



Reserve Bank  
of New Zealand  
Te Pūtea Matua

# Depositor Compensation Scheme Regulations

Consultation Paper

11 March 2024

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## **Submission Contact Details**

The Reserve Bank of New Zealand – Te Pūtea Matua invites submissions on this consultation paper by 5.00pm on 10 May 2024. Please note the disclosure on the publications of submissions below.

## **Address for Submissions and Enquiries**

Enquiries: email [dta@rbnz.govt.nz](mailto:dta@rbnz.govt.nz)

Email submissions: email [dta@rbnz.govt.nz](mailto:dta@rbnz.govt.nz) Subject line: DCS Regulations submission

Submissions can also be made online at <https://consultations.rbnz.govt.nz>

## **Publication of Submissions**

Your submission will be published on the Reserve Bank's website.

All information in submissions will be made public unless you indicate you would like all or part of your submission to remain confidential. Respondents who would like part of their submission to remain confidential should provide both a confidential and public version of their submission. Apart from redactions of the information to be withheld (i.e. blacking out of text) the two versions should be identical. Respondents should ensure that redacted information is not able to be recovered electronically from the document, the redacted version will be published as received.

Respondents who request that all or part of their submission be treated as confidential should provide reasons why this information should be withheld if a request is made for it under the Official Information Act 1982 (OIA). These reasons should refer to Section 105 of the Banking (Prudential Supervision) Act 1989, section 54 of the Non-Bank Deposit Takers Act, section 135 of the Insurance (Prudential) Supervision Act 2010 (as applicable); or the grounds for withholding information under the OIA. If an OIA request for redacted information is made, we will make our own assessment of what must be released taking into account the respondent's views.

We may also publish an anonymised summary of the responses received in respect of this consultation paper.

## Introduction

Following a first round of consultation in 2023 on Depositor Compensation Scheme (DCS) levy settings, this consultation paper outlines detailed policy proposals for regulations under the Deposit Takers Act 2023 (DTA). The DTA creates a new prudential regime by integrating the currently separate regimes for banks and non-bank deposit takers<sup>1</sup>, and introduces the DCS. Regulations are necessary to bring the DCS into force. Many of the regulations are technical in nature, and the proposals in this paper have benefited from industry feedback through a series of in-person workshops and bilateral meetings between August-December 2023.

We are sincerely grateful for the time and thought that industry has, and is, devoting to this work. Feedback from stakeholders is a valuable and important part of the policy development process.

## What is the DCS?

The DCS will provide protection of up to \$100,000 per eligible depositor, per deposit taker in the event of deposit taker failure. It will be funded through the DCS fund, which will be raised by levies charged to deposit takers.

## Why are regulations needed?

Regulations are secondary legislation which are made by Order in Council on the recommendation of the Minister of Finance. The Reserve Bank is responsible for providing advice to the Minister on proposed regulations. This consultation is intended to help with the development of this advice.

The DCS levies are to be set by regulations as outlined in this paper. The DTA specifies that all of the costs of the fund are intended to be met by deposit takers.

Regulations are also necessary to determine the detailed eligibility rules, payout conditions and to resolve detailed issues such as exemptions and determining balances in respect of payments made but not yet settled.

## Purposes of the DCS

The DTA sets out a number of purposes and principles that direct the exercise of the Reserve Bank's prudential function. Of particular relevance to the DCS, the Act seeks to:

- promote the safety and soundness of each deposit taker,
- promote public confidence in the financial system, and
- mitigate risks to the stability of the financial system.

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<sup>1</sup> when the document uses the terms 'bank' or NBDT, we are referring to institutions currently registered/licensed under those regimes.

The DTA also sets out a number of principles that must be taken into account by the Reserve Bank when achieving the purposes. Those relevant to the DCS include:

- taking a proportionate approach to regulation and supervision
- consistency in the treatment of similar institutions
- avoiding unnecessary compliance costs.

The DCS is subject to an additional purpose which specifies that it is intended to contribute to the stability of the financial system by protecting eligible depositors to the extent that they are covered by the DCS.

Beyond the general purposes and principles, regulations under the DTA may be guided by specific principles. For example, protected deposit regulations are guided by provisions specifying that typical banking products should be covered.

Levies are required to be designed with reference to a number of principles including that:

- the costs associated with the DCS should be met from the fund (and therefore, ultimately by deposit takers);
- levies should take into account the likelihood of deposit taker failure;
- levies should take into account the effect of the obligation to pay a levy on the soundness of an entity; and
- levies are predictable.

## Prior consultation

The DTA and the design of the DCS have been developed through a multi-year policy process, including a review of international practice, Cabinet decisions, consultation on an exposure draft and the full legislative process of the DTA.

From July to September 2023 we consulted on options for the design of the DCS levies. In addition, we met with deposit takers in workshops on the implementation of the DCS, and informally tested some of the proposals in this document. This consultation paper builds on this prior engagement with the industry to refine the proposals.

We have published a [summary of submissions](#) on the prior consultation paper.

## Structure of consultation paper

The regulations in this consultation paper are sorted into chapters by policy matter. Each chapter identifies the specific requirements that apply when making regulations and considers the alternative options, costs and benefits associated with making the regulation. We also identify in detail our preferred options.

## Feedback sought

We are interested in stakeholder feedback on the proposals in this consultation document. For many of the issues the range of options is limited by the legislation, and we have endeavoured to indicate where this is the case.

In each section we ask specific consultation questions to identify any potential issues with our proposals. We group these questions towards the end of this paper to help facilitate the preparation of submissions.

## Summary of consultation paper

This paper contains a range of proposals within the chapters listed below.

We anticipate that the most significant aspects of the proposals will be:

- the proposed levy calculation methodology,
- the scope of DCS coverage, and
- the impact of the compliance costs of the proposals, including the cumulative costs of the changes that would be required under the regulations.

We have structured the consultation paper to focus first on the levy design, given this is the second round of consultation on these proposals and the significance of this to industry. We thank respondents for their extensive and detailed submissions on the first round of levy consultation and this has informed our development of the proposal in this consultation document. We welcome further input from industry. We then focus the remainder of the document on the more technical aspects of DCS coverage and eligibility.

The structure of the document is as follows:

### DCS levy proposals

- Chapter 1 presents our proposed approach for the design of DCS levy regulations.
- Chapter 2 covers regulations for operational matters related to the payment of levies.

### DCS coverage and eligibility

- Chapter 3 proposes refinements to the scope and coverage of the DCS, including eligible products and entitlement conditions.
- Chapter 4 covers “relevant arrangements”, in which funds are held by a depositor on behalf of someone else for example, lawyers’ trust accounts. In this case, we propose the “relevant arrangement” is looked through to determine the DCS entitlement of the beneficial owner of the funds.
- Chapter 5 proposes to exempt branches of deposit takers from the DCS once they are only engaged in wholesale business.
- Chapter 6 outlines the treatment of in-flight payments.

In each chapter we outline the key costs and benefits of our proposals, alternative options we considered, and assess the options against the most relevant considerations for each issue. These considerations are related to the specific regulation making test for that regulation making power in the DTA, and/or the overall objectives and principles in the DTA. For ease of analysis these are often more tightly defined aspects of the principles. Note that in many cases the alternative options are constrained by the DTA.

### **Next steps**

The feedback received will help us develop advice to the Minister of Finance on the regulations. Depending on the Minister's decisions, we expect that regulations could be made by the end of 2024, ahead of the DCS coming into effect in mid-2025.



## Chapter 1 - DCS Levies

Following a first round of public consultation in 2023, this chapter presents our final proposal for the design of the DCS levies.

The chapter covers both our proposal for calculating the base of the levies (i.e. the amount of protected deposits the levy rate is applied to in order to calculate the total levy owing), and the levy method and rate itself, as well as the review cycle for setting the levy.

### Proposals at a glance

We propose using a proxy based on current survey data for the protected deposits base until the DCS standard comes into force.

We also propose a risk-based composite approach for calculating the levy that deposit takers will pay on their protected deposits. This is adjusted from the proposal in the first round of consultation. Based on the feedback received, the proposed composite approach only contains three risk factors - capital, liquidity and business management risk indicators. We propose rebalancing the risk bucket sizes, but do not propose changes to the levy risk multipliers.

We propose that the initial levy base methodology is not reviewed until 2028 (when Single Customer View Standards and other standards are set and required to be complied with) unless depositor behaviour changes to an extent that requires review.

We propose that the composite indicators and weights should also be reviewed in the lead-up to the updated standards in 2028.

## Part 1 - Initial levy base

### Background

The DCS will protect eligible depositors up to \$100,000 per depositor, per licensed deposit taker. Levies are calculated as a percent of the protected deposit amounts that each deposit taker has, also referred to as “the DCS levy base”.

Calculating the DCS levy base requires calculating the protected deposit amounts consistent with the Single Customer View (SCV) standard (i.e. a standard that specifies how deposit takers must record and inform the Reserve Bank of an individual depositor’s covered deposits). An estimate of the size of protected deposits is needed until the SCV standard is set and required to be complied with in 2028. For details please refer to Section 2.1 of the 2023 [consultation document](#), where we identified several options to use as the proxy for protected deposit amounts, including using information from existing surveys or conducting a one-off data collection. Submissions on the prior consultation were generally supportive of our preferred approach.

## Proposal

We propose to adopt the preferred estimation method contained in the first consultation, that is, the size of protected deposits be proxied for each deposit taker by applying adjustment factors to the data collected from the existing Bank Balance Sheet and NBDT surveys, until the DCS standard is fully operational. Overall, respondents supported this approach. Adjustment factors are used to recognise depositors may have multiple accounts totalling over \$100,000 at the deposit taker, and alternatively, accounts may have multiple owners.

As outlined in the prior consultation, the adjustment factors were calibrated using previously obtained granular data, and deposit data obtained from prudential surveys.<sup>2</sup> Based on this analysis, our preferred option for banks is to apply an adjustment factor of 70% to deposits up to \$100,000.<sup>3</sup>

For non-bank deposit takers (NBDTs) the adjustment factors are applied to all the deposit taker's deposits (currently, NBDTs do not report a detailed breakdown of the value of deposits). As outlined in the July 2023 consultation, and based on average deposit size, we propose adjustment factors of 80% for credit unions, and 40% for building societies. Submitters were generally comfortable with the approach but did note further information could be provided to support more accurate estimates.

Submissions on the prior consultation requested clarity on the adjustment factor for finance companies. Our preferred option for finance companies is a 40% adjustment factor. This is based on comparisons made with other deposit taking groups (banks, credit unions and building societies) and the average deposit sizes for finance companies. For example, average deposit sizes for finance companies are more comparable to building societies than to credit unions.

The review frequency for estimating the protected deposit base was also consulted on as part of the previous consultation. Following (or in anticipation of) the introduction of the scheme, depositors may begin deposit splitting (depositing up to \$100,000 in a separate deposit taker) resulting in a greater proportion of all deposits being protected deposits. This could result in an underestimation of the adjustment factor.

We therefore propose, if there are significant depositor behaviour changes, that we review and recalibrate the adjustment factors prior to 2028. On an ongoing basis after 2028, estimation should no longer be required as the SCV standard should provide accurate data on the DCS levy base.

## Part 2 - Levy approach

### Background

The DCS will be fully funded by levies collected from licensed deposit takers, with a Crown backstop to meet payout requirements if the DCS fund is deficient.

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<sup>2</sup> See the Joint Report published in 2021 about the granular data collection. This also describes the deposit data these adjustment factors are applied to.

<sup>3</sup> The adjustment factor for banks will apply to all eligible deposit accounts under \$100,000, this is then added to the number of deposit accounts that contain over \$100,000 multiplied by \$100,000. For example, Bens Bank Ltd has \$1.5m deposits that are under \$100,000. Bens-Bank Ltd also have 5 accounts above \$100,000. Bens-Bank Ltd's estimated eligible deposits are:  $\$1.5m + (5 * \$100,000) = \$2.0m$ . The estimated eligible deposits are then multiplied by the adjustment factor of 70% to get Bens-Bank Ltd's DCS levy base of:  $70\% * \$2m = \$1.4m$ .

The size of levies paid by deposit takers will be affected by the funding strategy for the DCS (particularly the target fund size and the time to build the fund), as set out in the Statement of Funding Approach (SoFA). The Treasury will soon be undertaking a second round of consultation on the SoFA, which is expected to include in-principle decisions on the use of a target size for the DCS, and the timeframe to reach this target. The SoFA is published by the Minister of Finance at least every five years.

The levy approach being consulted on in this chapter relates to the method used to calculate the levy each deposit taker will pay on their eligible deposits.

As detailed in Section 3 of the 2023 [consultation document](#), we outlined three options for calculating the levy that deposit takers will pay on their protected deposits. These options were:

- **Flat rate** method which is a uniform percentage of the amount of protected deposits;
- **Credit ratings** method which uses an official credit rating to assess the risk posed by a specific firm; and
- **Composite risk indicator** which leverages several risk metrics (i.e. capital, liquidity, asset quality, profitability, etc.) to calculate an aggregate risk score for a firm.

## Proposal

Our recommendation is to set DCS levies based on a simplified composite risk-based approach. We propose refinements to the Composite Risk Indicators following further analysis and in response to feedback from the consultation on the DCS levy framework.

[The summary of submissions](#) was released in late 2023.

Of the three options consulted on in 2023, most respondents did not support the credit rating method noting that the rating may not reflect underlying risk of the deposit taker.

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

We propose applying the composite risk-based approach with the following changes (see the table below for further details):

- Increase the weights of long-term systemic indicators. We intend to improve the predictability of levies by reducing volatility of inputs, and place greater weight on more stable inputs, which we think also better reflect the likelihood of a compensation event for a deposit taker (capital, stable funding, and profitability).

- Remove the inputs related to large exposures and non-performing loans. This should improve the sensitivity of levies by removing inputs that respondents argued may not be well correlated with the overall riskiness of the firm.
- Calibrate the risk bucket boundaries such that fewer deposit takers are concentrated in the lowest risk bucket and more in higher risk buckets. This provides a more even spread over the four risk buckets.

Overall, the number of indicators and their corresponding weights have been simplified for banks and NBDTs, and is now more heavily weighted towards capital and liquidity metrics. This should improve the predictability of levies and better reflect the likelihood of a compensation event, by setting a longer-term focus.

The previous consultation document assumed both the payment of levies and the investment returns from the DCS fund would be taxable. Inland Revenue has now substantially completed work on the tax status and has provided draft advice to the Reserve Bank that the DCS is exempt from income tax as a public authority. This tax exemption should reduce the amount of levies required to be collected annually.

### **Risk multipliers**

Other than the changes discussed, no additional adjustments were made to the levy calculation. Specifically, we propose no adjustment to the levy risk multipliers (referred to as the aggregate risk component (ARC) and increasing from 100% to 400%) or the number of risk buckets (four). There were mixed views from the submitters on the risk multipliers proposed in the first consultation. On balance we believe the proposed multipliers adequately mitigate the moral hazard risk of the DCS.

The risk multipliers are explained in more detail in the prior consultation.

Overall, these changes are designed to be more equitable, reduce cyclicity of the levies and focus on long-run factors such as capital and liquidity.

### **Analysis of preferred option**

Our preferred option is to set DCS levies on a risk-based approach. This decision was made considering the feedback received and the assessment criteria outlined in the 2023 consultation, including those principles within the DTA that the Minister must have regard to:<sup>4</sup>

- the levy rate should reflect the likelihood of a compensation event for a deposit taker,
- the levy rate should consider the impact of DCS levies on the soundness of deposit takers, and
- the desirability of predictable levies.

Risk-based levies should support mitigation of 'moral hazard' risks and therefore be consistent with the need to reflect the likelihood of a compensation event for a deposit taker. It was clear following

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<sup>4</sup> See section 239 of the Deposit Takers Act 2023.

consultation, that the composite risk indicators approach, as compared to the credit ratings approach was generally preferred by submitters.

We recognise that a risk-based approach is likely to result in, on average, smaller deposit takers having higher levies, as a proportion of their covered deposits, than larger deposit takers. This consequence of risk-based levies may impact the soundness of those deposit takers. We have sought to address this along with improvements in predictability, by reviewing the risk factor and weights used within the composite model. This includes reducing weights on inputs submitters noted could be cyclical or volatile. The tax exemption of the fund should also assist in mitigating the impact on the soundness of deposit takers by reducing the amount of levies required to achieve any target fund size (as outlined in the SoFA).

The tables below provide details of the risk indicators and weights that we propose to use to calculate each deposit takers risk score and compares the proposed factors and weights to those in the 2023 consultation. The risk scores will then be used to allocate deposit takers into four risk buckets.

We propose using the following risk indicators for NBDTs (Table 1) and banks (Table 2).

**Table 1: Risk indicators for NBDTs**

<b>Indicator (weighting)</b>	<b>Measure (sub-weighting within category)</b>	<b>Formula</b>	<b>Boundary</b>	<b>Change from previous consultation</b>
<b>Capital adequacy</b> (33.3%)	Regulatory capital ratio	$\frac{\text{Net Regulatory capital}}{\text{Risk Weighted Assets}}$	9 – 20%	<ul style="list-style-type: none"> <li>Increased weight, from 25% to 33.3%.</li> </ul>
<b>Asset quality</b>	Removed indicator from composite			
<b>Liquidity</b> (33.3%)	Simple Coverage Ratio	$\frac{\text{Liquid assets}}{\text{Total assets}}$	8 – 50%	<ul style="list-style-type: none"> <li>Increased weight, from 25% to 33.3%.</li> </ul>
<b>Business model and management</b> (33.3%)	Return on equity	$\frac{\text{Net income before tax}}{\text{Net regulatory capital}}$	0-15%	<ul style="list-style-type: none"> <li>Changed from return on assets.</li> <li>Removal of Top 6 credit exposures.</li> </ul>

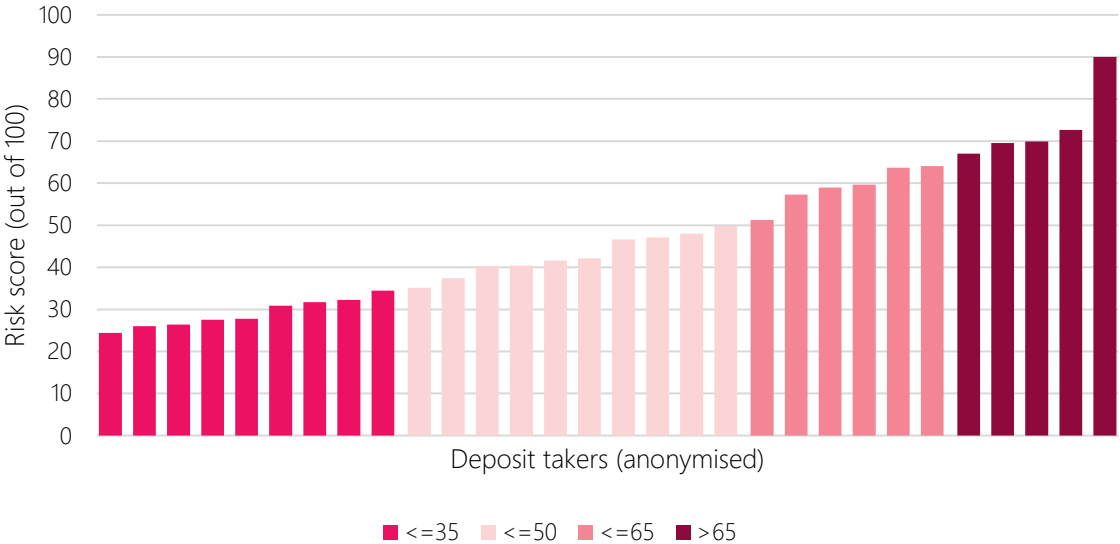
**Table 2: Risk indicators for banks**

<b>Indicator (weighting)</b>	<b>Measure (sub-weighting within category)</b>	<b>Formula</b>	<b>Boundary</b>	<b>Change from previous consultation</b>
<b>Capital adequacy</b> (33.3%)	Total capital ratio	$\frac{\textit{Total capital}}{\textit{Risk Weighted Assets}}$	9 – 18%	<ul style="list-style-type: none"> <li>• Increased weight, from 25% to 33.3%.</li> <li>• Reduced maximum boundary from 20%.</li> </ul>
<b>Asset quality</b>	Removed indicator from composite			
<b>Liquidity</b> (33.3%)	One month mismatch ratio (50%)	$\frac{\textit{1 month mismatch}}{\textit{Total funding}}$	0 – 10%	<ul style="list-style-type: none"> <li>• Removal of one-week mismatch.</li> <li>• Increased weight, from 6.25% to 16.67%.</li> <li>• Reduced maximum boundary from 20%.</li> </ul>
	Core funding ratio (50%)	$\frac{\textit{One year core funding}}{\textit{Loans and advances}}$	75 - 100%	<ul style="list-style-type: none"> <li>• Increased weight, from 6.25% to 16.67%.</li> </ul>
<b>Business model and management</b> (33.3%)	Return on equity	$\frac{\textit{Profit after tax}}{\textit{Average equity}}$	0 - 20%	<ul style="list-style-type: none"> <li>• Changed from return on assets.</li> <li>• Removal of Top 5 credit exposures.</li> </ul>

Our preferred option, using recent survey data, results in two-thirds of deposit takers staying in the same risk bucket compared to the composite from the initial consultation. Deposit takers that do shift buckets only move by one bucket.

**Figure 1: Anonymised aggregate risk scores, with risk buckets of under 35 for bucket 1, between 35 and 50 for bucket 2, between 50 and 65 for bucket 3, and the remaining in bucket 4.**

**Proposed Composite Aggregate Risk Scores**



These proposals result in a more even distribution of deposit takers per bucket which better differentiates the risk profiles of deposit takers. Some submitters on the prior consultation round indicated that there were too many deposit takers in the lowest risk bucket.

**Estimated levies**

The table and analysis below assumes the target fund is to be 0.8% of protected deposit amounts and the target fund size is to be reached within 15 years. This is in line with the median proposed in the Treasury’s July 2023 SoFA consultation paper published by the Treasury. As final Ministerial and Cabinet decisions are still to be made on the SoFA, the analysis should be considered as indicative only. In-principle decisions on the size of the DCS target fund (if any) are expected to be included as part of the Treasury’s upcoming second round of consultation of the SoFA.

The table below shows the estimated levy as a percentage of the protected deposits under the flat rate, credit rating, original composite as proposed in the 2023 consultation and the new simplified composite proposed. These rates differ from those contained in the 2023 consultation partly due to the new information on the tax status of the DCS discussed above.

The proposed rebalance of the risk buckets would shift some deposit takers from bucket 1 to bucket 2, as compared to the Original Composite proposed in the 2023 consultation. This rebalancing reduces the levy rate that would apply to each bucket because more deposit takers pay the relatively higher bucket 2 levy rate on their covered deposits, as compared to the bucket 1 levy rate.

However, if deposit takers, particularly those with a large proportion of covered deposits, reduce their risk as measured by the risk factors this effect may reverse in the future.

**Table 1: Illustrative comparison of estimated levy as a % of covered deposits between considered levy approaches**

Risk band	Flat rate (Applies to all deposit takers)	Credit rating (# of deposit takers)	Original Composite (# of deposit takers)	Simplified composite + risk bucket changes (# of deposit takers)	Range indicated in prior consultation (with tax)
1	0.066%	0.063% (10)	0.063% (15)	0.050% (9)	0.080%
2		0.125% (6)	0.125% (1)	0.100% (10)	0.160%
3		0.188% (7)	0.188% (7)	0.149% (6)	0.240%
4		0.251% (7)	0.251% (7)	0.199% (5)	0.320%

The above levy rates differ from those provided in the first consultation due to the effects of the tax exemption. All figures are adjusted to account for the changes to the assumed tax status (except the final column, which sets out the composite levy range from the prior consultation where it was assumed the DCS fund would be subject to tax).

These figures are illustrative and will depend on final decisions taken by the Minister in the SoFA.

## Impact on deposits and deposit takers

### Impact on retail deposit rates

The impact on deposit rates is difficult to predict as it depends on a number of factors, which have differing effects, including:

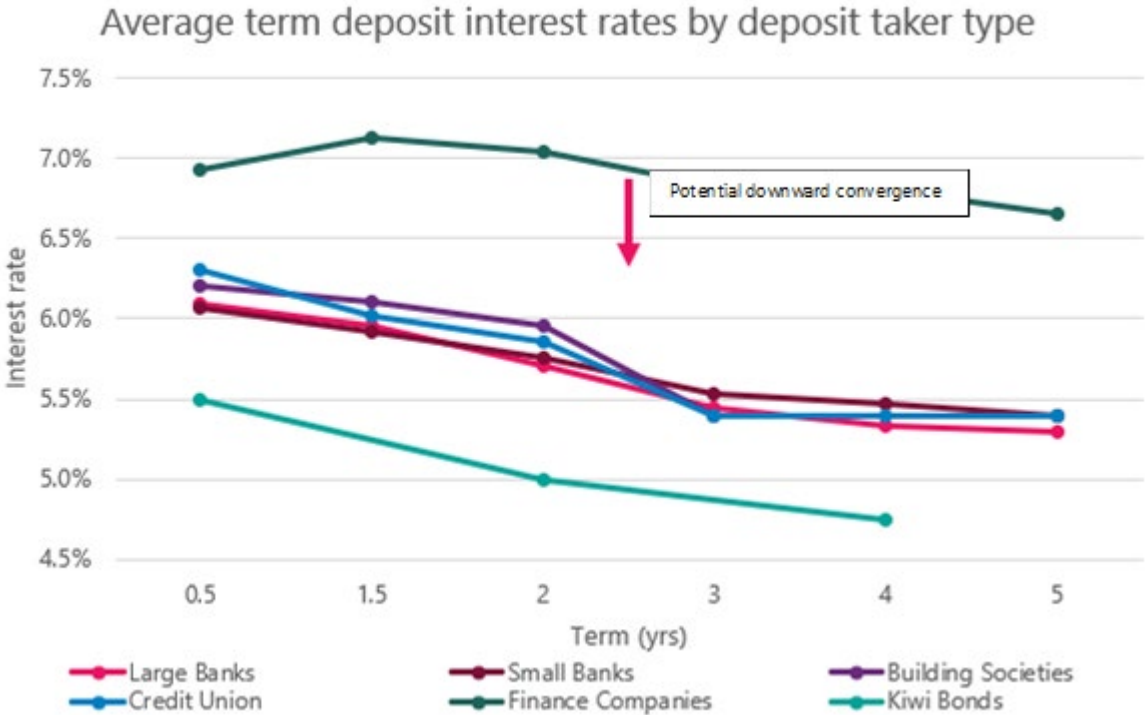
- the extent to which deposit takers pass on the costs of the levies to depositors or lending rates, and
- the extent to which depositors reduce their expectations of deposit rates given the lower risk afforded by the DCS.

We expect some level of deposit rate convergence across the deposit taking industry, as the perceived risk of deposit takers who previously offered higher deposit rates falls in line with other deposit takers due to the protection now available to depositors under the DCS.

For example, interest rates offered by credit unions and buildings societies for term deposits are generally around 15 basis points higher than comparable rates offered by the major banks. Finance companies, by comparison, offer a much higher premium (often around 120 basis points higher than those offered by major banks). The DCS levy is expected to narrow, but not fully close, those gaps for deposit takers covered by the scheme.



**Figure 2: Average term deposit interest rates by deposit taker type, based on a simple average of term deposits offered online, as at February 2024.**



**Deposit takers**

The impact of DCS levies on the soundness of deposit takers is one of the DTA principles that the Minister must have regard to when setting levies. The impact of the simplified DCS levy 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 through depositor’s deposit-splitting;
- attract deposits by offering insured deposits at competitive deposit rates,<sup>5</sup> which might still be lower than those they offer currently as discussed above.

We expect the offsetting factors relating to deposit-splitting and ability to reduce deposit rates to impact small deposit takers, especially finance companies due to their generally higher deposit rates. On the other hand, the impact on larger banks from these effects may be minimal and the impact on their profitability is likely to be largely driven by their ability to pass on the levy costs. Their ability to pass on levy costs may also be reduced by the increased competition in the industry as a result of the rate compression by small deposit takers.

<sup>5</sup> As outlined previously there is currently divergence in the deposit rates offered by depositors. We expect this divergence to be reduced due to all deposit takers falling under the purview of the Deposit Takers Act, and the accompanying standards.

Assuming banks do not change the deposit rates offered and absorb the levy cost, the impact on banks' profitability is generally expected not to be significant. The levy cost as a percent of past net profit has a median of 0.67%, using net profit before tax for the 12 months ending 31 September 2023. With four of the 15 banks, we estimate that profits will be reduced by 2% or more (assuming that these costs are not passed onto depositors, which will be a commercial decision for the deposit takers to make).

The impact on NBDTs is more difficult to model due to the range of potential behavioural impacts as outlined above. Deposit takers who are able to lower the deposit rates or increase the lending rates they offer could improve their profitability. However, if NBDTs did not change the rates offered and absorb the levy cost, the median levy as a percentage of net profit before tax for the year ending 30 September 2023 is 8.6% (this excludes deposit takers that were unprofitable). Due to the diversity of NBDTs, the impact may be quite variable.

Affected groups	Comment	Impact	Evidence Certainty
<b>Additional costs of the preferred option compared to taking no action</b>			
Deposit Takers	If levies are absorbed, for most deposit takers the impact on profitability should be small	Low	Low – the ability of deposit takers to pass on the costs of the levy is a business decision, furthermore profitability and business models vary among the deposit taking sector
Depositors	Levies could be passed onto depositors through lower deposit rates	Low	Low – it is uncertain the extent to which deposit takers would pass on any costs associated with levies. The quantum is likely to be minimal
<b>Additional benefits of the preferred option compared to taking no action</b>			
Deposit takers	The risk premium implicit in the pricing of the products of higher risk deposit takers would reduce due to the DCS reducing their risk	Medium	Medium
Depositors	Adequate funding of the DCS ensures that depositors are protected from the impacts of a deposit taker failure. The proposed levy design will manage moral hazard risks to further protect depositors.	Medium	Medium

## Alternative options

We have analysed the alternative options of having a:

- flat rate levy,
- credit rating risk-based levy, against the assessment criteria outlined on page 11.

The adjustments proposed in this paper to the composite risk-based approach (“simplified composite”) have also been analysed. The alternatives are compared against the composite risk-based approach outlined in the 2023 consultation.

The assessment criteria used identified the most relevant principles as: the likelihood of a compensation event, the impact on soundness of deposit takers and the predictability of levies. The table on page 19 provides a summary breakdown of each option against the assessment criteria.

### Flat rate levy approach

We do not recommend the flat rate levy approach. Our primary concern with the flat rate is that it is not risk-based, and therefore does not account for the likelihood of a compensation event of deposit takers.

At first glance, a flat rate model is consistent with the principle of deposit taker soundness on the basis that a flat rate model results in lower levies for riskier deposit takers who, by definition of being riskier, are generally less sound than other deposit takers. Submitters in favour of the flat rate model on the prior consultation tended to be smaller deposit takers and emphasised the proportionality or competitive impacts of this approach. We acknowledge that there may be some benefits to some deposit takers from this approach. However, a lack of risk-based pricing results in incentives for all deposit takers to increase their risk (referred to as the moral hazard of insurance). In the long run, this will have a detrimental impact on the soundness of deposit takers and wider financial stability.

Finally, the flat rate model would result in predictable levies.

### Credit rating levy approach

Consistent with feedback on the first consultation paper, we do not recommend the credit rating levy approach. Our primary concern with the credit rating is that it is less sensitive to changes in the riskiness of deposit takers; credit rating agencies review and adjust ratings on average every twelve months, and that it may not reflect the true underlying risk of DCS payout of the deposit taker. Furthermore, not all deposit takers have credit ratings.

As compared to the composite approach where factors and weights used are known, the credit rating approach is relatively less predictable and transparent.

Sensitivity analysis was completed on a hybrid approach which gave weight to deposit taker’s credit rating and risk factors, as outlined in the composite model. This exercise was useful when considering how equitable the chosen risk factors and weights were but was not explored further due to the same drawbacks as the credit rating approach.

	<b>Composite indicators</b>	<b>Option 1: Flat rate</b>	<b>Option 2: Credit rating</b>	<b>Option 3: Simplified composite indicators</b>
<b>Reflect the likelihood of a compensation event</b>	++	--	+	++
Comment: The risk-based options score very highly. The composite factors are better at reflecting risks that relate to a compensation event.				
<b>Effect on the soundness of deposit takers</b>	++	-	+	++
Comment: The flat rate option suffers from considerable moral hazard risk which is likely to impact the soundness of deposit takers. The composite models can be customised to better reflect the soundness of all deposit takers				
<b>Predictable levies</b>	+	++	-	++
Comment: The flat rate option scores highly on predictability and transparency. Of the risk-based options the credit rating option is less predictable given the uncertainty created by relying on international private agencies.				
<b>Overall assessment</b>	++	-	+	++ <b>(Preferred option)</b>

### Key for options analysis:

- ++ much better than doing nothing
- + better than doing nothing
- 0 about the same as doing nothing
- worse than doing nothing
- much worse than doing nothing

## Review

As outlined within Part 1: Initial levy base section (see page 8), the protected deposit base will be recalculated in 2028 once SCV standards are complied with.

In addition, we propose that a review of the levy risk factors used within the composite risk indicator approach should be undertaken to reflect the new liquidity and capital standards that are being updated for 2028. For consistency and to reduce compliance costs on deposit takers we envisage updating the risk factors to reflect the updated capital and liquidity standards (for example, if a liquidity coverage ratio as outlined in the Liquidity Policy Review was adopted, this would likely replace the current liquidity ratio used within the risk factors).

Finally, we propose, if there are significant depositor behaviour changes, that we review and recalibrate the adjustment factors prior to 2028.

### Initial levy base

**Q1** Do you agree with our preferred approach and have any final comments?

### Levy approach

**Q1** Do you agree with the revised composite approach with respect to the quantitative risk indicators, boundaries, and weights for each input?

**Q2** Do you agree with our preferred DCS levy approach?

**Q3** Do you agree with our assessment of alternative options we have disregarded?

**Q4** Do you agree that the composite risk indicators and weights should be reviewed in 2028 to better reflect updated standards?

**Q5** Do you have any other comments about the proposed DCS levy approach?

## Chapter 2 - Operational aspects of levies

This chapter outlines proposals for the various regulations that govern administrative and operational aspects of levies.

### Proposals at a glance

We propose that interest on unpaid levies is set at the OCR + 4%.

We propose that relief would be available in exceptional circumstances.

We propose that levies are calculated on an annual basis and invoiced annually by default, with the option for deposit takers to make more frequent payments.

We also propose that reassessment of levies would be limited to within four years of the original levy payment.

### Background

The DTA contains powers to create regulations necessary for certain operational aspects of levies. The most significant of these is the power to charge interest on unpaid levies. Additional regulations underpin the payment and administration of levies.

In developing regulations, the DTA outlines a number of factors that the Minister must have regard to or that must be taken into account by the Reserve Bank. The most relevant factors for this chapter are:

- That the costs of collecting the levy money should be met fully out of the fund.
- That the scheme should be fully funded by licensed deposit takers.
- The desirability of predictability in levies.
- To promote public confidence in the financial system or avoid risks to the stability of the financial system.
- To avoid unnecessary compliance costs.

These regulations are necessary to the smooth functioning of the DCS which supports public confidence in the financial system.

The DCS is to be funded by levies. These regulations are intended to support this by ensuring that the DCS fund is compensated for late payment, with a margin for risk, and that levies are able to be collected efficiently and with minimal compliance costs. These regulations are also intended to provide options for managing exceptional circumstances.

## Proposals

### Interest

The DTA allows for interest to be charged on unpaid levies. We propose that this interest rate is set equal to the OCR + 4%. Interest would be calculated daily and charged monthly. The Act specifies that interest compounds.

### Relief and Instalment arrangements

We propose that a variety of forms of relief would be available in exceptional circumstances. We expect that it would be rare for this relief to be applied but consider it useful to have powers available to resolve issues if they arise.

We propose that the Reserve Bank would be able to provide relief in exceptional circumstances, if it would be inequitable for a deposit taker to pay a levy. The types of circumstances in which we expect that relief could be available include:

- administrative or technological issues;
- small outstanding amounts that are uneconomic to collect;
- significant changes in circumstances;
- facilitating an orderly wind down of a deposit taker business;
- refunding overpayments;
- unforeseen and exceptional circumstances such as natural disasters.

Relief could take a variety of forms depending on what is appropriate in the circumstances:

- Discounts – a reduction in the invoiced levy amount ;
- Waivers – an exemption from needing to pay an invoiced levy;
- Refunds – a partial or full refund of a levy amount that has been paid;
- Instalment arrangements – an agreement that an amount can be paid in instalments.

### Frequency of calculation and payment

We propose that levies are calculated on an annual basis, starting once the DCS commences in 2025. We also propose that levies are invoiced annually in arrears by default. The first invoice would therefore be made in mid-2026 for the 2025-26 financial year. We are also considering if regulations should allow for deposit takers to make more frequent payments if they inform the Reserve Bank of that intention before the end of the financial year. For example, this could be quarterly or monthly. We are interested in whether deposit takers would find this flexibility advantageous or if a simpler approach would be sufficient.

**Time Bar for reassessment**

If information comes to light that would impact the calculation of a levy that has been paid, we propose that the deposit taker would be able to submit this information and receive a refund on the next levy paid (or, in the case of an underpayment, be liable for the shortfall from when the corrected information is disclosed to the Reserve Bank). We propose that this would be limited to within four years of the original levy payment, to increase the certainty in levies paid.

**Analysis and application of assessment considerations**

**Interest**

The charging of interest is necessary for the functioning of the scheme as it will compensate the DCS fund for the time value of money and additional risk of non-payment associated with a delay in levies being paid. It also helps to ensure that licensed deposit takers have an incentive to pay the levies that fund the DCS, ensuring that the DCS will be funded by licensed deposit takers.

Our preferred option ensures that the interest rate will maintain relative to other interest rates, and so be proportionate over time. Given other interest rates are influenced by the OCR, it is unlikely that using an alternative rate would lead to significantly different interest rates over time. The margin of 4% approximates the additional risk of non-payment borne by the DCS fund and balances the likelihood of a compensation event for a deposit taker with the potential impact on the soundness of the deposit taker.

We expect that deposit takers will generally meet their requirements to pay levies so it would be rare that interest will be charged.

We note that our proposed rate is lower than equivalent overseas rates, in some cases significantly so. The proposed rate will also be lower than other Government underpayment rates such as the Use of Money Interest rate<sup>6</sup>.

Affected groups	Comment	Impact	Evidence Certainty
<b>Additional costs of the preferred option compared to taking no action</b>			
Deposit Takers	If levies are not paid on time, interest would be charged	Low	Medium – the charging of interest is certain it is difficult to predict the behaviour of deposit takers
Depositors	Interest charges could be indirectly passed onto depositors	Very low	Low – it is uncertain the extent to which deposit takers would pass on any costs associated with levies. The quantum is likely to be minimal

<sup>6</sup> Set at the floating first mortgage new customer housing rate plus 250 basis points



Affected groups	Comment	Impact	Evidence Certainty
<b>Additional benefits of the preferred option compared to taking no action</b>			
DCS fund	Interest charged compensates the scheme for any non-payment and helps ensure that levies are paid	Medium	Medium
Depositors	A well-functioning DCS ensures that depositors are protected from the impacts of a deposit taker failure	Low	Low – deposit taker failures are unlikely

### Relief and instalment arrangements

Relief provisions allow for exceptional circumstances to be resolved. This makes the system fairer by reducing the likelihood of unforeseeable circumstances leading to additional interest being imposed.

The major risk with relief provisions is that they risk worsening long term compliance by reducing the costs associated with non-payment. Our preferred option is to recognise that the circumstances in which relief would be provided are limited, and to allow for instalment arrangements as a graduated option which can maintain some incentives for payment. We expect that in practice it would be exceptional that relief would remit more than any interest charged.

Affected groups	Comment	Impact	Evidence Certainty
<b>Additional costs of the preferred option compared to taking no action</b>			
DCS fund	Options to provide relief risk worsening compliance by allowing for mitigation of penalties	Low	Medium – it is difficult to predict the behavioural response of deposit takers but evidence for the impact of relief is established
<b>Additional benefits of the preferred option compared to taking no action</b>			
Deposit takers	Provides clarity that exceptional circumstances can be resolved fairly	Low	Medium

## Frequency of calculation and payment

Making regulations for the calculation frequency of levies increases certainty for deposit takers, which improves the administration of the DCS. Allowing some flexibility in payment frequency allows deposit takers to determine a payment cycle which minimises their individual compliance costs. However, allowing flexibility in the system will also increase the complexity of the regulations and compliance.

Affected groups	Comment	Impact	Evidence Certainty
<b>Additional costs of the preferred option compared to taking no action</b>			
DCS fund	Flexibility slightly increases the complexity of administering the levies as deposit takers may have differing invoicing cycles	Low	High
<b>Additional benefits of the preferred option compared to taking no action</b>			
Deposit takers	Provides certainty of the frequency of calculation and minimises compliance costs	Low	Medium

## Time Bar for reassessment

A time bar to limit reassessment creates certainty when a certain amount of time passes after levies are paid. It could increase the likelihood that errors in levies are not corrected. As a result, it is desirable to set the time bar at a level that is proportionate with the likelihood of errors occurring. Our proposal of four years is based on that which applies in respect of tax (on the basis that the calculation of levies is likely to be approximately as complex). We are open to alternative time frames if there are good reasons for this.

Overall, the costs and benefits are likely to be shared between the DCS fund and deposit takers, assuming that it is equally likely for errors to result in overpayments and underpayments. However, the time bar increases certainty for both deposit takers and the DCS fund, so is desirable.

Affected groups	Comment	Impact	Evidence Certainty
<b>Additional costs of the preferred option compared to taking no action</b>			
DCS fund	Risks historic underpayments not being rectified	Low	Low

Affected groups	Comment	Impact	Evidence Certainty
Deposit takers	Risks historic overpayments not being refunded	Low	Low
<b>Additional benefits of the preferred option compared to taking no action</b>			
Deposit takers and the DCS fund	Additional certainty of historic levy payments	Low	Medium

## Alternative options

### Interest

Alternative options for the charging of interest are to either not charge interest, charge interest at a fixed rate, or to charge interest benchmarked to an alternative rate.

Of these options, not charging interest is unlikely to meet the requirements of the DTA, charging interest at a fixed rate is likely to require more frequent updating over time, and would be less reactive to changes in interest rates. Benchmarking to an alternative rate would have similar costs and benefits to the preferred option but may be perceived as more independent from the Reserve Bank. However, we think that this is not significant, and that alternative benchmarks may be clunkier in practice.

	Not Charging interest	Interest charged at OCR+4% [Preferred option]	Interest charged at a fixed rate	Interest charged at alternative benchmark rate
Compensates DCS for time value cost	--	++	+	++
Will not require amending over time	++	++	-	+
Ensures that scheme is funded by deposit takers	--	++	+	++
Transparency and perceived independence	++	+	++	++
Overall assessment	-	++	+	+

## Relief and instalment arrangements

There are limited alternatives to the relief provisions as described here. The specific circumstances can be expressed in different ways but are unlikely to be meaningfully different. Relief also potentially has an indirect effect of reducing the likelihood that levies adversely impact deposit taker soundness.

	Option 1: No regulations for relief	Option 2: Relief available
Proportionate in the circumstances	--	++
Impact on long run compliance	+	+ (if used in limited circumstances)
Predictability of levies	-	+
Overall assessment	-	+

## Frequency of calculation and payments

We consider it preferable that the frequency of payment is set out in regulation, to provide certainty to deposit takers. Alternatively, this could be achieved operationally through the frequency of invoicing. A further alternative option would be to have a single option for the frequency of payment, such as annually. This would be slightly less complex to administer but would provide deposit takers with less flexibility in the frequency of payment, and therefore impose slightly higher compliance costs.

	Option 1: No regulations	Option 2: proposed regulations	Option 3: annual assessment and payment
Minimises compliance costs	--	++	-
Provides predictability of payment timing	--	++	++
Minimises Administrative costs	0	-	+
Overall assessment	-	+	+

## Time bar for reassessment

These regulations will improve the administration of the DCS but they are not necessary. We are open to considering alternative lengths of time for the time bar, if four years is unnecessarily long.

	Option 1: No regulations	Option 2: proposed regulations
Certainty of levies paid	--	++
Long term accuracy of levy payments	+	-
Overall assessment	-	+

## Consultation questions

### Interest

**Q1** Do you support our proposed default rate of the OCR+4%?

### Relief and instalment arrangements

**Q1** Do you agree with our proposed approach? Are there any other circumstances in which you consider it would be appropriate to consider relief for deposit takers?

### Frequency of calculation and payments

**Q1** Do you agree that regulations would be desirable to provide certainty in payment frequency?

**Q2** Do you agree that it is useful to have options for deposit takers to make more frequent levy payments, or are you comfortable with making a single annual payment? Alternatively, would you prefer another payment frequency (other than annually) if regulations did not allow for flexibility?

### Time bar for reassessment

**Q1** Do you think that a time bar would be necessary, or is it sufficiently unlikely that recalculations would be required?

**Q2** If a time bar is necessary, is four years an appropriate length of time?

## Chapter 3 – DCS scope

This Chapter explains and seeks your feedback on our proposed scope of protected deposits and entitlement conditions.

### Proposals at a glance

We propose that the definition of protected deposits include credit balances of specific lending products (credit cards, revolving credit facilities, revolving home loans) as these can be equivalent to current accounts in substance.

We also propose an entitlement condition that ensures depositors cannot be paid twice for the same deposit where funds are recovered by a liquidator.

We propose that trusts are required to provide prescribed documents. This should support the Reserve Bank to act with certainty when making a payout.

### Background

Protected deposits are those covered by the DCS. It is important to have a detailed definition of “protected deposits” to ensure that the coverage of the DCS is clear and unambiguous.

Protected deposits, as defined in the DTA, are New Zealand dollar denominated “debt securities”,<sup>7</sup> and include current accounts, savings accounts and term deposits. The Act also allows other products offered by deposit takers to be included or excluded as protected deposits through the use of regulation.

These regulations (described in section 192 of the DTA) are intended to be based on a test described in section 457 of the DTA. Broadly, the test is the debt securities:

- are commonly referred to in the financial markets as current account, savings account, or term deposit products, and
- are not readily tradable.

The regulation-making test places emphasis on the economic substance of the securities to which the regulations relate. For example, non-bank deposit takers (NBDTs) such as Credit Unions and Building Societies have products which are similar in purpose to normal banking products (redeemable shares). The legislation allows for these to be included as protected deposits given their similar economic substance and we propose these be classified as protected deposits.

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<sup>7</sup> ‘Debt security’ has the same meaning as in section 8 of the Financial Markets Conduct Act 2013.

## Assessment principles

We have considered the following assessment principles to be most relevant when proposing certain debt securities for inclusion in the protected deposit regulations:

- The impact on financial stability and the desirability of diverse institutions, financial products and services,
- Whether the arrangements are easy to define and understand for depositors, and
- The practicality of implementation from industry's perspective.

## Proposals

### Treatment of debentures

A debenture is a type of debt security between a borrower and a lender, that commonly provides the lender security over the borrower's assets. A small group of deposit takers, primarily finance companies, commonly issue debentures to depositors. In general, depositors may treat these debentures as ordinary deposits (or be otherwise unaware of their different legal status). Whether debentures are protected deposits is therefore important to clarify.

Whether debentures are protected deposits is likely to be determined by whether they are 'readily tradeable'. Tradability can create uncertainty about the appropriate protected balances. For example, if half of a \$200,000 balance was in the process of being transferred at the point of failure, it may not be clear if it has become a separately eligible \$100,000 deposit in the hands of the new owner.

Section 457 aids in the interpretation of 'readily tradable'.

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### Examples

#### *Tradable on market*

A deposit taker intends to issue a debt security that is quoted on a licensed market or listed on some other established market. Investors will be able to readily buy and sell the debt security.

Regulations may be made to prevent compensation from being available under the depositor compensation scheme in relation to that debt security.

#### *Tradable under terms and conditions*

A deposit taker issues a debenture. The terms and conditions of that debenture provide the means to allow an investor to readily sell the debenture.

Regulations may be made to prevent compensation from being available under the depositor compensation scheme in relation to the debenture.

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As supported by the example, characteristics of 'readily tradable' include that the product is tradeable on a licensed or established market; or the terms and conditions of the product means investors are able to readily sell it. We therefore propose that products such as bonds and notes, which are issued from time to time by New Zealand deposit takers, should not be covered by the DCS.

The traditional debenture product offered by finance companies has generally included terms and conditions that allow the initial buyer to sell it, with product terms that describe the process through which it would be transferred to the new owner. This can be contrasted to a traditional 'term deposit' offered by a bank, where the terms and conditions contemplate the buyer seeking early repayment from the issuer, instead of trading the product, if they need their funds early.

We propose that a term deposit would be covered by the DCS whereas a traditional debenture would not be covered by the DCS due to the tradability clause. We understand that some issuers of traditional debenture products have been altering their terms and conditions so that they do not have 'transfer' clauses in their terms and conditions.

### **Specific products with credit balances**

While amounts owed by depositors will not affect DCS compensation, it is possible for some products commonly regarded as borrowing products to enter credit balance, for example credit card balances. When in credit balance some borrowing products can be substantially similar to deposits from the depositor's perspective. Therefore, the regulations will also need to address whether credit balances on revolving home loans, revolving credit facilities, and credit cards ('specific borrowing products') are also covered as protected deposits.

We propose the protected deposit regulations include credit balances on specific borrowing products as set out below.

Almost all banks in New Zealand provide **revolving loan products** to their customers (including both revolving home loans and revolving credit facilities). These products may suit customers who want a flexible loan that allows them to repay and redraw up to the credit limit at any time. The available funds are always on call, so they do not have to reapply when they need extra funds. From discussions with industry, we understand that a substantial proportion of revolving loan products are generally in positive balance.

**Example:** After 10 years a customer pays off the amount owing on their revolving home loan, then continues to use the product in credit balance. The product otherwise has the features and capabilities of a current account.

**Credit cards** are mainly used as a form of borrowing. However, credit cards can be in credit balance for various reasons, including topping up before international travel, getting a refund from a merchant, or receiving payments from others. Reserve Bank credit card survey data as at 30 November 2023 showed \$153 million of credit balances on credit cards.

Only credit balances on these specific borrowing products are proposed to be included in the protected deposit regulations. We do not recommend covering all borrowing products, where a



credit balance may occasionally arise due to an error or an inadvertent extra payment (such as on a personal loan), as these products are unlikely to be equivalent to deposits and would be more complex to include. Note that the DTA specifies that debit balances (negative balances such as accounts in overdraft) are disregarded when calculating DCS entitlement.

We sought informal feedback on our initial view on deposit coverage through industry workshops in 2023.<sup>8</sup> There was broad support for the protected deposit regulations to also include credit balances on specific borrowing products (revolving home loans, revolving credit facilities, and credit cards). There was also support to restrict the coverage to products designed to operate in credit balance, and not to extend the coverage to products which might inadvertently go into credit balance.

## **Subordinated products**

Subordination is the act of lowering the priority of a claim with respect to another claim, for example, equity products are generally subordinate to debt products. The broad intention of the DCS is to not cover products subordinated to deposits (e.g. equity in financial institutions).

The 'debt securities' concept removes many subordinated sources of funding from DCS eligibility but not all. Some further subordinated products may also be excluded as they are often tradable (as discussed above), which means they are excluded.

However, further clarity may be needed as non-bank deposit takers offer a variety of deposit-like products, for example, redeemable shares. The DTA is intended to cover these sorts of products, with the test being that their economic substance is similar to that of transaction accounts, saving accounts or term deposits.

In some cases, (e.g. certain building societies) deposit takers issue a variety of tranches of shares, with a deposit-like senior tranche and then one or more other tranches that are subordinated and more in the nature of an investment (perhaps counting as capital for regulatory purposes).

We propose that the regulations should make it clear that:

- the senior tranche of deposit-like products will be eligible for deposit compensation to the extent not already excluded by the 'tradability' rules
- products which are subordinated to the senior tranche of deposit-like products will not be eligible for deposit compensation.

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<sup>8</sup> [rbnz.govt.nz/-/media/project/sites/rbnz/files/about/our-legislation/deposit-takers-act-industry-workshop-slides-august-2023.pdf](https://www.rbnz.govt.nz/-/media/project/sites/rbnz/files/about/our-legislation/deposit-takers-act-industry-workshop-slides-august-2023.pdf) (slides 43 to 45 relate to protected deposits)

## **Entitlement Conditions**

In addition to product characteristics above, we propose other regulations to narrow entitlement in particular circumstances, as outlined below, to maintain the consistency and integrity of the DCS.

### ***Funds recovered from the liquidator***

We propose making an entitlement condition that any funds recovered from the liquidator that would have been part of a DCS entitlement will reduce the entitlement by the same amount.

This will ensure that a depositor is not paid twice for the same deposit. This situation may occur where a depositor has not claimed entitlement from the DCS until after they have received some funds from the liquidator.

### ***Deposits held on trust***

We propose limiting the entitlement to compensation for deposits held on trust to the kind of trust known as an express trust (within the meaning of section 12 of the Trusts Act 2019). Trusts created by or under a trust deed or enactment would be covered. This includes charitable trusts, estates, family trusts, and statutory trusts (e.g. a trust for retention money created under the Construction Contracts Act 2002). A non-express trust such as a constructive trust, resulting trust, or other trust recognised at common law would not be covered.

Trusts, as defined above, would, if eligible, receive up to \$100,000 in compensation but would not be considered as relevant arrangements (covered in the following chapter) unless specified as such in the regulations.

In order for the Reserve Bank to be able to act with reasonable certainty, documents must be provided to the Reserve Bank in the event of a payout event to prove eligibility of the trust to compensation by the trustee as the person required under section 45 of the Trusts Act 2019, or other enactments, to keep core documents.

The payment of compensation to a trust will only be made if the Reserve Bank is satisfied on the basis of the documentation provided that the trust is entitled to compensation.

We propose that compensation payments for trusts would be paid to the account holder, rather than to individuals. Our rationale for this approach is to ensure that there are no unintended consequences from payments being released to individuals, for example, releasing money to an individual where it was being held on a lawyer's trust account pending the result of a legal dispute.

The proposed conditions would ensure that family trusts and statutory trusts are covered by the DCS as intended by section 209. The purpose of these conditions is to limit compensation to those trusts intended by the legislation and not open the scheme to claims based on verbal, or other non-documented agreements.

# Analysis and application of assessment considerations

## Protected deposits

The primary purpose of the DTA is to protect the stability of New Zealand’s financial system and an additional purpose is to promote public confidence in the financial system.

As outlined in the table below, including credit balances on specific borrowing products as protected deposits for DCS coverage appears to have significant net benefits, in terms of public confidence and financial stability relative to excluding these products. Including these products will minimise potential volatility to the banking system, as customers (especially those who frequently have credit balances) will not need to change their behaviour.

Furthermore, it is accessible for a diverse range of New Zealanders to define and explain why these products are covered under the DCS, since the credit balance is money owned by customers and to be repaid by deposit takers.

The marginal operational cost of making such products protected deposits is expected to be low, so is considered to be practical from an implementation perspective.

Affected groups	Comment	Impact	Evidence Certainty
<b>Additional costs of the preferred option compared to taking no action</b>			
Deposit takers	Will need to accurately identify and flag credit balances on specific borrowing products.	Low	High. Existing requirements already exist for some deposit takers to identify such accounts.
<b>Additional benefits of the preferred option compared to taking no action</b>			
Holders of credit balances on specific borrowing products	Promotes public confidence as customers will not need to change their behaviour.	Medium	High

For the entitlement condition proposals, the major benefit is increased certainty in a payout event and the avoidance of inconsistent treatment, which should support public confidence.

Affected groups	Comment	Impact	Evidence Certainty
<b>Additional costs of the preferred option compared to taking no action</b>			
Depositors	Some depositors may receive less than they would if conditions did not apply.	Low	High
<b>Additional benefits of the preferred option compared to taking no action</b>			
Reserve bank	Ability to act with certainty in a payout event.	Medium	High

## Alternative options

The options considered are whether or not the regulations include credit balances on specific borrowing products. A comparison of the two options is shown in the table below.

	<b>Option 1: Regulation making credit balances on specific borrowing products protected deposits (Preferred option)</b>	<b>Option 2: No regulations making credit balances on specific borrowing products protected deposits</b>
<b>Financial stability and public confidence</b>	+	-
<b>Easy to define and understand</b>	+	0
<b>Practicality of implementation</b>	0	0
<b>Overall assessment</b>	++	-

## Entitlement conditions

We consider that the entitlement conditions proposed will maintain the integrity of the DCS (for example, by ensuring depositors do not receive compensation twice for the same funds and that only well documented trusts are eligible for compensation) and ensure that the Reserve Bank is able to act with certainty in a payout event.

	Option 1: Regulation making specified entitlement conditions	Option 2: No regulations
<b>Integrity of the DCS</b>	++	--
<b>Ability to act with certainty</b>	++	-
<b>Overall assessment</b>	++	-

## Consultation questions

- Q1** Do you have any comment on the proposal that the protected deposit regulations include normal banking products such as current accounts, savings accounts and term deposits, as well as similar products offered by non-bank deposit takers?
- Q2** Do you agree with the proposal that the protected deposit regulations also include credit balances on specific borrowing products (revolving home loans, revolving credit facilities, and credit cards)?
- Q3** Do you foresee any boundary issues arising from the protected deposit proposals? For example, are you aware of any financial products which appear to not clearly fall in or out?
- Q4** Do you agree with our entitlement condition that funds paid by the liquidator that would have been part of a depositor's DCS entitlement be subtracted from the compensation amount?
- Q5** Do you agree with our proposals to only cover express trusts and those created by enactment, subject to the relevant documentation being provided?

**Please provide any other feedback in relation to the DCS scope proposals.**

## Chapter 4 Relevant Arrangements

This chapter outlines the treatment of ‘relevant arrangements’ and proposes that specific client account arrangements and bank-sponsored PIE funds are specified as relevant arrangements through regulations. This means that deposit takers will need to be able to identify and flag these accounts, and that in a payout event, eligibility will be calculated with reference to the client’s eligibility rather than the account holder.

### Proposals at a glance

We propose that certain client accounts would be specified as relevant arrangements through regulations:

- Conveyancers
- Lawyers
- Accountants
- Real estate agents
- Retirement village deposits

We propose that Bank sponsored PIE funds would be included as relevant arrangements.

We propose that payouts would be paid to the account holder in a compensation event.

We propose that record keeping requirements for these arrangements would reference the governing legislation for the class of relevant arrangements.

### Background

DTA section 191(2) deems certain account arrangements to be ‘relevant arrangements’ for DCS compensation entitlement purposes. From a policy perspective, the term ‘relevant arrangements’ is designed to capture trusts, schemes, or other arrangements (including regulated client money or property services) where an amount is held in the name of a depositor on behalf of another person (e.g. brokerage accounts, lawyer’s trust accounts). For DCS compensation entitlement purposes, relevant arrangements receive ‘look-through’ treatment. In other words, it is the underlying beneficial owner of the funds, not the named account holder, who will be entitled to DCS compensation.

Ensuring relevant arrangements receive look-through treatment maintains public confidence in the continued use of these types of arrangements and ensures equitable treatment between these types of deposits and those held directly. If relevant arrangements were not covered by the DCS there may be an incentive to avoid the use of these types of arrangements, even when it makes commercial sense.

While section 191(2)(a) explicitly includes one specific type of relevant arrangement (a deposit held under regulated client money or property service as defined in the FMCA), it also includes other trusts, schemes, or arrangements prescribed by regulation (under section 191(2)(b)).

This chapter:

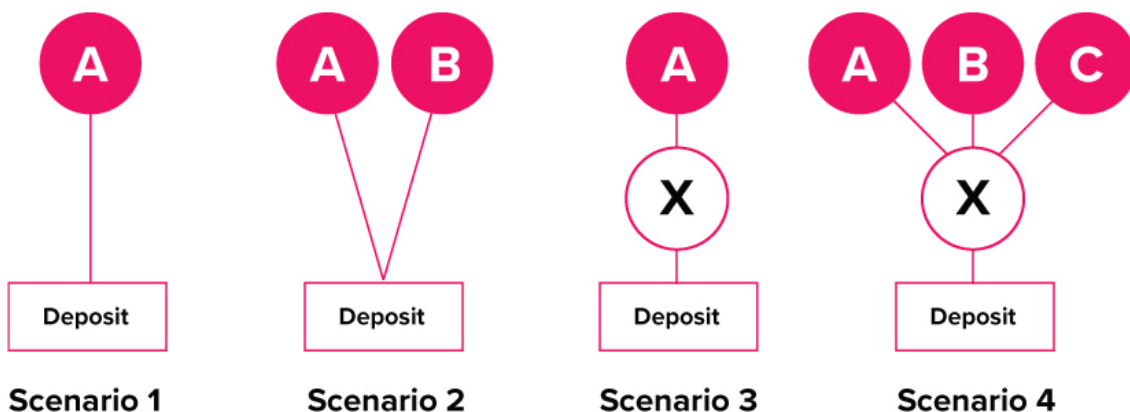
- provides detail on the concept of a regulated client money or property service, and
- sets out proposals for additional arrangements to be covered by regulations under limb (b) of the definition.

## DCS compensation entitlement scenarios

The DCS has different treatment for four compensation entitlement scenarios – set out under sections 202-205:

- Scenario 1: Depositor A holds the protected deposit in Depositor A’s own right. The total amount of the protected deposit goes to Depositor A’s compensation entitlement.
- Scenario 2: Depositor A holds a joint account that is a protected deposit together with Depositor B. 50% of the deposit goes to Depositor A and another 50% goes to Depositor B’s compensation entitlement unless the deposit taker has a record showing that the proportion of the joint account is not equal among the joint account holders. Depositors A and B are each entitled to up to \$100,000 in compensation.
- Scenario 3: Depositor X, a client account holder under a relevant arrangement, holds the protected deposit on behalf of Depositor A (a client of Depositor X under a relevant arrangement). The total amount of the protected deposit goes to Depositor A’s compensation entitlement.
- Scenario 4: Depositor X, a client account holder under a relevant arrangement, holds the protected deposit on behalf of Depositors A, B and C (different clients of Depositor X under relevant arrangements). For the purposes of compensation entitlement, the protected deposit is distributed among Depositor A, B and C, according to the records provided by Depositor X—the account holder.

The four compensation entitlement scenarios are shown below.



## Regulated client money or property services

For the purposes of defining relevant arrangements, the DCS includes 'regulated client money or property service' (RCMPS), as defined in the Financial Markets Conduct Act 2013 (section 431W). 'Client money' means money received in connection with a financial advice product, on account of a client by a service provider. Likewise, 'client property' means property (other than money) received in connection with a financial advice product, on account of a client by a service provider.

The RCMPS definition includes most custodial services. Examples of such custodial services which will qualify as relevant arrangements include the following:

- A bank offers a Discretionary Investment Management Service (DIMS). Client money or property held by the DIMS custodian falls under the RCMPS definition, thus qualifies as a relevant arrangement under the DCS, and will receive look-through treatment in the event of a deposit taker failure.
- A peer-to-peer (P2P) lender's client money is held by a custodian on behalf of the client. This client money scenario falls under the RCMPS definition.
- Brokers may offer 'cash management accounts' to clients as an alternate way to access bank accounts. Client deposits may be aggregated to earn a better interest rate. Cash management accounts also fall under the RCMPS definition.
- Digital platforms may offer clients access to savings accounts and term deposits. Again, such products allow for client deposits to be aggregated to earn a better interest rate, and also fall under the RCMPS definition.

For the avoidance of doubt, custodianship of property of a registered scheme is not a RCMPS, according to section 229ZD of the Financial Markets Conduct Regulations 2014. This means a holding in a Managed Investment Scheme (MIS) does not qualify as a relevant arrangement. We understand an MIS will generally have bank accounts (e.g. these may be used to hold dividends or new inflows prior to investment), however because the MIS is not a RCMPS, these accounts would not create entitlements for the underlying investors.

## Additional account types to be included as relevant arrangements under regulation

We have considered the following assessment principles when proposing account arrangements for inclusion in the relevant arrangement definition via regulation:

- the impact on financial stability and public confidence of inclusion,
- whether the arrangements are easy to define and understand, and
- the practicality of implementation from industry's perspective.

## Proposal

As stated above, as well as the relevant arrangements specified in section 191(2)(a) of the DTA, further relevant arrangements can be prescribed under section 191(2)(b), read in conjunction with section 455(1)(b).



If section 191(2)(b) regulations were not issued, certain arrangements which fall outside section 191(2)(a) would not be covered as relevant arrangements. Accordingly, we consider it desirable to issue regulations broadening the scope of the relevant arrangement definition, to give full effect to the policy intent of the relevant arrangement definition. We propose the regulations include:

- specific client account arrangements
- bank-sponsored PIE funds

### **Specific client account arrangements**

Various client money or property services (CMPS) are excluded from the RCMPS definition and are listed in clause 19 of Schedule 5 of the FMC Act 2013:

- Conveyancers
- Lawyers
- Accountants
- Real estate agents
- Registered legal executives
- Tax agents

These services relate to occupational client money or property arrangements where holding client money or property is incidental to the occupation, but not the principal activity of the occupation. For example, a lawyer may operate a client account, but their principal activity is providing legal advice, not holding client money or property. As the Schedule 5 exclusions fit within the broader CMPS definition, we have assessed whether they should be included within the definition of relevant arrangement for the purposes of the DCS.

With regard to the practicality of implementation assessment principle, we have considered the extent to which including these accounts would impose additional compliance costs, in particular, in relation to the need for deposit taker records. We are aware conveyancers, lawyers, and real estate agents are already subject to client money requirements under existing law (Lawyers and Conveyancers Act 2006, Real Estate Agents Act 2008). Furthermore, accountants are already subject to client money requirements under existing professional standards (Professional Standard No. 2, 2008). In contrast, we are not aware of client money requirements under existing law for registered legal executives and tax agents.

Certain other client money arrangements (falling outside of Schedule 5 of the FMC Act 2013) were assessed for inclusion in the relevant arrangement regulations, including:

- Property managers
- Tax pooling intermediaries
- PAYE intermediaries
- Payroll providers
- Marine brokers
- Construction company retentions
- Retirement village deposits

We do not recommend including property managers and marine brokers within the relevant arrangement definition, as we could not identify a formal (legislated or set via professional standards) set of client money requirements. Tax pooling intermediaries do have client money requirements, but there does not appear to be a requirement to notify the deposit taker that the account is held on behalf of clients.

We understand payroll providers provide payroll system software to perform various functions such as calculating and deducting PAYE and calculating leave under the Holidays Act 2003. However, we understand payroll providers do not handle client money.

It was noted the general public would be unaware of PAYE intermediaries, so their inclusion would do little to promote public confidence. Furthermore, if look-through treatment was applied to these entities, large organisations would often be the 'clients', rather than individuals, and the DCS compensation limit of \$100,000 would often not be a material amount in terms of the cashflow of a large organisation.

Construction company retentions involve construction companies holding subcontractor retentions in a trust account until the end of a defects liability period. Such arrangements have not been included in the proposals as they may create complexities given the money is commonly deposited by one person but could become the property of another (at the end of the defects liability period).

Retirement village deposits must be independently held for the benefit of the resident until settlement of the occupation right agreement transaction. Despite falling outside the list of occupational client money arrangements from Schedule 5 of the FMC Act 2013, we understand retirement village deposits may be regarded as similar to property transactions undertaken by the likes of lawyers and real estate agents.

On the basis of the above, we recommend the following arrangements be included in the relevant arrangement regulations:

- Conveyancers
- Lawyers
- Accountants
- Real estate agents
- Retirement village deposits

### **Bank-sponsored PIE funds**

We also propose including holdings in bank-sponsored PIE funds as relevant arrangements. Bank-sponsored PIE funds are funds issued by a related entity of a bank and only invest in that bank's New Zealand dollar deposits. These funds offer investors the tax advantages of the portfolio investment entity (PIE) regime, paying tax at the prescribed investor rate (PIR) of the investors, rather than at the issuer's tax rate. The rationale for prescribing bank-sponsored PIE funds as relevant arrangements rests on their economic substance of being wholly invested in deposits which would otherwise be eligible for DCS compensation.

It should be noted that relevant arrangements prescribed by regulations are intended to be a narrow and well-defined category of products. For example, while it is proposed to include bank-sponsored PIE funds as relevant arrangements, a wide variety of other cash funds will fall outside the definition. This is because they may not solely hold deposits but can often hold investments such as short-term Government bonds. For example, a provider may offer a money market fund which holds deposits but also holds investments such as government bonds, therefore the fund does not qualify as a relevant arrangement.

Depositor compensation schemes typically restrict compensation to deposits and exclude all types of investments. Such excluded investments in the context of the DCS include equities, bonds, derivatives, property, and Managed Investment Schemes (MIS). It should be noted however that bank-sponsored PIE funds may be structured as a MIS, and thus could be considered as an exception to the 'no investments' rule. Notwithstanding their technical form, the proposal to include them as relevant arrangements is considered appropriate due to their economic substance (i.e. they are akin to a deposit).

Including bank-sponsored PIE funds as relevant arrangements should mitigate against depositors moving their funds from a bank sponsored PIE into other deposit products which might occur if cash PIEs are not included.

## **Prior informal feedback from industry**

We sought informal feedback on the proposed coverage through industry workshops in 2023<sup>9</sup>. Follow-up bilateral meetings were also held with various deposit takers which included more detailed discussions of the relevant arrangement proposals.

With regard to the client account arrangements proposals there was broad support for a prescriptive list approach. Advantages of such an approach include reduced administrative burden for deposit takers, reduced complexity during a DCS payout, and ability to ensure consistent treatment across deposit takers. There was also broad support for the proposal to capture Bank-sponsored PIE funds as relevant arrangements under regulations.

The industry workshops primarily involved deposit takers, however we also sought feedback from various industry bodies representing relevant arrangement providers. Relevant arrangement providers have a provider/client relationship with clients affected under the relevant arrangement regulation proposals. For example, if lawyers' trust accounts are included in the relevant arrangement regulations, then individual law firms would be regarded as relevant arrangement providers.

In discussions with industry bodies, we noted lawyers would not be designated 'deposit takers' for the purposes of the DTA, and as relevant arrangement providers no further regulatory or financial burden is intended beyond existing requirements to maintain client records.

## **Payments into accounts for relevant arrangements**

We propose requiring that payouts for relevant arrangements be paid to the account holder. This would mean that while we will calculate entitlement based on the individual eligible depositors who have money in these accounts, we will not make payments to the individuals.

Our rationale for this approach is to ensure there are no unintended consequences through payments being released from a relevant arrangement account to individuals, such as if there are conditions attached to the funds.

## **Record-keeping requirements**

In addition to prescribing relevant arrangements under section 191(2)(b) regulations, further regulations will be required under section 205(2)(a) to ensure the arrangements are workable. The Section 205(2)(a) regulations relate to the record-keeper of eligible depositors' shares of the protected deposit held under the relevant arrangement, and the manner in which those records must be maintained.

We propose the manner in which records must be maintained is the manner in which the records must be maintained under its governing legislation (e.g. section 112 of the Lawyers and Conveyancers Act 2006) or document (i.e. PIE trust deed or retirement village statutory supervisor's deed of supervision).

For completeness, we note that we expect relevant arrangement payments to be made via a slower process after depositors have received direct entitlements. For example, a customer with

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<sup>9</sup> [rbnz.govt.nz/-/media/project/sites/rbnz/files/about/our-legislation/deposit-takers-act-industry-workshop-slides-august-2023.pdf](https://rbnz.govt.nz/-/media/project/sites/rbnz/files/about/our-legislation/deposit-takers-act-industry-workshop-slides-august-2023.pdf) (slides 46 to 50 relate to relevant arrangements)

\$50,000 in direct deposits and \$20,000 in a relevant arrangement account will receive \$50,000 via DCS payout for the direct deposit, and will be eligible for \$20,000 in respect of the relevant arrangement, but that will be paid via a slower process.

## Analysis and application of assessment considerations

Our analysis indicates that prescribing relevant arrangements under regulations has significant net benefits in promoting public confidence in the continued use of client money or property scenarios (relative to not making these regulations).

The assessment principles that are particularly relevant are:

- the promotion of public confidence and financial stability,
- the rules being easy to define and understand,
- the practicality of implementation.

Affected groups	Comment	Impact	Evidence Certainty
<b>Additional costs of the preferred option compared to taking no action</b>			
Deposit takers	Will need to accurately identify and flag relevant arrangement accounts.	Low	High. Existing client money requirements give deposit takers the ability to identify affected accounts.
<b>Additional benefits of the preferred option compared to taking no action</b>			
Holders of protected deposits under relevant arrangements	Gain access to 'look-through' treatment. Promotes public confidence in the continued use of client money scenarios.	Medium	High. Will give clients of lawyers, accountants etc. continued confidence in using their services, as the clients continue to be eligible for the \$100,000 maximum entitlement.

## Alternative options

An alternative option to issuing relevant arrangement regulations would be to not issue such regulations. This alternative option would restrict relevant arrangement coverage to the section 191(2)(a) arrangements (deposits held under regulated client money or property service). A comparison of the two options is shown in the table below.

	<b>Option 1: Cover a specified list of arrangements (preferred option)</b>	<b>Option 2: No further relevant arrangements</b>
<b>Financial stability and public confidence</b>	+	-
<b>Easy to define and understand</b>	+	0
<b>Practicality of implementation</b>	+	0
<b>Overall assessment</b>	++	-

## Consultation questions

- Q1** Do you agree with our proposal that protected deposits held under the following client account arrangements be prescribed as relevant arrangements: conveyancers, lawyers, accountants, real estate agents, and retirement village deposits?
- Q2** Do you agree with our proposal that holdings in bank-sponsored PIE funds be prescribed as relevant arrangements?
- Q3** Do you foresee any boundary issues arising from the proposals? For example, are you aware of any financial products which may not clearly fall in or out of the intended scope of the proposals?
- Q4** Do you have any comments on the proposals with regard to possible implementation challenges, timeframes to implement and likely scale of accounts covered?
- Q5** Do you agree with our proposal to make payments into 'like' accounts for relevant arrangements?
- Q6** For relevant arrangement record-keeping requirements, are you aware of any instances where records are not required (or not available) and how else eligible depositors' shares could be identified/notified?

**Please provide any other feedback in relation to the relevant arrangement proposals.**

## Chapter 5 - Exempting Deposit Takers from the DCS

The DTA allows deposit takers to be exempt from the DCS. The Reserve Bank has recently announced regulatory settings are shifting to require branches of foreign banks operating in New Zealand (i.e. without having a locally incorporated subsidiary) to only interact with wholesale customers. Most branch banks already meet this, while others are transitioning to do so.

### Proposals at a glance

We propose exempting wholesale-only branches from the DCS from the start of the DCS. As branches with existing retail customers divest them, they would then also be exempted from DCS membership.

### Background

The DTA allows regulations to be made that exclude debt securities issued by certain deposit takers (or classes of deposit takers) from DCS coverage. These regulations (described in s 192(2)(c) of the DTA) are intended to be based on a test described in section 459. Broadly, the test is either that:

- the deposit taker generally does not issue protected deposits to retail investors, or
- there are alternative protections for relevant investors that are satisfactory in the circumstances (such as a foreign deposit compensation scheme that can reliably be expected to protect New Zealand depositors).

Given that most banks in New Zealand that operate as branches of foreign banks do not take retail deposits, and those that do will be required to cease doing so over the next few years according to the policy decisions made in the Reserve Bank's recent Branch Policy Review,<sup>10</sup> we recommend this class of deposit taker be exempt from the DCS.

The branch policy review has adopted the definition of wholesale investor in the Financial Market Conduct Act 2013 (Clause 3(2), Schedule 1). This is described in more detail in the second consultation paper on the [Branch Policy Review](#).

If a deposit taker is covered by the DCS, in general the wholesale deposit accounts it offers will be eligible for payout, but the scale of the payout is likely to be low relative to average account balances. The benefits of this protection appear relatively low, while the operational costs of being a member of the scheme (paying levies and producing a single customer view file) would still be significant.

Technically, deposit takers which only have wholesale customers could effectively also be serving retail customers if they maintained 'relevant arrangement' accounts as discussed in chapter 4. If those deposit takers are exempt from the DCS, their customers would not get the 'look through' protection they could otherwise expect. We have asked deposit takers if they have wholesale

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<sup>10</sup> The Branch Policy Review also describes which banks operate in New Zealand as branches, and the list of registered banks maintained on the Reserve Bank's website also shows this. It is important to note that many banks are "dual-registered" in New Zealand, meaning they operate a branch and a local subsidiary. In these cases, retail deposit accounts are within the local subsidiary and will be eligible for DCS coverage under the proposal we describe here.

clients that maintain accounts where the money is held in a custodial arrangement and retail customers are able to exercise effective control over these sums, as this sort of custody account would potentially overlap with the RCMPS arrangements described in chapter 4. We understand that while some New Zealand branch banks have certain custodial arrangements, they are not of this nature or of other types we recommend as relevant arrangements in chapter 4 (e.g. lawyers' trust accounts). Our expectation would be that firms that are exempted from the DCS would continue to not offer this sort of service going forward. We may monitor this in supervisory engagements.

## Proposal

We recommend exempting wholesale-only branches from membership in the DCS. We have sought formal feedback from branches on their views and also discussed this informally at the industry workshops in 2023. The formal feedback from branches indicated they agree an exemption would be appropriate. Our preferred option is to remove the existing wholesale only branches from the DCS from the start date of the DCS using the regulation power above.

Branches that currently have retail customers are working through how they will divest those customers prior to the 2028 deadline set by the branch policy review. We have not identified home country DCS schemes to which these firms belong that appear to match the protections that would be offered by the New Zealand DCS sufficiently to be 'satisfactory alternative protections'.

Therefore, we recommend these firms remain as members of the scheme at its inception if, at that point, they have not divested their retail deposit books. However, divestment should occur prior to 2028 and, at this time, they should qualify for an exemption. Because SCV requirements are only likely to arise from 2028, this still removes a key administrative burden from those firms.

## Analysis and application of assessment considerations

The additional purpose of the DCS is to protect financial stability, by protecting eligible depositors to the extent they are covered by the scheme. As discussed above, branches will have few eligible customers, and they will tend to be only protected in respect of a small proportion of their balances. For the same reason, the financial stability benefits of those accounts having DCS protection will be very small (a large wholesale deposit is still likely to run in the event of deposit taker distress whether or not the first \$100,000 is insured).

As in the table below, the exemption of wholesale-only branches appears to have significant net benefits. Two principles that are particularly relevant are the reduction of compliance costs and the maintenance of competition. In particular, removing regulatory obligations for foreign bank branches that wish to be licensed in New Zealand increases the possibility that more of those firms will enter the market and offer a wider range of wholesale services.



Affected groups	Comment	Impact	Evidence Certainty
<b>Additional costs of the preferred option compared to taking no action</b>			
Wholesale customers	Lose access to protection on first \$100,000	Low	High. That it will not be material for most wholesale customers is highly plausible but quantitative data is limited.
<b>Additional benefits of the preferred option compared to taking no action</b>			
Wholesale only branches	Diminished compliance costs of operating in NZ; and ability to compete more effectively in wholesale markets	Medium	High: Clear, and consistent with feedback from affected parties.

## Alternative options

	Option 1: No regulations making firms non-members of DCS	Option 2: Regulation making wholesale only branches non-members
Reduce compliance costs	0	++
Competition (in wholesale markets)	--	0
Protection of eligible deposits (DCS objective)	0	-
Overall assessment	-	++

## Consultation questions

- Q1** Do you agree with our analysis that the protection offered by the DCS is unlikely to be particularly significant for wholesale depositors?
- Q2** Will it be possible to manage a situation where some deposit takers are not DCS members, noting that they will not be allowed to take deposits from retail depositors if they are not members (unless an equivalent foreign scheme provides adequate protection).
- Q3** Do you agree with our overall assessment of the costs and benefits of exempting foreign branches from DCS membership?

**Please provide any other feedback in relation to the branch exemption proposals.**

## Chapter 6 - In-flight payments

This chapter discusses how balances will be calculated for compensation under the DCS when balances could be influenced by partially completed or 'in-flight' payments to or from the protected deposit.

### Proposals at a glance

We propose following the approach taken under the Reserve Bank's current open bank resolution (OBR) policy as described below, with the exception of card payments, which we propose that these are only taken into account where the transaction has been settled and the protected deposit has been debited or credited to take into account the transaction.

## Background

### In-flight payments and DCS

In determining a protected depositor's entitlement to compensation under the DCS, it is necessary to calculate the aggregate balance of that depositor's protected deposits (or shares of protected deposits). These balances must be calculated at the "quantification time" (which is the time specified as the quantification time in the relevant specified event notice issued under section 194 of the Act).

In some cases (primarily where the protected deposit is a transactional account) the balance at the quantification time may be influenced by whether in-flight payments to or from the protected deposit are taken into account (by in-flight payments we mean payments that have been initiated but not fully processed at the quantification time).

### The approach to in-flight payments in Open Bank Resolution (OBR)

This issue also arises under the Reserve Bank's existing OBR policy when determining the balances of accounts that may be partially frozen under that policy. In that context the Reserve Bank's *BS17 Open Bank Resolution (OBR) Pre-Positioning Requirements Policy* provides that in determining the customer liability account balance as at the effective time, the statutory manager is generally expected to take the following approach:

- Where a payment is an "on-us payment" (i.e. a payment between accounts at the same deposit taker) it should be taken into account in determining account balances.
- Where the payment is not "on-us" there are two key cases:
  - If the payment requires interbank settlement on the Exchange Settlement Account System (ESAS) (e.g. payments settled through Settlement Before Interchange (SBI) and the High Value Clearing System (HVCS)), these should only be taken into account in determining account balances where the interbank settlement has been completed.

- Where the payment is a “card transaction” (card transactions are transactions settled through other means e.g., transactions settled through Visa or Mastercard networks), the statutory manager may exercise discretion as to how these payments are to be treated.

## **The regulation making power for in-flight payments**

The Act allows for regulations to be made prescribing the treatment of in-flight payments when calculating entitlements under the DCS. Specifically, section 213 of the Act states that:

“(1) This section applies if:

(a) before the quantification time:

(i) a transaction connected with a protected deposit is entered into and an instruction relating to the transaction has been received by the licensed deposit taker; but

(ii) the protected deposit has not yet been credited or debited to take into account the transaction; and

(b) the circumstances specified in the regulations (if any) apply.

(2) For the purposes of this subpart, the regulations may provide for the calculation of the amount of a person’s protected deposits or share of protected deposits to be increased or decreased to take into account the transaction.

(3) The regulations may provide for the transaction to be taken into account in the prescribed manner.”

## **Proposal**

Our preferred option for the treatment of in-flight payments is divided into three parts. Specifically, the treatment of “on-us” payments, the treatment of payments requiring interbank settlements in ESAS, and the treatment of card payments.

### **“On-us” payments**

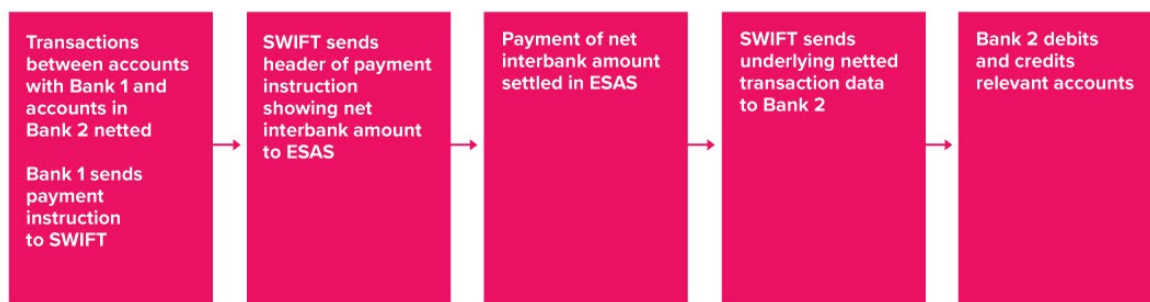
“On-us” payments occur immediately (so when the payment instruction is received from the payor the payor’s account is immediately debited and the payee’s account is immediately credited). In effect this means that these payments do not exist in an in-flight state. As a result, we propose these transactions always be taken into account in determining a protected depositor’s protected deposit balances.

This is the same way that on-us payments are currently treated in OBR.

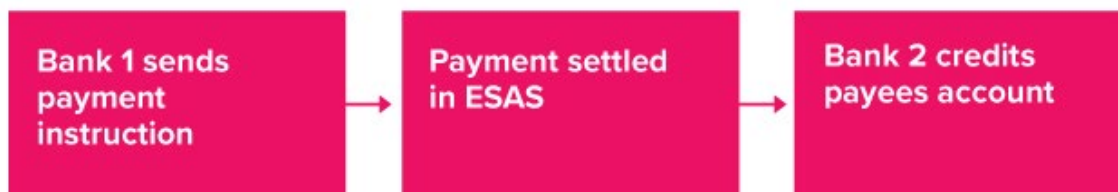
## Payments requiring interbank settlement in ESAS

Payments requiring interbank settlement in ESAS are payments made via SBI (which include direct debits, direct credits, automatic payments, bill payments, EFTPOS payments, and certain mobile payments) and payments made via HVCS (which include large value payments between corporate institutions, and property settlements).

The SBI process is set out in the following diagram.



The process for effecting HVCS payments is simpler. HVCS payments are cleared on a per payment message basis rather than grouped together and netted with other payments (as in SBI). Settlement of these payments occurs on ESAS. The HVCS process is set out in the following diagram:



We propose that payments made via SBI and HVCS only be taken into account in determining protected deposit balances when the settlement has occurred in ESAS. This is the same way these payments are treated in OBR.

## Card payments

Card payments can be processed and settled in a variety of ways and over a range of timeframes. We are concerned that trying to design specific rules for all of these scenarios will introduce excessive complexity, but that applying discretion to the treatment of these transactions is not an adequate approach in the context of determining legal entitlements under the DCS.

Accordingly, we are proposing that card transactions only be taken into account in calculating protected deposit balances where the transaction has been settled, and the protected deposit has been debited or credited to take into account the transaction.

This differs from the current treatment of card payments under OBR (as noted above, the treatment of card payments are left to the statutory manager's discretion in the context of OBR).

## Conclusion

In conclusion, we propose the following:

- “On-us” payments be taken into account in determining protected deposit balances (the payor’s account is debited and the payees account is credited immediately in relation to the payment),
- Payments requiring interbank settlement on ESAS only be taken into account in determining protected deposit balances where the interbank settlement has been completed (at this point the payor’s account has already been debited and payees account will shortly be credited),
- card payments only be taken into account in determining protected deposit balances once the transaction has been settled, and the protected deposit has been debited or credited to take into account the transaction.

We think this approach is largely consistent with existing payments system related processes and rules. However, because it is only focused on the calculation of entitlements under the DCS, it would not override the application of relevant payment system rules. We anticipate that these would still operate as currently, and determine (amongst other things) whether a transaction that has not yet settled at the quantification time could still be settled after that time, and the circumstances in which a transaction could be reversed.

## Analysis and application of assessment considerations

**Table 2: Costs and benefits of the proposed option**

Affected groups	Comment	Impact	Evidence Certainty
<b>Additional costs of the preferred option compared to taking no action</b>			
Deposit takers	Costs associated with system builds	Medium	Low-medium
Protected depositors	Occasional possibility of slightly lower DCS entitlements than might otherwise be the case	Low	Medium
Payment system operators	Possibility that minor changes to systems or rules may be required	Low	Medium
<b>Additional benefits of the preferred option compared to taking no action</b>			
Deposit takers	Additional clarity about the treatment of in-flight payments when designing systems, and communicating with customers	Medium	Medium

Affected groups	Comment	Impact	Evidence Certainty
Protected depositors	Additional clarity about the treatment of in-flight payments	Low-medium	Medium
Payment system operators	Additional clarity about the treatment of in-flight payments	Low	Medium

## Alternative options

We do not consider that there are any alternative options in relation to the treatment of on-us payments.

The tables below assess different options against our proposed approaches to payments requiring interbank settlement on ESAS, and card payments.

**Table 3: Payments requiring interbank settlement on ESAS**

	No set rule on the treatment of payments requiring interbank settlement in ESAS	Only include payments requiring interbank settlement in ESAS when the payor's account has been debited, the interbank settlement has occurred, and the payee's account has been credited
<b>Financial stability and public confidence</b>	--	-
<b>Clarity for deposit takers and protected depositors</b>	--	0
<b>Ease of implementation</b>	--	0
<b>Overall assessment</b>	--	-

**Table 4: Card payments**

	No set rule on card payments	Different rules for different types of card payment
<b>Financial stability and public confidence</b>	-	+
<b>Clarity for deposit takers and protected depositors</b>	--	0
<b>Ease of implementation</b>	-	--
<b>Overall assessment</b>	--	-

### Consultation questions

- Q1** Do you agree with our conclusion that on-us payments will automatically be included in protected deposit balances for the purpose of calculating DCS entitlements? If not, how would you recommend these payments be treated?
- Q2** Do you agree with our proposal that in-flight payments requiring interbank settlement in ESAS only be included in protected deposit balances for the purpose of calculating DCS entitlements where the interbank settlement has been completed? If not, how would you recommend that these payments be treated?
- Q3** Do you agree with our proposal that in-flight card payments only be included in protected deposit balances for the purpose of calculating DCS entitlements where the payment has been settled, and the protected deposit has been debited or credited to take into account the transaction. If not, how would you recommend that these payments be treated?



## Consultation questions

This section consolidates the consultation questions identified elsewhere in this paper.

### Chapter 1 – DCS levies

#### Initial levy base

**Q1** Do you agree with our preferred approach and have any final comments?

#### Levy approach

**Q1** Do you agree with the revised composite approach with respect to the quantitative risk indicators, boundaries, and weights for each input?

**Q2** Do you agree with our preferred DCS levy approach?

**Q3** Do you agree with our assessment of alternative options we have disregarded?

**Q4** Do you agree that the composite risk factors and weights should be reviewed in 2028 to better reflect updated standards?

**Q5** Do you have any other comments about the proposed DCS levy approach?

### Chapter 2 – Operational aspects of levies

#### Interest

**Q1** Do you support our proposed default rate of the OCR+4%?

#### Relief and instalment arrangements

**Q1** Do you agree with our proposed approach? Are there any other circumstances in which you consider it would be appropriate to consider relief for deposit takers?

#### Frequency of calculation and payments

**Q1** Do you agree that regulations would be desirable to provide certainty in payment frequency?

**Q2** Do you agree that it is useful to have options for deposit takers to make more frequent levy payments, or are you comfortable with making a single annual payment?

Alternatively, would you prefer another payment frequency (other than annually) if regulations did not allow for flexibility?

### Time bar for reassessment

- Q1** Do you think that a time bar would be necessary, or is it sufficiently unlikely that recalculations would be required?
- Q2** If a time bar is necessary, is four years an appropriate length of time?

### Chapter 3 – DCS scope

- Q1** Do you have any comment on the proposal that the protected deposit regulations include normal banking products such as current accounts, savings accounts and term deposits, as well as similar products offered by non-bank deposit takers?
- Q2** Do you agree with the proposal that the protected deposit regulations also include credit balances on specific borrowing products (revolving home loans, revolving credit facilities, and credit cards)?
- Q3** Do you foresee any boundary issues arising from the protected deposit proposals? For example, are you aware of any financial products which appear to not clearly fall in or out?
- Q4** Do you agree with our entitlement condition that funds paid from the liquidator that would have been part of your DCS entitlement are subtracted from your compensation amount?
- Q5** Do you agree with our proposals to only cover express trusts and those created by enactment, subject to the relevant documentation being provided?

### Chapter 4 – Relevant arrangements

- Q1** Do you agree with our proposal that protected deposits held under the following client account arrangements be prescribed as relevant arrangements: conveyancers, lawyers, accountants, real estate agents, and retirement village deposits?
- Q2** Do you agree with our proposal that holdings in bank-sponsored PIE funds be prescribed as relevant arrangements?
- Q3** Do you foresee any boundary issues arising from the proposals? For example, are you aware of any financial products which may not clearly fall in or out of the intended scope of the proposals?

- Q4** Do you have any comments on the proposals with regard to possible implementation challenges, timeframes to implement and likely scale of accounts covered?
- Q5** Do you agree with our proposal to make payments into 'like' accounts for relevant arrangements?
- Q6** For relevant arrangement record-keeping requirements, are you aware of any instances where records are not required (or not available) and how else eligible depositors' shares could be identified/notified?

## Chapter 5 – Exempting deposit takers from DCS membership

- Q1** Do you agree with our analysis that the protection offered by the DCS is unlikely to be particularly significant for wholesale depositors?
- Q2** Will it be possible to manage a situation where some deposit takers are not DCS members, noting that they will not be allowed to take deposits from retail depositors if they are not members (unless an equivalent foreign scheme provides adequate protection).
- Q3** Do you agree with our overall assessment of the costs and benefits of exempting foreign branches from DCS membership?

## Chapter 6 – In-flight payments

- Q1** Do you agree with our conclusion that on-us payments will automatically be included in protected deposit balances for the purpose of calculating DCS entitlements? If not, how would you recommend these payments be treated?
- Q2** Do you agree with our proposal that in-flight payments requiring interbank settlement in ESAS only be included in protected deposit balances for the purpose of calculating DCS entitlements where the interbank settlement has been completed? If not, how would you recommend that these payments be treated?
- Q3** Do you agree with our proposal that in-flight card payments only be included in protected deposit balances for the purpose of calculating DCS entitlements where the payment has been settled, and the protected deposit has been debited or credited to take into account the transaction. If not, how would you recommend that these payments be treated?