The Treasury

Additional Documents Related to Phase 2 of the Reserve Bank Act Review - December 2019 to April 2021 - Proactive Release

June 2021

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Where information has been withheld, no public interest has been identified that would outweigh the reasons for withholding it.

Key to sections of the Act under which information has been withheld:

[7] 6(e)(ii) - to prevent serious damage to the economy of New Zealand by disclosing prematurely decisions to change or continue government economic or financial policies relating to the regulation of banking or credit

[27] 9(2)(ba)(ii) - to protect information which is subject to an obligation of confidence or which any person has been or could be compelled to provide under the authority of any enactment, where the making available of the information would be likely otherwise to damage the public interest

[29] 9(2)(d) - to avoid prejudice to the substantial economic interests of New Zealand

[33] 9(2)(f)(iv) - to maintain the current constitutional conventions protecting the confidentiality of advice tendered by ministers and officials

[35] 9(2)(g)(ii) - to maintain the effective conduct of public affairs through protecting ministers, members of government organisations, officers and employees from improper pressure or harassment

[36] 9(2)(h) - to maintain legal professional privilege

[39] 9(2)(k) - to prevent the disclosure of official information for improper gain or improper advantage

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RESERVE BANK
OF NEW ZEALAND
TE PŪTEA MATUA

TE TAI ŌHANGA
THE TREASURY

Joint Report: Phase 2 Review - Further advice on the coverage limit for the deposit insurance scheme

Date:	Friday 11 December 2020	**Report No:**	T2020/3741
		File Number:	MC-1-7-3-1-13

Action sought

	Action sought	Deadline
Hon Grant Robertson **Minister of Finance**	**Indicate** your preferred option for the coverage limit for the deposit insurance scheme. **Note** differences of view between the Reserve Bank and the Treasury.	14 December 2020

Contact for telephone discussion (if required)

Name	Position	Telephone		1st Contact
Ashley Dunstan	Advisor, Reserve Bank Act Review	[35] (wk)	N/A (mob)	✓
Tamiko Bayliss	Director, Reserve Bank Act Review	[35] (wk)	N/A (mob)	

Minister's Office actions (if required)

Return the signed report to the Treasury.

Refer the Report to the Associate Minister of Finance (Hon David Parker)

Note any feedback on the quality of the report	

Enclosure: No

Joint Report: Phase 2 Review - Further advice on the coverage limit for the deposit insurance scheme

Executive Summary

You have requested further advice on the appropriate level of the coverage limit for the permanent deposit insurance scheme (DIS), in light of stakeholder feedback from smaller deposit takers provided through the Phase 2 of the Reserve Bank Act Review. Cabinet has agreed in-principle to introduce a DIS in New Zealand and that the coverage limit for the scheme would be $50,000 per depositor, per institution.

Small deposit takers highlighted in their feedback that deposit splitting (depositors with amounts above $50,000, shifting those amounts around deposit takers to maximise coverage under the DIS) under a $50,000 limit would result in a material loss of deposits, undermining their ability to support lending to the economy.

There is uncertainty about how the introduction of the DIS with a $50,000 limit would play out for small deposit takers. Because depositors will have protection up to $50,000 when they don't now, depositors may view their savings as safer and split or shift their deposits into these small entities. On the other hand, many depositors appear to be under the impression that their funds are fully protected by the Government, and could shift the above-cap deposits to the perceived safety of the major banks in response to the implementation of the DIS with a $50,000 cap.

Officials have provided further analysis of the pros and cons of different limits, consistent with the criteria that were used to support your and Cabinet's in-principle decision in June 2019. The analysis is also supported by improved data on the number and value of customers covered. There are both costs and benefits of a higher coverage limit and any decision is based on limited information. The Treasury and Reserve Bank draw different conclusions from the data and decision-making criteria:

- The Reserve Bank recommends you confirm your in-principle decision of a $50,000 limit and that there is insufficient evidence to warrant a change to this previous decision. This reflects that any impact on small deposit takers is likely to be small and transitional and that a $50,000 limit still provides full coverage for the vast majority of depositors. The design of the deposit insurance framework should be based on protecting ordinary depositors from hardship and not the narrow concerns of particular sectors.

- The Treasury recommends you agree to a $100,000 limit. A $100,00 limit would help mitigate risks to competition and financial sector inclusion highlighted by small deposit takers, as well as responding to broader concerns raised by stakeholders in the last two consultations (including alignment with international norms). A $100,000 would do more to support confidence in the financial system and credibility of resolution tools. The increased incentives for risk-taking and a larger contingent liability of the Crown implied by the higher limit can be mitigated through more intensive supervision and the use of risk-based levies for the scheme.

Recommended Action

We recommend that you:

a) **note** that some stakeholders have provided feedback supporting a higher coverage limit the deposit insurance scheme than your in-principle decision of $50,000.

b) **note** that small deposit takers are concerned that deposit splitting resulting from the $50,000 limit would result in a material loss of deposits, which would undermine their ability to provide lending to support the economy, threaten their liquidity and stability, and disproportionately benefit the major banks.

c) **note** that there is uncertainty about how the introduction of the DIS would play out for small deposit takers.

d) **note** that this report includes improved data on the number and value of depositors covered under different limits, which was not available at the time the in-principle decision was made.

e) **agree** to:

EITHER

- Reconfirm your in-principle decision of a $50,000 limit, reflecting that any impact on small deposit takers is likely to be small and transitional, a $50,000 limit still provides full coverage for the vast majority of depositors, that the design of the deposit insurance framework should be based on protecting ordinary depositors from hardship and not the narrow concerns of particular sectors, and that there is insufficient evidence to warrant a change to this previous decision

  (Reserve Bank recommendation)

Agree/disagree

OR

- agree to a $100,000 limit, reflecting that this would help mitigate risks to competition and financial sector inclusion highlighted by small deposit takers, respond to broader concerns raised by stakeholders in the last two consultations (including alignment with international norms), would do more to support confidence and credibility, and the increased incentives for risk-taking and fiscal risks can be mitigated.

  (Treasury recommendation)

Agree/disagree

f) **refer** to the Associate Minister of Finance (Hon David Parker) for his information

Tamiko Bayliss
Director, Reserve Bank Act Review

Hon Grant Robertson
Minister of Finance

Joint Report: Phase 2 Review - Further advice on the coverage limit for the deposit insurance scheme

Purpose of Report

1. The purpose of this report is to provide you with further advice on the coverage limit for the Deposit Insurance Scheme (DIS) in light of concerns raised by smaller deposit takers.

Context

2. On 30 November, you requested officials provide you with further advice on the coverage limit for the DIS. Our understanding is that a key area of concern for you is the impact of a $50,000 limit on small deposit takers, which is a risk that was not considered at the time the in-principle decision was made.

3. In June 2019, Cabinet agreed in-principle to introduce a DIS in New Zealand and that the coverage limit for the scheme would be between $30,000 and $50,000 [CAB-19-MIN-0161]. Following public consultation on this limit, Cabinet agreed in-principle that the coverage limit be set at $50,000 per depositor, per institution. [CAB-19-MIN-0346].

4. Officials have since received further submissions from some stakeholders raising concerns that the proposed $50,000 limit is too low. Officials [27] also received more granular deposit data from the deposit takers sector that provides a more robust picture of depositors covered (by number fully covered and by total value), than data previously provided. The insights from the data are discussed further in the Report.

5. The coverage limit is a core building block for the DIS and changing the limit has consequential impacts on other design elements of the scheme. As such we are seeking a decision on the limit now which could be taken to Cabinet for final approval in April/May 2021.

6. The Review will provide you with further advice on design elements of the DIS early next year, taking into account the implications of your decision on the coverage limit. These design elements will include funding arrangements, the products covered by the DIS, and the expected functions and location of the DIS.

Stakeholder feedback

7. As part of the third round of Phase 2 public consultation, the Review has received feedback from deposit takers and other stakeholders supporting the Government revisiting the in-principle decision that the coverage limit will be $50,000. Deposit takers have continued to support a higher coverage limit.[1]

8. Small banks, credit unions and building societies, and finance companies (collectively ‘small deposit takers’) are concerned that deposit splitting resulting from the $50,000 limit would undermine their ability to provide lending to support the

[1] Prior feedback highlighted that the $30,000 to $50,000 range was too low.

economy, and threaten their stability. Deposit splitting occurs where depositors with amounts exceeding the coverage limit shift their deposits across multiple deposit takers to maximise their coverage under the DIS. These submitters also raised concerns with risk-based pricing of levies.

9. While recognising the in-principle decision, the New Zealand Bankers Association (NZBA) also supports a higher coverage limit. In their earlier submission as part of the second round of public consultation in mid-2019, the NZBA suggested that the in-principle decision would increase the risk that the DIS would fail to prevent bank runs or support public confidence, and that a low limit could result in an increased reliance on account splitting, with resulting administrative costs for banks and customers.

10. The feedback from industry is consistent with broader feedback received in the second round of consultation (C2) [T2019/3011 refers]. The majority of stakeholders that commented on the coverage limit preferred a significantly higher coverage limit than the in-principle decision range, and suggested that a limit more in line with international norms would improve the ability of deposit insurance to contribute to financial stability. This concern feedback came from several individuals as well as interest groups representing the public (such as Consumer New Zealand and the Te Arawa Federation of Maori Authorities).

11. In making the case for a higher limit, many stakeholders referred to international norms and, in particular, the level of coverage provided in Australia. We note the majority of OECD countries have a coverage limit of approximately NZD $150,000, while Australia has a significantly higher limit of AUD $250,000.

Risks to small deposit takers

12. There are risks that small deposit takers could lose deposits and there are also risks they could gain them. Because depositors will have protection up to $50,000 when they don’t now, depositors may be more willing to deposit funds in smaller, riskier entities in exchange for marginally higher returns. On the other hand, many depositors appear to be under the impression that their funds are fully protected by the Government, and could shift the above-cap deposits to the perceived safety of the major banks in response to the implementation of the DIS with a $50,000 cap.[2] These risks are elaborated below. Officials are uncertain how these risks will play out and it will depend on depositor behaviour.

13. Small deposit takers are more reliant on deposit funding than major banks and have limited access to wholesale markets to replace any lost retail funding. Small banks and building societies currently rely on deposits larger than $50,000 to fund approximately 70 percent of their balance sheet, and the corresponding figure for credit unions is 30 percent.

14. The extent to which deposit splitting will occur is uncertain and in part depends on how aware depositors are of the DIS and their level of sophistication. There is also uncertainty about the timing of deposit splitting, as some depositors may only become aware of the amount of protection provided by the DIS during times of stress. Splitting during a time of crisis may disproportionately impact smaller deposit takers if there is a flight to safety among depositors. However, it is reasonable to

[2] This expectation was reinforced by the introduction of a deposit guarantee in response to the Global Financial Crisis. A survey of 1,000 households commissioned by the Review team found that only a quarter of respondents were aware that they stood to lose money in the event of a bank failure.

expect that some depositors will split accounts across multiple deposit takers in order to maximise coverage once the DIS is introduced.

15. The level of returns offered by small deposit takers will affect the extent to which they benefit from increased inflows of insured depositors seeking the highest yield. During the Crown Deposit Guarantee Scheme with a $1 million coverage limit, there were large flows of deposits to finance companies. The potential for deposits to shift to higher risk-return deposit takers as a result of the introduction of the permanent DIS highlights the need for risk-based pricing for the DIS and more intensive supervision to manage risks to financial stability [T2020/3517 refers].

16. Alternatively, the $50,000 limit could have negative effects on small banks and CUBS, given that they currently only offer a small premium relative to larger banks and risk-based levies would further reduce this premium. The introduction of a DIS with a $50,000 limit may therefore reduce the perceived level of protection, making above-cap depositors less willing to hold their funds at smaller deposit takers. Above-cap depositors could be wary of the complexity and management costs of having multiple accounts, and instead shift their deposit (including any above-cap amount) to the perceived safety of the major banks. [3]

17. Many of the customers of small banks and CUBS will have long-run relationships and a level of loyalty, and will be reluctant to shift deposits to another sector. There is nevertheless a risk is that, for example, 5-10 percent of depositors shift funds to the major banks, and that the relatively modest premium on deposit rates compared to the major banks is not sufficient to attract new insured deposits to fill the gap. This scenario may require small banks and CUBS to offer higher returns in order to sustain lending, reducing their ability to compete with the major banks. It is possible that these institutions could experience increased liquidity stress while they await inflows of new customers.[4]

18. Some credit unions are likely to face particular challenges replacing any lost customers, due to their community/regional focused customer model. Credit unions also do not have high brand recognition, and suffer from weak profitability that could be worsened by the use of risk-based levies for the DIS. For this reason, $50,000 limit is likely to pose a larger risk to credit unions than other small deposit takers. To the extent that credit unions fulfil a unique role that cannot be easily substituted by other deposit takers, this could present a risk to financial sector diversity and inclusion. Although this point could mean that depositors of credit unions could be more sticky than other deposit takers.

19. It is important to note that at present some credit unions have excess deposits available, and that an oversupply of deposit funding is putting pressure on the viability of their business models in a low interest rate environment. The risk to credit unions also needs to be put into the context of the small size of the sector in terms of financial sector assets (although the sector is more material in term of number of depositors). The size of the risk also differs within the sector, with larger firms having more capacity to attract new customers. Previous Reserve Bank analysis published in their November 2019 *Financial Stability Report* has identified concerns around whether the returns currently offered by higher risk entities are fully reflective of the risks involved, suggesting that there may be valid reasons for deposits to shift to other deposit takers.

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[3] Empirical studies on deposit splitting are scant, however the one relevant study of the Danish experience of shifting from an unlimited guarantee to a €100,000 limit suggests that deposit splitting is likely to result in substantial flows away from non-systemic deposit takers.

[4] As a rough rule of thumb, evidence from the United Kingdom found that a 5 basis points increase in deposit rates is required to attract a 1 percent increase in deposits. This would suggest a 5-10 percent net outflow would require an increase in deposit rates of 25-50 basis points.

20. There is no 'right' number for the appropriate coverage limit for a DIS, and a judgement must be made after weighing the various factors at play. There are both costs and benefits of a higher coverage limit and any decision is based on limited information.

21. We previously provided you with a set of considerations to take into account in making your in-principle decision for a $50,000 limit [T2019/3011] refers. We continue to recommend you take into account those considerations (see Table 2), with the addition of considering the impact on smaller deposit takers.

22. We also have obtained more granular information from deposit takers on the value of deposits covered and the number of depositors fully covered at $50,000, $100,000 and $250,000 coverage limits than was available at the time you took the in-principle decision (see Table 1 below, and Annex 2 for further information). This data indicates that the number of depositors fully covered and the value of deposits covered under various limits is somewhat lower than shown by the previous data, although the earlier data was caveated at the time.[5] The new data indicates that a $50,000 limit would cover 89% of depositors in full.

Table 1: Coverage rates under different deposit insurance limits

Average by institution type[1]	Share of depositors fully covered			Value of total deposits covered		
	$50,000	*$100,000*	*$250,000*	*$50,000*	*$100,000*	*$250,000*
Big 5	[27]	[27]	[27]	[27]	[27]	[27]
Small banks	[27]	[27]	[27]	[27]	[27]	[27]
Building societies	[27]	[27]	[27]	[27]	[27]	[27]
Credit unions	[27]	[27]	[27]	[27]	[27]	[27]
Finance companies[2]	[27]	[27]	[27]	[27]	[27]	[27]
Total	**89%**	**93%**	**97%**	**27%**	**38%**	**54%**

Note: 1. Some deposit takers are not included in the 'small bank' and 'credit union' broad industry groups, however these groups should provide an accurate example of value and number of depositors fully covered. 2. Finance company data was only available for a subset of finance companies and only for a $50,000 limit

23. Guidance from the International Association of Deposit Insurers (IADI) suggests that the coverage limit should cover the vast majority of depositors by number, while leaving the majority of the value uncovered in order to retain market discipline. However, there is significant judgement required in order to define "vast majority" and "majority of the value". Consequently, there is a wide range of limits implemented by different countries based on the guidance (albeit most comparable countries have a limit higher than $50,000). Annex 1 provides further analysis of international guidance and the coverage limits applied across the OECD.

24. However, setting the coverage limit is a matter specific to individual jurisdictions and New Zealand does not have to align with other jurisdictions (for example, if a concern was that New Zealanders would move their deposits offshore, it is often not

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5 Officials advised you in making your decision on a $50,000 limit that such a limit would fully cover 94% of household accounts and cover 45% of the value of household accounts. We noted at the time that this data was per account and covered registered banks only. We noted that this data was at best a proxy for actual coverage levels that will result under the scheme as many customers will have multiple accounts at the same institution resulting in lower coverage levels suggested by accounts data at the same bank. Also customers are likely to adjust their behaviour once deposit insurance is implemented, thereby increasing coverage levels. We note, that coverage information provided to you in October 2019 and the updated coverage information is not on a like for like basis. The key differences are that the 2019 information was for households only (e.g. did not include businesses and trusts), whereas the updated information is for all depositors. In addition, the 2019 information was per account and the updated information is per depositor.

feasible New Zealanders to open deposit accounts in other jurisdictions, including Australia, in order to obtain greater protection).

25. The previous advice you received on the coverage limit did not discuss the potentially disruptive impacts of deposit splitting on small deposit takers. A $100,000 limit would provide more certainty that the introduction of deposit insurance won't undermine competition and financial sector diversity through this channel:

- Approximately [27] percent of the value of deposits at credit unions would be fully covered (compared to [27] percent under the in-principle decision).
- Approximately [27] percent of the value of deposits of small banks would be covered (compared to [27] percent under the in-principle decision), reducing the likelihood that they need to offer higher deposit rates to maintain their customer base.
- A $100,000 limit would reduce the number of times that high-value deposits need to be split to achieve a desired level of coverage, thereby potentially reducing the likelihood that high-value deposits are shifted in their entirety to the perceived safety of the major banks.

26. Putting aside the impact on deposit splitting, there are three elements to consider in assessing the appropriate coverage limit.

Coverage of less sophisticated depositors

27. You noted in your Cabinet paper that the DIS was being introduced to protect, with certainty and consistency ordinary New Zealanders from the risk of losing their savings placed in the deposit taker – and in doing so contribute to public confidence and the stability of New Zealand's financial system [CAB-19-SUB-0161]. Officials see this aim as to cover less sophisticated depositors that do not have the time and resources to monitor the risk of their deposit taker, as opposed to more sophisticated groups using deposits as a financial investment.

28. Making a distinction between depositors based on their level of financial sophistication requires a high degree of judgement. It is hard to claim a sharp distinction between the financial literacy a depositor with, say, $50,000 versus one with $100,000. Nevertheless, as the coverage limit increases, the DIS may increasingly cover wealthier depositors that are using deposits as a financial investment.

29. You indicated at the time that you were interested in a coverage limit that reliably covered 9 in 10 depositors. A $50,000 limit fully covers 89 percent of depositors, reflecting that the vast majority of depositors have a small amount of money held in deposits for transactional purposes. The aggregate coverage rate marginally increases to 93 percent under a $100,000 limit.

30. Most deposit insurance schemes do not fully cover all potentially vulnerable groups that have large deposits (eg charities). However, a $100,000 limit will substantially increase cover for depositors such as retirees who use deposits to fund retirement consumption and hold deposits in excess of $50,000.[6] Deposits needed to purchase a first home would also plausibly exceed $50,000. Officials can provide you with further information on the impact of different coverage limits on different persons or groups of persons.

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[6] Analysis by the Treasury using the 2017/18 Household Economic Survey suggests that more than 25% of single people over the age of 65 have cash and deposits over $50,000 (+/- $11,000), and 25% of couples over 65 have cash and deposits over $130,000 (+/- $33,000). We cannot say with any certainty whether these deposits are held at multiple deposit takers or one deposit taker. In addition, this data includes 'cash' held by families (i.e. amounts not held at a bank).

31. An underlying goal of the Phase 2 review is to develop a credible financial safety net that allows a deposit taker to be resolved in an orderly manner without recourse to public funds. Deposit insurance supports this goal by protecting most depositors from loss in a resolution (and disproportionately everyday depositors). The coverage limit should be set at a level where you, and future Governments, can credibly commit to using resolution tools – including imposing losses on wholesale investors and above-cap depositors.

Impact on financial stability

32. In protecting depositors, the DIS aims to contribute to financial stability. Deposit insurance has two opposing effects on financial stability:

    i Protected depositors have reduced incentives to join bank runs, thereby contributing to financial stability.

    ii Protected depositors will not monitor the risk-taking of their bank, which may reduce financial stability through a reduction in market discipline.

33. Higher limits than the in-principle decision would increase the benefit of deposit insurance in improving the stability of deposit funding. However, part of the rationale for the $50,000 limit is that it leaves approximately 70 percent of the value of deposits uncovered and with incentives to monitor the risk of their deposit taker. Higher limits – particularly a $250,000 limit – can result in higher moral hazard through this channel.

34. Of more concern is that insured funds may be shifted to higher-risk institutions offering higher returns. The size of this risk would increase under a higher coverage limit given that more funds can be insured at a given institution. A higher coverage limit would place more reliance on tools to manage risks to financial stability, including larger costs being borne by riskier deposit takers (and potentially their customers) through levies (i.e risk-based pricing). Supervision and risk-based pricing mitigate but do not eliminate potential increases in risk-taking resulting from an increase in the coverage limit.

Impact on fiscal risk or other creditors

35. The coverage limit affects the amount that the Crown will need to lend to the DIS in the event of failures. The total value of deposits covered by the DIS based on deposit takers' current balance sheets as of March 2020 is $86 billion under a $50,000 limit, $122 billion under a $100,000 limit and $174 billion under a $250,000 limit.[7] These figures represent the maximum exposure of the DIS and are not a particularly useful metric as they do not include any offset results from the recovery of the remaining assets of the deposit taker in the event that a deposit taker fails and the DIS is called upon.

36. As it becomes likely that a deposit taker will fail and therefore call on the DIS, the DIS will need to reflect the likely cost of that failure on its balance sheet (i.e. the total exposure *less* expected recoveries). Should the DIS's assets be insufficient to cover the cost of a payout, then the Crown will be required provide funds through the backstop. Cabinet has agreed in-principle that the DIS will be fully funded by industry over time, as such the DIS (and the Crown) would recover the costs of any failure over time. However, the larger the call on the Crown, the more likely it will be that the time to recover any funds is prolonged (e.g. if a major bank failed). It is likely, given the DIS's design, that the fiscal risk that the Crown will suffer losses from the Scheme (Operating Balance impact) is likely to be remote, but the fiscal

[7] The estimated contingent liability is likely to go up once the scheme is in place as depositors seek to maximise the protection offered by deposit insurance and reflecting growth in aggregate deposits.

risk that there will be a liquidity impact on the Crown is claims were made (Debt risk) will be somewhat higher.

37. There are policy options to help manage the liability of the DIS (and the Crown), including those that could increase the rate at which the Crown is paid back by the DIS. For example, an insured depositor preference is under consideration, which could greatly diminish the net costs of insurance, although this would shift additional cost of increased protection onto other creditors rather than removing it.

Criteria	$50,000 (RBNZ option)	$100,000 (Treasury option)	$250,000
Type of depositor covered			
Coverage rate	89% of depositors are fully covered, consistent with international guidance to cover vast majority of depositors. Coverage is lower than 9 in 10 at some deposit takers.	Approximately 93% fully covered. Likely to enhances protection for retirees and first-home buyers. Increases coverage to at least 9 in 10 at the individual institution level, including at small banks and building societies.	Approximately 97% fully covered.
Credibility of resolution tools	Increases political willingness to use resolution tools (relative to the status quo) by protecting less sophisticated depositors.	Further increases willingness to use resolution tools by increasing coverage for less sophisticated groups that have higher balances.	Limited impact given that coverage increasingly skews towards more sophisticated depositors.
Impact on financial stability			
Mitigating run risk	27% of the value of system deposits is fully covered, with account splitting further increasing coverage, thereby supporting confidence	38% of the value of system deposits is fully covered, providing additional support to confidence	54% of the value of system deposits is fully covered, providing substantial support to confidence.
Blunting depositor incentives to apply discipline	Limits incentives for larger depositors to shift to higher risk/return deposit takers and maintains more incentive for depositors to monitor risk.	Increased moral hazard risk would be mitigated through prudential supervision and differential levies (albeit these tools are imperfect). Unclear whether depositors up to $100,000 are currently engaging in risk monitoring.	Substantially increased moral hazard risk.
Impact on fiscal risk			
Potential need for the Crown to lend to the insurer	Limits likelihood of Crown having to lend to the DIS.	Higher likelihood of having to lend to the DIS. Can be managed through levies and potentially insured deposit preference (but at cost to industry or other creditors).	Substantial increase in contingent liability.

Amount of insurance premiums paid by institutions	Lower levies and associated impact on economic activity.	Higher levies but impact can be limited by approach to levying, lengthening timeframe for covering costs of the scheme (albeit this may impact the ability to manage additional moral hazard).	Substantially higher levies but impact can be limited by approach to levying, lengthening timeframe for covering costs of the scheme.
Other			
Ability for depositors to obtain additional coverage through splitting	Additional coverage is available to depositors through splitting their accounts across multiple entities.	Deposit splitting will still occur but impacts on small deposit takers could be reduced.	Deposit splitting will still occur but will have fewer disruptive impacts on small deposit takers.

Treasury position

38. The Treasury recommends that you agree to a revised coverage limit of $100,000.

39. The Treasury believes that deposit splitting under a $50,000 limit presents material risks to the ability of small deposit takers to compete, and to financial sector diversity and inclusion. The Treasury believes it is also important to reassess the limit in light of broader concerns raised in stakeholder feedback through two rounds of public consultation and the further data obtained as part of [27].

40. The Treasury believes there is significant uncertainty about the appropriate coverage limit. Judgement is required to choose the appropriate limit, and a strong case for a $100,000 limit can be made based on the criteria used to make the in-principle decision. This is particularly relevant as the in-principle decision was predicated on the likelihood of there being substantial deposit splitting in order to increase coverage levels over time, without consideration for the potentially disruptive impacts of splitting on small deposit takers.

41. A $100,000 limit would be more credible and provide greater confidence by covering more unsophisticated depositors, such as first-home buyers and retirees. It would also materially increase the number of individual deposit takers where at least 9 in 10 depositors are fully covered, including at small banks and building societies (illustrated by the new data obtained as part of [27] in figure 2 above). A$100,000 coverage level would enhance the likelihood that future Governments are willing to use resolution tools that impose losses on depositors. A $100,000 limit would enhance the benefit of the scheme in supporting confidence in the financial system, without materially blunting incentives of more sophisticated depositors to monitor risk.

42. The increase in risk-taking and the Crown's contingent liability would need to be managed using the enhanced monitoring, supervisory, and regulatory powers being provided to the Reserve Bank under the Deposit Takers Act and through levies differentiated according to the level of risk. You could also choose to hold levies in a fund, which would be the first port of call to fund any payouts, or to charge *ex post* levies to recover exceptional net losses on the scheme. Also, a facility under which the Reserve Bank may provide temporary liquidity to backstop the DIS is also under consideration, which would reduce immediate / shorter term fiscal risks.

43. The Treasury also notes that the Review is considering whether to introduce a preference for insured deposits. This would significantly reduce the long term costs of the DIS by increasing the level of ultimate recoveries from failed deposit takers, thereby reducing the longer term risks to the DIS and fiscal risks to the Crown via the backstop. There are other benefits of an insured deposit preference, including improving the operational effectiveness of resolution tools.

44. The Treasury notes that several stakeholders supported a significantly higher coverage limit of, say, $250,000. A higher limit would do more to support public confidence, and would align more closely with Australia's limit. However, this option is significantly less consistent with your intention to cover less sophisticated depositors, and would have questionable impacts on long-run financial stability given the more substantial moral hazard impact that would be expected.

45. The Treasury also notes that updated data shows that there is also significant variation across individual deposit takers, which is important when, for example, considering the number of depositors that would suffer losses under various coverage levels and the corresponding hardship impacts when individual institutions fail.

Reserve Bank position

46. 46. All entities will argue for the own self-interest, and some will see significant upside in maximising the proportion of their balance sheet that is guaranteed, irrespective of whether this is optimal for the long run stability of the financial system.

47. The Reserve Bank does not believe the C3 submissions have raised new issues that warrant changes to the $50,000 coverage limit. A higher coverage limit increases moral hazard and the risks to the taxpayer/other creditors. As such, the Reserve Bank sees no basis for incurring those additional costs in exchange for a small and largely hypothetical benefit to our riskier firms.

48. We note that the Phase 2 review is a fundamental review of the regulatory framework in New Zealand, and it should be set according to first principles analysis. There may be winners and losers amongst the existing cohort of entities. We should not risk undermining the overall coherence of the framework by seeking to protect the existing interests of some entities.

49. On the coverage limit specifically, the Reserve Bank notes the following points.

Objective of Depositor Protection

50. The Government has taken an in-principle decision to introduce deposit insurance primarily to avoid hardship on ordinary depositors in the event of a deposit taker failure. This objective suggests a relatively modest coverage limit that is sufficient to cover, at a minimum, ordinary day-to-day expenses such as mortgage/rent, food, petrol, etc., as well as a modest level of savings. It is about protecting customers / savers, not about protecting institutions. The current limit is sufficient to meet these objectives.

51. Deposit insurance is a safety net. It is not designed as a facility to promote credit diversity nor financial inclusion, notwithstanding that these are laudable objectives. It is also possible that deposits in banks could shift to CUBS and smaller banks, given that all insured deposits are effectively 'risk-free' on account of deposit insurance. It is important not to lose sight of the fact that deposit insurance benefits smaller (riskier) entities by providing equal protection for their insured deposits.

52. Consistent with international best practice, the Minister has indicated the Government believes that the vast majority of depositors (for example, 90% of depositors) should be fully protected by the deposit insurance scheme. A $50,000 coverage limit is sufficient to achieve this.

53. Furthermore, international best practice suggests that a 'substantial amount of deposits' should be exposed to market discipline (i.e., remain uninsured). New Zealand data suggests that with a $50,000 coverage limit, approximately 55% of deposits would remain uninsured and therefore able to exert market discipline on deposit takers. An increase in the coverage limit to $100,000 would result in approximately 40% of deposits being uninsured. Account splitting is likely to mean that both of these figures is understated.

Assessment of CUBS concerns and stakeholder feedback

54. It is difficult to evaluate the validity of CUBS' concerns as it is uncertain how their depositors would respond to the introduction of a $50,000 coverage limit. However, we believe it is highly unlikely that the majority of uninsured deposits would leave the CUBS sector given the general stickiness of retail deposits and the fact that this sector serves a particular niche market where customers have a common affiliation or purpose. Additionally, there is also likely to be some deposit inflows into CUBS as depositors from other institutions spread their deposits.

55. The Basel Liquidity Coverage Ratio (LCR) specifies that 'less stable' (uninsured deposits) should assume a run-off rate of a minimum of 10% (with no maximum limit). This is the assumed run-off rate where the institution is under stress. While it is challenging to say with certainty how depositors will react to the introduction of deposit insurance, we believe it is difficult to mount convincing arguments that deposit outflows would significantly exceed this stressed run-off assumption, particularly for those CUBS where depositors have an industry/vocational connection to their institution and may be reluctant to create a new relationship with another deposit taker.

56. We would expect any deposit outflow experienced by CUBS to be gradual and occur both in the lead up to, and after, the implementation of the deposit insurance scheme. As such, we believe that CUBS should be able to manage any deposit outflows accordingly. Furthermore, it is open to authorities to put in place support mechanisms should some individual entities need assistance in managing changes to their balance sheets. This would represent a more efficient option to address any concerns that the system could be destabilised by the transition to a post DI world.

57. Risk based pricing will be a critical tool for managing the moral hazard created by DI. These entities are the riskiest entities, and as such, the levies that they would face are likely to be material. Increasing the coverage limit can be expected to exacerbate this.

Broader long-term financial system settings

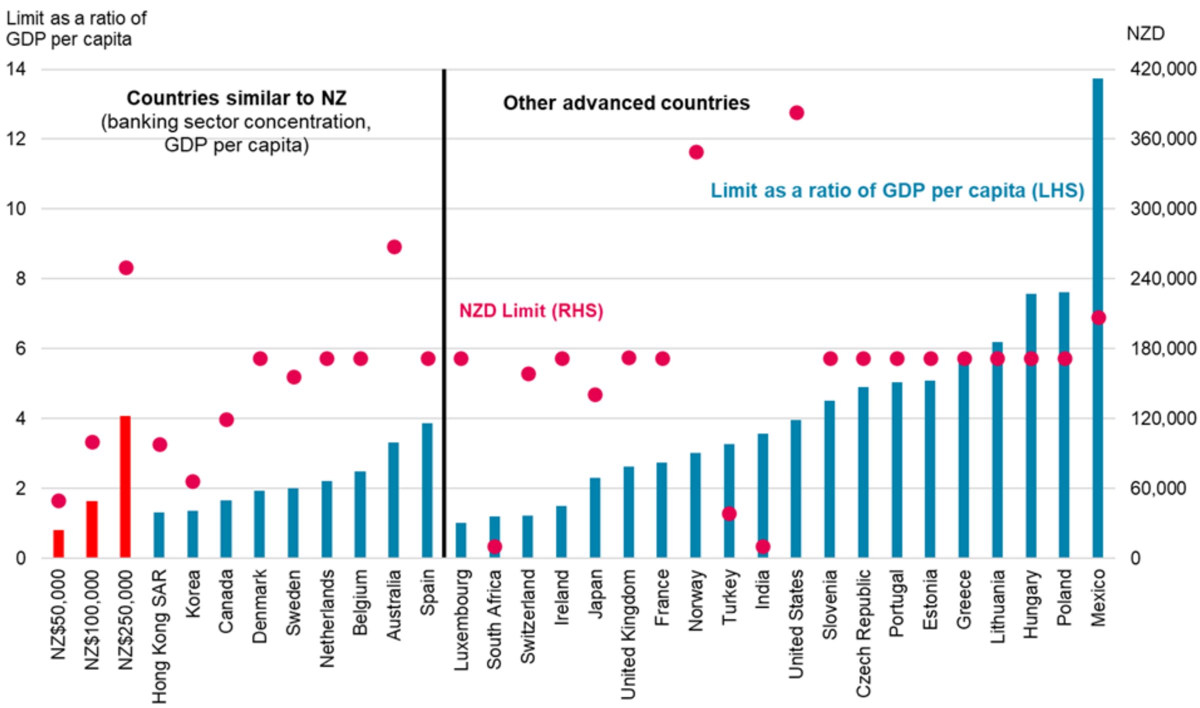
58. Around [27] of the value of deposits in credit unions would be protected at the $100,000 coverage limit. This could potentially be higher once the scheme is implemented. Although a higher limit may mitigate risks to the funding and liquidity management of a small number of very small entities, it is not costless. It materially increases moral hazard across the entire financial system. The exposure of the Crown (via the backstop)/other creditors (depending on final decisions on insured depositor preference) increases for very little demonstrable benefit (for example, the Crown's contingent liability is estimated to increase by 42% [27] As noted above, the actions that would need to be taken to address these effects are likely to impose significant additional costs on smaller, riskier entities.

59. Any significant policy change, such as the introduction of deposit insurance, will result in behaviour changes. The deposit insurance coverage limit should be set according to the objectives of the deposit insurance scheme and be consistent with promoting a sound and efficient financial system – the coverage limit should not be set in accordance with the concerns of any particular sector.

Annex 1: International guidance and comparisons

Figure A1 compares insurance limits across OECD jurisdictions. It shows coverage limits as a nominal dollar amount, and as a ratio to GDP per capita (a measure commonly used by the IMF to compare the adequacy of deposit insurance schemes across jurisdictions). It suggests that the in-principle decision of $50,000 would be low by international standards. Most countries have an NZD limit of approximately $160,000 – partly because this is the European standard.

Figure A1: Comparing deposit insurance limits in advanced jurisdictions



The International Association of Deposit Insurers has published core principles for effective deposit insurance schemes. With respect to the coverage limit, decision-makers need to apply substantial discretion in order to implement the guidance:

Policymakers should define clearly the level and scope of deposit coverage. Coverage should be limited, credible and cover the large majority of depositors but leave a substantial amount of deposits exposed to market discipline. Deposit insurance coverage should be consistent with the deposit insurance system's public policy objectives and related design features.

The level and scope of coverage are limited and are designed to be credible, so as to minimise the risk of runs on banks and do not undermine market discipline. The level and scope of coverage are set so that the large majority of depositors across banks are fully protected while leaving a substantial proportion of the value of deposits unprotected. In the event that a substantial proportion of the value of deposits is protected, moral hazard is *mitigated by strong regulation and supervision, as well as by the other design features of the deposit insurance scheme.*

Annex 2: Updated data

Figure 1: Value of deposits covered at a $50,000, $100,000 and $250,000 limits
[27]

Figure 2: Number of depositors fully covered at a $50,000, $100,000 and $250,000 limits
[27]