Statement of Funding Approach for the Depositor Compensation Scheme 2024

Minister of Finance

July 2024

Te Kāwanatanga o Aotearoa
New Zealand Government

ISBN 978-1-991149-29-9

The Treasury URL at July 2024 for this document is https://www.treasury.govt.nz/publications/sofadcs/statement-funding-approach-depositor-compensation-scheme-2024

Contents

Purpose of this document

The purpose of this document is to set out the Minister of Finance's (Minister's) Statement of Funding Approach (SoFA) to manage the liabilities of the Depositor Compensation Scheme (DCS) for its first five years.

Executive summary

The DCS contributes towards protecting and promoting the stability of New Zealand's financial system by protecting depositors in the event of a deposit taker failure. The DCS has liabilities associated with the costs of protecting depositors and administering the DCS. The SoFA provides estimates of the costs of the DCS over the next five years and sets out the strategy for funding these costs and liabilities over time to support the objectives of the DCS. The publication of the SoFA is an important milestone towards implementing the DCS in mid-2025.

The SoFA uses targets for the DCS fund to set the amount of levies that will be collected over time as a result of the funding strategy. The target fund approach results in a predictable forward path of levies and is consistent with international practice. Based on the Treasury's estimates of the liabilities for the DCS associated with severe but plausible failure scenarios, the target for the DCS fund will be 0.8% of protected deposits. Given the resilience of the New Zealand financial system, a timeframe of 20 years has been set for reaching this target, which provides scope to adjust the targets over time in response to new information.

The other aspects of the funding strategy are targeted towards public confidence in the DCS, while ensuring efficiency in delivering the scheme. The SoFA sets an expectation that the Reserve Bank will invest the fund in a way that preserves real capital value[1] and prioritises liquidity to ensure prompt payout after a failure event. The Crown will provide temporary and cost-reflective lending if the fund is not able to meet the liabilities of the DCS (in the event that failures occur prior to the fund targets being reached, or in systemic failure scenarios that place demands upon the DCS that are larger than its target fund size).

The SoFA will be updated at least every five years. The Treasury will also monitor the liabilities of the DCS and recommend an out-of-cycle adjustment to the SoFA in certain situations. These could include the fund targets being met, significant failures events, or significant changes in risk information. This SoFA includes guidance on what an out-of-cycle review triggered by failures could cover, while recognising it is important that the Government of the day has flexibility to respond to new information or events.

---

1 Real capital value takes into account inflation.

Guide to this document

This statement sets out the rationale for the decisions made as part of the SoFA, and how it meets the requirements set out in section 247 of the *Deposit Takers Act 2023* (the Act).

Table of Contents:	Key decision(s) within the chapter:
Chapter 1: The role of the SoFA in funding the DCS	This chapter contains no decisions. It explains the role of the SoFA within the funding framework for the DCS, and the objectives it is seeking to achieve.
Chapter 2: Information about estimated costs of the DCS	This chapter contains information about the estimated costs of the DCS, including estimated costs of failure scenarios, and qualitative information about the likelihood of failure and the cost of administering the DCS.
Chapter 3: Approach to funding the DCS (targets for the fund)	This chapter explains the target fund approach that will be used to set the amount of levies to be collected over time, and the targets to reach a fund size of 0.8% of protected deposits over 20 years.
Chapter 4: Approach to managing the financial impact of the DCS on the Crown	This chapter contains the approach to implementing the backstop through an interest-bearing loan to the DCS that will be repaid through future earnings. It also demonstrates the ability of the Crown to backstop the DCS.
Chapter 5: Investment requirements for the DCS fund	This chapter contains investment objectives for the Reserve Bank when investing the fund, that prioritise preservation of capital value and liquidity. It also sets out eligible asset classes, and oversight information.
Chapter 6: Review of the SoFA	This chapter includes the factors the Treasury will monitor to determine when an out-of-cycle review could take place, and guidance for any review of the funding strategy following failures.

Further details on the process for developing the SoFA, including feedback received and how it was taken into account, is available on the Treasury website.

1 The role of the SoFA in funding the DCS

Summary:

- This section contains background information on the funding framework for the DCS and the role of the SoFA within the framework.
- The legislative framework sets an expectation that the DCS will be fully funded by licensed deposit takers, with levies held in a fund that is backstopped by the Crown.
- Other aspects of funding arrangements can be adapted over time through the SoFA. The SoFA sets how to build and invest the fund and puts in place arrangements for possible use of the Crown backstop.
- The SoFA has been guided by a range of decision-making principles.

1.1 The Depositor Compensation Scheme

The DCS is scheduled for implementation in mid-2025. The DCS will protect each eligible depositor up to $100,000 per licensed deposit taker in the event of failures. The DCS will payout depositors if it is triggered by the Reserve Bank and may also be used to fund the resolution of a failed deposit taker within limits defined in the Act. The DCS will contribute to financial stability by providing confidence that depositors will be able to access deposits promptly in the event of deposit taker failure.

Robust funding arrangements are critical to achieving the objectives of the DCS.

The legislative framework sets an expectation that the DCS will be fully funded over time by the levies collected from licensed deposit takers. These levies will be held in a statutory fund administered by the Reserve Bank, and they can only be used to meet the costs of the DCS. A Crown liquidity facility ensures that the DCS can meet its obligations if the money in the fund is insufficient for a payout or to cover other costs of the DCS.

1.2 The Statement of Funding Approach

There is significant flexibility for the Minister to alter the funding arrangements through the publication of the SoFA at least every five years. This enables the Minister to adapt the funding of the DCS in response to new information, including evolving evidence about likely costs. The SoFA defines the funding arrangements for the DCS by providing specific estimates of the costs that are expected to be incurred, uses those estimates to inform the strategy for how the DCS fund will be built and invested, and puts in place arrangements for the possible use of the Crown backstop.

The publication of the SoFA will largely determine the overall future path of DCS levies charged to the deposit taking sector and must be taken into account in the Minister's decision about levy regulations. The publication of the SoFA will enable levy regulations to be introduced alongside the implementation of the DCS in mid-2025. The SoFA sets out targets that will impact the overall levies charged to deposit takers, while the levy regulations will determine how the costs of funding the DCS are to be distributed amongst deposit takers.

1.3 Objectives and decision-making principles

The SoFA is seeking to balance a range of objectives. These include promoting public confidence in the financial system, supporting the ability of the levy regulations to achieve the principles set out in the Act, adhering to the Treasury's cost recovery guidelines and ensuring that the implications for the Crown's balance sheet of the Crown backstop commitment are effectively managed. These various objectives are summarised in the objectives and decision-making principles that are used to guide the funding strategy (Table 1).

Table 1: Objectives and decision-making principles to guide the SoFA

Objective or principle
The DCS has the objective of contributing towards protecting and promoting the stability of New Zealand's financial system by protecting depositors and allowing the DCS fund to be used to support a resolution measure (**public confidence**).
The DCS should be fully funded by industry over time (**accountability**).
The funding strategy should aim for levies to be predictable over time (**predictability**).
The DCS's funding strategy should have regard to the impact of failures on the Crown's balance sheet and the wider deposit-taking sector (**resilience**).
The DCS's funding strategy should consider the likelihood of failure, and be tailored to the nature of New Zealand's financial system and existing and forthcoming prudential regulation (**system alignment**).
The DCS's funding strategy adopts an equitable approach to funding over the long-term (**equity**).
The DCS's funding strategy adopts an efficient approach to funding over the long-term (**efficiency**).

2 Information about estimated costs of the DCS

Summary:

- This section contains information on the costs of the DCS and the likelihood of the DCS being triggered during the five-year period covered by this SoFA.
- The costs of protecting depositors in the event of deposit taker failures is likely to be the largest component of the costs of the DCS.
- The funding strategy uses severe but plausible failure scenarios to estimate the scale of these costs, supported by qualitative judgements about the likelihood of a failure happening.
- Operating costs are expected to be a small component of the overall costs of the DCS and there will be opportunities for stakeholders to scrutinise them over time.

2.1 Overview of potential costs of the DCS

There are various costs that the DCS could incur:[2]

- the costs of meeting entitlements if a failure event triggered a payout
- supporting the resolution of a licensed deposit taker, although the contribution of the DCS is limited to the modelled net cost of a hypothetical payout process
- the costs for the Reserve Bank performing its functions, powers, and duties in administering the DCS, including preparing for and executing a payout process, and the costs of establishing and maintaining the fund,
- paying any costs to the Crown associated with backstopping the fund.

2.2 Costs associated with deposit taker failures

There is significant uncertainty about the likelihood of deposit taker failures over the period of the SoFA. With the exception of finance company failures during the Global Financial Crisis, there have been very few failures of deposit takers in recent years that would provide data to estimate the likelihood of failures, and the costs to the DCS in the event of failures. The regulatory environment is also in the process of being strengthened through the implementation of the Act and more robust capital requirements for banks. This is likely to lower the likelihood of failures in the future.

[2] See sections 199, 238(2) and 247 of the Act.

The SoFA uses severe but plausible failure scenarios to estimate the costs associated with failures. This approach provides scope to apply qualitative judgements about the likelihood of failure when designing and using the scenarios to inform the funding strategy. In this way, the scenario methodology can indirectly consider the characteristics of New Zealand's financial system that impact on the likelihood of failures occurring. Although it would be possible to quantify the likelihood of failure using credit models, any insights from such modelling would be limited given the scarcity of available data on historical failures.[3]

The failure scenarios used in the SoFA are shown in Table 2. The calibration of the scenarios reflects the qualitative assumptions, the remote likelihood of more systemic scenarios involving multiple deposit takers and reflects that large- and medium-sized banks tend to be lower risk than non-bank deposit takers (NBDTs). The scenarios use the Reserve Bank's estimates of protected deposits for each deposit taker and derive losses to the DCS using assumptions about losses in the event of failures and data on the other assets and liabilities of deposit takers.

Table 2: Severe but plausible failure scenarios

Failure scenario		Assumed loss given default
Resolving a large deposit taker to maintain financial system stability or continuity of critical services	In this scenario, the DCS contributes to a resolution, subject to a maximum contribution equal to the net cost of a hypothetical liquidation. It assumes that a large deposit taker would be resolved and not liquidated to avoid significant damage to the financial system, consistent with the additional purposes of Part 7 of the Act.[4]	5-15 per cent
Liquidating one medium-sized bank	In this scenario, the DCS compensates depositors up to the $100,000 limit. It conservatively assumes that a medium-sized bank would be liquidated or placed into receivership. However, the resolution authority (the Reserve Bank) may decide to use resolution tools, which would lower the upfront cost to the DCS.	10-25 per cent
Widespread liquidations in the non-bank deposit taker sector	In this scenario, the DCS compensates depositors up to the $100,000 limit.	25-50 per cent

* Loss given default represents the percentage of the failed deposit takers total assets that are not recovered through a liquidation, receivership or resolution process. The assumed loss given default draws on overseas evidence and finance company losses after the Global Financial Crisis.

[3] The scenario approach is often referred to as the "discretionary" method in the international deposit insurance literature. The discretionary method relies on judgements based on, for example, features of a jurisdiction's financial system. A statistical approach is used to estimate expected losses in some deposit insurers, especially where a long history of deposit taker failures provides data needed to estimate these models.

[4] Part 7 of the Act has the additional purpose of avoiding significant damage to the financial system by maintaining the continuity of systemically important activities and by mitigating, or otherwise managing, any loss of confidence in the financial system.

Table 3 provides current estimates of how severe but plausible failure scenarios would be expected to affect the funding of the DCS. The estimated numbers in the table will grow as the protected deposit base grows, which is why the target for the fund is set at 0.8% of protected deposits, rather than as a specific number.

The largest estimated cost would be the liquidation of a medium-sized bank. The next largest cost would be liability for resolution of one of the largest five banks and is more of a remote likelihood, given buffers in place for domestically systemic important banks (D-SIBs)). The smallest cost would be for the NBDT sector (although noting that this would be the most likely liability to crystalise).

Table 3: Funding requirements for the DCS in severe but plausible failure scenarios

Failure scenario	Funding required for upfront payout to depositors ($ billion)	Losses after recoveries are made or following use of resolution tools ($ billion)
Resolution of one of the largest five banks	Not estimated, given the low expected likelihood that liquidation would be used over resolution	0-3 The upper end is the estimated maximum contribution the DCS would make to a resolution of a deposit taker
Liquidating one medium-sized bank	1.5-3.5	0.1-0.7
Widespread liquidations in the non-bank deposit taker sector	0.8-1	0.1-0.4

* The range of losses in each scenario were derived by applying the assumed loss given default to the relevant entities, allocating those losses to holders of capital and other financial instruments that rank below the DCS, and allocating any remaining losses to the DCS and equally ranking creditors.

2.3 Information about costs to establish and operate the DCS

The DCS fund will be administered by the Reserve Bank, on behalf of the Crown. The costs that are expected to be incurred by the Reserve Bank in undertaking this role include: maintaining and investing the DCS fund, developing single depositor view (SDV) standards to enable prompt payout of depositors, and the administrative cost of executing a payout process or another mechanism to protect depositors following any failures.[5] Specific decisions on the costs of the DCS to be recovered from deposit takers will be made by the Reserve Bank (and monitored by Treasury), rather than specified in the SoFA.

5 Section 238 of the Act, particularly subsections 238(2)(a), (b), (c), and (f), describes the costs expected to be incurred in administering the DCS in more detail.

The Reserve Bank expects to run the DCS on a cost recovery basis, minimising the cost to deposit takers. The funding framework for the DCS is designed so there is flexibility to allocate operating costs to the DCS fund, ensuring that expenditure of the DCS can be quickly scaled in response to deposit taker failures. The Reserve Bank must, however, consult deposit takers in preparing its advice on levy regulations, where it is proposing changes that would materially change the amount of levies or the method for ascertaining levies.[6]

The Reserve Bank is also incentivised to demonstrate value for money in its operating costs through accountability and transparency requirements. The Treasury monitors the performance of the Reserve Bank and as a part of this responsibility will scrutinise the operating costs of the DCS. Quarterly and annual reporting requirements outlined in chapter 5 will include information on operating costs for the relevant period of time.

2.4 Costs to the DCS associated with the Crown backstop

It is desirable that costs to the Crown for the backstop should be fully met out of the fund over time.[7] As a consequence, the SoFA includes arrangements for the cost-reflective provision of liquidity to DCS. Chapter 4 discusses these arrangements.

---

[6] See section 242 of the Act.

[7] This includes costs incurred in holding additional liquidity, and the costs of repaying any money provided to the DCS fund (eg, any interest, or other charged). See sections 238(2) and 199(d) of the Act.

3 Approach to funding the DCS (targets for the fund)

Summary:

- This section contains information on how the DCS will be funded via a target fund approach.[8]
- The DCS will target a fund size of 0.8% of protected deposits built over a 20-year timeframe.
- The targets for the fund reflect the net cost of a severe but plausible failure event, the stability of New Zealand's deposit taking sector and ensure a resilient fund that can respond to the estimated failure scenarios.

3.1 Target fund approach

A target fund approach provides the most flexible framework for charging levies before a payout event ('*ex ante* levies'). This approach provides a stable forward path of levies giving the deposit taking sector (and depositors) predictability and transparency. It ensures that a deposit taker contributes to the costs of its own failure and allows the Government to signal its long-term intentions for funding the DCS. The target fund approach is used by the vast majority of deposit insurers overseas.

The specific calibration of the targets for the fund are informed by the estimates of the costs of a severe but plausible failure events to the DCS and will largely determine the future path of DCS levies charged to the deposit taking sector. The targets do not, however, consider other operating costs, establishment costs or investment returns as these do not affect the costs of a severe but plausible failure event. Nor do the targets seek to fund the cost of systemic failure scenarios, given the remote likelihood of these events and the high cost of funding them ahead of failures through levies on deposit takers.

The targets reflect the likely net cost of a failure event (ie, they take into account recoveries from the failed deposit taker). The net cost approach is in-line with the Treasury and Auditor-General's guidelines that levies should reflect the costs of providing the goods or services. It is also consistent with the 'efficiency' principle, in that levies are not charged ahead of time to cover the short-term cost of paying out depositors prior to recoveries being made. New Zealand does not have depositor preference, and this has been reflected in the proposed range for the target fund size.

---

8 See subsections 247(e) and (f) of the Act.

3.2 The target fund size is 0.8% of protected deposits to be built over 20 years

The 0.8% target fund size ensures a resilient fund is built that is estimated to be sufficient to cover the net cost of the estimated severe but plausible failure scenarios (see Table 3). It provides a buffer against the Crown bearing the medium-term costs of a failure event. Internationally the average target size (in jurisdictions analysed by Treasury) is around 1.1%. However, in New Zealand a higher target would risk levies being higher than the expected cost of failure events over time, taking into account recoveries that would likely be made from a failed deposit taker.

The aim is to reach the target fund size in 20 years. This reflects that the New Zealand deposit taking sector is sufficiently stable to support a relatively long timeframe (compared to the timeframes used by overseas deposit protection schemes that set a specific target). It also supports equity with DCS costs spread over a large cohort of potential beneficiaries and allows more time to recalibrate the targeted size of the DCS fund over time based on new risk information, including any failure events that occur during the build-up phase.

4 Approach to managing the financial impact of the DCS on the Crown

Summary:

- This section sets out the Minister's approach to managing the Crown backstop.[9]
- The DCS has a Crown backstop in case there are insufficient funds in the DCS to meet its objectives. The backstop represents an explicit liability to the Crown and the Minister will provide money on suitable terms and conditions when needed.[10]
- The backstop supports public confidence in the DCS by assuring the public that compensation will be paid in a timely manner following a deposit taker failure/resolution.[11]

4.1 Ability of the Crown to backstop the DCS

The Crown backstop ensures that depositors can be confident that sufficient funding will be available to enable a prompt payout to occur in the event of failures. Although the target fund size of 0.8% of protected deposits reduces the risk that the Crown backstop will be drawn on, the Crown is well-placed to support the DCS should the costs exceed the size of the fund, or should a failure occur during the 20-year build-up phase. The availability of a credible Crown backstop supports a more efficient funding strategy, by avoiding the need to rely solely on the DCS fund to make payouts (and therefore to have a sufficiently large fund to payout in remote scenarios).

4.2 Structure of the Crown backstop

Money provided through the Crown backstop will be in the form of an interest-bearing loan to the DCS. This loan will be reflective of costs to the Crown, with no additional margin. Earnings from the DCS will be used to service the loan repayment obligations as well as the other ongoing DCS costs. The loans will be structured to ensure the loan servicing costs are manageable within the expected DCS earnings. This is consistent with the principle that costs to the DCS should, over time, be fully met out of the fund.[12] The Crown will provide two types of loan facility to backstop the DCS:

1) **A liquidity facility**: Following a failure event that triggers the backstop, the liquidity facility will cover the period of liquidation or resolution. This will be charged at a variable market rate plus a risk premium.

[9] See section 247(d) of the Act.

[10] See section 250 of the Act.

[11] Under section 199(d) of the Act, money may be paid out of the DCS fund to pay the costs of the Crown arising in connection with provision of the Crown backstop.

[12] See section 238(2) of the Act.

2) **A term lending facility:** The term lending facility will cover any amounts still unpaid after the liquidation or resolution period. This will be charged at a fixed market rate plus a risk premium for a period that reflects the DCS's ability to repay the loan.

The specific approach to pricing will be set out in a term sheet agreed between the Reserve Bank and the Treasury. This will be an operational matter rather than a funding strategy matter, as better information would only be available at the time of any failure.

For this SoFA, a liquidity fee (reflective of the costs incurred in holding liquidity via the Crown Liquidity Buffer) will not be charged. There will be optionality for this in future SoFAs, and subject to the Minister's discretion. A justification of costs incurred by the Crown, as and when any liquidity fee is introduced, would be part of the public consultation for a future SoFA.

4.3 Implications for the Crown balance sheet and deposit takers

The implications for the Crown and deposit takers of the backstop being drawn on will depend on how quickly future levies repay the loan. If a medium-sized bank were to fail in the early years of the DCS, the Treasury estimates that the Crown might not be repaid for six years, assuming that the pre-failure levy rates are maintained. Alternatively, levies would need to increase more than 50% if they were increased in order to maintain the timeframe for reaching the fund target. See section 6.2 for guidance on reviewing the SoFA following failure events.

5 Investment requirements for the DCS fund

Summary:

- The Reserve Bank acts as fund manager for the DCS on behalf of the Crown and may invest DCS funds that are not immediately needed.[13]
- However, the Bank must follow the requirements for investment that are in the SoFA.[14] This includes the investment objectives, constraints, and information on oversight of the investment performance by the Treasury.
- For this first SoFA the investment guidance prioritises capital preservation and liquidity, while maintaining the value of the funds in real terms. This is to ensure the DCS can promptly payout depositors in the event of a failure.

5.1 Investment objectives for the DCS fund

The Fund's principal investment objectives are to:

- safeguard the capital value of the Fund in real terms,[15] ensuring that assets are immediately accessible to fulfil DCS obligations, thereby necessitating high liquidity[16]
- maintain New Zealand's reputation as a responsible member of the world community.

The secondary investment objective of the fund is to maximise returns within its prescribed risk boundaries. By doing so, the fund could potentially minimise the levies required to reach any given fund target.

The investment objectives recognise there is a trade-off between liquidity, risk and returns. Maximising returns is integral to maintaining the real value of the fund's capital over time.[17] Rapid payment of compensation following a failure event is crucial for maintaining public trust in the DCS.[18] As such, the SoFA prioritises the primary investment objective, placing a premium on the liquidity of assets to ensure swift disbursements when necessary.

---

13 See section 201(1) of the Act.

14 See section 201(2) of the Act.

15 For the SoFA 'real terms' means generating real (inflation-adjusted) returns over the long-term, protecting the DCS from inflation's potential to increase DCS liabilities or erode the value of its investments.

16 The World Bank recommends that Deposit Insurers should be able to reimburse most insured depositors within seven working days. (see: World Bank Document)

17 The World Bank advises that deposit insurers should strive for capital preservation in real terms and net of costs. Operational costs and inflation threaten the achievement of the capital preservation objective. Therefore, returns are needed to mitigate these threats, while ensuring that the primary investment objectives are met. (see: World Bank Document)

18 See section 195(c) of the Act.

It is anticipated that, once the fund reaches its target size, there would be increased flexibility to focus on the secondary investment objective of return maximisation. This matter will be subject to future SoFA reviews.

5.2 Constraints on the investment strategy and risk management

While the Reserve Bank is tasked with devising an investment strategy conducive to the fund's goals, the SoFA sets out certain constraints to ensure the fund's investment objectives and risk tolerance are followed. These constraints are designed to guarantee fund availability for depositor protection and to prioritise the preservation of capital over the pursuit of higher returns.

The chief limitation imposed on the Reserve Bank's investment strategy is the permitted asset classes. Consistent with global standards, such as stipulations from the European Union Directive on Deposit Insurance Schemes, the DCS fund may be invested in some or all of the following specified asset categories:

- cash and deposits in certain currencies, excluding those held with New Zealand or Australian financial institutions
- highly-rated money-market instruments in specific currencies, maintaining an A+/A1 credit rating or higher, and barring holdings with New Zealand or Australian financial institutions
- sovereign bonds and treasury bills from nominated countries with a minimum rating of A+/A1
- fixed interest instruments issued by municipal and regional governing bodies, rated at least A+/A1
- fixed interest securities from international organisations and development banks with a minimum A+/A1 rating
- corporate bonds from the non-banking sector of particular countries, highly-rated at A+/A1 or above
- covered bonds issued in predetermined countries, maintaining a rating of at least A+/A1
- other assets deemed to mirror similar risk and liquidity profiles as determined by the Treasury on an individual basis
- derivatives, such as futures and swaps, used for hedging or liquidity purposes, provided they introduce no financial leverage to the DCS fund. Counterparties and exchanges involved must possess a credit rating not less than A+/A1.

In line with the investment objectives, the Reserve Bank, as the Fund Manager, retains the discretion to select specific securities and to define the asset allocation framework amongst the allowed asset classes as part of the DCS investment strategy. The Reserve Bank is not compelled to disclose a fixed strategic asset allocation, giving it the necessary agility to adapt to evolving market conditions.

To manage overall risk, the Reserve Bank is developing a Risk Appetite Statement (RAS) that will be agreed with the Treasury.[19] The Treasury's review of the RAS will help to ensure alignment with the overarching investment requirements. For transparency, the RAS will be published by the Reserve Bank prior to the launch of the DCS (although certain sensitive information may be withheld). A reference portfolio will also help to set overall risk limits for the DCS fund and will be developed by the Reserve Bank and agreed with the Treasury.

5.3 Monitoring and reporting of investment performance

The Treasury assists the Minister with the stewardship and management of the Crown's interests in the Reserve Bank. As the monitor, the Treasury is tasked with providing informed advice to the Minister on the Reserve Bank's performance, which could include analysis of opportunities to improve DCS fund management. Additionally, the Minister can set performance expectations through an annual Letter of Expectations and retains the authority to review the Reserve Bank's performance and operations at any time.[20]

The Treasury will be provided with comprehensive reports detailing the DCS's fund performance, both quarterly and annually to facilitate effective monitoring. These reports should minimally cover:

- the allocation of the DCS fund across different asset classes
- the DCS fund's performance relative to the reference portfolio and its returns across each asset class.[21]

The Treasury will evaluate the Reserve Bank's fund management, focusing on how well it aligns with the investment mandate, including investment objectives, and the RAS. Other considerations include its relative performance to the reference portfolio, as well as its performance over time.

The Reserve Bank is obligated to produce annual financial statements that will account for the fund's financial activities and position.[22] These statements are expected to feature detailed commentary on investment performance, explaining adherence to investment objectives, risk parameters, year-on-year performance, and comparisons with the reference portfolio. This level of reporting ensures transparency and enables the Minister, the Finance and Expenditure Committee of Parliament, alongside the public, to scrutinise the fund's performance and the operations of the Reserve Bank effectively.

---

19 Risk appetite is the level of risk the DCS fund is prepared to accept to achieve its investment objectives.

20 See section 194 of the *Reserve Bank of New Zealand Act 2021*.

21 This information is expected to include duration, FX hedging, liquidity, overall credit rating, and ex post and ex ante Value-at-Risk. Duration is a measure of the sensitivity of the price of a bond or other debt instrument to a change in interest rates. In general, the higher the duration, the more a bond's price will drop as interest rates rise (and the greater the interest rate risk).

22 See Subpart 9 of Part 6 of the Act.

6 Review of the SoFA

Summary:

- The SoFA is required to be reviewed at least every five years, so the next cyclical update can be expected in 2029.
- The cyclical updates enable assumptions in the SoFA to be revisited and updated (based on, for example, new risk information[23] and/or new information about the size of the protected deposit base).
- An out-of-cycle SoFA review might be triggered when there are large changes to the liabilities of the DCS, which will be monitored by the Treasury in between the required five-yearly reviews.
- In the event of failures occurring, the decision about how to adjust the SoFA targets should balance the resilience of the DCS fund, the stability of the deposit taker sector, and public confidence in the DCS.

6.1 Monitoring and adaptation of the funding strategy

Future events are highly uncertain, and it is important for the Government of the day to have flexibility in how they respond to any events (eg, a failure event or significant changes in information) based on the best information available at the time. However, there is a tension between this flexible approach and the principle of 'predictability'. To enhance predictability, this section sets out expectations for how the funding strategy could adjust in a range of different circumstances.

The levies for the DCS may deviate from initial forecasts due to a range of factors, including the occurrence of failure events, the extent of growth of protected deposits, changes in consumer behaviour and the amount of earnings made from DCS fund investments. The analysis in this section aims to provide more predictability and provides a benchmark against which the decisions of a future Minister could be compared.

Regular SoFA reviews will be frequent enough to capture and apply most slow-moving changes that would alter the funding strategy. However, if the Treasury were to observe a significant and material change with implications for the funding strategy it could recommend an out-of-cycle review of the SoFA to the Minister. This review, like other SoFA reviews, would consider the information available at the time before recommending any changes to the SoFA.

[23] The Reserve Bank regularly publishes Financial Stability Reports which would be expected to identify any major risks to the stability and resilience of the New Zealand financial system that would materially change the likelihood that the DCS is triggered. These reports can be read here: Financial Stability Report - Reserve Bank of New Zealand - Te Pūtea Matua (rbnz.govt.nz)

To support this approach, the Treasury will monitor the liabilities of the DCS in between regular SoFA publications. Monitoring will focus on identifying the following changes that could warrant an out-of-cycle review:

- The fund target being met: although it is expected that the regular cycle of reviews would consider the impact of this scenario as the targets move closer to being achieved, an out-of-cycle review could be warranted if the targets are achieved much sooner than expected (such as from strong investment performance). Although some degree of levies will always be required for the DCS due to deposit growth and operating costs, levies are expected to reduce once the fund targets are met.
- Increased liability of the DCS: the introduction of deposit protection could result in depositors spreading deposits across multiple institutions, increasing the amount of protected deposits. Alternatively, deposits as a whole could grow significantly more than the 6.2% p.a. used to inform the funding strategy. These scenarios could significantly alter the impact of the DCS on the Crown balance sheet, and the required levies to meet the fund targets.
- New risk information: deposit spreading may also result in a shift in the composition of deposits towards riskier deposit takers. More generally, it is possible that the funding strategy needs to be recalibrated if there are large changes in likelihood of failures due to risk-taking among deposit takers. A significant failure event could also change the estimated risk exposure of the DCS.

6.2 SoFA reviews following failures

A significant failure occurring during the build-up phase of the DCS fund would also likely trigger a review of the SoFA and the Minister of the day would need to make a judgement about whether to adjust the targets for the DCS fund. A SoFA review at the time would focus on whether and how much to extend the timeframe for reaching (or returning to) the target fund size, which would affect the amount of levies. However, this SoFA does not set any maximum/minimum expectations on what a levy change might look like due to the unknown nature of a failure event, and the need for the Minister of the day to have flexibility.

The outcomes of a SoFA review of the targets for the DCS fund would be expected to influence the terms and conditions of the loan to the DCS, including the timeframe for repaying the loan. This SoFA suggests that the Minister of the day would need to balance the following considerations when reviewing the SoFA:

- The benefits for the resilience of the DCS fund to future failures from reaching or returning to the fund size target as soon as possible. This would include the benefit to the Crown balance sheet of being repaid earlier than otherwise for any outstanding amount on loans provided to the DCS, following recoveries from the failed deposit taker.
- The stability of the deposit taker sector. Rapidly rebuilding the resilience of the DCS fund after failures would potentially require significant increases in levies, which could be procyclical, and even undermine confidence in the stability of the financial system, or sub-sectors of the deposit taker system.

- Public confidence. Rebuilding the fund too quickly could create a perception of increased risk, so a more gradual approach may be more appropriate. Consideration of the stability of deposit takers is also important for public confidence and any increase in levies following an event would need to safeguard the financial stability of the remaining deposit takers to promote public confidence in the financial system, especially if the failure event is driven by market-wide factors rather than firm-specific factors.

The tension between these considerations will become more acute during the build-up phase if the DCS fund is severely depleted following an event at the higher end of the severe but plausible failure scenarios (ie, the resolution of a large bank). In such a case, the Crown backstop may be needed.

The Treasury would therefore expect any SoFA review would carefully consider the following principles when advising on the timeframe for returning the DCS to surplus if the fund is in deficit following recoveries:

- amount of the loss to the DCS
- the nature of the failure event (eg, is it firm specific or systemic)
- how far it is along the original funding path
- profitability impact to deposit takers of increased levies (that could impact the stability of the remaining deposit takers)
- the costs and benefits of relying on a Crown loan (eg, the interest costs on any medium – long term loan).

Glossary

Term	Definition
Deposit takers	Firms that are in the business of borrowing and lending; includes banks, credit unions, building societies, and finance companies. Deposit takers must be licensed by the Reserve Bank of New Zealand.
Deposit Takers Act 2023 (the Act)	The Act modernises New Zealand's regulatory framework to help ensure the safety and soundness of deposit takers. It strengthens the Reserve Bank's supervision and enforcement powers, creates a single regulatory regime for all entities who hold deposits (for example, banks and credit unions, to enable robust monitoring of all deposit takers to ensure consumers are protected), provides the framework for managing and resolving any deposit taker in financial distress and establishes the Depositor Compensation Scheme.
Depositor Compensation Scheme (DCS)	A scheme, established by the Act to protect deposits up to $100,000 per eligible depositor, per licensed deposit taker, in the event of the deposit taker failing.
Liquidation	If a company cannot pay its debts, it may be put into liquidation, meaning all its unsecured assets are sold to pay creditors.
Non-bank deposit taker (NBDT)	A non-bank deposit taker can be a credit union, building society, or finance company.
Prudential regulation	Regulation that aims to reduce the risk from deposit takers; regulation can be firm-specific ("micro") or system-wide ("macro").
Resolution	Resolution is the restructuring of a deposit taker by a resolution authority using resolution tools to safeguard public interests, including the continuity of the deposit taker's critical functions, financial stability, and minimal costs to taxpayers. Resolution can involve another deposit taker purchasing the assets and assuming the liabilities of the failing deposit taker or transferring the assets and liabilities to a bridge bank until a buyer is found.
Severe but plausible failure scenarios	Given the lack of data on failure events in New Zealand, these are the Treasury's best estimates of the possible types of failure event that could occur and the cost to the DCS if one of these were to occur (as well as the likelihood of one occurring). They are based on features of New Zealand's financial system and overseas evidence. The scenarios are for modelling and do not reflect the Treasury or the Reserve Bank's assessment of the relative riskiness of individual deposit takers within each category.