TE TAI ŌHANGA
THE TREASURY

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

Summary of Submissions

November 2023

Te Kāwanatanga o Aotearoa
New Zealand Government

Contents

Introduction

Background to the consultation

In late 2017, the Government announced an intention to review the Reserve Bank of New Zealand Act 1989, beginning with monetary policy arrangements. The second phase looked at the governance of the Reserve Bank of New Zealand, and matters related to prudential policy. A team of Treasury and Reserve Bank staff conducted policy work (including a three-stage consultation process) between 2018 and 2021. This led to two pieces of major reform.

The first reform led to the passage of the *Reserve Bank of New Zealand Act 2021*. The second was the passage of the *Deposit Takers Act 2023* (the Act). The Act deals with the framework for the regulation and supervision of banks, credit unions, building societies, and finance companies (referred to as "deposit takers"). The Act also introduces a formal scheme to protect depositors from loss, called the Depositor Compensation Scheme (DCS). The DCS will protect each eligible depositor up to $100,000 per licensed deposit taker.

The DCS's costs will be funded by levies on all licensed deposit takers, that will be held in a DCS fund. If the DCS fund does not have enough money to meet its statutory obligations, the Act will require the Minister to provide public money to the fund on terms and conditions suitable to the Minister. The commitment to provide this 'Crown backstop' to the DCS will provide public assurance that compensation will be provided in a timely manner following the failure of a deposit taker. The Crown is expected to recover a significant portion of these funds from later in the process if a payout is triggered.

The DCS fund may also be used to support a resolution of a failing deposit taker and/or compensate creditors or shareholders that are made worse off from a resolution action, relative to outcomes under a hypothetical liquidation.

Consultation on the Statement of Funding Approach (the funding strategy for the Depositor Compensation Scheme)

In July 2023 The Treasury issued a consultation paper on the SoFA for the DCS. The consultation closed on 25 September 2023.

The SoFA consultation ran in conjunction with the Reserve Bank's consultation on the levy framework for the DCS. The SoFA sets out the overall costs of the DCS that are to be recovered by a levy on deposit takers and the levy framework will set out how the DCS's costs are allocated amongst deposit takers. The Reserve Bank is working on an approach to setting the levy for different deposit takers and the appropriate proxy for calculating the protected deposit base in the early years of the DCS.

The DTA requires the Minister of Finance (the Minister) to publish a SoFA for the DCS at least every five years. The SoFA is the funding strategy for the DCS, and will set out its estimated costs, a target size for the DCS fund (if any), the timeframe to reach this target, how the target will be invested, and a proposed approach to managing the Crown's financial position on the DCS.

The consultation discussed:

- Objectives and principles that guide the funding strategy in the SoFA
- Conceptual approaches to the funding strategy
- The role of post-failure recoveries in the funding strategy
- Methodology for assessing the funding obligation of the DCS in severe but plausible scenarios
- Using 'severe but plausible' failure scenarios to estimate costs to the DCS
- Target Fund approach options
- Changes to the SoFA

In total, we received 18 submissions (see annex 1) from deposit takers, industry associations and the public. We would like to thank everyone who took the time to make submissions.

The purpose of this report is to:

- Highlight emerging themes – this is done via the sub-headings in each section of the report.
- Summarise and share the key messages that we received.

We do not provide a direct response to the feedback because we are developing our policy response and intend to publish a second round of consultation, planned for early 2024, on a full draft SoFA. In this second round of consultation, we will also seek feedback on more operational aspects of the funding strategy.

We received comments on tax treatment of DCS levies and returns, the need for clear communications from Treasury, Reserve Bank of New Zealand and banks to depositors, reconsideration of the implementation timeline of the DCS and consideration of the burden of regulation. We note guidance for these topics are supported by other workstreams and are out of scope for the discussion on the SoFA.

We also received comments on the investment mandate (including treatment of ongoing earnings in the fund), operational aspects of the DCS, and the Crown Backstop. These aspects will be included in the next round of consultation on the draft SoFA, and we welcome more detailed feedback at that time.

Objectives and Principles that guide the funding strategy in the Statement of Funding Approach

There was broad support for the principles consulted on.

We received suggestions for additional principles as follows:

Banks	Non-bank deposit taking (NBDT) sector
One submitter suggested adding "Transparency" – to ensure the financial position of the DCS fund is transparent to deposit takers. One submitter suggested that "moral hazard" is included which would consider the increased deposit inflows to risker deposit takers.	One submitter suggested adding a principle related to the impact on competition and pathway for the growth of licensed deposit takers. Another suggested adding proportionality to enable the SoFA to consider the DCS impact on different business models.

Submitters also commented on the existing principles as follows:

Banks	NBDT sector
One submitter stated that the efficiency principle should consider the appropriateness of the investment strategy and operating expenses to avoid creating undue costs to deposit takers. The same submitter would like to understand better how new entrants would be treated under the equity principle. One submitter would like the progressive uplift in capital requirements over the next 5 years to be given specific consideration in setting a target fund size. One submitter noted that timely and effective communication will be needed prior to the DCS taking effect to meet the public confidence principle.	One submitter believes that equity and efficiency are the key principles for the SoFA to consider.

Conceptual approaches to the funding strategy

The vast majority of submitters agreed with adopting a target fund approach to communicate the future path of levies.

All submitters, except one, support adopting the target fund approach to communicate the future path of levies. Submitters stated that the target fund approach gives them certainty around levy obligations, supports the proposed principles of the SoFA, aligns with international practice and supports stability.

One NBDT supervisor suggested that NBDT supervisors retain a security trustee role after the transition to Reserve Bank supervision occurs under the DTA. This would benefit the DCS fund because the retention of a first ranking security would mean recoveries to the DCS fund would be higher.

One public submission noted that they would prefer that there should not be a target for the deposit insurance reserve fund at all because [according to the submission] once the target is reached, no further premiums are charged so the deposit insurance becomes free.

The role of post-failure recoveries in the funding strategy

Submitters generally agreed that the target fund size should take into account likely recoveries from failed deposit takers.

All submitters, except two, agreed that the target fund size should consider likely recoveries from failed deposit takers. Submitters support the proposal because it reflects the net cost of the DCS fund, supports the efficiency and equity principles, reduces pressure on surviving deposit takers after a failure event (supporting the resilience principle) and is the international norm.

Two NBDTs were neutral about this proposal. They stated that there is limited evidence to reliably determine the likelihood of a deposit taker failing and what likely recoveries would be. Particularly as the new DTA requirements for NBDTs are likely to reduce their risk of failure. However, they stated that if failures are considered then recoveries should be too.

Two banking industry submitters stated that they would like to see more information in the SoFA about the post-failure approach to levies. They expressed concern that a rapid rebuild of the DCS fund could create issues for remaining deposit takers and could contravene the predictability principle.

One bank stated that Open Banking Resolution (OBR) should be considered in the likely recovery scenarios.

One NBDT industry body stated that many previous liquidations of NZ finance companies took longer than the 12–18-month period suggested in the consultation. They suggested reviewing the outcomes of the receiverships and liquidation of NZ finance companies to better estimate the repayment period to the DCS fund.

Two submitters acknowledged that taking likely recoveries into account places greater reliance on the Crown backstop.

Methodology for assessing the funding obligation of the Depositor Compensation Scheme in ‘severe but plausible’ failure scenarios

Submitters supported the use of the discretionary method for assessing the funding obligation of the DCS in severe but plausible failure scenarios.

Submitters agree with using the discretionary method due to the scarcity of data in New Zealand. One NBDT stated that the consultation paper does not consider the new regulatory regime under the DTA. The new regime adds more uncertainty for estimating DCS costs. One NBDT industry body questioned the appropriateness of using data from the global financial crisis. The failures at that time were during an unprecedented global event, the NBDT sector was larger, and the regulatory environment was different.

Overall, submitters disagreed with commissioning independent modelling to estimate the DCS's expected losses.

Most submitters did not see any benefit of independent modelling due to the lack of data available in New Zealand. One bank stated that the periodic reviews of the SoFA allow the Treasury to assess the appropriateness of the target fund as new information becomes available.

On the other hand, three NBDT sector submitters could see merit in commissioning independent modelling. One stated that if the output of the modelling is not considered sufficiently robust or reliable then it should not be used. Another wants independent modelling but with input into the terms of engagement. The last one would like independent modelling that uses the discretionary method.

Using 'severe-but-plausible' failure scenarios to estimate costs to the Depositor Compensation Scheme

Submitters from the banking industry agreed with the 'severe-but-plausible' failure scenarios. However, NBDTs disagreed with the assumption of contagion in their sector.

One bank submitted that they would like to understand more about how a maximum contribution to the resolution of a deposit taker will be modelled in the SoFA.

NBDT's believe that contagion is more likely to occur in larger banks due to the inter-company balances and arrangements. They suggest that a more realistic scenario would be the failure of 1-2 NBDTs rather than widespread liquidations. One submitter stated that the failure of a Mutual may be better addressed through resolution.

Similarly, Banks agreed with the assumed losses given default for the different classes of deposit taker whereas NBDTs disagreed.

Banks agreed with the assumed losses because they reflect the higher-risk nature of the NBDT sector and key aspects of the NZ financial system.

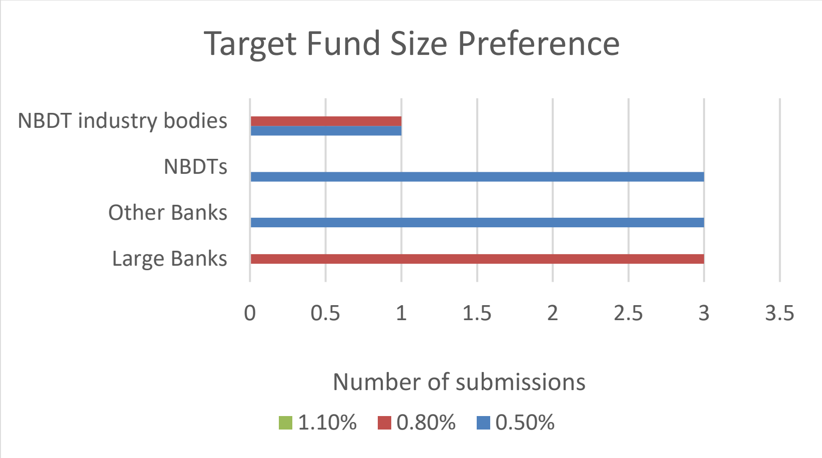
NBDTs disagreed with the assumed losses for the following reasons:

- The risk of contagion is overstated and does not consider the regional and business model diversity that exists in the sector.
- The data used is out-of-date and does not reflect modern prudential regulation.
- The assumed losses for smaller banks are too large given modern prudential capital requirements. The range for smaller banks should therefore be $0.8b. The assumed losses for NBDTs should be the same as for smaller banks ($0.8b).

One public submission disagreed with the assumed losses because the target fund sizes do not assume that most calls on the fund will be from NBDTs which the submitter expects to be the case.

Target Fund approach options

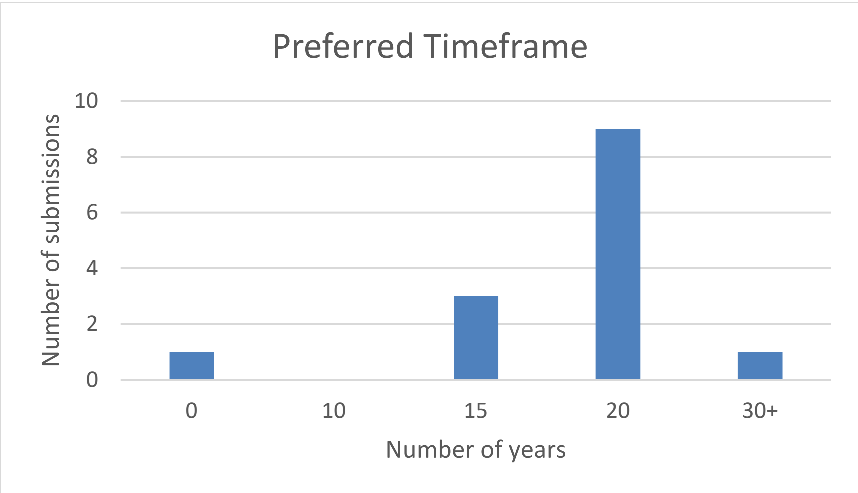
Submitters preferred a target fund size in the range of 0.50%-0.80% of protected deposits.



Reasons:

Banks	NBDT sector	Public
0.8% is similar to other jurisdictions, sends a positive message to deposit holders on the soundness and stability of the financial system and balances the public confidence and efficiency principles. 0.5% builds an appropriately sized fund and mitigates impact on customers.	A 0.5% fund minimises the impact of the DCS on the sector. 0.8% would balance the interests of the Crown and the cost to Deposit takers.	One submitter would prefer a larger target fund than proposed in the consultation to consider (in their view) likely deposit transfers to the NBDT sector and the recent bank runs overseas.

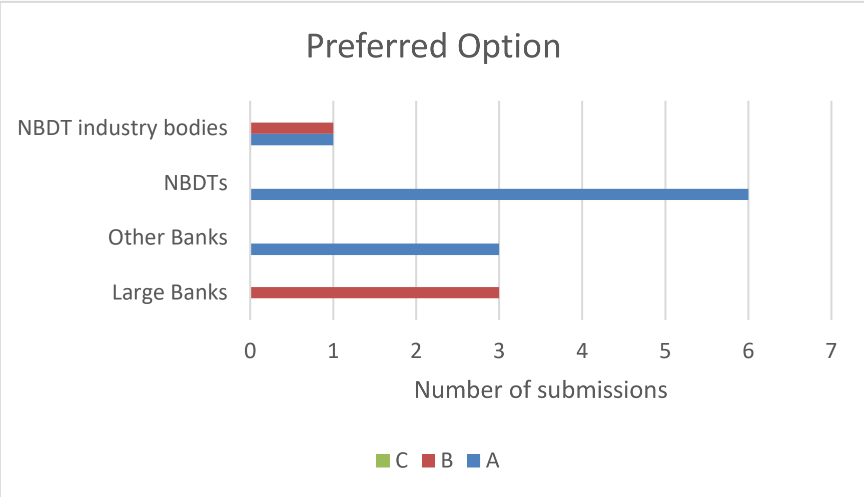
Most submitters preferred a 20-year timeframe to build up the DCS fund.



Most industry submitters prefer a 20-year timeframe for building the target fund. Submitters noted that a longer timeframe supports the equity principle as it spreads the costs of the DCS over a larger cohort of depositors, stabilises and reduces the levy burden, gives more time to calibrate levies, reduces the barrier to entry for new entrants and shows confidence in the NZ financial system (supporting the public confidence principle).

One public submission would prefer the fund to be "front-loaded" by deposit takers and another would prefer a larger fund size built over a longer timeframe. Two NBDTs would prefer a longer timeframe but acknowledge that this may result in an insufficient fund.

The majority of submissions preferred option "A" (a target fund size of 0.5% built over 20 years.



- Option A – an approach that prioritises lower upfront costs with a target fund size of 0.5 per cent fund over 20 years.
- Option B – a middle ground option with a target fund size of 0.8 per cent over 15 years.
- Option C – an approach that mitigates reliance on the Crown backstop with a target fund size of 1.1 per cent over 10 years.

Reasons:

Banks	NBDT sector
The banks that supported option B reiterated their comments given in previous sections. One bank noted that they would prefer the 0.8% fund built over 20 years rather than 15. Three submissions stated that option A aligns with NZ's risk profile, noting the high capital requirements for the sector in NZ. They also noted that a more aggressive approach could send unintended messages to the public on the soundness of the deposit taking sector.	Option A reflects the risk of failure level in NZ. No fund size would cover the failure of a big bank so the fund should be focused on covering the failure of an NBDT which a 0.5% fund would achieve.

Suggested changes to the Statement of Funding Approach

Submitters were generally supportive of the processes for updating the SoFA and suggested some additional triggers for review.

Banks agree with the process but suggested the following, additional triggers for review:

- Post implementation – this submitter noted that potential deposit spreading once the DCS is implemented could change the relative risk profile in the deposit market – changing the failure scenarios in the SoFA.
- Upon any resolution action being undertaken by the Reserve Bank of New Zealand.
- Any emergence of external/macro-economic shocks that could cause a deposit taker failure.
- After single customer view is implemented.
- After all other aspects of the DTA are implemented.

We received the following suggestions from the NBDT sector:

- Two NBDTs would like more consideration of a scenario where the extent of failures of deposit takers is lower than previously assumed (suggesting a reduction in levies).
- Additional triggers
    - If investment returns significantly differ from current assumptions.
    - Following a failure but after the liquidation report is published.
    - Force majeure

Further comments

We received the following, additional comments.

A summary of additional comments within scope of the current consultation are in the table below. Some out-of-scope feedback received was noted in the introduction of this document.

Banks	NBDT sector	The public
The SoFA should provide clarity on any ongoing earnings of the DCS fund once the target is reached. Would levies cease or be refunded? More clarity is needed on how new entrants to the market will be treated.	The investment return assumption (2%) in the consultation is too conservative. The consultation has a lack of data on the impact of the levy on NBDT profits – full transparency is important. Representatives from the deposit taking industry should be able to participate in the governance of the DCS fund. All issues highlighted need to be considered proportionally as it is unwise to treat an NBDT in the same way as a bank. Need to better understand the business models of NBDTs and the effect of the DCS on competition.	Due to potential deposit spreading the DCS may encourage risk taking and lead to more failures (particularly if depositors move money from banks to riskier NBDTs). The consultation does not consider NBDTs growing. In 2008 there was a surge in funds to NBDTs. Recent overseas banking failures haven't been considered in the consultation. Consultation does not consider that banks have access to the Reserve Bank of New Zealand as a lender of last resort.

Annex 1 – Summary of submitters

Table 1: Summary of submitters

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<tr><th rowspan="2">Banks</th><th colspan="2">Large Banks</th><th colspan="2">Other Banks</th><th colspan="2">Industry bodies</th></tr>
<tr><td colspan="2">3</td><td colspan="2">3*</td><td colspan="2">1</td></tr>
<tr><th rowspan="2">NBDT Sector</th><th>Credit Unions</th><th>Building Societies</th><th colspan="2">Finance Company</th><th>Joint Submission</th><th>Industry bodies</th></tr>
<tr><td>1</td><td>3</td><td colspan="2">1</td><td>1**</td><td>2</td></tr>
<tr><th>General Public</th><td colspan="6">3</td></tr>
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* We received 2 individual submissions from “other banks” and 1 joint submission. The joint submission was on behalf of 4 domestic banks.

** This joint submission was on behalf of 11 NBDTs.