

Treasury Report: Wholesale Guarantee Facility: Cabinet Paper

Date:	3 November 2008	Report No:	T2008/2118
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Action Sought

	Action Sought	Deadline
Minister of Finance (Hon Dr Michael Cullen)	Agree to recommendations. Sign and refer the attached Cabinet paper to the Cabinet Office. Sign the delegation to the Secretary to the Treasury to give authority for writing, managing and administering the Wholesale Guarantee Facility.	In time for the Cabinet meeting on Tuesday 4 th November 2008.
Associate Minister of Finance (Hon Phil Goff)	Note	None
Associate Minister of Finance (Hon Trevor Mallard)	Agree to recommendations	In time for the Cabinet meeting on Tuesday 4 th November 2008.
Associate Minister of Finance (Hon Clayton Cosgrove)	Note	None

Contact for Telephone Discussion (if required)

Name	Position	Telephone	1st Contact
John Whitehead	Secretary, The Treasury	917 6040 (wk) <i>[deleted – privacy, OIA s9(2)(a)]</i>	✓
John Matheson	Chief Financial Officer, The Treasury	971 6100 (wk) <i>[deleted – privacy, OIA s9(2)(a)]</i>	

Minister of Finance's Office Actions (if required)

Forward to the Associate Minister of Finance, Hon Trevor Mallard, for signing.
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Enclosure: Yes

Treasury Report: Wholesale Guarantee Facility: Cabinet Paper

Purpose of Report

1. This report briefs you on the attached Cabinet paper, which updates Cabinet on the key characteristics of the Crown wholesale guarantee facility ("the Facility") its fiscal implications and seeks Cabinet approval for funding to implement and operate it.
2. In order for Treasury to manage and administer the wholesale guarantee facility on your behalf, a delegation will be required to the Secretary to the Treasury. A letter of delegation is attached for your signature.

Costs of Implementing the Wholesale Guarantee Facility

3. The implementation and administration of the wholesale scheme will be quite different from that of the retail deposit scheme as it will involve engagement with the relevant financial institutions on a general understanding of the guarantee being provided with each issue being covered by an eligibility certificate.
4. Depending on the market conditions facing those wishing to make commercial paper issues, the number of issues being sought under the scheme can be expected to vary. The issue by issue nature of the scheme as well as the variable demand for its use pose some challenges for assessing the associated administration costs.
5. Implementation of the scheme will require:
 - policy guidelines to underpin the delegation of authority to the Secretary of the Treasury;
 - establishing and ensuring the soundness of the processes intended to be operated;
 - writing of understandings with each financial institution eligible and intending to use the facility.
6. The main areas of activity in administering the scheme include:
 - managing fees including:
 - managing the fee income
 - managing foreign exchange issues;
 - calculating fees; and
 - charging monthly on the month's transactions.
 - Writing of individual certificates and signing off on the necessary documentation. We expect the initial costs of this process to be high, but as we have repeated applications over the period the scheme is available, these costs should fall significantly.
7. The Treasury estimates that operational funding of \$5.060 million will be required to implement and operate the Facility. This consists of two elements.
8. It is estimated that \$4.760 million will be required over the estimated seven year period of the Facility for the significant legal, financial and administration costs that will be incurred to establish and monitor the Facility. The Facility is expected to be utilised by financial institutions for up to two years and any paper with maturities up to five years will be covered. Therefore, the overall life of the Facility is estimated to be up to seven years.

9. We have assumed that financial institutions will not require the facility beyond 2 years and therefore costs (and revenues) over the remaining 5 years will be lower as guaranteed paper matures.
10. The Treasury will contract the Reserve Bank of New Zealand to perform the ongoing monitoring and administration of the Facility. This arrangement will take advantage of the Reserve Bank's established expertise and systems resulting in costs being significantly less than alternative options, such as establishing a new unit in the Treasury.
11. The Treasury is also seeking funding to employ a lawyer on contract to work on Treasury legal business while the in-house legal staff focus on implementing and managing the deposit and wholesale guarantee schemes. The duration of this contract is expected to run for 24 months at a cost of \$0.300 million.
12. The role of these legal and financial staff will be to reduce the Crown's exposure to the wholesale guarantee by performing regular monitoring of the financial institutions and debt issues to ensure they meet the necessary guarantee criteria. The budget is summarised in the following table.

Wholesale Guarantee Facility: Operating Budgets

Operating Expenditure & Fees	2008/09 \$m	2009/10 \$m	2010/11 \$m	2011/12 – 2016/17	Total \$m
Legal fees	1.170	0.780	0.260	-	2.210
Professional legal and financial personnel	0.260	0.390	0.270	1.000	1.920
Administration	0.070	0.100	0.035	0.125	0.330
Contingency	0.140	0.120	0.040	-	0.300
Back-fill in-house legal services	0.100	0.150	0.050	-	0.300
Total Operating Expenditure	1.740	1.540	0.655	1.125	5.060
Fee Revenue	300.000	450.000	400.000	1,150.000	2,300.000
Net Revenue	298.260	448.460	399.345	1,148.875	2,294.940

13. The above expenditure and revenue are best estimates and may change as details of the guarantee scheme are finalised and the amount of debt guaranteed is evident.
14. The expenditure budget above does not include litigation costs and further funding may need to be sought if litigation costs are incurred.
15. We recommend that you agree to seek additional operating funding of \$5.060 million in Vote Finance to fund the implementation and operations of the wholesale guarantee facility.
16. We also recommend that a new departmental output expense "Crown Wholesale Guarantee Facility" be added to the Multi-Class Output Expense "State Sector and Economic Performance Policy Advice and Management" in Vote Finance, because

the implementation and operation of the Facility is outside the appropriation scopes of existing departmental output expenses in Vote Finance. A separate output class will 'ring-fence' funding and any funding that is not required will be returned to the Crown.

17. The Minister of Finance's approval is required to add a new output class to a multi-class output expense. However, where the Minister of Finance is also the Vote Minister, Cabinet Office Guideline (CO (02) 17) requires the Associate Minister(s) to take on the role of Finance Minister for the purposes of approval.

Revenue from the Wholesale Guarantee Facility

18. As noted in our report of 30 October, the guarantee fee is set to cover the risk of losses under the guarantee facility itself, which would be very large should they occur. In addition, the guarantee facility is likely to increase the Crown's own borrowing costs for a period. The risks to New Zealand's credit rating from the deteriorating fiscal position and the offer of the retail guarantee scheme, combined with the weakening domestic and international economic environment, make it important that considerable fiscal discipline is maintained over the next few years.
19. In addition the estimate of fee revenue is highly variable, being very dependent on how heavily the wholesale guarantee facility is used, which will depend largely on how quickly market access conditions improve.
20. We recommend that revenue from the guarantee facility be applied to debt reduction and not be thought of as an improvement in the fiscal position available to fund additional expenditure.

Delegation of Authority

21. A delegation will need to be made to the Secretary to the Treasury to manage and administer the wholesale guarantee facility on your behalf. A letter of delegation is attached for you to sign.
22. In addition, we are preparing policy guidelines. These will cover areas where we will need to exercise discretion under the delegation. These will be available for your sign off later this week.

Retail Scheme

23. As requested, we have added into the operational guidance for the wholesale facility your expectation that any deposit taking financial institution seeking to use the wholesale guarantee facility will also apply for a guarantee under the Crown retail deposit guarantee scheme.

Recommended Action

Minister of Finance and Associate Minister of Finance

We recommend that you:

- a **agree** to seek Cabinet's approval to additional operational funding of \$5.060 million to implement and operate the wholesale guarantee facility.

Agreed/Disagreed

Minister of Finance

(acting as Vote Minister)

Agreed/Disagreed

Associate Minister of Finance

(acting as Minister of Finance)

- b **agree** to add a new Output Class: "Crown Wholesale Guarantee Facility" to the Multi-class Output Expense "State Sector and Economic Performance Policy Advice and Management" in Vote Finance;

Agreed/Disagreed

Minister of Finance

(acting as Vote Minister)

Agreed/Disagreed

Associate Minister of Finance

(acting as Minister of Finance)

Minister of Finance

- c **note** that the guarantee fee has been set to cover the risk of losses under the guarantee facility itself, which would be very large should they occur.
- d **note** that the estimate of fee revenue from the wholesale guarantee facility is highly variable, depending on how heavily the wholesale guarantee facility is used, which will depend largely on how quickly market access conditions improve.
- e **agree** that revenue from the guarantee facility should be applied to debt reduction and not used to fund additional expenditure.

Agreed/Disagreed

Minister of Finance

- f **sign** the attached Cabinet paper and submit it to the Cabinet Office in time for the Cabinet meeting on 4 November 2008.
- g **sign** the delegation to the Secretary to give authority for writing, managing and administering the Crown's wholesale guarantee facility.

John Whitehead

Secretary to the Treasury

Hon Dr Michael Cullen

Minister of Finance

Hon Trevor Mallard

Associate Minister of Finance