THE TREASURY
Kaitohutohu Kaupapa Rawa

Date: 4 August 2009 SH-11-4-3-4

To: Alex Harrington, Office of Minister of Finance

AIDE MEMOIRE: RESIDUAL DEPOSIT GUARANTEE SCHEME ISSUES

The following issues have arisen associated with the Cabinet Business Committee (CBC) paper "Extending the Retail Guarantee Scheme" (the Scheme), some of which will need to be resolved and reflected in the CBC paper. These are:

- Whether the amended scheme should cover collective investment schemes. Currently, a limited type of collective investment scheme is covered (largely cash portfolio investment exemption – PIE – schemes that, in order to be covered by the guarantee, are required to invest solely in guaranteed institutions and/or Government stock);
- Whether the scheme expires on 31 December 2011 or at an earlier date in December 2011; and
- The process of legislating for the Scheme to be passed under urgency.

These issues need to be resolved before the Cabinet paper is submitted on 6 August 2009.

Coverage of the Scheme

Collective investment schemes (CISs) are currently covered by the retail deposit guarantee scheme (DGS) to the extent that they solely invest in guaranteed retail deposits and/or Government stock. This is to recognise that the risk characteristic and substance of these investments is no different to a retail deposit that would be guaranteed if made by an eligible institution. However, CISs are legally different from deposits covered by the DGS in that units in these funds do not represent deposits or other liabilities, and are subject to investment risk, including possible delays in repayment and loss of income and principal invested.

As the CISs covered by the DGS invest solely in guaranteed institutions and/or Government stock, they do not pay fees as the invested in institutions already pay fees on eligible deposits.

The Cabinet paper has not explicitly addressed the issue of CIS coverage, referring instead to bank and non-bank deposit takers.

Removing this limited category of CISs from the extended DGS's coverage would be consistent with the core coverage of the DGS. It would also reduce one of the boundary issues that has arisen between CISs and other institutions (such as mortgage trusts) with similar legal structures but different investment approaches that are not covered by the present DGS, and result in slightly reduced administration costs which are currently associated with managing separate deeds of guarantee and some monitoring. If CIS coverage is removed, there may be some shifting of investors from CISs to guaranteed deposits, but this would be minimal.

Retaining CISs in an extended DGS would not cause any particular issues, other than potentially raising boundary issues again with non-guaranteed schemes.

In terms of moving toward a tighter scheme with limited coverage, we propose that the CBC paper be amended to state that CISs will be excluded from the extended scheme.

Expiry date

The amended scheme is presently designed to lapse on 31 December 2011. We investigated whether it might be sensible to move this back to a date earlier in December (such as 9 or 15 December) to enable easier management of any end of scheme issues (e.g. needing to manage a late default) that might arise.

Our assessment is that the likelihood of a default occurring close to 31 December 2011 is remote. This is because of tighter eligibility in the amended scheme, the riskier deposit takers should have exited, merged or restructured before that point, and new liquidity rules extending the term of funding should prevent too much funding maturing at any given time. In addition, deposit taking institutions are used to managing year end funding issues and moving the expiry date earlier would disrupt normal cash flow management practices around quarter ends – something the current expiry date of 12 October 2010 does not take into account.

If there were to be failure between Christmas and New Year, resources would be brought in to manage the default and payout process. Therefore, we see little benefit from shifting the expiry date. If any end-of scheme issues do arise, it will place pressure on DGS administration but these can be managed.

Urgency

It is proposed the amended scheme be passed under urgency. However, there variations that could apply in that some parts of the legislative process could follow the normal process. Using urgency throughout the process would avoid uncertainty that would be of concern to financial markets and institutions arising from delays or possible drafting amendments. A legislative process that is compact in terms of time and certain in terms of reducing policy/decision uncertainty is key. Using urgency across substantive parts of the process could achieve a similar result.

Recommendations

We recommend that you:

a Agree to exclude collective investment schemes from coverage under the amended retail deposit guarantee scheme;

(Agreed/not agreed)

b Agree to retain the expiry date of the amended retail deposit guarantee scheme at 31 December 2011; and

(Agreed/not agreed)

c Either
- Agree to use urgency for the whole legislative process for extending and amended retail deposit guarantee scheme;

(Agreed/not agreed)

Or

- Agree to use urgency for the legislative process allowing for a shortened (one- two day) Select Committee process.

(Agreed/not agreed)

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