New Zealand's Wholesale Funding Guarantee

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Abstract

In 2008, the United States subprime crisis sparked international financial turmoil with effects becoming particularly severe after the collapse of Lehman Brothers on September 15. Due to their banks' dependence on foreign funding, New Zealand's money market experienced significant friction spilling over from the United States and Europe. Liquidity premiums rose and interbank lending became increasingly restricted. Although the crisis was not as severe in New Zealand as it was in many other countries, the problems in the money market caused some level of financial strain. To combat the crisis, the Minister of Finance announced on November 1, 2008 that the Crown would offer a wholesale funding guarantee to investment grade financial institutions in New Zealand. The program was intended to facilitate access to international financial markets for New Zealand financial institutions in a time of risk aversion for international investors. The program was administered as an opt-in system with eligible banks applying for a guarantee for each security for which they desired the government backing. Participants were charged a fee for the guarantee, with the amount determined by the riskiness of the issuer, the currency of issuance, and the maturity of the loan. A total of five institutions were granted twenty-four guarantees worth $10.3 billion NZD ($7.54 billion) being issued before the issuance window closed on April 30, 2010. There we no defaults, and $290 million NZD ($212.3 million) was collected from the program.

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New Zealand's Wholesale Funding Guarantee

At a Glance

Summary of Key Terms	
Purpose: To facilitate access to international financial markets for New Zealand financial institutions in a time of risk aversion for international investors.	
Announcement Date	November 1, 2008
Operational Date	November 1, 2008
Date of First Guaranteed Loan Issuance	February 19, 2009
Issuance Window Expiration Date	Closed to new issuances April 30, 2010.
Program Size	Opt-in; Unspecified
Usage	$10.3 Billion NZD ($7.54 Billion)
Outcomes	$290 million NZD ($212.3 million) in fees collected. No defaults.
Notable Features	Fees lowered twice to better reflect market conditions and promote usage

The 2008 U.S. financial crisis caused worldwide financial distress. The dependence of New Zealand banks on foreign funding made them vulnerable to this turmoil. Liquidity on the international capital market tightened significantly, causing the New Zealand money market to experience increased frictions. Interbank lending became more and more rare as the spread between interbank interest rates and expectations of official rates gradually rose. The failure rate of non-bank deposit-taking entities increased as funding became more difficult to find.

To facilitate access to international financial markets for New Zealand financial institutions, the Minister of Finance announced on November 1, 2008 that the Crown would offer a wholesale funding guarantee to investment grade financial institutions in New Zealand. The program allowed eligible banks to apply for guarantees for individual securities. Participants were charged relatively high fees for the guarantees with the intention of encouraging withdrawal from the program as soon as market conditions returned to normal. The fee schedule was revised several times but ultimately depended on the creditworthiness of the issuer and the maturity and currency of the issuance. Securities with a maximum maturity of five years or less could be guaranteed, and participants were expected to commit to lengthening the average maturity of their funding whenever possible. The government does not appear to have established minimum maturity requirements for eligible debt.

The first eligibility certificate for the program was issued on February 19, 2009 to the Bank of New Zealand. A total of five banks participated in the program with 24 guarantees being issued worth a total of $10.3 billion NZD ($7.54 billion). The Crown collected a net total of $290 million NZD ($212.3 million) in fees from the program. The last guarantee was issued on February 12, 2010 and the issuance window of the facility formally ended on April 30, 2010.

Summary Evaluation

Some studies and regulators concluded the measure was an attractive method of moving credit risk to the BOJ, especially during a time that many banks saw declining credit ratings due to the riskiness of the CP and other corporate financing vehicles they held. CP rates decreased noticeably. One study found a correlation between the implementation of the measure and the issuance of new CP in Japan. By March 2009, as CP market began to stabilize, issuers used the measure less, relying instead on other official liquidity operations. This may have been because the penalty rates on purchases discouraged counterparties from using the measure; banks viewed other BOJ operations as less expensive and were more equipped to offload risky CP.

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I. Overview

Background

In 2008, the Unites States subprime crisis destabilized the global financial system, with effects becoming particularly severe after the collapse of Lehman Brothers in mid-September. Due to the interconnectedness of the global financial system, New Zealand's money market experienced significant friction due to spillovers from the United States and Europe. At the time of the crisis, New Zealand banks were heavily dependent on foreign funding. About 45% of their funding came from overseas capital markets (IBP 2015). In New Zealand, liquidity premiums rose and, as a result, interbank lending became more and more restricted. The spread between short-term interbank interest rates and expectations of official rates crept up (Bollard 2009). When these effects began taking place, some finance companies were already under pressure due to credit weaknesses. The failure rate in non-bank deposit taking institutions increased as funding became more difficult to obtain. In the years before the introduction of New Zealand's guarantee schemes, 45 finance industry entities failed (Dalziel 2011).

In spite of these difficulties, New Zealand was not hit as hard by the crisis as many other countries. Most of the institutions that failed were relatively small, non-bank entities. The core of New Zealand's financial system remained solid. Despite increased frictions, money continued to flow through New Zealand's economy without the devastation of a liquidity freeze (Bollard 2009). Two guarantee programs were introduced as precautionary measures to ensure depositors remained confident in a time of turmoil and uncertainty: the Wholesale Funding Guarantee, which is the focus of this case, and the Retail Deposit Guarantee Scheme, which was announced prior to the Wholesale Funding Guarantee on October 12, 2008.

Program Description

On November 1, 2008, the New Zealand Minister of Finance announced that the Crown would offer the Wholesale Funding Guarantee to investment-grade financial institutions in New Zealand. The program was intended to facilitate access to international financial markets for New Zealand financial institutions in a time of risk aversion for international investors. The Ministry also stated that the facility would be designed to encourage withdrawal from the program as soon as markets return to normal. The cited legal basis for the program was sections 65ZD and 65ZG of the Public Finance Act of 1989.

The guarantee was meant to assure international investors that they would receive timely repayment through the facility. The program was available to financial institutions with an investment grade credit rating of BBB- or better and that had substantial New Zealand borrowing and lending operations. Non-financial issuers and collective investment schemes were ineligible for the program. All newly issued senior unsecured negotiable or transferable debt securities were eligible for a guarantee. The facility was offered on an opt-in basis by institution and instrument. Institutions that sought to cover a security needed to apply for a Guarantee Eligibility Certificate for a proposed debt security liability.

The scheme covered the New Zealand dollar, Australian dollar, U.S. dollar, the Euro, British pound, the Swiss Franc, Japanese Yen, Hong Kong dollar, and the Singaporean dollar. Other currencies were considered by application on a case-by-case basis. A guarantee fee was charged for each issue with the level of the fee determined by the riskiness of the issuer, the currency of the security, and the term of the security. The fee schedule was lowered several times during the program, with the final version depicted in the table below:

Wholesale Funding Guarantee Facility Fees

Credit Rating of issuer	**1 Year or less (bps per annum)**	**More than 1 year (bps per annum)**	
		NZD	**non-NZD**
AA- and above	**70**	**90**	**70**
A- to A+	**130**	**150**	**130**
BBB- to BBB+	**180**	**200**	**180**

Guarantees covered securities to maturity or for up to five years from the time they were issued, whichever came earlier. The government does not appear to have established minimum maturity requirements for eligible debt. Participants in the program were not allowed to have guarantees for debt larger than 125 percent of the total stock of eligible types of debt on issue before the intensification of the crisis. This rule was the only limit imposed on the amount of debt the government was willing to guarantee.

Participating institutions were required to commit to lengthening the average maturity of their funding whenever possible. To ensure compliance, the government asserted an intention to monitor the issuing activities of participants. Institutions were also required to maintain a capital buffer to ensure that the capital position of the issuer would not be depleted during the coverage period. The specified buffer was an additional 2 per cent Tier 1 capital buffer, above the 4 per cent regulatory minimum.

Finally, institutions seeking to participate in the Wholesale Funding Guarantee were expected to have applied for a guarantee under the Retail Deposit Guarantee Scheme, New Zealand's other guarantee program during the crisis.

Outcomes

The first eligibility certificate for the program was issued on February 19, 2009 to the Bank of New Zealand. In total, five institutions participated in the program: ANZ National Bank Limited, Bank of New Zealand, Westpac New Zealand Limited, Kiwibank Limited and ASB Bank Limited, which were the five largest banks in New Zealand.

Bank	Eligibility Certificates Issued
Bank of New Zealand	9
ANZ National Bank Limited	8
Westpac New Zealand Limited	6
Kiwibank Limited	1
ASB Bank Limited[1]	0
[1] *ASB Bank Limited received a guarantee deed to participate but did not use any guarantees.*	

A total of 24 instruments were covered by the program, worth about $10.3 billion NZD (approx. $7.54 Billion)[2]. There were no defaults under the Wholesale Guarantee Scheme, and the New Zealand government's net gain was worth about $290 million NZD (approx. $212 billion USD) in fees (RNZ 2010). The last eligibility certificate was issued on February 12, 2010 to Westpac New Zealand Limited, and the program formally ended on April 30, 2010.

II. Key Design Decisions

1. **The program was seemingly part of a package of measures introduced in late 2008 to help stabilize the financial system.**

In addition to the Wholesale Funding Guarantee Scheme, which was announced on November 1, 2008, the government of New Zealand also announced a Retail Deposit Guarantee scheme on October 12, 2008, which covered "all retail deposits of participating New Zealand-registered banks as well as retail deposits by eligible depositors in non-bank deposit-taking entities, including building societies, credit unions and finance companies."

[2] $212.3 million ($1 USD = $1.36 NZD as of Apr. 30, 2010).

2. **Legal authority for the scheme was derived from sections 65ZD and 65ZG of the Public Finance Act of 1989.**
3. **The program was administered by the Treasury of New Zealand.**
4. **There was no explicit maximum amount that the government of New Zealand could guarantee.**
5. **Financial Institutions that possessed an investment-grade credit rating (BBB- or higher) were eligible to participate in the scheme.**

Nonfinancial issuers and collective investment schemes were not eligible, however. The holdings of guaranteed debt by collective investment schemes would be eligible, however.

There was also a requirement of an additional capital buffer, which was intended to protect the Crown as guarantor. The buffer would defend against the risk that the capital position of financial institutions was depleted during the period of the guarantee. Guaranteed "locally incorporated, registered" banks were required to maintain a Tier 1 capital buffer at 2 percent over the required minimum. If a bank failed to maintain the additional buffer, the Crown would not issue any additional guarantees to that institution. Any non-bank issuers would have their buffers assessed on a case by case basis (NZ Treasury Report T2008/2109).

Any guarantees already issued, however, would have to be honored, so the requirement was not particularly stringent. The additional buffer was a safety precaution designed to protect the Crown from excessive financial strain.

6. **All newly issued senior unsecured negotiable or transferable debt securities would be eligible for the guarantee scheme.**

Any new issues of these instruments by eligible financial institutions would be eligible for coverage under the wholesale scheme. Ones targeted partly or wholly at retail investors would also be included.

7. **Securities were covered to maturity or up to five years, whichever came earliest.**

The decision to cover loans for up to five years was made despite the expectation that the program would end in under five years. After the program ended, no new issuances would be covered, but loans already covered that had not reached maturity would continue to be guaranteed. The government implemented this decision to spread wholesale funding over a range of maturities. This spread was intended to reduce the risk of a concentrated rollover at some point in the future, which would likely cause macroeconomic damage and create great strain on the government. The government does not appear to have established minimum maturity requirements for eligible debt.

8. **Currencies that were eligible were the New Zealand dollar, Australian dollar, U.S. dollar, the Euro, British pound, the Swiss Franc, Japanese Yen, Hong Kong dollar, and the Singaporean dollar.**

Other currencies could be included but had to be applied for and were considered on a case-by-case basis.

9. **Participants in the program were not allowed to have guarantees for debt larger than 125 percent of the total stock of eligible types of debt on issue prior to the intensification of the crisis.**

This figure was the stated limit on guarantee coverage for New Zealand financial institutions. The limit was intended to protect the government against the risk that banks attempt to increase their funding solely on the basis of the guarantee. The constraint was also designed to protect against the risk that NZD issuance by New Zealand branches of wholesale banks under the guarantee might be used to fund broader activities of the banks. This protection was necessary since the Crown agreed to allow branches of foreign banks to apply for guarantees for their New Zealand Dollar issuances. This limit was the only constraint imposed on guarantee issuances as the Crown stated there was no explicit limit on the total volume of issuances.

10. **Guarantee fees were based on issuer creditworthiness, maturity and currency, and were lowered twice in response to market conditions.**

The fees were intended to encourage withdrawal from the program as soon as market conditions returned to normal. Fees were lower for securities with shorter terms reflecting the lower market prices for credit risk on loans of shorter maturity. Riskier loans warranted significantly higher fees than more secure ones, to cover the risk of default. Guarantees for loans in NZD were more expensive than ones in other currencies, reflecting the stated purpose of the facility to increase New Zealand institutions' access to international capital markets. In the original fee schedule, for example, short term, (<1 year) debt from an issuer that was AA- rated or higher had an 85 basis point fee, with A- to A+ rated debt at 145 basis points, and BBB- to BBB+ rated short-term debt at 195 basis points. Longer-term debt (>1 year). Each of these different sets of ratings had an additional 55 basis points added onto these fees, with AA- rated or higher at 140 bps, A- to A+ at 200, and BBB- to BBB+ at 250.

These decisions were the result of a regular review of the fee schedule considering updated market conditions. The first drop in fees was due to the fact that the cost of raising funds abroad proved to be higher than expected. The fee for terms of one year dropped by 15 basis points while the fee for terms of more than one year dropped by 50 basis points. The revised fees can be seen in the Program Description.

The difference in the reduction was due to the fact that the cost of raising long-term funding was higher than that of raising short-term funding. A few months later, the fees for issuances of other currencies was reduced by twenty basis points. Lowering of fees for non-New Zealand Dollar issues matched the program's intention to enable New Zealand financial institutions to access international markets in a risk-averse global environment. The basis of these decisions was another decision stated in the operational guidelines making the fee schedule freely adjustable to changing market conditions.

11. Participating institutions were required to commit to lengthening the average maturity of their funding whenever possible.

This commitment was intended to protect against the risk that banks attempt to concentrate issuances in short-term maturities, for which the guarantee fee is lower. To enforce the rule, the Crown stated an intent to closely monitor the issuing activity of participants. Furthermore, the Crown retained the power to adjust the pricing structure of the guarantee to potentially counteract any maturity concentration.

12. Institutions seeking to participate in the Wholesale Funding Guarantee were expected to have applied for a guarantee under the Retail Deposit Guarantee Scheme.

In describing this requirement, the Crown acknowledged that the retail deposit guarantee has lower fees, and stated an expectation that financial institutions will not attempt to alter their fundraising activities so as to take advantage of the cheaper retail deposit guarantees. The Crown threatened to revoke the guarantee should such behavior be detected.

13. The issuance window for the program ran from November 1, 2008 to April 30, 2010.

III. Evaluation

There is little evaluation of the Wholesale Funding Guarantee. However, with twenty-four guarantees issued, the program seems to have aided New Zealand financial institutions in accessing international capital markets. The fee schedule was adjusted several times to assist participants in using the guarantee effectively. Usage increased after fee schedule adjustments, particularly after the first adjustment, suggesting these decisions accomplished their goals of assisting the institutions (WC 2010). A total of $10.3 billion (NZD) in loans were guaranteed, reflecting significant usage of and benefit from the program.

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