New Zealand's new deposit guarantee scheme

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One of the factors that drives differences in financial institutions' deposit rates is default risk. If a deposit taking institution (DTI) has a worse risk profile, we should expect it to have to pay more for deposit funds. This is an issue as New Zealand's Deposit Compensation Scheme (DCS) comes into effect in the middle of 2025. Because the first $100,000 of depositors' funds with any scheme participant will be guaranteed, will deposit rates get to be the same for all institutions covered by the scheme, and what should be expected to happen to deposit rates more generally?

Many countries around the world already have deposit guarantee schemes, with many of them having been in place for a considerable period. The United States was the first country to adopt a general scheme, and Demirgüç-Kunt & Detragiache (2002) report that 33 countries had deposit insurance in place by 1997. By 2003, the number of countries had increased to 87 (Demirgüç-Kunt, Kane & Laeven, 2008). Demirgüç-Kunt, Kane & Laeven (2015) report that the number of countries with explicit deposit insurance schemes had increased to 112 by the end of 2013. New Zealand was increasingly an outlier among advanced countries, although this is now changing.

We have previously had some deposit guarantees in New Zealand. For a long time, deposits at the Post Office Savings Bank and at the Trustee Savings Banks were guaranteed, but these guarantees were removed as these banks came within the symptoms of banking registration provided under the 1986 Amendment to the Reserve Bank of New Zealand Act. The Reserve Bank of New Zealand was traditionally opposed to deposit guarantees as they undermined market discipline, where banks were encouraged to conduct themselves conservatively, reducing the risk of failure. If bank deposits were guaranteed, depositors would no longer have to worry about potential bank failure, and banks could thus get away with taking greater risks in their business without engendering widespread withdrawals by depositors.

This changed with the Global Financial Crisis (GFC) of 2008, and on Sunday 12 October 2008 the Australian and New Zealand authorities both announced deposit guarantee schemes. In the New Zealand case, there had already been a number of failures of (deposit-taking) non-bank financial institutions, and there were concerns about the banks. A combined approach was considered necessary because of the extent of Australian ownership of the New Zealand banking sector. Although the Australian guarantee continued, albeit in a revised form, the initial version of the New Zealand guarantee lasted only until October 2010, and then continued in a revised and scaled back form for a smaller number of non-bank institutions through until the end of 2011. Moves towards a permanent deposit guarantee scheme were resumed in response to an IMF FSAP review in 2016, and following the enactment of the Deposit Takers Act 2023, this is due to come into effect in the middle of 2025, covering both registered banks and licensed deposit takers.

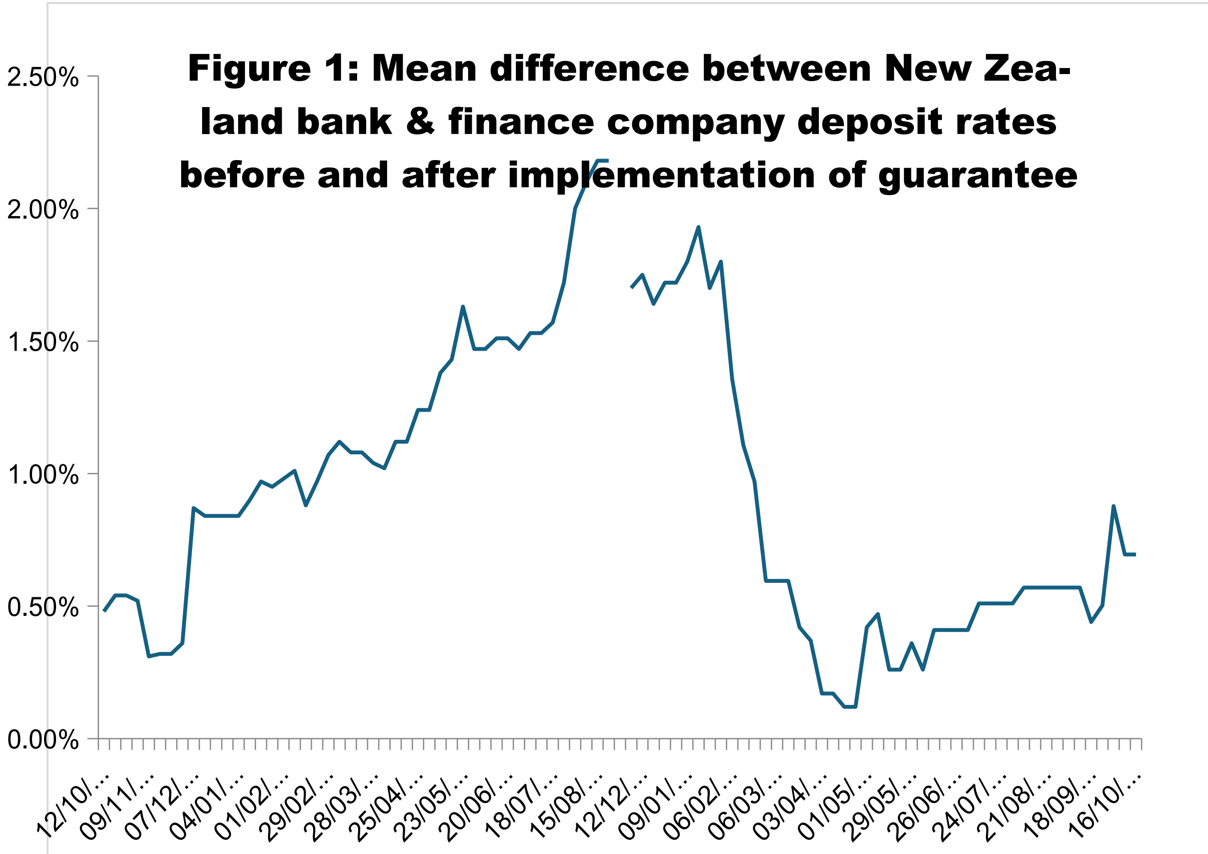
Prior research on the effects of deposit guarantees is somewhat limited, although there is a corpus of material which highlights the way in which deposit guarantees are inclined to increase risk-taking in banking systems (See, for example, Demirgüç-Kunt & Detragiache (2002)). Mondschean & Opiela (1999) note the trend towards convergence of deposit rates between institutions following the adoption of the deposit insurance scheme in Poland in the 1990s. Demirgüç-Kunt & Huizinga (2004) also found that deposit insurance tended to reduce both deposit rates and the interest rate sensitivity of measures of bank risk.

The Russian market has been more extensively researched. Prior to the introduction of deposit insurance, according to Karas, Pyle & Schoors (2010), depositor perception of bank risk was reflected more in quantities deposited, rather than deposit price, and indeed, higher deposit rates often aroused depositor suspicion. Karas, Pyle & Schoors (2013) found that business depositors, who were not insured, demanded higher interest rates that personal depositors (who were insured). Schoors, Semenova & Zubanov (2019) note that familiarity with a bank's name contributes to lower rates for deposits.

The Australian experience would be perceived as being of more direct relevance to New Zealand, although changes have been made to the deposit insurance scheme that was implemented in the GFC. The initial scheme covered deposits of up to $1 million at no charge, although there was a separate, optional and temporary wholesale scheme for larger deposits for which a premium was payable. Yan, Skully, Avram & Vu (2014) noted the challenges of measuring effects of the deposit guarantee because it was introduced during a crisis, but they note that the effect of the guarantee was to reduce market discipline, reflected in a reduction in deposit rate premia for weaker institutions. Luong, Pieters, Scheule & Wu (2020) affirmed this effect for the wholesale guarantee.

For the permanent scheme the limit for insured deposits has been reduced to AUD500,000. No premium is charged, on the basis that financial institutions will be levied if there are any shortfalls in covering the payouts after the liquidation of a failed institution.

Research on what has happened in New Zealand is even more limited, but we did undertake a comparison of bank and finance company deposit rates before and after the introduction of the guarantee in October 2008 (See Qin (2011)). This analysis had limitations, particularly because of the small number of both banks and non-bank financial institutions that could be included.



Note: figures are an average of 5 major banks and 5 finance companies, chosen on the basis of survival, and to provide a reasonable cross-section of the New Zealand finance company market. The finance companies included were F&P Finance, General Finance, PGG Wrightson Finance, Marac and South Canterbury Finance.

Figure 1 above reports the key findings of that research. We can see how the spread widened as the GFC developed during 2008, but how, after a gap, the spread contracted very substantially once the guarantee was in place. The gap did not reduce to zero, however, despite all deposits being guaranteed, which is presumed to reflect the familiarity issue identified in other research, noted above. The gap seemed to settle at around 0.50%, and perhaps that will be an indication of what we should expect once the DCS comes into effect in July 2025.

Another question that might arise is whether any distinction will be made between deposits that are covered by the DCS and other deposits that are larger: in other words, will institutions pay a premium for deposits that are over $100,000? Related to this is the question of whether depositors will split larger deposits across a number of institutions to maximise the proportion of larger deposits that is covered by the guarantee? This is a not uncommon practice in the United States, where there is a category of brokered deposits, which are spread across a range of banks for up to the amount of the guarantee.

Initial investigations suggest that these are not likely to be the case. The view is expressed that depositors with larger deposits are likely to be able to assess the credit ratings of the institutions where they are depositing funds: larger deposits will tend to gravitate towards larger institutions, as at present. Also, the number of eligible DTIs in New Zealand is much smaller than in the USA, which would limit the extent to which large deposits could be split among a range of institutions.

We can also look at what happens in other markets internationally. I am not aware of brokered deposits as a phenomenon in markets other than the USA, although this would be less likely to be an issue in Australia because of the much higher level of deposit coverage. We also do not generally find any sign of premiums being advertised for deposits that are above the limit of insurance coverage, although there may be practical reasons for this, as advertising such a premium would be in indication to the market of the probability of default, something which deposit takers would not generally want to promote. Banks will, however, sometimes suggest a discount for significantly larger deposits, because of the implications of large deposits for liquidity management, particularly when seeking compliance with regulation under Basel III.

This is not quite the whole story, however. Rates on large certificates of deposit, particularly in the United States, are established by negotiation between the bank and the depositor, and as Hannan & Hanweck (1988) note, the rates are impacted by bank risk. That would be likely to continue to be the case, and we would expect that to apply in New Zealand as well. Higher (or lower) rates for such large deposits should be expected to be negotiated between the bank and the depositor, although certificates of deposit are a relatively small part of New Zealand bank funding (and are generally only issued by the largest banks).

Because there is limited prior experience, and because that experience was in a crisis period, there is considerable uncertainty about the impact of the new deposit guarantee scheme on the New Zealand deposit taking sector. I think it is reasonable to assume that it will lead to some closing of the spread that currently exists between institutions, and between the banks and the non-bank deposit takers in particular. If there are significant flows of funds, they are more likely to be from people who are looking to reduce large exposures to single institutions, although this has the potential to be upset by mispricing, or by unexpected news for any members of the scheme.

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