

**Joint Report: Retail Deposit Guarantee Scheme – Further Issues
on Pricing and Coverage**

Date:	21 October 2008	Report No:	T2008/2051
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Action Sought

	Action Sought	Deadline
Minister of Finance (Hon Dr Michael Cullen)	Agree to recommendations	9am Wednesday 22 October 2008

Contact for Telephone Discussion (if required)

Name	Position	Telephone		1st Contact
John Whitehead	Secretary to the Treasury	<i>[deleted - privacy]</i>	<i>[deleted - privacy, OIA ss(2)(a)]</i>	✓
Alan Bollard	Governor, Reserve Bank of New Zealand		<i>[deleted - privacy, OIA ss(2)(a)]</i>	

Minister of Finance's Office Actions (if required)

None.

Enclosure: Yes

Treasury Report: Retail Deposit Guarantee Scheme – Further Issues on Pricing and Coverage

Summary

On 12 October 2008 you announced the government's decision to offer a two year Crown guarantee of retail deposits in eligible financial institutions on an opt-in basis. The objective of the scheme is to ensure ongoing retail depositor confidence in New Zealand's financial system given the international financial market turbulence.

In order to achieve this objective, the retail deposit guarantee scheme seeks to engender depositor confidence while continuing to ensure the efficient functioning of New Zealand financial markets. In pursuing these objectives, a number of issues have arisen around pricing of the scheme and its coverage which we would like to bring to your attention.

The nature and extent of these concerns has led us to look again at the coverage of the scheme and the pricing arrangements for the scheme as they currently stand. We understand that our Australian counterparts are also reconsidering a number of these design issues as they work through the implementation of their retail and wholesale schemes.

The issues relating to coverage of the scheme primarily relate to the boundary between what is retail and what is wholesale, as well as ensuring that the retail scheme continues to cover those it is primarily intended to cover (that is retail depositors in what are essentially bank-like transactions). Fund managers are concerned that their claims on guaranteed institutions are not covered unless held in vehicles invested solely in guaranteed paper. While we are not proposing to change the current coverage of the scheme, in the absence of a wholesale guarantee scheme, these issues are likely to be hotly pursued by those affected.

Providers of trustee and nominee services have raised concerns that deposits held by them as a bare trustee, (that is, where they are holding funds on behalf of other persons and have no discretion over the investment of the securities and no beneficial interest in them), would be excluded from the guarantee as a result of the exclusion for deposits held by financial institutions. We consider that funds held by such providers on bare trust do not come within the definition of financial institution in the Reserve Bank Act and consequently will be covered by the guarantee, provided that the bare trustee can demonstrate that the beneficiary of the bare trust comes within the ambit of the guarantee.

We are also aware of potential avenues for wholesale funding (whether deposits or securities) to get coverage under the deposit guarantee scheme. This is an issue that our counterparts in Australia are also addressing, particularly as there are likely to be justifiable and necessary pricing differentials between retail and any wholesale arrangements. We propose that a cap of \$1 million on deposits be placed on coverage per depositor per covered eligible institution in order to separate substantially retail from wholesale deposits. Caps of these dimensions, which can be claimed at several different institutions, should be ample to cover all reasonable needs of the household sector and, for example, working capital balances of even medium-sized businesses. Larger amounts could be dealt with under an explicit wholesale scheme if desired.

This report also outlines options for refinements to the scheme's pricing to mitigate the risk of material distortions to investor behaviour and incentives and choice among institutions over the life of the guarantee, while still ensuring that coverage remains affordable.

Specifically, we propose that pricing be refined to provide that risk-based fees be charged on the net new business of those registered banks and non-bank deposit takers covered by the guarantee that are not already subject to a fee charge. In addition to current provisions, this would mean that for entities whose covered liabilities are under \$5 billion, we propose fees of:

- 10 basis points per annum to institutions rated AA minus and above;
- 20 basis points per annum to institutions rated A+, A and A minus
- 50 basis points per annum to institutions rated BBB+, BBB and BBB minus; and
- 100 basis points per annum to institutions rated BB+ and BB;

on the cumulative growth in the book since 12 October 2008 with an allowance of plus 10 percent per year on this amount. Growth would be measured, and charged for, monthly.

As noted in our paper on 15 October 2008, the Reserve Bank is planning to move quickly on aspects of regulating the non-bank deposit taking sector. This is another means of managing the Crown's risks in the non-bank sector which has only just had legislation passed to bring in a prudential regulation regime. The Reserve Bank has identified regulations for minimum capital ratios and limits on related party exposures as the best option for bringing forward prudential requirements that would impose a measure of prudential discipline on non-bank deposit takers and is currently assessing what may be feasibly introduced within the next three or so months.

Recommended Action

We recommend that you:

- a **agree** to a cap on the size of deposit that is covered by the guarantee of \$1 million per depositor per guaranteed institution ;

Agree/disagree.

- b **agree** to introduce fees **for the new business component** of registered banks and non-bank deposit takers that are not already subject to a fee charge as follows:

For entities whose covered liabilities are under \$5 billion:

- 10 basis points per annum to institutions rated AA minus and above;
- 20 basis points per annum to institutions rated A+, A and A minus
- 50 basis points per annum to institutions rated BBB+, BBB and BBB minus; and
- 100 basis points per annum to institutions rated BB+ and BB;

on the cumulative growth in the book since 12 October 2008 with an allowance of plus 10 percent per year on this amount. Growth would be measured, and charged for, monthly.

Agree/disagree.

- c **agree** that as an incentive for institutions who are unrated as at 12 October 2008 to become rated BB and above, if a rating of BB and above is achieved during the term of the retail guarantee scheme, the institution will be eligible for a rebate to 100bps;

Agree/disagree.

- d **note** that collective investment schemes eligible for coverage under the guarantee scheme will not be charged a fee as this would, in effect, be double charging for these entities who are only covered if they are investing in government securities or liabilities of an institution itself covered by the guarantee (and hence already subject to the pricing regime);

- e **note** that, as an additional means of managing the risks in the non-bank deposit taking sector, the Reserve Bank is investigating options that will, if feasible, bring forward prudential requirements that would impose a measure of prudential discipline on non-bank deposit takers;

- f **note** that deposits held by a provider of trustee or nominee services as a bare trustee on behalf of a person who themselves comes within the ambit of the guarantee, will come within the scope of the guarantee and this will be clarified in the contractual agreements.

- g **refer** this report to the Prime Minister.

Agree/disagree.

John Whitehead
Secretary to the Treasury

Dr Alan Bollard
Governor, Reserve Bank of New Zealand

Hon Dr Michael Cullen
Minister of Finance

JointReport: Retail Deposit Guarantee Scheme – Further Issues on Pricing and Coverage

Background

1. The announced retail deposit guarantee scheme has the following coverage and pricing structure.

Coverage

Eligible institutions

2. Eligible institutions are:
 - New Zealand-registered banks including unincorporated New Zealand branches of overseas banks;
 - Non-bank deposit-taking entities (including building societies, credit unions and deposit-taking finance companies) who are fully compliant with the requirements of their trust deeds; and
 - Collective investment schemes (CISs, of which Portfolio Investment Entities [PIEs], super schemes, managed funds and unit trusts are subclasses) that invest solely in the debt securities of the New Zealand government or institutions subject to a government guarantee.
3. New entrants to the Scheme are required to be BBB- rated or better in order to be eligible to apply for coverage under the scheme.

Deposits covered

4. The Scheme protects those defined creditors who hold debt securities issued by businesses who receive a guarantee. It includes deposits, term deposits, current accounts, bonds, bank bills and debentures
5. It does not include interests in superannuation schemes, unit trusts, shares or similar instruments where the income from the investment is shared, except for cash PIEs.
6. The Scheme covers the following deposits:
 - New Zealand incorporated registered banks (which includes incorporated branches of overseas banks), including deposits from both residents or non-residents;
 - Unincorporated branches of overseas banks, non-residents deposits as at 12 October 2008 , to reduce the likelihood that these depositors will leave these branches for guarantee covered institutions;
 - For non-bank deposit takers, deposits of New Zealand citizens and New Zealand tax residents will be covered.

- For Collective Investment Schemes, investments must be held either in NZ government securities or debt securities held by guaranteed institutions. To manage the risk of funds flowing to government guaranteed higher-risk non banks any guaranteed CIS that extends its exposure to a guaranteed non-bank entity beyond 12 October levels will invalidate its guarantee.

Depositors covered

7. The scheme covers the debt securities held by any person, subject to specific exclusions for debt securities held by a related party, or by a financial institution as defined in the Reserve Bank of New Zealand Act 1989.

Pricing

8. For covered liabilities in excess of \$5 billion a fee of 10 basis points per annum will be charged for the guarantee. The fee will be charged on the basis of the total covered liabilities, in excess of \$5 billion of the institution. For non-rated non-bank deposit takers, a fee of 300 basis points per annum will be charged monthly on growth in the deposit book.
9. Deposit liabilities will be covered regardless of the currency in which they are denominated. Deposits and other liabilities owed to financial institutions, whether in New Zealand or offshore, are explicitly excluded from this guarantee.

Feedback on the pricing and coverage of the scheme

10. Significant concerns have been raised about the effects of the current pricing and coverage of the retail guarantee deposit scheme.
11. We are hearing considerable concern from banks and others that the current pricing structure of the scheme will lead to significant distortions in depositor choices away from less risky investments to riskier ones in the non-bank deposit taking sector that are not subject to any fees. This raises efficiency concerns as well as increasing the risks to the Crown.
12. We have also become aware of the potential for significant opportunist behaviour that would bring considerable amounts of wholesale deposits into coverage of the retail deposit scheme.
13. From information coming into the Reserve Bank from the industry over the past week, it is clear that a number of generic coverage issues are being raised about the guarantee scheme. These relate to the effects upon:
 - Issuers of corporate debt

Issuers of corporate debt are concerned that the scheme, as designed, would lead to the corporate commercial paper (CP) market in New Zealand closing. This is because the usual investors in commercial paper may seek to place their investments in institutions that are covered by the retail deposit guarantee instead. Not including fund managers in the scheme would also, in their view, reduce liquidity in the CP market or cause an unsustainable increase in CP rates.

- Fund managers

Fund managers have been concerned that their holdings of claims on guaranteed financial institutions are not covered by the scheme (unless held in vehicles investing exclusively in New Zealand government debt securities or institutions subject to the government guarantee). While they accept that they can restructure funds to offer cash PIE type protections through the scheme, this would take time and they believe that they would lose customers in the interim. They are concerned that balanced portfolios are not protected to the extent of their holdings in banks paper.

Fund managers would prefer the scheme to look through the entity holding the funds to the ultimate beneficiary and ensure that that beneficiary is covered if it is not a financial institution.

Fund managers and brokers have indicated that they are prepared to seek coverage under the Australian scheme if they are not covered in New Zealand. However, as the details of Australian scheme coverage are still unclear, it is not clear whether they would be eligible for coverage in Australia.

- Trustee and nominee services

These providers have been concerned that deposits held by a trustee company, nominee company or custodian as a bare trustee, (that is, where they are holding funds on behalf of other persons and have no discretion over the securities held and no beneficial interest in them), would be excluded from the guarantee. These providers have proposed a number of definition changes to bring such services under the coverage of the guarantee scheme.

- Large unrated non-bank deposit takers.

While some of the feedback received on the 300bp charge on the growth in the book of institutions rated below BB and non-rated has been favourable (including by some of those who will be covered), larger non-bank institutions consider the charge to be too high.

Those institutions working toward a rating by March 2010 (as required by the Reserve Bank Amendment Act) are concerned about the implications for their business processes of the incentive provided by the pricing structure to bring forward the need to be rated and, in particular, to try to obtain an investment grade rating. They have proposed that either they be exempt from the fee charge (on the basis of size) or that a rebate regime apply once the rating is obtained.

14. In summary, the issues that have been raised by providers are mostly around the boundaries of the retail scheme whose intention is to cover retail depositors and not to capture wholesale or equity markets. However, these issues have led us to consider coverage and pricing issues further.

Coverage issues

Ensuring retail deposit coverage

15. The prime intention of the deposit guarantee scheme is to provide a guarantee for retail depositors who are ordinary people (including natural persons, trusts, businesses and charities). There has been no decision to introduce a wholesale scheme which would cover the deposits/securities of financial institutions.
16. In the scheme as announced, the primary mechanism for excluding wholesale depositors from the guarantee is through the exclusion for the holdings of financial institutions. However, this is not by itself, a robust mechanism for excluding wholesale deposits.
17. Given this, there are significant incentives for those entities dealing with wholesale deposits or securities to try and route their funds through entities that do have coverage under the scheme. This means that, instead of covering the people intended, the government would end up covering unlimited deposits by corporations, including large off-shore corporations. The amounts involved could be substantial. All securities issued by guaranteed institutions will be more valuable to non financial institutions than they will be to anyone captured under the definition of "financial institutions". It was for this reason that officials originally recommended that this exclusion be supplemented by a cap on deposits by registered banks and non-bank deposit takers covered by the guarantee as a further way of limiting the government's exposure to wholesale deposits.
18. Options for ensuring that the deposit guarantee scheme coverage is largely limited to those it was intended primarily to cover is an issue that our Australian counterparts are also grappling with. We understand that they are considering introducing a cap on deposits as a refinement to their scheme and are currently considering the level of that cap.
19. This issue exists whether or not you decide to introduce a wholesale scheme later:
 - where a wholesale scheme is present, the issues relates to incentives to game against any differences in charges between a retail and a wholesale deposit scheme. For a retail scheme (here as in other countries) pricing, even at the margin, has been kept deliberately low). By contrast, in wholesale schemes, it is both necessary and reasonable to charge a much higher price , in a way that encourages wholesale issuers to graduate from reliance on a guarantee as soon as possible; and
 - where no wholesale scheme exists, the incentive is to obtain coverage under the retail scheme and all the more so, because the cost to institutions of the retail scheme's coverage is relatively inexpensive.
20. We have considered different ways in which to deal with this issue. The most practical approach would be a cap on claims per depositor per covered institution, in order to separate substantially retail from wholesale deposits. On 12 October, you decided not to include a \$250,000 and a \$50,000 cap in the scheme. We consider one cap of \$1 million would achieve substantially the same degree of assured protection under the scheme for individuals, while increasing the robustness of the scheme in excluding most genuinely wholesale funds from the coverage of the scheme.
21. Further, as noted in our report of 17 October "*Possible wholesale funds guarantee facility: issues and options*" if New Zealand were to introduce a wholesale guarantee facility, we would envisage make it a condition of signing a wholesale guarantee agreement that the borrowing institution would also sign an amendment to its deposit

guarantee agreement. Such an amendment would make clear that any paper eligible for the wholesale scheme would explicitly not be covered by the retail scheme.

Trustee and nominee services

22. As noted above, holdings by financial institutions will be specifically excluded from the retail deposit guarantee scheme.¹ Concerns have been raised by those providers of trustee and nominee services who hold deposits as bare trustee with no discretion over the investment of the securities held and no beneficial interest in them, that they will be excluded from the guarantee's coverage as a result of the exclusion for financial institutions.
23. A bare trustee is a person who holds funds in trust for the benefit and at the absolute disposal of other persons and who has no discretion in relation to the use of those funds. Funds held by a trustee or nominee service as a bare trustee may be held in separate individual accounts or may be held in one account for multiple clients. Bare trustees such as solicitors and brokers are required to operate under strict rules to ensure that they can clearly show to whom individual funds belong. From a legal point of view there is no distinction between funds held by an individual in their own name and funds held on a bare trust in the name of a trustee or nominee service.
24. Consequently, we consider that deposits held by trustee or nominee companies, brokers, or custodians where they are acting as a bare trustee do not come within the definition of financial institution in the Reserve Bank Act, and consequently such holdings will be covered by the guarantee, provided that the bare trustee can demonstrate that the beneficiary of the bare trust comes within the ambit of the guarantee. We recommend that this distinction be clarified in the contractual agreements.

“Look through”

25. As noted above, one of the key issues raised by fund managers is for the scheme to “look through” the entity holding the funds to the ultimate beneficiary and ensure that that beneficiary is covered by the guarantee if it is not a financial institution. This is a concern that has surfaced several times and been debated by officials over the last week.
26. In these discussions, we have gone back to the principles underpinning the scheme as well as the depositor's understanding of the arrangement they were entering into (does it look and feel like a bank), and the extent to which professionally managed funds are able to rearrange their affairs if need be to make the most of the opportunities for their clients. In drawing the line around collective investment schemes that are to be covered by the scheme, it was necessary to introduce requirements on where they deposited their funds to maintain the integrity of the retail deposit nature of the scheme. If we loosen the requirement for scheme coverage to “look through”, then the scheme would be extended considerably past its initial intentions.
27. In the event that a “look through” approach was adopted for fund managers, a cap on deposit size would be essential to differentiate between retail and wholesale deposits, and to limit the Crown's own exposure to risk in sectors we have very little information on.

¹ If it is subsequently decided to introduce a wholesale guarantee scheme the deposits of financial institutions would be likely to be covered by the wholesale scheme and subject to the different terms and conditions of that scheme.

Pricing of the Scheme

28. The current fee structure creates an incentive for investors to shift their funds from sound institutions to riskier institutions, especially if those institutions do not fully adjust their deposit pricing to reflect the value offered by the guarantee. This has been noted in the feedback above. The key issue here is not the flow of funds per se, but the flows that are purely a response to pricing incentives/distortions introduced through the guarantee scheme.
29. We believe there is merit in reconsidering the pricing structure of the scheme.
30. The current pricing arrangements are:
- for all covered liabilities (existing and new) of any institution in excess of \$5 billion a fee of 10 basis points per annum will be charged; and
 - a fee of 300 basis points per annum will be charged monthly to non-bank deposit takers that are rated below BB or are unrated (on the cumulative growth in the book since 12 October 2008).
31. The present arrangement leaves a substantial number of institutions who will not face any costs for obtaining the guarantee for their depositors, placing them in a very favourable position with respect to their competitors both within the sector and in related areas. In particular, for most mid-sized institutions, there is no financial incentive to limit the new business they can attempt to attract on the back of the government guarantee, creating significant distortions in the efficient allocation of savings. This will enable these entities to attract new business on more favourable terms than others both within and outside the scope of the guarantee can offer.
32. Our initial advice was to have risk-based pricing for all deposits covered by the scheme. We understand that affordability is an important consideration in offering the scheme, as well as the need, as far as possible, to ensure competitive neutrality in the sector going forward.
33. Against this background, we have assessed a number of alternative pricing structures:
- Lowering the \$5 billion exemption to \$100 million, and charging a risk-based rate on all deposits over \$100 million.

This option would mean that very small institutions (like building societies, credit unions and smaller deposit-taking finance companies) would be exempt from fees. However, it would go some way to reducing the imbalances in the current price structure by ensuring that all banks and larger finance companies are on a more competitively neutral footing, although this would still be at the margins.
 - You proposed an option that would require institutions to opt in to *either* a risk-based fee on total deposits *or* a cap on the guarantee to total book as at 12 October 2008 plus an allowance for natural growth (e.g. 10%). No guarantee would be provided for amounts above the 10% growth cap.

This option would mean that large scale shifts in investment between institutions would not be covered by the guarantee, and so, would not be likely to occur as it would lead to either proportional coverage or actual invalidation of the guarantee. In practice we would expect most entities to opt for the latter option (as the 10% cap is generous). This option would also be difficult to give effect to should the

guarantee ever be called on, as it would be difficult to distinguish guaranteed from unguaranteed deposits within a failed institution.

- Charge a risk-based fee on the new business component only for those registered banks and non-bank deposit takers (that is building societies, credit unions and finance companies) not already subject to a fee.

This proposal would not affect the affordability of the scheme: the fee would not apply to the base of the business as at 12 October 2008 and we recommend it include a 10% growth allowance per year, to generously accommodate (esp in the current econ climate, natural growth) on top of that base. We anticipate that most entities captured by such a fee would not be paying substantial amounts (if any). It would, however help mitigate the risks of large scale shifting of capital between institutions in the sector covered by the guarantee, based solely on pricing distortions that the guarantee itself has opened up..

As collective investment schemes covered by the scheme are investing in institutions with a guarantee or government debt, they would, in effect, be paying twice. To avoid this, collective investment schemes will not be subject to paying fees and we do not expect there to be any efficiency issues raised as a result.

34. Given this, we seek your agreement to the third option to introduce fees for the new business component for the remaining eligible entities not already subject to a fee charge as follows:

For registered banks and non-bank deposit takers whose covered liabilities are under \$5 billion at 12 October 2008:

For entities whose covered liabilities are under \$5 billion:

- 10 basis points per annum to institutions rated AA minus and above;
- 20 basis points per annum to institutions rated A+, A and A minus
- 50 basis points per annum to institutions rated BBB+, BBB and BBB minus; and
- 100 basis points per annum to institutions rated BB+ and BB;

on the cumulative growth in the book since 12 October 2008 with an allowance of plus 10 percent per year on this amount. Growth would be measured, and charged for, monthly.

35. Collective investment schemes covered by the scheme will not be charged fees.

Rebates for institutions that become rated BB and above

36. As noted in the feedback from large non-bank deposit takers, there are incentives for currently non-rated non-bank deposit takers to achieve a rating earlier than the timeframe required by the Reserve Bank Amendment Act, but this needs to be offset by the costs of changing business processes sooner than anticipated to do this. The Reserve Bank Act requires non-bank deposit takers to be approved by an approved rating agency by March 2010. The RBNZ is yet to announce which rating agencies will be approved.
37. The intent of the 300bp charge for non-bank deposit takers which are either unrated or are rated below BB is twofold. First it provides an incentive for better quality non-bank deposit takers to be able to differentiate their quality, in the form of a credit rating, from those who are rated below BB and are unrated over the longer term. Secondly, it

reduces the incentive for investors to shift their funds into higher risk non-bank deposit takers, to the extent that these fees are passed on to depositors.

38. Providing a rebate on the difference or on some proportion of the difference between the fee that would be charged to non-bank deposit takers before they are rated and the fee they would be charged after achieving a rating, would reduce the incentive for quality non-bank deposit takers to differentiate themselves as quickly as possible through a rating.
39. At the same time we recognise that non-bank deposit takers will have planned their business processes on the basis of the requirement in the Act to obtain a rating from an approved rating agency by March 2010 and these institutions do not yet have certainty on which agencies will be approved.
40. On balance, we consider that a rebate to 100 bps, without interest, for unrated non-bank deposit takers which obtain a rating of BB or above from 12 October 2008 to the date that the credit rating comes into force.
41. Attached is a summary of institutions that are potentially covered by the scheme and their credit rating status to help obtain a feel for who might be affected by different pricing arrangements.

Prudential Regulation Options

42. Over the longer term, a further means of managing the risk to the Crown is to bring forward some of the prudential requirements on the non-bank deposit taking sector. The Crown Deed places a requirement for non-bank deposit takers to meet any prudential requirements under the Reserve Bank of New Zealand Act. Ideally, key regulations would be in place before the non-bank deposit takers enter the guarantee scheme.
43. Some requirements under the prudential regime for the non-bank deposit taking sector come into force by regulation, and some requirements (the requirement to have a credit rating, governance and risk management requirements) come into force by a date set in the legislation or by Order-in Council. We do not recommend attempting to change or advance the timing of the legislative requirements.
44. The Reserve Bank had planned to have the full suite of regulations in place by the second quarter of next year. The Reserve Bank has identified regulations for minimum capital ratios and limits on related party exposures as the best option for bringing forward prudential requirements that would impose a measure of prudential discipline on non-bank deposit takers. The aim is to try and have in place expanded prudential requirements towards the end of 2008.

Deposit Guarantee Scheme

Financial institutions that are potentially eligible for the Government deposit guarantee scheme include those listed below. The final decision on eligibility will be made by officials under a delegated authority from the Minister of Finance. This is not a complete list.

[Information deleted under section 9(2)(b)(ii)- to protect the commercial position of the person who supplied the information, or who is the subject of the information.]