The Treasury

Statement of Funding Approach Consultation Submissions Information Release

December 2023

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Westpac New Zealand Limited

Submission to Te Tai Ōhanga – The Treasury on

Statement of Funding Approach – Funding Strategy for the Depositor Compensation Scheme.

22 September 2023

Classification: PROTECTED

1. INTRODUCTION

1.1 This submission to Te Tai Ōhanga – The Treasury is made on behalf of Westpac New Zealand Limited (**WNZL**) and Westpac Banking Corporation (together **Westpac**) in respect of the Statement of Funding Approach – Funding Strategy for the Depositor Compensation Scheme Consultation Paper (**Consultation Paper**). Thank you for the opportunity to provide feedback on the proposals.

1.2 Westpac wishes to retain confidentiality of this information and requests that the Reserve Bank contact WNZL before its release.

1.3 Westpac's contact for this submission is:

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2. KEY SUBMISSIONS

2.1 Overall Westpac is supportive of the objectives and decision-making principles used to guide the SoFA. We would welcome an additional principle, for transparency, of the DCS financial position.

2.2 Westpac supports the target fund approach and would prefer option B, 0.8% over 15 years as the preferred target fund size.

2.3 Westpac recommends a post implementation review of the impact of the DCS on the drivers to SoFA. In particular, the assumptions relating to the size of the fund relative to protected deposits because the impact of potential deposit spreading may trigger an earlier review of this assumption and consequently the fund size if we see a disproportional movement of deposits to riskier deposit takers.

2.4 Westpac looks forward to further details on the SoFA becoming available and supports early engagement on issues such as how new deposit takers will be treated, considering the principle of equity. In addition, our view is that DCS levies should not be taxed because it increases the cost on deposit takers and would welcome a discussion on this matter. We also note that jurisdictions such as Canada and the United Kingdom (UK) do not tax DCS levies though investment returns are taxed, and Westpac would be supportive of a similar approach.

3. RESPONSE TO CONSULTATION QUESTIONS

Question 1 – Are there other principles that you think we should consider:

3.1 The objectives and principles outlined in the Consultation Paper are appropriate. Westpac would welcome an additional principle, for transparency, to make the financial position of the DCS transparent to deposit takers. This would allow deposit takers to see how the fund is tracking against its projected path. The principle of transparency complements the principles of predictability and efficiency, as it would provide deposit takers with a view of early indicators if the funding strategy required modification.

3.2 The principle of efficiency should also consider the appropriateness of the investment strategy and operating expenses of the DCS, to avoid creating undue costs for deposit takers in the longer term.

3.3 With respect to the principle of equity, Westpac would like to understand the treatment of new entrant deposit takers in circumstances where existing deposit takers have brought the fund to size. Our view is that this is important to mitigate the moral hazard risk (i.e., the risks that new entrants may be inclined to take greater risks as they have not had to contribute to the DCS fund but benefit from the DCS fund) and reduce burden to existing deposit takers that have contributed to the DCS fund.

Question 2 – Do you agree with adopting a target fund approach to communicate the future path of levies? Why or why not:

3.4 Westpac supports the adoption of the target fund approach which reflects the most common approach taken globally and, in our view, is the most appropriate for communicating the future path of levies (supporting the predictability principle) prior to a drawdown event. This approach also provides flexibility for the levy to be reduced when the DCS fund reaches its target fund size and thereby supports the efficiency principle.

3.5 Westpac is keen to understand how the target fund approach will cater for the future path of levies, following a drawdown event. We note that Figure 1 in the Consultation Paper illustrates a scenario to accelerate the collection of levies to return the DCS to its previous funding path. Westpac would like to highlight that returning the DCS to its previous funding path could have a significant impact on the resilience of remaining deposit takers if a drawdown event occurred and the funds in the DCS were depleted in the later years of the funding path (for example, year 13, assuming a 15 year original term). The funding strategy post a drawdown event should consider the following guiding factors to support the predictability principle: 1) how far along we are against the original funding path, 2) profitability impact to deposit takers of increased levies, and 3) quantum of the loss to the DCS.

Question 3 – Do you agree that the target fund size should take into account likely recoveries from failed deposit takers? Why, or why not:

3.6 Westpac is supportive of the target fund size accounting for likely recoveries from failed deposit takers, as this is reflective of the net cost to the DCS and supports the efficiency principle, whereby the levies charged reflect the true costs to the DCS.

3.7 The inclusion of recoveries would also reduce financial pressure on surviving deposit takers, as the fund is replenished and brought on track with the target fund size following a drawdown event. This supports the resilience principle and is consistent with global practice whereby 73% of jurisdictions that use the target fund approach include recoveries from failed deposit takers as a source of funds.[1]

Question 4 – Do you agree with using the discretionary method? If not, why not? What method would you recommend and why:

3.8 Westpac agrees with the use of the discretionary method given the difficulties with estimating the likelihood and costs given the limited data and information available on deposit taker failures in New Zealand. This is consistent with the approach taken internationally, for countries with limited historical loss information.

3.9 As the SoFA will be published at least every five years, there will be the opportunity to incorporate elements of the statistical method, once more data becomes available.

Question 5 – Do you think we should commission independent modelling to estimate the DCS's expected losses:

3.10 In our view, the commissioning of independent modelling would provide little benefit relative to the cost and time it would take to produce. Instead, periodic reviews of the SoFA, will allow the Treasury to assess the appropriateness of the target fund size as new information on the likelihood and costs of failure become available.

Question 6 – Do you agree with our 'severe-but-plausible' failure scenarios? Are there other scenarios we should consider or modelling assumptions that are more appropriate:

3.11 The 'severe-but-plausible' scenarios appear to be reasonable. We note that the Consultation Paper provides that the DCS would contribute to a resolution subject to a maximum contribution, in a large deposit taker failure scenario. Westpac is interested to understand how a maximum contribution will be modelled.

Question 7 – Do you agree with the assumed losses given default for the different classes of deposit taker? If not, why not? What would be an alternative approach:

3.12 Westpac supports the assumed loss given default failure scenarios set out in Table 3 of the Consultation Paper.

Question 8 – What is your preferred target fund size? Why:

3.13 Westpac's preference is for a target fund size of 0.8% which is the mid-point of the range proposed. This size is in step with the fund size in Europe and we believe it sends the right message to New Zealand deposit holders on the stability and soundness of the New Zealand financial system, given the relative risk profiles of New Zealand deposit takers (noting there has not been a deposit taker failure since the Global Financial Crisis, and prudential regulation in New Zealand has strengthened since then).

[1] Sourced from the International Association of Deposit Insurers (IADI), 2018 "Deposit Insurance Fund Target Ratio: Research Paper".

3.14 We believe this fund size strikes a good balance between the principles of efficiency and resilience (in the context of impact to the Crown's balance sheet) given the likelihood of a deposit taker failure in New Zealand.

Questions 9 & 10 – Do you prefer a 10, 15, or 20-year timeframe to build up the DCS fund? Why? Do you prefer an alternative timeframe? Why:

3.15 Westpac prefers a 15-year timeframe to build up the DCS fund. We consider this to be a reasonable timeframe given the likelihood of deposit taker failure in New Zealand, and we think this supports the equity principle of spreading the costs over as large a cohort of beneficiaries as possible.

3.16 A 15-year timeframe would reduce the financial pressure on deposit takers to build up the DCS fund because the levy will be less concentrated in early years when compared to the shorter 10-year timeframe. The 15-year timeframe may also help to mitigate the moral hazard risk (discussed above at paragraph 3.3) associated with new entrants entering the market, after the commencement of the DCS.

Question 11 – Which of the three options do you prefer and why:

3.17 Westpac prefers Option B, a target fund size of 0.8 per cent over 15 years.

Question 12 – Do you agree with how we have described the process for updating the SoFA? Have we missed any key triggers for review:

3.18 Westpac is generally supportive of the process outlined for updating the SoFA as it allows for the funding strategy to be modified considering any new information. However, as the concept of deposit insurance would be new in New Zealand, Westpac's view is that it would be beneficial for the Treasury to undertake a DCS post implementation review to assess the impact of potential deposit spreading on the target fund size. This is because deposit spreading across different deposit takers following the commencement of the DCS may change the relative risk in the deposit market if there is a disproportional movement of deposits to riskier deposit takers. This in turn would change the outcome of the failure scenarios (i.e., upfront payout and losses after recoveries) set out in part 8 of the Consultation Paper used to inform the target fund size. For example, an increase in protected deposits with non-bank deposit takers will increase the impact to the DCS fund if there were to be a widespread liquidation in the non-bank deposit taker sector.

3.19 In the second consultation Westpac would like the SoFA to provide more detail on levies charged following a drawdown event, and whether the plan is to return to the original funding path. For example, returning to the original funding path will have a significant impact on the resilience of surviving deposit takers if a drawdown event were to occur in the later years (e.g., in year 13, assuming an original 15-year timeframe). As such, the funding strategy post a drawdown event should consider the following guiding factors to support the predictability principle: 1) how far along we are against the original funding path, 2) profitability impact to deposit takers of increased levies, and 3) quantum of the loss to the DCS.

Question 13 – Do you have any other comments on matters covered in this discussion document:

3.20 Westpac would like the SoFA or the RBNZ levy framework to provide clarity on both the operational aspects of the DCS fund, i.e., how it runs, fees charged (operational and investment), as well as the investment mix etc. as it has financial impacts on deposit takers on an ongoing basis.

3.21 Finally, Westpac's view is that DCS levies should not be taxed because a tax on the DCS levies would increase the cost to deposit takers and we note that jurisdictions including the United Kingdom and Canada do not tax DCS levies (though investment returns are taxed). For completeness we note that the EQC levy is exempt from income tax under the Earthquake Commission Act, and the Accident Compensation Scheme levy is exempt from income tax under the Accident Compensation Act 2001. We support a similar approach for the DCS levies.