Review of Levy framework for the Depositor Compensation Scheme

Summary of Submissions

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Reserve Bank
of New Zealand
Te Pūtea Matua

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Introduction

In July 2023, the Reserve Bank of New Zealand - Te Pūtea Matua (the Reserve Bank) - issued a consultation paper on the levy framework for the Depositor Compensation Scheme (DCS) to operationalise the DCS under the Deposit Takers Act (DTA). The consultation closed on 25 September 2023.

The consultation discussed:

- possible design of levies, including use and calibration of risk-based levy approaches;
- estimation of the protected deposit base prior to introduction of the Single Customer View (SCV) standard; and
- how frequently DCS levies should be set, and the method reviewed.

DCS levies will be set by regulations, made by the Governor General by Order-in-Council on the recommendation of the Minister of Finance, having regard to advice from the Reserve Bank (among other matters).

In total, we received 22 submissions from deposit takers and industry associations. We would like to thank everyone who took the time to make submissions. This document provides a summary of the feedback received. We will also publish submissions alongside this summary.

We note that submissions also requested guidance from the Reserve Bank on extending DCS timelines, clarity as to whether DCS levies and returns are exempt from GST and tax, in addition to our communication strategy to continuously engage with the sector on the DCS. Guidance on these topics are out of scope for this summary of submissions on DCS levies.

In parallel to the Reserve Bank's consultation on DCS levies, the Treasury also consulted on the Statement of Funding Approach (SoFA). The SoFA sets the funding strategy for the DCS. Two key parameters of the SoFA are the target fund size and the time to target. The setting of both influences how levies will be set by the Reserve Bank that will be paid for by deposit takers. A summary of submissions for the SoFA is published on the Treasury's website.[1]

We do not provide a direct response to the submissions because we are developing our policy response and intend to publish a second consultation on the DCS levy framework in the March quarter, 2024.

Background

The current programme for DCS is part of regulatory change that resulted from the Phase 2 review of Reserve Bank Act 1989. The Phase 2 Review was a direct response to the recommendations made by the International Monetary Fund (IMF) from the 2016/17 Financial Sector Assessment Programme (FSAP) on New Zealand[2].

The Phase 2 Review was a wide-ranging review conducted in two parts.

- The first part reviewed the governance arrangements and funding model at the Reserve Bank which resulted in the introduction of the Reserve Bank of New Zealand Act 2021.

[1] https://www.treasury.govt.nz/publications/consultation/statement-funding-approach-funding-strategy-depositor-compensation-scheme
[2] https://www.rbnz.govt.nz/-/media/project/sites/rbnz/files/consultations/banks/fsap/fsap-review-financial-system-stability-assessment-report-2017.pdf

- The second part of the Review assessed our role as the prudential regulator which resulted in the introduction of the Deposit Takers Act 2023 (DTA) expanding our prudential toolkit for regulation and supervision of deposit takers. The DTA also introduces the Depositor Compensation Scheme aimed to provide compensation for depositors with protected deposits of up to $100,000 per depositor, per deposit taker, in the event of a deposit taker failure.

Summary of DCS levy approaches proposed

Three levy approaches for DCS levies were detailed in our consultation document:

- Flat rate approach: This means deposit takers would be levied a constant percentage of the total value of protected deposits they hold.

- Credit ratings approach: Map the credit rating of each deposit taker to a multiplier. Apply a multiplier between one and four. A multiplier of one applies to deposit takers with the highest credit ratings and those with lowest credit rating would receive a multiplier of four. The credit ratings approach would scale the flat rate by the multiplier mapped from credit ratings.

- Composite approach: Produce an aggregated risk score based on the weighted sum of composite risk indicators covering capital adequacy, asset quality, liquidity, business model and management. Deposit takers are categorised into four risk buckets according to their aggregated risk score. A multiplier is assigned to each of the risk buckets. A multiplier of one is assigned to the lowest risk bucket and those in the highest risk bucket would receive a multiplier of four. The composite approach would scale the flat rate by the multiplier mapped from risk buckets.

Submission feedback

Design of levy approaches

Risk buckets and multiplier

Respondents were divided on risk buckets and multipliers (the proposed approach where firms are placed in four groups with a constant levy rate within groups).

Some respondents noted that risk buckets are a blunt tool while others agree with the proposal. Some suggested the calibration placed too many deposit takers in the lowest risk bucket and thought that the proposed risk buckets are insufficient to differentiate risk profiles and recommend the introduction of an additional risk bucket. Nonetheless, views on this are varied as several respondents advocated against further breakdown of the lowest bucket as this may have a disproportionate impact on the levy approach. Respondents note further break down of the lowest risk bucket based on the proposed composite approach would most likely impact smaller deposit takers. This may mean some deposit takers competing in the same market are treated differently with some being subjected to higher levies. These respondents submitted that most deposit takers should fit in the lowest risk bucket due to conservatism in capital adequacy requirements set by the Reserve Bank. One respondent suggested the use of four risk buckets appears inconsistent with the proposed proportionality framework.

There is a broad consensus that the multiplier should mitigate the moral hazard risk of the DCS (i.e., the risk that the DCS encourages additional risk-taking by deposit takers). However, views on how this should be achieved are diverse. Some respondents contend risk is exponential and should be reflected in the multiplier increasing faster as one moves across the risk buckets. In contrast, other respondents suggest the risk buckets may not be accurate and the approach may constrain competition, profitability, and diversity of the financial sector in New Zealand and thus advocated for a flat rate.

Quantitative factors and boundaries

Respondents raised a range of suggestions to refine the composite approach with respect to the quantitative factors and proposed boundaries. In summary, the suggestions were:

- Indicators considered under the composite approach for banks are slightly different from non-bank deposit takers (NBDTs). Lack of comparability between banks and NBDTs complicates the measure of risk of deposit takers under the DTA.

- The composite approach equally weights each indicator. Respondents suggest whether a greater weight should be placed on liquidity and capital. This approach would encourage a longer-term view for DCS levies and contribute to offset cyclicality of shorter-term metrics such as profitability.

- Several respondents suggest changes to the maximum boundary for capital and liquidity. One respondent noted the maximum boundary should be aligned to the 2019 Capital Review decisions. Respondents note the maximum boundary should be reduced given deposit takers already implement comprehensive programmes to manage their liquidity risk.

- For capital adequacy, several respondents expressed concern that the proposal provides an advantage for banks that are allowed to use internal ratings-based (IRB) capital modelling. Respondents thought their ability to optimise the risk weighted assets (RWA) from IRB modelling may lower RWA and inflate the total capital ratio. Respondents advocate the use of standardised equivalent reporting for total capital ratio to level the playing field for DCS levies.

- For asset quality, many respondents expressed concern with the selection of the non-performing loan (NPL) ratio. Respondents assert that the NPL ratio does not by itself signal a deposit taker's financial strength and the assessment should be accompanied by other metrics such as quality of collateral.

- The use of return on assets (ROA) as a profitability measure for small deposit takers and deposit takers with a trust, mutual or cooperative structure may not be appropriate as it does not recognise the non-profit nature of the industry. Respondents submitted that this does not recognise the diversity of the sector.

- The use of the 'top 5 credit exposure' as a proportion of Common Equity Tier 1 (CET1) may be more volatile for small institutions whose balance sheets are much smaller and any movements may appear more pronounced. Other respondents noted that the proposed measure provides a narrow view of their business model as it does not consider the overall

diversification of the deposit taker's lending portfolio. Accordingly, some respondents advocate for an alternative metric e.g., a measure of lending 'average risk' such as risk weighted assets (RWA) for the numerator and either total assets or net regulatory capital for the denominator.

Levy approach

Most respondents did not support the credit rating method. Respondents suggested credit ratings may not reflect the true underlying risk of the deposit taker. Some suggested the rating industry's independence and objectivity has been challenged in recent years. If used, some argue the approach may advantage larger institutions who benefit from the credit rating being supported by their Australian parents, and disadvantage smaller firms who are exempt from using credit ratings.

Some submissions also noted that risk rises exponentially as credit ratings decline. For example, the average cumulative default rates[3], over a time horizon of ten years for an AAA rated institution sits at 1% and rises to 13% for a B rated institution evaluated for the same tenor. However, the credit rating method we proposed captures rising risk linearly, with deposit takers in the higher risk buckets only paying two to four times the levies of firms in the lowest risk bucket.

Thus, submissions generally viewed the composite or flat approach more favourably. Submissions from large and medium sized deposit takers mostly favoured the composite approach, noting that DCS levies should be aligned with the inherent riskiness of the deposit taker.

However, support for the composite included a range of suggestions with respect to replacement and recalibration of quantitative factors and boundaries, including possible simplification of the composite approach. There was strong support from several deposit takers for the composite to exclude qualitative factors noting that inclusion would create a level of complexity and subjectivity that may be unnecessary. However, other respondents saw merit for the qualitative factor to include a forward-looking indicator factor such as credit rating as an additional measure of credit worthiness, signal financial standing and relative risk position of deposit takers relative to peers.

Nonetheless, some respondents saw merit for the Reserve Bank to combine the credit rating and composite into a hybrid levy approach. Others saw merit for the Reserve Bank to reduce the composite approach's dataset by considering financial indicators (i.e., capital adequacy, asset quality, liquidity) only.

In contrast, submissions from small deposit takers mostly favoured the flat rate approach. Some suggested this based on proportionality or competitiveness reasons, for example, the cost of any risk-based measure will drive operational costs up and reduce their ability to compete.

Respondents who were not in support of the flat rate note that the method does not reflect the likelihood of a compensation event for riskier deposit takers. Respondents in support of the flat rate approach assert that, while the likelihood of failure for a small deposit taker may be higher, the impact of their failure may be much less than for a larger deposit taker. Some respondents believe this 'impact on financial system' should be reflected in the levy approaches and recommend an additional premium for the most systemic firms (i.e., the firms whose failure will be the most costly or disruptive for the financial system and broader economy).

[3] Fitch Global corporate finance average cumulative default rates between 1990 and 2022

Protected deposit base prior to single customer view standard

Once SCV files are being collected, the protected deposit base will be calculated by aggregating covered deposits that are owned by an eligible depositor, then assessing whether the amount is more or less than $100,000. For aggregate balances over $100,000, the eligible deposit amount will be $100,000. For aggregate balances under $100,000, the amount will be the aggregate balance (plus any accrued interest) for that depositor.

Overall, respondents expressed support for the Reserve Bank's preferred estimation method of the protected deposit base prior to the introduction of the single customer view (SCV) standard. Respondents also requested clarity and conservatism on the adjustment factors. Respondents asked the Reserve Bank to explain how the adjustment factor was derived and whether an adjustment factor would be set for finance companies. It was suggested that the adjustment factors should be recalibrated based on new information until the SCV standard is developed and operational. Some respondents went further to advocate for early adoption for SCV, rather than waiting for all deposit takers to have harmonised data, as over time the proxy may be misaligned with underlying protected deposits.

Review frequency for estimation of the protected deposit base

Respondents were split on the review frequency for the estimated protected deposit base after the DCS is in place. Some support an annual review to ensure levies are charged more equitably (e.g., if customer behaviour changes the relationship between the estimation of protected deposit and actual protected deposit). Others support a review between one to two years to avoid the compliance burden of an annual review. One respondent thought a review is not practical and that the Reserve Bank should prioritise finalising the SCV standard.