RESERVE BANK OF NEW ZEALAND

THE TREASURY
Kaitohutohu Kaupapa Rawa

Treasury Report: Issues paper: Permanent arrangements after the retail deposit guarantee

Date:	Tuesday 2 June 2009	Report No:	T2009/1350

Action Sought

	Action Sought	Deadline
Minister of Finance (Hon Bill English)	**Read** prior to your meeting with the Prime Minister on the retail deposit guarantee scheme.	12.00-12.30pm, Wednesday 3 June 2009.

Contact for Telephone Discussion (if required)

Name	Position	Telephone		1st Contact
Joanna Gordon	Manager, Financial Markets and Institutions, Treasury	917 6939(wk)	[Withheld under s9(2)(a)]	✓
Toby Fiennes	Head of Prudential Supervision, RBNZ	471 3604 (wk)		

Minister of Finance's Office Actions (if required)

SPS to give directly to the Minister of Finance. Copy to Cat Moody, Bryan Dunne and Paul Dyer.

Enclosure: Yes

2 June 2009

Treasury Report: Issues paper: Permanent arrangements after the retail deposit guarantee

Executive Summary

At the financial system issues meeting on 13 May 2009 you expressed an interest in being exposed to our early thinking about permanent arrangements after the temporary retail deposit guarantee scheme expires. This report responds to that request.

Timing and announcement

It is our view that the case for permanent deposit insurance in New Zealand seems stronger than in the past (T2009/1049 refers). Given that deposit insurance would be a considerable change for New Zealand, we need time to thoroughly assess the case for deposit insurance and design options. Deposit insurance also needs to be considered as part of the wider system of financial sector regulation. There would also be benefits from letting international changes settle before committing to a scheme, including having a better understanding of planned arrangements in Australia (whose guarantee scheme expires one year after New Zealand's in October 2011).

Given these considerations, and that an announcement of future arrangements is required in the next month or so to provide markets with certainty, it is our view that it is not feasible or desirable to move to permanent arrangements directly following the end of the temporary scheme in October 2010. We recommend that the government extend the temporary deposit guarantee scheme for a year on tighter conditions, and announce the intention to consult publicly on permanent arrangements (be that deposit insurance, reverting back to no deposit insurance, or some other arrangements) later this year or early next year (T2009/1049 refers).

Preliminary analysis of permanent arrangements

This report provides you with our preliminary analysis of the issues that need to be considered when examining permanent arrangements. A summary is provided below. More detail is provided in the body of the report.

Overarching objectives: The primary objective is a sound and efficient financial system. This in turn will support economic growth. Another consideration the government may have is the fairness of outcomes from individuals' financial activities.

Existing approach: In order to promote financial stability and depositor confidence, countries have created financial 'safety nets' that include: prudential regulation and supervision; a lender of last resort; oversight of payment systems; and deposit insurance. New Zealand's past arrangements include all of these measures except for deposit insurance.

Problem definition and preliminary assessment of options:

- The **stronger implicit government guarantee** of banks is likely to have implications for financial sector stability (exacerbating "moral hazard"), efficiency (creating a wedge between institutions with and without an implicit guarantee), and fiscal costs (e.g. the government is providing a free good in the event of stepping in to support a bank).

- The sort of interventions that could address this problem are to reduce the likelihood of an institution failing (e.g. through prudential regulation, including capital requirements), retrenching the implicit guarantee (e.g. by credibly articulating a strategy for letting an institution fail), or making the guarantee explicit (e.g. by introducing a deposit insurance scheme).

- Deposit taking institutions are vulnerable to a **"run"**/ **contagion** which can lead to financial instability, and have consequences for the real economy (access to financial services, reducing asset prices, lending).

- The risk of a run on an otherwise sound financial institution could be reduced by promoting confidence in the financial system *ex ante* (e.g. through prudential regulation, or a deposit guarantee/ insurance) or by the government making a credible commitment to support an institution/s if there are signs of stress (e.g. making a credible commitment to support/ recapitalise a bank).

- By not articulating which institutions/ deposits are covered by the implicit guarantee the government has more discretion about its **crisis management response**. On the other hand it may lead to a greater expectation and pressure for government support than if the government articulated the boundaries of its interventions beforehand.

- **Information asymmetry** between financial institutions, depositors and regulators could result in depositors chasing higher returns, and investing in products that are riskier than their underlying risk preferences.

- The primary tool to address information asymmetry is disclosure standards. Financial literacy and standards for financial advisors may also assist depositors in making more informed choices. A deposit insurance regime could address information asymmetry problems for small depositors by removing their need to obtain and understand information about the risks of their investment decisions (beyond whether it is in the insurance scheme or not).

- "Looking different" from other countries in our approach to financial sector regulation may affect perceptions of New Zealand, competitiveness (positively or negatively), and some cross-border financial flows. **Internationally** there are likely to be changes to regulation as a result of post-crisis reviews, but the details of these changes are not yet clear. New Zealand will be the only country in the OECD without a permanent deposit insurance/ compensation scheme after Australia moves to its scheme when its blanket guarantee expires in October 2011. The OECD have suggested that New Zealand give consideration to introducing a well structured, self-financing retail deposit insurance scheme that minimises moral hazard.

- **Transition** from the temporary retail deposit guarantee scheme is a factor to take into account when considering permanent arrangements. However it is not discussed in this report as you have received separate reporting on this issue (e.g. T2009/1049 refers).

Recommended Action

We recommend that you:

a **note** that while Treasury and the RBNZ are yet to come to a view about the desirability or otherwise of introducing a permanent deposit insurance scheme in New Zealand, the case for considering deposit insurance seems more compelling than it has been in the past.

b **agree** to announce that the government will consult publicly about permanent arrangements either later this year or early next year. You could make this announcement alongside the announcement of the transitional retail deposit guarantee scheme.

Agree/disagree.

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

Toby Fiennes
Head of Prudential Supervision
Reserve Bank of New Zealand

Hon Bill English
Minister of Finance

Preliminary analysis of permanent arrangements

Overarching objectives

1. When assessing permanent arrangements, the primary objective is a sound and efficient financial system. This in turn will support economic growth. The Reserve Bank pursues these objectives by adopting an approach to prudential supervision that:

   - Encourages sound management of institutions by directors and managers.
   - Maintains clear minimum prudential standards for financial institutions.
   - In the event of major problems, seeks to minimise the impact of the problems on the wider economy, the financial system and on depositors or policyholders.
   - *Supports a* competitive and diverse financial system.
   - Does not seek to eliminate risk, but provides for risk levels to be well-signalled and for the risk of high-impact failures to be acceptably low.
   - Supports market participants' ability to make informed choices about risk.

2. Another possible consideration that the government may have is the fairness of outcomes from individuals' financial activities.[1] This could include for example:
   - Ensuring those who benefit from protection are the ones paying for it, as opposed to general tax payers. This could also be important from an efficiency point-of-view.
   - Protecting depositors from the loss of their deposits when deposit taking institutions fail; especially when they do not have the information or the ability to analyse the information to distinguish between higher and lower risk institutions.
   - Providing protection to depositors in similar institutions in a consistent manner over time.

Existing approach to financial sector regulation

3. In order to promote financial stability and depositor confidence, countries have created financial 'safety nets' that include: prudential regulation and supervision; a lender of last resort; oversight of payment systems; and deposit insurance. New Zealand's past arrangements include all of these measures except for deposit insurance.

4. The aim of the Reserve Bank's approach to prudential regulation of banks, non-bank deposit takers (NBDTs) and insurance companies is to harness and enhance market disciplines where possible and where this is not sufficient, tools that directly constrain market choices are used. It requires close collaboration between the key government agencies within New Zealand, as well as working closely with the Australian authorities in respect of the supervision of entities engaged in actively on both sides of the Tasman. The key elements are:
   - Financial and non-financial disclosure standards.
   - Minimum financial requirements in selected areas, including capital.
   - Rules around corporate governance, corporate structure and risk management.
   - Regular engagement with directors and senior managers of institutions with a potentially high impact on financial system stability.
   - An analytical and systematic approach to assessing risk in supervised financial institutions.

[1] "Fairness" objectives are largely beyond the RBNZ's statutory objectives.

5. The Reserve Bank has oversight of payment systems and relies heavily on moral suasion. However it does have powers to obtain and publish information about a payment system for the purposes of promoting a sound and efficient financial system.

6. Other agencies also play a key role including the Securities Commission, set up by the Securities Act 1978. The Commission's purpose is to strengthen investor confidence and foster capital investment in New Zealand by promoting efficiency, integrity, and cost effective regulation of our securities markets. The Treasury has a strong interest in financial sector regulation in terms of the wider implications for capital market development and economic growth.

7. During periods of stress additional tools may be used. These include the Reserve Bank acting as lender of last resort (e.g. by increasing access to liquidity facilities), or giving directions to a bank. In a crisis, a bank or NBDT can be placed under statutory management and the Government may elect to provide capital support to a 'distressed' financial institution.

8. New Zealand's financial regulation has undergone significant review and reform over the past 10 years. The Review of Financial Products and Providers is still underway. In 2008, the law was changed to strengthen regulation and oversight, particularly for NBDTs by introducing a registration system for financial service providers, an occupational licensing regime for financial advisers, and shifting responsibility for prudential regulation of NBDTs to the Reserve Bank.

Previous view about deposit insurance, and what has changed

9. In the past the Reserve Bank had explicitly not advocated a deposit insurance scheme. However Treasury and the Reserve Bank did begin a work program investigating the case for deposit insurance in New Zealand in mid-late 2008 (prior to the current guarantee schemes being introduced). The reasons why the Reserve Bank was of the view that deposit insurance would not be appropriate are that:
   - Deposit insurance schemes may not be effective in preventing a bank run.
   - Deposit insurance may weaken market discipline and exacerbate moral hazard risks.

   However, deposit insurance schemes can be designed to reduce these risks to the financial system.

10. The key factors that have changed that have caused us to reassess this position are that:
    - The introduction of the retail deposit guarantee scheme has reinforced the implicit government guarantee of systemically important banks (and also potentially non-systemically important banks).
    - There is now a tighter prudential regulatory regime being introduced for non-bank deposit takers that could be used to better manage the risks associated with deposit insurance in this sector.
    - We are now much more cognisant of the risk of runs on retail financial institutions.
    - Australia will be moving to introduce a deposit insurance scheme from October 2011. New Zealand will be the only country in the OECD without an explicit deposit insurance scheme.

Problem definition and preliminary assessment of options

11. This section identifies problems that may be hindering the achievement of a sound and efficient deposit taking sector. The assessment of permanent arrangements should be forward looking, rather than being overly focused on problems associated with transitioning from the temporary retail deposit guarantee scheme.

12. In our view, there is no need to fundamentally alter the approach to prudential regulation and supervision (described above). However, we have assessed current arrangement and noted some problems and options for improvement below.

Implicit government guarantee

13. In 2007 the Reserve Bank commissioned a survey of consumers regarding their understanding of the financial sector. The survey found that 60% expected the Government to bail out a bank in the event of a collapse. 13% were unsure or felt the bail-out would depend on the specific circumstances. 87% of under-30 year olds expected the Government to bail out a bank in the event of a collapse, indicating this level of expectation is likely to increase.

14. The introduction of the temporary blanket guarantee of retail deposits has probably increased the expectation that the government would step in to stop a New Zealand bank from failing. There is likely to still be some uncertainty about which banks the government would intervene to support (e.g. whether it would intervene to support a smaller bank). Whether and how the government intervenes could also depend on the timing and the circumstances of any potential bank failure. The finance company failures in 2007-2008 have indicated that the government is unlikely to step in to stop a finance company from failing, despite the decision being made to include non-bank deposit taking institutions in the retail deposit guarantee scheme.

15. The potential fiscal cost to the Government arising from the implicit guarantee depends on the probability of a bank/s becoming stressed and the size of the intervention that is required in the event a stress situation occurs, and the government intervenes. Excessive risk taking by financial institutions ("moral hazard") could potentially impact this. If banks feel they have an implicit government guarantee then they may select more risky albeit potentially more profitable portfolios, without having to pay higher interest rates to compensate depositors for the additional risk. Bank funders (depositors, wholesale funders) and shareholders would have less incentive to monitor the institution, and consider the riskiness of its investment decisions.

16. The implicit government guarantee could result in other economic inefficiencies, including:
    - The implicit guarantee provides an effective government subsidy for banks and bank depositors, which is not paid for by those who directly benefit, as it is funded from general taxation, and that depositors in other non-bank deposit taking institutions do not receive.
    - By creating a greater wedge between banks (with an implicit guarantee) and non-bank deposit taking institutions (without an implicit guarantee), this potentially creates a misallocation of resources, and a less diverse financial sector. It also potentially creates a bias against other forms of investment, such as equity investment and investment in managed funds, which could have implications for capital market development; and potentially perpetuate firms' reliance on debt rather than equity financing.
    - Stopping banks from failing could have negative impacts on the efficiency of the banking sector over time that we would expect to come from the "creative destruction" of unsound banks failing and new banks being formed.
    - By making the risk profile of different banks' deposit accounts more similar, the implicit guarantee potentially reduces customer choice. However, depositors do have a broader range of choices of financial services beyond the banking sector (e.g. government bonds).

17. The implicit guarantee may help to support depositor confidence in banks and reduce the likelihood of a run on the bank by retail depositors, other bank funders and shareholders.

Preliminary assessment of options to address problem

18. The Reserve Bank's prudential regulation and supervision framework serves to reduce the probability of default by a bank. Capital requirements are a key component, but the framework for banks also includes limits on related party lending, disclosure and governance requirements, and requirements relating to internal controls, risk management systems and outsourcing. In addition, the Reserve Bank is presently finalising liquidity requirements (e.g. requiring banks hold a minimum amount of liquid assets relative to liabilities) for banks. These requirements are generally conservative by international standards.

19. As a measure of conservatism, the Reserve Bank already applies overlays to its minimum capital requirements for banks on top of base international standards. However international standards for capital are evolving in response to the global financial crisis and the Reserve Bank plans to review its regulatory requirements for banks once international standards are settled. Given the current environment and potential future changes to international standards, the Reserve Bank has set expectations with banks that their capital holdings should be considerably more conservative than the "minimum requirement".

20. Prudential requirements for non bank deposit takers are presently being phased in. These are similar in nature to those that apply to banks, and the calibration of capital requirements has taken into account the likely strengthening of capital requirements for banks.

21. Capital requirements could be strengthened further to reduce the probability of default. However any such consideration would need to take into account:
    - Any flow on effects to credit availability and in turn the impact on the wider economy.
    - Significant discrepancies between the capital standards applying to New Zealand banks and their peers internationally, and the impact that this might have (for instance on funding availability).

22. In order to reduce the cost to Government in the case of a bank failure (loss given default) industry could be required to pay. Payment could be either ex ante (in the form of a fee) or ex post (via some kind of 'survivor pays' arrangements). Mechanisms for achieving this include something akin to the proposed more commercially based extension of the retail deposit guarantee scheme, or as a more permanent arrangement, such as a deposit insurance scheme, or a levy on banks. The case for deposit insurance has pros and cons. Potential 'cons' include increasing the cost of financial intermediation, entrenching moral hazard amongst retail depositors, the risk that the scheme is gamed/ lobbied over in ways detrimental to its objectives. The way it could be designed is also complex and needs further work. This work would include consideration of the impact of deposit insurance on the stability of the financial system, market discipline and financial market development. Consideration is also needed on what role deposit insurance would play in the broader context of the government's crisis management response.

23. Finally the size of the exposure faced by the Government could be limited. Within the context of the retail deposit guarantee scheme or a deposit insurance scheme this could be achieved by limiting coverage. Alternatively a retrenchment of the implicit guarantee could reduce the size of the Government's exposure. In order for such a retrenchment to be credible, at minimum, a clearly articulated failure resolution strategy would need to be developed and understood by the public. This strategy would need to address the various scenarios possible in the context of a trans-Tasman bank crisis. Overall, our preliminary view is that a retrenchment would be extremely difficult.

Bank run/ contagion

24. Deposit taking institutions are inherently fragile, because at any one time if all depositors/ funders wanted to withdraw their funds, then the institutions would become insolvent. A bank run is when reduced confidence in the soundness of a bank causes the withdrawal of retail deposits and/or wholesale funding. This could occur to otherwise sound institutions due to coordination failures amongst deposits (if other depositors are running on a bank, then it makes sense for a depositor to run as well). A bank run can lead to financial instability and have consequences for the real economy, for example by disrupting financial services, reducing asset values through "fire sales", and reducing the provision of credit in the economy.

25. The largest risk of a run on a bank in New Zealand is from large retail depositors and wholesale fund providers, rather than small retail depositors. However, the contagion effects of a retail bank run (depositors lining up outside the bank) may be greater than a wholesale bank run, which is less visible and, potentially, creates less panic.

26. Recent experience of small retail depositor behaviour in the light of finance company difficulties (prior to the retail deposit guarantee scheme, 2007-2008) has shown that this group of depositors can move their funds around relatively quickly. Depositors tended to move their funds to more sound institutions, and failures were largely contained amongst unsound institutions. However, as small retail depositors are not always well positioned to accurately interpret and receive timely information, it could initiate runs on financial institutions or classes of financial institutions that, in turn, destabilise and create a contagion effect among otherwise sound deposit taking institutions.

Preliminary assessment of options to address problem

27. Generally, the risk of bank runs can be reduced by directly reducing the probability of default of banks (through the existence of an appropriate prudential regulation and supervision framework such as that in place in New Zealand at present). Over the long run, as the public sees that failures are very rare, this helps to promote confidence in the financial system. However, a prudential supervision framework on its own may be insufficient to prevent a bank run when general market confidence has collapsed increasing volatility on the part of depositors in general. Other tools are probably required to deliver depositor confidence in these scenarios (e.g. crisis management tools).

28. The current roll-out of a prudential regime for non bank deposit takers may provide the basis for retail depositors to be more informed about their risks and more confident about the regulatory regime. The new regime could therefore reduce the risk of retail deposit runs.

29. Improved financial literacy and improvements to the quality of financial advisors could help depositors to distinguish between sound and unsound financial institutions, and reduce the likelihood of a run on a sound institution.

30. A government guarantee (such as the retail deposit guarantee scheme) is designed to strengthen confidence during a period of volatility. By its nature, such a guarantee is a 'crisis' tool established on an as-needed basis and intended as a temporary measure. In some cases, as we found in October 2008, the need for a guarantee scheme is precipitated not so much by a collapse in confidence in the financial system, but more as a counter measure to the competitive disadvantage and contagion risks brought on by the sudden introduction of similar guarantees in other jurisdictions (i.e. Australia in our case). However as such schemes expose the Crown to substantial fiscal risk and can create further moral hazard.

31. An alternative is for the Government to make a credible ex ante commitment to support a bank or to recapitalise a bank to prevent a run. We have yet to assess how effective this would be in terms of promoting confidence and reducing the risk of a bank run. However this option would lead to problems similar to those noted above in relation to the implicit guarantee (e.g. moral hazard problems).

32. Another alternative tool is deposit insurance. This could reduce the risk of retail depositors 'running' if these depositors had full confidence that the insurance would provide immediate and full payout of deposits. If the insurance coverage was clear and transparent, this would serve to reduce retail investors' uncertainty about which deposits are 'safe' and which are not. Deposit insurance would not directly address issues relating to the stability of corporate and wholesale funding. Also, as noted above, the case of deposit insurance is complex and we have yet to consider it fully.

Ad hoc crisis management response

33. The government may choose to respond to an isolated problem with a particular financial institution or to a systemic crisis by intervening to minimise the impact of the problems on the wider economy, the financial system, taxpayers and depositors. The Reserve Bank has tools to do this (refer to paragraph 6).

34. By not articulating which institutions and deposits are covered under the implicit guarantee, the government has more discretion about how they respond to potential bank failures. On the other hand, it may also lead to a greater expectation and pressure for government support than if the government articulated the boundaries of its interventions beforehand.

Preliminary assessment of options to address problem

35. The Treasury and the Reserve Bank undertakes crisis management preparedness work on an on-going basis, in discussion with the Australian authorities. This work is designed to pre-position ahead of an actual crisis and takes account of the crisis management powers and tools noted above.

36. The government may intervene ex ante to reduce the likelihood of a bank failing (e.g. through prudential regulation and supervision, including capital requirements), or to ensure systems are in place for a more orderly resolution of a failure.

37. In some cases, the presence of a deposit insurance system can influence crisis management strategies by setting parameters for resolving bank failures. The presence of deposit insurance does not however guarantee a more favourable outcome. For instance, in the presence of deposit insurance, a decision could be taken not to recapitalise a failed bank but to let it go into receivership/liquidation on the expectation that the maximum insurance payout will set a ceiling on the cost of failure resolution. However, if there are unexpected adverse systemic consequences of a bank failure than the strategy not to recapitalise could 'backfire' as the government potentially needs to intervene in an even more intrusive and costly manner in the interests of financial stability.

Information asymmetry

38. If some depositors do not have the information or the ability to distinguish between higher and lower risk institutions, they may tend to chase higher returns, and invest in products that are riskier than their underlying preferences. This will tend to create inefficiencies as capital is not allocated in line with underlying risk preferences.

39. When institutions fail, there may be a greater case to protect depositors from the loss of their deposits when they do not have the information or the ability to analyse the

information to distinguish between higher and lower risk institutions. However, it would be difficult to distinguish between informed and uninformed depositors.

Preliminary assessment of options to address problem

40. The principal tool for addressing information asymmetry between the depositor and financial institutions are disclosure standards. The information asymmetry between the Reserve Bank and financial institutions is also addressed via public disclosures as well as through the provision of additional prudential information as required. These arrangements generally work well, although small depositors can be disadvantaged if they cannot fully comprehend publicly disclosed information or be in a position to receive and act on it quickly.

41. A review of bank disclosure standards is already underway and will take account of information asymmetries. Non-bank deposit taker disclosure requirements centre on the publication of credit ratings (accompanied by a public communications strategy). While credit ratings will improve the information available to depositors; survey evidence suggests that there is a low level awareness of the meaning of credit ratings amongst depositors. This regime is just now being implemented (i.e. it is untested) and because of this our view is that it should not be re-examined at this point.

42. An appropriately designed deposit insurance scheme could address small depositor information asymmetry problems, by effectively removing the need for these depositors to obtain and understand information about the risks of their financial institution. However, this may also reduce the incentives for depositors to become financially literate.

43. There are also various initiatives underway to improve financial literacy. However improving financial literacy is a long-term game.

International connections

44. Looking “different” from other countries may increase the information costs of doing business with New Zealand. It could also impact on the competitiveness, perceptions of New Zealand internationally and cross-border financial flows.

Preliminary assessment of options to address problem

45. New Zealand’s prudential regulation and supervision framework is broadly consistent with international standards. As post-crisis reviews are undertaken internationally, there is likely to be broader changes to prudential regulations that are proposed. The Reserve Bank plans to continue to align broadly with international standards as they evolve in response to the financial crisis, although an assessment will need to be made about these changes, as changes internationally become more clear.

46. However, the absence of deposit insurance has been a point of difference between both New Zealand and Australia, and many other similar countries.

47. Once the Australian government guarantee is lifted in October 2011, a deposit insurance arrangement will be put into place. If New Zealand does not choose to introduce a deposit insurance scheme, New Zealand will be the only country in the OECD without one. It is possible that this could result in Australian financial institutions attracting retail funds at the expense of New Zealand financial institutions. Deposit insurance in New Zealand could help prevent this flow.

Next steps

48. We consider that consultation on options for new permanent arrangements could take place as early as October 2009; and recommend that you announce publicly that consultation will occur either later this year or early next year (to provide some flexibility over timing).

49. The timeline below assumes a one year extension of the retail deposit guarantee scheme (to October 2011), and allows for the possibility that legislation is required to implement permanent arrangements. This timetable allows:

- About three months for policy analysis (which may be ambitious if a full deposit insurance regime is to be developed)
- About three months for the consultation process.
- Six months for the select committee process of any legislative requirements.
- Around 14 months between enactment of any legislative requirements and implementation. This period is allowed in order to reduce a build up on uncertainty and resource misallocation during the final 12-14 months of the extension.

June to September 2009	October to December 2009	January 2010	February 2010	August 2010	October 2011
Policy development	Consultation period	Cabinet decision on permanent arrangements	Legislation on permanent arrangements introduced (if any)	Legislation on permanent arrangements enacted	Extended retail deposit guarantee scheme ends
			Institutions to support the new regime are designed and implemented		