RESERVE BANK OF NEW ZEALAND

THE TREASURY
Kaitohutohu Kaupapa Rawa

# Joint Report: Update on the Design Features of a Wholesale Guarantee Facility and Other Issues

| Date: | 30 October 2008 | Report No: | T2008/2109 |
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## Action Sought

| | Action Sought | Deadline |
|---|---|---|
| Minister of Finance<br>(Hon Dr Michael Cullen) | Agree to recommendations | 9 am 31 October 2008 |

## Contact for Telephone Discussion (if required)

| Name | Position | Telephone | | 1st Contact |
|---|---|---|---|---|
| John Whitehead | Secretary to the Treasury | 917 6040 (wk) | *[deleted – privacy, OIA s9(2)(a)]* | ✓ |
| Dr Alan Bollard | Governor, Reserve Bank of New Zealand | 471 3673 (wk) | *[deleted – privacy, OIA s9(2)(a)]* | |

## Minister of Finance's Office Actions (if required)

| None. |
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**Enclosure:**

**Joint Report:** Update on the Design Features of a Wholesale Guarantee Facility and Other Issues

### Detailed Design Features of a Wholesale Facility

The key design features of the wholesale facility are outlined in the attached Appendix. These largely reflect the structure you approved last weekend on the basis of the joint Treasury and Reserve Bank report (T2008/2069 refers). However, in the light of our consultation with banks and our own further reflection we are seeking your approval for the following changes.

#### *Maximum term of guarantee*

We now consider it appropriate to guarantee paper with maturities of up to five years (on a rolling forward basis). You had previously approved a three year rolling horizon, but feedback suggests that such a limit would unnecessarily concentrate maturities and also exclude banks from being able to tap a substantial investor base interested in longer-term maturities. Given our desire to lengthen the maturity of bank funding, it seems prudent to cover maturities up to five years (as in the Australian scheme). We consider that extending the term will materially increase the likely overall effectiveness of the scheme and by reducing the risk of concentrated rollovers a year or two hence, will reduce the macro-economic risks going forward. The greatest fiscal risks are in any case probably concentrated in the next two to three years when the economy is likely to be at its weakest and the financial system under its greatest stress.

#### *Currencies*

Our previous paper indicated that we would cover paper in all major currencies. We have now added a specific list (NZD, AUD, USD, EUR, JPY, GBP, CHF, SGD and HKD) with any others to be considered on a case-by-case basis.

#### *Capital buffer*

We indicated last week that we were considering the possibility of requiring an additional capital buffer, over and above the 4 per cent Tier 1 capital minimum. For locally incorporated registered banks, we now envisage establishing a Tier 1 buffer of 2 per cent. All banks are currently holding more capital than this, and we will convey an expectation that banks would not allow actual current capital levels to be reduced. Policy guidelines will indicate that fresh guarantees would not be issued if the enhanced capital requirement was not being maintained.

For non-bank issuers, we will approach the issue of a capital buffer on a case-by-case basis.

#### *Fees*

Relative to the fee schedule proposed in last week's paper, in light of feedback received we propose to cut 15 bps off the short-term fees. This partly reflects a longer-term assessment of normal market pricing, and partly minimises the risk of any distortions in the short term markets (eg bank bills) from differences to Australia's pricing (70 basis points for shorter terms) . We do not propose changing the longer-term pricing.

| Credit Rating of Issuer | Fee (bps per annum) Term at time of issue | |
|---|---|---|
| | **1 year or less** | **More than 1 year** |
| AA- and above | 85 | 140 |

| A- to A+ | 145 | 200 |
|---|---|---|
| BBB- to BBB+ | 195 | 250 |

***Coverage***

We previously recommended that all new negotiable or transferable instruments would be covered only in the wholesale scheme. However, there is a clear distinction between retail and other debt issues in the Securities Act. Reflecting this, we now propose that negotiable or transferable retail instruments, subject to all the attendant prospectus requirements and associated costs, would still be covered under the retail scheme, unless the issuer chooses to seek coverage under the wholesale scheme. The effect of this change is that it will allow retail-focused issuers of transferable instruments to maintain coverage under the deposit guarantee scheme.

***Foreign Exchange Risk***

We have reflected further on the issue of the foreign exchange risks associated with the failure of an institution that had used the wholesale guarantee facility to cover foreign currency debt. The failure of any large bank is likely to be handled through a "open bank" resolution model, and this, together with international experience that suggests that it will be in the interests of both the failing bank and its counterparties to maintain hedges, means that we propose not to take any further special steps to address these risks in the guarantee documentation. We plan to add to the draft deed a requirement that the foreign exchange risk on all foreign exchange borrowings be hedged and managed.

**Fiscal Implications of the Wholesale Guarantee Scheme**

The wholesale guarantee scheme is likely to generate a significant amount of revenue. All guarantee fees will be paid up-front, so that in the first year perhaps as much as $1 billion could be received. In terms of revenue reporting, this income would be brought to account over the life of the guarantee (up to five years on a rolling forward basis). However, the Crown's cash position would be materially improved.

The guarantee fee is set to cover the risk of losses under the guarantee scheme itself which as we have advised earlier would be very large should they occur. In addition, the guarantee scheme is likely to increase the Crown's own borrowing costs for a period. The risks to New Zealand's credit rating make it important that considerable fiscal discipline is maintained over the next few years. In particular, the revenue from the guarantee scheme should be applied to debt reduction and not thought of as an improvement in the fiscal position, which might allow increases in other expenditure items.

**Expressions of intent on enforcement of securities**

As you are aware we have discussed with the banks the high priority placed by the government on home ownership. The banks have noted that they have an active programme in place to work proactively with borrowers who are facing actual or potential servicing difficulties.

We do not recommend that a commitment by the banks of their approach to handling distressed borrowers in owner-occupied properties be included in the wholesale guarantee deed as this may confuse the purpose of the guarantee in the eyes of investors and may raise unintended litigation risks for the banks.

We have discussed with the banks the possibility of recording your expectations and their affirmation of those expectations by way of an exchange of letters. This exchange of letters

could be supported by public statements by yourself and the banks. A draft letter is attached. We have shown this draft letter to the chief executives of the main banks. The general reaction was that this captured the essence of their current approach and consequently they would be likely to be able to respond positively to such a letter.

This letter could be supported by a joint public statement between yourselves and the banks.

**Next Steps**

We are currently drafting a paper for you to take to Cabinet on Tuesday which updates Cabinet on the decisions taken to implement a Crown wholesale guarantee facility. This paper will also seek funding for implementing and operating the facility. This paper will be provided to you tomorrow.

We are currently liaising with your office on communications. We are preparing (in consultation with your media staff):

- A draft media statement.
- "Technical details" statement and Questions and Answers - for release on the Treasury and Reserve Bank websites after your announcement.
- A draft statement on mortgage agreement with the banks (possibly a joint statement between you and the banks, depending on your preference)

As advised by your office, we are working towards a public release around the middle of the day on Saturday, and will provide final drafts to your office on Friday afternoon.

In light of the changes to the scheme we recommend that officials brief the National Party on the key features of the wholesale guarantee facility before release.

## Recommended Action

We recommend that you:

*Detailed design features of a wholesale guarantee facility*

a **agree** to the following changes, from our report of 24 October, to the key design features of the wholesale guarantee facility:

i) Any paper issued under the guarantee would be covered for up to five years from the time it is issued.

*Agree/disagree*

ii) Eligible instruments in the following specified currencies would be covered (NZD, AUD, USD, EUR, GBP, CHF, JPY, HKD, and SGD).

*Agree/disagree.*

iii) Locally incorporated registered banks would be required to establish a Tier 1 capital buffer of at least 2 per cent over and above the 4 per cent Tier 1 capital minimum.

*Agree/disagree.*

iv) To reduce the short term fee by 15 bps.

*Agree/disagree.*

v) Negotiable or transferable retail instruments will be covered under the retail scheme, provided the prospectus requirements are met, unless the issuer chooses to seek coverage under the wholesale scheme.

*Agree/disagree.*

vi) Add to the draft deed a requirement that the foreign exchange risk on all foreign exchange borrowings be hedged and managed.

*Agree/disagree.*

***Expressions of intent on enforcement of securities***

b **agree** that a commitment by the banks to act in accordance with your expectations that they will use their best endeavours during the current financial turmoil not to enforce security over an owner-occupied home, where there is a reasonable likelihood all arrears will be honoured and further arrears will not arise, will not be included in the guarantee deed.

*Agree/disagree.*

c **agree** that your expectations and the banks affirmation of those expectations be recorded by way of an exchange of letters.

*Agree/disagree.*

d **agree** to send the attached letter to the Chief Executives of the four main banks and Kiwibank and TSB.

*Agree/disagree.*

***Other matters***

e **agree** that officials brief the National Party on the changes to the wholesale guarantee facility.

*Agree/disagree*

f **refer** a copy of this report to the Prime Minister.

*Agree/disagree.*

**John Whitehead**
Secretary to the Treasury

**Dr Alan Bollard**
Governor, Reserve Bank of New Zealand

**Hon Dr Michael Cullen**
Minister of Finance

## Appendix - New Zealand Wholesale Funding Guarantee Facility

This document outlines the operational details for the New Zealand wholesale funding guarantee facility.

### Objectives

The wholesale funding guarantee facility is designed primarily to:

- Facilitate access to international financial markets by New Zealand financial institutions, in a global environment where international investors remain highly risk averse and where many other governments have guaranteed their banks' debt.

- Encourage withdrawal from the guarantee facility as soon as the international markets return to normal

The Crown will not be obliged to offer a guarantee facility to any particular issuer or on any particular debt issues.

### Operational Details

#### *Which issuers could use the facility?*

*The facility will be available to financial institutions that have an investment grade credit rating, and have substantial New Zealand borrowing and lending operations (not institutions that are simply financing a parent or related company).*

- The scheme does not include non-financial (eg corporate and local authority) issuers. This is consistent with the objective of the scheme to facilitate access to international financial markets and with the approach to wholesale facilities being adopted in other countries.

- Any short-term disadvantage to non-financial issuers is reduced, in part, by ensuring that the pricing of any facility is set sufficiently high.

- Collective investment schemes will not be eligible as guaranteed issuers (although their holdings of guaranteed issues would be covered by the guarantee).

#### *Which instruments would be covered?*

*All newly issued senior unsecured negotiable or transferable debt securities would be eligible for inclusion[1].*

- As in the deposit guarantee scheme, only senior debt would be covered by the guarantee facility. Subordinated debt is best considered as quasi-equity.

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[1] Covered bonds (bonds in which the holder has a claim both against a specific pool of assets as well as a general claim on the issuer) would also be eligible. Other asset-backed securities and subordinated debt issues are explicitly excluded.

Any new bond issues undertaken by eligible financial institutions, including ones targeted partly or wholly at retail investors, would be eligible for coverage under the wholesale scheme.

- Any retail bond, issued under the prospectus requirements of the Securities Act, would be covered under the deposit guarantee facility, unless the issuer sought a guarantee under the wholesale guarantee facility.

- There is no need to cover existing debt. The focus of the New Zealand scheme is facilitating primary issuance, especially in foreign markets, not liquidity in domestic secondary markets which continue to function.

- To reinforce the segregation between the coverage of the deposit guarantee scheme and a wholesale scheme, any institution signing up to the wholesale guarantee facility will be required to explicitly exclude all securities eligible for a wholesale guarantee (whether guaranteed or not) from coverage by its retail deposit guarantee scheme agreement An exception will be made for retail bonds, as outlined above.

***Which currencies would be covered?***

*Eligible instruments in all major currencies (including the New Zealand dollar) would be eligible for cover. Specifically, the scheme would cover NZD, AUD, USD, EUR, GBP, CHF, JPY, HKD, and SGD issuance. Applications to cover paper denominated in any other currencies would be considered on a case-by-case basis.*

- The scheme would offer cover on both New Zealand dollar and foreign currency issuance. This is intended to minimise the risk of loss of funds to Australia, and from locally incorporated banks to the local branches of Australian banks (who would benefit from the Australian wholesale guarantee, which covers both NZD and AUD issuance).

- Including domestic issuance should enable managed funds and other similar entities, over time, to transfer most of their claims on New Zealand registered banks into instruments that are eligible for coverage under a wholesale scheme.

***What about branches of foreign banks?***

*Branches of foreign banks would be included among the institutions eligible for a wholesale guarantee scheme, but only in respect of their New Zealand dollar issuance.*

- Foreign branches would be eligible for coverage, but to avoid any risk of any New Zealand guarantee supporting the funding of the wider group, eligibility would be restricted to those branches' issuance of New Zealand dollar securities.

- This approach to branches is broadly parallel to the approach taken under the deposit guarantee scheme.

***What fees would be charged?***

*A guarantee fee would be charged, differentiated by the riskiness of the issuer and the term of the security being guaranteed, as follows:*

| **Credit Rating of Issuer** | **Fee (bps per annum)<br>Term at time of issue** | |
|---|---|---|
| | **1 year or less** | **More than 1 year** |
| AA- and above | 85 | 140 |
| A- to A+ | 145 | 200 |

| BBB- to BBB+ | 195 | 250 |
|---|---|---|

*The guarantee fee for new issuance would be reviewed, normally monthly, in the light of market developments and indicators (about pricing and usage) and could be adjusted as required. Adjustments would be made by the Secretary to the Treasury.*

*The rating used would be the rating applied to the issuing institution without the benefit of any government guarantees.*

- The fee schedule has been designed to ensure that the facility is used while it is needed, but to encourage issuers to graduate from using the guarantee as market conditions permit.

- *[Information deleted under section 6(a) "the making available of the information would be likely to prejudice the security or defence of New Zealand or the international relations of the Government of New Zealand"]*

- These prices have been set based on an average of the gap between government and private sector borrowing costs in normal times and over the crisis period. An alternative is the United Kingdom approach, in which a penalty margin is applied on top of market prices for credit risk[2]. Both approaches suggest that pricing a guarantee for terms greater than one year at around 140 basis points per annum for an AA-rated bank is reasonable.

- In terms of international benchmarks, this scheme would be more expensive than some (eg United States and Australia), and cheaper than others (eg Canada) and around the price of the United Kingdom facility.

- Pricing of the facility will be less expensive for shorter terms reflecting lower market prices for credit risk for shorter terms.

- It will be important that issuers do not concentrate their new issuance in short maturities. Issuance patterns will be monitored closely, and authority to adjust the fee structure in accordance with the principles that guided the development of the pricing framework would be delegated to the Secretary to the Treasury, as required in the light of experience with the scheme.

- Any changes in pricing would affect only issues approved for the guarantee from that point forward.

***How long a period would any guarantee cover?***

*Any paper carrying the guarantee would be covered to maturity or for up to five years from the time it is issued, whichever is the earliest[3].*

- The five year rolling term is longer than the fixed two year term on the deposit guarantee scheme.

- Most retail deposits are for terms less than two years. The longer term for the wholesale facility is warranted to reduce the risk of a bunching of the wholesale maturities into a very tight, relatively short-term, window.

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[2] Specifically, the United Kingdom approach applies a margin on 50 basis point on top of the median credit default swap (CDS) premium for each bank over the last year. There are quoted CDS prices for each of the Australian parent banks. The second approach was derived from the estimated gap between government bond yields and the indicative rates at which local banks could raise term funding, averaging normal period pricing and pricing in recent months.

[3] Formal documentation will allow issues of up to 61 months, to reflect market practice, whereby bonds typically mature on the 15th of the month.

***Opt-in or all encompassing?***

*The facility would operate on an opt-in basis, by institution and by instrument.*

- No financial institution would have to be covered by the scheme, nor would any particular issue of debt. Thus, it is possible that an institution could have two types of otherwise identical instruments on issue, one of which is government guaranteed (with a fee paid to the Crown) and one of which is not government guaranteed.

- This will facilitate institutions gradually withdrawing from using the guarantee on new paper, as market conditions allow.

***Whose holdings would be covered?***

*All holders of guaranteed paper would be covered by the guarantee, other than related parties.*

- The deposit guarantee scheme excludes deposits held by financial institutions in order to minimise the extent to which wholesale holdings of financial instruments are covered by the highly concessional deposit guarantee scheme. Under the wholesale scheme there is no need for such a carve-out. Thus, as one example, all holdings of guaranteed paper held by unit trusts and other collective investment schemes would be covered.

- Any debt held by related parties (including parents) of the issuer would be excluded.

***How much paper would we be willing to guarantee?***

*Issuers who joined the wholesale guarantee facility would not be permitted to have guarantees for debt in excess of 125 per cent of the total stock of eligible types of debt on issue prior to the intensification of the crisis[4].*

- This limit, provides the Crown some additional cover against the risk of banks seeking to increase their funding activities solely on the basis of the guarantee. It is similar to the limit in the United State Scheme.

- Itprovides a cap on the risk that NZD issuance undertaken by New Zealand branches of wholesale banks under this guarantee would be used to fund the wider activities of the group.

- No limit would be set on the total volume of paper we would be willing to guarantee. The overall use of the facility will be closely monitored. The pricing of the scheme could be adjusted ifmore debt is being issued under guarantee than we judge to be necessary in light of market access conditions.

***How long would the guarantee facility continue to be offered?***

*The guarantee offer for new issues would be withdrawn when market conditions in the key funding markets have returned to relative normality for a sustained period*

- There should be no expectation that the guarantee will continue to be offered on new issuance for any fixed or lengthy period. However, we recognise that the crisis to date has gone in waves, and once the guarantee scheme is introduced we would not

[4] For banks, as per the last published General Disclosure Statement, and for other issuers the last published set of annual accounts for a period prior to 12 October 2008.

envisage withdrawing it at the very first signs of normality (only to risk having to reintroduce it later).

- As market conditions normalise and unguaranteed funds can be raised more readily, at some point it will be cheaper for institutions to issue unguaranteed paper rather than guaranteed paper. Should we judge that that migration was not occurring sufficiently rapidly, in light of our reading of market access conditions, we would have the option to increase the price of the facility.

***What about the risk that issuers concentrate new issuance in very short maturities?***

*We will seek commitments from institutions using the facility that they would seek to lengthen the average maturity of their funding wherever that is possible. Moral suasion and discretion over the pricing of the facility will be used to reinforce this.*

- The pattern of issuance would need to be monitored closely. The option of adjusting the pricing structure on the guarantee facility, together with moral suasion from the Reserve Bank, may have an important role to play to ensure prudent funding strategies through the period ahead. To support this we will seek assurances that issuers will seek to lengthen the average maturity of funding wherever that is possible.

**Capital buffer**

*To protect the interests of the Crown as guarantor, we will establish additional capital buffers for issuing institutions. These will support an expectation that the capital position of an issuer will not depleted over the period when the guarantee is being offered. For locally incorporated registered banks, we would require, as a condition of obtaining fresh guarantees, that banks hold an additional 2 per cent Tier 1 capital requirement on top of the current minimum 4 per cent. Other issuers will have to be treated on a case-by-case basis.*

- Registered banks are subject to the full range of Reserve Bank prudential supervisory powers.

- We will impose a requirement that guaranteed locally incorporated registered banks maintain an additional 2 per cent Tier 1 capital buffer, above the 4 per cent regulatory minimum. The banks already hold at least such a buffer, and we would not expect them to reduce that buffer. The additional required buffer would provide additional protection for the Crown's position as guarantor, and no fresh guarantees would be issued if the additional buffer was not being maintained.

- Non-bank applicants would need to be treated on a case-by-case basis until the Reserve Bank's new prudential regime is implemented.

**Information requirements**

*For any non-bank issuers, additional information and related requirements will be required as part of the guarantee documentation.*

- For any non-banks seeking coverage we would need to have a version of the guarantee deed that provide enhanced information and related powers for the authorities.

**Foreign exchange risk**

- All issuers participating in this guarantee facility will be required to undertake that the foreign exchange risk associated with foreign currency borrowing will be hedged and managed.

# DRAFT

[MOF letterhead]

[Bank]

Dear.....

**Support for Distressed Mortgage Borrowers**

The slowing economy and the weakening housing market, together with the prospect of rising unemployment, may combine to put a number of your mortgage borrowers in a difficult financial position. Some, no doubt a small minority, will experience significant difficulty in servicing their mortgage obligations.

As you know, the Government places a high priority on home ownership. A high rate of home ownership has both economic and social benefits. We recognise too that banks place a high value on long-term relationships with their customers. As you have noted to my officials, your bank has an active programme in place to work proactively with borrowers who are facing actual or potential servicing difficulties. You also recognise that, in a weak housing market, it is typically in a bank's own interest to work with borrowers to ease servicing burdens, where appropriate, rather than take any steps that might lead to a forced sale of the property.

I am writing to invite you to respond to this letter with a clear statement of your own approach to handling distressed borrowers in owner-occupied properties. Your response might emphasise the approaches to the issue that are already an established part of your practices, and could note your reluctance to move towards forced sales. In particular, I would welcome an affirmation that, where there is a reasonable expectation that mortgage servicing could be resumed within a reasonable period, you would be using your best endeavours to work with the borrowers concerned, providing relief, either by rescheduling payments or temporarily reducing servicing obligations, wherever appropriate.

You will, of course, recognise that the Government itself has in recent weeks taken significant steps designed to help ensure public confidence in financial institutions and to enable you, as an important participant in the banking industry, to cope with the pressures that the global financial crisis is causing. We are committed to New Zealand emerging from this period of stress with a strong and vibrant financial sector and an economy that is well-positioned for a period of sustained growth ahead.

I would appreciate a prompt response to this letter, having in mind my intention to comment on these issues over the weekend. You might also wish to make your own public statement along these lines.

Yours faithfully