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### The Treasury: Implementing and Managing the Crown Retail Deposit Guarantee Scheme

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Performance audit report

# The Treasury: Implementing and managing the Crown Retail Deposit Guarantee Scheme





Office of the Auditor-General  
PO Box 3928, Wellington 6140

Telephone: (04) 917 1500  
Facsimile: (04) 917 1549

Email: [reports@oag.govt.nz](mailto:reports@oag.govt.nz)  
Website: [www.oag.govt.nz](http://www.oag.govt.nz)

# The Treasury: Implementing and managing the Crown Retail Deposit Guarantee Scheme

This is the report of a performance  
audit we carried out under section  
16 of the Public Audit Act 2001

September 2011

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## Auditor-General's overview

On Sunday 12 October 2008, at the peak of the global financial crisis, the Government decided that it needed to implement a form of retail deposit guarantee scheme to avoid a flight of funds from New Zealand institutions to those in Australia. It needed to do this urgently: the Crown Retail Deposit Guarantee Scheme (the Scheme) was designed and announced that same day.

The Scheme offered a Crown guarantee over the money that people deposited or invested with financial institutions – specifically banks and “non-bank deposit takers”, which is a group that includes finance companies and savings institutions (such as building societies and credit unions). If a financial institution in the Scheme failed, the Crown would repay all of the money that eligible people had deposited or invested, up to a cap of \$1 million each.

This was a major decision in both financial and policy terms. In financial terms, this decision resulted in the Crown guaranteeing up to \$133 billion in investor funds. In policy terms, it was a significant departure from the longstanding setting in New Zealand of minimal state intervention in the market. However, the Government considered the Scheme necessary to maintain depositor and public confidence in our financial markets.

I considered it important to tell the story of this Scheme, because it was so significant to our economy and because it was designed and implemented with such speed. After any crisis, there is value in pausing to reflect on how the response was managed and what lessons can be learned.

Our report does not question the policy choices made by the Government as the Scheme was developed. Nor does it look at how private sector finance companies were managed. That is not the Auditor-General's role. My focus is on the work of public sector organisations. We therefore carried out a performance audit of the Treasury's implementation and management of the Scheme that the Government had decided on. Inevitably, for something this complex and urgent, we found a mixed picture.

Overall, the Scheme achieved its goal. No banks in New Zealand failed, and there was no run on banks. Many of the other finance institutions also survived the global financial crisis. The economy was stabilised.

However, there have been costs. Nine finance companies in the Scheme failed, causing the Crown to pay out about \$2 billion to depositors. It will be some time before the various receiverships are completed and the total amount recovered from the finance companies is known. Expected recoveries are currently estimated at about \$0.9 billion.



At a practical level, implementing the Scheme proved to be challenging. It was a major project, and a significant change from the Treasury's usual work. The speed with which the Scheme was introduced, the scale of it, and its importance to the country's economy all demanded a disciplined project management approach.

The early months of the Scheme were undoubtedly busy, and the first few weeks were hectic. The initial focus was on getting the application system up and running, and starting to process applications. This task was important for instilling confidence in the economy quickly. The Treasury's work to put the Scheme in place, quickly and under significant pressure, is commendable.

However, this task was done at the expense of setting up good governance arrangements for the overall management of the Scheme and planning for the rest of the work that would be needed. In my view, the Treasury should have been doing both. Those early and very busy months were also when stronger governance frameworks, escalation procedures, and strategic management were needed most.

The lack of overall governance meant that there was no coherent strategic overview to inform the evolving thinking and work on individual tasks. This affected:

- the practical work needed for the successful operation of the Scheme;
- the approach taken to managing the Scheme's major risks, and
- how and when the hastily put-together Scheme was reviewed and refined over time.

### **Practical work needed**

Most of the practical challenges that arose, and required swift responses, were predictable. Some had been identified as a need in early notes or meetings, but had not been picked up and turned into a stream of work. Others could have been identified if the Treasury had made contact with its overseas counterparts that had substantial experience in running such schemes.

For example, at a very early stage the Treasury had identified operational matters it would need to address, such as how to resource and manage the claims process, monitoring successful applicants, the Treasury's own monitoring and reporting requirements, the payout process, and how the Crown might recover funds from failed financial institutions. However:

- Planning for payouts did not start until late February 2009, only one week before the first finance company failed. Many people told us the Crown was lucky that this first failure was not a large finance company.

- The Treasury waited for monitoring data to arrive from the Reserve Bank of New Zealand rather than planning for its arrival and working out what to do with the information once it arrived. The Treasury should have prepared a monitoring work stream to run concurrently with the application process.

In essence, the Treasury remained in a reactive mode for too long, responding to needs as they emerged, rather than systematically anticipating and preparing for the next eventuality.

### Managing the Scheme's risks

From the outset, the advice from officials recognised that the decision to include finance companies in the Scheme carried significant risk. Once deposits with these companies were guaranteed, depositors could safely move investments to where they would get the highest return, irrespective of the risk of company failure. The finance companies also had less reason to minimise risk in their investment activity. The Crown was carrying much of this risk.

During 2009, the Treasury watched some of that behaviour eventuate. Deposits with finance companies under the Scheme grew, in some instances significantly. We saw one example where a finance company's deposits grew from \$800,000 to \$8.3 million after its deposits were guaranteed. At South Canterbury Finance Limited, the deposits grew by 25% after the guarantee was put in place.

From mid-2009, the Treasury was closely monitoring these changes and the individual companies that were identified as being at risk. However, it was largely doing so to prepare for potential payouts. It did not see itself as able to interact with a finance company to attempt to moderate that behaviour, even when it could see the Crown's potential liability increasing markedly. The view appeared to be that it was better to recover what funds it could after an institution failed, than try to influence events before a failure.

In my view, this approach relied too heavily on the presumption of minimal intervention and gave insufficient weight to the need to manage the overall potential cost to the Crown. The presumption of minimal intervention had already been weakened when the Crown introduced the Scheme. Although the Scheme's primary objective was to secure depositor and public confidence, and it was accepted that this would involve a significant cost, financial prudence should still have been a significant consideration. There was still some capacity to manage risk within the Government's policy settings.

We did not see evidence of the growing financial risks being considered at a strategic level or informing the Treasury's ongoing policy analysis and advice to

Ministers on options. Although there were ongoing discussions with Ministers about policy settings, we did not see evidence of strategic analysis of the range of options alongside the unfolding risks. In particular, we consider the evidence of increasing deposits and liability should have prompted more policy work.

We saw the same approach in how individual applications were considered. In our view, further enquiries could have been made of some financial institutions as part of the application process. The Treasury and the Reserve Bank of New Zealand did not seek additional information in the early days of the Scheme, because they were squarely focused on the objective of depositor confidence. At that time, managing the size of the Crown's potential liability was not the primary concern.

Although we cannot say definitively that more immediate close monitoring would have reduced the overall cost to the Crown, closer monitoring could have helped identify risks for earlier consideration and possible management.

### Reviewing and refining the Scheme

Problems began to emerge as the Scheme was implemented. Some were caused by constraints when the Scheme was introduced, such as having to use contractual guarantees under the Public Finance Act 1989 rather than new legislation. Other problems had not been foreseen at the start, such as that the Crown would be liable for interest that continued to accrue on deposits after a finance company had failed and before payouts were made.

Problems were to be expected for a Scheme that was put together with such haste. In my view, the Treasury should have recognised this from the outset, and established an ongoing work stream for identifying problems and providing advice on options for addressing them. This work did not begin until 2009. However, the Treasury did then take steps to improve the effectiveness of the Scheme. It was later modified twice in ways that addressed many of the problems.

### Our overall conclusion

All entities, at some point or another, are faced with unexpected situations that necessitate a crisis response and major change. When these situations occur, the challenge is to respond to the immediate operational needs while at the same time setting up the strategic oversight and governance arrangements that will carry the entity through the rest of the crisis and its aftermath.

With the Crown Retail Deposit Guarantee Scheme, the Treasury repeatedly responded well to the immediate operational needs. It achieved this despite difficult circumstances, including the fact that Parliament was dissolved for a general election, there was a change of government, and it was simultaneously

responding to other aspects of the global financial crisis. However, it did not appreciate how important it is to “get ahead of the wave” as quickly as possible, to maintain a clear and comprehensive view of the strategic picture and start to plan and manage accordingly. The Treasury tells me that it has learned from the experience, and is now taking a more structured approach to crisis situations.

I thank the Treasury and the Reserve Bank staff for their co-operation during this performance audit. I would also like to thank the individuals in other organisations who contributed to our work. Although the views in this report are those of my Office, I would like to acknowledge the substantial assistance provided by Promontory Financial Group Australasia with this work.

A handwritten signature in black ink, appearing to read 'Lyn Provost', written in a cursive style.

Lyn Provost  
Controller and Auditor-General

29 September 2011

## Our recommendations

At its peak, the value of deposits covered by the Crown Retail Deposit Guarantee Scheme was \$133 billion. This is nearly twice the amount the Government spends in a year, or about two thirds of the value of New Zealand's total annual production (gross domestic product).

An initiative of this size and complexity necessitated formal and comprehensive management disciplines, complete with detailed planning and appropriate governance, management, and reporting frameworks.

We make the following recommendations because other large and complex initiatives necessitating rapid implementation will eventuate:

1. We recommend that the Treasury prepare a project planning framework to help the Treasury to implement large and complex initiatives. The framework should include an approach to crisis management planning and strong internal governance processes to ensure that appropriate senior managers are actively involved in the strategic direction of important aspects of policy implementation. These processes should include clear accountabilities, roles, and responsibilities for deciding and implementing policy.
2. We recommend that, for large and complex initiatives managed by the Treasury, the Treasury put in place a monitoring, escalation, and reporting framework that is agreed with the Minister of Finance and refined over time. This framework should require clear documentation of important implementation decisions and processes and provide for suitable formal reporting of results and emerging risks within the Treasury as well as to the Minister of Finance and other stakeholders.
3. We recommend that the Treasury carry out a formal post-project review after it implements any significant policy initiative. The review should be timely, independent, and sponsored by a senior official or committee within the Treasury. The findings of the review should be discussed and implemented where appropriate.
4. We recommend that the Treasury and the Reserve Bank of New Zealand document the analysis and thinking by the Treasury during its consideration of how to deal with South Canterbury Finance Limited. This could take the form of a framework for dealing with distressed institutions. The distressed institutions framework could set out possible courses of action for dealing with an institution, including deterrent processes, actions to take in the event of failure, the roles and responsibilities of regulatory agencies, and the communications that need to occur between agencies.

## Background

In October 2008, at the peak of the global financial crisis, the Government needed to very quickly implement a form of retail deposit guarantee scheme or risk a flight of funds from New Zealand institutions to those in Australia. The Crown Retail Deposit Guarantee Scheme (the Scheme) was designed during the course of, and announced in the evening of, Sunday 12 October 2008.

The Treasury and the Reserve Bank of New Zealand (the Reserve Bank) were jointly responsible for advising Ministers on the design of the Scheme. The Treasury was responsible for implementing and managing it.

The Scheme offered a Crown guarantee over the money that people had deposited or invested with financial institutions – specifically banks and “non-bank deposit takers” (NBDTs), which is a group that includes finance companies and savings institutions (such as building societies and credit unions). The Scheme was originally set up to last for two years, but revisions to the Scheme have meant that it now ends on 31 December 2011.

Financial institutions that were eligible for the Scheme needed to apply to the Treasury. If an institution accepted into the Scheme failed during the term of the Scheme, the Crown would repay depositors of that institution. The Crown would then rely on receivership processes to recover funds from the failed institution.

We carried out a performance audit of the Treasury’s implementation and management of the Scheme, given its economic and financial significance. Introducing the Scheme required the Treasury to play a larger operational role than it had historically played.

We considered all types of financial institutions covered by the Scheme when reviewing the Treasury’s implementation of it. However, we spent the most time reviewing the implementation as it related to finance companies. Including finance companies in the Scheme was controversial, and more complex than for other types of financial institution, because of their higher risk profile.

In terms of achieving the Scheme’s objectives, we record that:

- Ninety-six institutions were accepted into the Scheme (60 NBDTs, 12 banks, and 24 collective investment schemes).
- No banks accepted into the Scheme failed, and there was no run on the money in banks.
- No building societies or credit unions accepted into the Scheme failed.
- Of the 30 finance companies accepted into the Scheme, nine have failed since the Scheme was introduced.

- The Crown has paid out about \$2 billion to more than 42,000 depositors, and depositors received 100% of their entitlements up to the date of failure. The Crown expects to recover about \$0.9 billion after the receiverships and liquidations of failed companies are resolved.
- Investor confidence was maintained or improved during the term of the Scheme.

A recurring theme of our audit findings is that the Treasury should have started planning for the necessary implementation and operational activities in the weeks after the Scheme's introduction.

### **About finance companies**

Although finance companies hold less than 3% of the assets in the financial sector, they are considered important to the economy because they service sectors of the economy not serviced by other types of institutions.

Many finance companies experienced significant problems in the years leading up to the introduction of the Scheme. Their problems were compounded by the funding pressures and investor uncertainty that characterised the global financial crisis.

The Government had recognised, before the Scheme was introduced, that finance companies and other NBDTs needed a stronger regulatory framework. Several changes have occurred during the past few years to increase the regulatory oversight of finance companies, including the appointment of the Reserve Bank as regulator and the introduction of prudential requirements. These changes have been phased in since September 2009.

### **Comparisons with other countries' guarantee schemes**

Before the global financial crisis, New Zealand was the only country in the Organisation for Economic Co-operation and Development (OECD) without any sort of statutory depositor insurance or depositor preference arrangement. Introducing a deposit guarantee scheme represented a material departure from New Zealand's long-standing approach to supervision and regulation – an approach that favoured minimal intervention in the financial system and market-based solutions, supported by good disclosure requirements.

To the extent that it made sense to do so, we used international benchmarks and principles to carry out this audit. However, given New Zealand's unique minimal interventionist approach, no set of international benchmarks provides an adequate frame of reference against which to assess the Treasury's

implementation of the Scheme. New Zealand applied a less intrusive and disclosure-based regime to banks than did most other OECD countries.

## Introducing the Crown Retail Deposit Guarantee Scheme

By October 2008, several other countries had already responded to the global financial crisis by guaranteeing deposits in their countries. On 10 October 2008, the Treasury reported to the Government that such a scheme was not needed here, but the Treasury would continue to work out what might be needed should circumstances change. Two days later, Australia said that a scheme there was imminent. Officials here believed that, if the Government did not act quickly to implement a similar scheme, depositors would transfer funds from New Zealand to Australia, adding to the difficulties faced by New Zealand financial institutions and the broader economy.

The Treasury and the Reserve Bank had to work with Ministers to finalise the design of the Scheme quickly. Some work had been done already (to produce the 10 October 2008 report), but there was limited opportunity to fully explore the consequences of the various policy options available – such as which types of financial institutions would be offered the guarantee, and how much they would pay the Crown for the guarantee. The Treasury would later discover that the design of the Scheme presented some challenges for its implementation.

As part of the initial design, the Government decided that the Scheme would cover all banks and all NBDTs that met some basic eligibility criteria. It was recognised that including NBDTs would increase the potential cost to the Crown and the likelihood that the guarantee would be invoked. It could also encourage depositors to shift deposits from banks to NBDTs, where rates of return and risks were higher. Although the NBDT sector was small enough that it was unlikely to significantly affect overall confidence in the economy, excluding them would trigger a flow of funds from NBDTs to the banks. The Government's thinking was that this might cause the failure of a sector that was important to the diversity of the financial system. Including NBDTs meant that the Scheme guaranteed a broader range of financial institutions with a higher risk profile than most guarantee schemes elsewhere in the world.

Although the Scheme was broadly designed and announced on October 12, detailed design matters were refined in the weeks that followed to ensure appropriate Scheme coverage, pricing, and obligations on NBDTs. Policy Guidelines were also issued, setting out the criteria that might be considered by the Treasury when assessing applications for the Scheme.



The design of the Scheme saw the Crown acting as a guarantor. The Crown assumed the responsibility for repaying investors' deposits if financial institutions covered by the Scheme failed. The Scheme did not guarantee the solvency of those financial institutions.

The purpose of the Scheme was to maintain the confidence of depositors and the public in the financial system. There was no explicit reference to the need to minimise the Crown's liability. Including this as an explicit objective could have contradicted the urgent need for depositor and public confidence.

However, we consider it reasonable to assume that the Crown's liability was an important long-term consideration for the Treasury, because the Treasury manages the Crown's finances. Fiscal prudence was explicitly addressed in the design of the Extended Scheme, because many of the changes were aimed at minimising the Crown's liability (such as excluding interest payments after a guaranteed financial institution failed, and reducing the liability cap).

The Treasury faced a challenging environment in the early period of the Scheme. Parliament had risen; there was a general election then new Ministers and a new government. Work on a wholesale scheme was also under way, and there were lots of uncertainties in international financial markets.

## Planning and governance and reporting frameworks

The work the Treasury did to put the Scheme in place quickly, and under significant pressure, is commendable. It met the objective of maintaining public and depositor confidence. However, we consider that the Treasury should have carried out formal and documented planning early in the Scheme to ensure that all of the necessary processes and activities were rigorously developed and implemented. This should have included planning for processing applications, monitoring the financial institutions in the Scheme, monitoring the Scheme's performance, and payout processes. Formal, documented planning for many of these activities did not start until March 2009. Even then, much seems to have been done reactively and in response to immediate needs.

The Treasury did not start to intensively monitor individual financial institutions until March 2009. Earlier and intensive monitoring would have helped with earlier provisioning (being clear about the potential cost of paying out depositors of institutions that were considered likelier to fail) in the financial statements of the Government and understanding of the Crown's risk.

Similarly, planning for payouts started a week before the failure of Mascot Finance Limited in March 2009. The Treasury's analysis of possible payout solutions should

have happened in late 2008, instead of being finalised in late 2009. Planning the communications that would be needed if an institution failed should also have been done earlier. The Crisis Response Plan that was written in late 2009 should have been prepared before the first financial institution failed.

In our view, the Treasury should have established stronger governance and reporting frameworks for the Scheme. We found no evidence of formal senior management oversight, such as a steering committee, to provide senior strategic direction and to ensure that all aspects of the Scheme's implementation were addressed. More formal frameworks would have included clear roles and responsibilities for implementation and clear accountabilities for making decisions.

We expected a gap in documentation in the hectic early weeks after the Scheme was introduced, but the documentation deficiencies continued for too long. Some initial planning took place, but we saw little evidence of formal implementation planning discussions or documentation of important decisions and processes.

The Treasury told us that it is now taking a more structured approach in its response to crisis situations (such as its work on government support for AMI Insurance Limited).

## Processing applications

The focus for the Treasury in the first few months of the Scheme was processing the applications from individual financial institutions. The applications process was well defined and well documented, with input from the Reserve Bank and the trustee of each financial institution but with the Treasury deciding whether to approve or decline an application. The criteria to assess applications were documented and in line with the policy decisions about the Scheme's introduction.

However, there was some confusion about the interpretation of certain aspects of the criteria. The Policy Guidelines provided for "other factors" that could be considered in exercising discretion to offer the guarantee (including size, creditworthiness, related-party exposures, and business practices). These "other factors" could be used to decline an application. There was some initial confusion about how to apply these "other factors".

Some financial institutions were declined because they failed to meet the criteria. For example, some applicants were not deposit-takers, had complex structures, or were in a moratorium (that is, they were suspended from activity as part of a creditor arrangement). However, no applicant was refused in the first few months

of the Scheme based on the “other factors”, such as creditworthiness or business practices.

Although we accept the need to process applications quickly, we consider that the Treasury should have made further inquiries about some financial institutions before accepting them into the Scheme. We did not see evidence that the Treasury sought additional information in the early days of the Scheme, even though there may have been some indications in the material considered that additional review was warranted. We are not suggesting that these institutions should have been immediately declined, but further review would have placed the Treasury in a better position to understand the risks presented by these institutions.

Although it was consistent with the supervisory model, we were surprised by the degree of reliance on the advice of trustees.

Applications processed after the failure, in March 2009, of Mascot Finance Limited were more closely considered in terms of riskiness of the institution. The “other factors” became more of a focus and a number of institutions were declined based on their higher probability of failure. The Treasury told us that this change in focus reflected the fact that, by this time, the remaining applicants were generally higher-risk institutions.

At this time, there was an easing of external conditions and the Treasury started to receive reports on individual institutions from the Reserve Bank. The need to minimise the cost to the Crown also began to be emphasised within the Treasury. Although this change in emphasis was probably warranted, we consider that it was a change that should have been actively discussed, formally documented, and reported to the Minister.

## Assessing the performance of the Scheme

During the course of the Scheme, design issues emerged that made its implementation difficult. A small number of these were predicted on or before the Scheme’s introduction. Most design issues emerged only as the Scheme evolved. These issues included market distortion (significant growth in NBDT deposits), complicated depositor eligibility criteria (which depositors would be paid as part of the payout process), payment of interest after a financial institution failed, use of contracts, lack of Treasury powers, and the funding maturity wall (at the end date of the Scheme). Starting in 2009, the Treasury carried out much research into ways to improve the Scheme and was assessing various aspects of the Scheme’s performance.

We have not seen evidence that this research included discussions with overseas counterparts. Before the Scheme was introduced, New Zealand had neither depositor protection nor deposit insurance provisions. It would have been useful for the Treasury to contact its overseas counterparts, such as in the United States of America or the United Kingdom, about their experiences in implementing a deposit insurance scheme.

The Treasury's process for reviewing Scheme changes was otherwise comprehensive and carefully deliberated but, as noted earlier, could have benefited from a more structured approach. For example, the Treasury did not analyse NBDT deposit growth until March 2009, and we saw no evidence of the analysis being reported and escalated. Deposits with many of the NBDTs increased significantly in the first few months of the Scheme (deposits of South Canterbury Finance Limited increased by more than 25% to February 2009 before levelling off). A well-defined monitoring framework would have ensured that the Treasury was aware of this growth and the consequential risk exposure, and that the issue was reported and escalated.

The Treasury's powers were consistent with a policy against direct involvement in the management of guaranteed institutions. This was in line with New Zealand's longstanding minimal intervention approach to regulation and supervision. The strongest power was the ability to withdraw the guarantee. However, the use of the withdrawal power had to be carefully considered and it affected only deposits made after the date of withdrawal (deposits made up to the date of withdrawal continued to be covered by the guarantee).

The Treasury was responsible not only for implementing the Scheme but also for giving ongoing policy advice to Ministers on possible ways of enhancing the Scheme. Although there were ongoing discussions with Ministers about policy settings, we did not see evidence of strategic analysis of the range of options alongside the unfolding risks. In particular, we consider the evidence of increasing deposits and liability should have prompted more policy work. For example, early in the Scheme, the Treasury could have considered whether it might need additional powers to ensure the effectiveness of the Scheme. These might have included powers to issue directions, restrain activities, require extra capital, or improve risk management practices. We understand that imposing constraints on weak institutions to stop them making their financial exposures worse was a common feature of deposit guarantee schemes in other countries.

Decisions about any powers the Crown wanted to have available, and the level of intervention in the market, were policy choices that needed to be carefully considered. It is not our role to form a view on whether more or less intervention

was appropriate. However, we were concerned that we did not see evidence of detailed policy analysis informed by overseas models and assessments of the emerging risks.

We note that there were some changes made to improve the effectiveness of the Scheme and the terms and conditions of the Scheme were twice modified (by way of the Revised and Extended Schemes). The problem of the Crown needing to pay interest to depositors after an institution failed was addressed in part by changes to the Revised Scheme, and fully addressed by being explicitly excluded from the Extended Scheme. Similarly, issues with the use of contracts were addressed in the Extended Scheme through legislation. A number of changes were made to the (Revised and Extended) guarantee deeds to address concerns with the lack of Treasury powers under those deeds. The Extended Scheme introduced risk-based fees for all deposits and a lower liability cap.

## Monitoring individual institutions

One of the Treasury's important roles was monitoring the individual institutions covered by the Scheme. The Reserve Bank was contracted to help the Treasury by providing regular reports based on information it was receiving from the institutions (through the trustee). The Reserve Bank prepared templates to collect this information and models to analyse the results. The Reserve Bank provided the Treasury with reports that included a risk-ranking report, sector reports, and detailed individual analysis for higher-risk institutions.

The Treasury also reviewed information from other sources, including financial accounts, prospectuses, ratings reports, and general intelligence from regulators and market participants. The Treasury and the Reserve Bank worked collaboratively and were in frequent contact. Ultimately, the Treasury decided what an institution's risk ranking was and what the Treasury's response should be. The Treasury also asked for additional details from individual institutions as well as other third parties (such as auditors and trustees). From March 2009, the Treasury began to request additional details from a number of high-risk institutions and directors were asked to attest to the financial positions by providing directors' certificates.

The Treasury could, under the guarantee deed, appoint an inspector and would use this option if it had concerns about the information it had received or required additional detail. The first short inspection was in March 2009, with six more comprehensive inspections carried out during June and July 2009. During the Scheme, 12 institutions were inspected. The Treasury's use of inspectors was effective and the Treasury maintained close contact with inspectors.

The monitoring framework eventually implemented by the Treasury, which included reporting provided by the Reserve Bank, inspections, and the Treasury's analysis from other sources, was for the most part effective. It provided the Treasury with sufficient financial details on individual institutions to assess which institutions should be asked for additional information. Most of the institutions that triggered the guarantee were identified by the Treasury as having a high risk of failure at least three months before they failed. From March 2009, the Treasury was proactive in its analysis and review of the institutions and its search for additional evidence. The Treasury used a wide range of information sources and did not rely solely on the Reserve Bank's monitoring reports.

Monitoring under the Scheme had only just started when the first failure occurred in March 2009 (almost five months after the start of the Scheme). As soon as the Scheme was announced, a monitoring work stream should have been prepared to run concurrently with the application process. There was a long history of finance company failures and another failure was, in our view, predictable. If the monitoring process had started earlier, inspectors may have been appointed earlier and resulting actions potentially brought forward. Although we cannot say definitively that more immediate close monitoring and careful management of risk exposures would have reduced the overall cost to the Crown, closer monitoring could have helped identify risks for earlier consideration.

A similar comment applies to the quantification of the Crown's potential exposure for the purpose of including provisions in the financial statements of the Government. Once started, the provisioning process was well defined, with sufficient governance and amounts carefully analysed. However, this process started too late, both in terms of disclosure and in terms of active analysis of the institutions that had a high likelihood of failing.

The Treasury had several difficulties when monitoring. These included data accuracy (often addressed by the appointment of inspectors) and delays in receiving information (this improved as the Scheme progressed). The Treasury relied heavily on the models developed by the Reserve Bank. In our view, there should have been stronger governance processes for the use of those models within the Treasury, including independent review and validation.

## Payout processes

Nine finance companies accepted into the Scheme have failed, the first in March 2009, another in April 2009, six in 2010 under the Revised Scheme, and one in 2010 under the Extended Scheme.

There is evidence that planning for payouts had started in the week before Mascot Finance Limited failed in March 2009, but not earlier (although we were told that this was discussed in late 2008). Once the Treasury was aware of the pending failure, it responded quickly to ensure that the payout process was smooth. Several issues complicated the claims processing, including complex depositor eligibility criteria and the payment of interest to depositors from the date that the institution failed. Although the Treasury contracted in additional resources and payments were timely, if a large institution had failed in March 2009 the Treasury would have been caught unprepared and it would have taken significant effort to produce a workable solution.

In our view, the Treasury learned valuable lessons from the experience of the Mascot Finance Limited payout, and applied this knowledge successfully to improving the outcomes for future payout processes. The Treasury's experience with Mascot Finance Limited highlighted the need for a more robust and scalable payout solution. The Treasury comprehensively analysed what was needed and explored a number of options. An outsourcing arrangement was set up in late 2009 for Computershare Investor Services Limited to set up adequate systems and then process any claims as they occurred. All payouts after the first two failed institutions were made using this outsourcing model. The use of the outsourcing model was a sound decision and contributed to an efficient payout process.

South Canterbury Finance Limited's failure on 31 August 2010 presented more challenges because there were so many deposits and the potential for interest payments to significantly increase costs. Effective monitoring of South Canterbury Finance in the months leading up to its eventual failure provided ample warning of the failure and an opportunity to analyse and consider alternative payout approaches. The Treasury used this early warning to extensively analyse how to simplify the payout process and reduce the Crown's liability. A decision was made to pay both eligible and ineligible depositors in full on the day of the receivership (through the trustee) and to pay prior-ranking creditors to simplify the funds recovery process. Ineligible depositors of all institutions that had failed already were also paid in full. The Treasury's analysis was comprehensive and the outcome effective, likely resulting in significant savings to the Crown.

## Communicating information about the Scheme

In the early weeks of the Scheme, there was considerable effort to ensure that the public was aware of the Scheme and the policy decisions made to refine its design. There was a call centre and regularly updated information on the Treasury's website. In our view, this disclosure was adequate and timely.

Information about later aspects of the Scheme was also made available through the Treasury's website, including:

- a list of institutions approved under the Scheme, along with their guarantee deeds;
- details about changes to the Scheme for the Revised and Extended Schemes (in particular, timely and comprehensive information about the reasons for extending the Scheme, the implications of the various options, and the final design features); and
- details about institutions that had failed under the Scheme, the process for making a claim, progress with payouts to depositors, and the amount of repayments made.

In most instances, the amount and quality of information provided was useful and timely, but it was not always well organised or easy to find.

Information to Parliament (through the Minister of Finance) in the early weeks of the Scheme was comprehensive, providing adequate and timely background details and supporting analysis for the various policy design issues as they emerged. We did not see evidence that this level of disclosure was maintained between the early weeks of the Scheme and the first failure under the Scheme. However, we accept the Treasury's assurance that the Minister was kept informed, and note that Parliament was dissolved for the general election for some of this period.

Information to the Minister of Finance and Parliament on the options for an Extended Scheme was timely, effective, and of a high quality.





# Part 1

## Introduction

- 1.1 In this Part, we set out:
- the focus of our performance audit;
  - how we carried out our audit;
  - what we did not audit; and
  - the structure of this report.
- 1.2 On 12 October 2008, the Government announced that it was setting up a Crown Retail Deposit Guarantee Scheme (the Scheme) to assure the public that the money eligible people had deposited or invested (up to a \$1 million cap each) with particular financial institutions was safe. If the financial institution failed, the Crown would repay the money that people had deposited or invested. The Crown would then try to recover funds from the failed institution as part of the receivership or liquidation process.
- 1.3 We carried out a performance audit of the Treasury’s implementation and management of the Scheme, given the Scheme’s significance for our economy at the time and the amount of money involved.
- 1.4 The Scheme was introduced in response to the uncertainty caused by the global financial crisis and a risk that the public could lose confidence in New Zealand’s financial institutions. The Scheme was an emergency measure, implemented quickly at a time when the risk of our financial system ceasing to operate effectively was high and there were concerns about cash being withdrawn from New Zealand banks.
- 1.5 The Scheme covered banks, collective investment schemes, and non-bank deposit-taking institutions (NBDTs). It was to run until 12 October 2010 (that is, for two years). At the time of its introduction, banks and NBDTs in New Zealand held about \$140 billion in retail deposits.<sup>1</sup>
- 1.6 The Scheme was set up as an “opt-in” agreement between the Crown and a financial institution. Financial institutions could apply to join the Scheme and had to meet certain eligibility criteria to be accepted.
- 1.7 The Scheme was revised on 1 January 2010 to make it more flexible and manage risks to the Crown. It was extended under more stringent conditions on 12 October 2010, to ensure that no institutions failed because the Scheme ended too soon. The Scheme now runs until 31 December 2011. These changes are sometimes important to the discussion in this report, so in places we refer

1 “Retail deposits” means money held on behalf of individuals, in contrast to “wholesale deposits”, which means large deposits typically received from corporations, governments, or other financial institutions. See the Glossary for fuller explanations of the terms used in this report.

specifically to the Revised Scheme (between 1 January 2010 and 12 October 2010) and the Extended Scheme (between 12 October 2010 and 31 December 2011).

- 1.8 The Treasury and the Reserve Bank of New Zealand (the Reserve Bank) were jointly responsible for advising Ministers on the design of the Scheme, including its objectives. The Treasury was responsible for the Scheme's overall implementation, and for accepting financial institutions into the Scheme. It was also responsible for monitoring the institutions that were in the Scheme. The Treasury contracted the Reserve Bank to monitor financial institutions and report relevant matters to the Treasury. The Reserve Bank was also contracted to advise the Treasury whether institutions applying for the Scheme met the criteria set by the Minister of Finance (the Minister).
- 1.9 To date, nine NBDTs – all finance companies – accepted into the Scheme have failed (see Figure 1). At the time of writing, the Crown had paid out about \$2 billion to more than 42,000 depositors. The money recovered after receiverships or liquidation was estimated in April 2011 to be \$0.8 billion. Recoveries were estimated at \$0.9 billion as at 30 June 2011. Depositors received the full amount of their entitlements. As at 30 June 2010, the Crown had collected \$237 million in fees from institutions covered by the Scheme.

### The focus of our performance audit

- 1.10 Because of the technical nature of the material considered, we sought the help of specialist advisory services firm Promontory Financial Group Australasia, which is based in Sydney.<sup>2</sup> We chose an offshore firm because all specialist advisory firms with offices in New Zealand had potential conflicts of interest in commenting on the Scheme. Promontory Financial Group had no involvement with the Scheme.
- 1.11 We have examined how effectively and efficiently the Treasury has implemented and managed the Scheme, including how well the Treasury:
- identified and monitored the risks to the Crown posed by financial institutions covered by the Scheme;
  - identified and assessed how well the Scheme has met its objectives;
  - attempted to improve the Scheme based on the findings of its monitoring and policy advice; and
  - explained the purposes and functions of the Scheme to Parliament and to the public.

<sup>2</sup> Promontory Financial Group is an international organisation that provides expertise in a range of financial and regulatory fields, including consultation on regulatory requirements, risk management, and implementing global and national financial services regulatory policy. The consultants we used have expertise in risk management, financial regulation, and central and other banking.

**Figure 1**  
**Failures of nine finance companies covered by the Crown Retail Deposit Guarantee Scheme**

Company	Date of entry	Date of failure	Amount paid out to date*
Allied Nationwide Finance Limited	19 November 2008	20 August 2010	\$131.0m
Equitable Mortgages Limited	4 December 2008	26 November 2010	\$140.2m
Mascot Finance Limited	12 January 2009	2 March 2009	\$70.0m
Mutual Finance Limited	13 November 2008	14 July 2010	\$9.2m
Rockforte Finance Limited	20 February 2009	10 May 2010	\$4.0m
South Canterbury Finance Limited	19 November 2008	31 August 2010	\$1,580.3m
Strata Finance Limited	18 December 2008	23 April 2009	\$0.5m
Viaduct Capital Limited	13 November 2008	14 May 2010	\$7.6m
Vision Securities Limited	5 December 2008	1 April 2010	\$30.0m
<b>Total</b>			<b>\$1,972.8m</b>

Source: The Treasury.

Note: As at 30 June 2011. The Treasury expects to pay out a further \$37.3 million.

\* Includes interest payments after the institution failed and ineligible deposits. Note that some small payments remain outstanding because some deposits are yet to mature and some depositors cannot be traced.

- 1.12 An important aim of our audit was to provide Parliament and the public with an independent record of the history of the Scheme. Therefore, we have included in this report information about the origins of the Scheme, the important decisions that were made, and the main activities that the Treasury, the Reserve Bank, and the Government have carried out so far.
- 1.13 Although we considered all types of financial institutions covered by the Scheme, we focused on finance companies because of the significant payouts made under the Scheme in response to the failure of nine of these financial institutions.

## How we carried out our audit

- 1.14 To carry out our audit, we considered the main aspects of the Treasury's implementation and management of the Scheme:
- *Processing applications* – we looked at how the Treasury applied the criteria used to decide whether to accept an institution into the Scheme.
  - *Assessing and improving the Scheme* – we looked at whether the effects of the Scheme were effectively assessed against its objectives and whether the Treasury took steps to improve the Scheme as a result.
  - *Monitoring of financial institutions* – we considered whether the Treasury effectively monitored financial institutions and whether the Treasury's response to the results of the monitoring was adequate and timely.
  - *Payouts* – we looked at payout processes to assess whether these were efficiently managed to minimise Crown liability, as well as whether they facilitated timely and accurate payouts to maintain public confidence in the Scheme.
  - *Disclosure* – we considered the adequacy of explanations of the Scheme's purpose and functions to the public and to the Minister. We reviewed documents prepared by the Treasury and sent from the Minister to Cabinet. We also considered the Treasury's explanations about claims processes and payouts made under the Scheme.
- 1.15 We have not “benchmarked” the Treasury's performance against that of similar agencies overseas, because those other agencies were operating in quite different circumstances. Most comparable countries already had a form of guarantee or insurance scheme (several of which explicitly exclude interest payments after the date of any company failure) and had tighter regulation and monitoring of vulnerable institutions. In contrast, New Zealand officials have described the stance here before the Scheme was implemented as “non-interventionist” with a reliance on market factors to guide depositors' investment decisions.
- 1.16 We reviewed key documents, including:
- policy documents, media statements, and other documents that are publicly available on the Treasury and the Reserve Bank websites;
  - information releases on the Treasury and the Reserve Bank websites about South Canterbury Finance Limited (South Canterbury Finance);
  - monitoring reports provided by the Reserve Bank to the Treasury;
  - important internal Treasury documents such as guidelines, analysis and discussion papers, management reports, payout data, email and other correspondence, and service agreements; and

- Scheme application files containing documents about financial institutions applying to join the Scheme.

1.17 We also interviewed more than 20 current and former officials from the Treasury and the Reserve Bank as well as representatives of:

- trustee companies;
- Computershare Investor Services Limited (Computershare);
- New Zealand Companies Office (the Companies Office);
- Securities Commission;
- consumer groups and similar associations;
- financial institutions accepted into the Scheme; and
- other relevant parties involved with the Scheme, including advisors, receivers, liquidators, auditors, and investigators.

### What we did not audit

1.18 We focused on how the Treasury implemented and managed the Scheme. We did not consider in detail the financial and liquidity positions of financial institutions covered by the Scheme, the information they provided, or the risks that any individual financial institutions posed to the Crown. We also did not assess the risk measurement models used by the Reserve Bank and the Treasury to monitor these financial institutions, but we did consider how the Treasury used these models and the governance arrangements for them.

1.19 Our audit did not consider whether the Scheme was the most appropriate response to the global financial crisis as its introduction was a Government policy decision. We considered the Treasury's actions to suggest improvements to the Scheme, consistent with the Treasury's role as administrator of the Scheme, policy advisor to the Government, and guardian of the Crown's funds. These roles do not include directly making government policy decisions.

1.20 Although we considered the Treasury's actions to monitor the Crown's liability, we did not consider whether the provisions for payments of guarantees in the financial statements of the Government were adequate. We have already assessed and reported on this aspect of the Scheme through our annual financial audits of the Treasury.

1.21 We have not reviewed detailed operational matters, such as the accuracy of payout amounts, any prices financial institutions were charged to be part of the Scheme, or the processes set up to receive those fees.

- 1.22 Our Office has no mandate to audit private sector companies, so we have not examined in detail the finances of any of the financial institutions discussed in this report.
- 1.23 We have not examined the Wholesale Guarantee Scheme in any detail, but we mention it briefly in Part 3.

### Structure of this report

- 1.24 In Part 2, we describe the financial landscape and regulatory and supervisory framework in place before the Scheme was introduced. We focus on the experiences in the finance company sector leading up to the Scheme's introduction and the way the regulatory and supervisory framework for NBDTs has evolved in the light of these and other events.
- 1.25 Part 3 discusses the Scheme's introduction, providing some context for the initial policy decisions that were made. We describe the Scheme's objectives and look at why and how the Scheme was introduced. We also explain the changes that were made to the initial policy design during the first few weeks of the Scheme and set out our views on the Scheme's initial implementation.
- 1.26 In Part 4, we describe how financial institutions applied to be included in the Scheme, the criteria the Treasury used for accepting financial institutions into the Scheme, and the extensive work carried out to process the applications.
- 1.27 In Part 5, we describe some of the challenges presented by the policy design of the Scheme. We set out our views on how the Treasury assessed the overall performance of the Scheme against the Scheme's objectives. We also describe the changes that the Treasury made to the Scheme when it was revised and extended.
- 1.28 In Part 6, we consider the Treasury's monitoring of the financial institutions accepted into the Scheme and disclosure of the Crown's liability, and provide our views on the effectiveness of the monitoring process.
- 1.29 In Part 7, we look at the payout process the Treasury used to pay the depositors of the financial institutions that failed while under the Scheme.
- 1.30 The Appendix sets out a timeline of major events and decisions before and during the Scheme, and is followed by a Glossary of terms.

## Part 2

# Background

- 2.1 In this Part, we discuss:
- the financial landscape in New Zealand in the early 2000s; and
  - the regulatory and supervisory framework for banks and NBDTs.
- 2.2 In summary, in October 2008 the stability of banks (rather than other types of financial institutions) was most important to New Zealand. No banks failed in New Zealand during the global financial crisis.
- 2.3 The decision to include other institutions – NBDTs and, specifically, finance companies – in the Scheme was significant. Finance companies were regarded as a small but important source of lending to particular sectors of the economy, and some were important to particular regions. Forty-six finance industry entities (including 28 finance companies) had failed in the two years before the Scheme was introduced, and there were known weaknesses in the regulatory framework for NBDTs.

### Financial landscape in New Zealand in the early 2000s

- 2.4 The financial sector comprises registered banks, insurance companies, NBDTs, non-deposit-taking finance companies, and other financial institutions, such as collective investment schemes and superannuation funds. Of these, registered banks are by far the most financially significant (see Figure 2).

**Figure 2**  
**Types of institutions in the financial sector (and the value of the assets they hold)**

Type of financial institution	Value of assets held \$billion	Proportion of financial sector assets held %
Registered banks	373.0	79.0
Insurance companies	16.0	3.4
Non-bank deposit takers	13.2	2.8
Non-deposit-taking finance companies	9.7	2.1
Other financial institutions	60.0	12.7
<b>Total</b>	<b>471.9</b>	<b>100.0</b>

Source: Reserve Bank of New Zealand, Financial Stability Report, November 2010.

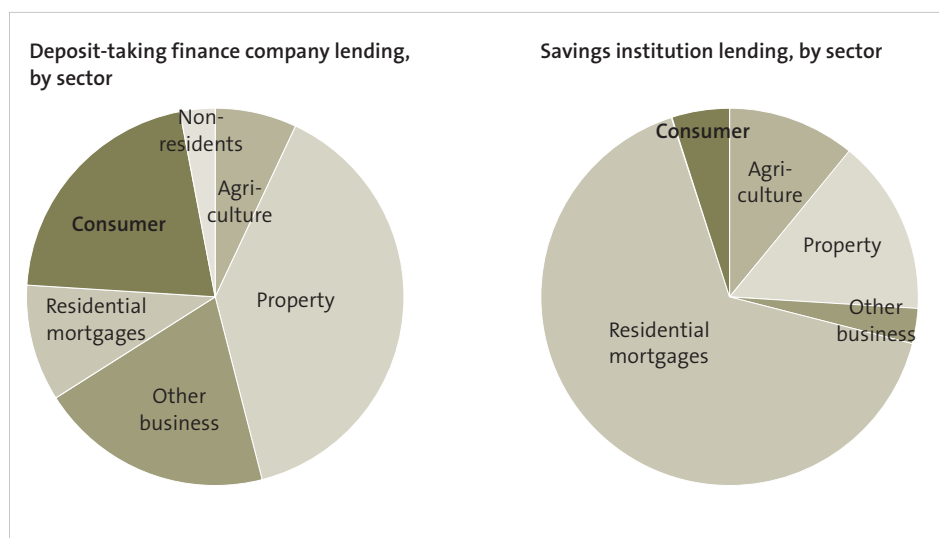
Note: The data is as at 30 June 2010 except for the insurance company data, which is as at 31 December 2008.

The Scheme did not cover insurance companies, non-deposit-taking finance companies, and most "other financial institutions".



- 2.5 Registered banks hold almost 80% of the sector's total assets. There are 20 registered banks in New Zealand, 17 of which are locally incorporated subsidiaries of foreign-owned banks. The five largest registered banks hold 84% of all 20 banks' assets.
- 2.6 NBDTs hold less than 3% of the assets held by the financial sector. NBDTs include savings institutions (such as building societies, PSIS Limited, and credit unions) and deposit-taking finance companies (finance companies). Most NBDTs are finance companies, and they have increased in number in the past decade alongside a boom in property development.<sup>3</sup>
- 2.7 Finance companies provide loans and/or financial services to different parts of the economy than other financial institutions. Although savings institutions tend to provide mostly retail lending (residential mortgage lending and personal secured lending), finance companies are often involved in more diverse lending activities, including motor vehicle and vendor finance, property development, and commercial and consumer finance (see Figure 3).

**Figure 3**  
**Comparison of savings institution loans and finance company loans (at June 2007)**



Source: Reserve Bank of New Zealand, NBDT Standard Statistical Returns, 2007.

Note: Comprises finance companies with assets greater than \$100 million.

<sup>3</sup> Of the \$13.2 billion of assets held by NBDTs in Figure 2, finance companies held \$9.4 billion, building societies and PSIS Limited held \$3 billion, and credit unions held \$0.8 billion.

## Problems experienced by finance companies

- 2.8 Figure 2 shows that finance companies are a small part of the financial system. However, Figure 3 shows that they play an important role in the economy by providing the public with alternative investment options, as well as lending to sectors of the economy often not serviced by savings institutions.<sup>4</sup> Problems in the finance company sector could affect the broader economy and some regional economies.
- 2.9 Some finance companies had been growing dramatically in the years leading up to the introduction of the Scheme, lending heavily to property developers and those in other higher risk sectors. Analyses of the reasons why some failed have shown that many finance companies did not have staff with adequate skills to make good lending decisions. Many also suffered from poor corporate governance, poor risk management and data systems and processes, large amounts of lending to related parties, low levels of capital, and high concentrations of lending to one sector, organisation, or individual.<sup>5</sup>
- 2.10 High growth rates, coupled with poor quality lending, inadequately skilled people, and deficient processes, increased the vulnerabilities of the finance company sector generally, but particularly when the economy and property markets slowed.

## The beginnings of the global financial crisis

- 2.11 In the second half of 2007, the global financial crisis that had its origins in the United States of America in 2006 made its way to New Zealand. The global financial crisis affected many aspects of the New Zealand economy. Initially, it increased the cost at which registered banks and other companies could borrow funds in offshore markets. Over time, this led to increases in borrowing costs for the public<sup>6</sup> and increased uncertainty about the outlook for the economy.
- 2.12 Investor and depositor uncertainty was common in most developed countries around the world and a reason why the global financial crisis spread so far and lasted so long. Uncertainty in September 2008 was so great that the international market for short-term liquidity essentially froze. This led many countries to implement or adjust deposit guarantee schemes to give depositors confidence that they would see the safe return of their deposits should their bank fail. Without this, governments, central banks, and regulators were concerned that a

4 In 2006, the Ministry of Economic Development noted that finance companies fill the gaps in the credit market left by the big banks, including residential mortgage lending, higher-risk property lending, and vehicle, plant, and machinery leasing.

5 See the Report of the Commerce Committee, *2007/08 Financial Review of the Ministry of Economic Development*, Appendix B, and Financial Stability Reports of the Reserve Bank of New Zealand (in particular, the reports from May 2006, November 2007, May 2008, November 2008, and May 2009).

6 The Reserve Bank of New Zealand attempted to counter increased funding costs by reducing official cash rates (from a high of 8.25% to 2.5%).

great many depositors would withdraw their deposits from banks, which would significantly disrupt their domestic economies.

- 2.13 Ireland was the first country to grant a temporary government guarantee of deposits for its largest banks in response to the global financial crisis.<sup>7</sup> Ireland's guarantee, granted on 30 September 2008, was controversial because it encouraged depositors to move funds to Irish banks. Other countries followed Ireland by implementing temporary or permanent guarantees, or by increasing the current levels of deposit insurance coverage.<sup>8</sup> In all, 48 countries implemented or adjusted their deposit insurance schemes during the global financial crisis.
- 2.14 These measures, although regarded as having contributed to financial stability and containing the global financial crisis to some extent, could not reverse its effects. In the first half of October 2008, global financial markets deteriorated markedly. The G7 finance ministers<sup>9</sup> met on 10 October 2008 and called for "urgent and exceptional action" to stabilise markets. Bailouts and government intervention continued around the world.

### The local environment

- 2.15 While global events were threatening to significantly affect the local economy, finance companies were experiencing problems of their own. Although some finance companies had been in trouble for some time, the property development market had begun to decline and investors became increasingly uncertain about the health of the finance company sector. The global financial crisis compounded these problems by introducing additional funding pressures and investor uncertainty. In a slower economy with public confidence low, depositors were reluctant to invest and finance companies in particular were finding it hard to attract new funds.
- 2.16 A number of finance industry entities, including 28 finance companies, failed from 2006 to 2008. This included some larger finance companies such as Bridgecorp Finance (New Zealand) Limited, Provincial Finance Limited, and Hanover Finance Limited (see Figure 4).

7 *Press Statement – Guarantee Arrangement* ([www.centralbank.ie/press-area/press-releases/Pages/PressStatement-GuaranteeArrangement.aspx](http://www.centralbank.ie/press-area/press-releases/Pages/PressStatement-GuaranteeArrangement.aspx)), Central Bank of Ireland, 30 September 2008.

8 Although there are technical differences between the terms "insurance" and "guarantee", in this context a guarantee scheme tends to be a temporary arrangement in response to a particular issue. An insurance scheme is long-term and is funded either by the government or by the institutions.

9 The "G7" is a group made up of the finance ministers from seven countries: France, Germany, Italy, Japan, the United Kingdom, the United States of America, and Canada.

**Figure 4**  
**Summary of finance industry entity failures before the Scheme, from 2006 to October 2008**

	2006	2007	2008 (to October)	Total
Number of companies	4	15	27	46
Deposits at risk	\$827m	\$1,107m	\$4,167m	\$6,101m
Number of deposits	25,526	46,892	109,007	181,425
Average value of deposits	\$32,379	\$23,612	\$38,230	\$33,628

Source: Compiled from data available at [www.interest.co.nz/saving/deep-freeze-list](http://www.interest.co.nz/saving/deep-freeze-list).

- 2.17 At this time, in contrast to finance companies, New Zealand's registered banks and savings institutions were withstanding the economic downturn relatively well. Although funding costs increased, net interest margins narrowed, and lending growth slowed, the sector remained reasonably strong compared with banking systems in many other countries. However, the banking sector was beginning to face substantial liquidity pressures and the sharp decline in investor confidence that had taken place in financial systems all around the world was looming for banks in New Zealand.

### Regulatory and supervisory framework

- 2.18 Up until the mid-2000s, banks and NBDTs had very different regulatory and supervisory frameworks. This has changed substantially. The main change during the past few years has been recognition of the need for a stronger framework for NBDTs. This was driven more by the unique difficulties experienced by the sector than it was by the global financial crisis, although the global financial crisis served to highlight the weaknesses that needed to be addressed.
- 2.19 Although there have been some changes to the regulatory and supervisory framework for banks, these changes have not been anywhere near as substantial as those in the NBDT sector. Banks continue to be registered and supervised by the Reserve Bank, consistent with the Reserve Bank's powers under Part 5 of the Reserve Bank of New Zealand Act 1989 (the Reserve Bank Act). The Reserve Bank monitors registered banks' compliance with banking supervision policies. The Reserve Bank continues to emphasise market discipline through disclosure. It sets disclosure requirements rather than detailed prescriptive requirements on banks' activities and financial positions (but has imposed more substantial capital, liquidity, and similar prudential requirements on banks in recent years).

- 2.20 An important aspect of the Reserve Bank's supervision framework is its focus on maintaining a sound and efficient financial system. The Reserve Bank's regulatory and supervisory framework aims to avoid the significant damage to the financial system that could result from the failure of a registered bank or NBDT.
- 2.21 Neither the Reserve Bank nor the Government provides a guarantee that a supervised institution will not get into difficulty or fail.
- 2.22 Importantly, the Reserve Bank also does not supervise financial institutions with the explicit objective of protecting depositors, which is different to the supervisory objective in many other countries. Rather, the Reserve Bank regulates banks primarily to promote soundness and efficiency in the financial system, leaving the responsibility for assessing the risk associated with deposit decisions largely with depositors.
- 2.23 Before the Scheme, New Zealand was the only country in the Organisation for Economic Co-operation and Development (OECD) without any sort of depositor insurance or depositor preference arrangements. New Zealand applied a less intrusive and disclosure-based regime to banks than did most other OECD countries.

### **Changing regulatory and supervisory framework for NBDTs**

- 2.24 In contrast to the supervisory framework for banks, the framework for NBDTs changed significantly during the past decade. Somewhat coincidentally, these changes largely aligned with the introduction of the Scheme in 2008.
- 2.25 Before October 2008, NBDTs operated under a complex framework of multiple regulators and pieces of legislation. All NBDTs were subject to some regulation, including the need to comply with product and issuer disclosure requirements and basic governance, financial disclosure, and audit requirements, as well as basic consumer protection law.<sup>10</sup>
- 2.26 The Reserve Bank had no formal role in regulating NBDTs and there was no prudential oversight of finance companies (that is, to establish and enforce minimum standards and practices for prudent management).

### **What a trustee is and what a trustee does**

- 2.27 The regulatory framework was, and largely still is, based primarily on a trustee supervisory model under which an NBDT appoints a trustee corporation or person approved for the purpose. Under this model, the NBDT agrees with the trustee a trust deed that sets out requirements that the NBDT must meet. Before 2008, there was no minimum standard for the requirements in the deed. The role of a trustee was to supervise and enforce the NBDT's compliance with the terms of the

<sup>10</sup> Building societies and credit unions were subject to some limited additional regulation.

trust deed. The trustee could also place the NBDT into receivership if that power was included in the trust deed.

#### **Weaknesses in the framework for NBDTs**

- 2.28 In 2005, the Minister of Commerce announced the Review of Financial Products and Providers, to be led by the Ministry of Economic Development (the Ministry). The Review found deficiencies in the NBDT regulatory framework. As a result, in December 2005, Cabinet agreed in principle that prudential supervision of the financial sector (including NBDTs and insurers) was to be consolidated into the Reserve Bank. The Reserve Bank supported this decision.
- 2.29 The Ministry released a number of discussion documents in August 2006, including one about NBDTs. The NBDT discussion document noted several deficiencies in the NBDT sector, including inconsistency in regulatory requirements and supervision for different NBDTs, the absence of minimum entry requirements for NBDTs, lack of governance requirements, and not enough information to enable depositors to assess and compare the risks of depositing with NBDTs.
- 2.30 On 12 September 2007, the Minister announced a new regulatory framework for NBDTs that required all NBDTs to be registered with the Reserve Bank and comply with minimum prudential requirements. Other components of the new framework included:
- a credit rating from a rating agency approved by the Reserve Bank (for all NBDTs with more than \$20 million in liabilities);
  - a minimum amount of capital of \$2 million;
  - a capital ratio, measured on a standardised and comprehensive basis;
  - restrictions on lending to people related to people in charge of an NBDT; and
  - “fit and proper person” requirements for the directors and senior managers of NBDTs.
- 2.31 Changes to the framework were implemented in stages (see Figure 5).

**Figure 5**  
**Staged introduction of prudential requirements for non-bank deposit takers**

The prudential requirements for NBDTs have come into force in stages since 2008. The categories of prudential requirements and the dates the requirements came or are expected to come into force are:

Stage 1:

- 1 September 2009 – risk management programme submitted to and approved by the trustee;
- 1 March 2010 – credit rating required (an exemption applies where liabilities are less than \$20 million);
- 1 December 2010 – governance requirements; and
- 1 December 2010 – capital, liquidity, and related party exposure limit regulations.

Stage 2:

- expected to come into force on 1 June 2013 – licensing and fit and proper person requirements; and
- expected to come into force on 1 June 2013 – enhanced Reserve Bank intervention and information-gathering powers.

- 2.32 Stage 1 began in September 2008 with changes to the Reserve Bank Act that empower the Reserve Bank to prescribe requirements and regulate NBDTs. Obligations under this act came into force in September 2009, and included a requirement for NBDTs to have in place a risk management programme that outlines how the NBDT identifies and manages its main risks. This programme is submitted to, and approved by, the NBDT's trustee.
- 2.33 Stage 2 of changes to the framework involves amendments to the Reserve Bank Act to empower the Reserve Bank to license and remove licences from NBDTs, and apply "fit and proper person" requirements to NBDT owners, directors, and senior managers. Stage 2 will also provide the Reserve Bank with stronger powers to direct an NBDT or to gather more information. A Bill to give effect to these changes was introduced in July 2011. Although weaknesses in the NBDT sector were evident in 2005, the last legislative changes will not come into effect until 2013.
- 2.34 Notwithstanding the shift of regulatory responsibility to the Reserve Bank, trustees remain the primary supervisors of NBDTs.

## Part 3

# Introduction of the Crown Retail Deposit Guarantee Scheme

- 3.1 In this Part, we discuss:
- why and how the Scheme was introduced;
  - the policy objectives of the Scheme;
  - implementing the Scheme;
  - communications about the Scheme's introduction; and
  - our views on the Treasury's implementation of the Scheme.
- 3.2 In summary, the Government was acting to maintain confidence in New Zealand's deposit-taking institutions when it introduced the Scheme. Minimising the Crown's losses was recognised as important in early documents but not, in practice, treated as one of the Scheme's objectives. Although a guarantee scheme was not consistent with New Zealand's minimal interventionist approach to financial markets, the Government decided that such a scheme was necessary after the Australian Government announced that its scheme was imminent. Once the decision to have a scheme was made, officials considered that including finance companies was necessary but would risk substantial Crown losses and could encourage those companies to make even riskier investment decisions.
- 3.3 The design of the Scheme saw the Crown acting as a guarantor. The Crown assumed the responsibility for repaying investors' deposits if financial institutions covered by the Scheme failed. The Scheme did not guarantee the solvency of those financial institutions.
- 3.4 In our view, the Treasury's focus for the first six months – when the risk to the economy was greatest – was administrative and reactive rather than comprehensive and well planned. The Treasury rightly processed applications to join the Scheme quickly, to maintain confidence in the financial system. However, it did this without a disciplined project management approach to the Scheme. Although the Treasury acknowledged relatively quickly that it did not have people with the necessary skills to implement the Scheme, it did not do enough to quickly fill that gap.
- 3.5 If the Treasury had implemented the necessary monitoring, escalation, and reporting framework as it worked to process applications, we consider the Treasury would have been better prepared when risks that it had long known about began to eventuate (see Part 6).
- 3.6 The Treasury told us that it is now taking a more structured approach in its response to crisis situations (such as its work on government support for AMI Insurance Limited).



## Why and how the Scheme was introduced

### The days leading up to 12 October 2008

- 3.7 In the days and weeks leading up to the Scheme, New Zealand's financial system was under considerable pressure (described in Part 2). A joint report from the Treasury and the Reserve Bank to the Minister on Friday 10 October 2008 (the Options Report) set out possible policy responses should the situation deteriorate further. The Options Report set out the broad design of a retail scheme. The Options Report stated that a retail deposit insurance scheme could be implemented quickly but was not needed at that time. The Options Report said that introducing such a scheme could distort investment choices and unnecessarily risk a downgrading of New Zealand's credit rating.
- 3.8 The Options Report also noted that introducing a retail guarantee scheme would mark a material departure from New Zealand's approach to supervision and regulation, and change expectations about the Government's response to future crises and institutional failures. Although not stated directly, implicit in the Options Report was a concern that a guarantee scheme could introduce a "moral hazard" into the financial system. In other words, there were concerns that setting up a scheme that transferred risk to the Crown would provide depositors with incentives to invest in riskier financial institutions than they would otherwise. This would in turn allow the riskier institutions to make riskier investment decisions.

### 12 October 2008

- 3.9 On Sunday 12 October 2008, officials were told by their counterparts in Australia that the Australian Government was likely to announce the introduction of a guarantee scheme later that day.
- 3.10 We understand that Australian and New Zealand officials had discussed earlier that week possible courses of action should the global financial crisis worsen. The advice from Australian officials of the Australian scheme's introduction was unexpected and invoked a flurry of activity by the Treasury and the Reserve Bank to prepare a similar announcement. Officials believed that, if the Government did not act quickly to implement a similar scheme, depositors would quickly transfer their funds from New Zealand to Australia to benefit from the Australian deposit guarantee. This could have resulted in runs on New Zealand banks and other financial institutions, and given rise to significant liquidity difficulties in financial institutions. This, in turn, could have led to substantial and widespread market disruption and economic instability.

- 3.11 During that Sunday, the Treasury and Reserve Bank worked to design a scheme, with guidance from the Minister. We were told it was a tense day, with significant pressure on all parties to achieve a workable solution by Sunday evening.
- 3.12 There was limited opportunity to fully explore the consequences of the various policy decisions made, such as which types of financial institutions would be offered the guarantee and how much financial institutions would need to pay to the Crown for the guarantee.
- 3.13 The Scheme was announced on the evening of 12 October 2008 by the then Prime Minister. This was followed by a media statement issued by the Minister. Further information was released in a media statement from the Reserve Bank and the Treasury, and in an initial “questions and answers” document posted on the Reserve Bank’s website (see Figure 6). On 1 November 2008, the Crown also introduced a Wholesale Guarantee Scheme.<sup>11</sup>
- 3.14 Initial draft guarantee deeds were available on the Reserve Bank’s website later in the evening of 12 October 2008. The deeds set out the terms under which the Crown would guarantee the deposits of the financial institution, as well as the circumstances under which the guarantee could be withdrawn.

11 The Wholesale Guarantee Scheme was introduced to help financial institutions access funding from wholesale markets. This was also constructed as an opt-in scheme, with financial institutions able to choose to use the Wholesale Guarantee Scheme each time they issued securities. The Wholesale Guarantee Scheme was available to investment-grade financial institutions with substantial New Zealand borrowing and lending. In practice, it was used by the five largest banks. The fee charged was based on the credit rating of the financial institution and the term of the security issued. Deposit-taking financial institutions seeking to apply for the Wholesale Guarantee Scheme were expected to have also applied for a guarantee under the Retail Deposit Guarantee Scheme. Importantly, the Wholesale Guarantee Scheme required that financial institutions covered maintain a minimum level of capital. The Wholesale Guarantee Scheme ended on 30 April 2010. During its term, it guaranteed 24 security issues covering \$10.3 billion of borrowing and made no payouts. It returned the Government almost \$290 million in fees.

**Figure 6**  
**Details of the Crown Retail Deposit Guarantee Scheme – 12 October 2008 media statements**

A media statement released by the Minister of Finance on 12 October 2008 noted that the Scheme:

- was designed to give assurance to depositors given prevailing uncertain international financial market conditions;
- would be introduced by the Minister using his powers under the Public Finance Act 1989;
- would be an opt-in scheme and would take the form of a contractual agreement between the Crown and the individual institutions that took up the guarantee;
- would have an initial term of two years;
- covered all retail deposits of participating New Zealand-registered banks and retail deposits by New Zealanders in non-bank deposit-taking financial institutions (building societies, credit unions and deposit-taking finance companies);
- would be free for institutions with total retail deposits under \$5 billion, but institutions with total deposits above \$5 billion would be charged fees; and
- would not cover related party liabilities.

Additional details released on 12 October included:

- eligible financial institutions included registered banks and NBDTs that were fully complying with their trust deeds;
- for registered banks, deposits from both residents and non-residents would be covered;
- for NBDTs and for the unincorporated branches of overseas financial institutions, only deposits of New Zealand citizens and New Zealand tax residents would be covered;
- deposits were covered regardless of currency; and
- deposits and other liabilities owed to financial institutions, whether in New Zealand or offshore, were explicitly excluded.

- 3.15 The reference to the Public Finance Act 1989 (the Public Finance Act) in these early media statements was important. Under section 65ZD of the Public Finance Act, the Minister, on behalf of the Crown, may give a guarantee in writing if it appears to the Minister to be “necessary or expedient in the public interest” to do so. The Minister delegated the power to give guarantees under the Scheme to the Secretary to the Treasury.
- 3.16 Using the Public Finance Act established overriding criteria for granting the guarantee. It also assigned the role of administering the Scheme to the Treasury (because of the Treasury’s role as overseer of Crown funds). Other mechanisms, such as new legislation, would have taken time and were not possible, because Parliament had been dissolved.

### Which types of financial institutions could apply under the Scheme

- 3.17 The designers of the Scheme considered which financial institutions would be eligible to apply for the guarantee. This was an important policy decision because it affected how the Treasury would implement the Scheme. It is also a commonly asked question in the light of the nine finance company failures that have triggered payments under the Scheme.
- 3.18 For the Scheme to give depositors confidence, it was clear to the Treasury and the Reserve Bank that, as a minimum, registered banks should be guaranteed. It was less clear to them whether NBDTs should be part of the Scheme. Changes to the regulatory framework for NBDTs were only just under way, and the finance company sector had experienced difficulties in the preceding two years, with many company failures.
- 3.19 The Options Report had considered which financial institutions should be eligible to apply for a guarantee. The Options Report recognised, on the one hand, that the NBDT sector was sufficiently small not to require inclusion for the purpose of maintaining public confidence. Moreover, including the NBDT sector under a form of guarantee would significantly increase the risk to the Crown and increase the likelihood of the guarantee being invoked. Unless the pricing of the Scheme was appropriately structured, it could also encourage depositors to shift deposits from banks to NBDTs where the rates of return paid on deposits would be higher.
- 3.20 On the other hand, excluding NBDTs would very likely trigger a flow of funds from NBDTs to the banks. Implicit in the Options Report seemed to be a concern that a government initiative that did not include NBDTs might risk causing the failure of a sector that was broadly regarded as necessary and as adding to the diversity of the financial system.
- 3.21 Therefore, the Options Report recommended that any guarantee scheme include banks and NBDTs. This recommendation, combined with a number of the proposed scheme design features, was agreed to by the Minister, subject to confirmation of the risk-based fee.
- 3.22 On 12 October 2008, the Government decided to include in the Scheme all banks and NBDTs that met some basic eligibility criteria. Including the NBDTs meant that the Scheme guaranteed a broader range of financial institutions, with a higher risk profile, than most guarantee schemes elsewhere in the world. In part, this reflected the important role that finance companies were believed to play in New Zealand. It also meant a higher likelihood of the guarantee being invoked.

### Refining the policy

- 3.23 After the Scheme's introduction on 12 October 2008, numerous policy issues emerged for which decisions needed to be made promptly. Early media statements about the Scheme suggested that the Treasury and the Reserve Bank were jointly responsible for making decisions about the design of the policy, because details were released jointly by the Treasury and the Reserve Bank.
- 3.24 Early policy decisions were mainly about the treatment of NBDTs and other non-bank entities, the price of the Scheme, and the extent of its coverage. Issues included the additional fiscal risks posed to the Crown by including NBDTs in the Scheme, the boundary between retail and wholesale deposits, and the need for risk-based pricing in the NBDT sector.
- 3.25 The Treasury and the Reserve Bank issued a joint media statement on Wednesday 15 October 2008 to refine the initial design of the Scheme. Details of this release are provided in Figure 7. Amended guarantee deeds were also made available on the Treasury's website on October 15.<sup>12</sup>

#### Figure 7

##### Details of the Crown Retail Deposit Guarantee Scheme – 15 October 2008 media statement

On 15 October 2008, the Treasury and the Reserve Bank issued a joint media statement to announce additional details about the Scheme. Among other things, these included:

- tighter requirements for NBDTs:
  - limiting the potential to strip out funds (for example, to pay dividends);
  - increasing reporting requirements;
  - allowing the Crown to appoint an inspector;
  - allowing for withdrawal of the guarantee on the basis of reckless business behaviour that would be deemed to be in breach of the guarantee terms; and
  - personal undertakings from directors about NBDTs' compliance with the guarantee deed;
- introducing a fee for NBDTs that either were rated below BB or did not have a rating;
- a requirement that all new entrants to the Scheme be rated BBB- or better; and
- extended (conditional) coverage to non-resident deposits in New Zealand branches of overseas banks and to certain collective investment schemes.

- 3.26 The Treasury and the Reserve Bank released a further media statement on Wednesday 22 October 2008. This statement set out the decision to introduce a cap on deposits covered by the Scheme (in line with a cap of A\$1 million about to be introduced by the Australian Government). It also announced a decision to charge those financial institutions not otherwise subject to fees a risk-based "new

<sup>12</sup> The deed for collective investment schemes followed in the next few days.

business fee". If an institution's balances increased by more than 10% a year, the institution would be charged the new business fee on the amount of the increase.

- 3.27 We have not seen any definite evidence that the Treasury considered the option to guarantee only existing deposits of NBDTs. The Options Report did not raise this as a possibility. It was mentioned in a report dated 21 October 2008 from the Treasury and the Reserve Bank, in the context of alternative pricing structures. The analysis was that this option would be difficult to effect because of the need to distinguish between guaranteed and non-guaranteed deposits. The only other reference to the new business of NBDTs was in relation to risk-based "new business fees".
- 3.28 To restrict the guarantee to NBDTs' existing business would have been counter to the objective of maintaining public and depositor confidence in the financial sector; new funds would have been directed only to financial institutions to which the guarantee applied or that were otherwise regarded as safer. Further, existing depositors whose deposits were guaranteed may have questioned the Crown's confidence in these NBDTs and, where they could, moved their funds to fully guaranteed entities so that any increases in their deposit balances would also be covered. If deposits in NBDTs matured and were not reinvested with them, the NBDTs would have faced shortfalls in liquidity and most likely have failed, effectively negating the objective of the policy decision to offer the guarantee to NBDTs.
- 3.29 The 22 October media statement also indicated that the Reserve Bank would investigate options to bring forward prudential requirements for NBDTs. This followed growing recognition of the fiscal risks faced by the Crown of including NBDTs under the Scheme. An estimate of the dollar amount of this risk (between \$462 million to \$945 million) was communicated to the Minister by the Treasury on 15 October 2008 and in a paper from the Minister to Cabinet on 17 October 2008.
- 3.30 Planned actions to manage the risks posed by NBDTs were communicated to the Minister by the Treasury and the Reserve Bank in a joint report on 21 October 2008. The report indicated that the Reserve Bank had identified regulations for minimum capital ratios and limits on related-party exposures as the best option for quick implementation of requirements to impose "prudential discipline" on NBDTs. The aim was to have stronger prudential requirements by the end of 2008 or in early 2009, but the last changes are not expected to take effect until 1 June 2013 (see paragraphs 2.32-2.34).
- 3.31 The Treasury issued Policy Guidelines on 22 October 2008 to help financial institutions that were considering applying for the Scheme and to guide the

Treasury's assessment of their applications. The Policy Guidelines set out the overarching principles in granting the guarantee and the main public interest factors (public and depositor confidence). They also set out the types of institutions that would be eligible for the guarantee and the "relevant criteria" and "other factors" that Treasury officials might consider when they assessed an application.

- 3.32 Relevant criteria included requirements to:
- have debt securities on issue;
  - be in the business of borrowing and lending or providing financial services, or both;
  - carry out a substantial portion of business in New Zealand; and
  - not primarily provide financial services to, or lend to, related parties and/or group members.
- 3.33 Other factors to be considered in exercising discretion to offer the guarantee included:
- the size of the entity and the number of depositors;
  - creditworthiness;
  - related-party exposure;
  - quality of the information provided by the entity and whether its financial statements are audited;
  - character, business experience, and acumen of controlling individuals;
  - business practices and track record of the entity (that is, meets reasonable standards, bank-like in nature, length of time in business, meeting payments, and maintaining solvency);
  - importance to the financial system; and
  - any other factors relevant to the maintenance of public and depositor confidence.
- 3.34 Officials in the Treasury told us that the "relevant criteria" set out in the Policy Guidelines were items that the financial institution needed to meet before being accepted into the Scheme. The "other factors" were items that the Treasury (and the Reserve Bank) could take into consideration on a case-by-case basis. We understand that the Treasury took this approach so that it could properly assess each application using discretion, as required under the Public Finance Act.
- 3.35 As the operational details of the Scheme were finalised, new guarantee deeds needed to be drafted. Final versions were issued on 30 October 2008 (after minor amendments). A revised version of the "questions and answers" document was

posted on the Treasury's website on 22 October 2008 (the questions and answers were previously on the Reserve Bank's website).

### Policy objectives of the Scheme

- 3.36 The Policy Guidelines issued on 22 October 2008 included a section called "Overarching Principles". This section noted that granting the guarantee must be "necessary or expedient in the public interest". The Policy Guidelines state that the main "public interest" factors to consider were:
- maintaining public confidence in the domestic financial system; and
  - maintaining the confidence of general public depositors in New Zealand's financial institutions.
- 3.37 Material changes to the Policy Guidelines were made before the 22 October 2008 media statement, to ensure consistency with the guarantee deeds and in response to Crown Law comments. These changes included adding "depositor confidence" as a key consideration for public interest. A reference to there being no public interest in providing the Crown guarantee to institutions that fail to meet reasonable standards of business practice was also removed.
- 3.38 The objectives of the Scheme do not refer to the need to minimise the Crown's liability. To include this requirement as an explicit objective could have contradicted the basis for the Scheme, which was depositor and public confidence. However, we consider it reasonable to assume that this was an important consideration for the Treasury in its implementation of the Scheme, given the role that the Treasury has as guardian of the Crown's funds. This assumption is supported by:
- the Policy Guidelines, which identify financial institution creditworthiness and prudent business practices as considerations for assessing an application under the Scheme;
  - the public interest test, which was interpreted by officials within the Treasury and the Reserve Bank as protecting not only depositors but also public assets;
  - documentation from the Treasury to support operational funding for implementing the Scheme (see paragraph 3.42);
  - the analysis by the Treasury, communicated to the Minister and by the Minister to Cabinet, in the days after the Scheme's announcement, to estimate the fiscal risk of the Scheme to the Crown and to highlight the requirement to disclose the Treasury's objectives, policies, and processes for managing the risk, consistent with New Zealand accounting standards; and
  - our understanding that imposing constraints on weak institutions to stop them making their financial exposures worse was a common feature of deposit guarantee schemes in other countries.



- 3.39 As the Scheme progressed and financial institutions guaranteed by the Scheme began to fail, the potential cost to the Crown became more important for the Treasury (see Part 6).
- 3.40 No banks covered by the Scheme failed, there was no run on the money in banks, and investor confidence was maintained during the Scheme.

## Implementing the Scheme

### The days immediately after 12 October

- 3.41 The Treasury was responsible for the Scheme's implementation. Before the Scheme was introduced, the Treasury's focus had been largely on providing policy advice and analysis to the Government. The decision for the Treasury to administer the Scheme required the Treasury to have a larger operational role than it had historically played. (The Treasury already had an operational role through its New Zealand Debt Management Office.)
- 3.42 On the Monday after the Scheme's introduction, the Treasury began developing the operational details for the Scheme. A report provided by the Treasury to the Minister on 13 October 2008 identified several implementation processes and activities, including:
- details of the application process;
  - resourcing the claims process (both the legal and commercial perspective);
  - monitoring requirements to be placed on successful applicants; and
  - monitoring and reporting requirements to be placed on the Treasury.
- 3.43 The 13 October 2008 report was followed by a further report from the Treasury to the Minister, dated 17 October 2008, and a Cabinet paper with the same date, setting out additional details of the Scheme's implementation. These documents sought operational funding of \$10.1 million and capital funding of \$0.8 million.<sup>13</sup>
- 3.44 The operational funding was intended to cover legal fees, financial and legal salaries, and other operating costs (including the Reserve Bank's monitoring). The role of the legal and financial staff was to "reduce the Crown's exposure to the Scheme by performing regular monitoring of the financial institutions to ensure they meet the necessary Scheme criteria" and to provide regulatory advice. The capital funding was largely for credit assessment software and computers.
- 3.45 In mid-October 2008, the Treasury was considering the financial implications of the Scheme (how much the Crown might need to pay if financial institutions covered by the Scheme failed), as well as the expected accounting treatment and legislative basis for reporting the potential amounts. A report from the Treasury to

<sup>13</sup> At that time, it was estimated that the Scheme would generate \$238 million in fees during the two years. The Minister noted in the Cabinet paper that he had asked officials to review this estimate.

the Minister on 15 October 2008 discussed this aspect of the Scheme, estimating a potential Crown liability between \$462 million and \$945 million. The report set out the assumptions for these estimates very clearly.

- 3.46 We have not seen evidence that the Treasury revised its estimates of possible Crown losses until June 2009. We expected updates of these estimates to be an important component of regular reporting, given the Treasury's role as guardian of the Crown's funds.

### **The role of the Reserve Bank of New Zealand**

- 3.47 The Reserve Bank also played a role in implementing the Scheme. The 13 October 2008 report (see paragraph 3.42) identified where the Reserve Bank could contribute to implementation. (The Reserve Bank was not identified as a co-author of the 13 October report.)
- 3.48 The two main roles for the Reserve Bank were determining the eligibility of financial institutions for the Scheme and monitoring the financial institutions covered under the Scheme. The Reserve Bank was involved in processing applications to join the Scheme by financial institutions (see Part 4). Its role was to confirm that the institution was eligible to apply and that the Reserve Bank had no reason to believe that entry to the Scheme would not be in the public interest.
- 3.49 The Reserve Bank's ongoing monitoring role was highlighted in the report but only for any institutions in the Scheme that were already subject to the Reserve Bank Act. The monitoring of NBDTs was not specifically considered in the report. An internal Treasury email dated 15 October 2008 noted the need to agree the Reserve Bank's role in monitoring and advising. However, the Reserve Bank's role in monitoring all financial institutions covered by the Scheme appears to have been first discussed with the Treasury in late October 2008.
- 3.50 The relative roles to be played by the Treasury and the Reserve Bank were not well defined in the weeks immediately after the Scheme was introduced.
- 3.51 The lack of clarity about roles was addressed, in part, by the official outsourcing of services to the Reserve Bank on 1 December 2008 through a contract for services. The Reserve Bank was contracted by the Treasury to provide monitoring services and advice on Scheme applicants. The contract between the Treasury and the Reserve Bank was brief and set out the services to be performed by the Reserve Bank, as well as the cost of those services (to be paid by the Treasury).
- 3.52 Under the contract, the Reserve Bank was to monitor and report to the Treasury on matters relevant to the objectives and administration of the Scheme, and to provide advice on whether applicants met the relevant eligibility criteria set

out in the Scheme's Policy Guidelines.<sup>14</sup> The description of services did not say how the Reserve Bank was to perform this monitoring task and what form the advice would take. We understand that this was to provide flexibility because the monitoring and reporting tools were yet to be developed.

- 3.53 In our view, it made sense to outsource monitoring to the Reserve Bank and for the Reserve Bank to provide advice about eligibility. The Reserve Bank was the regulator and supervisor of registered banks. As discussed in Part 2, changes to the regulatory framework for NBDTs were under way that established the Reserve Bank as the regulator of NBDTs (with the trustees as supervisors). Those changes also gave the Reserve Bank the power to request information from trustees about the activities and financial details of NBDTs. Although the Reserve Bank needed to recruit more staff, it already had some capacity to start this monitoring work, which the Treasury did not.

#### **From October 2008 to March 2009**

- 3.54 Between October 2008 and February 2009, the Treasury's attention was focused on assessing and approving applications from financial institutions to be guaranteed by the Scheme. For the Scheme to promote public and depositor confidence in the financial system, it was important that applications were processed quickly.
- 3.55 During our interviews with Treasury officials, we were told that some Treasury officials were also involved in planning the Scheme (for the activities needed to implement the Scheme) during this period. Much of this work was not documented. From late 2008 to early 2009, we have evidence of budgeting considerations for the staff and external advisers required to implement the Scheme. We are also aware of early effort to recruit legal resources to help primarily with preparing deeds and with the applications process. We do not have written evidence of implementation planning discussions within the Treasury.
- 3.56 We were also told that regular updates were provided to senior management and that senior leadership team meetings were regularly held to discuss important issues and policy direction for the Scheme. We were told of daily meetings in the early days with the Secretary to the Treasury. We saw evidence of meetings involving Treasury personnel in the legal, policy, operations, communications, and finance teams. We were told that the Secretary to the Treasury attended these meetings, which were often about the signing of the guarantee deeds as well as legal and other broader issues.
- 3.57 The Secretary to the Treasury was closely involved in the application process for some financial institutions, and we also saw evidence of this involvement

<sup>14</sup> The contract also covered the Wholesale Guarantee Scheme, which the Reserve Bank was to monitor and report on, and approve individual applicants and pricing and fee structures.

in our review of applications. We saw evidence of two Strategic Leadership Team meetings, one in each of October and November 2008 to discuss the organisational strategy and implementation details, but we are unsure of the issues discussed. Much of this detail was not documented.

- 3.58 From February 2009, we have documented evidence that planning for payout processes was under way. We reviewed notes from meetings on 23 February 2009 between the Treasury and the Reserve Bank to “brainstorm” the payouts process and failure scenarios. We were told that this activity took place before the Treasury learned of the pending failure of a financial institution covered by the Scheme.
- 3.59 On 2 March 2009, Mascot Finance Limited (Mascot Finance) failed (see Part 4). This was the first failure of a financial institution covered by the Scheme. As discussed in later parts of this report, there was significant effort put into ensuring a smooth payout process in response to this failure (see Part 7).
- 3.60 In our view, this failure marked a turning point in the Treasury’s work on limiting the cost to the Crown – matters that might have been discussed or acknowledged months earlier were actually worked on after Mascot Finance failed.
- 3.61 We reviewed a number of preparatory briefing notes that were drafted by the Treasury for senior officials in the Treasury, the Reserve Bank, and the Government after Mascot Finance’s failure. Some of these appear to have been drafted in response to questions about the inclusion of NBDTs in the Scheme and Treasury’s implementation of the Scheme. A Treasury and Reserve Bank report dated 17 March 2009 discusses four implementation “work streams” that were under way:
- day-to-day operations (including application processing, monitoring of entities, and managing risk to the Crown);
  - crisis resolution and payout;
  - developing an effective and timely way to end the Scheme; and
  - other work (such as financial system issues meetings).
- 3.62 The “work streams” set out in the 17 March report were activities rather than project work streams. The Treasury did not appear to have a project plan for the Scheme’s implementation, with time frames, dedicated resource commitments, performance metrics, and reporting requirements.
- 3.63 By March 2009, the Treasury was monitoring individual financial institutions (see Part 6) and had hired additional staff with the skills required to do this. There is also evidence that the Treasury was taking a wider view of the Scheme and had identified key considerations in managing the interests of the Crown and ways to

exit the Scheme.<sup>15</sup> There were several workshops conducted in May and June 2009 to analyse failure scenarios and accompanying responses.

- 3.64 Also at this time, the Treasury, the Reserve Bank, and the Minister began to meet regularly to discuss financial system issues. They discussed broad issues of financial stability and did not specifically focus on the Scheme. Regulators' meetings, involving the Treasury, the Reserve Bank, the Securities Commission, and the Companies Office were also held. These meetings contributed to inter-agency information sharing and discussion.

## Communicating information about the Scheme's introduction

### Information for the public

- 3.65 There was much effort in the early days of the Scheme's introduction to quickly release information about the Scheme and the policy decisions that were made to refine the Scheme's design. Quick disclosure was important given the objective of maintaining depositor and public confidence.
- 3.66 Both the Treasury and the Reserve Bank were involved in the early announcements immediately after the Scheme was introduced. We were told that the Treasury and the Reserve Bank worked together effectively to ensure adequate disclosure. Because of the Reserve Bank's role in answering queries about regulated financial institutions, the Reserve Bank set up a call centre (with prepared scripts for those answering calls) and responded to enquiries from the public and from financial institutions. The Governor of the Reserve Bank announced the free-call telephone number on radio on the morning of Monday 13 October 2008. (We were told that there were very many calls and much public interest in the Scheme.)
- 3.67 After the first few days, responsibility for handling public enquiries was passed to the Treasury, but extensive interaction between the Treasury and the Reserve Bank continued. An initial "questions and answers" document was on the Reserve Bank's website. This was then updated and posted on the Treasury's website on 22 October 2008 (and regularly updated by the Treasury).
- 3.68 Several media statements were released in the first few weeks to inform the public and financial institutions of the Scheme's introduction and key policy refinements. Several of these were joint statements from the Treasury and Reserve Bank. We understand from interviews that there was a concern that excessive public disclosure might unsettle markets further. In our view, the statements were

<sup>15</sup> There was a short comment in the Treasury's briefing to the new Minister in 2008 raising the important need to consider an exit strategy for the Scheme (*Briefing to the Incoming Minister of Finance: Economic and Fiscal Strategy – Responding to your Priorities*). We did not see further consideration of this issue between that briefing and March 2009.

timely and provided useful information about the Scheme's introduction and the changes to policy.

- 3.69 During our interviews, staff of the Treasury described "typical" NBDT investors as elderly, lacking financial awareness, and possibly lacking Internet access. Some of the people we interviewed suggested that providing information on websites was of questionable use to these investors. We were told that some investors did not realise that the Treasury was the public entity to speak with about the Scheme. However, Treasury staff also said that the cost of conducting a mass-market "brochure" campaign to reach all investors would have been too high. In the Treasury's view, investors would have benefited from the releases into mainstream media as well as information that was provided by the individual entities covered by the Scheme.
- 3.70 We understand that there was some confusion when Mascot Finance failed. Some people felt that the Scheme was about preventing failure and that Mascot Finance's failure signalled a problem with the Scheme. Others were surprised that Mascot Finance was covered by the Scheme. On balance, we consider that broader use of more readily accessible media sources might have helped minimise this confusion. As a general comment, we found that the Treasury's website was not always well organised and it was not always easy to find information.

### Information for Ministers and Parliament

- 3.71 In the first few weeks of the Scheme, Ministers were kept informed through reports from the Treasury and the Reserve Bank to the Minister, and Cabinet papers. In our view, the information and analysis provided in these reports was extensive and comprehensive, providing enough background detail, supporting analysis, and proposed direction for the various implementation issues that were emerging.
- 3.72 A Ministerial statement was provided to Parliament on 9 December 2008, and the implementation of the Scheme was debated. It was noted during debate that there were no surprises in the statement because the Scheme had been "well signalled in the media". The Scheme was next debated in Parliament in March 2009, after the failure of Mascot Finance.
- 3.73 The Scheme was discussed in the Treasury's Briefing to the Incoming Minister of Finance in 2008, and the Secretary to the Treasury met with the Minister in early December 2008. After this meeting, the next Ministerial briefing was on 4 March 2009. Mascot Finance failed on 2 March 2009.

- 3.74 We consider that it would have been useful for the Treasury to have set up in late 2008 an appropriate system for formal and regular reporting about the Scheme to the Minister, to ensure that the Minister received all required information and understood clearly the risks the Scheme posed to the Crown. We did not see evidence of this happening, but we accept the Treasury's assurance that the Minister was kept well informed during this period.

### **Our views on the Treasury's implementation of the Scheme**

- 3.75 The Treasury faced a challenging environment in the early period of the Scheme. Parliament had risen; there was a general election then new ministers and a new government. Work on a wholesale scheme was also under way, and there were lots of uncertainties in international financial markets.
- 3.76 In the early weeks of the Scheme, the Treasury faced significant pressure to provide policy advice and develop an implementation approach in an area where it had little experience. Many of the people we spoke with considered that the work the Treasury did to put the Scheme in place quickly was commendable and met the objective of assuring public and depositor confidence.
- 3.77 Very early in the Scheme, the Treasury identified several important operational aspects of the Scheme that it needed to address, including resourcing the claims process, monitoring requirements for successful applicants, and monitoring and reporting requirements for the Treasury. It also began to think about some important uncertainties ("what-if" analysis), including timing for the payout process and actions the Crown would need to take to recover any funds paid out under the Scheme.
- 3.78 However, there is very little evidence that these aspects were worked on until March 2009. Even then, much of the development appears to have been done "as needed".
- 3.79 It is generally acknowledged in private and public sector organisations that implementing any large and/or complex initiative is most effective when it is supported by formal planning. Formal planning helps clarify roles and responsibilities and allows for clearer objectives and goals against which to report performance. It also improves readiness for unexpected or unlikely events, such as the failure of a large financial institution, to ensure a quick and appropriate response.

- 3.80 In our view, the Treasury should have undertaken more formal and documented planning processes in October and November 2008. A formal planning framework would have ensured that each of the implementation processes and activities identified in the 13 October 2008 report to the Minister were developed and implemented. It would have contributed to ensuring that the monitoring requirements to be placed on successful applicants were developed and that the Reserve Bank's monitoring role was clear in the early days of the Scheme.
- 3.81 Planning would also have ensured that all key stakeholders within the Treasury were informed of developments at the right time. There is evidence from interviews that the communications team within the Treasury, for example, was sometimes not aware that decisions were being made that would need to be conveyed to the public.
- 3.82 Thorough planning would have set up payout processes well ahead of the failure of a financial institution guaranteed by the Scheme (at least the high-level processes, even if all the detail had yet to be determined). We heard often during our interviews that it was fortunate for the Treasury that the first financial institution to fail while in the Scheme was not a large finance company.
- 3.83 Effective planning is supported by strong governance processes for reporting and decision-making, including clear accountabilities. We did not find evidence of formal specific senior management oversight of the Treasury's work to implement the Scheme. We have not seen evidence that the Treasury worked through the monitoring and reporting requirements until March 2009, when the first round of information was received from the Reserve Bank and informal updates were initiated by the Treasury's operational team for the Scheme.
- 3.84 In our view, the Scheme's implementation would have benefited from a formal senior steering committee to provide strategic oversight.
- 3.85 We acknowledge that the first few weeks after the Scheme was introduced were hectic. However, the Treasury should have better documented its decisions and processes, and done so sooner, particularly after the first few weeks. The Treasury had a recognised "key person risk" in that two staff were critical to much of the Treasury's monitoring work. In instances like this, proper documentation is even more important.
- 3.86 The importance of complete and accurate documentation to formal planning is well established and particularly important for publicly accountable entities.



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**Recommendation 1**

We recommend that the Treasury prepare a project planning framework to help the Treasury to implement large and complex initiatives. The framework should include an approach to crisis management planning and strong internal governance processes to ensure that appropriate senior managers are actively involved in the strategic direction of important aspects of policy implementation. These processes should include clear accountabilities, roles, and responsibilities for deciding and implementing policy.

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**Recommendation 2**

We recommend that, for large and complex initiatives managed by the Treasury, the Treasury put in place a monitoring, escalation, and reporting framework that is agreed with the Minister of Finance and refined over time. This framework should require clear documentation of important implementation decisions and processes and provide for suitable formal reporting of results and emerging risks within the Treasury as well as to the Minister of Finance and other stakeholders.

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- 3.87 The Treasury told us that it is now taking a more structured approach in its response to crisis situations (such as its work on government support for AMI Insurance Limited).

## Part 4

# Managing the application process

- 4.1 In this Part, we discuss:
- the timing and number of applications that the Treasury processed;
  - the guarantee deeds that set out the agreement between the institutions and the Crown;
  - the application form that institutions were required to complete;
  - how information about approved applications was communicated;
  - how NBDT applications were processed;
  - how applications were assessed; and
  - how entry to the Scheme changed after Mascot Finance failed.
- 4.2 In summary, for the first six months, every institution that met the basic criteria was accepted into the Scheme. No applicant was refused in the first few months of the Scheme for failing to meet any of the “other factors”, which included creditworthiness and sound business practice. At this stage, and despite earlier references to limiting the Crown’s liability, depositor confidence was the Treasury’s priority.
- 4.3 In our view, the application process for NBDTs relied too heavily on the information and perspectives of the trustees. As noted earlier, trustees remain the primary supervisors of NBDTs in the new regulatory framework, and it was appropriate that their knowledge and advice was an important component of the application process. However, the Treasury could have made further inquiries about some applicants. For example, we consider that the Treasury should not have relied so heavily on the trustee’s confidence that Mascot Finance would continue to meet its obligations. Mascot Finance failed shortly after it was accepted into the Scheme.
- 4.4 After March 2009, the “other factors” of creditworthiness and sound business practices were more carefully considered. By then, more than 80% of the NBDTs that were accepted into the Scheme had already been accepted (including the nine finance companies that eventually failed). The Treasury told us that the NBDT applications remaining to be processed after March 2009 were generally the more complex applications that had been identified earlier as “borderline cases”.
- 4.5 In our view, the change in emphasis for the acceptance criteria should have been actively discussed within the Treasury and the Reserve Bank, and with the Minister.

## Timing and number of applications

- 4.6 The Treasury received the first applications on Monday 13 October 2008 – the day after the Scheme was announced. Four financial institutions applied on 13 October 2008, and another 43 applications arrived by 15 October 2008. These early applications came from all institution types, including banks.
- 4.7 The Treasury gave priority to handling applications from large institutions. The first application was approved on 29 October 2008, with three applications approved that day and three on 30 October 2008. All of these approvals were for banks. Of the 12 banks that applied, 11 were approved by mid-November 2008. The last bank's application was approved on 5 December 2008.
- 4.8 As at the end of 2008, 63 entities were covered by the guarantee after 125 applications (12 banks, 48 NBDTs, and three collective investment schemes). Of the remaining applications, 20 were withdrawn from consideration, six were declined, 17 were pending approval and eventually withdrawn or declined, and 19 were pending approval and eventually approved.
- 4.9 In total, the Treasury received 142 applications (85 from NBDTs, 12 from banks, and 45 from collective investment schemes). Ninety-six were approved (60 NBDTs, 12 banks, and 24 collective investment schemes), 15 were declined, and 31 applications were withdrawn. The 96 approvals were for 73 participating entities. Some entities had several investment schemes guaranteed, while some financial groups had multiple financial institutions accepted under the guarantee.

## Different types of guarantee deeds

- 4.10 Different guarantee deeds were needed for the different types of institutions. The Scheme had different eligibility criteria for registered banks and other types of institutions. NBDTs, for example, needed to meet additional ongoing requirements that did not apply to banks. Unrated NBDTs also needed to pay a different fee. A different guarantee deed to that for finance companies was drafted for building societies and credit unions (because of the need to include industry-specific references to Acts and Registrars and for coverage to include member shares).
- 4.11 The Scheme had five different guarantee deeds (for registered banks, building societies and credit unions, and three separate NBDT guarantee deeds covering finance companies, cash collective investment schemes, and unit trust collective investment schemes).

- 4.12 Although the guarantee deeds were different for each entity type, they were not individually negotiated with financial institutions. The guarantee deed for each finance company was the same.
- 4.13 A new draft specimen guarantee deed was made available on the Treasury's website each time the policy changed during the first days of the Scheme (for example, there were changes on 12, 15, and 22 October 2008). The urgency of the situation and the need to quickly restore depositor confidence meant that announcements were needed as soon as possible, so new specimen guarantee deeds were posted to the website quickly. This high level of transparency let financial institutions see the requirements they were working to.

### Application form

- 4.14 Along with the specimen guarantee deeds, the Treasury's website listed an application form setting out the information required in the guarantee application. For NBDTs, the information required included:
- the names of directors, management, and trustee;
  - a description of the corporate structure and a profile of the applicant's business and financial services provided;
  - the value of debt securities on issue and number of depositors; and
  - copies of the latest annual report, prospectus, investment statement, and trust deed.

### Communicating the approved applications

- 4.15 Although the Treasury did not release the names of applicants during the assessment process, the approvals were made public. In the interest of public confidence, the Treasury was aware of the need to assess applications and disclose approvals quickly. Once each application was approved, the name of the applicant was listed on the Treasury's website along with a copy of the signed guarantee deed. Also, consistent with the requirements of section 65ZD of the Public Finance Act about issuing a guarantee, a statement announcing the approval was published in the *Gazette* and presented to Parliament.<sup>16</sup>
- 4.16 The Treasury published on its website a list of all institutions participating in the Scheme and updated that list as institutions were approved under the Scheme. In our view, these disclosures were very clear. There was no public notice of financial institutions that had their application declined.

<sup>16</sup> Section 65ZD requires that issuance of a guarantee by the Crown in excess of \$10 million must be published in the *Gazette* and presented to Parliament.

## How non-bank deposit takers were processed

- 4.17 Approvals for NBDTs started on 7 November 2008. By the end of 2008, 48 NBDTs had been granted the guarantee.
- 4.18 Despite acknowledging that the risk to the Crown would be higher, policymakers in the Treasury and the Reserve Bank had recommended to the Minister in the Options Report of 10 October 2008 that the Scheme be offered to NBDTs. The rationale then was less about public and depositor confidence and more about avoiding a government initiative that could cause the NBDT sector to fail. This recommendation was largely adopted by the Minister.
- 4.19 The Options Report recommended a risk-based fee structure for NBDTs and a lower guarantee cap to reduce the fiscal risk to the Crown. The Options Report also indicated that officials would consider other measures to mitigate the additional fiscal risk, such as improved reporting requirements.
- 4.20 When the Scheme was implemented, not all of these measures were in place. Our interpretation of later Treasury reports was that the Minister preferred a flatter fee structure. The recommendation for a lower guarantee cap for NBDTs was considered in a Treasury report dated 21 October 2008. There was a cap of \$1 million for each depositor within each institution.

## Assessing applications under the Scheme

### The role of the Policy Guidelines

- 4.21 Each individual financial institution's application was considered in its own right. This was required by the Policy Guidelines and by the execution of the guarantee under the Public Finance Act using contracts.
- 4.22 The Policy Guidelines contained "relevant criteria" to be considered in assessing applications (see paragraph 3.31-3.32). The Policy Guidelines also provided a list of "other factors" to be considered in exercising the discretion to offer the guarantee (see paragraphs 3.33). These included size, creditworthiness, related-party exposures, business practices, and track record.
- 4.23 In contrast to the "relevant criteria" that needed to be met, the "other factors" were for guidance only. We understand they were introduced to provide a mechanism through which the Treasury could decline financial institutions that were attempting to misuse the Scheme or were clearly in serious financial trouble. The Treasury was mindful that it needed to exercise the discretion under the Public Finance Act rather than rigidly apply mandatory criteria.

### The relative roles of the Treasury and the Reserve Bank

- 4.24 As noted in paragraph 3.15, the Minister delegated the power to give guarantees under the Scheme to the Secretary to the Treasury. As part of the contract between the Treasury and the Reserve Bank, the Reserve Bank considered the applications provided to the Treasury and advised the Treasury about whether an applicant was eligible to apply for the guarantee. The Reserve Bank's advice was based on the relevant criteria outlined above and whether the Reserve Bank considered that it was in the public interest to grant the guarantee.
- 4.25 The application process for NBDTs included these steps:
- Information was received from the financial institution (see paragraph 4.14).
  - The Reserve Bank requested a letter of attestation from the trustee, which confirmed that the NBDT was a deposit-taker, was eligible for acceptance into the Scheme, did not have solvency issues, and was complying with the terms of its trust deed.
  - The Reserve Bank considered the application against the criteria and provided a letter of advice to the Treasury.
- 4.26 The Reserve Bank's role was advisory and it was the Treasury's decision (under delegation) to either grant the guarantee or decline the application.
- 4.27 The Treasury and the Reserve Bank agreed that the Reserve Bank would apply a negative assurance approach. That is, the Reserve Bank would recommend that the guarantee be given unless, after considering the relevant criteria and the "other factors", there was a reason not to. The "other factors" did not need to be individually confirmed. Moreover, because the content of prospectuses varied considerably across financial institutions, it is unlikely that the Reserve Bank would have been able to assess fully the "other factors" for all institutions.
- 4.28 The Treasury would then apply a positive assurance approach. To do this, the Treasury would consider the Reserve Bank's advice and any other information at hand (such as the institution's size and its importance to the financial system). This information would then be considered in the context of depositor confidence, to decide whether it was in the public interest to grant the guarantee.
- 4.29 Despite this agreement, there were some early discussions between the Treasury and the Reserve Bank about the extent of due diligence checking of the financial position of individual NBDTs. The level of enquiry needed for "other factors" such as creditworthiness, for example, was unclear. This led to some confusion about how to apply the "other factors" in the Policy Guidelines when assessing applications.

- 4.30 It was agreed that the Reserve Bank would assess the information provided as part of the application, the advice given by the trustees, and any other information the Reserve Bank held, but that the Reserve Bank would not carry out a full due diligence check. The Reserve Bank would not make further inquiries unless it had pre-existing information or was on notice about a particular matter relevant to the Policy Guidelines.

### Reviewing applications

- 4.31 The process for bank applications was relatively straightforward. The Reserve Bank had been the supervisor of registered banks for some time, so its advice was mostly about whether a bank was in breach of its prudential requirements.
- 4.32 A number of financial institutions were declined based on their failure to meet the relevant criteria. For example, some applicants were not deposit-takers or had complex structures. Some were in a moratorium (that is, they were suspended from activity as part of a creditor arrangement). No applicant was refused in the first few months of the Scheme based on the “other factors”, such as creditworthiness or business practices.
- 4.33 We understand that there was pressure to quickly process applications. This appeared to be driven by the objective of maintaining confidence rather than by any direct pressure from the Minister or senior managers within the Treasury. The pressure to process applications may have also resulted from the fact that an institution was not covered by the Scheme until its application was approved (due to the opt-in approach). Although we did not see any target times for processing applications, a media statement on 22 October 2008 indicated that it may take “several days for any particular application to be processed”, given the large number of applications.
- 4.34 Staff of the Treasury said during interviews that they felt under significant pressure to process applications quickly. There was limited opportunity to carry out extensive reviews of individual financial institutions. There was also limited time to request additional information and no time to appoint an inspector, which would have been required to fully investigate the financial position of NBDTs.
- 4.35 As part of the application process, the Reserve Bank, and hence the Treasury, relied on the advice of the trustee (as supervisors of the NBDTs). Although this was consistent with the terms of the supervisory model, it was clear during our audit that many in the industry had concerns about the capability of some of the trustees. The Registrar of Companies also raised a number of issues with

the trustee supervisory model as part of a report from the Ministry of Economic Development to the Commerce Committee in 2008.<sup>17</sup>

- 4.36 In our view, further inquiries could have been made of some financial institutions as part of the application process (either to the financial institution or to the trustee through the Reserve Bank). The Treasury and the Reserve Bank did not seek additional information in the early days of the Scheme. They were focused on the objective of depositor confidence rather than trying to minimise the Crown's liability.
- 4.37 If an institution's application was declined and the institution later failed, public and depositor confidence might have been affected when maintaining this confidence was the Treasury's priority. The Treasury also considered possible legal risk when reviewing the applications from financial institutions.
- 4.38 By the end of 2008, financial markets showed some signs of stabilisation, even though the economy was still in recession. The financial crisis had eased, and market confidence had improved. The Treasury and the Reserve Bank continued to consider applications to join the Scheme, but by late 2008 there were few financial institutions applying.

### **Mascot Finance Limited's entry into the Scheme**

- 4.39 Mascot Finance was one of the institutions considered in late 2008. Although Mascot Finance had applied for the guarantee on 15 October 2008, its application was not approved until early 2009 (mainly because there was a delay before the confirmation letter was received from the trustee – see Figure 8). Shortly after, on 2 March 2009, Mascot Finance was placed into receivership by Perpetual Trust Limited.
- 4.40 Although the Treasury and the Reserve Bank acknowledged that an NBDT failing under the Scheme was inevitable, the first failure so early in the Scheme was a surprise.

<sup>17</sup> Report of the Commerce Committee, *2007/08 Financial Review of the Ministry of Economic Development*, Appendix B.



## Figure 8 Application process for Mascot Finance Limited

Mascot Finance applied to join the Scheme on 15 October 2008 (the application letter was dated 14 October 2008). Mascot Finance was based in Timaru and primarily provided property loans (to developers and investors), and gaming and commercial loans.

About 57% of Mascot Finance's loans were to the property sector. Its total assets at 31 March 2008 were \$137 million (compared with \$183 million on 31 March 2007), with \$26 million in impaired loans. At the time of its application, Mascot Finance did not have a current prospectus (it had been withdrawn in September 2008) and was in wind-down mode, although it still had debt securities on issue (with retail deposits of \$98 million from about 5000 depositors at the time of application). A \$650,000 standby facility from Westpac was withdrawn on 18 June 2008.

As part of each application, a letter was required from the trustee to confirm certain aspects of an NBDT's position. The Reserve Bank requested this letter on 24 October 2008. The letter, dated 16 December 2008, from Perpetual Trust Limited was sent to the Reserve Bank confirming that Mascot Finance had eligible debt securities on issue and that, other than the trust deed breach described below, there was no issue with solvency or Mascot Finance's ability to pay its debts. The letter described a breach of the terms of the trust deed in March 2008, discovered in May 2008, due to a misclassification of certain assets. This breach was rectified by 31 May 2008.

In addition, Perpetual Trustees had appointed an investigating accountant in September 2008 to look at Mascot Finance's financial position, provisioning, and level of bad debts. The accountant reported that, although Mascot Finance was to exit the industry, it was concerned about Mascot Finance's ability to meet cash flow needs. The accountant suggested selling a specific loan, getting additional security, or presenting a capital repayment plan to investors.

The Reserve Bank raised these issues with the trustee on 19 December 2008. The trustee had confidence in Mascot Finance's ability to continue to meet its obligations and noted that there had been no further impairment and no further breaches of the trust deed. Additional security was also obtained for the specific loan. Mascot Finance was considering re-issuing its prospectus and recommencing taking deposits if it was granted the guarantee. There was also anecdotal evidence that South Canterbury Finance would not let Mascot Finance fail (Mascot Finance and South Canterbury Finance shared a common home base of Timaru).

In a letter to the Secretary to the Treasury on 22 December 2008, the Reserve Bank confirmed that Mascot Finance was eligible for a guarantee and met all the criteria set out in the Policy Guidelines. The Reserve Bank also confirmed that:

*... based on the material it has considered, and having considered other factors that might be relevant in coming to a decision as to whether or not to offer or refuse a Crown Guarantee, the Bank has no reason to believe that it would not be in the public interest and consistent with the maintenance of public confidence in New Zealand's financial system and the maintenance of confidence of general public depositors in New Zealand financial institutions, as referred to in the purpose of the Public Finance Act, the preamble to the deed and in the overarching principles of the Policy Guidelines, to invite the Entity to enter into a Deed of Guarantee with the Crown.*

The Treasury held an internal meeting on 22 December 2008 to discuss the application. Those at the meeting considered the Reserve Bank's advice, the size and status of the institution, the advice from the trustee, the nature of the prior breach of the deed, and Mascot Finance's solvency position. The Treasury was concerned that public confidence would be affected if Mascot Finance was not covered by the guarantee. The conclusion was that it was necessary and expedient to provide a guarantee.

Mascot Finance's application was approved on 12 January 2009.

Mascot Finance experienced problems when a single large borrower failed to repay as expected. The institution was put into receivership on 2 March 2009.

## Our assessment of the Treasury's handling of Mascot Finance Limited

- 4.41 The processing of Mascot Finance's application followed the steps that applied to all applications. The application took longer to process than some others (but this was mainly because of the delay in receiving the confirmation letter from the trustee).
- 4.42 When presented with information that could have possibly affected the outcome, the Reserve Bank went back to the trustee for more information. The Reserve Bank relied on the trustee's opinion that it was confident that Mascot Finance could continue to meet its obligations, which was consistent with the role of the trustee as the supervisor of Mascot. The Treasury relied on the advice of the Reserve Bank (which, again, was consistent with the terms of the service agreement and the expertise of the Reserve Bank) but also considered the issues surrounding the application, including the trustee's advice.
- 4.43 Mascot Finance clearly met the technical eligibility criteria as part of the Policy Guidelines (it had debt securities on issue, and provided financial services predominantly in New Zealand and not primarily to related parties).
- 4.44 However, based on the information provided by the trustee, in our view, a closer review of Mascot Finance's financial position was warranted. As discussed above, the process agreed between the Treasury and the Reserve Bank was that the Reserve Bank would not conduct a full due diligence check on the individual institution but would consider the information at hand that was relevant to the Policy Guidelines. The Treasury would then apply its positive assurance approach (see paragraph 4.28), relying on the Reserve Bank's advice as well as other information at hand. We consider that the concerns raised by the trustee constituted "information at hand" that warranted further review.
- 4.45 There is no question that both the Treasury and the Reserve Bank closely considered the issues raised by the trustee. The agreed process was followed (that is, making further inquiries when aware of any issues), and the issues raised in the letter from the trustee were pursued by telephone conversations between the trustee and the Reserve Bank. The outcome of that conversation was conveyed to the Treasury. In considering this information, the Treasury and the Reserve Bank relied significantly on the trustee and, in particular, on the trustee's confidence in Mascot Finance's ability to continue to meet its obligations.
- 4.46 In our view, the concerns raised by the trustee's investigating accountant about Mascot Finance's exit plans should have been further explored. We did not see evidence that the Treasury or the Reserve Bank met with the trustee or the

investigating accountant to discuss the concerns or to conduct any further inquiries. The application was processed quickly once the trustee's advice was received. We consider that there was time to pursue further lines of inquiry given that some of the initial urgency associated with getting institutions into the Scheme should have been starting to subside. If further investigation had been pursued in early 2009, it is possible that the deterioration in Mascot Finance's financial position would have been more evident.

- 4.47 We realise that our comments are made with the benefit of hindsight. We also note that there were some signs in late 2008 that Mascot Finance's position was improving. Therefore, we are not suggesting that Mascot Finance should have been immediately declined based on the information at hand. This carried some risk, and could have had repercussions for the public confidence that the Scheme was designed to maintain. Rather, we suggest that additional information should have been requested about Mascot Finance's liquidity position to provide further assurance that Mascot Finance was able to meet its upcoming debt obligations. We also appreciate that the supervisory model involved relying on the trustee's advice. Nevertheless, in a borderline case, and in the light of industry concerns about the weaknesses of the trustee model, further inquiries should have been made.

### **Reviewing applications for the Scheme after the failure of Mascot Finance Limited**

- 4.48 At the time of Mascot Finance's failure, media commentators, politicians, and others began questioning the Treasury's acceptance of Mascot Finance into the Scheme. Possibly because of this, or as a result of the easing of the financial crisis, the Treasury and Reserve Bank's emphasis on "other factors" when processing applications changed.
- 4.49 Until early 2009, the objective of depositor confidence was seen to be more important than concerns about credit quality or financial strength. As a consequence, applications were considered largely in the context of the "relevant criteria" in the Policy Guidelines.
- 4.50 Although not formally documented as a change, applications processed after February 2009 were more closely considered in terms of the riskiness of the institution. The "other factors" to be considered, such as creditworthiness and business practices, became more of a focus once eligibility was confirmed. The Treasury has told us that this change in focus reflected the fact that, by this time, the remaining applicants were generally higher risk institutions. A number of financial institutions were declined based on their high probability of failure and the potential for an increase in the cost to the Crown if they were accepted.

- 4.51 The change in emphasis occurred about the time that the Treasury increased its monitoring of individual institutions because the more straightforward applications had already been processed. The Treasury had started to receive risk reporting from the Reserve Bank about NBDTs under the Scheme (see Part 6). New Treasury staff with the skills needed to carry out this monitoring had also just started work.
- 4.52 With the failure of Mascot Finance and the need for the Treasury to pay depositors and wait to recoup funds, possibly at a loss, the financial implications of the Scheme had become clear. Although the objective of the Scheme was still maintaining depositor confidence, the Treasury started to place more emphasis on minimising the potential cost to the Crown.
- 4.53 We did not see evidence that the shift in emphasis was actively discussed in the Treasury or with the Minister. In our view, a change like this should be clearly documented and reported to the Minister.



## Part 5

# Assessing and amending the Scheme

- 5.1 In this Part, we discuss:
- the Treasury’s assessment of the overall performance of the Scheme;
  - the Treasury’s actions to enhance its powers;
  - some of the other issues with the design of the Scheme;
  - the Treasury’s work to revise and then extend the Scheme;
  - the information communicated when the Scheme was revised and then extended; and
  - our overall views on the Treasury’s actions.
- 5.2 In summary, we consider that the Treasury did not prepare a thorough assessment framework for the overall performance of the Scheme. A thorough assessment framework could have helped to ensure:
- that the Government was better informed about how the Treasury was implementing the Scheme;
  - that the Government was better informed about the effects and performance of the Scheme; and
  - earlier identification of any issues and challenges with the design and operation of the Scheme (including the tools available for responding to high-risk institutions).
- 5.3 In our view, the Treasury could have acted sooner to identify and offer advice on suitable tools for responding to high-risk institutions. However, tighter controls, including specific exclusion of interest payments after an institution failed, were put in place with the passing of the Crown Retail Deposit Guarantee Scheme Act in September 2009.

### Assessing the overall performance of the Scheme

- 5.4 Given the importance of the Scheme to the stability of the financial system, and the potential Crown liability, it was important for the Treasury not only to implement the Scheme but also to continually assess the overall performance of the Scheme against its objectives.
- 5.5 The Treasury’s *Statement of Intent 2009-2012* highlighted the Scheme as an important response to the financial crisis at that time, explaining that the purpose of the Scheme was to ensure continued confidence in the banking system by guaranteeing money deposited or lent. It considered the management of risks posed by the Scheme, noting the prudential regulation of banks, specific monitoring of NBDTs, and some of the controls imposed on business activities

of the NBDTs. The Statement of Intent did not say anything further about the Scheme, its objectives, or the Treasury's processes for assessing and measuring the Scheme's performance.

- 5.6 In its *Statement of Intent 2010-2015*, the Treasury indicated that it had the people, skills, and systems in place to:<sup>18</sup>
- process and make decisions on applications for guarantees by eligible banks and NBDTs;
  - monitor institutions' compliance with the guarantee deeds;
  - assess and collect guarantee fees;
  - manage any claims from depositors in a timely and efficient way in the event of a default; and
  - report the progress of the Scheme, including provisioning in the Financial Statements of the Government.
- 5.7 Also in the *Statement of Intent 2010-2015*, the Treasury explained that it was managing the Crown's exposure to risk related to the initial Scheme through the prudential regulation processes for registered banks and by requiring at least monthly financial reporting and other business controls from NBDTs.

## Assessing the effectiveness of the Treasury's powers

### New Zealand's approach to intervening in the financial system

- 5.8 The view long held by governments in New Zealand has been that intervention in the operations of a financial institution should be minimal. This long-standing approach, as explained by the Governor of the Reserve Bank in a speech in 2007, is that "market-based solutions – sometimes with regulatory prompting and encouragement – often result in a better performing financial system".
- 5.9 The approach is reflected in Part 5D of the Reserve Bank Act which says that "depositors are responsible for assessing risk in relation to potential increments and of their own investment choices".<sup>19</sup> It is also reflected in the Reserve Bank's general requirements for disclosure statements<sup>20</sup> for registered banks, and the reliance of the regulatory and supervisory framework for banks and NBDTs on credit ratings. The purpose of disclosures and credit ratings is to arm depositors, creditors, and other parties with information to assess the creditworthiness of the institutions and, in so doing, enforce market discipline. For this purpose, market

18 Of these, Part 3 discussed the changes that the Treasury made to the Scheme's draft design soon after its announcement on 12 October 2008. Part 4 discussed the applications process. Parts 6 and 7 consider the monitoring, provisioning, and payout processes.

19 Reserve Bank of New Zealand Act 1989, section 157F(2)(b)(ii).

20 Reserve Bank of New Zealand (2011), Registered Bank Disclosure Statements (New Zealand Incorporated Registered Banks) Order (No. 2) 2011, Wellington.

discipline is about encouraging institutions to behave appropriately on the basis that the depositors, creditors, and other interested parties will monitor the health of those institutions carefully and will choose to invest or lend to the healthiest of those institutions.

- 5.10 Consistent with this approach, there is no permanent deposit insurance scheme in New Zealand, nor a government guarantee or depositor preference arrangements. The belief is that such arrangements would undermine the incentives for depositors, creditors, and others to monitor effectively, and that this would be detrimental to soundness and efficiency. Moreover, it is believed that regulatory protection of depositors can inadvertently and inappropriately become a form of protection of shareholders, undermining incentives for good risk management and leading to lower-quality financial system performance overall.<sup>21</sup>
- 5.11 Introducing the Scheme was a significant intervention, and a major departure from previous policy settings. This was recognised in the Options Report of 10 October 2008, when the Treasury and the Reserve Bank highlighted that providing a scheme would fundamentally change New Zealand's approach to financial regulation.

### The Treasury's powers under the Scheme

- 5.12 The Scheme was implemented quickly, and there was no opportunity to fully explore the consequences of the various policy decisions that the Government made at the time. This included the powers given to the Treasury to implement the Scheme. Although the Treasury refined aspects of the Scheme in the weeks after its introduction, the formal boundaries and powers were set once the guarantee deeds were finalised.
- 5.13 At a level of principle, there are a range of options available for responding to emerging issues within a financial institution. At one end of the spectrum, relatively light oversight could include additional information requests, attestations from directors, or conversations with financial institutions to discuss business strategies. Along the spectrum are several other activities, including issuing directions to restrain activities, commit additional capital, or improve risk management practices (such as managing delinquent loans). At the other end, heavy-handed intervention could include powers to appoint receivers or statutory managers.
- 5.14 The Government's decisions when the Scheme was designed determined how far along that spectrum the Treasury could go. Within that range, the appropriate response depended on the circumstances of the financial institution. Ultimately,

21 Bollard, Dr A and Ng, T (September 2003), *Financial system regulation in New Zealand*, paper presented during a speech to the Finance Sector Ombudsman Conference and reproduced in the Reserve Bank of New Zealand Bulletin, Reserve Bank of New Zealand, Vol. 66, No. 3.



the response had to balance the cost of the intervention, including the risk of triggering the guarantee or of litigation, with the benefits of potentially reducing the Crown's liability. The Treasury's powers and remedies under the Scheme included:

- asking for information from the institution or third parties (such as the trustee, auditors, bankers, and regulators);
- restricting or prohibiting certain transactions for NBDTs (such as distributions and related-party transactions);
- appointing inspectors to NBDTs;
- asking for undertakings from directors of NBDTs; and
- withdrawing the guarantee.

5.15 The guarantee could be withdrawn if an institution failed to comply with ongoing obligations under the trust deed or failed to provide information requested, or for other reasons such as conducting affairs contrary to the intention of the guarantee.

5.16 The Treasury's ability to withdraw the guarantee was a complicated power. Once an institution was accepted into the Scheme, the Crown was committed to repay the institution's eligible deposit balance, regardless of whether the guarantee was later withdrawn. Withdrawing the guarantee could also have significant implications for the financial institution. The Treasury was reluctant to withdraw the guarantee if doing so would be at odds with the goal of keeping depositor and public confidence. It was possible that an institution would fail as a result of the withdrawal, which would trigger the guarantee (with no reduction in liability). Part 6 includes more discussion about withdrawing the guarantee.

5.17 Overall, the powers that the Treasury had under the Scheme were limited. Treasury officials interviewed had different views about the implications of the Treasury having limited powers. Some officials did not consider the Treasury's lack of powers to be problematic, believing that:

- the Scheme was not designed to prevent default or insolvency;
- the Treasury's role was to guarantee and pay out in the event of default, not to police the financial institutions covered by the Scheme;
- not intervening with institutions was consistent with the more general approach to regulation and supervision; and
- becoming involved in the running of an institution removed liability from directors and posed legal risks to the Crown if the institution failed during the period that the Treasury was directly intervening.

### Ongoing advice on options

- 5.18 In our view, the Treasury relied too heavily on the presumption of minimal intervention, at least in its early policy advice. It should have been giving earlier and more thorough policy attention to whether a wider range of powers might help to manage the cost to the Crown while still meeting the Scheme's primary objective. This comment applies mainly in relation to institutions that were involved in activities that were not prudent and thereby posed undue risk to the Crown, but were not yet failing.
- 5.19 The Treasury extensively analysed its options in the event of an NBDT being in difficulty or failing, including providing liquidity support or placing the institution under statutory management. The Treasury considered, among other management tools, more active management of deposit book growth (such as powers to intervene to prevent continued growth) and requirements that financial institutions get authorisation from the Treasury for any changes of ownership.
- 5.20 We saw evidence that the Treasury considered potential additional powers in the early days of the Scheme. In a draft internal note titled "Intervention Options for the failure of a deposit taker under the Crown guarantee",<sup>22</sup> the range of options included:
- no intervention;
  - payout under statutory management or receivership;
  - liquidity support;
  - merger/facilitated merger;
  - transfer of deposit book; and
  - recapitalisation or restructuring.
- 5.21 The paper was focused largely on responses to a failed institution or an institution that was close to failing. It did not appear to consider additional powers to provide directions to a financial institution that was in difficulty, although that is implicit in a facilitated merger. Some of these issues were considered further in an internal discussion note titled "Factors to guide government intervention in NBDT failure under the DGS" (undated, but we understand that it was drafted in August 2009).
- 5.22 Around the middle of 2009, in response to information provided by the Treasury, the Minister and Prime Minister asked the Treasury to identify additional management tools (steps the Treasury could take before an institution failed) and resolution tools (steps the Treasury could take after an institution failed), regardless of whether the Scheme was extended.

<sup>22</sup> Undated, but according to the Treasury's document management system it was drafted in February 2009.

- 5.23 The Treasury explored other resolution options but appeared to consider the standard resolution mechanisms (that is, payout and receivership) to be adequate.
- 5.24 The Treasury was concerned to ensure that changes to any management and resolution tools would not undermine eligible depositors' rights under the guarantee.
- 5.25 The Treasury prepared a "significance test" in August 2009, to help it assess whether the failure of an NBDT would have significant economic or fiscal effects. This was as well as the "systemic" test that the Reserve Bank applied for intervention to support a failing financial institution and maintain the stability of the financial system. The Treasury considered it unlikely that any NBDTs would meet the significance test's threshold.
- 5.26 Minutes of the monthly financial system issues meeting between the Treasury, the Reserve Bank, and the Minister in September 2009 show that the resolution framework was discussed. The Minister noted that the framework needed to be developed to identify all available options and to ensure that the Treasury and the Government were ready, even though each response would be specific to the situation.
- 5.27 At this September 2009 meeting, the Reserve Bank indicated that it had been working on a "pre-emptive distressed asset management fund" to avoid paying out under the guarantee. The Treasury noted that it would provide the Minister with additional information on options to recover funds from institutions that failed while in the Scheme.
- 5.28 In general, there appeared to be a view that recovering funds after a payout and receivership or liquidation was more desirable and less costly than intervening before a failure. However, we did not see evidence of the growing financial risks being considered at a strategic level or informing the Treasury's ongoing policy analysis and advice to Ministers on options. Although there were ongoing discussions with Ministers about policy settings, we did not see evidence of strategic analysis of the range of options alongside the unfolding risks. In particular, we consider the evidence of increasing deposits and liability should have prompted more policy work.

## Other design issues that affected the operation of the Scheme

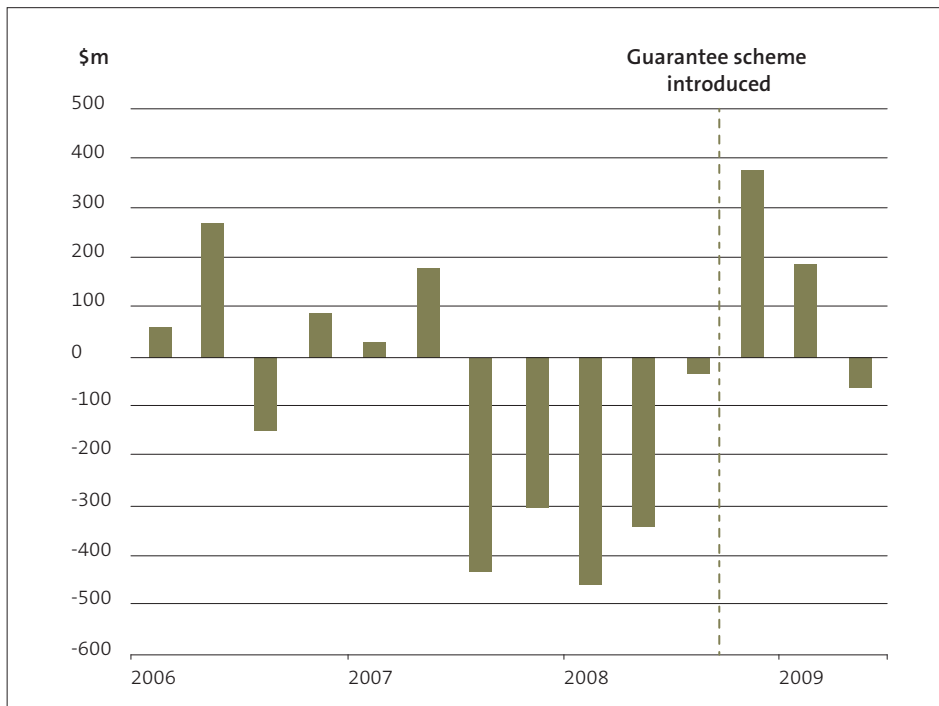
### Description of design issues

- 5.29 Other issues emerged with the design of the Scheme which challenged its implementation. Some of these were predicted on or before the Scheme's introduction. Some emerged only as the Scheme evolved.
- 5.30 These design issues included:
- market distortion;
  - complicated eligibility criteria for depositors;
  - how to deal with interest payments after guaranteed institutions failed;
  - implications arising from the contractual relationship between the Crown and financial institutions; and
  - a “funding wall” of investments due to mature when the Scheme ended.

### Market distortion

- 5.31 The Treasury recognised early that including NBDTs in the scheme would create distortions in the financial system. Before the Scheme was introduced, the deposit books of many of the finance companies were shrinking. In the months after the Scheme's introduction, the deposits of the finance companies grew significantly (see Figure 9).
- 5.32 The returns that finance companies paid to depositors before the Scheme were higher than those paid by banks, reflecting finance companies' higher-risk lending. When the Scheme was introduced, some finance companies continued to pay these high returns. This encouraged depositors to invest in higher-returning government-guaranteed (effectively risk-free) finance company deposits. Without regulatory restrictions, the growth in deposits allowed finance companies to continue to engage in higher-risk lending.

**Figure 9**  
**Growth in retail deposits with finance companies before and after the Scheme was introduced**



Source: Reserve Bank of New Zealand Financial Stability Report, November 2009.

- 5.33 The Treasury was aware of, and had highlighted before the introduction of the Scheme, concerns about potential effects on deposits and the importance of monitoring deposit flows. Deposit flows were a useful measure of effectiveness. Metrics related to overall deposit volatility were an indication of whether depositors had regained confidence in the financial system. Overall deposit growth measures, as well as measures reflecting changes in deposit levels within and between the banking and NBDT sector, provided the Treasury with information about whether the Scheme was distorting the market. These measures were also an indication of whether some financial institutions were taking advantage of the guarantee to raise large amounts by attracting deposits at higher rates of return to fund riskier loans.
- 5.34 The design of the Scheme provided some incentive for NBDTs to constrain deposit growth. Deposit growth of more than 10% a year would incur a fee based on the credit rating of the NBDT. However, the Treasury recognised that this did not adequately deter some NBDTs from offering attractive interest rates on deposits.

- 5.35 The Treasury carried out more targeted analysis in May 2009 of deposits in NBDTs. There were concerns about NBDTs in wind-down mode (as they could have been vulnerable to takeover) as well as those showing high rates of growth. The Treasury decided to send particular NBDTs a letter asking for more information about their business plans and reasons for the high or low levels of growth. The Treasury decided that it could put a cap on the guaranteed amount, carry out closer monitoring, and/or send reminders of prudent business behaviour.
- 5.36 Letters were sent to a number of institutions in May 2009 asking for further financial information and for a director's certificate. The information obtained was then used to identify where inspectors needed to be sent in to have a closer look at the business operations. When designing the Revised Scheme and Extended Scheme, the Treasury recognised that additional powers to prevent continued deposit growth would be useful.

### **Complicated criteria for deciding which depositors were eligible for the guarantee**

- 5.37 From the outset, the policy intention was to guarantee retail deposits made with financial institutions. Details issued in the early days of the Scheme made it clear that deposits of New Zealand citizens and New Zealand tax residents were guaranteed, but deposits and other liabilities owed to financial institutions and related parties were not guaranteed. The guarantee also covered deposits held by those who provided trustee or nominee services as a bare trustee.<sup>23</sup>
- 5.38 These definitions were reasonable but in practice were difficult to apply. Moreover, the criteria were not tested until they needed to be used. When an NBDT under the Scheme failed, the Treasury had to decide which depositors would be paid. The criteria were complicated for a number of reasons, such as the definition of financial institution (which included unintended complexities in assessing the eligibility of depositors such as financial advisers and public trusts), the wide range of investor types (including trusts, joint accounts, companies, and deceased estates), and the fact that some of the information required (such as tax status and residency) were not details normally held by the NBDT. These issues did not emerge until Mascot Finance failed and the Treasury had to work out who was to be paid. Eligibility was further complicated by claimants (that is, depositors) often submitting incorrect claim forms to the Treasury.
- 5.39 The eligibility criteria were refined when the Scheme was revised and when it was extended, to clarify the position of certain investor types. This complicated the criteria further.

<sup>23</sup> Bare trustees are sometimes called naked trustees or simple trustees. They have no duties other than conveying the trust's assets to beneficiaries, according to the trust's provisions.

### **Paying interest after a financial institution failed**

- 5.40 The question of how to deal with the payment of interest on deposits between the time that a financial institution failed and the time that the depositor was repaid arose unexpectedly when the Treasury was processing claims for Mascot Finance. The treatment of these interest payments was not clear, so the receivers, the trustee, and the Attorney-General (on behalf of the Crown) sought a court interpretation. The Treasury supported this move and agreed that clarification was required.
- 5.41 The High Court ruled on 27 August 2009 that the Crown was liable to pay interest on deposits at the interest rate agreed to be paid by the financial institution. The interest accrued from the date the institution failed until the Crown paid the claim.
- 5.42 This decision meant that depositors could take advantage of the system; they could continue to receive high interest payments at a cost to the Crown by delaying when they submitted their claim forms. There was no deadline in the original guarantee deeds for submitting claim forms.

### **Use of contracts**

- 5.43 An important early policy decision was to set up the Scheme through a contract between the Crown and the individual institution under the Public Finance Act. Specific legislation to provide the guarantee would have taken time to write and implement. Given the urgency of the situation, and the fact that Parliament had been dissolved on 3 October 2008, legislation was not possible.
- 5.44 The Scheme was based on opt-in contracts that enabled risk-based fees to apply. The opt-in nature of the Scheme also allowed NBDTs to be subject to monitoring and information requirements.
- 5.45 However, there were a number of unintended practical consequences that arose from the decision to use contracts. These included the issue of paying interest after an institution failed, difficulties in modifying the contract, issues with the way the Crown recovered funds from failed institutions (as part of the receivership process), and limitations in the powers that the Treasury had (its powers were limited to those set out in the contract or under existing statutes).

### **Funding wall**

- 5.46 Another effect of the Scheme was the creation of a “funding wall” on 12 October 2010 (the Scheme’s original end date). The finite term of the Scheme meant that financial institutions took deposits out to the end date of the guarantee but found

it difficult to get deposits beyond this date (investors wanted their investments to mature inside the guarantee period). As a result, there was a significant amount of funding that would mature at the end of the Scheme.

## Revising and extending the Scheme to address design issues

### Overview of the amendments

- 5.47 In March 2009, the Treasury started taking steps to revise and extend the Scheme. The problem of interest payments after an institution failed (which was clarified in August 2009 by the High Court ruling) was addressed, in part, by changes to the Revised Scheme and explicitly excluded as part of the Extended Scheme. Problems with the use of contracts were addressed under the Extended Scheme through the introduction of new legislation. The Treasury made several changes to the guarantee deeds under the Revised and Extended Schemes to address problems with the Treasury's lack of powers.
- 5.48 The main design features of the Revised Scheme and Extended Scheme are set out in Figure 10. In summary, under the Revised Scheme:
- some debt products were guaranteed and others were not;
  - there was a cap on any interest payments after an institution failed; and
  - the Treasury redefined what a “default” was under the Scheme (that is, what constituted an institution failing).
- 5.49 In summary, under the Extended Scheme:
- fees were based on the risk that an institution posed;
  - changes were made to eligibility (which institutions would be covered);
  - the Treasury had stronger powers to manage institutional risk;
  - the caps on the size of deposits covered were reduced; and
  - changes were made to the timing and structure of the guarantee.



**Figure 10**  
**Comparing the original, revised, and extended phases of the Scheme**

Original Scheme	Revised Scheme	Extended Scheme
<b>Guaranteed period</b>		
12 October 2008 to 12 October 2010	1 January 2010 to 12 October 2010	12 October 2010 to 31 December 2011
<b>Institutions*</b>		
73	63	7
<b>Number of failures</b>		
2	6**	1
<b>Guarantee</b>		
Includes interest accrued after the failure date	Includes interest accrued after the failure date, but cap applies (claim forms must be submitted within adequate time)	Interest after the failure date is explicitly excluded and claim forms must be received within 180 days
<b>Excluded debt security</b>		
N/A	Guarantee does not apply to Excluded Security (entity can offer non-guaranteed debt)	Guarantee does not apply to Excluded Security (entity can offer non-guaranteed debt)
<b>Liability cap</b>		
\$1 million	\$1 million	\$250,000 for NBDTs and \$500,000 for banks
<b>Fees</b>		
Charged if an institution had more than \$5 billion in deposits Charged if an institution experienced a more than 10% increase in its deposit book from year to year	Same as for the original Scheme	Risk-based fees apply to all guaranteed debt (not just growth)
<b>Ratings requirement</b>		
Minimum credit rating of BBB-	Same as for the original Scheme	Minimum credit rating of BB
<b>Supporting legislation</b>		
Public Finance Act 1989	Public Finance Act 1989	Crown Retail Deposit Guarantee Scheme Act 2009

Original Scheme	Revised Scheme	Extended Scheme
<b>Other notable changes</b>		
	<p>Clarifies the treatment of joint account holders and trustees</p> <p>Definition of “default event” provides for 14-day period before guarantee is triggered</p> <p>Expanded reporting requirements (to include subsidiaries)</p> <p>For NBDTs, expanded ongoing obligations and entity to pay for cost of inspector</p> <p>New obligations for NBDTs – adequate disclosure of excluded securities and assistance to the Crown to verify liability and make payments</p>	<p>Carries over the changes to the Revised Scheme, and:</p> <ul style="list-style-type: none"> <li>extended reporting requirements (to include controlled entities)</li> <li>for NBDTs, new obligation to provide notice and information of changes in control</li> <li>for NBDTs, increased requirement for prior Crown consent for certain transactions</li> <li>new withdrawal power as a result of changes to the Crown’s liability</li> </ul>

\* Number of institutions covered when the Scheme started.

\*\* A large proportion of deposits in failed entities covered by the revised guarantee deed continued to be covered by the original guarantee deed (which was the deed in place when the deposit was made).

## The Revised Scheme

- 5.50 In March 2009, the Treasury began considering options for either exiting from the guarantee (an option soon discounted) or extending the Scheme (which was due to expire on 12 October 2010).
- 5.51 The Treasury intended to announce the Extended Scheme about a year before the Scheme expired, to provide market certainty and give institutions enough guidance to enable them to make informed investment decisions. The planned extension was designed to continue to maintain public and depositor confidence while at the same time achieving an orderly exit from the Scheme and allowing institutions to revert to their normal business practices.
- 5.52 At the same time that it was preparing to extend the Scheme, the Treasury was also trying to change the terms of the Scheme to provide more flexibility and address some of the problems noted earlier. Revising the Scheme would also allow a smoother transition to an Extended Scheme by introducing some of the sorts of changes that an Extended Scheme would include.

- 5.53 There were many problems with the Scheme that the Treasury would have liked to address, including the payment of interest after an institution failed and adjustments to allow institutions to offer non-guaranteed deposits. However, the use of contracts constrained the extent of changes that the Treasury could make.
- 5.54 The Treasury had a contractual obligation to ensure that the rights of eligible depositors were not undermined. Under the terms of the original guarantee deed, the Crown was able to withdraw its guarantee as long as it provided the guaranteed institution with the opportunity to enter into another form of guarantee on terms that were not materially adverse to the interests of depositors generally.
- 5.55 On 18 November 2009, the Treasury announced these changes to the Scheme:
- Participating institutions would be able to offer both guaranteed and non-guaranteed debt securities (with clear disclosures in their offering documents).
  - The deeds would provide a 14-day “stand down” period between a potential failure and triggering the Crown guarantee. Without this change, seeking to appoint an administrator, manager, or liquidator would trigger the guarantee. The 14-day period would provide time for the institution to work through its problems and avoid receivership without triggering the guarantee.
  - The Crown would set a time frame for claims to be made after an institution failed. Although it was not possible to remove the payment of interest, this allowed the Crown to set a limit on its liability for interest payments.
- 5.56 Other changes in the Revised Scheme included more detail about depositor eligibility (for example, clarifying how different types of depositors – such as joint holders, beneficiaries, and trusts – would be treated), additional reporting requirements (for example, requesting information about subsidiaries), and refined ongoing obligations (see Figure 10).
- 5.57 The revised guarantee deeds came into effect on 1 January 2010. Institutions had to choose whether to sign up for the Revised Scheme. Replacement deeds that included revised terms and conditions were issued to the institutions that chose to sign up. However, the changed terms affected only new deposits or deposits “rolled over” after 1 January 2010. Existing deposits remained under the terms of the original Scheme.
- 5.58 The Treasury contacted all institutions participating in the Scheme to inform them of the changes and then to send out revised guarantee deeds. Institutions had until 4 December 2009 to accept the revised guarantee deeds. A list of all participating institutions was kept up to date on the Treasury’s website, along with the names of the institutions that did not sign up.

- 5.59 Six institutions elected not to accept the revised guarantee deeds, representing \$84 million of existing deposits. Revised guarantee deeds were issued to 63 institutions, effective from 1 January 2010 for new or rolled over deposits.
- 5.60 For those institutions that chose to decline the revised guarantee deed, new deposits or those rolled over after 1 January 2010 were no longer covered by a Crown guarantee. However, deposits made before 1 January 2010 remained under the original Scheme until 12 October 2010 (unless they became due and payable earlier). Institutions that did not sign up for the Revised Scheme were not eligible to join the Extended Scheme.

### The Extended Scheme

- 5.61 The Treasury considered it necessary to extend the Scheme to continue to promote depositor confidence, minimise economic distortions that might be caused by the “funding wall” (see paragraph 5.46), facilitate the transition to “normal” arrangements, and minimise potential costs to the Crown. Although the potential cost of the Scheme to the Crown was an acknowledged risk earlier in the Scheme, minimising that risk became an explicit objective when the Scheme was extended. The Treasury was active in assessing options for extending the Scheme and produced a number of analysis papers, both for internal purposes and for the Minister and Cabinet.
- 5.62 The Government announced on 25 August 2009 that the Scheme was extended and would expire on 31 December 2011. As part of this, some of the Scheme’s terms and conditions would change. It was the Treasury’s intention to announce the Extended Scheme’s details at least a year in advance to provide certainty for investors and institutions. Changes made when the Scheme was extended included:
- Risk-based fees were to apply to all deposits covered by the Scheme. It was thought that more risk-based pricing would reduce the potential for market distortions due to the Scheme, be more favourable to lower-risk institutions, and encourage some financial institutions to opt out of the Scheme.
  - Eligible bank deposits were to be covered up to a maximum \$500,000 for each depositor in each institution and eligible NBDTs to a maximum \$250,000 for each depositor in each institution (reduced from \$1 million). The reduced cap signalled the transitional nature of the Scheme.
  - The minimum credit rating for institutions wanting to join was BB (institutions rated BB- or below, or unrated, were no longer eligible to join).
  - Collective investment schemes were not eligible for the Extended Scheme.
  - Interest payments after an institution failed were explicitly excluded.

- The reporting requirements for NBDTs were expanded to include controlled institutions and introduce new obligations about changes in control.
- Certain related-party transactions for NBDTs needed the Treasury's prior approval.
- New withdrawal powers were introduced (as a result of changes to the Crown's liability).

5.63 Figure 11 sets out the fees (which were charged monthly) for each version of the Scheme.

**Figure 11**  
Fees charged for the original, revised, and extended phases of the Scheme

	Original Scheme and Revised Scheme	Extended Scheme	
Guaranteed deposits of more than \$5 billion	Annual fees of 10 basis points per annum on amount over \$5 billion.	Monthly fees on full guaranteed amount. Fees as per table below.	
Guaranteed deposits of less than \$5 billion	Monthly fees on cumulative growth in guaranteed amount from 12 October 2008 (growth above an allowance of 10% each year on this amount). Fees as per table below.	Monthly fees on full guaranteed amount. Fees as per table below. Same fees apply whether guaranteed deposits were under or more than \$5 billion.	
Credit rating	All institutions with guaranteed deposits of less than \$5 billion (basis points)	Finance companies (basis points)	Banks, credit unions, building societies, PSIS (basis points)
AA and above	10	15	15
AA-	10	20	15
A+	20	25	20
A	20	30	20
A-	20	40	20
BBB+	50	60	25
BBB	50	80	30
BBB-	50	100	40
BB+	100	120	50
BB	100	150	60
Below BB or Unrated	300	N/A	N/A

Note: A basis point is one hundredth of a percentage point (0.01%). This means that a bank with an A+ credit rating and \$7 billion in deposits guaranteed under the original Scheme would pay fees of 0.1% of \$2 billion each year, or \$2 million.

- 5.64 Another important change was the use of specific legislation to offer the guarantee, instead of using powers under the Public Finance Act. This had the following advantages:
- There was greater certainty about the end date for the Scheme.
  - It enabled better management of Crown risk.
- 5.65 On 13 September 2009, the Crown Retail Deposit Guarantee Scheme Act 2009 came into force, providing legislative authority for extending the Scheme. Under the Act, the Minister can specify entry criteria and terms and conditions of the guarantee. It also included provisions to strengthen the Crown's ability to recover funds from the guaranteed institution, including giving the Crown the same priority as creditors. The legislation provided for the granting of a guarantee if the Minister believed it "necessary or expedient in the public interest to do so" (which also applied in the original Scheme under the Public Finance Act).
- 5.66 Participation in the Extended Scheme was voluntary and by application. Institutions in the original Scheme were not covered automatically by the Extended Scheme. The Extended Scheme was open only to institutions that had been in the original Scheme (except for newly registered banks and merged institutions, at the Crown's discretion). It was important that newly merged institutions be eligible because there was scope for consolidation in the non-bank sector, and the Crown did not want the guarantee to act as a barrier to that. On 18 September 2009, the Treasury released:
- Policy Guidelines setting out the factors to be considered in exercising discretion to offer or refuse the extended guarantee;
  - a notice from the Minister on institutional eligibility;
  - draft deeds for the Extended Scheme (for banks, building societies and credit unions, and NBDTs); and
  - an application form (similar to that for the original Scheme).
- 5.67 The Policy Guidelines were different to those that applied to the original Scheme. Although the "Discretion" and "Overarching Principles" were the same, there were several other changes. The section on "Institutions eligible" was removed because this topic was covered in a separate section on eligibility criteria, and the section on "Relevant criteria" was removed because institutions in the existing Scheme had already met these criteria. There were also changes to the "Other factors to be considered", based on the Treasury's experience of implementing and managing the Scheme. In particular, factors that had proved not to be relevant (such as the size of institution, the number of depositors, and audited accounts) were removed. Other factors were refined or expanded (for example, reference to

compliance with the Reserve Bank's prudential requirements and compliance with the trust deed).

- 5.68 The Policy Guidelines for the existing guarantee period were also revised to be consistent with those for the Extended Scheme. These revised Policy Guidelines would apply to any new institutions with deposits guaranteed until 12 October 2010. Further, the Policy Guidelines were amended to provide for mergers so that a new merged institution with a rating of at least BB would be eligible (previously, new entrants needed to be rated BBB- or better). It was thought that mergers in the NBDT sector might be beneficial for the institutions and could reduce the Crown's risk.
- 5.69 The Notice from the Minister on institutional eligibility was given under section 5 of the Crown Retail Deposit Guarantee Scheme Act 2009. Banks, building societies, credit unions, and other NBDTs such as finance companies were eligible for the Extended Scheme, but collective investment schemes were not. The criteria required eligible institutions to be already approved under the original Scheme, not be subject to withdrawal or default, and have a rating of BB or better. New banks and merged institutions were also eligible. Existing institutions also had to meet criteria similar to the "relevant criteria" from the original Scheme (that is, to have debt securities on issue, to be in the business of borrowing and lending, to be a New Zealand business, and to not lend primarily to related parties).
- 5.70 Only eight institutions – all NBDTs – were approved to join the Extended Scheme. Three institutions are still in the Scheme. Four financial institutions merged, one failed under the Extended Scheme, and one (South Canterbury Finance) failed before the Extended Scheme started – see Figure 12.
- 5.71 Most institutions chose not to join the Extended Scheme. Some institutions were deterred by the cost of participation. Others were performing well and did not need the guarantee. Others did not meet the eligibility criteria (the minimum BB credit rating requirement, in particular).
- 5.72 Guarantee deeds were signed between March and May 2010. As at 30 April 2011, the four institutions still in the Extended Scheme had guaranteed deposits totalling \$1.9 billion.

**Figure 12**  
**Institutions approved to join the Extended Scheme**

Institution	Date extended deed signed	Comments
South Canterbury Finance Limited	1 April 2010	Did not make it into the Extended Scheme. Receiver appointed on 31 August 2010.
Equitable Mortgages Limited	19 March 2010	Failed. Receiver appointed on 26 November 2010.
Canterbury Building Society	28 May 2010	Merged into Combined Building Society, which was covered by the Extended Scheme from 5 January 2011 (now <b>Heartland Building Society</b> ).
MARAC Finance Limited	11 March 2010	
Southern Cross Building Society	28 May 2010	
PGG Wrightson Finance Limited	1 April 2010	The guarantee was withdrawn on 1 September 2011 after completion of arrangements for acquisition of PGG Wrightson Finance Limited by Heartland Building Society.
<b>Fisher &amp; Paykel Finance Limited</b>	17 May 2010	
<b>Wairarapa Building Society</b>	28 May 2010	

Note: The NBDTs still covered by the Extended Scheme after the failures, mergers, and name changes are shown in bold type.

## Applying for the Extended Scheme

- 5.73 The application process for the Extended Scheme was similar to that used for the original Scheme (see Part 4). The Reserve Bank was not contracted to provide monitoring services for the Extended Scheme, but applications were processed in early 2010 when the Reserve Bank was still contracted to provide services under the original Scheme. Also, the Treasury was in a better position in 2010 to assess applications, having had two years' experience in receiving financial and other information about institutions covered by the Scheme.
- 5.74 As well as an assessment against the Policy Guidelines, the application process for NBDTs now involved:
- confirmation from the trustee to the Reserve Bank that the institution met the eligibility criteria, could meet its payments, was solvent, and was complying with the trust deed;
  - advice from the Reserve Bank, confirming that the institution was not in breach of prudential regulations under the Reserve Bank Act, estimating the capital



- ratio and exposure to related-party transactions, and providing the latest financial details of the institution (along with historical key indicators);
  - confirmation from the Registrar of Companies about any obligations under the Companies Act, any issues in prospectus registration, any ongoing inspections or notices, and any enforcement activity; and
  - advice from the Securities Commission on any relevant matters (which had not been required before).
- 5.75 As before, the Minister delegated responsibility to the Treasury for deciding whether to approve applications. This delegation consent specified more exactly the officials who had authority to approve applications. The consent also required the Treasury to provide the Minister with the details of all guarantees entered into.
- 5.76 Once institutions signed the new guarantee deed (from March to May 2010), the Treasury was able to call on many of the additional powers available under the Extended Scheme (that is, the Treasury did not have to wait for the official 12 October 2010 start of the Extended Scheme). These powers included:
- the requirement for the Crown's prior consent for certain related-party transactions;
  - additional grounds for withdrawing the guarantee as a result of changes in the institution's circumstances (such as certain material reductions in the institution's net asset position or insolvency);
  - new obligations to provide notice and information about changes in control; and
  - expanded reporting obligations to include controlled institutions.
- 5.77 Two financial institutions that applied and were accepted for the Extended Scheme have since failed. One of these was Equitable Mortgages Limited. The other was South Canterbury Finance, which was accepted into the Extended Scheme but failed while still in the Revised Scheme. The application process for Equitable Mortgages Limited, and its subsequent failure, is considered in Figure 13.

**Figure 13**  
**Application process for Equitable Mortgages Limited**

Equitable Mortgages Limited is a deposit-taking finance company and part of the Equitable Group. The company invests predominantly in the Equitable Property Mortgage Fund (a group investment fund governed by a trust deed and formed in 2007 to hold most of the Equitable Group's mortgages). This fund in turn invests in loans secured by first mortgages over commercial, industrial, and residential properties. The Equitable Property Mortgage Fund also invests for the other members of the Group. The manager for the Equitable Property Mortgage Fund is Equitable Property Finance Limited (which is also part of the Equitable Group) and the trustee is the same trustee as for Equitable Mortgages (Trustees Executors).

At 31 March 2008, Equitable Mortgages had total assets of \$177 million, equity of \$20.7 million, and debentures of \$152.7 million (at 30 September 2008, assets were \$136 million and deposits \$116 million). The credit rating of Equitable Mortgages was affirmed at BB+ on 11 September 2008 with a stable outlook. A prospectus was registered on 24 September 2008 (and later amended).

Equitable Mortgages applied to join the Scheme on 14 October 2008. The affirmation from the trustee was received by the Reserve Bank on 4 November 2008 with no concerns. However, the Reserve Bank said that Equitable Mortgages was not eligible to join the Scheme because it primarily invested in the Equitable Property Mortgage Fund, which is managed by the Equitable Group. It was the Reserve Bank's view that Equitable Mortgages was providing financial services to a related party, which was contrary to one of the main eligibility criteria in the Policy Guidelines.

However, the Treasury took a broader view and determined that, because of the trust arrangement and the nature of the transactions, the recommendation of ineligibility from the Reserve Bank was not persuasive. The Treasury concluded that it was in the public interest for a guarantee to be granted, so the application was approved on 4 December 2008.

Before entering the Scheme, deposits for Equitable Mortgages had been declining. After it joined the Scheme, Equitable Mortgages experienced significant growth in deposits (to \$141 million by 31 March 2009). Deposits continued to increase. The Reserve Bank and the Treasury's monitoring revealed issues with large exposures to individual borrowers, much vacant land or development lending, poor loan book performance, a large funding mismatch, and only modest levels of capital (until a capital injection of more than \$4 million in March 2010). However, the institution was profitable and mortgages were first mortgages only, with reported conservative loan-to-valuation ratios.

On 27 February 2009, Equitable Mortgages' credit rating was lowered from BB+ to BB with a negative outlook. The Treasury monitored the performance of Equitable Mortgages closely, asking for additional information directly from the company in May 2009 and appointing an inspector in July 2009. The support of shareholders was critical to the viability of Equitable Mortgages, with a shareholder support mechanism and insurance underwriting in place to provide support of up to \$20 million.

Equitable Mortgages was closely analysed by the Treasury as part of monthly Provisioning Working Group meetings, but the support of the shareholders was a significant factor in the continued view that it would not fail. Its ongoing viability also depended on acceptance into the Extended Scheme. Although a provision was recommended for June 2009 (assuming there would not be an Extended Scheme), there were no provisions in all later months for Equitable Mortgages. Equitable Mortgages continued to be closely monitored, with considerable direct contact, additional information requests, weekly liquidity reporting, comprehensive monthly reports, independent verification of monthly data provided to the Reserve Bank, and meetings with management, the Board, and shareholders.

Equitable Mortgages joined the Revised Scheme (from 1 January 2010) and applied to join the Extended Scheme on 5 February 2010. In processing the application, the Treasury received advice from the Reserve Bank on 1 March 2010 (which had advice from the trustee on 24 February 2010). The Treasury also received advice from the Registrar of Companies and the Securities Commission on 9 March 2010. Equitable Mortgages met all the relevant eligibility criteria for the Extended Scheme (including the minimum credit rating of BB), and there were no issues of concern. Having considered the Policy Guidelines and the recommendation of the Reserve Bank, the Treasury concluded that extending the guarantee was necessary or expedient in the public interest. Equitable Mortgages was accepted into the Extended Scheme on 19 March 2010.

On 20 August 2010, the rating of Equitable Mortgages was downgraded to BB- with a negative outlook, because of its poor asset quality and its failure to resolve arrears as promptly as anticipated. A new prospectus was registered on 28 September 2010. In November 2010, the Equitable Group was rationalised into a single issuer structure (the Equitable Property Mortgage Fund was terminated) to better position itself to meet the impending Reserve Bank NBDT prudential regulations (effective 1 December 2010). The shareholders injected an additional \$10.5 million of capital into Equitable Mortgages. Future business opportunities were also being explored.

In late November 2010, Equitable Mortgages told the Treasury that it no longer had a viable business in the current economic climate and would struggle to meet the Reserve Bank's upcoming capital requirements. The shareholders were not prepared to provide any additional capital support beyond the \$4 million in uncalled credit support. The failure of South Canterbury Finance on 31 August 2010 had also affected investor interest in non-guaranteed debentures (which, before the failure of South Canterbury Finance, had been experiencing slow but steady growth). On 26 November 2010, Equitable Mortgages was placed into receivership with about \$178 million in Crown-guaranteed deposits.

### **Our assessment of the Treasury's handling of Equitable Mortgages Limited**

- 5.78 Equitable Mortgages met the eligibility criteria for the Extended Scheme, and it appeared to be well managed. The Treasury was vigilant in its monitoring of Equitable Mortgages during the Scheme and met with directors and shareholders, which gave the Treasury comfort in their ability and the inclination of the shareholders to provide any additional support required.
- 5.79 However, we consider that the Treasury relied too much on implicit additional shareholder support. Throughout the Scheme, Equitable Mortgages was consistently ranked as high risk, with recognised issues with liquidity, capital, loan exposures, and loan delinquencies. Although shareholder support was an important consideration, it should have been only one of many indicators of ongoing viability.
- 5.80 In our view, the Treasury should have tested the strength of the shareholder support by requesting a written guarantee (of the obligations of Equitable Mortgages) or otherwise analysing the position without this support (on a "what if" basis). Without this explicit support, the financial position of Equitable Mortgages should have been more closely scrutinised and analysed with associated detailed reporting and escalation to senior management in the Treasury.

### **Communicating information about the Revised Scheme and the Extended Scheme**

- 5.81 The Treasury conducted extensive analysis into the need for an Extended Scheme and the possible design options of such a scheme. Many documents were prepared, in the form of Treasury Reports, aides-memoire, memoranda for Cabinet

Committees, and presentation slides for meetings with the Minister and Prime Minister. These documents were dated from April 2009 to September 2009. On 25 September 2009, the Treasury publicly released 22 of these documents. Some of the documents were joint reports by the Reserve Bank and the Treasury. A media statement was issued by the Minister on 25 August 2009 detailing the final changes to the Scheme and providing a link to the Treasury's website for further information.

- 5.82 The Treasury's website posted the main documents as these were released (policy guidelines, draft guarantee deeds, and eligibility criteria). It also hosted the "questions and answers" statement, which was updated on 12 October 2010 to reflect the Scheme changes. A list of institutions approved for the Extended Scheme was included, along with the guarantee deed for each institution. A Regulatory Impact Statement was issued on 8 September 2009, providing further details on the Scheme's extension.
- 5.83 In our view, the documents and the information on the Treasury's website provided timely and comprehensive public information about the Government's reasons for extending the Scheme, the implications of the various design features considered, and the final terms and conditions. The information could have been structured better to improve access to the various types of information.
- 5.84 The Treasury relied on its website to communicate this information. Using more communication channels might have been more helpful for investors to understand the nature of the guarantee. There was evidence from one of our interviews that some investors were confused about the changes to the Extended Scheme and the implications of those changes (in particular, details such as the change in the maximum amount of deposit guaranteed).
- 5.85 The Treasury provided the Minister and Cabinet with detailed information about the Extended Scheme. The Cabinet agreed to the design of the Extended Scheme (including timing, coverage, fees, caps, tools, and use of legislation) on 17 August 2009. The terms of the Extended Scheme were debated in Parliament on 26 August 2009, and the Crown Retail Deposit Guarantee Scheme Bill 2009 was introduced on 8 September 2009. In our view, the disclosures to the Minister and Cabinet were timely, effective, and of a high quality.
- 5.86 The changes made when the Scheme was revised were not as significant as they were when the Scheme was extended, so there was less to communicate. The Treasury issued a media statement on 18 November 2009, setting out details about the changes as part of the Revised Scheme and the need for institutions to sign replacement deeds if they wanted to stay in the Scheme. The general "questions and answers" statement on the Treasury's website was updated to

reflect the changes. Further media statements were issued on 18 December 2009 and 24 December 2009 (to say how many institutions were covered under the Revised Scheme and that six institutions had opted out).

### Our views on the Treasury's actions

- 5.87 In our view, the Treasury should have prepared a thorough assessment framework for the overall performance of the Scheme. If such a framework had been prepared, it is likely that many of the activities that did not begin until March 2009 or later would have taken place sooner.
- 5.88 Most importantly, the framework might have helped to ensure that the Government was better informed about the effects of the Scheme and established which aspects of the Scheme the Minister wanted to be alerted about. We make this comment having reviewed diary notes of some of the discussions between the Treasury and the Minister after the failure of Mascot Finance. In these discussions, it was apparent that the Government could have been better informed.
- 5.89 It is clearly in the best interests of the Treasury to ensure that the Government understands how the Treasury is implementing government policy, the effects and performance of the policy, and any issues and challenges faced. A performance assessment and reporting framework for the Scheme could have included, for example:
- measures to assess and report overall Scheme effectiveness (such as deposit volatility and public awareness and confidence);
  - measures of overall fiscal risk;
  - an issues register for emerging policy design issues;
  - an issues register for concerns with individual financial institutions covered by the Scheme; and
  - a stronger project management approach to the Scheme, including an issues register to catalogue implementation concerns, such as resourcing.
- 5.90 In 2009, many of the activities supporting the above components were taking place within the Treasury. For example, the Treasury was aware of, and had highlighted before the introduction of the Scheme, concerns about its potential effect on deposits and the importance of monitoring deposit flows. We have seen evidence that the Treasury looked closely at deposits from March 2009 to determine how the Scheme was affecting the financial sector and individual financial institutions. The deposit growth of financial institutions in the Scheme was considered each month as part of the monitoring of individual financial institutions. We have not seen evidence that this analysis was taking place before

March 2009. Moreover, we have not seen evidence that the analysis was reported and escalated within and beyond the Treasury.

- 5.91 The Treasury was also actively considering possible revisions to the Scheme in response to emerging policy design issues and considering its powers to act in the event of an issue with a particular financial institution. The Treasury carried out much research into ways to improve the Scheme and was assessing various aspects of the Scheme's performance. We did not see evidence of these two areas of work coming together. The policy or design work did not appear to be informed by information on the emerging level of financial risk.
- 5.92 We saw evidence that, from March 2009, the Treasury was trying to work out how it could quantify how much money the Crown could lose if a financial institution covered by the Scheme failed (see Part 6). The Treasury had prepared a report for the Minister that discussed fiscal risk and estimated possible payout amounts, but we have not seen any evidence that the Treasury updated these amounts between October 2008 and March 2009.
- 5.93 We also saw evidence that, in July 2009, the Treasury was beginning to consider how it could increase the amount that the Crown could recover from a failed institution. This issue was discussed at the financial system issues meeting in November 2009 and a number of analysis papers were produced (including papers in January 2010 and June 2010).
- 5.94 We have evidence of discussions with Australian counterparts in the lead up to the Scheme's introduction and in mid-2009. We have not seen evidence that the Treasury's considerations to design or improve the Scheme included discussions with any other offshore counterparts. In our view, if the Treasury had talked to counterparts in additional jurisdictions more familiar with deposit insurance schemes, it is likely that some of the design issues that later emerged could have been identified. We understand that interest payments after an institution fails, for example, is one aspect of deposit insurance addressed under the United States' deposit insurance arrangements.
- 5.95 As well as the Treasury's extensive analysis about desired changes under the Revised and Extended Schemes, the Treasury also analysed:
- options for dealing with South Canterbury Finance (see Part 6);
  - intervention options for institutions that were expected to trigger the guarantee;
  - the possible introduction of permanent deposit insurance;
  - exit options for the end of the guarantee; and
  - weekly liquidity analysis for higher-risk institutions to gauge the potential effect of the "funding wall".

- 5.96 Overall, the Treasury carried out much research in 2009 into ways to improve the Scheme. In our view, the Treasury's process was comprehensive and carefully deliberated but could have benefited from a structured approach in keeping with a monitoring, escalation, and reporting framework. Although changes to the Revised Scheme were limited, many of the problems with the Scheme were remedied in the Extended Scheme.

### Reviewing the Extended Scheme

- 5.97 In November 2009, the Treasury reviewed the lessons it had learned from offering the Extended Scheme. The review gathered and analysed views from all teams with responsibility for aspects of the Scheme (including communications, policy, operations, and legal teams). The lessons covered the co-ordination and communication between teams, as well as internal processes and stakeholder engagement.
- 5.98 From all accounts, the review was a useful exercise. We were told that the review was initiated by a relatively junior staff member, and we are unsure of the extent of escalation of the findings of this review. Another useful review was commissioned about the failure of Mascot Finance. This review was completed in May 2009, with the aim of improving Treasury's ability to anticipate and manage operational risks under the Scheme. The findings of the review were escalated broadly, including to the Secretary to the Treasury, and a summary of the lessons learned was circulated widely within the Treasury. The Treasury also carried out a supplementary review to consider decision-making.
- 5.99 In our view, the Treasury could usefully carry out reviews of this type after it implements all significant policy initiatives. Such reviews would best be sponsored by a senior official or senior committee within the Treasury to ensure that the reviews are thorough and that findings are implemented.

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### Recommendation 3

We recommend that the Treasury carry out a formal post-project review after it implements any significant policy initiative. The review should be timely, independent, and sponsored by a senior official or committee within the Treasury. The findings of the review should be discussed and implemented where appropriate.

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## Part 6

# Monitoring the institutions in the Scheme

- 6.1 In this Part, we discuss:
- the objectives of monitoring the institutions that were in the Scheme;
  - how the monitoring was carried out;
  - appointing inspectors;
  - the outcome of the monitoring;
  - provisioning for institutions' failure; and
  - our views on the monitoring framework.
- 6.2 In summary, the Treasury knew when the Scheme was introduced that it would be important to monitor the institutions covered by the guarantee. The monitoring framework that the Treasury implemented was, for the most part, effective. The Treasury identified all the institutions that triggered the guarantee as having a high risk of failure before they failed. However, it took five months for the Treasury to begin monitoring using information received under its agreement with the Reserve Bank. The Treasury had just started monitoring when the first failure under the Scheme occurred.
- 6.3 In our view, the Treasury was waiting for monitoring data to arrive from the Reserve Bank rather than planning for its arrival and for the next stage in the monitoring process (that is, what it would do with the information once it arrived). The Treasury should have prepared a monitoring work stream to run concurrently with the application process.
- 6.4 The Treasury monitored to prepare for potential payouts rather than to ensure that institutions did not fail. When monitoring showed that deposits with finance companies were increasing, the Treasury did not ask those finance companies what they were doing with the money or take measures to prevent finance companies from engaging in riskier investments.
- 6.5 When South Canterbury Finance was accepted into the Scheme, the Treasury could not know how vulnerable that finance company really was. However, South Canterbury Finance's deposit base increased by 25% in the four months immediately after the Scheme was introduced. Its loan book increased in the early months of 2009, with many loans made to property developers and with capitalising interest and second mortgages, increasing South Canterbury Finance's risk profile.
- 6.6 Although we cannot say for certain, closer monitoring of South Canterbury Finance earlier in the Scheme might have helped identify it as a problem institution and allowed the Treasury to consider earlier whether it needed to take steps to limit the Crown's liability.



- 6.7 The Treasury's monthly financial statements did not include any provisions for payouts under the Scheme until June 2009, when the provision was estimated at \$0.8 billion. The Treasury knew before June 2009 that further failures of finance companies were likely, so this information should have been better reflected in the monthly financial statements earlier than June 2009. Once a Provisioning Working Group was set up in May 2009, it worked very well – but lower-level staff were instrumental in setting up some of the processes that should have been set up by senior management in late 2008.

### Objectives of monitoring institutions

- 6.8 Issuing a deposit guarantee meant that the Treasury needed to closely monitor the financial institutions covered by the Scheme to effectively manage the Crown's liability at the same time as maintaining depositor and public confidence. Monitoring of financial institutions was important because the conduct and financial health of an institution covered by the Scheme determined:
- whether the Crown would be required to pay out under the guarantee; and
  - how much the Crown would be required to pay.
- 6.9 The Treasury recognised very early the importance of monitoring. In its 13 October 2008 report, the Treasury highlighted ongoing monitoring as a “practical detail” that the Treasury and the Reserve Bank needed to work through. In those early days, the Treasury thought that monitoring would include receiving a report after 12 months to assess aggregate indebtedness and liability for the fees charged under the Scheme. The report also indicated that additional monitoring could be imposed under the contract, such as quarterly reporting or copies of the standard reports provided to the trustees. At the time, the Treasury saw the role of the Reserve Bank as helping to verify the information received and monitoring registered banks. It was clear that monitoring financial institutions was an unfamiliar activity for the Treasury. The Treasury did not have staff with the necessary skills and, we were told, began a process to recruit people with the necessary skills in December 2008.
- 6.10 In our view, the Treasury's objectives for monitoring financial institutions were to:
- assess the effect that the Scheme was having on depositor confidence and any unintended consequences of the Scheme (see Part 5);
  - ensure compliance with the guarantee deed (which included a requirement to comply with the terms of the trust deed);
  - identify any activities by financial institutions that did not align with the Government's intention for the Scheme (including activities to take undue advantage of the Scheme by taking deposits under the guarantee that the institutions would not otherwise have taken); and

- assess the financial position and anticipated failure of institutions to:
    - provide accurate provisions in the Government’s financial statements for likely payouts under the Scheme;
    - prepare to pay out depositors; and
    - take any other action before or after an institution failed.
- 6.11 The Treasury adopted a minimal intervention approach to monitoring financial institutions. This meant that there was no objective of taking steps to prevent a guaranteed institution from failing or to minimise the costs of failure for the Crown.
- 6.12 In our view, the objectives of monitoring financial institutions should have been clearly documented, along with the monitoring tasks designed to meet these objectives, including the role of the Reserve Bank as well as the Treasury’s own role. There is a useful document prepared by the Treasury that sets out the NBDT monitoring process, including a flowchart detailing the information flows and relevant responsibilities. We understand that this flowchart was produced in June 2010 to help with the provisioning process, but this was more than a year after the start of the Treasury’s monitoring work. A document of this nature (but relating to the broader monitoring role) should have been prepared by the Treasury in late 2008, along with clear monitoring objectives.

## How the monitoring was carried out

### The role played by the Reserve Bank

- 6.13 Initially, the intention was for the Reserve Bank to monitor only banks covered by the Scheme. Over time, however, the Treasury and the Reserve Bank determined that the Reserve Bank was also best placed to monitor NBDTs. This was because the Reserve Bank’s formal relationship with the trustees enabled it to collect prudential information from individual NBDTs. The Reserve Bank had to recruit additional resources to do this monitoring.
- 6.14 The Reserve Bank used its new powers under Part 5D of the Reserve Bank Act to request regular information from trustees, which were the supervisors of the institutions. The information gathered was not audited and was based on management accounts. Apart from being slow, this process was preferable to having the Treasury, which early in the Scheme had limited experience in monitoring financial institutions, collect this information directly from trustees.

### The framework for NBDT monitoring

- 6.15 The Reserve Bank prepared the monitoring framework for NBDTs in consultation with the Treasury and some trustees. The Scheme was announced on 12 October 2008, and the Treasury received its first risk ranking report based on this information at the end of March 2009. (The information was from January 2009.) We have been told that some financial data for individual institutions, as well as sector information, were collected by the Reserve Bank before the introduction of the Scheme and were provided to the Treasury. We have not seen any evidence that the data and information were used in the Treasury's monitoring.
- 6.16 The Scheme was in place for five months before NBDTs began to be monitored by the Treasury through its agreement with the Reserve Bank. The reasons for this delay in the Treasury's monitoring included the need to hire new staff and the time required by individual institutions to implement systems to facilitate the flow of data from the trustees. The December and January holiday period added to the delay. Nevertheless, the timing worked well from the Treasury's perspective. The Treasury had almost completed assessing all the applications and had hired some staff (who started in February and March 2009) with experience in analysing financial institutions.
- 6.17 The Reserve Bank prepared a monthly template that was completed by the institutions, sent to the trustee for review, and then forwarded to the Reserve Bank. Institutions had six weeks to submit the data to the Reserve Bank through the trustee. This was later reduced to four weeks. The information collected was a typical suite of prudential statistics covering the balance sheet, asset quality, performance, and related-party activity. This template was drafted in January 2009 and refined by the Reserve Bank by mid-2009. The Reserve Bank also reviewed additional data, such as financial accounts and prospectuses.
- 6.18 The Reserve Bank gave the Treasury:
- a monthly report that ranked the riskiness of the NBDTs relative to each other (but not the risk of them failing);
  - monthly reports providing a sector overview for the finance company and savings institution sectors;
  - detailed individual monthly analysis for institutions on the watch-list (those that were ranked as high or medium risk, based on the relative risk ranking report and/or those with higher potential losses); and
  - weekly liquidity reports for higher-risk institutions (which began in September 2009).

- 6.19 The Reserve Bank prepared models to analyse the data and to estimate the relative risk of the institutions and the losses that would occur if institutions failed. The Treasury used one of these models (the estimated loss model) as the basis for provisioning estimates (that is, estimates of how much the Crown needed to include in its financial statements for expected losses under the Scheme). Provisioning estimates also required estimates of the probability of failure. These were prepared by the Treasury's Provisioning Working Group rather than by the Reserve Bank.
- 6.20 The relative risk ranking model used a spreadsheet to combine measures of liquidity, asset quality (that is, the quality of the institution's lending), income margins, capital sufficiency, and related-party exposures (added in December 2009) into a single riskiness measure. The measure was then used to rank each institution. The Treasury relied substantially on the output of this model, which was developed by the Reserve Bank. Changes made by the Reserve Bank to the relative risk ranking model included judgement-based overrides of output (for example, increasing or decreasing the risk ranking of institutions). Ultimately, the Treasury decided what the relative risk ranking should look like and what the Treasury's responses should be. Accordingly, the Treasury adjusted the risk ranking of institutions based on all of the information that it had available.
- 6.21 The Reserve Bank also provided qualitative input based on its knowledge of the institutions and on market intelligence (such as feedback from other regulators, including the Securities Commission and Companies Office, as well as trustees and other industry participants).
- 6.22 In November 2009, the Treasury requested that the Reserve Bank provide more-detailed monthly monitoring (watch-list reports) for more institutions. Our evidence from interviews is that, although the Treasury had "a good feel" for the risks in larger entities, it needed additional detail for some smaller institutions.
- 6.23 As well as the reports received from the Reserve Bank, the Treasury also reviewed other external information. This included financial accounts, prospectuses, reports from ratings agencies, information provided as part of the application process, and general "intelligence" from other market participants. The Treasury also received updates from the Securities Commission and the Companies Office in the form of regulator meetings and informal information exchanges. Information was also exchanged at the monthly financial system issues meetings, although these exchanges tended to focus on general system-wide information rather than on information about the circumstances of individual institutions.
- 6.24 The Treasury and the Reserve Bank worked collaboratively and, at the operational level, were in frequent contact. The Treasury and the Reserve Bank also shared

information from time to time with the Securities Commission and the Companies Office. Information sharing between the Treasury and the Reserve Bank appeared to work well. Information sharing with other agencies did not appear to be as frequent or structured and open, or even possible under the requirements of the deeds until the Extended Scheme.

- 6.25 The Treasury had broad powers to gather information under the guarantee deed. The Treasury could request additional details directly from institutions as well as details from third parties such as trustees, auditors, bankers, the Securities Commission, the Companies Office, and ratings agencies. The Treasury used these powers when it required additional details. From February 2009, the Treasury began to request further details from a number of higher-risk institutions (including data on liquidity positions and loan portfolios) and was in regular telephone contact with a number of institutions. The directors of institutions were also individually asked to provide directors' certificates to support the financial position of the institution.

### Appointing inspectors

- 6.26 Because of weaknesses in the information management and reporting systems of some finance companies, the only way to be certain of the accuracy of information was to appoint an inspector. The Treasury had the broad power under the guarantee deed to appoint an inspector at any time. It would use this option if it had concerns about the information that it had received or if it required additional information.
- 6.27 The Treasury determined that the best method for appointing inspectors was to set up a panel of potential inspectors that could be called on at short notice. The Treasury set up this panel using the Crown's procurement process. This took time because it required detailed price and contract negotiations and scoping discussions. The panel was in place by the end of 2009 and comprised eight inspectors with a range of skills and expertise.
- 6.28 While this tender process was under way, the Treasury sought approval to appoint a number of inspectors outside the panel. The Treasury decided to do this because the need was urgent, which was consistent with Crown procurement guidelines. The urgency appeared to stem mostly from the need to quantify the Crown's potential exposure and to provide provisioning estimates for the Government's financial statements. Other factors contributing to the urgency included:
- the high-risk nature and deteriorating financial position of a number of institutions;
  - the growth in guaranteed deposits of these institutions;

- a potential review of the institutions' credit ratings; and
- market intelligence about these institutions.

- 6.29 Because of the cost of inspecting, the scope of each inspection needed to be carefully considered. We were told by those we interviewed that, for most inspections, the Treasury knew what aspects it wanted the inspectors to focus on, based on its knowledge of the individual institutions. Some inspections were generic. Others were targeted at specific concerns in a financial institution. In all instances, the Treasury sought additional information and analysis on asset quality, liquidity and funding, and business practices.
- 6.30 The Treasury kept in close contact with inspectors during inspections. The inspectors provided regular (often daily) updates, and there was frequent interaction. The inspectors often made interim presentations, with the focus of the inspections sometimes changing based on preliminary findings. In a number of instances, the reports uncovered other matters that needed further investigation.
- 6.31 During the Scheme, 12 institutions were inspected. For some of these institutions, there were multiple inspections for a range of issues. The first comprehensive inspection started in June 2009. There was an earlier shorter inspection in March 2009 because of the potential withdrawal of the guarantee. Overall, six inspections were begun in June and July 2009 before the inspection panel was operating. These inspections provided the Treasury with new information and greater insight into the risk of failure of an individual institution and the timing of a potential failure (which helped in planning for responses, in payout processes, and with the provisioning recommendations). The Treasury provided copies of the inspection reports to the Reserve Bank. We understand that the Treasury was reluctant to provide the reports to other regulatory agencies.

## The outcome of the monitoring

### The Treasury's response to the results of monitoring

- 6.32 The Treasury had a range of tools at its disposal for responding to risky institutions. These included withdrawing the guarantee, restricting or prohibiting certain transactions, and requiring certain undertakings from directors.
- 6.33 The most significant of the Treasury's explicit tools was withdrawing the guarantee. The Treasury did not take using this tool lightly. Any withdrawal of the guarantee needed to be disclosed to the public and could well cause an institution to fail because of the resulting loss of depositor confidence, triggering the guarantee for all existing deposits held by the institution. The withdrawal would

affect only new deposits. All deposits up to the date of withdrawal continued to be covered by the existing guarantee.

- 6.34 Therefore, the effect of any withdrawal could be limited. The Crown's potential payout would be roughly the same at the time of withdrawal as it would be if the institution eventually failed, unless the institution's deposit book grew or the quality of its assets deteriorated. There was a chance that letting the institution resolve its issues could lead to a more favourable outcome for the Crown.
- 6.35 Three institutions had their guarantees withdrawn. The first withdrawal was Viaduct Capital Limited (Viaduct) on 20 April 2009. Its guarantee was withdrawn on the basis that the business operations were being conducted in a manner inconsistent with the intentions of the Crown (see Figure 14). The institution continued to operate for another year but eventually failed and triggered the guarantee on 14 May 2010. The payout covered deposits made up to 20 April 2009. In this instance, the Treasury's monitoring successfully identified activities within an institution that were not consistent with the intentions of the Crown in extending the guarantee.

**Figure 14**  
**Viaduct Capital Limited (formerly Priority Finance Limited)**

Priority Finance Limited (Priority) was a commercial and property lender with total assets at 31 March 2008 of \$4.8 million. It raised funds through secured and unsecured term deposits.

Priority applied to join the Scheme on 23 October 2008 (its letter was dated 17 October 2008). The trustee (Prince and Partners Trustee Company Limited) provided a letter dated 31 October 2008 confirming that:

- Priority held a current prospectus with eligible securities on issue (registered on 10 October 2008);
- there was no breach of trust deed covenants; and
- the trustee was not aware of any information about Priority not being able to pay its debts or being insolvent.

The Reserve Bank provided a letter to the Treasury on 6 November 2008 stating that Priority met the eligibility criteria and that there was no reason not to offer the guarantee. The Treasury considered this advice, the trustee's confirmation, the size of the institution, and other factors to determine that its failure would undermine confidence. Therefore, it was necessary and expedient in the public interest to grant a guarantee. The guarantee was approved on 13 November 2008 with a supplemental deed signed on 19 November 2008 (because of minor drafting errors in the original guarantee deed).

On 13 February 2009, ownership of Priority changed when another entity purchased Priority through several complex transactions. As part of these transactions, Priority was renamed Viaduct Capital Limited (Viaduct). These transactions gave rise to concerns within the Treasury that Viaduct could be in breach of a number of obligations in its guarantee deed (including breaches of the deed, the arm's-length nature of transactions, and business conduct). After consulting with the Reserve Bank, the Treasury told Viaduct on 16 March 2009 that it was planning to appoint an inspector to investigate the sale and associated transactions.

In response to the inspection report and its own analysis, the Treasury concluded that Viaduct conducted its business and affairs in a manner that was inconsistent with the Crown's intentions in entering into the guarantee and that Viaduct extended the benefit of the guarantee to people who were not intended to receive that benefit. On 20 April 2009, the Treasury withdrew the guarantee with immediate effect. The Treasury did this after extensive internal consideration of the possible effects of withdrawal, as well as extensive consultation with Crown Law. The withdrawal applied only to deposits made after 20 April 2009. All deposits made up to 20 April 2009 were guaranteed. Viaduct strongly disagreed with the conclusions the Treasury drew.

Viaduct had issued a prospectus on 3 March 2009, seeking \$50 million in additional funds. The prospectus was amended on 24 June 2009 to disclose the guarantee withdrawal. Another prospectus was registered on 9 October 2009, seeking deposits that would not have the benefit of the guarantee.

The Treasury continued to monitor Viaduct closely, despite the withdrawal of the guarantee, as the deposits up to the date of the guarantee withdrawal were still covered by the Scheme. The Treasury requested additional information, and Viaduct was subject to detailed monthly reporting from November 2009, as well as the weekly liquidity analysis that applied to higher-risk entities. From November 2009, it became apparent that Viaduct was selling off its good residential mortgage assets, leaving poorer-quality property development loans on its books. This could increase the Crown's loss if the guarantee was triggered.

On 14 May 2010, receivers were appointed to Viaduct, triggering the guarantee for the \$7.5 million in deposits that were covered by the Scheme.

- 6.36 In our view, the Treasury was thorough and timely in its analysis and response to the Viaduct transactions. The Treasury quickly appointed an inspector once it was aware of the transactions, and the Treasury sought specific advice from the Reserve Bank and Crown Law. The guarantee was withdrawn relatively quickly on the basis of "inappropriate activity". In withdrawing the guarantee, the Treasury considered the intentions of the guarantee, the requirements of the guarantee deed, and the implications for the Crown's liability if the guarantee was not withdrawn.
- 6.37 The second guarantee withdrawal was less contentious. The guarantee extended to FAI Money Limited was withdrawn on 7 May 2010. The withdrawal came after the Crown was notified that all debenture holders had been repaid, FAI Money Limited had ceased taking deposits from the public, and FAI Money Limited had no outstanding debt securities on issue. The third guarantee withdrawal was from PGG Wrightson Finance Limited in September 2011, when it was acquired by Heartland Building Society.
- 6.38 As well as the withdrawal of the guarantee and the appointment of inspectors, the Treasury's response to monitoring results included:
- requesting additional information from institutions directly (either due to increased risk of the institution or in response to business plans or proposed transactions);
  - requesting additional details where growth in deposits was too high or lower than expected;



- requesting undertakings from directors about compliance with the deed, the institution's position, or particular transactions;
- notification and requesting additional details from auditors and the trustee about possible breaches of the guarantee deed;
- requesting assurance that certain transactions were conducted on an arm's-length basis; and
- advising the Provisioning Working Group about the probability of an institution failing and the appropriate level of provisioning for specific institutions.

6.39 Growth in deposits could signal that a financial institution was misusing the system. Some institutions experienced strong deposit growth by offering attractive interest rates under a government guarantee. This was a legitimate and expected practice. The challenge for the Treasury was in knowing how those deposits were being applied.

### South Canterbury Finance Limited

6.40 The Treasury's actions in response to a financial institution in difficulty are well illustrated by how it dealt with South Canterbury Finance, which failed while under the Revised Scheme. The Treasury did not issue directions or attempt to influence South Canterbury Finance's operations directly or through another agency before it failed. Figure 15 sets out some of the main aspects of the Treasury's response to South Canterbury Finance.

#### Figure 15 South Canterbury Finance Limited

South Canterbury Finance Limited (South Canterbury Finance) was a large and diversified finance company based in Timaru. It was placed in receivership on 31 August 2010 with assets recorded at \$1.6 billion. South Canterbury Finance's failure triggered the largest payout under the Scheme.

The Treasury received South Canterbury Finance's application to join the Scheme on 15 October 2008. At the time of its application, the reputation of South Canterbury Finance was unquestioned and it had a BBB- rating based on its "sound business profile". (It had maintained this rating since 2006.) Leading up to the start of the Scheme, South Canterbury Finance had been growing strongly with solid results. It had a strong local support base and the support of a highly regarded individual in Allan Hubbard.

As with other applications, the Treasury considered the advice of the trustee (on 15 October 2008) and the Reserve Bank (on 6 November 2008). Neither had any concerns. Other than following up on some additional documentation, the processing of South Canterbury's application was straightforward.

South Canterbury Finance was a sizable company and its failure could have had a significant effect on public confidence in the financial system and in the confidence of depositors generally. After the Treasury concluded that it was necessary and expedient in the public interest to grant a guarantee, South Canterbury Finance was accepted into the Scheme on 19 November 2008.

South Canterbury Finance's deposit base increased by 25% in the four months immediately after the Scheme was introduced.

The Treasury received the first Reserve Bank assessments of individual finance companies at the end of March 2009. The potential deficiencies in South Canterbury Finance were recognised at this time, including concerns about corporate governance, asset quality, and related-party exposures.

In April 2009, the Reserve Bank alerted the Treasury to a possible breach of the guarantee deed for two related-party transactions (in December 2008 and January 2009). South Canterbury Finance had not sought Crown consent to the transactions and had not provided an independent expert's written opinion about whether the transactions were on an "arm's-length" basis. The Treasury asked South Canterbury Finance for more information on 21 April 2009 about these transactions and, more generally, about South Canterbury Finance's financial position, including liquidity, arrears, and loan portfolio. The Treasury also asked for directors' certificates.

South Canterbury Finance responded that it was an oversight to not seek the Crown's consent – one transaction was a security-sharing agreement (not a loan) and the other a reclassification of investments. South Canterbury Finance was to obtain an expert opinion. We do not know whether an expert opinion was obtained.

Based on this response, the Treasury decided that an inspector needed to be appointed. The Treasury told South Canterbury Finance on 12 May 2009 that the Treasury would appoint an inspector to examine the affairs of South Canterbury Finance. The Treasury received the inspector's report on 17 July 2009. The report reaffirmed the seriousness of the risk factors suspected with the books and management of South Canterbury Finance.

From April to August 2009, the Treasury investigated the affairs of South Canterbury Finance extensively. On 12 August 2009, the Treasury made a provision for the estimated loss if South Canterbury Finance failed. This provision reflected the Treasury's judgment that South Canterbury Finance was more likely than not to fail. The provision was made with the benefit of the inspector's report.

The Treasury's main tool was the power to withdraw the guarantee for new deposits raised by South Canterbury Finance. The announcement of such a decision would almost certainly have resulted in a run on the deposits of South Canterbury Finance and its early failure, triggering the Crown's liability under the guarantee.

The Treasury explored many options for South Canterbury Finance and kept the Minister well informed. In August 2009, the Treasury provided a report setting out the options available for dealing with South Canterbury Finance. The options included a Crown equity injection or other government support, but the report recommended against them. Other options were receivership or statutory management. The report set out the comparative costs to the Crown of these options. In October 2009, the Treasury also looked at the option of providing a short-term bridging loan, which was thought to potentially increase the probability of South Canterbury Finance surviving. The Treasury's advice was that the Minister should proceed with the loan as a last resort if he thought the precedent could be adequately managed. The loan was never required.

South Canterbury Finance applied to join the Extended Scheme on 19 January 2010. The Treasury carefully considered the application, obtaining advice during March 2010 from the trustee, the Reserve Bank, the Companies Office, Securities Commission, South Canterbury Finance's directors, and its auditors. Although South Canterbury Finance had made significant progress in addressing some of its main challenges from October 2009 to March 2010, the Treasury was well aware that it was more than likely that South Canterbury Finance would fail and trigger the guarantee.

The Treasury could have denied South Canterbury Finance entry to the Extended Scheme. By early 2010, the Treasury knew from the inspector's report that South Canterbury Finance's risk management and governance systems were inadequate for such a large company. The Treasury knew that South Canterbury Finance had little hope of meeting the Reserve Bank's new prudential requirements for finance companies, which were to become effective later that year. However, the Treasury accepted South Canterbury Finance into the Extended Scheme because excluding the company would likely have resulted in its immediate failure.

The Treasury was of the view that, from mid-2009 to August 2010, the Crown's liability if South Canterbury Finance failed was not increasing and that, while South Canterbury Finance continued to operate, there was a chance that a private sector solution would emerge that reduced the Crown's liability. The Treasury decided to accept South Canterbury Finance into the Extended Scheme (on 1 April 2010), to provide South Canterbury Finance an opportunity to achieve a solution to its funding and capital challenges.

South Canterbury Finance's deposit base did not increase from mid-2009 when the Treasury first made a provision against South Canterbury Finance's likely failure. The Crown's liability is not determined only by the volume of deposits guaranteed but also by the net loss on default, which depends on the quality of South Canterbury Finance's asset portfolio. The Treasury's estimate of this loss was \$655 million in August 2010.

In the end, no private sector solution eventuated and a receiver was appointed to South Canterbury Finance on 31 August 2010. The receiver for South Canterbury Finance found that the state of its impaired assets was worse than expected. Our understanding is that related-party transactions were the source of a good deal of these unanticipated losses.

- 6.41 Evidence from interviews specifically about South Canterbury Finance, together with our review of documentation, confirms that the Treasury was monitoring South Canterbury Finance's activities from April 2009.
- 6.42 Although we cannot say for certain, closer monitoring of South Canterbury Finance earlier in the Scheme might have helped identify its problems and allowed the Treasury to take earlier steps to constrain the Crown's liability. Closer investigation of South Canterbury Finance's specific circumstances would be needed to determine which, if any, tools might have been appropriate.
- 6.43 Although the Treasury did not use any such tools, its analysis and research during the period was plentiful, comprehensive, and thorough. We consider that it would be useful to use much of the good work that was done by the Treasury to prepare a framework for dealing with distressed institutions.

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#### **Recommendation 4**

We recommend that the Treasury and the Reserve Bank of New Zealand document the analysis and thinking by the Treasury during its consideration of how to deal with South Canterbury Finance Limited. This could take the form of a framework for dealing with distressed institutions. The distressed institutions framework could set out possible courses of action for dealing with an institution, including deterrent processes, actions to take in the event of failure, the roles and responsibilities of regulatory agencies, and the communications that need to occur between agencies.

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## Provisioning for institutions' failure

### Measuring and disclosing the potential cost to the Crown

- 6.44 An important reason for monitoring was to determine the value of the potential Crown liability for the Scheme for the purpose of the Government's financial statements.
- 6.45 In March 2009, the Treasury began to work out how it could quantify the Crown's potential loss. The Treasury made a provision for losses based on the likelihood of an institution failing and the expected loss if that failure were to occur (taking into account asset recoveries as part of the receivership process).
- 6.46 In October 2008, the Treasury had prepared a report for the Minister that discussed fiscal risk and estimated possible payout amounts by the Crown. At that time, the Treasury's worst-case estimate of loss was \$945 million, and the best and mid-cases were \$462 million and \$704 million respectively. These estimates drew on work by the Reserve Bank and had several cautionary notes about the uncertainty of the underlying data and assumptions. We have not seen evidence that the Treasury updated these amounts between October 2008 and March 2009, nor that it provided any further reporting internally or to the Minister.
- 6.47 The same report noted that the Government's financial statements must disclose information to enable users to evaluate the nature and extent of risks that the Crown is exposed to from the Scheme. The report noted that the Treasury was required, under New Zealand financial reporting standards, to recognise as a liability any risk exposures where a payout was probable. It also had to disclose the Crown's objectives, policies, and processes for managing the risk, the method used to measure the risk, and any changes. The report noted that, as long as the likelihood of the guarantee being called was remote, a provision for the amount was not necessary. However, if a payment under the guarantee became likely or eventuated, then the Treasury would need to estimate the likely expenditure and include an expense and a provision in the financial statements.
- 6.48 The October 2008 monthly financial statements mentioned the Scheme. However, the statement notes indicated that, because the likelihood that the guarantee would be invoked was considered remote, the guarantee did not meet the definition of a contingent liability and was excluded from the statement of contingent liabilities and assets. The Treasury made similar disclosures in later months, including the February 2009 financial statements – just before the failure of Mascot Finance. In March and April 2009, the notes to the financial statements disclosed the failures by Mascot Finance and another financial institution, Strata Finance Limited. The notes also indicated that no further failures under the Scheme were likely.

- 6.49 The end-of-year financial statements for 30 June 2009 were, unlike the monthly statements, subject to audit and included a liability under the Scheme for the first time. The liability recognised the likelihood of future Scheme payouts, estimated at the time to be \$0.8 billion. The 2009 end-of-year financial statements also included disclosures about the nature of the Crown's exposure to risk under the Scheme.
- 6.50 In our view, the Treasury should have recognised the Crown's obligations under the Scheme as a liability and contingent liability and provided additional disclosures about the nature of the Crown's exposure to risk in its monthly financial statements earlier than it did. We have drawn this conclusion based on several factors, including:
- the Treasury's October 2008 estimates of possible losses;
  - the Treasury's acknowledgement that, under New Zealand financial reporting standards, it was required to recognise a liability and disclose details of the Scheme in its financial statements should a payout become likely; and
  - the Treasury's internal communications about the health of some financial institutions in the first half of 2009 and its general view about the likelihood of failures in the NBDT sector.
- 6.51 The Treasury started to estimate Crown losses more thoroughly after March 2009, after the monitoring process became fully operational. The information and methodology for these estimates was drawn from the monitoring reports provided by the Reserve Bank.
- 6.52 In May 2009, the Treasury established a Provisioning Working Group and began estimating potential Crown exposure and reporting the amount within the Treasury. The provisioning analysis improved with each monthly meeting. The Provisioning Working Group appeared to work well, especially from September 2009 when the June 2009 provisions were reviewed. This analysis was comprehensive. It was well organised, with main discussion points documented and findings pursued. The output of Provisioning Working Group meetings appeared to have been circulated broadly within the Treasury. Although set up primarily to consider the amount of the liability for the financial accounts, the Provisioning Working Group considered a range of matters about individual financial institutions under the Scheme.
- 6.53 In our view, the Provisioning Working Group should have been set up earlier than seven months after the Scheme was introduced. It should have operated within a formal monitoring, escalation, and reporting framework.
- 6.54 After March 2009, the Treasury assessed the need to provide for losses under the Scheme on a monthly basis. A recommendation to provide for losses was made

when an institution was assessed to have a greater than 50% chance of failing. The provisioning recommendation took into account the estimated loss if the failure were to occur, the interest that would have to be paid to depositors after the failure, and the interest effect of timings of all payments (to depositors and from the receiver's distributions). Under the Extended Scheme, the Crown did not have to pay interest to depositors.

- 6.55 The results of the monitoring allowed the Treasury to assess which institutions were the most and least likely to fail. However, the Treasury needed to be more precise in its assessment of possible failure. To make a provision in the Crown's financial statements, the Treasury needed to decide whether a financial institution had a higher than 50% chance of failure. This was beyond "normal prudential assessment ability" but was required by accounting standards. It was also the main reason why the Treasury initiated a series of inspections of NBDTs. In our view, these inspections were consistent with the activities of many prudential supervisors that carry out intensive on-site examinations of regulated institutions to assess the quality of assets and risk management.
- 6.56 Figure 16 sets out the final provisions recognised in the Government's financial statements during the Scheme.

**Figure 16**  
**Provisions for liability under the Crown Retail Deposit Guarantee Scheme**

Date (as at)	Provision for net cost of institutions failing under the Scheme \$million	Total Crown liability if all institutions failed \$billion
31 October 2008	0	15.6
30 November 2008	0	122.0
31 December 2008	0	126.0
31 January 2009	0	126.0
28 February 2009	0	126.1
31 March 2009	0	126.1
30 April 2009	0	126.3
31 May 2009	0	126.3
30 June 2009	831	124.2
31 July 2009	Monthly reports not required	Monthly reports not required
31 August 2009	Monthly reports not required	Monthly reports not required
30 September 2009	866	124.3
31 October 2009	899	133.1
30 November 2009	899	133.1
31 December 2009	776	133.0
31 January 2010	771	133.0
28 February 2010	849	133.0
31 March 2010	881	133.0
30 April 2010	880	133.0
31 May 2010	887	133.0
30 June 2010	748	133.0
31 July 2010	Monthly reports not required	Monthly reports not required
31 August 2010	Monthly reports not required	Monthly reports not required
30 September 2010	0	133.0
<b>Expiry of initial guarantee Scheme</b>		
31 October 2010	0	2.3
30 April 2011	0	1.9

- 6.57 The Crown considered it unlikely that any of the four institutions left in the Scheme then would fail. Therefore, as at 30 April 2011, the Crown had not made any provision for the amount guaranteed under the Extended Scheme.
- 6.58 As already noted, discussions about levels of provisions started in March 2009. The first meeting of the Provisioning Working Group in May 2009 discussed the provisioning process and decisions about two entities, including South Canterbury Finance. The Group then held monthly meetings. In our view, the provisioning process, once started, was thorough. High-risk entities were considered closely by the Provisioning Working Group, which carefully deliberated the probability of each institution failing and associated level of provisioning required. The Group was given detailed information about the individual institutions and tracked significant changes from month to month and the reasons for those changes. There were good governance procedures, with clear documentation of the process, the recommendations, and decisions each month.
- 6.59 The information assembled by the Treasury through the Reserve Bank, the inspectors, and by direct means from the institutions allowed it to judge in August 2009 the likelihood of the failure of several institutions under the Scheme. In mid-2009, we said (in our role as the Treasury's auditor) that this information needed to improve. As more inspectors' reports became available, the quality and understanding of the information improved.

### **Our views on the monitoring framework**

- 6.60 The monitoring framework that the Treasury implemented – which included reporting by the Reserve Bank, inspections by the Treasury, and the Treasury's analysis of information from other sources – was, for the most part, effective. It provided the Treasury with enough financial details on individual institutions to assess which institutions should be asked for additional information.
- 6.61 The Treasury identified most of the institutions that triggered the guarantee as having a high risk of failure at least three months, and often more, before they failed. Most of the institutions that failed were the subject of more detailed "watch-list" reports and were being monitored reasonably closely. The two exceptions were Mascot Finance and Strata Finance Limited, which failed before the monitoring system began. All the other institutions that failed had been inspected (except for one small institution where there was no expected loss if it failed).
- 6.62 From March 2009, the Treasury was proactive in its analysis and review of the institutions and its search for additional evidence. The Treasury used a wide range of information sources and did not depend only on the Reserve Bank's monitoring



reports. The Treasury's use of inspectors was effective, and the Treasury closely interacted with inspectors to ensure valuable outcomes.

- 6.63 However, we consider that the monitoring of financial institutions started later than it should have. The first monitoring information was received by the Treasury on 30 March 2009 (for data as at 31 January 2009), five months after the start of the Scheme. The Reserve Bank began planning for its role in the monitoring process in November 2008. It worked from November 2008 to March 2009 to ensure that it was collecting the required information, building the templates and models to analyse the data, and analysing the first data collected.
- 6.64 In our view, the Treasury was waiting for monitoring data to arrive from the Reserve Bank, rather than planning for its arrival and for the next stage in the monitoring process (that is, what it would do with the information once it arrived).
- 6.65 We consider that the Treasury should have prepared a monitoring work stream to run concurrently with the application process. The people involved with this work stream could have worked with the Reserve Bank to prepare a monitoring framework and gather information more quickly.
- 6.66 From a practical viewpoint, there were many reasons why quicker monitoring did not take place, including:
- Part 5D of the Reserve Bank Act was enacted in September 2008, so the formal regulation of the NBDTs was new to the Reserve Bank.
  - The monitoring contract between the Treasury and the Reserve Bank was effective from 1 December 2008.
  - During October and November 2008, the Treasury focused mainly on processing applications and on broader concerns associated with the financial crisis.
  - There were not enough skilled staff to conduct this monitoring, and other staff were occupied with processing applications. It takes time to recruit new staff and wait for them to start (and recruitment was further delayed by the summer holidays).
  - Until applications were processed, the Treasury did not know how many institutions would be in the Scheme and would need to be monitored.
  - There were delays in receiving data from the trustees. The trustee supervisory model posed some challenges because monthly data went from the institutions to the trustees to the Reserve Bank. The Reserve Bank then analysed the data before sending it to the Treasury. Although the institutions were already reporting to the trustee, the data collected for the Scheme was in

a different format. It took time for the institutions to change their systems to compile this data. It also took time for information to start flowing through to the trustee and then on to the Reserve Bank.

- 6.67 Despite these issues, we consider that a monitoring process could have been in place before the end of 2008. There was a long history of finance company failures, so another failure was not unlikely. In our view, planning for thorough monitoring, how to manage any failures, and provisioning should have been a high priority.
- 6.68 The Treasury recognised early that appointing inspectors would be an essential part of the monitoring process. If the monitoring had started earlier, inspectors might have been appointed early in 2009 rather than in June and July 2009. It is by no means clear that appointing inspectors any earlier would have led to any significant savings to the Crown. However, a number of higher-risk institutions, such as South Canterbury Finance, had experienced strong deposit growth during the first six months of the Scheme. It is possible that earlier inspections might have identified issues with the higher-risk entities and allowed for early withdrawal of the guarantee or other intervention to restrict deposit growth and limit the potential cost to the Crown.
- 6.69 One of the risks associated with appointing an inspector is the possible market and media speculation about the appointment and the consequent loss of public confidence in that institution. There is evidence that the Treasury's concern about this risk might have contributed to initial delays in appointing inspectors.
- 6.70 Data accuracy issues and the need to send in inspectors to fully understand the institution's position also affected the effectiveness of monitoring. Data provided to the Reserve Bank from the trustees was not audited and was based only on management accounts. Requesting audited data would have significantly slowed the reporting process. In many instances, the data turned out to be inaccurate, particularly about loan classification. Many of these data inaccuracies could not be overcome until an inspector was appointed to conduct a detailed review of the loan book.
- 6.71 In our view, the Treasury was well aware of these issues and acted to appoint inspectors as early as possible, once monitoring began. Six inspections were conducted before the panel of inspectors was appointed. In some instances, the Treasury reconciled the data provided by the Reserve Bank with data from other sources.

- 6.72 In a 2007/08 report to Parliament, the Registrar of Companies expressed concern about the rigour with which some failed finance companies were audited by smaller firms that may not have had enough capability and experience to conduct these audits (especially given the complex business structures that many of the finance companies operated). As a result, the reliability of some of the financial information might have been questionable.<sup>24</sup>
- 6.73 The delays in receiving data also affected the performance of the monitoring framework. Because of the path of the information flows (dictated by powers under the relevant reporting obligations) and the amount of information required to be analysed initially, data in the reports was two months old when the Treasury received the reports from the Reserve Bank. This improved as the Scheme progressed (with the reporting time frame shortened from six weeks to four weeks) and as the Reserve Bank's analysts became more familiar with the individual entities and their issues. We do not consider that the Treasury could have acted differently to alter these reporting delays.
- 6.74 The Treasury relied on the models developed by the Reserve Bank (including the risk ranking model and the estimated loss model). The relative risk ranking and estimated loss models were important tools the Treasury used to target the institutions that warranted closer monitoring (and eventual inspection). The models also fed into the provisioning process.
- 6.75 These models proved to be very accurate and provided the basis for the Treasury identifying all the institutions that triggered the guarantee as having a high risk of failure at least three months, and often more, before they failed. Most of the institutions that failed were the subject of more detailed "watch-list" reports and were being monitored reasonably closely.
- 6.76 We recognise that these complex models were developed quickly. However, given the Treasury's reliance on these models, we consider that much stronger processes should have governed their use within the Treasury. These should have included comprehensive documentation, robust override and change control processes, and independent reviews and validations.
- 6.77 The Treasury carried out its own checks and validation (by feeding data of failed institutions back through the model to estimate losses). In July 2009, as part of the annual audit of the Treasury, we reviewed at a high level the estimated loss model used for provisioning in the financial statements. Around that time, Treasury significantly increased the amount and accuracy of the estimated loss.

24 See the Report of the Commerce Committee, *2007/08 Financial Review of the Ministry of Economic Development*, Appendix B.

- 6.78 There was a particular risk in the monitoring process. Responsibility for monitoring sat solely with two Treasury officials (supported by officials in other teams, such as legal, policy, and communications). This risk was compounded by the apparent lack of senior management oversight of the monitoring process. There is evidence that these two staff provided relatively frequent written updates to senior management. These updates appeared to be provided when needed. We understand that there were also senior leadership team meetings about the Scheme and that matters were raised with higher management as required (we did not see evidence about these meetings). Much of the information flow and reporting that we have reviewed was “bottom-up” rather than “top-down”. In other words, it was not prepared in response to information requests from senior management within the Treasury.
- 6.79 In our view, it would have been useful and sensible to set up a steering committee with senior management directing and reviewing the monitoring process. We understand that a steering committee was set up when South Canterbury Finance failed, with very senior representation. A group was also formed to deal with extending the Scheme, which was an important policy decision for the Government on advice from the Treasury.
- 6.80 The early months of the Scheme were undoubtedly busy. However, that was also the time when governance frameworks, escalation procedures, and strategic management were needed most.



## Part 7

# Paying depositors when institutions failed

7.1 In this Part, we discuss:

- the first payout under the Scheme;
- outsourcing the processing of claims;
- paying the depositors of South Canterbury Finance;
- paying depositors under the Extended Scheme;
- communications about the payout process;
- communications about the extent of repayments;
- informing the Minister of Finance about failures and payouts; and
- our views on the payout process.

7.2 In summary, despite the number of finance company failures in the two years before the Scheme was introduced, the Treasury was surprised by the March 2009 failure of a finance company accepted into the Scheme. Because the payout was not expected nor adequately planned for, some aspects of the first payout process could have been improved. However, the Treasury learned from the first payout and managed later payouts effectively and efficiently.

7.3 The Treasury was well prepared for the South Canterbury Finance payout and provided comprehensive analysis of the advantages and disadvantages of the various options that were available. Because of this, the Treasury secured an effective outcome that significantly reduced the liability that the Crown would otherwise have faced. In our view, the Treasury chose the best available option for paying out South Canterbury Finance's depositors.

### The first payout under the Scheme

7.4 A number of finance companies in the Scheme experienced difficulties. Problems in finance companies ranged from poor management and excessive related-party dealings to poor quality lending decisions and not enough capital or liquidity (because of the long-term and illiquid nature of their loans, finance companies often did not have enough short-term funds to repay depositors).

7.5 The first institution to fail under the Scheme was Mascot Finance, which was placed in receivership on 2 March 2009. Another small institution, Strata Finance Limited, failed in April 2009. A further six institutions failed under the Revised Scheme in 2010. Only one institution, Equitable Mortgages Limited, has failed under the Extended Scheme. Equitable Mortgages Limited was placed in receivership in November 2010.

7.6 Figure 17 provides details of the payments made to institutions that failed while covered by the Scheme.

**Figure 17**  
Institutions that have failed while covered by the Crown Retail Deposit Guarantee Scheme

Institution	Date of failure	Amount paid* \$million	No. of depositors	Months taken to complete payout
Mascot Finance Limited	2 March 2009	70.0	2,494	20
Strata Finance Limited**	23 April 2009	0.5	17	20
Vision Securities Limited	1 April 2010	30.0	967	8
Rockforte Finance Limited	10 May 2010	4.0	66	4
Viaduct Capital Limited	14 May 2010	7.6	88	4
Mutual Finance Limited	14 July 2010	9.2	329	2
Allied Nationwide Finance Limited	20 August 2010	131.0	4,094	3
South Canterbury Finance Limited	31 August 2010	1,580.3	30,404	0
Equitable Mortgages Limited	26 November 2010	140.2	3,852	Not applicable
<b>TOTAL</b>		<b>1,972.8</b>	<b>42,311</b>	

Source: The Treasury.

Note: As at 30 June 2011. The Treasury expects to pay out a further \$37.3 million.

\* Includes interest payments after the institution failed and ineligible deposits. Note that some small payments remain outstanding because some deposits are yet to mature and some depositors cannot be traced.

\*\* Most eligible depositors were paid on 4 June 2009.

7.7 Under the Scheme, the Crown committed to pay depositors 100% of their eligible amount up front. This was to facilitate quick payment to depositors. The alternative would be to wait for the receivership process to be finalised and for the Crown to make up any shortfall after the failed institution's assets had been sold. The Crown would participate in the receivership process to recover as much as it could from the sale of the institution's assets. The receivership process takes a lot of time, so the payment process was instead designed so that depositors would not have to endure lengthy delays before they received their funds.

7.8 During interviews, we were told that officials in the Treasury were thinking about and discussing their planning for payout processes in late 2008 and early 2009.

However, there is no documented evidence of this planning. There is evidence that planning for possible Scheme payouts was under way in February 2009. In particular, the Treasury and the Reserve Bank met on 23 February 2009 to “brainstorm” the payout process and failure scenarios.

- 7.9 When Mascot Finance failed in early March 2009, the Treasury needed to quickly implement a payout process. Several Treasury officials said that they were surprised by Mascot Finance’s failure and that the Treasury was fortunate a larger institution had not failed, given the Treasury’s lack of established payout and communication processes.
- 7.10 Once the Treasury was aware of the pending failure of Mascot Finance, it quickly responded to ensure that the payout process was as smooth as possible. The Treasury planned a media statement to reassure eligible depositors that they would receive 100% of their entitlement and to provide details of the step-by-step process on the Treasury’s website. This information was released the day the receiver was appointed.
- 7.11 The Treasury made claim forms for simple claims available within a few days of Mascot Finance’s failure. All claim forms were available within a few weeks. The Treasury also set up a free-call telephone number to handle queries from depositors. The process for claiming was:
- Depositors submitted a completed *Notice of claim form* to the Treasury (with all supporting information).
  - The Treasury sent an acknowledgement that it had received the claim.
  - The Treasury checked the institution’s records and directed any queries to claimants.
  - The Treasury made payments as requested (either by cheque or directly to a bank account) and provided a final statement to the depositor.
- 7.12 By all accounts, processing payouts for Mascot Finance was complicated and the Treasury quickly realised that it would require additional resources. It engaged PricewaterhouseCoopers (PwC) to help in processing claims. A contract between the Treasury and PwC was signed on 10 March 2009 for services until 30 June 2009, providing both on-site and off-site support.
- 7.13 Issues that complicated the claims processing included:
- complex eligibility criteria – as discussed in Part 5, an unintended consequence of the Scheme’s design was the need to meet complex depositor eligibility criteria, which created processing difficulties;
  - incorrect claim forms – many investors submitted the wrong claim form for



their circumstances, which required follow-up with the claimant; and

- payment of interest – the Treasury received a ruling from the High Court on 27 August 2009 that it had to pay interest after the date of failure until the claim was paid. The Treasury had not anticipated this. The decision had significant implications because it meant that claimants could delay submitting their claim form to continue to receive high interest payments. The guarantee deeds did not limit the interest to be received or set a deadline for submitting a claim form.

7.14 Despite these complications, the payments were timely. The first payment was made on 9 April 2009. By 30 June 2009, 78% of payments had been made.

7.15 The second failure, in April 2009, was a very small institution (Strata Finance Limited) that had only 17 depositors and was in the process of winding down. The institution's failure was triggered by a failure to pay a depositor on the maturity date. With the small number of depositors, the payout process was a much smaller task than for Mascot Finance. The Treasury handled it internally. The Treasury sent claim forms directly to each depositor in May 2009, and most eligible depositors were paid on 4 June 2009.

### Outsourcing the processing of claims

7.16 Despite its success, the Treasury's experience with Mascot Finance highlighted the need for a more robust payout solution. Using the Mascot Finance model, it would have taken too long to process payouts for a large institution. The Treasury prepared a comprehensive analysis document (undated, but entered in the Treasury's document management system in August 2009) detailing the costs and risks associated with the various options considered. The Treasury explored three options:

- fully outsourcing the payout process;
- continuing to process payouts in-house; or
- a combination of the two processes.

7.17 Because of potential NBDT failures and the Scheme's limited term, the Treasury did not see that an in-house capacity was practical or cost-effective. It favoured a single service provider over multiple providers because of the cost efficiencies of a single provider and the minimisation of potential duplication and inconsistency. Further, it favoured an end-to-end arrangement to ensure efficiency and clear responsibilities and deliverables. The Treasury decided that outsourcing the end-to-end payout process to a single service provider was the best option.

7.18 The Treasury then analysed the capacity, credibility, and experience of three potential providers. These providers were scored against a comprehensive list of

requirements, sub-criteria, and key risks in the payout process. The Treasury also analysed the cost of two potential providers, considering the payout for a small and a large institution.

- 7.19 The Treasury carried out appropriate due diligence checks of possible service providers. It met a number of potential outsource providers in August 2009 and also met with potential receivers to discuss the payout process. The Treasury decided to outsource claims processing to Computershare. It also decided to investigate a refined in-house process for smaller NBDTs, but this never eventuated because of the success of the Computershare arrangement.
- 7.20 The Business Management Team (which makes resourcing decisions) agreed to appoint Computershare on 11 September 2009. The contract was structured in two stages. The initial stage was to prepare adequate processes and systems. (This initial engagement was confirmed on 5 November 2009.) The second stage was processing claims. The final services agreement between the Treasury and Computershare was signed on 19 July 2010.
- 7.21 The services provided by Computershare included managing a help desk and telephone hotline, setting up a claimant database (after reviewing and reconciling claimants with the institution's register), sending and processing claim forms, and forwarding payments to each depositor. The register could take up to two months to prepare, putting pressure on other aspects of the process.
- 7.22 The Treasury retained oversight of the payout process. It met regularly with Computershare, received weekly reports, reviewed a sample of payment files, approved all payments, approved all decisions to decline payments, and processed the complex claims. The Treasury, with Computershare, prepared detailed business rules and checklists to clearly set out the payment process and to help in applying the eligibility criteria. The Treasury also spent time training Computershare staff. Learning from its experience with Mascot Finance, Computershare sent the correct claim form to each depositor after it had confirmed their details (avoiding the problem of the depositor sending in an incorrect form).
- 7.23 All preparation under the first stage was completed by March 2010. Computershare was then ready to process claims if a financial institution covered by the Scheme failed. As part of its preparation, in November 2009, the Treasury requested details of the debenture registers for institutions most likely to fail. This helped to identify any data quality issues before an institution failed.
- 7.24 The first payout under the outsourced arrangement was for Vision Securities Limited (Vision Securities), which was placed in receivership on 1 April 2010. The contract between the Treasury and Computershare was not yet final (because of

delays in preparing service standards and other documentation). However, this did not affect the claims processing for Vision Securities, which was carried out under a Statement of Work required for each individual claims payout.

- 7.25 All payouts after Mascot Finance and Strata Finance Limited used the Computershare outsourcing model.

### **Paying the depositors of South Canterbury Finance Limited**

- 7.26 South Canterbury Finance was placed in receivership on 31 August 2010. Its failure triggered the guarantee under the Revised Scheme: the deed for the Extended Scheme was signed, but the Scheme had not yet started.
- 7.27 Although the payout process had been set up and had proven to be efficient, the failure of South Canterbury Finance presented additional challenges. Some of these were administrative. Others were because of how the Scheme was designed.
- 7.28 The Treasury expected claims and payout processing for South Canterbury Finance depositors to be large and complex. The finance company had more than 30,000 depositors and a large deposit base of more than \$1.6 billion. The Treasury was also concerned that significant additional costs would arise from interest payments, particularly if depositors deliberately tried to maximise their interest payments under the guarantee.<sup>25</sup> The interest rates paid on South Canterbury Finance's investments were high relative to other investments, so the interest payments after the company failed could have been significant. Although the Crown had paid interest to depositors for all the earlier failures, they had been smaller institutions and the payout process was efficient.
- 7.29 The Treasury's close monitoring of South Canterbury Finance in the months leading up to its eventual failure provided ample warning and an opportunity to analyse and consider alternative payout approaches. In the month before South Canterbury Finance's failure, the Treasury carried out a lot of planning. It analysed extensively the options to simplify the payout process and reduce the Crown's liability. The Treasury prepared a paper for Cabinet on 26 August 2010, setting out its analysis to reduce costs if South Canterbury Finance failed.

<sup>25</sup> If South Canterbury Finance had failed under the Extended Scheme, there would have been no interest payments to make because they were explicitly excluded when the Scheme was extended.

- 7.30 Accordingly, the Treasury announced several decisions on 31 August 2010. These included that:
- eligible and ineligible depositors would be fully paid out on the first day of the receivership; and
  - the Crown would pay certain other organisations owed money by South Canterbury Finance (“prior ranking charge holders”) so that the Crown would become the first-ranked creditor.

7.31 On 31 August 2010, the Crown paid the trustee of South Canterbury Finance \$1.8 billion, with both the Treasury and trustee co-operating to promptly repay all depositors (once an up-to-date register was available). Negotiations with the trustee included a requirement for the trustee to also use Computershare, under a separate agreement. The Treasury continued to oversee the payments made.

### **Repaying eligible and ineligible depositors**

- 7.32 The decision to repay all depositors of South Canterbury Finance, regardless of any previous eligibility criteria, was in response to anticipated difficulties in assessing eligibility criteria and concerns about the interest payments that would accrue as claims were processed. Assessing the eligibility of individual depositors would have been an enormous administrative task.
- 7.33 Under the simplified repayment criteria, all that was required was for the depositor to be on the register of debt securities at the date of the company’s failure. The relaxing of eligibility criteria resulted in payouts to depositors who would have otherwise been ineligible. This included related parties, financial institutions, depositors with deposits of more than \$1 million, trusts, and non-tax residents/citizens.
- 7.34 To implement this full payout, the trustee was nominated as the eligible creditor. This allowed the Crown to pay the trustee in full instead of depositors making a claim to the Treasury and the Crown repaying amounts to individual depositors. Under this payout method, interest to depositors ceased to accrue on the date that the trustee was paid.
- 7.35 In the 26 August 2010 Cabinet paper, the Treasury estimated that interest payments to depositors if South Canterbury Finance failed would be between \$170 million and \$240 million or more under the standard payout arrangements. This range reflected assumptions about how many depositors might delay making claims and how long they might take to lodge their claims. The Cabinet paper also contained the Treasury’s estimate of the net saving to the Crown of an early full payout with the trustee nominated as the eligible creditor. The net saving to the Crown of the early full payout was estimated at about \$109 million.

- 7.36 The decision to pay “prior ranking charge holders” gave the Crown control over the payout process. This allowed for an orderly and well-managed receivership that minimised the cost to the Crown. Prior ranking charge holders could otherwise have appointed their own receiver, which might have resulted in longer processes, more complicated receivership processes, and, ultimately, additional Crown losses. Taking this step was estimated to cost no more than \$175 million, which the Crown received back in full by February 2011.
- 7.37 The Treasury also announced that changes to the eligibility criteria would also apply to any other guaranteed companies that failed (including those that had already failed). Paying out previously ineligible depositors was a controversial decision and an about-turn in policy, because many depositors would benefit from the guarantee who were not originally intended to do so.
- 7.38 The decision to extend this change to institutions that had already failed under the Scheme was based on a cost-benefit analysis and was an attempt to manage issues of “precedent and fairness.” The saving to the Crown was the overriding factor in the decision. The Treasury had calculated that quickly paying all depositors (eligible and those previously ineligible) through the trustees was administratively sensible and would cost about the same as continuing to pay interest to individual eligible depositors until their claims were fully settled.
- 7.39 At the time of the South Canterbury Finance failure, payments had not been made to any of the depositors in the preceding four failures (as registers were still being verified) and around 75% of payments due had been made to the depositors of Vision Securities (which failed in April 2010). Interest would have been payable for these claims (which would have taken time to process).
- 7.40 Eliminating the need to assess eligibility resulted in faster payments to depositors. Payment from the Crown to the trustee enabled it to make payments to South Canterbury Finance’s bond holders on 23 September 2010 and to its debenture holders and depositors on 20 October 2010.
- 7.41 The remaining Vision Securities payouts and payouts for depositors with other failed institutions were also able to be processed more quickly.

### **Paying depositors under the Extended Scheme**

- 7.42 Under the Extended Scheme, paying interest after an institution failed was explicitly excluded as part of the guarantee deed. Interest was paid only up to the date of the failure.
- 7.43 Because the interest problem was adequately dealt with under the Extended Scheme, any payouts made under the Extended Scheme would be subject to

the full eligibility criteria. This differed to the original Scheme, which relaxed the eligibility criteria to hasten payments and avoid the interest payments.

- 7.44 One institution has triggered the guarantee under the Extended Scheme. Equitable Mortgages, which had about 4000 eligible depositors and \$178 million in deposits, failed. With no ability to misuse the Scheme and maximise interest payments, and with the Extended Scheme's requirement that claim forms be received within 180 days, claim forms arrived early. The Treasury continued to use Computershare to process the payments.
- 7.45 The Treasury had introduced tighter and more complex eligibility criteria for the Revised Scheme and the Extended Scheme. For example, under the original Scheme, joint deposit holders were eligible if one of the joint deposit holders was eligible. However, for the Revised and Extended Schemes, both joint deposit holders needed to be eligible (with some exceptions). Other revisions were also made for the Extended Scheme (such as a lower cap). These tighter criteria and other revisions meant changed business rules, and a higher proportion of claims for Equitable Mortgages were classed as complex. This led to greater interaction between the Treasury and Computershare. In other respects, the payout process was similar to earlier payouts.

## Communications about the payout process

### Failures and claim processes

- 7.46 One of the objectives of monitoring institutions was to anticipate any failures and allow preparations to be made for communicating with and paying depositors. The first two failures under the Scheme occurred before the monitoring process was set up. There was limited early warning. However, for other failures under the Scheme, the Treasury was aware that a failure was approaching and planned the necessary responses.
- 7.47 Mascot Finance triggered the guarantee on 2 March 2009. The Treasury released details of the company's failure and the accompanying payout process:
- A media statement was issued on the day of the failure, assuring eligible depositors that they would receive 100% of their money back. It provided a free telephone helpline during business hours for depositors wanting further information and directed depositors to the Treasury's website for further details.
  - A *Claims Frequently Asked Questions* (Claims FAQs) and a *Step by Step Claims Process* guide were also released on 2 March 2009. Both provided useful and clear information about what depositors needed to do to make a claim.

- A claim form for individual depositors was available on the Treasury's website on 5 March 2009, with other claim forms (for trustees, corporations, and joint holders) following from 13 March 2009 to 23 March 2009. Updates to these forms were completed by 14 April 2009.
- 7.48 The Treasury answered queries from depositors by email or by telephone. The Treasury set up a dedicated web page about Mascot Finance, providing contact details and the claim forms for download, as well as a link to the Claims FAQs. The Claims FAQs were updated on 1 April 2009 to clarify that interest would be paid after the date of failure (based on the High Court ruling). The *Step by Step Claims Process* was amended on 9 July 2009 to remove references to the receiver and refer to claim complexity only in the context of payment timing. The web page was updated in September 2010 about the decision to pay all depositors (including those previously ineligible). Further updates were made in October 2010 and on 10 December 2010 to advise that payments to all Mascot Finance depositors had been completed.
- 7.49 An equivalent amount of communication about the payout process for Strata Finance Limited was not necessary because there were only 17 depositors. However, the Treasury also set up a dedicated web page for Strata Finance Limited, similar to that created for Mascot Finance's depositors.
- 7.50 By late 2009, the "questions and answers" web pages had comprehensive information on claims and failures. On 25 February 2010, the Claims FAQs were incorporated into the "questions and answers".
- 7.51 The Treasury was better prepared for the company failures that occurred in 2010 (starting with Vision Securities in April 2010 through to South Canterbury Finance in August 2010). The extensive "questions and answers" were in place, and the Treasury had prepared a Crisis Response Plan that set out the steps and responsibilities for the payout process. With the heightened monitoring of institutions, there was enough warning of impending failures for web pages and communications to be prepared well in advance. A media statement on 19 July 2010 also provided detail on the process for repayments.
- 7.52 Each company failure had a dedicated web page and toll-free telephone number for enquiries. The Treasury issued a media statement on the date of failure, directing depositors to this information. The dedicated web pages were frequently updated to provide information on the Treasury's progress, the reasons for any delays, changes to eligibility or payment of interest, expected dates for receiving letters, and expected payment dates. A specific "questions and answers" page was also provided on the dedicated web page (as well as the general listing).

- 7.53 On 12 October 2010, the general “questions and answers” were updated to reflect the changes to the Extended Scheme. There has been one failure under the Extended Scheme. For this payout, the disclosure regime has been similar to those in 2010, with regular updates provided on the progress towards payout.
- 7.54 In our view, the communications about company failures under the Scheme provided clear, timely, and comprehensive information to depositors on the process for making a claim and receiving a payout. In 2010 in particular, web pages were frequently updated to provide depositors with a good understanding of the Treasury’s payout process and progress, and when depositors could expect contact or payment.
- 7.55 Although the information about Mascot Finance was clear, timely, and comprehensive, it was not regularly updated as often as was the case for later payout processes. Depositors could have benefited from more regular updates on payment progress. Moreover, there was no communications plan in place before Mascot Finance’s failure. However, the Treasury learned from Mascot Finance’s failure. The Treasury had improved information and a Crisis Response Plan to apply for the later company failures. The Crisis Response Plan included the necessary tasks and the timing for those tasks in the event that an institution failed.

### Communications about the extent of repayments

- 7.56 In each media statement to announce that an institution covered by the Scheme had failed (other than the statement for Mascot Finance), the Treasury provided an estimate of the number of depositors and the total deposits for the institution. The initial announcement was followed by a number of media statements that provided updates on the payments made and those that were outstanding (on 19 July 2010, 6 September 2010, and 8 December 2010). The media statement on 8 December 2010 detailed the total amounts paid for each of the eight failures that had occurred. Details of the failures, net costs, and the gross payouts to investors were also provided in the month-end and year-end financial statements of the Government.
- 7.57 In our view, the information about each failure under the Scheme was timely and comprehensive. A list of institutions that had failed is clearly available on the Treasury’s website, along with links to the media statement about the failure (which provided details on the estimated deposit amounts covered by the Scheme), the web page for that institution (which was updated as payments progressed), and the media statements on payments progress.



## Informing the Minister of Finance about failures and payouts

- 7.58 As well as information for the public, the Crisis Response Plan required the Treasury to provide details of each failure to the Minister through a Treasury Report or aide-memoire. These were to provide details on the institution's history, monitoring, default details, amounts of deposits, number of depositors, and likely outcomes. We have not seen any of these documents (other than for South Canterbury Finance).
- 7.59 Although we have not seen the documents, we know from other documents that the Minister received a Treasury Report on the Mascot Finance failure on 27 February 2009 (in the week before the failure), as well as an aide-memoire on 10 March 2009, which set out a step-by-step outline of the application process and the plans for the Mascot Finance payout. The Treasury also provided the Minister with updates as part of the fortnightly financial system issues meetings. The disclosure to the Minister for Mascot Finance was before the Crisis Response Plan was prepared.
- 7.60 The Crisis Response Plan required Treasury officials to notify the Minister. It also required the Minister's press secretaries to be notified, and they were to tell the local member of Parliament if the failed institution had a concentration of investors in that member's constituency. We have not seen evidence that this aspect of the Crisis Response Plan was applied.
- 7.61 In our view, the Minister was well informed about company failures and expected payouts.

## Our views on the payout process

- 7.62 In our view, the Treasury learned valuable lessons from its experience with the Mascot Finance payout and applied this knowledge to improve the payout processes. Using Computershare was effective and made the payout process efficient. The Treasury was well prepared for the South Canterbury Finance payout and provided comprehensive analysis of the advantages and disadvantages of the various options that were available. As a consequence, the Treasury secured an effective outcome that provided significant savings to the Crown.
- 7.63 The payout process was adversely affected by unintended consequences of some aspects of the Scheme's design, namely the payment of interest after an institution failed and dealing with complex eligibility criteria. If these issues had been explicitly provided for at the outset, the payout process would have been significantly simplified. However, the Treasury learned lessons from the

Scheme's design and made sure that, in the Extended Scheme, there were no interest payments after an institution failed and there was an explicit deadline for submitting claim forms. Complex eligibility criteria continued to be a feature of the Revised and Extended Schemes.

- 7.64 The payout process could have been improved by contingency planning for possible payouts in the early days of the Scheme. We have not seen evidence of any formal planning of proposed payout methods before the failure of Mascot Finance in 2009. Ideally, the arrangement with Computershare would have been in place at the start of 2009. The Treasury told us that it could not have done so because the arrangements with Computershare reflected what the Treasury had learned from the payouts after Mascot Finance failed.
- 7.65 In our view, having a provider broadly prepared for processing payments, even if finer details were yet to be determined, would have been better than having no arrangements in place. If South Canterbury Finance had failed in mid-2009, the Treasury would have been caught unprepared and the effort to achieve an effective payout solution would have been significant. We consider that the Treasury took too long to finalise the Computershare agreement and should have done this earlier than its effective date of July 2010.



# Appendix

## Timeline of decisions and events

Date	Event
May 2005	Announcement of a “Review of Financial Products and Providers”
December 2005	Cabinet indicates prudential supervision for the financial sector should be consolidated into the Reserve Bank
May 2006 to September 2008	28 finance companies fail (receivership, liquidation, or in moratorium/frozen payments)
12 September 2007	Minister announces a new regulatory framework for non-bank deposit-takers (NBDTs)
3 September 2008	Part 5D of the Reserve Bank of New Zealand Act enacted, giving the Reserve Bank rule-making powers for NBDTs
12 September 2008	Announcement of 2008 General Election (Parliament dissolved on 3 October 2008)
26 September 2008	GDP figures for June show New Zealand is in recession
30 September 2008	Ireland guarantees bank deposits of six specific banks for two years (other countries follow)
8 October 2008	G7 Finance Ministers meet and call for “urgent and exceptional action”
12 October 2008	Australia announces its deposit guarantee scheme
12 October 2008	Crown Retail Deposit Guarantee Scheme (the Scheme) introduced  Minister of Finance announces Scheme in a media statement, with further details provided in a joint media statement from the Treasury and the Reserve Bank
13 October 2008	The Treasury receives first application for the Scheme
15 October 2008	The Treasury receives 47 applications by this time
15 October 2008	The Reserve Bank and the Treasury release joint media statement providing further Scheme details
22 October 2008	The Treasury releases Policy Guidelines
22 October 2008	The Treasury releases “questions and answers” on its website (previously on the Reserve Bank’s website)
29 October 2008	First applications approved (for three banks)
30 October 2008	Final guarantee deeds available on the Treasury’s website for banks and NBDTs
1 November 2008	Wholesale Guarantee Scheme introduced
8 November 2008	Change of Government (National Party is elected)
1 December 2008	Start date for the Reserve Bank’s monitoring agreement with the Treasury
31 December 2008	The Treasury receives 125 applications by this time, with 63 applications approved
2 March 2009	First trigger of the guarantee: Mascot Finance Limited placed in receivership

Date	Event
30 March 2009	The Treasury receives its first monitoring report from the Reserve Bank based on data as at 31 January 2009. These reports were provided as part of the monitoring agreement with the Treasury and included a risk ranking report, sector reports, and detailed individual information for higher-risk entities
30 March 2009	The Treasury receives 134 applications by this time, with 86 applications approved
9 April 2009	First payouts to Mascot Finance Limited's depositors (78% paid by end of June 2009)
16 April 2009	Strata Finance Limited triggers the guarantee following a failure to repay debt
20 April 2009	Viaduct Capital Limited guarantee withdrawn for new deposits (due to the business affairs of Viaduct being carried on in a manner inconsistent with the intentions of the guarantee)
4 June 2009	First payouts to Strata Finance Limited's depositors (69% of payouts made on this day)
12 June 2009	The Treasury sends appointment letter for the first of the inspections under the Scheme (another five sent in June/July)
23 July 2009	Last application received
25 August 2009	The Treasury announces that the Scheme would be extended from 12 October 2010 to 31 December 2011
27 August 2009	High Court ruling in relation to Mascot Finance Limited finds the Crown liable for interest accrued on guaranteed deposits between the date of default and the date claims are paid
1 September 2009	New Reserve Bank requirements for risk management programmes for NBDTs come into force
12 September 2009	Crown Retail Deposit Scheme Act 2009 passes to provide legislative authority for the Extended Scheme
18 September 2009	The Treasury releases Extended Scheme Policy Guidelines and eligibility criteria
14 October 2009	<i>Financial Statements of the Government</i> released with an \$816 million provision for the Scheme
18 November 2009	The Treasury announces the Revised Scheme
1 January 2010	Revised Scheme begins – 86 replacement deeds issued to 63 entities (six entities elect not to accept)
1 March 2010	New Reserve Bank requirements for credit ratings for NBDTs come into force
11 March 2010	First entity signs up for the Extended Scheme (MARAC Finance Limited). A further seven entities are approved for the Extended Scheme between March 2010 and May 2010, including South Canterbury Finance Limited (which went into receivership before the start of the Extended Scheme)

Date	Event
1 April 2010	Vision Securities Limited placed in receivership
30 April 2010	Wholesale Guarantee Scheme closes to new applications
7 May 2010	Guarantee withdrawn for FAI Money Limited – no outstanding debt securities on issue
10 May 2010	Rockforte Finance Limited placed in receivership (guarantee applied only to deposits up to 31 December 2009 because Rockforte elected not to enter the Revised Scheme)
14 May 2010	Viaduct Capital Limited placed in receivership (guarantee applied only to deposits before the date of withdrawal of 20 April 2009)
30 June 2010	First payouts to Vision Securities Limited's depositors (62% paid by end of July 2010)
15 July 2010	Mutual Finance Limited placed in receivership
19 July 2010	The Treasury signs services agreement with Computershare Investor Services Limited for the payout process
20 August 2010	Allied Nationwide Finance Limited placed in receivership
27 August 2010	First payouts to Rockforte Finance Limited's depositors (72% paid by end of September 2010)
31 August 2010	South Canterbury Finance Limited placed in receivership, full payment of \$1.8 billion made to Trustee
31 August 2010	Announcement that all depositors are to be repaid in all entities that have defaulted, regardless of previous eligibility criteria
3 September 2010	First payouts to Viaduct Capital Limited's depositors (74% paid by end of September 2010)
30 September 2010	First payouts to Mutual Finance Limited's depositors (72% paid on this day)
12 October 2010	Extended Scheme starts with seven entities participating
15 October 2010	The Treasury issues an extensive information release about South Canterbury Finance Limited
29 October 2010	First payouts to Allied Nationwide Finance Limited's depositors (payouts complete by 30 November 2010)
1 November 2010	The Reserve Bank issues an information release about South Canterbury Finance Limited
26 November 2010	Equitable Mortgages Limited placed in receivership
1 December 2010	New Reserve Bank requirements for NBDTs relating to capital, liquidity, related-party exposures, and governance come into force
8 December 2010	The Treasury announces original Scheme payments complete with 38,000 depositors paid as at 31 August 2010
5 January 2011	Three NBDTs merge to form Combined Building Society

Date	Event
14 April 2011	The Treasury issues a second information release about South Canterbury Finance Limited
21 April 2011	First payouts to Equitable Mortgages Limited's depositors (35% of payouts completed by 12 May 2011)
1 May 2011	Financial Markets Authority forms to replace Securities Commission and certain functions of the Companies Office (such as the pre-registration checking of prospectuses)
12 May 2011	The Reserve Bank issues a second information release about South Canterbury Finance Limited
1 September 2011	Guarantee for PGG Wrightson Finance Limited withdrawn after acquisition by Heartland Building Society – only three entities remain in the Extended Scheme
31 December 2011	Extended Scheme due to expire

# Glossary

**Arrears:** A loan is in arrears when one or more payments due have not been paid.

**Capital ratio:** Key financial ratio of capital to assets (or risk-weighted assets) measuring an institution's capital adequacy or financial strength. The Reserve Bank requires that institutions maintain a minimum capital ratio to ensure that there is enough capital (mostly shareholders' equity and retained earnings) to protect the institution from unexpected losses. As a general rule, an institution with a higher capital ratio is more resilient than one with a lower capital ratio.

**Capitalising interest:** Where the interest owed on a loan is added to the total debt, rather than paid regularly.

**Collective investment scheme:** An investment product where a professional manager invests money on behalf of many individual investors (for example, a unit trust).

**Contingent liability:** A liability that might arise if a certain event occurs (for example, if a financial institution fails while under the Scheme).

**Credit rating:** Rating provided by an independent agency that estimates the creditworthiness of an organisation (that is, the ability of the organisation to meet its financial commitments). Credit ratings are publicly available and used by investors and analysts as a guide for investment decisions because they indicate relative credit standing or strength.

**Credit worthiness:** A measure of a borrower's ability to meet debt obligations.

**Debentures:** A fixed-interest debt security issued to raise funds, often medium- to longer-term funds but sometimes short-term. The security is often secured but can also be unsecured.

**Debt security:** A debt instrument that can be bought or sold, where the issuing company agrees to repay the amount borrowed (principal) at a specified date with specified interest. Examples of debt securities include deposits, bonds, debentures, and certificates of deposit.

**Delinquent loan:** A loan with repayments that are overdue (that is, the borrower is behind or late in making payments).

**Impaired loans:** Loans for which the institution does not expect to receive part or all of the principal and interest back in a timely manner.



**Liquidity:** The ability to turn an asset into cash at short notice with minimum loss of value. Liquidity also refers to an institution's ability to pay its obligations when they become due (for example, to fund withdrawals by depositors).

**Market discipline:** Incentives imposed by the market on institutions to conduct their business in a safe, sound, and efficient manner. For example, with comprehensive disclosure, the concern of depositors for the safety of their deposits will cause institutions to control and limit the riskiness of lending activities, because depositors will choose to lend to the less risky institutions.

**Moral hazard:** Occurs when a party insulated from risk behaves differently than it would if it were fully exposed to the risk. For example, people with insurance may take greater risks than they do without it because they know they are protected (and the insurer may receive more claims as a result).

**Provision:** An estimate of how much needs to be allocated in financial statements to cover expected losses (funds set aside to meet future liabilities).

**Related-party exposure:** Lending to related parties (also known as connected lending). Parties are considered related if one party has the ability to control the other party or to exercise significant influence over the other party's financial and operating decisions. In terms of a deposit-taker, a related party would include directors, senior managers, and their relatives; subsidiaries; members of the borrowing group; people with a substantial interest in the deposit-taker or a group member; entities in which the deposit-taker or group member has a substantial interest; and entities with interlocking boards.

**Retail deposits:** Money held by financial institutions on behalf of individual investors and small businesses.

**Trustee:** An individual or organisation that holds or looks after assets on behalf of someone else (beneficiary) and ensures that the terms of the trust deed are met.

**Wholesale deposits:** Money held by financial institutions on behalf of large companies, other financial institutions, and governments.

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- Government planning and support for housing on Māori land
- Inquiry into the use of parliamentary travel entitlements by Mr and Mrs Wong
- The Emissions Trading Scheme – summary information for public entities and auditors
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Office of the Auditor-General  
PO Box 3928, Wellington 6140

Telephone: (04) 917 1500  
Facsimile: (04) 917 1549

Email: [reports@oag.govt.nz](mailto:reports@oag.govt.nz)  
Website: [www.oag.govt.nz](http://www.oag.govt.nz)