Office of the Minister of Finance

Chair
CABINET BUSINESS COMMITTEE

EXTENDING THE RETAIL DEPOSIT GUARANTEE SCHEME

Executive Summary

1. The Retail Deposit Guarantee Scheme (DGS) was put in place on 12 October 2008 to maintain depositor confidence during a period of extreme international financial market stress. Similar actions were taken around the world, including in Australia.

2. The DGS is due to expire on 12 October 2010. Given the need for firms and depositors to be able to make informed business and reinvestment decisions it will be necessary to give certainty to the market soon on what will happen post October 2010.

3. The main decision to be taken at this point is whether to let the Scheme finish at October 2010 or to extend the scheme (on tighter terms). This decision needs to be communicated in the near future – certainly before October this year.

4. The acute financial stability concerns prevailing in October last year have now abated. While conditions cannot be said to have normalised, the risks to system wide financial stability from exiting the DGS – in 2010 or later – are both considered to be low. These risks are probably lower if the DGS is extended.

5. The DGS creates distortions by under-pricing risk, distorting between institutions and products with and without the guarantee. This would be removed with the lapse of the guarantee. However, removal of the guarantee may lead to more failures in the non-bank sector as depositors remain risk averse and there is insufficient opportunity to develop and implement private sector solutions such as consolidation and restructurings. The extension of the Scheme would enable these distortions to be somewhat reduced through tighter terms and more risk sensitive pricing.

6. There is the potential for significant fiscal costs in the event of failures under the guarantee. [Withheld – economically damaging] While an extension to the scheme exposes the Crown for longer (though with more limited coverage), it offers the potential for private sector solutions and more orderly exit of firms in a potentially improved economic environment. This could reduce both the incidence (and co-incidence) of failures and the loss to the Crown in the event of failure. [Withheld – economically damaging]

7. In conclusion, while the issues are finely balanced, this paper proposes to extend the DGS on revised terms until 31 December 2011 in order to achieve a less disruptive and potentially less costly exit from the DGS.

Proposal

8. This paper seeks Cabinet's agreement to:

- Extend the DGS on revised terms until 31 December 2011, to facilitate an orderly exit from the current DGS.

- The high-level design features of the extended DGS:
  - More risk sensitive fees, paid on the whole deposit book.
  - Voluntary scheme (institutions will need to apply).
  - Tougher eligibility criteria (firms rated BB- or below or unrated are ineligible).
  - Reduced and differential coverage for banks and non-banks (up to $500,000 for banks, and up to $250,000 for non-banks, per depositor, per institution).

- Delegate further detailed decisions on the design features of the extended DGS to the Minister of Finance. If significant policy issues arise, the Minister of Finance will refer these back to Cabinet.

9. [Withheld – under active consideration

]

Background

10. The DGS is to expire on 12 October 2010. Decisions need to be taken soon as to what will happen after October 2010 so that firms and depositors can make informed business and reinvestment decisions. To provide this certainty, decisions need to be taken as soon as possible, and one year out from the expiry of the scheme at the latest - that is, before October 2009.

11. The main options available to the government are:

- Option 1: Let the current DGS cease in October 2010 (status quo).

- Option 2: Extend the DGS on revised terms until 31 December 2011 (recommended option).

12. [Withheld – under active consideration

]

13. The options have been assessed against the following objectives:

- System-wide financial stability. Ensuring depositor confidence promotes system-wide financial stability.

- Economic growth and efficiency. Minimising economic distortions, including "moral hazard' and ensuring well-priced credit markets. Ensuring a viable non-bank sector in the future.

- Fiscal costs. Managing Crown exposure and likely fiscal costs.

14. An assessment of the options is provided below, followed by an outline of the design features of the extended DGS.

Option Analysis

System-wide financial stability

15. System-wide financial stability concerns have abated since the retail DGS was introduced in October 2008. The risk that a loss of depositor confidence from the removal of the DGS will impact significantly on financial stability is low. However, some risks remain including:

- The Australian guarantee remains in place until October 2011. Although ex ante we cannot be certain about the size of the flow to Australian guaranteed banks if the New Zealand scheme ceases in October 2010, anecdotal evidence from the period around October 2008 suggests some flow could occur, particularly by corporate and high net worth individuals. However, a large flow of retail funds is not expected.

- [Withheld – economically damaging]

- Relatively high levels of non-performing loans are currently affecting the profitability of some deposit takers. This situation is not expected to improve in the near term and will impact on the ability of affected institutions to absorb any additional unexpected pressures.

16. Extending the DGS to 31 December 2011 could avoid the risks (considered low) of a loss of depositor confidence on system-wide financial stability by allowing more time for financial markets to stabilise and aligning the end of the scheme better with that of Australia's.

Economic growth and efficiency

Market distortions

17. The DGS has created economic distortions by under-pricing risk. Letting the DGS cease in October 2010 would remove these distortions. Examples of the economic distortions that have been created include the following:

- Under the guarantee, depositors can receive sovereign risk whether they invest in an AA-rated or a B-rated financial institution. Because the fee structure does not fully price this risk differential, depositors are able to receive higher returns for the same risk by investing in lower-rated financial institutions. Deposit taking institutions may also be able to attract funds by offering lower rates of return, increasing their profit margins.

- The DGS creates a wedge in the market between institutions and products with and without the guarantee, and puts institutions without the guarantee at a competitive disadvantage.

- The guarantee may encourage depositors and deposit taking institutions to make riskier investment decisions since they receive the gains from these investment decisions, while the losses to depositors are borne by the taxpayer (this is referred to as a "moral hazard" problem). For example, finance companies within the current DGS have grown their deposit books by approximately 19% since the guarantee was introduced, whereas before the guarantee the deposit books of many finance companies were shrinking.[1] Much of this retail funding has been used to replace bank funding lines.

---

[1] Growth in finance company deposit books had been flat since December 2008. Growth in a few large entities is driving the overall growth in finance company deposit books.

- The DGS may also lessen the market incentives on firms to restructure, merge, or exit the industry by relieving the liquidity pressures that they might otherwise face (by making it easier for firms to attract retail deposits).

- The DGS has also created an artificial shortening of terms offered by some firms as depositors are not willing to invest beyond the guarantee period; some firms are also having to hold more liquidity than normal, which is costly.

18. Extending the DGS would prolong economic distortions. However, distortions could be partially mitigated by:

- The scheme being extended until 31 December 2011, with a definitive end date.

- Introducing more risk sensitive pricing, so riskier institutions will be required to pay higher fees to reflect their higher probability of default and likely loss given default.

- Lowering the coverage per depositor, per institution to $500,000 for banks, and $250,000 for non-banks. Deposits in excess of that coverage limit will not be covered by the DGS.

Non-bank sector

19. Throughout 2009-2011 a new prudential regime for non-bank deposit takers is being put in place. The transition into this new regime may be challenging for some non-bank deposit taking institutions, but once fully in place the new regime should result in a more robust sector.

20. A phased transition from the DGS will provide more time for non-bank deposit takers to take steps to ensure their future viability after the DGS ends and to adjust to the new prudential regime under the 'umbrella' of a guarantee.

21. While asset prices may not be recovering by the end of the extension period, it is likely that there will be more certainty around asset prices, which is likely to make restructuring easier for institutions. Extending the DGS could therefore potentially result in fewer failures in the non-bank sector, and increase the likelihood of a viable non-bank sector remaining in the future.

22. Despite its relatively small size (6.5% of guaranteed deposits in the DGS), a viable non-bank sector does contribute to the efficiency of New Zealand's financial markets. It provides competition and domestic capability in the financial sector, particularly in regional New Zealand, where larger banks are less active, and for certain specialised forms of lending, such as SME, vehicle, consumer and property financing.

Financial services

23. Ceasing the guarantee in October 2010 is likely to mean that any firms that default do so in a concentrated way in mid to late 2010. Throughout the adjustment period, failures in particular of significant entities could also result in the disruption of financial services and credit markets, particularly in regions and sectors where the entities operate.

24. If the DGS is extended, then it is likely that any exits from the sector will be more spread out, as they are triggered by, among other things, the affordability of the new fee schedule and the new prudential requirements being introduced for non-bank deposit takers. This could potentially result in less disruption in financial services and credit markets.

25. In summary, ceasing the DGS in October 2010 avoids the additional period of economic distortion. However, it does so at the potential cost of market disruption during the adjustment period, and the longer term viability of the non-bank sector, which may take some time to recover.

Fiscal costs

26. [Withheld – economically damaging]

27. If the DGS ceases in October 2010 some non-bank entities may find it difficult to find new equity investors and depositors which could lead to both capital and liquidity shortfalls. [Withheld – economically damaging] It still remains possible that firms will default during either the current guarantee or extension period. A number of firms are beginning to change their strategies by looking to raise additional equity, focusing on their core business, exiting property development and working out ailing assets, in preparation for the end of the guarantee period.

Contingent liability

28. Allowing the DGS to cease on October 2010 would remove the $128 billion contingent liability from the Crown from that date. Extending the DGS until 31 December 2011 will prolong the period of time that the Crown will have this contingent liability. However, the extent of the Crown's contingent liability during the extension period, and the extent to which it might grow, will be limited (but not removed entirely) by the following design changes:

- Limiting the scope of coverage (covering up to $250,000 for non-banks, and $500,000 for banks, per depositor, per institution; down from $1 million in the current scheme). However, some depositors may choose to spread their money around to avoid exceeding the coverage limit.

- Increasing the threshold for institutions to be eligible for the scheme. Firms will not be eligible for the scheme if they are rated BB- or below, or are unrated.

- Removing the consideration that to gain access to the Wholesale Funding Guarantee Facility (WFGF) institutions that take deposits are members of the retail DGS. This may mean major banks choose not to join the DGS for the extension period. This group currently represents a significant portion of the contingent liability.

- Firms will potentially have less scope to grow their deposit books on the back of the guarantee as more risk sensitive fees will be charged to firms on their full deposit books and a requirement will be introduced to seek authorisation for deposit book growth with contractual penalties for non-compliance (such as a withdrawal of the guarantee or financial penalties). However, the authorisation measures would still need to be used with caution.

Operating costs of DGS

29. There will be direct costs associated with the Treasury continuing to operate the guarantee scheme for the extension period; an estimated total $5.293 million additional direct operating costs, of which $0.755 million will be absorbed from current DGS funding in 2009/10 with additional funding of $4.538 million required over FY2010/11 and FY2011/12. [Withheld – protect commercial position]

Summary

30. The decision of whether to extend the DGS on revised terms until 31 December 2011 or proceed with the status quo of exiting in October 2010 is finely balanced.

31. On balance it is recommended that the DGS is extended on revised terms until 31 December 2011 in order to achieve a less disruptive and potentially less costly exit from the DGS. It also reduces the risk that the DGS has to be reintroduced if financial conditions deteriorate. However, for the extension of the DGS to have the anticipated benefits, and not just delay the inevitable adjustment process, it needs to promote adjustment by introducing more limited coverage and risk sensitive pricing than the current DGS and have a definitive end date.

[Withheld – under active consideration]

32. [Withheld – under active consideration

]

33. [Withheld – under active consideration

]

34. [Withheld – under active consideration

]

35. [Withheld – under active consideration

]

Proposed Design Features of the Extended DGS

36. For the extended DGS to have the anticipated benefits and not just delay the inevitable adjustment process, it needs to promote adjustment by being on more limited and risk sensitive terms than the current DGS. It also needs to have a definitive end date.

37. The proposed design features of the extended DGS are summarised in Table 1. More detail on the design features is provided in the Annex. The indicative fee schedule is provided in Table 2.

Table 1: Summary of proposed design features

Design parameter	**Current DGS**	**Extended DGS**	**Rationale for difference (if any)**
Length of extension	Expiry on October 2010.	Expiry with definite end date on 31 December 2011.	Less disruptive and potentially less costly exit from DGS.
Fees	Heavily subsidised. Fees only on growth and guaranteed deposits in excess of $5 billion - somewhat risk based.	Reduced subsidy. Full book pricing. More risk-based (see Table 2 below).	Manage Crown risk better, facilitate adjustment and minimise distortions.

Design parameter	Current DGS	Extended DGS	Rationale for difference (if any)
Institutional eligibility	Voluntary. General eligibility criteria later restricted to BBB- or above for new entrants. Membership of retail DGS one consideration for gaining access to Wholesale Facility.	Voluntary. Minimum credit rating BB. Only open to institutions currently guaranteed (except new entrant registered banks, or merged entities, at the Crown's discretion). Access to the Wholesale Facility will no longer take into consideration membership of the retail DGS. CISs not eligible for extended scheme.	Tighter criteria to assist transition from the scheme.
Depositor coverage cap	Up to $1 million per depositor per institution.	Up to $500,000 for banks and $250,000 for non-banks per depositor per institution.	Signals transitional nature. May reduce Crown contingent liability.
Management tools	Limited tools, but can introduce amended deed to cover the desirable changes to the current DGS, including restrictions on undesirable asset acquisition and deposit growth, and change of control authorization.	These additional provisions can also be included in the deed for extension.	Attempt to better manage the exposure by using existing tools more actively.
Resolution tools	Statutory management triggers payout under the DGS.	Redefine default event so that statutory management can be used without immediately triggering requirement to payout.	Institution may be able to continue to trade under statutory management Time to consider resolution options.

38. The fee schedule for the extended scheme (Table 2) would apply to all eligible deposits and better reflect risk (based on credit ratings) and likely loss given default than the current fee schedule.

39. The principles underpinning the fee schedules are to align the fees toward commercial rates, reflect the underlying risk of the firms and to balance this with enabling firms to realistically be able to participate in the extension and to exit into an environment of fully commercial rates when the scheme ends. The proposed fee structure is based on historical market rates. Current market spreads are considerably higher than this and, depending on how markets stabilise, it is possible that firms could exit into an environment where they face higher funding costs than they do under the DGS. However, choosing fees higher than historical rates could make the Scheme unaffordable for some firms and trigger their default under the current scheme.

40. A lower fee structure is recommended for banks, credit unions and building societies compared to finance companies. This is because our present estimates of loss given default for finance companies in the current scheme are higher than for other institution types.

Table 2: Proposed fee schedule

Credit rating	Finance Companies (bpts)	Banks, Credit Unions, Building Societies, PSIS (bpts)
AAA +/-	15	15
AA+	15	15
AA	15	15
AA-	20	15
A+	25	20
A	30	20
A-	40	20
BBB +	60	25
BBB	80	30
BBB-	100	40
BB+	120	50
BB	150	60

Legislation

41. Although it is possible to extend the DGS using the Minister of Finance's existing Public Finance Act powers, this paper proposes introducing new legislation to give effect to the extended DGS.

42. [Withheld – legally privileged

]

43. New legislation has the following key advantages:

- Greater certainty for the end date of the scheme.
- More appropriate from a constitutional perspective, considering the size of contingent liability under an extension and given that Parliament is in session.
- Enables better management of Crown risk in respect of the guarantees.

44. Urgency is recommended for such legislation in order to give certainty to financial markets. Urgency could be used for some or all of the stages, and there could be an option of a shortened select committee process (e.g. of one or two days). This paper proposes that support from key support and opposition parties is sought for this. If legislation is not passed under urgency there will be an extended period of uncertainty through debate in Parliament and select committee processes until the legislation is passed. Legislation could be passed under urgency during the sitting week of 14 September 2009.

45. This paper proposes that legislation:

- Confirms the establishment of the current DGS and enables an extension of the DGS only until 31 December 2011 on terms and conditions, including eligibility criteria, the Minister of Finance considers fit.

- Provides permanent legislative authority for the cost of undertaking investigations, to make payments under guarantee and for expenses incurred administering those claims.

- Ensures that any payments to creditors under the guarantees are debts due to the Crown from the guaranteed entity.

- Ensures such payments will be given the same priority as that held by the relevant creditor. The reason for this is that if the Crown does not pay out to depositors in full (e.g., if the individual has a deposit in a non-bank in excess of the $250,000 cap), then this can have the result of the Crown losing the priority it would otherwise have.

46. Given the urgency required, the Minister of Finance would seek authority from Cabinet to make further decisions on the detail of the legislation. If significant policy issues arise in drafting, the Minister of Finance will refer these back to Cabinet.

Communications

47. The DGS is due to expire on 12 October 2010. Given the need for firms and depositors to be able to make informed business and reinvestment decisions it will be necessary to give certainty to the market soon on what will happen post October 2010.

48. Next steps involve an announcement in late August or early September of Cabinet's policy decisions and in tandem with this, a decision on the parliamentary timetable for the Bill and securing support from other key support and opposition parties.

49. Some elements of the proposed design are likely to attract mixed views. Institutions in the scheme will pay higher fees than under the current DGS. Smaller New Zealand banks would be paying a higher fee than the large banks, due to their lower credit ratings. Tighter eligibility criteria and higher fees may be considered the trigger point for some defaults leading up to October 2010 and potentially beyond, but are necessary for the extension of the DGS to achieve its objectives of promoting adjustment.

50. A very clear communications strategy will be needed to explain the objectives of extending the DGS and how it best meets the interests of New Zealanders. We would propose a proactive release of the papers leading to a decision on this using the Official Information Act as a guide.

Consultation

51. The proposals for policy changes to the DGS were developed by the Treasury and the Reserve Bank of New Zealand in consultation with the Ministry of Economic Development (including the Companies Office) and the Securities Commission. The views of these departments and agencies have been reflected in the paper. The Department of Prime Minister and Cabinet has been informed of the proposals.

52. The Treasury and the Reserve Bank regularly engage with stakeholders in the sector, which have provided their views on the scheme and its possible extension. This includes financial institutions, trustee corporations, unions and professional services companies. The key issues raised by these groups were:

- Distortions being created by the scheme – many non-banks are finding it difficult to attract deposits after the end of the guarantee period (creating a "wall" of maturities). A business grouping has expressed concerns about the distortions to financial markets created by the DGS.

- Timing of future arrangements - non-banks in particular require clarity about future arrangements as soon as possible.

- Extending the scheme – mixed support for extending the scheme to match the Australian scheme (October 2011). Banks tend to think it is not necessary for them and risk of depositor flight to Australia is low. Finance companies tend to support extension. Some credit unions have chosen not to sign up to the DGS, at least in part because they tend to have a relatively sticky deposit base. Entities operating outside of the DGS (e.g. managed funds) are concerned about the competitive disadvantage that the Crown guarantee puts them at.

- Conditions on institutions' behaviour – it has been suggested that there should be conditions added to firms that are part of the DGS, e.g. employment protection/ mortgage holiday provisions.

- Fee structure – fees should be more risk-based, and not involve cross-subsidisation of non-banks by banks.

- Eligibility criteria – concerns raised about whether Mascot Finance should have been eligible for the DGS, given that it was in wind down.

53. Stakeholder views have been considered when developing the policy proposals.

54. The decision was made not to consult proactively on the proposals with the public. This is because:

- Officials already have a reasonable amount of information about stakeholder views from regular interactions (as summarised above).

- The desirability of making an announcement soon, limiting the time available for any consultation. A period of consultation would make timing significantly worse and may not make us any better informed.

- Commercial sensitivity.

- Concern that public consultation could create further uncertainty in the market.

- The proposed course of action is temporary.

55. For these same reasons, we recommend the legislation to enact these changes be passed under urgency for some or all of the stages of the legislation.

Financial Implications

Contingent liability and loss given default

56. It is expected that the contingent liability under the extended DGS will be lower than under the current DGS since some institutions may choose to not opt in to the extended DGS, the coverage per depositor, per institution is lower, and the eligibility threshold for institutions to be covered is higher.

57. Calls on the guarantees remain a possibility throughout the remainder of the current DGS and the extended DGS due to devaluation of assets, liquidity issues and the foreseeable removal of the guarantee which has enabled some deposits to be attracted or retained when they might not have been otherwise. The government is monitoring this risk closely to assess the likelihood of further defaults by any individual deposit-takers and the Crown's likely loss given a default.

58. When it is *probable* that an individual deposit-taker will default, the estimated loss given default will be provided for in the Financial Statements of the Government. Currently no provision for loss has been made beyond those entities that are currently in default. This is reviewed on a monthly basis.

Operating costs

59. The operating costs of the DGS were approved within Vote Finance Multi-Class Output Expense Appropriation (MCOA) – State Sector and Economic Performance Policy Advice and Management for the two years ending 12 October 2010. These were approved as a separate output class - Crown Deposit Guarantee Scheme with the following scope –"This output class is limited to the implementation and operation of the Crown's deposit guarantee scheme excluding expenses incurred in connection with administering claims under a guarantee or indemnity given under the scheme".

60. Subsequently the operating costs of the Wholesale Funding Guarantee Facility (WFGF) were also approved within the same MCOA, as a separate output class Crown Wholesale Guarantee Facility – "This output class is limited to the implementation and operation of the Crown's wholesale guarantee facility". These costs were approved on the basis of issuing guarantees up to October 2010, with ongoing monitoring of existing guarantees for up to a maximum five years.

61. As part of the Vote Finance Line by Line review in February 2009, funding that was not forecast to be used by these Guarantee Schemes was returned, being $3.2 million operating and $0.6 million capital expenditure.

62. The total direct operating costs of extending the scheme ($5.293 million) are due to immediate costs in the 2009/10 financial year to reissue the Crown Deed of Guarantee to eligible institutions for the extension period ($0.755million) and the operating costs for the extension period from 12 October 2010 to 28 February 2012 including a two month wind-down ($4.538 million). Operational costs include (but are not limited to) the costs of approving guarantees, collection of fees, monitoring and reporting of total contingent liability and provisions, risk monitoring and risk management. [Withheld – under active consideration / free and frank advice]

63. The additional immediate operating costs in 2009/10 financial year ($0.755 million) will be met from reprioritization of existing DGS funding in Vote Finance.

64. In Budget 2009, Vote Finance received additional operating funding to provide for an increased level of advice and support; deliver on immediate Ministerial priorities (infrastructure, regulation quality, value for money, current economic downturn); and deliver on medium to long-term issues (e.g. future economic agenda, improved public sector). However this funding did not include operational costs of any extension or changes to the guarantee schemes. [Withheld – free and frank advice]

65. [Withheld – under active consideration]

66. As the decision to extend cannot be deferred, funding options such as scaling or deferring until Budget 2010 are not appropriate. Therefore to deliver on the DGS extension Treasury will require new

departmental funding of $4.538 million in Vote Finance for the direct operating costs of the extension to the DGS from 12 October 2010 to 28 February 2012 as only costs for the two year scheme to 12 October 2010 had previously been approved. [Withheld – protect commercial position

]

67. [Withheld – under active consideration

]

68. As the operational requirements of both the DGS and WFGF are significantly different from other outputs undertaken by the Treasury, it is proposed to remove from the MCOA and "ring fence" these output classes into a single annual appropriation from 1 September 2009. This will ensure transparency and if funding is not required, it will be available to be returned to the government as savings to apply to other priorities rather than being offset against other output classes within that MCOA.

69. It is proposed to establish Crown Guarantee Schemes as a new Departmental output expense appropriation in Vote Finance with the following scope "This appropriation is limited to the implementation and operation of the Crown's deposit guarantee scheme and Crown's wholesale funding guarantee facility excluding expenses incurred in connection with administering claims under a guarantee or indemnity given under the scheme" and transfer forecast expenses from existing output classes from 1 September 2009. Any unspent balance of existing output classes within the MCOA will be transferred to the new appropriation by joint Ministers, and approved at the October Baseline Update.

Expenses incurred in meeting claims

70. Expenses incurred to administer claims made under the DGS are currently authorized by permanent legislative authority (PLA) within section 65ZG of the Public Finance Act 1989. Operational expenses within the control of the Treasury are sought under an annual appropriation expense. Other departmental expenses incurred for administering of the deed of guarantee that are beyond those envisaged in the annual appropriation, including costs of investigation (under the Crown deed of guarantee) and costs of processing of claims made under the guarantee, are paid under the PLA.

71. Payments in respect of guarantees and indemnities are also currently authorised by section 65ZG and reported as Non-Departmental Other Expenses.

72. It is recommended that permanent legislative authority for the payment of these expenses would be established within new legislation.

Non tax revenue

73. Fees from the DGS are accounted for as Crown non-tax revenue. [Withheld – protect commercial position

]

Departmental capital

74. [Withheld – under active consideration

]

75. [Withheld – under active consideration

]

76. [Withheld – under active consideration

]

Summary of financial implications

77. Below is a summary of the financial implications of extending the DGS on the net operating balance if the major banks join for the extension period:

	Financial implications of extension in DGS in Vote Finance – including major banks $m – positive/(negative)				
	2009/10	**2010/11**	**2011/12**	**2012/13**	**Total**
Departmental operating costs (Additional expenses from extension to the scheme).	-	(2.362)	(2.176)	-	(4.538)
Non Tax Revenue from fees (including major banks).	-	[Withheld – protect commercial position]	[Withheld – protect commercial position]	-	[Withheld – protect commercial position]
Net impact on Operating balance before possible loss from default and costs of claim.	-	[Withheld – protect commercial position]	[Withheld – protect commercial position]	-	[Withheld – protect commercial position]

78. Below is a summary of the financial implications of extending the DGS on the net operating balance if the major banks did not join for the extension period:

	Financial implications of extension in DGS in Vote Finance – excluding major banks $m – positive/(negative)				
	2009/10	2010/11	2011/12	2012/13	Total
Departmental operating costs (additional expenses from extension to the scheme).	-	(2.362)	(2.176)	-	(4.538)
Non Tax Revenue from fees (excluding major banks).	-	[Withheld – protect commercial position]	[Withheld – protect commercial position]	-	[Withheld – protect commercial position]
Net impact on Operating balance before possible loss from default and costs of claim.	-	[Withheld – protect commercial position]	[Withheld – protect commercial position]	-	[Withheld – protect commercial position]

79. Below is a summary of the financial implications of the DGS, both current and proposed changes (assuming inclusion of major banks):

	Financial implications of DGS (including current and proposed changes) $m – positive/(negative)				
	2009/10	2010/11	2011/12	2012/13	Total
Departmental operating costs (current and proposed).	(3.720)	(3.262)	(2.176)	-	(9.158)
Non Tax Revenue from fees.	[Withheld – protect commercial position]	[Withheld – protect commercial position]	[Withheld – protect commercial position]	-	[Withheld – protect commercial position]
Net impact on Operating balance before possible loss from default.	[Withheld – protect commercial position]	[Withheld – protect commercial position]	[Withheld – protect commercial position]	-	[Withheld – protect commercial position]
Possible loss from default (i.e. Gross payments less assets recovered) at 31 May 2009 (PLA) (contingent liability).	[Withheld – economically damaging]	Unknown	Unknown	Unknown	Unknown
Costs of processing claims and undertaking specific investigations (PLA).	Unknown	Unknown	Unknown	Unknown	Unknown
Net impact on operating balance after possible loss from default.	Unknown	Unknown	Unknown	Unknown	Unknown

Treaty Implications

80. The agreement to extend the DGS does not create Treaty of Waitangi implications.

Human Rights

81. The agreement to extend the DGS does not have implications for the Human Rights Act 1993.

Regulatory Impact Analysis

82. The Code of Good Regulatory Practice and the regulatory impact analysis requirements have been complied with.

83. A Regulatory Impact Statement (RIS) has been prepared, and the regulatory impact analysis (RIA) and RIS have been independently reviewed by the Treasury's Regulatory Impact Analysis Team (RIAT). RIAT considers the analysis to be adequate according to the adequacy criteria.

84. The RIS was circulated with the Cabinet paper for departmental consultation (refer paragraph 51).

Publicity

85. This paper recommends that the extension to the DGS be announced in late August 2009. The extension of the DGS is expected by the market (on 30 July 2009 *ipredict* was placing a 76% likelihood on the scheme being extended). There may be negative public comment from financial institutions about the higher fee structure and the reduced coverage cap.

Recommendations

86. It is recommended that Cabinet:

Extended DGS

1 **note** that a decision to end the retail DGS on 12 October 2010 (retain the status quo) or extend the retail DGS (to 31 December 2011) is finely balanced;

2 **note** that the decision to favour extending the DGS on revised terms is to achieve a less disruptive and potentially less costly exit from the DGS;

3 **note** that for the extension of the DGS to have the anticipated benefits, and not just delay the inevitable adjustment process, it needs to promote adjustment by being on more limited and risk sensitive terms than the current DGS and have a definitive end date;

4 **agree** to extend the retail DGS;

Length of transitional DGS

5 **agree** that the extended DGS will expire on 31 December 2011;

***Institutional* coverage**

6 **agree** that the extended DGS will be voluntary for deposit taking institutions;

7 **agree** the extended DGS will only be open to institutions that are already members of the current DGS with the exception of any new entrant New Zealand registered banks that may wish to join and with discretion to allow merged entities to join the scheme where that reduces the Crown's risk;

8 **agree** that only institutions with a credit rating of BB or above will be eligible for the transitional DGS and that collective investment schemes (CISs) will not be covered. That is, some (BB- or below, and unrated; and CISs) members of the current DGS will not be eligible;

Depositor coverage

9 **agree** to set a per depositor per institution coverage cap of up to $500,000 for banks and up to $250,000 for non-bank deposit takers;

Fees

10 **agree** that fees will apply to all guaranteed deposits (full book);

11 **agree** that fees will be risk sensitive and based on the probability of default, and likely loss given default, so as to balance efficiency and stability objectives;

12 **note** the Minister of Finance will set a fee schedule in line with the principles outlined in recommendations 10 and 11. An indicative fee schedule is as follows:

Proposed fee schedule

Credit rating	Finance Companies (bpts)	Banks, Credit Unions, Building Societies, PSIS (bpts)
AAA +/-	15	15
AA+	15	15
AA	15	15
AA-	20	15
A+	25	20
A	30	20
A-	40	20
BBB +	60	25
BBB	80	30
BBB-	100	40
BB+	120	50
BB	150	60

Management tools

13 **note** that the Crown's powers to manage exposure under the current and extended DGS could be extended to include:

- authorization of deposit book growth and asset acquisition; and
- change of control authorization requirement.

Resolution tools

14 **agree** that the Crown's powers to resolve defaults under the extended DGS be extended to include the redefinition of what constitutes a trigger for default so institutions entering statutory management would not be in default and depositors would not need to be paid out immediately;

15 **agree** to delegate further detailed decisions on the design features of the extended DGS to the Minister of Finance.

Legislation

16 **agree** to the extended DGS being enacted by new legislation;

17 **note** it is recommended the new legislation be passed under urgency in order to provide market certainty, and urgency could be used for some or all stages of the legislation;

18 **agree** that the Minister of Finance now seek the support of key support and opposition parties to pass legislation for the DGS;

19 **agree** that the legislation:

- confirm the establishment of the current DGS and enable an extension of the DGS only until 31 December 2011, on terms and conditions including eligibility criteria the Minister of Finance considers fit;

- provide permanent legislative authority for the cost of undertaking investigations, to make payments under guarantee and expenses incurred administering those claims;

- ensure that any payments to creditors under the guarantees are debts due to the Crown from the guaranteed entity; and

- ensure such payments will be given the same priority as that held by the relevant creditor. The reason for this is that if the Crown does not pay out to depositors in full (e.g. if the individual has a deposit in a non-bank in excess of the $250,000 cap) this can have the result of the Crown losing the priority it would otherwise have.

20 **agree** that the Minister of Finance make further decisions on the detail of the policy and legislation;

21 **note** that if significant policy issues arise in drafting, the Minister of Finance will refer these back to Cabinet;

Communication

22 **agree** to announcing the extension of the DGS following Cabinet policy decisions and a decision on the Parliamentary timetable for the Bill, and securing support from other key support and opposition parties;

Financial implications

23 **note** that the operating costs of the current DGS and Wholesale Funding Guarantee Facility (WFGF) were approved as two separate output classes within Vote Finance Multi-Class Output Expense Appropriation (MCOA) – State Sector and Economic Performance Policy Advice and Management;

24 **agree** to “ring fence” these output classes into a single annual appropriation from 1 September 2009, and transfer existing output classes into this new appropriation;

25 **note** that if funding is not required it will be available to be returned to the government as savings to apply to other priorities;

26 **agree** to establish a new Departmental Output Expense “Crown Guarantee Schemes” in Vote Finance, with this appropriation to be the responsibility of the Minister of Finance;

27 **agree** that the output class scope shown in the Estimates will be “This appropriation is limited to the implementation and operation of the Crown's Deposit Guarantee Scheme and Crown's Wholesale Funding Guarantee Facility excluding expenses incurred in connection with administering claims under a guarantee or indemnity given under the scheme”;

28 **note** the total direct operating costs of extending the scheme ($5.293 million) are due to immediate costs in the 2009/10 financial year to reissue the Crown Deed of Guarantee to eligible institutions for the extension period ($0.755 million) and the operating costs for the extension period from 12 October 2010 to 28 February 2012 including a two month wind-down ($4.538 million);

29 **note** the additional immediate operating costs in 2009/10 financial year ($0.755 million) will be met from existing funding for the DGS already in Vote Finance;

30 **note** that Vote Finance will require funding for the direct operating costs of the extension to the DGS from 12 October 2010 to 28 February 2012 as only costs for the two year scheme to 12 October 2010 had previously been approved;

31 **approve** the following changes to appropriations to implement the decisions in recommendation 4 and 23 to 30 above, with the following impact on the operating balance:

	$ million increase/(decrease)						
VOTE FINANCE **Minister of Finance,**	**2009/10**	**2010/11**	**2011/12**	**2012/13**	**2013/14**	**2014/15**	**2015/16 only**
Departmental Output Expense: Crown Guarantee Schemes	4.383	3.717	2.401	0.225	0.225	0.225	0.225
Departmental Multi-class Output Expense: State Sector and Economic Performance Policy Advice and Management							
Crown Deposit Guarantee Scheme	(3.100)	(0.700)	-	-	-	-	-
Wholesale Guarantee Facility (funded by revenue Crown)	(1.283)	(0.655)	(0.225)	(0.225)	(0.225)	(0.225)	(0.225)
Total Operating impact	**-**	**2.362**	**2.176**	**-**	**-**	**-**	**-**

32 [Withheld – under active consideration

]

33 **note** that while operational expenses within the control of the Treasury are provided from the annual departmental output expense appropriation, other departmental expenses incurred for administering of the deed of guarantee beyond those envisaged in the annual appropriation, including costs of investigation (under the Crown Deed of Guarantee) and costs of processing of claims made under the guarantee, are currently paid under the permanent legislative authority (PLA) authorized by section 65ZG of the Public Finance Act 1989 and will be paid under a PLA within the proposed legislation;

34 **note** that payments in respect of guarantees and indemnities currently authorized by section 65ZG, will be authorised under a PLA within the proposed legislation and reported as Non-Departmental Other Expenses;

35 [Withtheld – protect commercial position

]

	$ million increase/(decrease)				
VOTE FINANCE **Minister of Finance,**	**2009/10**	**2010/11**	**2011/12**	**2012/13**	**2013/14**
Non-Tax Revenue: Crown Deposit Guarantee Scheme	-	[Withheld – protect commercial position]	[Withheld – protect commercial position]	-	-
Total	-	[Withheld – protect commercial position]	[Withheld – protect commercial position]	-	-

36 [Withheld – economically damaging

]

37 [Withheld – under active consideration

]

38 [Withheld – under active consideration

]

39 **agree** that the changes to appropriations agreed to in recommendation 31 and/or under recommendation 38 above be included in the Supplementary Estimates for the relevant year and that, in the interim, the increases be met from Imprest Supply.

Hon Bill English
Minister of Finance

Date:

ANNEX: PROPOSED DESIGN FEATURES OF EXTENDED DGS

Length of extension – extend until 31 December 2011, with a clear expectation it will be removed

The current DGS runs until 12 October 2010 (total of two years). The extended DGS is proposed to run for an additional fourteen and a half months and expire on 31 December 2011. Expiry in December 2011 will align more with Australia's current guarantee, which expires in October 2011. It also provides more time for organisations to prepare their businesses for withdrawal of the guarantee and adjust to the new regulatory environment for non-bank deposit takers, while not allowing the market to become dependent on a guarantee. It is critical that the market views the expiry date as certain and credible to ensure that the necessary adjustment does occur.

Fees – pricing to reflect probability of default and likely loss

Fees in the current DGS involve a strong element of subsidy from taxpayers to shareholders and depositors, as fees are only charged on growth of more than 10%, on all growth for unrated firms or on guaranteed deposits in excess of $5 billion. [1] All classes of institution are charged on a less than expected cost recovery basis. Subsidised fees have lead to economic distortions, namely, under-pricing of risk. For example finance companies have shifted funding sources from bank funding to retail funding with a growth in deposits of $880 million since October 2008.

The extended DGS attempts to reduce economic distortions with pricing that reflects risk as much as possible. This will help to reduce moral hazard, minimize distortions of investment decisions between equity, bonds, non-guaranteed and guaranteed deposits and to ease the transition out of the guarantee.

The proposed fees (see Table 3) would apply to all eligible deposits and better reflect risk (based on credit ratings) and likely loss given default. The proposed fee structure is based on historical market rates. Current market spreads are considerably higher than this, and so depending on how markets stabilise, it is possible that firms could exit into an environment where they face higher funding costs than they do under the DGS. However, choosing fees higher than historical rates could make the scheme unaffordable for some firms and trigger their default under the scheme.

The proposed fees will aid transition off the guarantee by providing less of a subsidy to guaranteed institutions which will help to ensure institutions have a real choice about whether to opt into the scheme, or to opt out of the scheme and offer higher, but unguaranteed deposit accounts. The fees may also encourage firms to undertake measures to improve their credit ratings where they think that it is possible over the next two years. This will also improve their chance of long-term survival. As an added incentive for firms to improve their credit ratings it is proposed that if firms improve their credit ratings over the extension period (for instance through an amalgamation) they will receive a refund for fees previously paid at the higher rate. This arrangement occurs under the current DGS.

Higher fees are expected to lead to some market adjustments with guaranteed depositors offered lower interest rates, borrowers charged higher interest rates, and a decrease in the return to the firms' equity where the fee cannot be passed on to depositors or borrowers.

A lower fee structure is recommended for banks, credit unions and building societies compared to finance companies. This is because our present estimates of loss given default for finance companies in the current scheme are higher than for other institution types.

In determining the fees, some consideration has also been given to affordability issues for non-bank deposit takers although the primary consideration was to reduce economic distortions. While potentially viable in the long-run, some institutions may struggle to be viable in the short run as they adjust to the new prudential requirements and are subject to the more risk-based fees schedule.

Table 3: Proposed fee schedule

Credit rating	**Finance Companies (bpts)**	**Banks, Credit Unions, Building Societies, PSIS (bpts)**
AAA +/-	15	15
AA+	15	15
AA	15	15
AA-	20	15
A+	25	20
A	30	20
A-	40	20
BBB +	60	25
BBB	80	30
BBB-	100	40
BB+	120	50
BB	150	60

However, it is possible to have a higher fee schedule than what is proposed here. The proposed fee schedule is based on average market rates with a small risk premium, which is appropriate if affordability of the scheme is desired in order to allow the non-bank sector in particular, to adjust while under a guarantee. In 2012 it is likely that the market will still include a premium for risk that is higher than proposed here, especially at the lower credit ratings. That will mean that firms exiting the guarantee may face a significant difference in rates. The alternative is to raise the level of fees at the lower end of this scale. This will mean that fewer firms may opt into the scheme, fewer firms participate in the transition and some may choose to exit before the current DGS expires rather than lower their overall risk profile and pursue adjustment options.

[Withheld – protect commercial position

]

Institutional eligibility – minimum quality-based eligibility criteria for all institutions

Under the current DGS deposit taking institutions were eligible for the guarantee if they met general eligibility criteria. New entrants after a certain date were required to have a credit rating of BBB- or above to be eligible to join the scheme.[2] To be eligible for the wholesale funding guarantee facility (WFGF), consideration is currently to whether members that take deposits are members of the retail DGS.

The extended DGS would have a higher eligibility threshold than the current DGS by only being available to institutions covered by the current DGS which have a credit rating of BB or higher. The credit rating requirement may help provide impetus for consolidation, for entities to lift their credit rating and for credit unions to join the credit union cross-guarantee (private sector risk-sharing initiative). This means smaller and potentially more risky organizations will transition out of the guarantee more quickly. Also, once accepted into the extended DGS, institutions would not necessarily have the guarantee withdrawn solely due to a credit downgrade.[3]

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 recognize 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

[2] They must be in the business of borrowing and lending money, and carry on a substantial proportion of their business in New Zealand.
[3] Note that there is no exception for entities without a rating where as the Reserve Bank Act only requires NBDTs with liabilities over $20 million to have a credit rating by March 2010.

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.

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, it is recommended that CISs be excluded from the extended scheme.

Tighter eligibility criteria are proposed to help to meet the transitional objectives of the scheme. Credit ratings are simple and objective criteria. [Withheld – economically damaging

]

It is proposed that the scheme be voluntary for all institutions and that the link between use of the wholesale guarantee facility (WFGF) and participation in the DGS be discontinued under the extended DGS. [Withheld – protect commercial position

]

The Crown would have the discretion to allow new institutions into the scheme where it is a newly merged entity and its inclusion lowers Crown risk by improving the long-term viability of guaranteed institutions, or it is a newly registered bank.[4]

Depositor coverage cap – reduced and differential coverage for banks and NBDTs

The current DGS has a cap on eligible deposits of up to $1 million per depositor per eligible institution. This is relatively high by international standards.

The extended DGS proposes reducing coverage per depositor per institution to $250,000 for NBDTs and to $500,000 for banks. Reduced coverage signals the temporary and transitional nature of the DGS, reduces Crown contingent liability, and could reduce fiscal costs of any future default events (to the extent that depositors do no spread deposits across institutions). It also reduces NBDT reliance on a few large depositors, but balances these objectives against not setting the cap on NBDTs so low as to be likely to trigger failure. The higher cap for banks compared to NBDTs reflects the lower risk of banks due to the tighter prudential regime covering banks.

Management tools - improve ability to manage risks to the Crown under the guarantee

At present the current Crown deed setting out the terms of the retail guarantee has limited tools to control or effect change in the behaviour of guaranteed institutions. Existing powers include the ability to prevent or to require the entity to remedy particular transactions such as distributions, material non-commercial transactions and related party transactions, removal of the guarantee to limit potential future increases in the nominal exposure, and ensuring appropriate contingency plans are in place to respond effectively to a default. These limited tools and concessionary fee schedule have not adequately deterred growth in higher risk institutions; to date finance company

[4] A newly registered bank would eligible to apply for the transitional DGS as it is part of a stricter prudential regime, it is likely to be low risk, and would increase market competition. However, a newly registered bank is unlikely over this period.

growth of guaranteed deposits is about $880 million or 19%. [Withheld – free and frank advice].

Tools that provide additional options for the Crown to attempt to better manage the exposure under the DGS are needed. These include:

- More active management tools: Restricting undesirable asset acquisition and deposit growth by introducing a requirement to seek authorization with contractual penalties for non-compliance (such as withdrawal of guarantee or financial penalties). This will need to be carefully defined.

- Change of control authorization requirement: Where a firm is in wind-down under the guarantee, there is a risk of a buyer entering the market with the aim of using the guarantee to rapidly build a deposit book. An explicit power could be granted to authorize (or provide 'no objection' to) change of control under the guarantee, or else require re-application before change of control occurs. This could prevent firms being able to enter the market to exploit the guarantee.

These terms can also be introduced into the current guarantee deeds to have effect before October 2010.

Resolution tools – allow for a more orderly resolution of default events under the guarantee

In the current DGS, once the defined default event has occurred the guarantee must be paid out. The extended DGS proposes redefining trigger events for default so institutions entering statutory management would not necessarily be in default. This would mean the institution could potentially continue to trade to allow more time to consider resolution options. This change cannot be introduced into the current deed so will not be available prior to the extended DGS coming into affect.