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A Wholesale Guarantee Facility: Detailed Design Issues and an Overall Assessment

New Zealand Treasury/Kaitohutohu Kaupapa Rawa

Treasury Report: A wholesale guarantee facility: detailed design issues and an overall assessment

Date:	24 October 2008	**Report No:**	T2009/2069

Action Sought

	Action Sought	Deadline
Minister of Finance (Hon Dr Michael Cullen)	Read and discuss with officials	Teleconference 9am Saturday 25 October

Contact for Telephone Discussion (if required)

Name	Position	Telephone		1st Contact
Peter Bushnell	Deputy Secretary, The Treasury	917 6176 (wk)	*[deleted – privacy, OIA s9(2)(a)]*	✓
Grant Spencer	Deputy Governor, Reserve Bank of New Zealand	471 3651 (wk)	*[deleted – privacy, OIA s9(2)(a)]*	

Minister of Finance's Office Actions (if required)

None.

Enclosure: No

24 October 2008

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Executive Summary

International funding markets are currently largely closed to New Zealand banks. Those funding markets have been the key channel through which New Zealand's substantial accumulated external financing needs have been met. If the economy's access to foreign credit is not restored quickly, the risks of intensified economic downturn will rise markedly: domestic credit conditions would be tightened materially further and the exchange rate could come under significant renewed downward pressure.

This report follows on from our 17 October 2008 report on a possible wholesale guarantee facility. It outlines in greater detail, and seeks your approval of, the operational details of such a scheme. It then seeks to assess what role a wholesale guarantee facility should play, and when, in responding to the current intense pressures on bank access to foreign funding markets and the attendant, and growing, macroeconomic risks.

The proposed operational details of a wholesale funding guarantee scheme are developed at length in the body of the report. The basic structure is as you approved in last week's report, subject to some relatively minor refinements and clarifications.

The critical aspect for the success of any wholesale scheme, if it is to help to facilitate improved access while minimising the additional Crown fiscal risk by encouraging an early exit from reliance on a guarantee facility, is that a relatively high price is charged for use of the guarantee. The price needs to be low enough to be used while market access remains very difficult, but high enough that banks do not rely on it as market conditions normalise.

There are other possible approaches to restoring the flow of foreign credit to the New Zealand economy. The most obvious would be to increase the Crown's own foreign borrowing, lending the proceeds to the banks. Our judgement is that, at present, a wholesale guarantee facility would be a preferable approach. It is now a more internationally conventional model, and is better tailored to ensuring a smooth exit from reliance on government assistance. Increasing Crown foreign borrowing at present might pose more of an immediate risk to New Zealand's sovereign credit rating than offering a well-structured guarantee facility which involves assuming contingent liabilities. We also cannot be sure that a guarantee facility will enable the banks to secure sufficient funding consistently through time. Global market conditions are likely to remain difficult, perhaps intensely so at times, for some time to come. It seems prudent to reserve the option of using direct Crown foreign borrowing should the overall situation deteriorate further.

We have also considered, and do not endorse, the proposal that any wholesale guarantee facility should be tied to a requirement on the Australian banks to raise additional capital in their subsidiaries from the New Zealand public markets. Bank capital adequacy is not the issue at present, and attempting to link a guarantee scheme designed to reduce macroeconomic risks to capital injections could be quite directly counterproductive. However, it would be sensible, as under the deposit guarantee scheme, to require that recipients of the guarantee continue to meet appropriate prudential standards, including maintaining a strong capital position.

Finally, we consider the question of whether we should proceed to offer a wholesale guarantee facility now. This is, inevitably and appropriately, an on-balance judgement. Any intervention of this sort has material costs and risks - in this case, largely fiscal in nature – and these need to be weighed against the benefits in terms of reduced macroeconomic risk.

The choice may now be best framed in a least regrets framework: would we prefer to launch the scheme and find that it had not really been needed, or not to have done so only to find that it really was needed.

Our judgement is that, with a well-designed scheme along the lines set out in the report, priced so that it will not be used if it is not needed, it is better to proceed. We would not know for months that conditions had improved sustainably in a way that meant the scheme would not have been needed. Thus, the risk that in a few weeks time we would regret having offered the facility is small. On the other hand, the scale of macroeconomic risks is rising steadily the longer the banks are unable to access foreign funding markets on a substantial scale. Those risks could intensify quite sharply in the next few weeks, in a period when global market sentiment appears likely to remain jittery at best.

Accordingly, we propose to complete operational design and planning, including quick consultation with banks next week, with a view to a final report to you at the end of next week allowing the announcement, and effective deployment, of a wholesale facility shortly thereafter. We also recommend that further consultation take place with National Party representatives.

Recommended Action

We recommend that you:

- **Note** that the macroeconomic risks (from reduced credit availability and the potential for significant further downward pressure on the exchange rate) that would arise from continued severe limitations on access to foreign wholesale funding markets are significant and increasing.

  Noted

- **Agree** that a New Zealand wholesale guarantee facility would have the operational design features outlined in the body of this report. Key elements include:

  - The fee structure would differentiate by term and by the credit rating of the issuer, and would be set sufficiently high to encourage issuers to graduate from dependence on a government guarantee as soon as market conditions permit;
  - The fee schedule would be reviewed regularly;
  - The facility would apply only to new issuance, on an opt-in basis;
  - Eligible financial institutions would be those with substantial New Zealand borrowing and lending operations (excluding those established to fund related parties) and an investment grade credit rating;
  - Any paper issued under the guarantee would be covered for a period no longer than three years from the day the facility was launched;
  - Transferable or negotiable senior unsecured instruments issued by eligible issuers in any major currency (including the New Zealand dollar) would be eligible for the guarantee;
  - New Zealand branches of foreign financial institutions would be eligible, but only in respect of New Zealand dollar issuance; and
  - For each eligible institution, total guaranteed issuance would be capped at 125 per cent of the initial total stock of eligible types of instrument on issue.

  Agree/Disagree

- **Agree** that, of the range of possible options for responding to the current funding pressures, a wholesale guarantee facility, appropriately designed and priced, is the best tool that could be deployed in current circumstances.

  Agree/Disagree

- **Note** that providing a wholesale guarantee facility poses significant fiscal and economic risks, not only were a major bank to fail during the term of the guarantee, but also in terms of pressure on New Zealand's sovereign credit rating and likely increases in new borrowing costs.

  Noted

- **Agree** that, having regard to both the increasingly significant macroeconomic risks if no action is taken, and the costs and risks of taking action, a wholesale guarantee facility should be put in place.

  Agree/Disagree

- **Note** that as part of preparing final recommendations for you towards the end of next week, officials will consult briefly with banks on the basis of the scheme design outlined in this report. This timing will also allow the final details of the Australian scheme to be more fully reflected in our advice.

  Noted

- **Agree** that further consultation should take place with National Party representatives.

  Agree/Disagree

- **Agree** to refer this report to the Prime Minister.

  Agree/Disagree

Peter Bushnell
Deputy Secretary
for Secretary to the Treasury

Grant Spencer
Deputy Governor
Reserve Bank of New Zealand

Hon Dr Michael Cullen
Minister of Finance

Treasury Report: A wholesale guarantee facility: detailed design issues and an overall assessment

This joint report follows on from our 17 October 2008 report on a possible wholesale funding guarantee facility. That report focused on two things: reviewing some of the range of possible responses to the announcement of a wholesale guarantee facility in an increasing number of countries (most particularly Australia), and outlining the form that a New Zealand wholesale funding guarantee facility could take, were such a facility to be required. You indicated your agreement to further development work taking place along the lines of the approach outlined in that report.

This report also has two areas of focus. The first is to outline in greater detail the form that a New Zealand wholesale facility could take. We outline each of the key features and the reasons for the recommendations we make. The second focus is on outlining and attempting to assess the range of considerations relevant to a decision on whether and, if so, in what circumstances it would be appropriate to launch a New Zealand wholesale facility.

What would a wholesale guarantee scheme be attempting to achieve?

Before outlining our detailed proposals for a possible wholesale guarantee facility, it is worth stepping back for a moment to outline what such an instrument, if deployed, would be aiming to achieve.

At present, international funding markets are largely closed to New Zealand and Australian banks. Those markets have financed New Zealand's accumulated external imbalances, and if material volumes of maturing debt cannot be rolled over, the risk of a more severe economic dislocation over coming months will be heightened[1]. The traditional funding markets are likely to re-open only gradually. As they do there is likely to be, for some time, a marked investor preference for securities issued by banks that carry a government guarantee over those that do not. That could be so even if the issuers of non-guaranteed paper were willing to pay a materially higher interest rate. Moreover, we cannot safely assume that we have now seen the final period of intense pressure on funding markets.

Thus, the primary goal of any wholesale funding guarantee facility would be to support the re-entry of the banks to the regular foreign markets, on a scale commensurate with the New Zealand economy's overall financing needs. At the same time, we would wish to structure a guarantee facility in a way that encouraged issuers to graduate from using a government guarantee as soon as reasonably possible. The goal would be to use instruments tailored in a way that helped facilitate the normalisation of financing and funding structures, and to do so in a way that limits and manages the Crown's contingent risks to the extent possible.

The proposed details of a wholesale guarantee scheme have been developed primarily with these considerations in mind.

[1] Even though, as outlined in our previous report, Reserve Bank liquidity facilities are readily able to ensure that any additional domestic settlement cash is available as required.

Operational details

What fees would be charged?

A substantial 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 (basis points per annum)**	
	Terms < 1 year	**Terms > 1 year**
AA and above	100	140
A	160	200
BBB	210	250

The guarantee fee for new issuance would be reviewed, normally monthly, in the light of market indicators (about pricing and usage) and could also be adjusted as part of an exit strategy. Adjustments would be made by the Secretary to the Treasury under delegated authority.

As outlined earlier, our fee schedule has been designed with the goal of helping to facilitate market access while that remains very difficult (i.e. to ensure that the facility is used while it is needed), but encouraging issuers to graduate from using the guarantee facility as market conditions permit.

Secondarily, we have also tried to balance two, somewhat conflicting, other considerations. On the one hand, market prices for credit risk are lower for shorter terms. On the other hand we want to ensure that banks do not concentrate their new issuance in short maturities, in the hope that future borrowing costs will be lower than those prevailing now. Our judgement is that the banks have had a sufficient scare from the funding difficulties of recent months that they will make every effort to secure longer-term funding when it is available, and will not unnecessarily run the risk of exposing themselves to a new period of concentrated maturities early next year.

We have looked at the absolute level of pricing from a number of angles. One of these was the United Kingdom approach outlined in last week's paper, applying a penalty margin on top of market prices for credit risk. Another involved looking at an average of the gap between government and private sector borrowing costs in normal times and over the crisis period[2]. Both suggest that pricing a guarantee for terms greater than one year at around 140 basis points per annum is reasonable.

In terms of international benchmarks, this proposed pricing is very similar to that being charged in the United Kingdom. Media reports suggest that Germany plans to charge 200 basis points and that Ireland plans to charge between 100 and 200 basis points. Indications from other countries are generally a bit lower (75 basis points in the United States for example). Details of the Australian scheme are to be released tonight. Reports from Australian officials suggest that the Australian facility is likely to be priced more cheaply (probably not over 100 basis points). *[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"]*

[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.

We propose that authority to adjust to the fee structure would be delegated to the Secretary to the Treasury, who would exercise that discretion in light of the principles that guided the development of the pricing framework (i.e. a price low enough that the facility would be used when market access conditions required it, and high enough to encourage banks to graduate from use of the facility as market conditions allow).

We are continuing to explore the option of charging some portion of the fee as an upfront 'facility fee'. If we conclude that this would be a useful modification to the pricing structure we will report back to you.

Eligible institutions

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

The focus of any wholesale guarantee scheme would be on re-establishing access of financial intermediaries to wholesale funding markets, and in particular to international funding markets. The proposed eligibility criterion captures all the financial institutions we are aware of that have made use of foreign wholesale markets in recent years. Around half a dozen non-bank financial institutions appear likely to be eligible[3].

Consistent with the approach to wholesale facilities being adopted in other countries, we do not consider it appropriate to broaden the scheme to encompass non-financial (corporate and local authority) issuers. The focus of wholesale guarantee schemes has been on ensuring the effective functioning of the financial intermediation process, which over time will benefit borrowers and savers more generally. The launch of a wholesale scheme that was widely used would relatively disadvantage non-financial issuers in the short-term. However, that risk can be reduced, in part, by ensuring that the pricing of any facility is set sufficiently high to avoid unduly disadvantaging non-financial issuers. Indications are at present that even in markets where wholesale schemes have been announced, sound corporate issuers continue to find it materially easier to tap funding markets than financial sector issuers do.

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

The Crown would not be obliged to offer a guarantee facility to any particular issuer, and the policy guidelines that would guide our discretion in this regard would capture these eligibility considerations.

Term of guarantee

Any paper carrying the guarantee would be covered until a date no later than three years from the launch of the facility.

A three year term is longer than the two year term on the deposit guarantee scheme. We consider that this is necessary as it will help to minimise the risk of a bunching of the wholesale maturities into a very tight window, which could leave the system and economy exposed to significant rollover risks again at some point. A case could be made for an even longer term, given the desirability of encouraging banks to lock in longer-term funding.
The recommendation of a three year term is a pragmatic balance: weighing the desire to

3 In addition to the registered banks, institutions such as MARAC, South Canterbury Finance, Medical Securities and Motor Trade Finance would meet the criteria for eligibility. Institutions such as Telecom Finance, which exist to finance a parent, would not be eligible.

minimise concentrated future rollover risks, against the desire to move the contingent fiscal liability associated with the guarantee off the books as soon as practicable.

The proposed three year term is implicitly premised on an assumption that funding markets return to a fairly normal state over the next year or so. If severe stresses were still to be apparent after 12-18 months we would need to consider extending the term of the guarantee, again to avoid renewed concentrations of rollover risk.

Coverage: existing or new debt

Only newly-issued debt would be eligible for coverage.

This facility would be available only on eligible instruments issued on or after the guarantee instrument was signed with the issuing institution. In some countries, wholesale guarantee facilities have offered cover on existing debt. Covering existing debt is usually intended to help restart secondary market trading activity in debt instruments about which market participants have become nervous. That is not an issue in New Zealand, where secondary markets in existing debt instruments continue to function. In New Zealand, the primary issue is the ability to issue new paper in international financial markets. Accordingly, access to a wholesale guarantee should be limited to new debt issues.

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 conceivable, and perhaps likely over time as markets begin to normalise, 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 approach is consistent with facilitating as early an exit from offering a guarantee as possible, by allowing institutions to gradually withdraw from using the guarantee on new paper, as market conditions allow.

The Crown would not be obliged to offer a guarantee on any particular issue, and policy guidelines to govern our discretion would be developed and published.

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. That exclusion was designed as a crude proxy to minimise the extent to which wholesale holdings of financial instruments were covered by the highly concessional deposit guarantee scheme. Under the possible 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.

We would, however, propose excluding any debt held by related parties (including parents) of the issuer. Paper issued solely to such parties would not be approved for a guarantee, and any guaranteed paper held by related parties would be specifically excluded from coverage in the wording of the guarantee deed.

Which instruments would be covered?

All newly issued senior unsecured negotiable or transferable debt securities would be eligible for inclusion[4].

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

Covering negotiable or transferable debt security issuance enables us to provide cover cleanly on an issue by issue basis. However, as one example, term deposits or call account balances held by larger investors (above the $1m cap in the deposit guarantee scheme) would not be covered. Our judgement is that holders of these products, in conjunction with eligible institutions, would be able to ensure that the bulk of their claims were able, in future, to be held in instruments for which a guarantee could be obtained. Note that any new bond issues undertaken by eligible financial institutions, including ones targeted partly or wholly at domestic retail investors, would be eligible for coverage under the wholesale scheme.

As indicated in our paper last week, to further reinforce the segregation between the coverage of the deposit guarantee scheme and a wholesale scheme, we would require any institution signing up to the wholesale guarantee facility to agree to amend its deposit guarantee scheme agreement to explicitly exclude all securities eligible for a wholesale guarantee from coverage in the retail-focused deposit guarantee scheme.

Which currencies would be covered?

Eligible instruments in all major currencies would be eligible for cover

In both Australia and New Zealand, the major issue has been the inability of banks to issue a sufficient volume of paper, for sufficiently long terms, in international funding markets. Little non-government NZD paper issued by institutions likely to be eligible for this guarantee is held directly by foreign investors and New Zealand domestic securities markets continue to function. Accordingly, the focus of the scheme should be on the foreign currency paper that banks issue internationally. Details released to date on the Australian scheme suggests that it will cover NZD and AUD paper, as well as that denominated in the main funding market currencies. Given that the Australian scheme is likely to cover NZD and AUD issuance we would also want to cover domestic issuance, 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 guarantee).

Moreover, including domestic issuance in a New Zealand wholesale scheme would also assuage many of the concerns currently being expressed by fund managers, whose holdings of claims on guaranteed institutions are not covered by the current deposit guarantee scheme. Managed funds and other similar entities should be able to hold most of their claims on banks in the form of instruments eligible for coverage under a wholesale scheme along the lines outlined in this report.

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.

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4 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. These bonds are not issued by New Zealand banks at present, but the possibility is being actively explored by some. Other asset-backed securities would be explicitly excluded.

The United States' FDIC has applied such a limit to its wholesale guarantee operation. For most institutions it is unlikely to be a binding constraint, for several reasons, but it does provide some additional cover against any risk of banks seeking to increase their activities solely on the basis of the guarantee. It might be of particular relevance to any smaller institutions who rely only to a limited extent on wholesale funding markets.

There is no need to announce any sort of quantitative limit on the total amount of paper we would be willing to guarantee. In total, there is probably around $150 billion of wholesale paper on issue, but as we would be covering only new issuance it would take some time for the volume of guaranteed issuance to approach that total, even if market conditions remain particularly adverse. We would monitor the overall use of the facility and would be able to adjust the pricing should we judge that more debt was being issued under guarantee than we judged to be necessary.

How would branches of foreign banks be treated?

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.

The Westpac and Commonwealth Bank branches in New Zealand (which are both registered banks in their own right) would be covered by the Australian wholesale scheme (at least on the basis of the information known at present).

The situation of the other branch registered banks is unclear. Some of these branch operations play a significant role in the domestic bank bill market, and the interest rates set in that market are an important part in the effective functioning of the interest rates swaps market. Our on balance judgement is that foreign branches should be eligible for coverage, but to minimise any risk of our guarantee offer helping to fund the wider group, we would restrict eligibility to those branches' issuance of New Zealand dollar securities. This would help support the ongoing effective functioning of the domestic bank bill market, and the 125 per cent limit outlined above on total guaranteed issuance would act as a further check on any risk of abuse.

This approach to branches is broadly parallel to the approach taken under the deposit guarantee scheme. Branch liabilities are covered under that scheme, but with tailored rules to minimise any risk of our scheme being abused.

How long would the guarantee continue to be offered?

The guarantee offer for new issues would be withdrawn when market conditions in the key funding markets had returned to relatively normal for a sustained period

There should be no expectation that the guarantee will continue to be offered on new issuance for longer than is needed. We recognise that the crisis to date has gone in waves, and so once it was introduced we would not envisage withdrawing the scheme at the very first signs of normality (only to risk having to reintroduce it later). Instead, the relatively high price on the facility (including the scope to adjust that pricing), and the opt-in nature of the scheme, allows us scope to keep the facility in existence, able to be used if conditions deteriorate markedly, but not actually being used most of the time, until we were confident that the funding markets had sustainably normalised.

How can we limit the risk of banks concentrating new issuance in very short maturities?

In difficult market conditions, it would not be feasible to rely on firm rules as to the maturity mix of new funding. We would, however, in the guarantee deed secure commitments from institutions using the guarantee facility that they would seek to lengthen the average maturity of their funding wherever that is possible.

If individual banks, despite the storms of recent months, take an optimistic view on the extent to which market conditions will improve, and borrowing rates drop, over the next few months, there will be a strong temptation for them to concentrate as much new issuance as possible in relatively short maturities (to minimise their own costs). This could expose the economy and the banks to a new episode of serious concentrated rollover risk early next year if market conditions did not improve as rapidly as the banks expected. In the immediate future, some concentration in short-term paper is quite likely, as very short-term paper might be the only paper that could be sold in any volume. For this sort of reason, precise or specific rules under the guarantee agreement or the Reserve Bank's forthcoming liquidity policies could not be used to govern new issuance in the immediate wake of the crisis. Our sense is that the banks, chastened by the experience of the last year or so will do everything possible to lengthen the maturity structure of their funding when they can. However, the pattern of issuance would need to be monitored closely and moral suasion from the Reserve Bank may be an important strand in our toolkit of responses, to ensure prudent funding strategies through the period ahead.

Should we impose any other restrictions on guaranteed entities?

Other than imposing information and related requirements on non-bank entities using the facility, our judgement is that no additional restrictions are required beyond standard contractual protections.

The vast majority of the funds likely to be raised by issuers under a wholesale guarantee facility would be raised by registered banks. Registered banks are subject to the full range of Reserve Bank prudential supervisory powers. 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. As this facility would operate on an issue by issue basis, there is less need to build in specific provisions providing flexibility to deal with distortions that may arise. As noted above, we will have no obligation to guarantee any particular issue, and would also have the ability to alter pricing as required.

In some other countries, other restrictions have been imposed as part of overall assistance packages. These have included, *inter alia*, restrictions on dividends and requirements on banks to maintain a flow of credit to the wider economy or to particular sectors. Other proposals have included requiring guaranteed lenders to participate in reviews further down the track.

The ability to restrict dividends might appear substantively useful – if the New Zealand government is guaranteeing funding (offshore funding in particular), we do not want to see that improvement eroded by a large flow of funds out of the country to offshore parents. To get more directly at this issue, we could require the guaranteed banks to maintain an additional Tier 1 capital buffer, above the 4 per cent regulatory minimum, for the life of the guarantee. Most of the banks already hold such a buffer, and we would not wish to see that buffer impaired. Another possibility might be to require the foreign bank subsidiaries to agree, for the life of the guarantee, not to reduce their net funding from parents below that prevailing at some recent date.

Our judgement, at present, is that provided any New Zealand scheme has a high price, and, in particular, is priced more expensively than the Australian scheme, price incentives should achieve the desired economic effects (it will be in the interests of subsidiaries to use parent funding to the fullest extent possible, and to use our scheme as little as possible). Our discretion to adjust the pricing at any time, and to decline to guarantee any particular issue, provide additional tools to ensure that the scheme is not misused. We reflect further over the next few days on the possibility of building a capital buffer into the guarantee deed, and will report back to you if it is an option we believe should be pursued.

What is the exit strategy?

The relatively high price charged for the facility, combined with the flexibility to adjust pricing and to withdraw the offer to guarantee issuance, are the essential elements of the exit strategy for this facility.

The relatively high price we would charge for using the facility would be the key element in an exit strategy. 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. Finally, the guarantee facility will not be offered for any fixed pre-specified period. It can be withdrawn, on new issuance, at any point, and would be withdrawn when we judged that conditions had sustainably normalised.

Other details

We have commissioned lawyers to commence drafting a deed of guarantee to give effect to the terms outlined above. The drafting process is likely to bring some further issues into relief, and may suggest a need to refine, at the margin, some of the proposed terms outlined above. We will report back to you on any further issues as required.

We are also retaining the services of outside experts in wholesale financial markets to help us test the likely robustness of the proposed scheme outlined above, and to identify any further protections we might need to build in.

Administrative procedures for conducting a wholesale guarantee scheme have yet to be developed. We will continue to work on these over the coming week. Our aim is to be positioned to move quickly on signing guarantees, and allowing issuance to occur under the guarantee, once a final decision was made to launch such a scheme.

Implications of the Australian scheme

The Australian authorities are to publish details of their wholesale guarantee facility tonight. Based on indications we have received the key features are likely to be:

- An opt-in scheme, on an issue by issue basis;
- A fee structure differentiated by the credit rating of the issuer, but with a flat price across all maturities;
- Lower fees than in our scheme across all maturities;
- Excluding the liabilities of foreign bank branches (as is the case in the Australian retail scheme); and
- Guarantees would be for a term of up to three years.

On the basis of this information we do not envisage major difficulties arising from any differences between the two schemes. *[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"]*

Our proposed scheme would cover the New Zealand dollar issuance of foreign branches. We do not believe that the different treatment of branches in New Zealand and Australia will pose risks or problems for us. This is largely because we will only cover New Zealand dollar issuance, and because the 125 per cent cap will also limit any scope for issuers to attempt to increase significantly their issuance of New Zealand debt.

We understand that Australia is also likely to announce a refinement to their retail scheme. A cap (per depositor, per institution) would be put in place, perhaps at around $1 million, but cover could be obtained for any deposit larger than the cap, on paying a fee, set on the basis of the wholesale guarantee pricing schedule. That is a different, more administratively cumbersome, approach than the one we have taken. As outlined above, we would expect holders of deposit products in excess of our $1 million cap to shift those funds into wholesale guarantee eligible instruments, should they wish to obtain the protection of a government guarantee.

Fiscal issues

A wholesale funding scheme would be offered to address the macroeconomic risks of continued limited access to foreign wholesale funding markets. The state of the economy is, of course, the main factor driving fluctuations in government revenue. Were the macroeconomic risks to be realised, government revenue would be likely to be impaired quite severely.

Last week's report noted that offering a wholesale guarantee facility to address these macroeconomic risks would represent a further large contingent fiscal risk. We do not have a good sense of how heavily the facility would be used (that would depend largely on how quickly market access conditions improve), but last week's report noted that $60 billion of guaranteed issuance within six months would be a plausible estimate if conditions remain difficult. The total stock of wholesale issuance is estimated to around $150 billion.

The expected claims on the scheme are very small (at least based on long-term historical default experience of AA rated banks) and the fee structure proposed would amply cover those statistically expected losses. However, the concentrated nature of the exposure means that although the most likely outcome is that no claims are made at all under the guarantee, if a major bank were to fail, any claim could run to billions of dollars.

Last week's report did not deal with the potential implications of offering this facility for New Zealand's sovereign credit rating. The deterioration in the fiscal position, and the offer of the deposit guarantee facility, combined with the weakening domestic and international economic environment, all point in the direction of downside risk to our sovereign credit ratings. Offering a wholesale guarantee facility represents a further contingent fiscal liability.

We believe that the risks to the rating can be reduced if it is clear that any wholesale facility is well-designed and managed, tightly targeted to deal with the current crisis but within an overall framework that envisages an early exit as market conditions permit. Setting a relatively high price, and restricting eligibility to new issuance are likely to be helpful in this regard. In addition, the fact that most developed countries are also now offering such facilities (and most of them from materially worse government debt positions than New Zealand's) is likely to assist. In public comment, Moody's has suggested that the impact of a guarantee facility on its assessment of the fiscal position is unlikely to be large. In the past Standard & Poors has tended to place considerable weight on the strength of the fiscal position in underpinning the sovereign credit rating.

Even if our sovereign rating was not adversely affected, a wholesale guarantee facility could be expected to increase future Crown borrowing costs, especially if extensive use was made of the facility over a prolonged period of time. As we noted in last week's report, there is no easy way of determining how large any such effect might be, and little guidance yet from the experience of other countries. The more quickly we could prudently exit from offering such a facility, the lower the likely sustained impact on Crown funding costs.
Most of the issuance that would be likely to be covered by a wholesale guarantee scheme would be denominated in foreign currency. This exposes the Crown to two specific significant risks.

The first of these is that, under the terms of the guarantee, the Crown would be committing to pay out the full value of the guaranteed debt when it falls due, and taking the place of the creditors in the queue to have the failed bank's assets paid out at liquidation (when the actual deficiency might prove to be quite modest). For example, if a large bank was to fail a year from now, having taken out guarantees on $20 billion of foreign currency liabilities, perhaps mostly for short terms, we would be due to pay the full $20 billion, in foreign currency, in fairly short order. If market conditions remained difficult, it might be very difficult to raise the required foreign exchange. For example, doing so without additional borrowing would largely exhaust the current total gross foreign reserves of the Crown (including Reserve Bank assets) and in difficult market conditions it might even be difficult for the Crown to borrow that amount of foreign currency. Even though the risk of failure is low, the consequences of having to meet such obligations in difficult market conditions could be serious.

The second issue relates to the way in which hedging contracts work in the event of the failure of a bank. Banks will normally hedge their foreign currency borrowings, but in the event of a bank failure, the counterparties to the hedge contracts have the right to close-out those contracts[5], leaving the bank's foreign currency borrowing unhedged. Exchange rates are, of course, quite volatile in normal times, but in the wake of the failure of a major local bank could be expected to be both more volatile and weak, exposing the Crown to considerable additional risk, as the guarantor, until the hedges could be replaced. Replacing hedges, on a large scale, at a time when one major bank has just failed, is unlikely to be able to be done very quickly.

There is a variety of possible responses to these sorts of risks. We are continuing to examine the issues and to assess the best way to handle them should a decision be made to proceed with a wholesale guarantee scheme. Both are likely to be of considerably lesser significance to the extent that we envisage that the failure of a large bank would be handled using open resolution mechanisms, rather than by liquidation. In general, we should recognise that offering a wholesale guarantee facility that is extensively used would probably make it more difficult to simply walk away from a failing bank. We will report further on these issues in due course.

Overall, the additional fiscal costs and risks that any wholesale guarantee facility would give rise to will reinforce the need for sustained fiscal discipline across the board in the next few years.

An overall assessment of the way ahead

The first part of this report has focused on ensuring that we have a robust wholesale guarantee mechanism to hand that could be effectively deployed should you choose to offer such a scheme.

[5] But do not always do so, especially if, for example, the "failure" of the bank has led to an "open bank" resolution model (such as being taken over by the Crown). Thus our understanding is that when Lehmans went into liquidation the hedges were closed out by counterparties, but when AIG and the US agencies were taken into state control, rights to close-out were not exercised (the failing institution typically becomes a better credit under state ownership than it was just prior to moving into state ownership).

This section focuses on the sorts of considerations that should guide our deliberations on whether and, if so, when to launch such a scheme.

It is worth, first, stepping back and reflecting on whether, if some further steps were needed, a wholesale guarantee facility is the right approach.

Possible Alternative Approaches

From a banking liquidity perspective, the Reserve Bank can continue to meet the needs of banks indefinitely, lending as required against residential mortgage backed securities. Indeed, it will need to continue to be willing to do so under any of the options that are chosen. However, simply providing New Zealand dollar liquidity in this way is unlikely on its own to mitigate the more serious downside macroeconomic risks. If banks are unable to rollover maturing foreign debt and secure reliable medium-term funding from traditional sources, it is likely that they will over coming weeks begin to markedly tighten credit policies, intensifying constraints on access to credit for firms and households. The second strand of the adjustment would be likely to come in the form of the risk of intensified downward pressure on the exchange rate. Over the next 12-18 months either strand of the macroeconomic risks, if realised, would intensify the economic downturn that is already underway.

The Crown could also act directly to increase the supply of foreign capital in to the New Zealand economy, by increasing our own foreign currency borrowing and on-lending the proceeds to the banks. If we were confident that the difficulties in market access were likely to be very short-term in nature that approach could be worth considering now, especially as part of getting banks across the hump of foreign maturities in the next month or so.

We cannot be confident that difficult market conditions will be very short-term in nature. Since the international financial crisis began in mid 2007, there have been repeated waves of intense pressure. After each, some have concluded that the crisis was well on its way to being over. The extent of imbalances that are now unwinding in asset markets around the world, including but not limited to US and European housing markets and currently intensifying pressures on emerging market countries with a heavy reliance on external finance, suggests that we cannot safely assume that we have now seen the final period of intense pressure in the funding markets.

Using additional direct Crown foreign currency borrowing would, of course, boost our gross Crown debt now, rather than taking on a contingent liability in respect of government-guaranteed debt. That might place our credit rating in greater jeopardy, especially as it would be a quite different approach to the one taken by other countries. Depending on the scale of funding needed, such an approach might, in current market conditions, test the Crown’s ability to raise sufficient debt in a relatively short period.

An important goal is to restore normal funding patterns and normal market access as soon as possible, especially as many private issuers around the world are reported to be facing heavy refinancing commitments over the next year or so, at a time when the process of global deleveraging (reducing overall access to credit) is likely to be continuing. A wholesale guarantee facility, which focuses on restoring access to conventional markets, appears to be better suited to a smooth and gradual exit from reliance on a guarantee.

In many respects the options are not of an either/or nature. There is no certainty that, even if a wholesale guarantee facility is put in place, banks will consistently be able to raise sufficient foreign financing over the next couple of years. Against that sober backdrop, it may still be necessary to utilise our own borrowing lines and stocks of reserves later if market access conditions remain difficult for a prolonged period. It is possible to envisage periods, probably brief, or renewed intense pressure in which it might not be possible for banks to raise much foreign funding, even with the assistance of a government guarantee. The recent agreement by the Federal Reserve to offer a substantial foreign exchange swap facility to the Reserve Bank of New Zealand would give us additional leeway should be need to fall back on direct Crown provision of foreign exchange at some later point[6].

There are no ideal mechanisms or tools for responding to the current situation and the macroeconomic risks to which it is giving rise. Each possible tool or response has its own risks, and risks creating its own set of distortions. A wholesale guarantee facility, even a well priced one, involves material fiscal risks, actual and contingent. However, in the current circumstances our judgement is that a good wholesale guarantee facility, along the lines set out earlier in this paper is the best suited to the needs of the New Zealand economy now, and to facilitating a return to a relatively normal environment in as smooth a manner as possible. A relatively high price, that can be adjusted as required, is the critical component of any such guarantee facility.

Our report last week reviewed several options that might involve linking other actions to provision of some sort of wholesale guarantee facility. *[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."]*

In that report we also noted that in some countries, the authorities have sought to take an equity stake (typically as options/warrants) as part of the price for assistance, including under wholesale guarantee facilities. We noted that that did not appear to be an option for us, given that neither we nor the banks nor the Australian authorities regard the banks as being undercapitalised at present. Nonetheless, international norms for levels of capitalisation appear to be increasing, and the possibility of taking equity at some point, should the situation of the Australasian banks deteriorate further, is among the issues that we will keep under review and report back on later.

Mark Weldon, of NZX, has proposed that, as a condition of any wholesale guarantee facility, the New Zealand government should require the Australian banks to raise 20 per cent additional capital in their New Zealand subsidiaries, from the New Zealand Superannuation Fund and the New Zealand public. As noted above, we do not consider that the banks need additional capital at this point, nor do the banks themselves. Thus any such proposal would meet considerable resistance from the banks and from the Australian authorities. As the presenting issue is not the level of capital of local banks, but rather restoring a sufficient flow of foreign credit to the economy, we believe that a proposal of this sort is ill-targeted, and, if it delayed action, would potentially be quite counterproductive. If a wholesale facility is offered, a high price is the best way to protect New Zealand interests.

As noted above, we wish to keep open the option of making it a condition of using the guarantee facility that registered banks maintain a Tier 1 buffer, above the regulatory minimum, throughout the guarantee period. The banks have a considerable buffer at present, but requiring some of that to be maintained throughout the guarantee period even if further loan losses were to reduce the current level of capital, could mean that some new capital raising could be required. That would help to protect the Crown's position as guarantor.

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6 The International Monetary Fund is also currently developing a possible foreign exchange swap facility. Such a facility, if implemented, would be targeted at sound countries facing temporary market access issue and without access to official swap facilities with the major currency central banks.

Deploying a wholesale scheme

Our advice is that a wholesale scheme is the best instrument should further initiatives be needed. That leaves open the question of when, if at all, it should be launched.

As you aware from our daily markets reporting, global credit markets have shown some signs of improvement in the last week[7]. Some Australasian banks have even been able to place limited amounts of short-term commercial paper offshore this week, at a high price. These are encouraging signs, but they need to be kept in perspective. The challenge is not just to be able to raise any foreign funding at all, but to be able to attract the required volume consistently over time. To illustrate the continuing stresses, Federal Reserve data on the US commercial paper market show further significant reductions this week in the stock of financial issuers' paper on issue, suggesting that only very limited volumes of maturing paper is able to be rolled over by any issuing banks.

Because the stock of debt is large, and mostly quite short-term, the refinancing needs of both New Zealand and Australian banks are large. If the maturing debt cannot be refinanced, downside risks to the real economy are likely to intensify, to be felt most immediately in a further tightening of domestic credit availability from the banks. In an environment where most other international bank issuers will have the option of using a government guarantee, it is difficult to be optimistic about the likely ability of banks to raise the required volume of funds, for appropriate terms, without the support of a guarantee facility.

Improvements in market conditions are also unlikely to be steady. As noted earlier in this report, the international financial crisis has gone through a series of waves: pressures have intensified to extremes for a period, and then have eased, only to return again, often in slightly different forms, several months later. Our judgement is that financing conditions are likely to be difficult for some considerable time – easier at times, and more intensely difficult in others. The process of global deleveraging is likely to continue for some considerable time, world economies are likely to be very weak for at least the next 12-18 months, and financial stresses are unlikely to disappear quickly even in core markets, let alone those with a heavy dependence on external capital.

Against this backdrop, it may be helpful to frame our thinking in terms of least regrets. Having regard to the macroeconomic and the fiscal risks, would it be better to have launched an appropriately priced wholesale guarantee facility, only to find that it had not really been needed, or to have held off such an announcement only to find later that it really had been needed?

Despite our assessment earlier it is possible that funding markets will actually improve quickly and sustainably over the next few weeks. But even if so, we would only know that the improvement was sustainable with the benefit of hindsight, looking back perhaps six months from now. Given the scale of the financing needs, and the increasing burden of rolling over the foreign debt, the longer the New Zealand banks are not able to raise large amounts in international markets, the greater the serious downside macroeconomic, and perhaps even banking, risks are. In this context, it is worth noting that all markets, including funding markets, are typically very thin over the end of the year period even in normal times.

On the other hand, the scheme outlined in this paper is a robust one: structured and priced so that it will not be used if it is not needed. That means that the risk of launching the scheme, only to find quite quickly that it was not really needed, now appear very limited.

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7 And the first bond under the United Kingdom's wholesale guarantee scheme was issued on Wednesday, by Barclays. Despite the government guarantee the cost of the debt was still relatively high (well above comparable UK government rates).

There is some risk in terms of precedents being set, given that our entire regulatory and supervisory framework places considerable emphasis on market disciplines and encouraging the costs of bad decisions to fall on those responsible for them. However, at this point, that risk needs to be kept in perspective. We have not been in the forefront of countries moving to provide such a guarantee facility, and our pricing would be among the more onerous applied in the various international models. Finally, your own public comments have already made it clear that we would be willing to deploy such an instrument if it is needed.

On balance, and having regard to all the costs and risks to which the New Zealand economy and the Crown would be exposed under the various options, we believe that it would be prudent now to move to the point of announcing a wholesale guarantee facility, along the lines outlined earlier in this paper.

By late next week, planning would be sufficiently advanced that a scheme could be deployed quickly. As part of bringing back final recommendations at the end of next week, we would envisage engaging in a quick consultation with banks on the detailed parameters of the proposed scheme as outlined in this report. That timing will also allow us to absorb more fully the final details of the Australian scheme. A robust facility could be announced and operational shortly after the final recommendations are presented at the end of next week. As part of the process, we recommend that further consultation should also be undertaken with National Party representatives.