they normally use to fund up to a third of their total balance sheets[2].

This closure raises no immediately pressing banking liquidity issues. The Reserve Bank's extended facilities to provide settlement cash to banks against approved collateral mean that there should be no system-wide settlement cash issues this year, even if the foreign funding

[1] Most of the countries offering wholesale facilities to date have been host countries of parent banks.
[2] The annex sets out the funding structure for the New Zealand banking system as at 31 August 2008.

markets remain closed. More generally, there is no technical constraint on the Reserve Bank's ability to lend as many New Zealand dollars as it wanted to, provided that it was at some point willing to lend unsecured.

Banking liquidity is, however, not the only relevant consideration. In New Zealand, bank foreign borrowing not only funds the balance sheets of the banks, but has also been the principal form in which the current account deficit has been financed. Of our accumulated indebtedness, most takes the form of bank borrowing. The situation is similar in Australia. Because of the relatively short-term nature of most of the bank wholesale funding (around $40 billion maturing in the next three months), if the flow of international capital is not restored in some form[3], or not restored fully, then at some point the New Zealand exchange rate could come under significant renewed downward pressure. Markets appear to be beginning to focus to a greater extent on banking systems and countries with large external wholesale funding requirements (including, most recently, intensifying pressure in South Korea).

The longer local banks are dependent on Reserve Bank liquidity support, the greater the risk that investors could take an increasingly negative view of all classes of New Zealand risk. Moreover, banks are likely to be increasingly reluctant to find themselves in a position of becoming more dependent on direct Reserve bank financing, unable to access conventional financing structures and sources. That would be likely to affect their attitudes to extending or maintaining credit lines to the domestic economy. In other words, there are important macroeconomic and market confidence considerations involved in the whole issue of regaining access to wholesale financing markets.

Our actions will not, of course, have any influence on when international markets as a whole begin to re-open more generally. However, in shaping our response to the current situation, it should be a priority to see our banks able to regain their ability to raise material volumes of funds in the international wholesale markets as quickly as possible as the markets themselves begin to re-open.

Principles guiding responses to the crisis

Since the crisis began last year, a key dimension of most countries' responses, including New Zealand's, has been to make available domestic liquidity on whatever scale has been required, and to liberalise as required the classes of security acceptable for central bank liquidity operations. Banks, here and abroad, generally do not hold large pools of liquid assets - certainly not large enough to cope with shocks of the magnitude experienced in the last year or so. Accordingly, central banks have been willing to lend against assets that would not normally be liquid at all, and certainly not useable at central bank liquidity facilities. In New Zealand, the Reserve Bank is now willing to lend against the security of bank bills (usually tradable, but not previously acceptable security at the Reserve Bank) and residential mortgage backed securities (included unrated ones), mostly created specifically for this purpose.

In responding to the crisis, authorities have sought to balance two principles that, in the midst of the crisis, are almost inevitably in tension. First is the important principle of seeking, wherever possible, not to reward or validate past bank choices (as regards risky funding structures and relatively low levels of genuinely liquid assets). This consideration argues for trying to sheet home costs to shareholders, management, and creditors (wholesale ones in particular). Second, however, has been the concern to avoid unnecessarily exacerbating financial system stresses, or exaggerating economic downturns that were already underway. In providing additional liquidity, in particular, the latter consideration has outweighed the former. Additional liquidity has been made available, here and abroad, liberally if required, and on terms that have almost invariably not been designed to be penal.

[3] Whether by the banks borrowing or, perhaps as a last resort, by the Crown borrowing directly in international markets.

This approach also shaped the recommendations we sent to you last week on the principles that should guide the pricing of a retail deposit insurance scheme.   The 10 basis points per annum fee that large banks are facing under the scheme announced on 12 October was designed to roughly approximate the cost of insuring bank debt in private markets in normal periods. That was consistent with the Reserve Bank's judgment that the asset quality of the New Zealand banks is sound.

Implications of the Australian wholesale guarantee

On 12 October, the Australian authorities announced both retail and wholesale guarantee schemes. The details of the wholesale guarantee scheme have not yet been finalised, but several of the important features are clear. In particular, the guarantee will be available for issuance undertaken by Australian banks, but not for that undertaken by Australian bank subsidiaries operating in other countries. Specifically, that means the subsidiaries operating in New Zealand are excluded. Excluding offshore subsidiaries appears to be consistent with the approach taken by other countries that are offering wholesale guarantee facilities.

It is worth briefly restating the way in which Australian banks are represented in New Zealand:

- ANZ National, and the BNZ operate here as locally incorporated subsidiaries of the Australian parent banks.
- ASB is also a locally incorporated subsidiary, but its parent - Commonwealth Bank – is also a registered bank here, and conducts wholesale and institutional business under that registration (as a branch).
- Westpac New Zealand Limited is a locally incorporated subsidiary of Westpac Banking Corporation. The subsidiary conducts the retail and much of the commercial business of Westpac in New Zealand. Westpac Banking Corporation is also a New Zealand registered bank (as a branch), and wholesale and institutional business is conducted under that registration.

For Australian-owned banks operating in New Zealand, local incorporation in respect of the retail operations has become an important part of the supervisory and regulatory policy framework in recent years. *[Information deleted under section 6(a) "the making available of the information would be likely to prejudice the security or defence of New Zealand or the international relations of the Government of New Zealand"]*

The Australian wholesale guarantee facility changes the ground for New Zealand in a number of ways.

On the one hand, to the extent that the Australian scheme enables the parent banks to re-enter funding markets earlier than otherwise, then to the extent that they are willing and able to pass on some of that funding to the New Zealand subsidiaries, the funding position of the New Zealand subsidiaries will be improved. In addition, the Westpac and Commonwealth Bank wholesale and institutional **branches** operating in New Zealand will directly benefit from any improvement in market access for the Westpac and Commonwealth Bank Australian-incorporated entities.

The Australian Prudential Regulatory Authority (APRA) places prudential limits on the extent to which Australian parents can lend to **subsidiaries**. The parent can have no more exposure to any subsidiary than 50 per cent of the parent's core (Tier One) capital. There are good reasons for these sorts of restrictions in normal times, to protect the capital of the regulated entity. Indeed, for the same reason we place our own restrictions on the amount that subsidiaries can lend to parents.   At present, data from the banks suggests that most, but not all, have quite material "headroom" within the limits on how much can be advanced to them by their parents.

However, there are less favourable effects of the Australian facility as well.

Most importantly, in the current environment of extreme risk aversion, even when world markets begin to re-open it may be very difficult for New Zealand unguaranteed subsidiaries to raise wholesale funds directly from international markets. For some considerable time, even as the current intense risk aversion subsides, most investors are likely to prefer the paper of the parent, especially in a climate in which most developed countries are offering similar guarantees on wholesale bank paper. The APRA limits on raising funds via the parent will not meet New Zealand needs indefinitely.

Because the local bank deposits of some financial institutions are not covered by our deposit guarantee scheme (e.g. some managed funds), some are reported to already be actively planning to relocate their funds from New Zealand wholesale instruments, to (guaranteed) wholesale instruments offered by Australian banks. Such transfers are unlikely to occur until the Australian scheme is formally implemented. Even then both the likely scale of such a transfer, and the full implications, are unclear. However, if world markets remain tense (as seems likely) those flows may increase over time.

Finally, a materially uneven playing field has been created. As noted above, the Westpac (and CBA) branch in New Zealand will be able to fund their significant New Zealand commercial and institutional operations, without regulatory limit, using paper guaranteed by the Australian government, including paper denominated directly in New Zealand dollars. The locally incorporated operations do not have that flexibility.

Unsurprisingly, the local subsidiaries themselves have urged that New Zealand respond to the Australian move by offering a wholesale guarantee facility ourselves.

Our response to the Australian "facts on the ground"

The first strand of our response is to sheet home a degree of responsibility to the banks themselves. The pressures they are facing reflect their own past choices about funding and liquidity structures, having misjudged the risks of occasional sustained periods of disruption to offshore wholesale market access. *[Information deleted under section 6(a) "the making available of the information would be likely to prejudice the security or defence of New Zealand or the international relations of the Government of New Zealand"]*

The second strand of our response should be to keep on with the planning and design work in case we need to introduce a possible wholesale guarantee scheme ourselves. If we decide to go ahead with offering such a facility at some point, it will be effective most quickly if as much detailed planning as possible has been done in advance.

[Information deleted under section 6(a) "the making available of the information would be likely to prejudice the security or defence of New Zealand or the international relations of the Government of New Zealand"]

Warrants/Options

[Information deleted under section 6(a) "the making available of the information would be likely to prejudice the security or defence of New Zealand or the international relations of the Government of New Zealand"]

A possible New Zealand wholesale scheme

Officials have been working on the development of a possible wholesale funding guarantee facility in New Zealand. We have sought to learn from what is known of the schemes that have been announced in other countries. However, many of the details are still sketchy and in some cases have not been finalised.

One common theme that appears to be emerging as these plans are refined is the importance of setting the fee at an appropriate level. It is important that a fee is charged – a valuable Crown service is being provided to private banks. And it is also important that that fee is not too low. The aim of wholesale guarantee facilities is not to **subsidise** financial institution borrowers, or to unreasonably advantage borrowers from financial institutions over other debt issuers (e.g. corporates). Instead, the focus on helping to restore issuers' **access** to wholesale funding and debt markets. The aim is also to encourage issuers to graduate from relying on government guarantees as soon as market conditions allow them to do so. In this case, a reasonably substantial fee would also be consistent with the goal of reinforcing market disciplines (including imposing the costs of past choices on shareholders).

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The United Kingdom authorities have outlined the basis on which they plan to charge for the wholesale guarantee. They have looked at market prices of credit insurance (specifically, credit default swap spreads) over the last year or so, taken a median (to exclude brief periods of extreme market stress) and added a 50 basis point penalty. Applied to the New Zealand subsidiaries of the Australian banks, that might justify a fee of around 130 basis points per annum (higher for any other less well-rated entities covered by the guarantee). A higher fee would be charged for any paper issued by less well-rated entities. For example, a BBB rated entity might be charged 180 basis points per annum.

The other key features of a possible New Zealand wholesale scheme would be as follows:

- It would probably[4] be available only to banks and depost-taking financial institutions incorporated in New Zealand with an investment grade (BBB- or better) credit rating. In practice, MARAC and South Canterbury Finance are the only non-banks that would be covered.
- It would be an opt-in scheme, under which issuers would apply for coverage on an issue by issue basis to public debt issues (e.g. commercial paper, bank bills etc). This is the model being adopted in Australia and the United Kingdom.
- It would apply only to new debt. This is consistent with the approach taken in most other countries, although the Australian opt-in model will allow borrowers to apply to cover existing debt issues as well. Even with a significant fee, there is no obvious public policy interest in guaranteeing existing debt. The focus of the policy would be on reopening markets to enable new issuance to occur.
- The term of the guarantee would be three years from the date any announcement was made (i.e. not a rolling three year forward window). This is longer than the term of the retail scheme. Most retail deposits are for quite short terms, and it is important to avoid creating new rollover pressures in a year or two’s time by bunching the new wholesale maturities into too tight a window.
- As with the deposit guarantee scheme, only senior debt would be covered.
- Paper issued in New Zealand dollars and any major foreign currency would be covered (e.g. AUD, JPY, USD, EUR, GBP)
- If a bank fails, the risk to the Crown is somewhat greater for foreign currency borrowing than for domestic currency, but as the aim would be to encourage re-entry to foreign markets we do not propose to charge a higher price for guaranteeing foreign currency borrowing.
- It is probably not necessary to differentiate pricing by term (e.g. cheaper for shorter terms), but we would reserve the option for the time being.
- For bank issuers, existing information, supervisory and directive powers are adequate. If either of the other eligible institutions sought a guarantee we would have to tailor a contract for them, as we have done for non-banks in the deposit guarantee scheme.
- Other than related parties, no classes of creditors would be excluded from the coverage of the guarantee. As is the case under the deposit guarantee scheme, both resident and non-resident investors would be covered by the wholesale guarantee.
- The fee would be kept under regular review and could be adjusted, for new issues, at short notice as required.
- Because this facility would apply only to new issues, it would only be offered for as long as was needed. Ability to adjust the price may well be an important part of the exit strategy (the fee could, for example, be moved to very high levels, but the facility kept available in case market conditions deteriorated sharply). When the facility is withdrawn the (up to) three year guarantee on debt issued under the guarantee facility would continue to be covered.

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[4] There is some possibility that we might need to include some branches of non-Australasian foreign banks, which are active participants in the domestic bank bill market. Further work on the extent to which these branches might be eligible for cover under schemes available in other countries may be needed.

A facility could be launched (with appropriate Crown documentation) relatively quickly and would be likely to have immediate benefits in terms of investors' attitudes towards the wholesale debt of New Zealand bank issuers. However, there are indications that it could take several weeks, perhaps longer, for banks to be fully positioned to utilise a guarantee in their international issuance programmes.

There are various other operational details that we would need to work through as part of finalising a possible New Zealand scheme. We envisage continuing that work over the coming week, engaging with lawyers on the preparation of draft contracts which would, to enable us to test more robustly possible loopholes and problems.

Fiscal implications

A wholesale guarantee scheme will considerably extend the scope of the Crown's contingent liability. The maximum estimate of that extension is around another $150 billion, similar in scale to the exposure under the deposit guarantee scheme. However, the likelihood of the guarantee being called is considerably lower (given the restriction to investment grade issuers) and the fee being charged for assuming that risk would be considerably higher than the fee under the retail deposit scheme.

We do not know how much use would be made of such a facility, but if market conditions remain difficult it would be plausible to envisage perhaps $60 billion of issuance within six months. On that volume of issuance, and the indicative pricing structure mentioned above, the annual fee would be in the order of $800m. Using historical default rates for AA banks, on the same basis used in our report on the fiscal costs of the deposit guarantee scheme, the expected loss on $60 billion over two years would be around $12m. If, however, market pricing of bank credit risk over the last year or so was more representative of the actual risk, the expected claim on the guarantee over two years would be $384 million. If the guarantee was used more extensively both the fee revenue and the expected claims under the guarantee would be commensurately greater. With only four main banks, risk is quite concentrated. Thus the most likely outcome is no claims at all, but the next most likely outcome is a claim for billions of dollars.

The probability of a bank failing is, in our judgement, low. However, if one or more of the major banks were to fail, it is likely that the exchange rate would fall quite sharply. As much of the debt that would have been guaranteed under a wholesale guarantee facility would be denominated in foreign currency, the New Zealand dollar value of these obligations could escalate sharply. The banks themselves would typically have hedged the exposures, but the guarantor would not have access to the countervailing gains on the hedge transactions. Thus, the Crown's exposure under this guarantee is probably quite skewed. However, as the Crown would also be guaranteeing most of the other liabilities of the bank concerned (under the deposit guarantee scheme), foreign exchange losses on the wholesale guaranteed instruments would largely be offset by the benefit arising from the foreign exchange hedging gains which would reduce our overall liability under the deposit guarantee.

Moving to offer a wholesale guarantee, as a contingent liability of the Crown, is likely to result in some increase in government bond yields, and hence a rise in ongoing Crown financing costs. Quite how large such an effect might be is difficult to judge. To illustrate, bond yields around the world rose quite sharply earlier this week. Some of that will have been because of the widespread move to offer guarantees, some will have been because of extreme risk aversion receding somewhat in the expectation that the policy interventions will work. And there may well have been other factors. There is no easy way to disentangle the significance of each of these effects at this stage. In considering whether to offer such a facility, it would be important to weigh the risks that financing costs might rise, because of the increase in the overall stock of Crown or Crown-guaranteed liabilities, against the expected benefits in improving overall New Zealand access to international funding markets.

Interactions and interfaces

The current deposit guarantee scheme already covers some wholesale funding. That scheme explicitly covers all types of debt securities issued by the guaranteed entities, but then specifically excludes financial institutions as debtors under the scheme. What that means, as an example, is that if a corporation or charity holds bank bills, they are covered by the deposit guarantee scheme, but if a superannuation scheme or a hedge fund (financial institutions) hold those bills, they are not covered by the deposit guarantee scheme. The financial institutions exclusion was intended as a crude proxy to minimise the risk of large scale wholesale funding being captured under the terms of the deposit guarantee scheme.

In the short-term that approach is effective. However, it sets up an incentive for holders or purchasers of wholesale instrument to either sell that paper to parties who would themselves be covered by the deposit guarantee scheme, or to attempt to structure their own holdings through vehicles which might be difficult for us, in the event of liquidation, to prove were, in fact, being held by/for a financial institution. Either way, over time there is a risk that an increasing proportion of the wholesale paper on issue will come within the ambit of the (relatively cheap) retail scheme. If New Zealand were to introduce a wholesale guarantee facility, we would envisage make it a condition of signing a wholesale guarantee agreement that the borrowing institution would also sign an amendment to its deposit guarantee l agreement. Such an amendment would make clear that any paper eligible for the wholesale scheme would explicitly not be covered by the retail scheme. Other responses to this issue will be covered in a paper on the deposit guarantee scheme itself early next week.

Because we have structured the deposit guarantee scheme to exclude the claims of financial institutions, some classes of deposits with guaranteed institutions are not covered by that scheme: The more important examples appear to be:

- Brokers' trust accounts with commercial banks are not covered by either our deposit scheme (because these entities are considered as financial institutions). Such accounts are covered in the Australian retail scheme.

- At present, claims on banks (whether deposits or securities) held by superannuation funds, unit trusts etc are not covered by the deposit guarantee unless those funds are held in vehicles that invest exclusively in government securities or liabilities of guaranteed institutions. Again, these bodies are excluded by the financial institutions restriction.

There is a reasonable case that these sorts of balances should be brought within the coverage net. Proceeding with a wholesale scheme would provide the most effective remedy, as the bulk of any such assets would be likely to be shifted to be held in instruments (e.g. short term bank bills) that were covered by the wholesale scheme (in which the risk to the Crown is more appropriately remunerated).

It is worth noting that we have received negative feedback this week from corporate issuers of commercial paper, whose paper is not covered by any guarantees. The commercial paper market in New Zealand is relatively small (smaller than usual at present) and in no other country have wholesale guarantee facilities been extended to corporate issuers of commercial paper. The proposed pricing of the wholesale facility outlined above is designed to be high enough to avoid putting corporate issuers in an unusually disadvantageous position. Note that, to the extent that domestic and foreign issuers do have a very strong preference for government-guaranteed debt, the absence of a New Zealand wholesale guarantee facility for banks would not markedly improve the position of unguaranteed corporate issuers.

Conclusion

This report has noted the importance of re-establishing New Zealand banks' access to international funding markets. In particular, it has explored the way in which the Australian wholesale guarantee scheme poses both opportunities and challenges for New Zealand and the New Zealand subsidiaries of Australian banks. *[Information deleted under section 6(a) "the making available of the information would be likely to prejudice the security or defence of New Zealand or the international relations of the Government of New Zealand"]*
Work should also continue on the detail design features of a New Zealand scheme so that it could be deployed quickly should we conclude it is needed. *[Information deleted under section 6(a) "the making available of the information would be likely to prejudice the security or defence of New Zealand or the international relations of the Government of New Zealand"]*

The second half of the report focused mainly on outlining the key features of the sort of wholesale guarantee scheme that could be used in New Zealand. We believe that it is particularly important to set a reasonably significant fee on such a facility. There is a balance to be struck: the fee would need to be low enough to be used while markets remain very difficult, but high enough to encourage issuers to graduate from depending on a guarantee as soon as market conditions reasonable allow. The other features outlined above would provide a sufficient framework on which to build a detailed facility, and would also provide enough detail should we need to launch such a facility before all the formal documentation was in place.

Annex

Structure of banking system funding
As at August 2008

	$ Billions
Resident funding:	
Retail	132
Other resident funding	45
Resident funding	**177**
Non-resident funding:	
in New Zealand dollars	41
in foreign currency	86
Non-resident funding	**127**
Total funding	**304**

Of the total non-resident funding, just over two-thirds ($87 billion) matured within a year. Indications from banks indicate that of the wholesale funding maturing within a year, a substantial majority matures within six months