THE TREASURY
Kaitohutohu Kaupapa Rawa

Treasury Report: Cabinet paper on extending the retail deposit guarantee scheme

Date:	31 July 2009	**Report No:**	T2009/1791

Action Sought

	Action Sought	Deadline
Minister of Finance (Hon Bill English)	**Read** the attached Cabinet Paper	Monday 3 August

Contact for Telephone Discussion (if required)

Name	Position	Telephone		1st Contact
Joanna Gordon	Manager	[Withheld – privacy]	[Withheld – privacy]	✓

Minister of Finance's Office Actions (if required)

Provide a copy of the report and attached paper to the Minister for his weekend reading.

Enclosure: Yes

31 July 2009

Treasury Report: Cabinet paper on extending the retail deposit guarantee scheme

Executive Summary

Policy decisions

1. The attached Cabinet paper seeks Cabinet's agreement to:

   - Extend the retail deposit guarantee scheme (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 not eligible).
     - 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.

2. The decision whether to extend the DGS until 31 December 2011 or proceed with the status quo of exiting in October 2010 is finely balanced. On balance it is recommended that the DGS is extended on revised terms in order to achieve a less disruptive and potentially less costly exit from the DGS. 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.

3. The proposals for policy changes to the retail deposit guarantee scheme 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.

Fee schedule

We have had a number of discussions with you and your office about the principles and details of the fee schedule that could apply during the DGS extension period. This report outlines the principles behind the proposed fee schedule, and how the schedule compares with historical and current market rates.

The fee schedule for the extended scheme would be paid on all guaranteed deposits. While the fee structure is not set on a fully commercial basis, the fee levels are set relative to the <u>risk of default</u> (based on credit ratings) and reflect the <u>likely loss given default</u> of the different types of non-bank deposit taker. Fees set on this basis would assist in reducing economic distortions, promoting economic adjustment during the extension period and ensuring that firms do not exit into an environment where they have significantly higher funding costs than under the DGS. Fees are not set so high as to make the Scheme unaffordable for firms which could trigger their default under the Scheme.

4. Current market spreads are considerably higher than this and historic numbers would have underpriced risk, at least during the middle part of this decade. Depending on how markets stabilise, it is possible that firms could exit into an environment where they have to pay higher rates to attract market funding than they do under the DGS. However, choosing fees substantially higher than historical rates could make the scheme unaffordable for some firms with fewer firms participating in the transition and firms defaulting under the current scheme.

5. 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 institutional types.

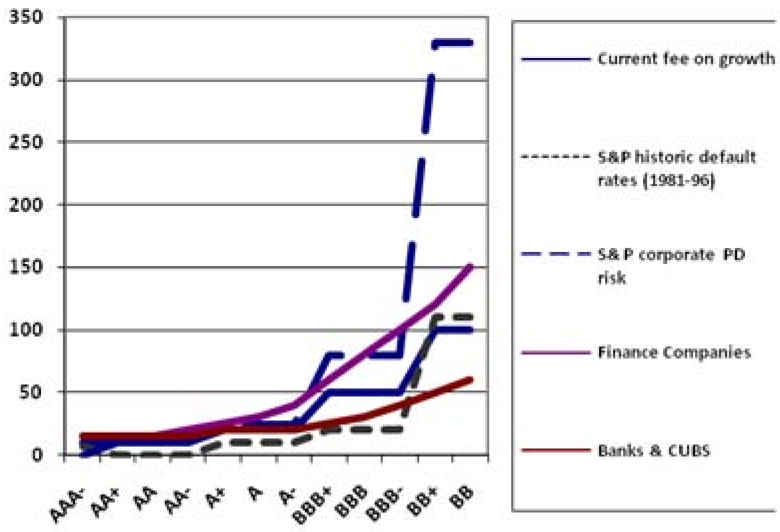
6. Table 1 summarises the proposed fee schedule and the historical and current market rates.

Table 1: Recommended fee schedule, historical and current market rates

	Recommended option		**Historical market rates**			**Current market rates**
Credit rating	**Finance Companies (bpts)**	**Banks, Credit Unions, Building Societies, PSIS (bpts)**	**B-bill minus T-Bill (**for AA at 20bp) scaled up based on current market prices for US financials	**10 year median option adjusted spreads**	**Historic US commercial rates (6 mths)**	**Current US commercial rates (6 mths)**
AAA +/-	15	15	20-30	50-60	30	140
AA +	15	15		60-70		
AA	15	15				
AA-	20	15				
A+	25	20	40-60	70-80	40	250
A	30	20				
A-	40	20				
BBB+	60	25	70-100	80-150	60	490
BBB	80	30				
BBB-	100	40				
BB+	120	50	120-150	-	100	630
BB	150	60				

7. As outlined in T2009/1589 (29 June 2009) previous estimates have also been based on historic credit rating default rates with fees for banks, building societies and credit unions being based on a much lower expected loss (refer Figure 1).

Figure 1: Recommended fees; historical and current default rates



8. We have suggested Cabinet agree to the design principles of the fee schedule, and delegate responsibility to you for setting the schedule. The principles articulated in the Cabinet paper are that fees will apply to all guaranteed deposits; 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.

Financial implications

9. There will be direct costs associated with the Treasury continuing to operate the DGS for the extension period. The current paper seeks Cabinet agreement to an estimated total $5.293 million additional direct operating costs, of which $0.755 million immediate costs will be absorbed from current DGS funding in 2009/10. The paper proposes the option of seeking in Vote Finance the additional funding of $4.538 million that is required over FY2010/11 and FY2011/12. [

Withheld – protect commercial position

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10. The option to seek additional funding in a 'ring-fenced' appropriation in Vote Finance is on the basis of:

- As part of the Vote Finance line by line review in February 2009 funding that was not forecast to be used by the guarantee schemes was returned ($3.2 million operating and $0.8 million capital expenditure).
- In Budget 2009 Vote Finance received additional funding for work on specific government priorities for current and out years. However this funding did not include operational costs of any extension or changes to the guarantee schemes.
- [Withheld – free and frank

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- Continued pressure on Vote Finance baselines to deliver on government priorities.

11. [Withheld – under active consideration

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12. [Withheld – under active consideration

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13. [Withheld – under active consideration

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Regulatory impact statement and timeline

14. A regulatory impact statement (RIS) is required to be submitted along with the Cabinet paper since this policy decision meets the economic significance test. RIAT's preliminary statement is as follows:

"A Regulatory Impact Statement (RIS) has been prepared for this proposal. Treasury's Regulatory Impact Analysis Team (RIAT) was provided with extremely limited time in which to review a near final RIS. The Regulatory Impact Analysis (RIA) was primarily provided to RIAT in the form of the draft RIS itself (i.e. there was limited separate documentation of analysis). In the very limited time available, RIAT has formed a *preliminary view* *that the RIA/RIS is not adequate for the following reasons:*

- *it is not clear the extent to which other regulations being put in place, and expected to come into force prior to the current scheme expiring, will address concerns related to non-bank deposit takers (e.g., prudential regulations and strengthening of the trustee supervision regime);*
- *the analytical framework appears disjointed between the initial rationale for intervention, the stated problem definition and the objectives against which options are assessed;*
- *alternative options have not been analysed against the stated objectives making it unclear what the qualitative and quantitative differences (impacts, risks, costs and benefits) are between the options; and*
- *there is no consideration of implementation issues, including what criteria will be applied to the suggested new powers and the extent to which they can be operationalised within the 14½ months.*

15. We will undertake further work on the RIS and provide you with the RIS, final adequacy statement and Cabinet paper for your signature by next Wednesday.

16. RIAT cannot prejudge the outcome of its final adequacy statement. However, they are of the view that the additional time will allow the Treasury to:
    - better reflect the regulatory impact analysis in the RIS;
    - allow RIAT sufficient time to undertake a robust adequacy assessment; and
    - provide us with an opportunity to remedy issues raised as part of RIAT's review.

17. Given that EGI is not sitting during the week of 10 August the Cabinet paper could be considered by CBC on 10 August. The below table outlines a possible timeframe.

Cabinet policy committee	Cabinet	Drafting and Bill of Rights checking	Cabinet Legislation Committee	Cabinet	Legislation introduced
CBC on 10 August	17 August	Week of 17 August	27 August	31 August	14 September

18. Please note that we will provide your office with a more detailed timeline of the policy, legislative and other processes later today.

Recommended Action

We recommend that you:

a **note** the Cabinet paper seeks Cabinet agreement to extend the retail deposit guarantee scheme on revised terms until 31 December 2011, in order to achieve a more orderly, and potentially less costly exit from the DGS;

b **note** that we have designed a fee schedule to reflect probability of default (based on credit ratings) and likely loss given default;

c **note** that agreement is sought from Cabinet to 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 the option of seeking additional funding of $4.538 million required over FY2010/11 and FY2011/12;

d [Withheld – free and frank]

e [Withheld – under active consideration];

f [Withheld – under active consideration];

g **note** a regulatory impact statement is required to be submitted along with the Cabinet paper since the policy decision meets the economic significance test;

h **note** that because of the timeframes available to review the regulatory impact statement (RIS) the Regulatory Impact Analysis Team (RIAT) has made a preliminary statement of the adequacy of the RIS, forming the view that the RIS is not adequate;

i **note** that we will be undertaking further work on the RIS and provide you with a revised RIS and final adequacy statement by next Wednesday; and

j **note** that a possible timeframe for progressing the Cabinet paper would be for it to be considered by CBC on 10 August and Cabinet on 17 August.

Joanna Gordon
Manager – Financial Markets and Institutions
for Secretary to the Treasury

Hon Bill English
Minister of Finance