

## Treasury Report: Guarantees to the Banking Sector - when might these be considered?

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### Action Sought

	Action Sought	Deadline
Minister of Finance (Hon Bill English)	<b>Indicate</b> if you wish to discuss with officials.	Thursday 21 June

### Contact for Telephone Discussion (if required)

Name	Position	Telephone	1st Contact
Nick McNabb	Senior Analyst, Financial Markets, Treasury	917 6964 (wk)	[Withheld under s.9(2)(a)] ✓
John Park	Manager, Deposit Guarantee Schemes, Treasury	917 8252 (wk)	
Bernard Hodgetts	Head, Macro-Financial Stability, Reserve Bank	471 3781 (wk)	

### Minister of Finance's Office Actions (if required)

None.
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**Enclosure: No**

## **Treasury Report: Guarantees to the Banking Sector - when might these be considered?**

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### **Executive Summary**

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The continued volatility and uncertainty around Greece raises the question of whether banking sector guarantees may again be rolled out around the world and required in New Zealand. While we cannot rule out circumstances emerging where either wholesale or retail guarantees might be considered, the differing context this time around means we see this as unlikely.

The key things that differentiate the context this time around from 2008 are:

- Sovereign balance sheets are much weaker, meaning there is likely to be greater reluctance to move quickly to issue wide-ranging guarantees. Also many extended guarantees remain in place, so room to extend even further may be limited. A key driver of the 2008 retail deposit guarantee in New Zealand was a concern that the introduction of a retail guarantee in Australia would lead to a flight of deposits to Australia. Given that we now know that any Australian scheme is likely to be limited to Australian dollar deposits, there will be costs to New Zealanders taking advantage of the Australian scheme, which reduces the risk of deposits moving to Australia.
- The domestic context is more robust than 2008 – the prudential regulation net is broader, reaching to the NBDT sector, and banks' capital and liquidity positions are stronger. Also, depositor confidence is likely to be less fragile, given that we are not in the immediate aftermath of repeated high profile finance company failures.

New Zealand's direct and immediate exposure to a worsening situation in Europe will likely be related to banks' access to offshore funding markets. Mitigating this is that our banks are now more resilient than in 2008. They are less reliant on shorter term sources of funding, meaning they could ride out a longer period of funding market closure. If markets were to remain closed for a prolonged period, or short term markets also seized up, the Reserve Bank and Government have a number of options to address potential liquidity pressures. Reserve Bank funding would be the first line of defence, but in an extreme disruption there could be value in complementing this with a targeted wholesale guarantee. But we do not see there being immediate need to introduce these measures.

While we think it unlikely that a loss of depositor confidence will emerge as a result of current volatility, there are some key indicators that would help the RBNZ get early warning of an issue emerging. These include outflows of cash from the banking system or unusual activity in the Reserve Bank's open market operations. In a troubled environment the Reserve Bank would likely increase the frequency of bank liquidity reporting from monthly to at least weekly.

If a loss of depositor confidence did lead to retail guarantees being required, lessons learned from the RDGS about how to best safeguard the Crown's interests would be picked up in design. These would include tighter eligibility criteria, more control mechanisms for the Crown and full risk-based pricing. We would also consider the option of introducing a retail guarantee through legislation in order to further strengthen the controls that could be achieved.

We recommend that any public comment emphasise the differences in context between 2008 and now, and the relative strength of our banking system compared to those under stress in Europe.

## Recommended Action

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We recommend that you:

- a **note** that we cannot rule out circumstances emerging where either wholesale or retail guarantees might be considered, but that the differing context this time around means we see this as unlikely.
- b **indicate** if you wish to discuss with officials.

*Yes/No*

John Park  
**Deposit Guarantee Schemes, Treasury**

Bernard Hodgetts  
**Reserve Bank of New Zealand**

Hon Bill English  
**Minister of Finance**

## Treasury Report: Guarantees to the Banking Sector - when might these be considered?

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### Purpose of Report

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1. This report considers the circumstances under which Treasury, in consultation with the Reserve Bank, would consider banking sector guarantees in response to further deterioration of financial market conditions in Europe.

### Analysis

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#### How are things different now from the situation in 2008?

##### *The external context is different this time....*

2. New Zealand's direct and immediate exposure to a worsening situation in Europe would likely be limited to deteriorating access to wholesale funding markets. Any wider impact on the domestic economy is likely to be through second order effects, such as a slowdown in growth across key trading partners and reduced demand for New Zealand's exports, and is likely to emerge on a more protracted timescale. An early indication of this may be falls in commodity prices, such as through Fonterra dairy auctions.
3. Even if wholesale funding markets tighten, the nature of the emerging crisis in Europe is different from the crisis of 2008. Then, widespread counterparty distrust resulting from the unwinding of complex financial positions contributed to significant liquidity pressure. The current difficulties in Europe, on the other hand, are largely centred on the financial weakness of sovereigns in addition to the financial sector.
4. The financial sector in New Zealand is less complex and more creditworthy than those in other countries. For example, just one of the 100 largest global banking groups (Rabobank) has a higher credit rating than the 4 major Australasian banks. In addition, while our sovereign position is weaker than it was in 2008, it is much stronger than those of many advanced economies. New Zealand remains among the world's highest 20 rated sovereigns

##### *...Australasian Banks are in a healthier position....*

5. Our banking sector is more resilient to external shocks now than it was in 2008. In response to their own experiences during 2008, and the introduction of the Reserve Bank's Core Funding Ratio, banks now rely much less on shorter term sources of funding. More than 80% of banks' funding now comes from long-term wholesale sources and retail deposits (compared to 65% in 2008). In addition, under new mismatch rules, banks must now hold sufficient liquid assets (such as government securities) to meet net outflows for one-week and one-month periods of distress. Australian parent banks also face similar requirements in their home jurisdiction, and could provide support if the problem was contained to NZ.<sup>1</sup>
6. Banks hold more capital than before the financial crisis giving them greater capacity to absorb losses. This is on top of the Reserve Bank's traditionally conservative approach

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<sup>1</sup> Australian banks do face a limit on lending to the New Zealand subsidiary, although this could be raised in a period of distress. [Withheld under s.6(b)(i)]

to calculating capital ratios, and has enabled the Reserve Bank to propose accelerating the implementation of the new Basel III capital standards.

7. The situation in 2008 was also complicated by a run of 46 finance company failures between May 2006 and August 2008, which had a negative impact on the financial system. The non-bank deposit market is now significantly smaller and regulated by the Reserve Bank. Finance companies and other NBDTs must now meet capital requirements and obtain a credit rating.
8. These factors, combined with recent trends of relatively low credit growth and increased domestic saving, lead us to believe that banks would be able to ride out periods of distress in term funding markets.

***.... and we are less likely to see a wave of guarantees***

9. In 2008, as problems emerged in the banking sector, sovereigns moved quickly to introduce or extend existing guarantees to the banking sector, acting as a catalyst for Australia and New Zealand to do the same. Given the weakness of many European sovereigns, similar action will be less credible now and is less likely to be part of the solution. Moreover, many countries have not retrenched the extensions to guarantees put in place in 2008. In the UK deposits of up to £85,000 remain fully insured, compared with 100% coverage of the first £2,000 and 90% coverage of another £33,000 which was insufficient to prevent the Northern Rock retail run. For these reasons we are unlikely to see a wave of new or further-extended guarantees.
10. Although a wave of guarantees is unlikely, some changes to guarantee arrangements are possible. There is growing consideration of Europe-wide banking union and guarantee, but this is only likely to be effective in controlling bank runs in the most troubled countries if repayment is guaranteed in Euros even if the country exits the Euro. But this sort of guarantee seems unlikely to be granted by the core European countries. There is also a possibility that, should there be a disintegration of the Euro, more creditworthy countries such as the UK, US, Germany and Australia would extend their existing national guarantees.
11. However, New Zealand does remain an outlier compared to other countries in not having deposit insurance. This increases the risk of a retail bank run should there be a significant loss in depositor confidence – a risk we regard as remote at present. We believe, however, that domestic confidence, and not the presence of schemes in other countries, should be the main factor when considering any re-introduction of a retail deposit guarantee. It is more complicated for New Zealand deposits to run than it is for (for example) Spanish deposits to migrate to Germany. For example, Australia has now reduced the limit of its deposit insurance scheme from \$1m to \$250,000 and does not cover foreign currency accounts (which were covered in 2008). New Zealand depositor's would face a higher hurdle if trying to benefit from the Australian scheme, as they would be exposed to full exchange rate risks and transactions costs of opening and operating a foreign account.

**How could New Zealand be affected and how might guarantees be applied?**

12. The key risk facing New Zealand's banks is that they may be unable to access wholesale funding markets. While this is not an immediate problem, continuing dysfunction in Europe or a potential disintegration of the Euro could heighten risks substantially.
13. Given that our banking sector is stronger and more resilient than it was in 2008, we believe that banks would be able to ride out a period of non-access to term markets lasting several months. In addition, there would be a number of different options that could be used to maintain liquidity and confidence in the market. Without a

corresponding loss in domestic confidence, problems in wholesale markets should not affect retail depositors.

14. We consider a number of different scenarios below, and outline the range of responses available and how guarantees might fit within that.

#### ***Access to long term funding markets closed for a prolonged period***

15. Given high levels of core funding, banks would be able to ride out the closure of offshore long term markets for several months. Also, the market for covered bonds may remain open as it did in late 2011 (although one bank is already close to the 10% limit). If banks were closed out of the markets beyond this, they would risk falling below the minimum required level of Core Funding. This by itself might not be of major concern, because core funding would still be substantially higher than in 2008, and one of the reasons for requiring higher core funding is to create a buffer that can be used during times of prolonged market stress. In addition, the Government and Reserve Bank would have a number of further options including:

- Term Auction Facility (term funding from the Reserve Bank)
- Allowing banks to use the buffer inherent in the core funding requirement
- Increase covered bonds limit<sup>2</sup>
- Wholesale guarantee of individual term funding issues

16. Given the set of available options (which is wider than 2008), there would be no immediate need for New Zealand to implement a wholesale guarantee.

#### ***Short term markets close***

17. If, as in 2008, access to short term markets were closed or limited to overnight funding, the Reserve Bank could step in to provide liquidity to the banking system. Liquidity would be secured against residential mortgage backed securities. This would help to maintain a minimum level of liquidity in the market to support and maintain confidence. In 2008 the measures introduced included broader eligibility requirements for collateral (RMBS), the Term Auction Facility to provide long term funding to the banking system, and introduction of an additional OMO auction window to support corporate debt market liquidity. While some of these measures took time to get up and running in 2008, they could be reactivated within days if needed this time round.
18. A wholesale guarantee could be considered if banks became over-reliant on central bank liquidity. Such over-reliance may provide a negative signalling effect of bank strength, and it may look better if banks are able to choose between term funding from RNBZ and from the market under a guarantee. Supporting banks to seek funding in international markets would also support the NZD, particularly where it has fallen significantly. If we were to consider a wholesale guarantee, this could be based on the one designed in 2008 which operated fairly well and could be introduced quickly. Even under this scenario where short term markets seize, there would be no immediate urgency to consider a wholesale guarantee and we would have time to consider the full range of options<sup>3</sup>.

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<sup>2</sup> The Australian limit on covered bonds applies at the group level, so may prevent the NZ subsidiary from taking advantage of the higher limit were to be increased.

<sup>3</sup> These events may also impact on the DMO's ability to finance government debt operations; though there are a number of options (such as the issue of foreign currency bonds to tap a larger investor base) that might be deployable should credit conditions for the sovereign deteriorate.

### **Higher hurdle for a retail guarantee**

19. A retail guarantee would have no material influence on banks access to offshore funding markets, and so would not be considered where access issues are limited to wholesale markets. If depositors were to become concerned, reassurances from the Reserve Bank and Government about the relative strength of our banks and maintaining liquidity to the system may be sufficient to address their fears.

20. [Withheld under s.9(2)(d)]


21.

22. Although a run could gain speed fairly quickly, there are some key indicators that we would look for to detect any emerging trends and risks. A sizeable outflow of deposits from the banking system into cash could be detected within a few days. If the run was across the banking system, the drain to cash would probably be apparent before any queues outside particular branches (unlike in the Northern Rock example, where the run was on a small part of the system). In the event of a run from the banks into cash or foreign assets, unusual activity would be visible in short term markets, including the Reserve Bank's open market operations and settlement cash system. This would lead to discussions with contacts at the banks that would reveal the underlying outflow, if the banks had not already brought it to the attention of the Reserve Bank. Slower outflows of deposits could be detected in the monthly liquidity reporting that banks provide to the Reserve Bank. It is quite likely that in a troubled environment, the Reserve Bank would already have requested higher frequency (e.g. weekly) liquidity reporting which would reveal any issues sooner.

23. If we were to consider introducing a retail guarantee, any scheme would be likely to be tougher than the one introduced in 2008. We would look to strengthen the nature of the government's controls over entities within the scheme, and consider full risk based pricing. If we did need to introduce the scheme quickly we would look to take greater advantage of the announcement effect and take more time to determine the detail. Following announcement of the DGS in 2008 it took several days before the first entities were brought into the scheme (and months for some), but the announcement had the effect of calming markets in a much shorter timescale. Australia also waited a week after announcement before it provided the details of its retail guarantee scheme. This announcement effect would also provide the option to introduce additional measures to strengthen the effectiveness of the guarantee via legislation. Governance of any future retail deposit guarantee scheme would be carefully considered from the outset.

24. [Withheld under s.9(2)(d)]

[Withheld under s.9(2)(d)]



## Annex: Suggested talking points

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25. If there is increasing public interest or emerging concern around the strength of the banking sector as a result of continued volatility in Europe, you may wish to use the following talking points:

- **Our financial sector is sound and under no immediate threat from events in Europe.** The government is closely monitoring events in Europe, and New Zealand's financial sector is now well equipped to respond.
- **Our banking sector handled events well in 2008 and is now in better shape than it was in 2008.** Our banks are more capitalised, more stringently regulated, and less reliant on short-term funding than during the GFC in 2008. Additional steps, such as the introduction of legislation around covered bonds, will help banks better manage their funding needs in the event of a worsening situation in Europe.
- **KiwiSaver funds are not immune to global events, but these are medium to long term investments.** Investors should be looking through short term fluctuations and hold a medium to long term view. In addition, investors have a choice between conservative, medium or growth funds depending on their tolerance for risk given current conditions.
- **Our non-bank deposit taking institutions are better regulated.** Non-bank deposit takers are now regulated by the Reserve Bank, required to have credit ratings, and to hold appropriate levels of capital.
- **This does not mean we face no risk.** New Zealand remains vulnerable to second-order effects from Europe through our trading partners, as we have outlined in our Budget 2012 economic forecasts.
- **Should financial sector pressures emerge, there are a number of policy options available to address them.** As in 2008, the Government and Reserve Bank can respond to events in a number of ways to ensure that confidence in our financial markets is maintained.
- **There is no need for government to guarantee deposits.** Our banks are well placed to deal with potential disruptions in funding markets, and are less reliant on short term funding. They are better prepared than they were in 2008 to respond to shocks generally.

### **If pressed on government guarantee of deposits**

- **A government guarantee of deposits might be considered in extraordinary circumstances, but if it were, the terms would be significantly tougher than last time.** Although a remote possibility, if a guarantee were needed it would incorporate much tougher oversight and controls over entities than 2008, including full risk based pricing.