TE TAI ŌHANGA
THE TREASURY

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

Second Stage Consultation Paper

May 2024

Te Kāwanatanga o Aotearoa
New Zealand Government

Contents

How you can contribute

This public consultation provides New Zealanders with a further opportunity to give their views on the funding strategy for the Depositor Compensation Scheme (DCS), that will be established by the *Deposit Takers Act 2023* (the Act).

An online form to assist you with providing written comments is available on the Treasury's website at https://www.treasury.govt.nz/publications/consultation/second-stage-consultation-statement-funding-approach-funding-strategy-depositor-compensation-scheme, or you can email to sofaconsultation@treasury.govt.nz. Alternatively, responses can be sent to the address below:

Financial Markets
The Treasury
PO Box 3724
Wellington 6140

The deadline for submissions is **31 May 2024.**

As the Statement of Funding Approach (SoFA) is closely related to the design of the DCS levies, we will share with the Reserve Bank of New Zealand any parts of your submission that are also relevant to the Reserve Bank's current public consultation on the DCS regulations, and the related matter of the levy framework for the DCS.

Current information about the Act is on the Reserve Bank's website at https://www.rbnz.govt.nz/about-us/responsibility-and-accountability/our-legislation/proposed-deposit-takers-act. Background information about the policy development process for the DCS and the Deposit Takers Bill can be found on the Treasury's website at https://www.treasury.govt.nz/news-and-events/reviews-consultation/reviewing-reserve-bank-act/deposit-takers-bill.

Questions about the consultation process can be sent by email to sofaconsultation@treasury.govt.nz. Following the completion of the consultation process, we intend to publish all submissions as well as a report summarising the key messages and emerging themes.

Private information

The *Privacy Act 2020* establishes certain principles with respect to the collection, use and disclosure of information about individuals by various agencies, including the Treasury. Any personal information you supply in the course of making a submission will only be used for the purpose of assisting in the development of, and policy advice in relation to, the SoFA. Please clearly indicate in your submission if you do not wish your name, or any other personal information, to be included in the summary of submissions and consultations that the Treasury will publish.

Submissions and the Official Information Act 1982

Submissions received are subject to the *Official Information Act 1982* (OIA). Please set out clearly with your submission if you have any objection to any information in the submission being released under the OIA. In particular, clearly state which part(s) you consider should be withheld, and the reason(s) for doing so.

The OIA sets out reasons for withholding information. Reasons could include that the information is commercially sensitive or that you wish us to withhold personal information, such as names or contact details. An automatic confidentiality disclaimer from your IT system is not a reason to withhold information.

Your objections will be considered when responding to requests under the OIA.

1 Executive summary

The Statement of Funding Approach (SoFA) is the funding strategy for the Depositor Compensation Scheme (DCS). The *Deposit Takers Act 2023* (the Act) requires that the Minister of Finance (the Minister) take all reasonable steps to publish it before 7 July 2024, and at least every five years thereafter.

A first stage public consultation on the SoFA was completed last year, with key proposals about whether to implement a target fund approach. Following feedback from this first round of consultation, the Minister has decided to target a fund size of 0.8% of protected deposits over a 20-year timeframe.

This second stage consultation paper communicates the implications for targeting a 0.8% fund over 20 years and seeks feedback on outstanding issues of a more operational and technical nature, to inform publication of the SoFA.

This consultation draws on the decision-making principles and scenario analysis developed for the first consultation and contains the following chapters:

- Chapter 3 shares decisions (made to date) on key design features for the SoFA, including the target fund approach and confirms other matters from the first consultation. We are not seeking feedback on this section.
- Chapter 4 responds to feedback on additional triggers for SoFA review (and the forward path of the DCS fund) with some scenario analysis.
- Chapter 5 provides estimates of the total costs the Depositor Compensation Scheme (DCS), including operating costs.
- Chapter 6 discusses our proposed investment guidance for the DCS fund.
- Chapter 7 discusses in more detail the structure of the Crown backstop and associated costs to the DCS.
- Chapter 8 provides guidance on key milestones up until the DCS is implemented in mid-2025.

Following this public consultation, next steps will be for the Minister to make final decisions, and to publish the SoFA. It is intended that the SoFA will be published before DCS regulations (including levy regulations) are implemented. It is expected that the DCS levy methodology will be finalised by the end of the year and that the DCS regulations will be in place sufficiently in advance to give industry enough time to prepare before the DCS commences.

2 Introduction

This consultation paper shares decisions on the target fund approach that will guide the funding strategy for the Depositor Compensation Scheme (DCS) and seeks feedback on remaining aspects of the Statement of Funding Approach (SoFA) for the DCS. Feedback from this consultation will be considered ahead of publishing the first SoFA later this year.

What is the Depositor Compensation Scheme?

The *Deposit Takers Act 2023* (the Act) deals with the framework for the regulation and supervision of banks, credit unions, building societies, and finance companies (collectively referred to as “deposit takers”) and introduces the DCS.

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 when 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 is currently targeted for implementation in mid-2025. The DCS will be fully funded by the DCS levies (to be prescribed by regulations) collected from licensed deposit takers. These levies will be held in a statutory fund with a Crown backstop to meet payout requirements if the DCS fund is in a deficit position.

What is the Statement of Funding Approach?

The SoFA is the funding strategy for the DCS and the Act requires that it is published by the Minister of Finance (the Minister) at least every five years. The SoFA will inform how to fund the DCS by setting out:

- the estimated costs of the DCS over the period covered by the SoFA
- any targets for the size of the DCS fund and the timeframe for reaching that target
- the strategy for investing the DCS fund
- the proposed approach for managing the financial position of the Crown in connection with the scheme (including how the legal requirement for the Crown to backstop the DCS will be complied with).

The Minister is required to take all reasonable steps to publish the SoFA before 7 July 2024 (before the first anniversary of the commencement of subpart 7 of Part 6 of the Act).
The SoFA will have an impact on the size of levies paid by deposit takers in coming years (ie, design choices in the funding strategy impact the forward path of levies needed to fund the DCS). The SoFA will also influence the likelihood of the Crown backstop being drawn on to support prompt payout (after a failure event), how the funds will be provided through the backstop, and the Reserve Bank’s approach to investing the DCS fund.

The SoFA is therefore closely related to work the Reserve Bank is leading on the DCS regulations, including the design of the DCS levies, and development of the levy advice. The publication of the SoFA will enable the levy advice (expected later in 2024) to be properly informed by the funding strategy prior to the implementation of DCS levy regulations. The SoFA will set out targets that will impact the overall levies charged to deposit takers and the levy advice will address how the costs of funding the DCS are best allocated and distributed amongst deposit takers.

The Commerce Commission has recently published its draft recommendations from a market study into personal banking services. This includes a draft recommendation that the Reserve Bank should explicitly and transparently articulate how it is applying the purpose and principles of the Act, most notably the principle relating to maintaining competition, to its forthcoming levy advice. The final recommendations are expected to be published in August, followed by the Government's response to the recommendations.

It is not proposed that the SoFA should consider the relationship between competition and the DCS levy settings. This reflects that the target fund settings influence the total amount of levies being paid by the sector, but not how those levies are allocated across different deposit takers. Therefore, the influence of the SoFA on competition is considered to be limited.

Prior consultation

In 2023 we held a first round of consultation focused on the approach to building the DCS fund, estimates of the impact of failure scenarios on the funding obligations of the DCS, determining a target size of the DCS fund (if any), and a timeframe for reaching any target. Submissions and a summary of submissions from the first consultation can be found at: Statement of Funding Approach – Funding Strategy for the Depositor Compensation Scheme | The Treasury New Zealand

3 Decisions on targets for the DCS fund

The purpose of this section is to share decisions made to date (by the Minister) on SoFA design settings for the DCS following feedback from the first consultation, including:

- the adoption of a target fund approach to guide the funding strategy of the DCS
- treatment of likely recoveries following a failure event within that approach
- the size of the fund target and timeframe to reach it.

Decisions for the SoFA are guided by seven decision-making principles

Decisions to date have been guided by the seven decision-making principles in *Table 1* below. These are the same as those communicated in the first consultation and are based on the levy principles in the Act, cost recovery guidelines and consideration of the implications for the Crown's balance sheet given the Crown backstop commitment. There was broad support for these principles in the first consultation and we are not suggesting any changes for the first SoFA. The principles have been applied to the proposals in the second consultation where relevant.

Table 1: Objectives and decision-making principles to guide the Statement of Funding Approach

Objective or principle	Explanation
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 funding arrangements (the DCS fund and the Crown backstop) must enable the DCS to rapidly pay out eligible depositors following failure of a deposit taker, thereby limiting incentives for depositors to run.
The DCS should be fully funded by industry over time (accountability).	The costs of the DCS should be borne by deposit takers who benefit from the DCS.
The funding strategy should aim for levies to be predictable over time (**predictability**).	The intended future path of levies should be well-signalled to levy-payers, along with the factors that could cause the Minister to adapt the strategy.
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 funding strategy should have regard to the impact of the DCS on the volatility of the Crown balance sheet and avoid creating a need to charge large pro-cyclical levies on deposit takers after a failure.
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 is part of New Zealand's financial 'safety net' and intends to protect depositors following failure of a deposit taker; consideration should be given to other aspects of the 'safety net' that aim to reduce the likelihood of failure, such as capital requirements and prudential supervision.

Objective or principle	Explanation
The DCS's funding strategy adopts an equitable approach to funding over the long-term (**equity**).	The funding strategy should aim to spread the costs of the DCS over as large a cohort as possible to avoid the costs falling disproportionately on one group at any given time.
The DCS's funding strategy adopts an efficient approach to funding over the long-term (**efficiency**).	The funding strategy should ensure that levies reflect the true costs to the DCS and avoid over-charging deposit takers for the benefits they receive.

The SoFA will set targets for the DCS fund that take account of likely recoveries following a failure event

The Minister has decided to implement a target fund approach to guide the funding strategy for the DCS. Relative to the alternatives described in the first consultation, a target fund approach provides the most flexible framework for charging levies before a payout event ('ex ante levies'). It is transparent, aligns with the decision-making principles (notably 'accountability' and 'predictability') and allows the Government to signal its long-term intentions for funding the DCS. This approach provides a stable forward path of levies giving the deposit taking sector (and depositors) certainty.

In the first consultation, submitters were generally supportive of adopting a target fund approach but wanted more clarity on the treatment of levies once the target fund size is reached, the path of levies after a payout event and the treatment of new entrants. We provide an indication of the forward path of the DCS fund under different scenarios in the next chapter.

The target fund approach used for the SoFA will take into account the likelihood of significant recoveries made by the DCS during a receivership or liquidation. As discussed in the first consultation, this approach is consistent with the Treasury and Auditor-General's guidelines that levies should reflect the costs of providing the goods or services and is consistent with the 'efficiency' principle. The Treasury is confident that the Crown has sufficient liquidity to provide funds through the backstop during the initial phase of a failure prior to recoveries being returned to the DCS fund, should this be required (thereby supporting the 'public confidence' principle). Submitters were supportive of this proposal.

The SoFA will target a fund of 0.8% of protected deposits built over 20 years

A target fund size of 0.8% of protected deposits is planned to be adopted. This target is estimated to be sufficient to cover the net cost of the estimated 'severe-but-plausible' failure scenarios that has Treasury modelled (see *Table* 4), supporting the 'system alignment' principle. There was general support in the consultation for the methodology used to determine the nature of the failure scenarios and their impact on the DCS. Further information on how the failure scenarios link to the estimated costs of the DCS is provided in Chapter 5.

The first consultation sought feedback on a range of options for the fund size of between 0.5-1.1% of protected deposits. A 0.8% fund, relative to 0.5%, places greater weight on the 'resilience' principle and would provide a greater buffer against the Crown bearing the medium-term costs of a failure event (given that the likelihood of the Crown backstop being required after a failure would be lower, especially as the DCS fund nears its target). A higher target fund, ie, 1.1% of protected deposits, would not be consistent with the 'efficiency' principle, as there would be a material risk that levies would exceed the expected cost of failure events over time, taking into account recoveries that would likely be made from a failed deposit taker.

The Minister has also decided that the funding strategy should aim to reach the 0.8% target over a 20-year timeframe. A build time of 20-years supports the 'equity' principle with the costs spread over a larger cohort of potential beneficiaries relative to the alternative options of 10 or 15-year timeframes that were consulted on. A longer timeframe also 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.

The adoption of a 20-year timeframe for building the fund further supports the 'system alignment' principle, reflecting that the New Zealand deposit taking sector is sufficiently stable to support a relatively extended timeframe. The most recent systemic failure was the failure of several finance companies during the Global Financial Crisis. Since then, to further support financial stability, capital and liquidity requirements have been increased and the Act has been passed, which will introduce a new framework for the prudential regulation and supervision of deposit takers. The New Zealand deposit taking sector has been stable despite failures in the USA and Switzerland in 2023. The 0.8% fund combined with the resilience of the NZ deposit taking system provides confidence that 'severe-but-plausible' failure scenarios could be managed.

The fund targets respond to feedback from the first round of consultation. Larger banks were supportive of a 0.8% fund with smaller banks and non-bank deposit takers (NBDTs) more in favour of a 0.5% fund. Most submitters preferred a 20-year timeframe, with some support from larger banks for a 15-year timeframe. Smaller deposit takers were particularly concerned about the impact of the DCS levies on their profitability and competitiveness. Box 1, below, provides an estimate of how the fund targets could affect future profitability of deposit takers, and illustrates how the chosen approach mitigates this impact relative to alternative options in the first consultation.

The estimated levies required to reach the fund targets take into account the final tax treatment of the DCS. The previous consultation document assumed both the payment of levies and the investment returns from the DCS fund would be taxable. In response to industry feedback the Reserve Bank sought greater clarity on the tax treatment of the DCS. Inland Revenue has now completed work on the tax status of the DCS and has provided advice to the Reserve Bank that the DCS fund will be exempt from income tax under section CW 38 of the *Income Tax Act 2007* as a "public authority" and that the DCS fund will make exempt supplies of financial services under section 14 of the *GST Act 1985* for levies charged to deposit takers. This tax exemption will reduce the amount of levies required to be collected annually to meet the fund targets, compared to what was assumed in the first consultation.

Box 1: Impact of the fund targets on profitability and deposit rates

The impact of DCS levies on the profitability of deposit takers is likely to be unique to each deposit taker and will depend on several offsetting factors, including, the deposit taker's ability to:

- pass on the levy costs without losing deposits. Factors including banking services, community involvement, established relationship or the benefits of mutuality may determine a deposit takers ability to pass on costs
- attract deposits that result from deposit-splitting (ie, the likelihood that depositors with balances exceeding $100,000 at a single deposit taker will split that deposit across multiple deposit takers in order to maximise coverage under the DCS)
- attract deposits by offering insured deposits at competitive deposit rates, which might still be lower than those they offer currently.

Table 2, below, is provided for illustrative purposes and gives an indication of the impact of DCS levies on profitability under the Reserve Bank's preferred "simplified composite risk-based" levy approach. The impact on profitability associated with the levies required to achieve the DCS fund targets has been modelled by the Bank to be:

Table 2: Estimated impact of DCS levies on profitability

	Banks		NBDTs	
	Median	Average	Median	Average
0.8% over 15 years	0.7%	2.7%	5.0%	10.7%
0.8% over 20 years	0.6%	2.2%	4.1%	8.9%

- The estimates in *Table 2* make no adjustments for any possible effects of DCS introduction.
- Underlying assumptions for this table were updated to reflect the tax exemption but use the same investment return and operating cost assumptions as the first consultation, which net out at +2%.
- The Reserve Bank is currently consulting on its preferred levy approach. A different levy approach would change the impact on profitability.

The estimates in *Table 2* assume that the cost of additional levies is fully absorbed by deposit takers through lower profitability. As noted above, it is possible that the cost is instead passed on to customers. Illustrative estimates suggest that levies could impact deposit rates by approximately 5.5 basis points for the 0.8% target fund built over 20 years and 6.7 basis points for the 15-year timeframe.

4 How the funding strategy will be adapted under different scenarios

The Minister is required (by the Act) to publish a SoFA at least every 5 years. These updates ensure that the funding strategy can respond to structural changes in New Zealand's financial system that may impact on the risks to the DCS over time. Additional 'out-of-cycle' adjustments to the SoFA could foreseeably occur if there are rapid and unexpected changes to the estimated costs of the DCS and/or there is a payout from the DCS fund (potentially resulting in the Crown backstop being engaged).

The flexible approach provided for in the Act recognises that future events are highly uncertain and that there is value in enabling adjustments to the funding strategy to be made by the Government of the day based on the best information available at the time. However, there is a tension between this flexible approach and the principle of 'predictability', which requires that deposit takers have a broad understanding of how the levies could adjust in a range of different circumstances and scenarios.

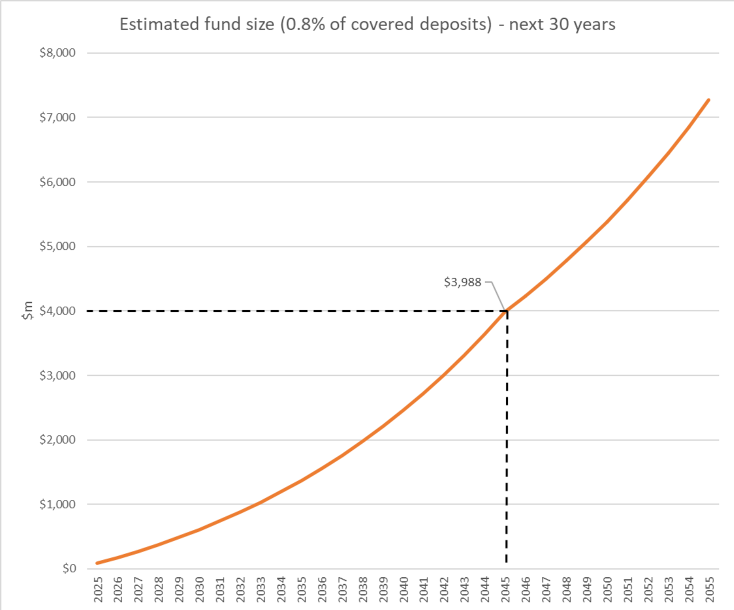
The levies for the DCS may deviate from initial forecasts due to a range of factors, including the occurrence of failure events, the extent of growth of protected deposits, and the amount of earnings made from DCS fund investments. In response to feedback on the first consultation, this chapter provides more clarity on the forward path of the DCS fund once the targets are reached or there is a large-scale failure event. Although a current SoFA cannot bind future Ministers, the analysis in this section would provide a benchmark against which the decisions of a future Minister could be compared.

Scenario 1: the target fund size is reached

In the first consultation deposit takers stated that they would like more clarity on the forward path of levies once the target fund size is reached. Even once the fund target is reached, levies will continue to be charged to cover the growth in deposits and ongoing operating costs of the scheme, assuming that DCS fund earnings are not sufficient to offset these factors.

Figure 1 shows the expected forward path of the DCS fund over the next 30 years. It is not an illustration of the path of levies but rather the growth of deposits over time. However, the illustration shows that it is likely that some degree of levy will be required even once the 0.8% target for the DCS fund is met, to account for growth in deposits (estimated at 6.2% p.a.) and operating costs of the fund. We propose that the initial SoFA will include a scenario along these lines, to demonstrate that some degree of levies will be required to meet deposit growth and operating costs, even once the target is reached.

Figure 1: Estimated DCS fund size over the next 30 years



**This graph assumes deposit growth of 6.2% p.a. It does not include any assumptions on operating costs, investment returns or levy settings. These are aspects to be considered in other parts of this consultation and/or Reserve Bank levy consultations.*

We expect that future SoFA documents will reassess the DCS fund targets in light of any new risk information. In order to ensure consistency with the 'efficiency' principle (ie, to avoid over-charging deposit takers for the benefits they receive), any increase to the targeted size of the DCS fund would need to be justified based on updated estimates of the costs of the DCS.

Submitters were interested in whether new entrants to the deposit taker sector would be required to pay a higher levy rate for a period if they entered after the DCS fund had reached its targets. If a new entrant joins, the RBNZ will be required to consult industry on any change to levies. This has not been specifically addressed in levy consultations to date but will be considered in future development of the levy regulations.

Scenario 2: a significant failure occurs during the build-up phase of the DCS fund

In the first consultation there was interest in understanding how the funding strategy would be adapted if the DCS fund (and possibly the backstop) is drawn on following the failure of a deposit taker. As noted above, this could occur following a payout under the DCS being trigged during a liquidation or receivership, or upon the funds of the DCS being drawn on to support a resolution action being undertaken by the Reserve Bank.

Following a failure event that results in the funding of the DCS being drawn on, the Minister of the day would need to make a judgement about whether to adjust the targets for the DCS fund. This would be expected to trigger a review of the SoFA. The SoFA review would focus on whether and how much to extend the timeframe for reaching (or returning to) the target fund size, balancing the following considerations:

- 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 would potentially require significant increases in levies, which could be procyclical in the context of recent failures, and even undermine confidence in the stability of the financial system, or sub-sectors of the deposit taker system.

The tension between these considerations will become more acute 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) during the build-up phase.

If the DCS fund is in a deficit position, the Treasury expects that a loan would be provided to the DCS to cover the deficit. Any earnings from the DCS (including recoveries from the failed deposit taker) would be used to repay the principal and interest on the loan. 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, including the timeframe for repaying the loan. High-level expectations for the terms and conditions for the loan are provided in Chapter 7. *Table* 3 shows illustrative scenarios for the balance of the DCS fund, following a 'severe-but-plausible' failure event 5 years after the DCS is implemented. The analysis shows that maintaining the pre-failure timeframe for reaching the target fund size (ie, 20 years) would require levies to increase by approximately 20% if there were widespread failures in the NBDT sector, or in excess of 50% if a medium-sized bank was liquidated. Alternatively, if the path of levies was maintained at the pre-failure rate, the timeframe would need to be extended by 5 and 10 years, respectively. These scenarios illustrate the tension between 'resilience' and other funding strategy principles in these circumstances.

Chapter 7 discusses the expectation that the DCS will incur risk reflective interest costs on any borrowing from the Crown. Illustrative estimates of these costs in the same scenarios are included in Table 3, noting that specific pricing of loans to the DCS will be agreed with the Reserve Bank at the time that the loan is provided.

Table 3: Estimated impacts of 'severe-but-plausible' failure scenarios occurring 5 years after implementation

	Widespread failures in the NBDT sector	Liquidation of one medium-sized bank
Upfront loss	$0.9 billion	$3.4 billion
Assumed recovery rate over 3 years	50%	75%
Time to reach target fund size under pre-failure levies	25 years	30 years
Increase in levies to reach target in 20 years	20%	50%
Time to repay Crown under pre-failure levies[1]	2 years	6 years
Illustrative estimates of costs of DCS paying interest on loans provided through the Crown backstop	$20 – 26 million	$233 – $297 million

** Underlying assumptions for this table assume that recoveries take place over 3 years, interest is expensed between 4-5% and use the same investment return and operating costs assumptions as the first consultation, which net out at +2%.*

Proposal for feedback

We propose that the first SoFA will summarise the information in this chapter. In particular, it will set out the expected approach to levies once the fund targets are met, considerations that should guide Ministerial decisions about whether and how to adjust the funding strategy following 'severe-but-plausible' failure scenarios, and modelling of how different choices for the funding strategy could affect the DCS fund balance and forward path of levies.

Although the initial SoFA cannot bind the decisions of future Ministers, we are interested in feedback on whether it could also set out more specific expectations for:

- the maximum timeframe for returning the DCS fund to surplus if there is a deficit in the fund and/or
- the maximum increase in levies that would be consistent with the decision-making principles.

Questions:

- Do you agree with the proposed content for the initial SoFA to provide guidance on how the strategy would be adapted in the scenarios?
- Do you have any views on whether more specific expectations should be provided for how the DCS fund is returned to surplus following deficits?
- Do you have any other comments on the Treasury's analysis of how levies may adjust in response to the scenarios described in this chapter?

1 This is partially dependent on interest rate charged on Crown loan.

5 Estimating the costs of the DCS

The Act requires the SoFA to provide estimates of the total costs of the DCS.[2] In the first consultation, we provided estimates of 'severe-but-plausible' failure scenarios associated with the Reserve Bank issuing one or more specified event notices during the period of the SoFA; or authorising an amount to be paid out of the DCS fund to support resolution measures for a deposit taker. We have subsequently updated these scenarios to reflect new data outturns since the first consultation. This section illustrates how these estimated failure scenarios link to the estimated costs of the DCS fund, and provides estimates of the operating costs of the DCS.

Decisions on the target fund consider the 'severe-but-plausible' failure scenarios from the first consultation

Table 4 provides updated estimates of how 'severe-but-plausible' failure scenarios would be expected to affect the funding of the DCS. We propose that these estimates are included in the SoFA as the best quantitative estimates of the possible DCS costs associated with failures. We propose that the funding impacts shown in *Table 4* are the primary method used to estimate the costs to the DCS associated with failure events.

The Act also requires that the SoFA includes information about the likelihood of the DCS being triggered during the period of the statement. This is difficult to estimate quantitatively with any degree of accuracy, given the minimal number of deposit taker failures in recent decades. While it would be possible to use credit models to quantify the likelihood, we agree with submitters that there is insufficient data available in New Zealand to justify the cost of independent modelling. We propose that the SoFA will instead set out the qualitative evidence discussed in the first consultation suggesting that the likelihood of the 'severe-but-plausible' failure scenarios is remote.

There is substantial uncertainty about the estimates of the costs of the DCS. Periodic reviews of the SoFA (at least every 5 years) will allow these assumptions to be revisited if and when new information becomes available. The public also has access to the Reserve Bank's regular Financial Stability Report publication, 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.

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2 Sections 238(2) and 247 of the Deposit Takers Act 2023.

Table 4: 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

Likely scale of operating costs

There will also be costs associated with establishing and operating the DCS and estimates of these costs will be provided as part of the SoFA. The establishment and operating costs have not been taken into account in the SoFA fund targets, which are based on risk-scenario modelling. The specific costs that will be charged to deposit takers, while ensuring that the Minister’s fund targets are met, will be covered in the Reserve Bank’s future levy consultation processes. (The Act sets out an expectation that the costs of the Reserve Bank undertaking its functions related to the DCS will be fully funded through levies.)

The DCS fund will be administered by the Reserve Bank, and the Reserve Bank will be responsible for ensuring that the DCS is able to achieve its objectives. During the implementation and lifecycle of the DCS, there will be three broad cost categories associated with establishing and operating the DCS:

1) Implementation and set up costs: these include short-term personnel to develop the regulations and operating model needed to support the DCS, and overheads and costs related to IT and data systems (such as those needed to implement a single customer view (SCV)). Certain costs incurred to date have been funded via the August 2023 amendment to the 2020-25 Reserve Bank Funding Agreement,[3] and there may be further implementation costs through to full implementation in 2028.

2) DCS run costs: DCS run costs are business as usual operating costs to meet the statutory purpose of the DCS. This would include employee salaries and overheads incurred by RBNZ in undertaking the DCS functions, apportionment of RBNZ expenses related to the maintenance of the DCS and investment of the DCS fund, and ongoing costs needed to service regulations requiring deposit takers to maintain a SCV that would enable rapid identification of the amount of protected deposits under the DCS.

3 DCS implementation costs were not included in the 2020-25 funding agreement.

3) Payout and resolution event costs: the costs of the DCS are likely to increase significantly if a payout is triggered. There is uncertainty around what payout and resolution event costs may look like and these will depend on the size of any event. A larger event would likely incur more costs than a smaller event. Having said that, these costs are likely to include intermediary payout provider costs, communications and incident response management costs.

The Reserve Bank is currently in the process of building operational systems in advance of commencement of the DCS and is developing its ongoing approach to operating the DCS. The ongoing operating costs will depend on the final model chosen. The Reserve Bank will endeavour to use existing infrastructure and resources where possible, targeting an efficient cost model, while ensuring that the DCS's objectives are met. Although the modelling of future levies draws on illustrative estimates about future operating costs made as part of the Reserve Bank's levy consultation, these estimates may be significantly revised as the Reserve Bank makes decisions on how to best operate the DCS. Having the DCS managed by the Reserve Bank brings efficiency benefits, but also means it will be more complex to attribute costs between the DCS and the Reserve Bank.

The Act provides the Reserve Bank with flexibility in how they allocate operating costs to the DCS fund and by extension the levies. This approach is necessary to ensure that the Reserve Bank can quickly scale its expenditure in response to future 'severe-but-plausible' failure scenarios. The Reserve Bank must consult deposit takers in preparing its advice on levy regulations to the Minister, including on any amendments that change the amount of levies or the method of calculating or ascertaining levies (other than those that have a minor effect). The Reserve Bank expects to run the DCS on a cost recovery basis, minimizing the cost to industry and consumers.

It will be important that operating costs are in proportion to the target fund size and demonstrate value for money. To this end, it is expected that the Reserve Bank should be able to demonstrate that DCS operating costs maximise outcomes for a given cost and operating costs are reasonable. The Reserve Bank's framework provides for checks and balances on the expenditure of the DCS that incentivise efficient spending of operating costs and provide assurance that DCS expenditure represents value for money:

- The Act requires that the Reserve Bank prepare financial statements on the DCS fund each year. These must include any information to fairly reflect the financial operations and financial position of the DCS fund, and a forecast statement of comprehensive revenue and expense for the fund, prepared at the start of the financial year, for comparison with actual financial statements. The annual statements will be public either via the Reserve Bank's normal reporting or as a separate set of statements, depending on how the DCS is operationalised within the bank.

- The Reserve Bank Board is accountable for ensuring the Reserve Bank performs its functions efficiently and effectively and operating in a financially responsible manner.[4]

4 Sections 46(a) and 47 of the Reserve Bank of New Zealand Act 2021.

- The Treasury monitors the performance of the Reserve Bank, which includes considering the Reserve Bank's effective use of resources.
- The Minister can set expectations around the Reserve Bank's performance.
- The Minister has the power to review the performance and operations of the Reserve Bank at any time.[5]
- The Parliamentary Finance and Expenditure Committee provides a further financial scrutiny of the Reserve Bank's expenditure, through the annual review process. We would expect costs associated with spending on the DCS to be reflected through this process.

Specific decisions on the implementation costs that are directly attributable to the DCS and the timing of any recovery should be made by the Minister on the advice of the Reserve Bank, as they are best situated to understand any impact of DCS implementation costs to their baselines. As noted above, this would be subject to consultation with deposit takers to the extent that it results in a material change to the path of levies resulting from the levy regulations.

Questions:

- Do you have any comments on the Treasury's proposed approach to fulfilling the requirement to estimate the cost of failure events and their likelihood?
- Do you have any comments on the likely running costs of the DCS and how they have been incorporated into the funding strategy?

5 Section 194 of the Reserve Bank of New Zealand Act 2021.

6 Investment guidance for the DCS fund

Under the Act, the Reserve Bank may invest DCS funds that are not immediately required for expenditure.[6] However, the Reserve Bank must comply with requirements for investment contained in the SoFA.[7] This section seeks feedback on the proposed investment mandate for the DCS fund.

Investment objectives for the DCS fund

It is proposed that the SoFA will set the following primary investment objectives for the DCS fund:

- ensure the value of funds are preserved in real terms and can be readily available to meet DCS obligations (ie, funds need to be liquid).[8]
- avoid prejudice to New Zealand's reputation as a responsible member of the world community.

The secondary objective of the DCS fund is to maximise returns within the risk parameters of the fund as a whole. We anticipate that future SoFAs will place a higher weight on this secondary objective, particularly once the DCS fund has reached its target fund size.

The proposed investment objectives recognise there is a trade-off between liquidity, risk and returns, and that maximising returns has a role to play in preserving the real value of capital. On the one hand, investment objectives that focus too much on liquidity and low risk/return assets forgoes potential returns. On the other hand, too much focus on higher returns runs the risk that funds are not available when needed and will add to costs of managing the DCS fund. It can also lead to a loss if assets must be sold at a suboptimal time.

The World Bank advises that deposit insurers should strive for capital preservation in real terms and net of costs.[9] Operational costs and inflation threaten the achievement of the capital preservation objective. Returns are needed to mitigate these threats, while ensuring that the primary investment objectives are met.

Constraints on investment strategy and risk management

The Reserve Bank will be responsible for setting an investment strategy that achieves the investment objectives set out in the SoFA. We propose that the SoFA will also include constraints on the investment strategy to ensure the strategy pursued aligns to investment objectives and risk appetite. Consistent with the investment objectives, the constraints on the investment strategy for the DCS should balance higher rates of return against the certainty that funds will be available when needed and guards against the loss of principal.

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6 See subsection 201(1) of the Deposit Takers Act 2023.

7 See subsection 201(2) of the Deposit Takers Act 2023.

8 The World Bank recommends that Deposit Insurers should be able to reimburse most insured depositors within seven working days.

9 World Bank Document

We expect that the SoFA will include authorised asset classes that the Reserve Bank can choose to invest in as the main constraint on the investment strategy. Consistent with international practice, such as the European Union Directive on Deposit Insurance Schemes, the SoFA is expected to enable the DCS fund to invest in some or all of the following asset classes:

- cash and deposits in specified currencies as long as they are not held with New Zealand or Australian deposit takers
- highly-rated money-market instruments in specified currencies (at least A+/A1) as long as they are not held with New Zealand or Australian deposit takers
- specified countries' sovereign bonds and treasury bills (at least A+/A1)
- fixed interest instruments issued by local and regional authorities (at least A+/A1)
- fixed interest instruments issued by international organisations and development banks (at least A+/A1)
- highly-rated non-banking sector corporate bonds issued in specified countries (at least A+/A1)
- covered bonds issued in specified countries (at least A+/A1)
- any other assets which are considered to be of "similar risk and liquidity" by the Treasury (to be considered on a case-by-case basis)
- derivatives, such as futures and swaps, used for hedging or liquidity purposes as long as they do not add financial leverage to the DCS fund and the counterparty used has a credit rating of at least A+/A1 and for Exchange transactions the Exchange has a credit rating of at least A+/A1.

The rationale for the authorised asset classes will be driven by risk management considerations.

It is proposed that, consistent with the investment objectives the Reserve Bank, in its role as Fund Manager, will have flexibility to select individual securities and the asset allocation targets between the authorised asset classes as part of its investment strategy.

Risk appetite and risk management approach to manage risks

Risk appetite is the level of risk the DCS fund is prepared to accept to achieve its investment objectives as set out in the SoFA. To manage overall risk, the Reserve Bank will develop a Risk Appetite Statement to be agreed with the Treasury. The Risk Appetite Statement will include information on principal risks to the DCS fund and mitigation strategies for these risks.

Measuring and reporting on investment performance

The overall investment performance of the DCS fund will be measured and compared against a reference portfolio developed by the Reserve Bank and agreed with the Treasury. This will help to set overall risk limits for the DCS fund. It is expected that reports on portfolio performance and characteristics are provided to the Reserve Bank Board and the Treasury on a quarterly and annual basis, and will include:

- allocation of the DCS fund between asset classes
- performance of the DCS fund against the benchmark and return on each asset class.[10]

Review of Investment Mandate

The investment mandate forms part of the SoFA and as such will be reviewed at least every five years.

Discussion points for feedback

Weight given to capital preservation compared to maximising investment returns objectives

The proposed investment objectives (above) place greater weight on capital preservation rather than maximising investment returns. An alternative option would be to give equal weight to these two objectives, ie, place more weight on the objective to maximise returns (within the risk parameters of the DCS fund as a whole). We are open to feedback on this and any other alternatives.

Placing more emphasis on capital preservation reduces the potential to maximise investment returns. If the DCS fund gave equal weight to each objective this could increase returns, which may have the flow-on effect of reducing levies. On the other hand, giving greater weight to maximising investment returns would also increase risk, which could result in losses to the DCS and in the event of a failure, assets may need to be sold at suboptimal levels.

The extent to which assets with growth attributes should be included within authorised asset classes

The approach to including assets with growth attributes in investment portfolios of deposit insurance schemes varies internationally. For example, the EU directive on Deposit Insurance Schemes allows investment in highly rated corporate bonds but not equities. The World Bank describes equities as “far from being an ideal asset class for deposit insurers.”

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10 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).

We are keen to get views on the extent to which assets with growth attributes, such as corporate bonds, should be included in the authorised asset classes. *Table 5* outlines some of the positives and negatives of including these asset classes.

Table 5: Advantages and disadvantages of higher growth asset classes

	Advantages	Disadvantages
Corporate Bonds	• Corporate bonds almost always have higher yields and – in good times – somewhat higher expected returns than comparable sovereign bonds. • Diversification benefit – sovereign bonds are often worse hit than corporate bonds in an environment of rising interest rates because corporate bonds typically have shorter durations than sovereign bonds and reductions in credit spreads. • During the global financial crisis, corporate bonds issued by companies other than financial institutions actually increased in value.	• Exposure to corporate bonds increases risk of losses and may reduce liquidity depending on the bond. • The entire value of a corporate bond can be lost if the issuer goes bankrupt. Also, significant losses may result if there is a rating downgrade of the company, and the bond needs to be sold as this typically increases credit spreads and lowers bond values. Defaults or downgrades are more likely to occur during recessions when the potential for deposit taker failure is also higher. • Corporate bonds are exposed to a degree of illiquidity risk. • During the global financial crisis, corporate bonds issued by financial institutions declined significantly in value.
Equities	• Could help to increase returns and diversify risks. • In some cases, may increase liquidity (eg, blue chip stocks are often more liquid than corporate bonds).	• Exposure to equities can result in large losses. • Equities are generally illiquid and may need to be sold at a loss in an event.

As noted above, given the various factors in *Table 5* and international norms, the draft investment mandate allows only exposure to highly rated non-banking sector corporate bonds issued in specified countries. This allows for the deposit insurance scheme to gain some of the benefits of assets with growth attributes while mitigating some of the downside. The high risk of loss in banking sector corporate bonds during financial crises is mitigated by only allowing non-banking sector corporate bonds. Liquidity risk is mitigated by not allowing New Zealand issued corporate bonds, which tend to have a high degree of illiquidity risk.

Questions:

- Do you have any comments on the investment objectives of the DCS fund and how they are proposed to be ranked?
- Do you have any comments on the authorised asset classes? Should assets with growth attributes be included? (If so, which assets would you propose and why?)

7 Implementing the Crown backstop

If the DCS fund does not have enough money to meet its statutory obligations, the Act requires the Minister to provide public money to the fund on terms and conditions suitable to the Minister.[11] This statutory obligation is known as the Crown backstop. The Crown backstop will provide public assurance that compensation will be provided in a timely manner, following the failure of a deposit taker.[12]

The Crown backstop represents an explicit liability to the Crown, and the SoFA must set out the Minister's proposed approach to manage the financial position of the Crown in connection with the DCS.[13] A target fund approach of 0.8% over 20 years, as outlined in Chapter 3, should provide a greater buffer against the Crown bearing the medium-term costs of a failure event, and reduces the likelihood of the Crown backstop being required after a failure, especially as the DCS fund nears its target.

Structure of the Crown backstop

A prudent approach to implementation of the backstop should enable rapid payout well in excess of the 'severe-but-plausible' failure scenarios shown in *Table* 4 above. The Crown is well placed to play this role given New Zealand's relatively low debt levels and the significant liquidity buffer operated by the Crown. The Crown's liquidity buffer was increased significantly post-Covid and as a result, a $15 billion buffer is now maintained, which will result in greater resilience and flexibility to provide sufficient liquidity in adverse scenarios.[14]

The Crown is confident that it can backstop the funding obligation for the DCS. However, the cost and timeframes for doing so may increase for more systemic events, where the funding of the DCS is likely to be used to support a resolution that contributes to the protection of depositors, up to a net cost of a hypothetical liquidation, taking into account recoveries.

The Treasury expects that backstop money would be provided through a loan to the DCS. Any earnings from the DCS (including recoveries from the failed deposit taker, and subsequent levies) would be used to service the principal and interest on the loan until it is repaid. The Crown will provide two types of loan facility to backstop the DCS:

- a liquidity facility, to be utilised in the first instance and which may be required for 18 months to 2 years post a depositor failure
- a term lending facility to finance any longer-term deficiency in the DCS.

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11 Section 250 of the Deposit Takers Act 2023. Under section 248(2) of the Act, this would be by way grant or advance as may be necessary to meet the shortfall.

12 Under section 199(d) of the Deposit Takers Act 2023, money may be paid out of the DCS fund to pay the costs of the Crown associated where there is a deficiency in the DCS fund.

13 Section 247(d) of the Deposit Takers Act 2023.

14 Building resilience in the Crown's liquidity management.pdf (treasury.govt.nz)

Costs associated with the Crown backstop

The Act sets out an expectation that the costs to the Crown in connection with the backstop, including the costs incurred in holding additional liquidity, and the costs of repaying any money provided to the DCS fund (eg, any interest, or other charges) are to be fully met out of the fund.[15] As a consequence, the Treasury has designed arrangements for the provision of liquidity to the DCS to be cost-reflective.

Illustrative estimates of the associated costs to the DCS in 'severe-but-plausible' failure scenarios are provided in *Table 4* of this document. If the Crown backstop is called on, associated costs would depend on the size of the loan to the DCS, the time taken to repay the loan, and whether or not a liquidity facility or a term lending facility is used.

Standby liquidity fee

For the first SoFA, a liquidity fee (reflective of the costs incurred in holding liquidity via the Crown Liquidity Buffer) will not be charged, but there will be optionality for this in future SoFAs, and subject to the Minister's discretion. Any in-principle decision to charge the cost of holding liquidity to meet the objectives of the DCS would be subject to public consultation as part of the process for setting DCS levies.

Liquidity facility

Following a failure event that triggers the backstop, the intention is for the liquidity facility to cover the period of liquidation or resolution. Due to the short period between a risk event (eg, a bank failure) and when funds are required, the Crown Liquidity Buffer will likely be used for initial funding of the liquidity facility (if required).

It is proposed that there will be two different risk premiums included in the pricing of any loan, depending on the size of the event and current models of 'severe-but-plausible' failure scenarios.[16] This is to reflect the ease at which the Crown can replace liquidity for events of $0-$2 billion and events over $2 billion.[17]

Term lending facility

It is intended that the term lending facility will cover any amounts still unpaid after the liquidation or resolution period. It is expected that term lending will have fixed maturity dates and fixed interest rates, consistent with the levy's ability to repay the loan. The term lending facility will be priced at a base rate, calculated as the government bond yield consistent with the maturity of the loan with a standard risk premium added to the base rate.

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15 See section 238 of the Deposit Takers Act 2023.

16 The Treasury expects to adjust these thresholds in future SoFAs in response to any changes to the estimated risks to the DCS, including to reflect the impact of growth in deposits.

17 These ranges will be continually reviewed as events happen and as a part of future SoFA processes to ensure the methods still reflect the 'severe-but-plausible' failure scenarios, and account for growth in deposits.

Potential impacts on the government's balance sheet

Although the targets for the DCS fund reduce the risk that the Crown backstop will be drawn on, 'severe-but plausible' failure scenarios could potentially result in the Crown funding the DCS for an extended period. Chapter 4 provided estimates of these possible impacts, and discussed expectations for how the fund targets would be reviewed following failure events. It is expected that the review of the SoFA would include consideration of the benefits of repaying the Crown as soon as possible following events that draw down on the backstop, alongside other factors.

Questions:

- Do you have any comments on the Treasury's proposed approach to recovering costs associated with providing liquidity to the DCS?

8 What happens next?

We will consider all feedback to inform publication of the first SoFA. The Act requires the Minister to take all reasonable steps to publish the SoFA before 7 July 2024.

The DCS levy regulations will take into account the SoFA settings, and so that the overall levies charged on the sector, appropriately build the DCS fund to the target size.

It is expected that the DCS levy methodology will be finalised by the end of the year and that the DCS regulations (including levy regulations) will be in place sufficiently in advance to give industry enough time to prepare before the DCS commences, in mid-2025.

Table 6 shows next steps until implementation of the DCS.

Table 6: Key milestones to finalise decisions and implement the DCS

Milestone/Activity	Timeframe
Stage two consultation on the DCS Regulations (Reserve Bank-led)	11 March – 10 May 2024
Stage two consultation on the SoFA (Treasury-led)	6 May – 31 May 2024
Submissions analysis and preparation of the first SoFA	June 2024 onwards
Final decisions from MoF on the SoFA	June 2024 onwards
Publication of the SoFA	Before 7 July 2024
DCS levy advice provided to Minister (Reserve Bank-led)	After SoFA is published
Final DCS levy regulations implemented	Expected late 2024
DCS commences	Mid-2025

Questions:

- Do you have any other comments on matters covered in this discussion document?

Annex 1: Glossary

Term	Definition
Crown backstop	If the Depositor Compensation Scheme (DCS) does not have enough money to meet its statutory obligations, the *Deposit Takers Act 2023* (the Act) will require the Minister of Finance (Minister) to provide public money to the DCS fund on terms and conditions suitable to the Minister. The commitment to provide this is known as 'Crown backstop' to the DCS. It will provide public assurance that compensation will be provided in a timely manner following the failure of a deposit taker.
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)	This Act will replace the existing prudential regulatory regime contained in the *Banking (Prudential Supervision) Act 1989* and the *Non-bank Deposit Takers Act 2013*. The integration of these previously separate regimes will create a single, consistent framework for the regulation and supervision of financial institutions that essentially engage in the same activity – the business of taking 'deposits' from the public, and lending to individuals, households, and businesses.
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. NBDTs are regulated by the *Non-bank Deposit Takers Act 2013* but will be regulated under the *Deposit Takers Act 2023* in the single regulatory perimeter for deposit takers.
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.
Risk-based levy	A levy that is charged to a deposit taker or group of deposit takers according to the risk they pose to the DCS. See the Reserve Bank's consultation documents: *Depositor Compensation Scheme Regulations*, and *Levy framework for the Depositor Compensation Scheme* for further information.