REGULATION AND GOVERNANCE IN THE NON-BANK FINANCIAL SECTOR: LESSONS FROM NEW ZEALAND

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Abstract

This paper uses the example of the collapse of the finance company sector in New Zealand in 2006-2010 to illustrate the problems with light touch regulation and a reliance on good governance to ensure financial stability. It shows two major governance failures, the first in the governance of the sector by the authorities and the second, serious failures in corporate governance by the firms involved. While a light touch may assist economic development it also increases fragility. New Zealand has now switched to a greater emphasis on regulation and to a better alignment of incentives to ensure good governance. While other countries might consider implementing aspects of its new bank resolution regime most are opting for considerably more regulation and compliance costs.

Key words: regulation; governance; financial sector; finance company

Many countries have made distinctions between heavily regulated and supervised banks and similar non-bank financial institutions that face a lighter regulatory environment. The global financial crisis (GFC) has highlighted the consequence of this distinction, leading countries to widen the definition of banks and tighten regulation of non-banks. A primary reason for this reaction has been the revelation of poor governance within these more lightly regulated firms and the disastrous consequences, for their shareholders, lenders and ultimately in many cases the taxpayer and the economy at large. This is in clear contrast to the finding that light touch regulation has generally been associated with faster economic growth.[1] It is only with the GFC that the association with more substantial declines has also been revealed.

While the best known example of the consequences of this distinction between types of bank-like financial institutions is the case of Lehman Brothers in the US, which failed in September 2008, Lehman Brothers was an investment bank with a rather different line of business from commercial banks in the US. Most importantly for the crisis Lehman Brothers did not benefit from the powers of intervention and resolution

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wielded by the Federal Deposit Insurance Corporation (FDIC). Many countries distinguish in their treatment of banks and near banks between those that take deposits from the general public and those that do not. Where ordinary depositors are involved the authorities usually take the view that some degree of protection should be offered as such depositors are not well informed and hence exposed to risks they do not realise. In return for such protection, the insurer naturally requires substantial powers of investigation and control over the financial institution to reduce its risk to manageable proportions.

This article, however, focuses on a recent example where depositors were faced with a choice between two types of depository institutions where neither had depositor protection but one group was subject to much closer supervision than the other. This was the case in New Zealand until 2011, where financial institutions were only subject to prudential supervision by the Reserve Bank of New Zealand (RBNZ) if they wanted to call themselves a bank and hence chose to register and comply with the extensive qualification criteria.[2,3] If they were content to label themselves a finance company or a building society or a credit union then they were subject to a very light regime, where they simply had to meet the terms of a trust deed which was overseen by a trustee.[4] Thus in this latter case shareholders, depositors and other lenders had to rely on the normal procedures of corporate governance to ensure that the funds they had advanced were being prudentially managed.

These arrangements turned out to be disastrous. Starting in 2006, almost all of the deposit-taking finance company sector failed and by the end of 2011 it was virtually non-existent with the handful of remaining independent institutions seeking to turn themselves into banks or find other routes to credibility.[5] Thus most of these companies failed not in the GFC but before it. Failure cannot therefore be blamed on unusual circumstances or bad luck but almost entirely on bad management and governance failure. In several cases the directors of the companies have been successfully prosecuted for breaches of corporate legislation and outright fraud[6] and a number of other cases are still in progress. The main directors of Nathans Finance were convicted in February 2012 for misleading depositors and shareholders in the run up to their failure in August 2007. Two of the non-executive directors found guilty were former Ministers of Justice and hence senior members of government. (It seems likely that a number of well-known people in effect gave their names as backing for finance companies run by people they knew, without doing due diligence on what those companies were in fact doing.)

The banking sector on the other hand, not only got through the GFC (thus far) without any failures but with good capitalisation and AA ratings intact. Since all the main banks are foreign owned and the largest domestic competitor effectively government owned it is difficult to suggest that this reflects the success of the RBNZ supervisory regime, which is itself ‘light touch’ by international standards.[7,8] Although the Basel requirements were fully enforced, the principal tool for influencing bank behaviour was extensive public disclosure and not the traditional intrusive supervision. What New Zealand does offer however is an open bank resolution framework even for its largest banks, which involves virtually a debt for equity swap with a write down of claims so that there is no need to call on the taxpayer.[9] The evidence thus points to the balance between regulation and governance in the finance company sector being poorly judged.

While there are some special circumstances – for example New Zealand is a small country, so non-bank lenders will themselves tend to be small, which increases the risk of failure when lending to high risk sectors – these do not overturn the overall conclusions. The situation was made even worse by the introduction of a temporary deposit guarantee scheme in September 2008, which if anything increased risk taking and resulted in a large loss for the taxpayer.[10] There are thus two failures of governance. The first is a widespread failure of corporate governance to ensure that companies managed their risks in the interests of stakeholders. The second was a failure in governance of the financial sector by the authorities. The weaknesses in the system were obvious.

This article tackles these issues by beginning with a brief description of the structure of the finance sector in New Zealand, followed by a history of the demise of the finance company sector and an analysis of its causes. The picture is completed by a review of the temporary deposit guarantee scheme and its failings before drawing conclusions for a better balance in future policy between regulation and governance, not just for New Zealand but for other countries as well.

It is often argued, particularly by banks, that, provided there are firm procedures in place to permit orderly exit, the financial sector could be subject to much lighter regulation, perhaps even to the extent of the 'free banking' that applied in the nineteenth century before the end of limited liability.[11,12,13] This article draws on a rare example of where such a regime has been tried in modern times. Its comprehensive failure suggests that a different balance is required and that at the very least governance needs to be tightened and regulation improved.[14] There is an irony here that is repeated in other some other countries, where the riskier activities are less regulated, principally because the implications of adverse outcomes for financial stability are thought to be lower. The experience of the GFC questions that judgement.

The financial sector in New Zealand

As Table 1 shows, even at the peak of the finance company sector, banks formed the bulk of deposit taking in New Zealand. Earlier, building societies had a substantial share of the market but increasingly banks took over mortgage lending for house purchase. In the period before the collapse, the non-bank sector was composed of finance companies, building societies and credit unions and similar institutions. Of these the finance companies were the most important. Not all finance companies took deposits and a small number of larger companies dominated the sector.[15] Deposits with finance companies thus represented around 7-8% of total household deposits at their maximum. Finance companies concentrate on two main areas: finance for consumer durables, particularly motor vehicles and finance for construction projects, although there is also some finance for other small business projects. They provided mezzanine finance for construction and business, taking on higher risk projects or second mortgages. Thus much of their work was higher risk, although with consumer finance there is usually a large number of borrowers, so risk can be priced reasonably accurately. The problem with consumer finance however is that risk is correlated with the economic cycle. So, in a downturn, many households get into difficulty at the same time. One can also expect that banks will try to cream off most of the best business.[16]

The prudential regulation of the finance sector was clearly divided in two until the recent changes. Banks were governed by the Reserve Bank Act of 1989, which had sweeping powers for the prudential regulation of banks. However, it was not until 1996 that clear regulations were introduced. This regime was based on the idea that market discipline would be the most effective form of regulation subject to some minimum standards based on the Basel Committee's recommendations.[17] Banks were required to produce quarterly disclosure documents that set out not just the normal sort of income and expenditure information included in annual reports but greater detail on exposures to markets and counterparties. Moreover banks were required to explain how they managed risks. Unlike some requirements[18] banks needed to reveal peak exposures and not quarter averages or end quarter figures. The directors of the bank also needed to sign these documents as being a correct record and could be held both criminally liable if they were incorrect and civilly liable for losses. The maximum criminal punishment was three years imprisonment.[19,20]

Thus although the New Zealand authorities did not believe that they would be able to remain a step ahead of the banks through the normal intrusive regulation imposed in other countries, they did require publication of much more information to enable credible private sector monitoring and sufficiently strong penalties that bank directors would want to make sure that the disclosures they signed were correct.[21]

As noted in the Introduction, New Zealand banks did remain well capitalised and prudently run under the Act. However, it is difficult to say how much this was due to the regulations and how much to the banks' own choices and how much to the requirements of the supervisors of their parent banks.

Non-bank deposit takers, including finance companies, were however regulated under the Securities Act 1978 (particularly with a set of Securities Regulations issued in 1983). The requirements were simple. A company needed a trustee, chosen from an approved list, and a trust deed to cover its behaviour. Such Trust Deeds are registered with the Companies Office. When it wished to issue a security to raise funds it needed to issue a prospectus that revealed information about its financial condition, risk management practices and the nature of its existing and proposed loan portfolio.[22] Such trust deeds would have limitations on related party lending, loan concentration etc.[23] Since none of these institutions were of systemic importance individually and the sector was small it did not feature in any macroprudential concern or intervention by the Reserve Bank.[24]

The monitoring agency was the Securities Commission. Trustees should draw any breach of trust deeds to the attention of the Securities Commission. However, the Securities Commission itself possessed very limited powers[25] and could not follow up such breaches vigorously or fine the offenders.[26] If a company breached its trust deed or its prospectus was found to be false then the Securities Commission, acting on the advice of the trustee, would require its removal (withdrawal) which would mean that the offenders could then not raise further funding and would either have to comply with the trust deed or retrench and go out of business. Finance companies had annual reporting requirements and annual shareholder meetings like other companies but in practice monitoring proved rather difficult in many cases. Accounts were subject to annual independent audit, although it has been argued that the meaning of the word independent in the case of some such auditors can be a rather stretched concept.[27,28]

Most of these finance companies were owned by small groups of private individuals, who were normally directors of the company.[29] They were funded largely by fixed term retail deposits. Thus these were not demand deposits which could be withdrawn at any time by depositors but they were made normally by households. Typically they were fairly substantial deposits (compared with people's non-housing wealth) so the failure of a finance company would have a major impact on the household's finances. Often these deposits were concentrated on a specific company (to get the best rates) rather than spread round and were effectively a household's retirement fund – the common alternative for such investors being an investment property, either owned directly or through a property company. Some such property companies have also got into difficulty, as the sector is subject to strong cyclical fluctuations, but in some cases also revealing fraud.[30]

Finance companies paid an interest margin over bank deposits in order to obtain funds but not as large a margin as the risks they were running might have warranted. New Zealand retail investors had financial literacy levels similar to those in other OECD countries,[31] so they were not particularly gullible.[32,33] But it is clear that many households do not equate higher interest rates with higher risks. Some of the larger companies recruited well-known media personalities to provide endorsements in TV and other advertisements, endowing such companies with a veneer of respectability.

As a result there was considerable asymmetric information. Not only were the disclosures through prospectuses relatively unrevealing but many of the investors were not capable of understanding them and did not take the time to read them. Investors also suffered from a lack of good investigative financial journalism to help publicise the weak basis of some of the issues. This applied not just to finance companies but also to banks. It had been expected that the greatest market discipline under the disclosure regime would be applied by competitors, who would be eager to point out any weaknesses in order to increase their own market share. In practice this did not happen, although informed investors would have been able to see through to the problems and banks would have drawn conclusions over the viability of counterparties. Finance company directors did not face any stiff fit and proper persons test. Thus some had run companies that had previously failed.[34] Informed investors would of course know this and be able to distinguish quality of management and assess the riskiness of the companies' strategies.

As a result ordinary depositors were severely exposed. They provided finance at what was effectively bargain rates and did not monitor behaviour of the company either before or after purchase.[35] With no deposit insurance, they would not only face the first loss after shareholders but could lose substantial proportions of their lifetime savings. Since shareholders were also directors they had a number of opportunities for extracting value from the company and avoiding severe loss. There were no effective capital adequacy requirements and Bridgecorp, one of the more notorious failures, was effectively operating with negative equity owing to the extent of loans to related parties.[36]

The most obvious consequence is the funding structure of the deposit-taking finance companies, where two-thirds came from household deposits. Whereas one normally expects higher risk lending to come from informed investors. This statistic if nothing else should have alerted the authorities.

The collapse of the finance companies

The story of the collapse of the finance company sector is familiar and predictable. Nominal yields fell rapidly during the early 1990s as inflation targeting monetary policy became very successful. To some extent earnings expectations did not fall in line with the decline in expected inflation, pushing the sector into taking increasing risk. The extent of the increase in risk may not have been realised either by investors or by the companies themselves. At the same time the economy became more stable and there were no serious economic downturns. Asset prices, particularly in property increased rapidly after the collapse of the dotcom boom in the first years of the twenty-first century to levels that were historically high compared to incomes, not just for New Zealand but for all OECD countries. At the same time household indebtedness compared to income was climbing to record levels and saving was small. Thus classic credit and asset price booms were developing as was seen elsewhere in the world with the 'great moderation'.

The economic cycle in New Zealand was somewhat ahead of that in the United States and interest rates, in common with Australia, rose to high levels. New Zealand's annual real GDP growth rate peaked in 2004Q4 at 5.5%, although there was a secondary peak of 3.7% in 2005Q4. US real GDP growth peaked at 3% in 2006Q2 although it was still 2.4% in 2007Q1. Central bank interest rates rose from 5.25% in January 2004 in New Zealand to 7.25% in December 2005, while in the US they had a steady climb from 1.25% in July 2004 to 5.25 % in July 2006.[37] With finance companies heavily exposed to large non-housing speculative property projects, particularly as secondary lenders, they were the first to be exposed to the downturn. Furthermore many of these projects had been financed on a no income basis – so until the project is completed the lender receives no income, yet it has to pay out interest to investors.[38] Delays and failures thus have a rapid impact on the viability of lenders. The problems were not restricted to property lending. Finance companies specialising in consumer finance, such as National Finance 2000 and Provincial Finance, had been expanding their lending and so were taking on increasingly marginal borrowers, particularly in the second-hand car market. When there were defaults they discovered that the resale value of the vehicles did not cover the extent of the loans even though they had only advanced on what appeared to be reasonable proportions of the transaction price. Their failure in mid-2006 was not immediately followed by a string of others (see Table 2).

However, as some companies got into difficulty so depositors would not roll over or increase their lending to the others, so the problem spread and a typical crisis developed. Because the deposits were term deposits there could be no run as such, just a withdrawal when the term became due. By the onset of the main phase of the GFC in September 2008 most of the finance companies had failed or were under a moratorium (Table 2). The failure of Bridgecorp, a property finance company, in mid-2007 started the main stream of failures. While this is around the time that the initial problems appeared in the US and Northern Rock got into difficulty in the UK, there was no major feedback into the New Zealand economy either through trade or financial markets from those problems. Banks were still able to raise finance, it was just the finance companies who found it hard to borrow.

This description, however, leaves out the crucial facet of governance. If the cycle observed, including the crisis, was typical and therefore in most respects predictable, it should not have occurred. Investors would not have been prepared to risk their funds, directors of the finance companies themselves would have been more prudent in their lending and had adequate capital cushions and the authorities would have intervened to ensure a manageable cycle. As discussed earlier, the authorities had decided that this was not an area in which they intended to intervene, although the effects of the demise of the sector were sufficiently large that by September 2008 they had decided that they would change the rules for the prudential regulation of the sector,[39] bringing it under the responsibility of the Reserve Bank and hence introducing a closer regulatory environment. However, this process had not even got as far as draft legislation by the time the GFC broke and emergency measures were introduced.[40] These emergency measures are the subject of the next section. These changes therefore were not intended to save the sector but to regulate its successor better.

At September 2008, although most of the sector had failed, one large company, South Canterbury Finance, was still in operation and hence there was still something to be salvaged. However, the emergency measures were not well managed[41] and by the end of 2011 the sector had effectively disappeared.

The demise of the sector thus followed a predictable course for risky lending focused on cyclically sensitive sectors. Since it was predictable it is therefore difficult to understand why it should have happened, except for the fact that, as already explained, the finance companies were able to obtain finance despite the risks because they were accessing retail depositors, who were not well informed and underestimated the risks. The other parties involved could extract the returns they required before the failure of the companies and, because of limited liability, could not have their gains clawed back unless their actions were shown to be illegal.

As can be imagined, because a lot of people lost money it is hard to find a dispassionate assessment.[42] Even the report from the Parliamentary Inquiry[43] is quite strongly worded, arguing that 'The investors were let down by virtually every aspect of the system'.[44] It lists the causes as:

- Poor governance and management
- Criminal misconduct
- Deficiencies in disclosure, advice, and investors' understanding
- Inadequate supervision.[45]

The then Chairman of the New Zealand Shareholders Association put the collapse down to four factors:[46]

- Greed and stupidity
- Misaligned incentives
- Governance failure
- Regulatory failure (his words).

Part of the problem in his view was slow learning. In the earlier more inflationary times, investors had been used to higher rates of nominal return and expected them to continue, without realizing that this implied higher rates of risk. Second the finance companies themselves had to take on riskier projects in order to meet make a decent margin over the costs of borrowing. However, since this whole process was all forward looking it was possible for it to be mispriced in the property sector and for projects that were highly speculative at any interest rate to receive finance. In effect the finance companies helped finance a boom. In consumer lending also, with the benefit of hindsight they simply underpriced the risk. With no overall prudential supervision of the sector the bubble could emerge with little to restrict it.

The structure of misaligned incentives is also predictable.[47] Depositors get drawn in by brokers and advisors who get their fees up front. Brokers are similarly employed to try to set up the lending contracts, again with fees paid when the contract is completed and not later when the project itself is finished and its success known. Managers have remuneration related to profits and in some cases to growth, thereby helping to stoke the problem initially even if they will lose (income) in the downturn.

The incentives for auditors and rating agencies have been the subject of considerable concern during and indeed before the GFC, in the wake of the Enron collapse, so New Zealand is not unusual in this regard. Auditors receive a fixed fee in a competitive market, while their firms have an opportunity to undertake more lucrative consultancy contracts with the same companies.[48] Rating agencies receive their fees in advance. The particular twist in the New Zealand case is the role of trustees. Trustees are also paid fixed fees and are paid by the company and not by the shareholders or the depositors. Therefore while their actions may be intended to safeguard the interests of the depositors and shareholders the structure of their remuneration does not reflect that.

The prime concern here however is with the governance failure and Sheppard is not alone in emphasising it. The head of the FMA has made it clear that governance lay at the heart of the previous problems:

> '… the finance company failures were largely a failure of corporate governance. That is, that many of the directors of these companies (and others closely involved in their operations) weren't doing their jobs adequately. Sentences such as [the] prison terms given to some … directors do send a message to our corporate community that they have clear responsibilities and a duty to act with diligence and care. But the failures also raise the bigger question of the role of regulation and the pros and cons of "light touch" regulation. … It would be fair to say that there is little faith remaining in the notion of "light touch" regulation and inherently stable markets … .'[49]

Thus although it may have been corporate governance which was at fault, it was the deficiencies in the regulatory framework that let this happen. It was the governance of the financial sector which bears the primary blame and governance within the sector followed from that. However, there are limits to want any regulatory system can achieve. As the Parliamentary Inquiry put it 'crooks will find a way'.[50]

The finance companies were effectively run by their owners. One can question how 'independent' their independent directors were.[51] They received fees, they were normally long term appointments, thereby limiting the incentive to challenge the executive directors. These boards decided on dividend policy so rates of return could be high. Furthermore, it is not clear that related party loans were properly identified.[52]

It is important not to assume that, had a more intrusive regulatory regime been in place, these problems would have been avoided entirely. In the official Material Loss Reviews of bank failures in the US during the GFC submitted to Congress, a large portion reflected traditional sources of failure such as 'weak management, fast growth, reliance on volatile sources of funding, inaccurate accounting that exaggerated earnings and capital, concentrated assets, particularly assets involving commercial real estate and construction, acquisition, and development loans', all of which should have been picked up by the supervisors.[53] Such reviews are only conducted for the few banks that fail with significant loss to the insurer. There are no matching reviews of banks that recovered despite making similar mistakes, nor a list of how many such instances there were. The analysis of the failure of Northern Rock in the UK by the supervisor[54] admits failings and the other spectacular difficulties with both HBOS and RBS in the UK will no doubt have contributed to the decision to remove supervisory responsibility from the FSA (Financial Services Authority) and return it to the Bank of England. Some cases will always slip through the cracks but it is clear that some authorities had systematic problems with their regulatory systems.

The FSA in the UK had a risk-based focus to its supervision, trying to concentrate on the areas where the potential risks were highest in terms of institutions, sectors and products. This seems a sensible approach but it does require correct identification of the risks in the first place. Thus although the New Zealand authorities can be rightly criticised for their handling of the deposit taking finance companies, this does not ipso facto imply which approach would have been better.

The deposit guarantee debate

Operating a dual system where banks are more heavily regulated than non-banks and only the banks are supervised by the Reserve Bank also generates a problem when it comes to responding to a crisis and trying to ensure that the ensuing losses are managed and distributed in a way that minimises the harm to the real economy and is felt fair by the ordinary person (who is of course also an elector). New Zealand treated both sectors equally in the sense that there was no deposit insurance or deposit guarantee scheme before the GFC. Deposit insurance is normally thought to introduce a moral hazard, so, to offset this, insured entities need to be closely supervised to protect the insurer from that risk. A light touch regulatory system and no deposit insurance are thus logically consistent in this sense.

However, when the GFC struck New Zealand felt compelled to introduce deposit guarantees to maintain confidence in the system – if only because those OECD countries with such insurance were all either introducing blanket guarantees or substantially increasing the size of deposits covered.[55] The main immediate stimulus was the introduction of a deposit guarantee scheme by Australia. Because New Zealand had to introduce deposit insurance in a hurry and apparently had no prepared scheme in the drawer ready for just such an emergency[56] it unfortunately compounded the problems of the finance company sector.

There is an irony in any deposit insurance scheme in that it is the smaller, riskier entities that tend to fail. Hence in a contributory scheme it is the main better-managed entities who bear the cost (even if there is some risk-weighting to premia) and in a non-contributory scheme it is the taxpayer. New Zealand's scheme not surprisingly covered all deposits otherwise it would have killed off the uninsured sector. However, by offering insurance to lightly supervised entities, it took on a major exposure to existing depositors. Not only that but it encouraged new deposits, as finance companies offered higher interest rates and yet depositors were going to have complete security, thereby rapidly expanding the moral hazard.[57] If that were not enough, resolution systems were not in place to enable rapid repayment of depositors. As result, when South Canterbury Finance, the largest independent deposit taking finance company, failed the authorities had no choice but to pay out all creditors in full in order to both respect equal treatment in an insolvency and avoid the rapid build up of interest costs, thus incurring a non-trivial cost for the taxpayer.[58] Thus the crisis was made somewhat worse by the intervention.[59] While these circumstances are unusual this provides clear pointers for other countries with lightly regulated sectors if it turns out that in a crisis failures are regarded as a threat to financial and economic stability.

The problem developed rapidly. Following the collapse of Lehman Brothers, when wholesale financial markets froze, the Australian banks were substantially affected as a major proportion of their financing came from overseas and some of this needed to be rolled over. Thus, while the banks themselves had little exposure to derivative or sub-prime related losses in the US, they did face a funding problem.[60] The Australian authorities responded on 12 October 2008 by issuing two guarantees: a temporary wholesale funding guarantee, from AUD1mn upwards, for which issuers had to pay, and a deposit guarantee for which they did not.[61] The wholesale guarantee made sense for a country which believed it had strong banks. There was a clear short-term market failure, where the creditworthy could not borrow, whose existence would have threatened the financial stability of the system unnecessarily. The chances of serious exposure were small. The deposit guarantee is more difficult to understand. There was no sign of any depositor uncertainty or fear of a run on the banks.

New Zealand implemented a very similar arrangement, also on 12 October 2008, with the same $1mn limit, but this time in New Zealand dollars. The NZD was worth about 20 per cent less than the AUD, although this also reflects the difference in measured income per head. The New Zealand deposit guarantee was also slightly different in character. It was for two years and eligible institutions could opt in. Furthermore, the four largest institutions had to pay for the guarantee, while it was free for the others, given the threshold of NZD5bn in assets. After the initial launch a number of changes were introduced, including a ceiling to the guarantee, only institutions with investment grade ratings were eligible without a fee.[62] (New Zealand did not introduce a wholesale guarantee scheme until 1 November 2008. This was also an opt-in, ratings-based fee system.)

The differences between the two countries' responses, while small, were significant. Australia's wholesale guarantee scheme was among the least costly of the OECD countries[63] and its deposit guarantee was free.[64] New Zealand's wholesale guarantee was towards the upper end of the charges, while the deposit guarantee scheme had a reverse risk weighting, making the highly rated banks (and the taxpayer) bear the risks. (The scheme was changed and risk weighted premia introduced in two stages on 15 and 22 October 2008.)

The guarantees achieved their immediate aim. Deposits increased rapidly and longer term wholesale funding was resumed as soon as the guarantee came into effect, as a result short term wholesale funding declined as a share of the total. The deposit guarantee thus had some rather adverse results and provides an example of moral hazard at work. Because it was only accompanied by an increase in supervision after the event, those institutions most at risk took the opportunity to increase deposits and in some cases to increase risky lending, thus increasing the exposure of the taxpayer to risk and allowing some private sector lenders to exit.

It was not banks that were really at risk, it was non-bank deposit takers. Although legislation had been introduced in 2007, after reviews of the position, amendments to the Reserve Bank Act, giving the Bank limited prudential responsibility for the sector, were not passed until 3 September 2008 and would only come into force progressively from September 2009.[65]

By the time the Act came into force most of the sector had disappeared with the firms being closed, in liquidation, receivership or at least moratorium (see Table 3). The principal concern of the guarantee scheme was therefore with the few remaining companies. The companies were all vetted against a set of criteria for eligibility set out on 22 October 2008 comprising:

- 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.

Under these circumstances a depositor could not be sure whether the more marginal institutions would be covered. Since there was no prior prudential supervision, it took some time to decide which firms would be admitted and the first company (Mascot Finance) failed on 2 March 2009, before the process was completed. Hence, if the intention of introducing the guarantee had been to reassure depositors in the institutions most at risk, it would have failed. For this reason authorities normally introduce blanket guarantees for groups of creditors without considering the credit risk. Mascot, however, had passed the eligibility test and was covered as from 12

January 2009.[66] Eventually 73 institutions were covered by the scheme, 12 of them banks – not surprisingly no information was revealed on who had applied.

There proved to be more problems with the scheme when it came to paying out, not least because interest still had to be paid to depositors after default until the principal was repaid. The scheme was therefore revised as from 1 January 2010.

The main problem for the scheme was the failure of South Canterbury Finance (SCF) in August 2010 (Table 3). On failure SCF had approximately NZD1.6bn in assets and later estimates of the loss suggested it might be as high as NZD1.2bn.[67] On entry into the scheme SCF was rated BBB- and was generally thought sound. It appears that on entry the company was able to raise considerable new finance from depositors and was able to increase its loan portfolio by a third, at a time when the economy was in trouble. Thus, far from using the guarantee to reduce its risks and improve the solidity of its position, SCF expanded its risk base, by booking loans outside its main geographical coverage, for example. In the early stages of the guarantee there was no supervision of the guaranteed entities and no detailed assessment of where the risks might lie. These deficiencies were corrected eventually, but by then moral hazard had taken its toll and the damage was irreparable.

SCF also presented an additional problem. The guarantee scheme was under an obligation to pay interest on outstanding deposits after failure. If payouts to depositors were to be made rapidly the authorities, after putting in a statutory manager, would need to treat creditors according to their priority. Paying out depositors would therefore be likely to be drawn out, as more senior and other junior creditors would have to be dealt with as well. The government therefore decided to take on SCF as a whole and payout all creditors in full, so it could then manage the remaining assets in a manner that would maximise their value, without having to pay anything more than a few days interest to depositors. It is not clear whether this minimised the loss to taxpayers, but it did enable a swift payout. Clearly, as a result of this one failure alone, without adding in the other eight, one of which, Mascot, was mentioned above, taxpayers are going to incur a net loss. Without the guarantee, no doubt these finance companies would have failed earlier and some that survived might also have failed in the end. In retrospect it is not clear whether the guarantee increased or diminished the loss. None of those thought likely to fail by the authorities were either singly or jointly of systemic importance.

The scheme also faced the usual exit problem. Any institution that is in trouble and actually needs the guarantees will fail just before the scheme ends, as those depositors who can withdraw their funds will do so. Hence exit requires that some credible scheme be put in place for the longer term survival of the remaining institutions or alternatively they should be closed. The scheme was duly extended from 12 October 2010, when the original two years were complete, until the end of 2011. By the end of 2011 only 3 institutions were left: Fisher & Paykel Finance, Wairarapa Building Society and Heartland Building Society, the last of which is an amalgamation that later became a bank and hence regained credibility with depositors and potential bondholders.

In the extended scheme most of the awkward features of the initial one were removed, coverage limits were reduced to NZD250,000 for non-banks, a rating of BB or above was required for acceptance and interest was not payable after failure. Most importantly controls are now placed on the activities that the subject institutions could perform so that they do not use the guarantee to advantage related parties and thereby shift the risk onto taxpayers. However, it did not include an overall objective for the management of the system, such as loss minimisation.

Clearly the taxpayer was exposed to loss from the failure to have prudential supervision of the whole deposit taking sector. Introducing guarantees without clear prior knowledge of the possible exposures is a risky choice.

The wholesale guarantee scheme, on the other hand, turned out well. The NZ scheme, which was closed to new issues on 30 April 2010, not only enabled new issues, but earned substantial fee income for the government as no payouts were needed.

Lessons for the balance of regulation and governance

There are 9 main lessons identified in this paper:

- light touch regulation may help in stimulating growth but it can also increase fragility
- it is easy for the principles of good governance to be neglected or even perverted if there are no strong incentives or means for shareholders and depositors to ensure firms take their interests into account
- the role of auditors, rating agencies and trustees tends to be weak in maintaining good governance
- effective self-regulation depends very much on the ethics of the environment in which firms operate
- depositors suffer from asymmetric information and most tend to have relatively low levels of financial literacy – deposit insurance for them therefore seems politically inevitable – hence insurers will want to manage their risk
- having a lightly regulated sector can generate significant moral hazard if people believe there are implicit guarantees available – the GFC has reinforced that belief
- much more of financial activity is important to financial stability than realised before the GFC
- most of the sources of failure of lightly and poorly regulated finance companies and poorly regulated banks were well-known from previous experience - weak management, fast growth, reliance on volatile sources of funding, inaccurate accounting that exaggerated earnings and capital, concentrated assets, particularly assets involving commercial real estate and construction, acquisition, and development loans – and hence were predictable and should have been guarded against
- there were clear problems with the remuneration of those owning some of the finance companies – not only was it not properly controlled where the owners were the directors but nature of performance and other contracts then prevailing enabled those taking the risks to get their reward early in the process and, unlike the depositors, not be dependent on longer term performance.[68]

One the surprising features of the literature is the paucity of work on the corporate governance issues facing the banking sector in the years before the GFC.[69]

A simple and concise assessment of the plusses and minuses of light touch regulation with which it is difficult to disagree suggests:

> 'New Zealand has a venerable tradition of using trust and transparency to regulate its financial markets. The benefits of such an approach include the empowerment and individual accountability of institutions who then can act on shared beliefs to obtain optimal benefits for the society at large. The social contract that underlies the principal of trust and ethical behaviour can and has added value beyond expectations. It can also reduce compliance costs. But, a regulatory system based on trust, ethical behaviour and transparency will have few oversight mechanisms in place to regulate behaviour. If trust and transparency principles are violated, sub-optimal outcomes can and will occur. This was the case in the New Zealand finance company industry.'[70]

If the circumstances exist in society for a light touch regime to be vigorously self-policing then it has very clear advantages over an intrusive regime and the sorts of burdens that appear to be being introduced by such as the Dodd-Frank Act in the US, where the compliance costs could be major. Such self-restraint clearly existed in the Scottish free banking era but it was backed up by clear financial responsibility. Those who did not manage the risks well were bankrupted and were not able to walk away from the problems wealthy unlike in the GFC.[71]

One of the responses to the GFC, as exemplified in both the UK and the US, has been to recognise that the low levels of financial literacy mean that ordinary depositors do not recognise risks nor do they plan sufficiently well in many cases to avoid concentration of risks.[72] Deposit takers emphasise this trend by increasing the interest rates they offer with the size of a deposit. No doubt increasing financial education will help people recognise risks better but it is unlikely to offer sufficient protection for many. In many respects the high rates of deposit insurance that are being offered round the OECD countries (excluding New Zealand) are a reflection not just that ordinary depositors will not be able to exit from failing institutions in time but that society regards the losses they would otherwise incur as unacceptable. In return for this support authorities naturally expect to exercise a degree of control over how such deposit takers are managing their risk. It no longer seems possible to draw a dividing line between those that are controlled and insured and those that are not, in most countries.

However, the reaction of countries including New Zealand in the GFC may be a large part of the explanation for this. Before the GFC most countries were prepared to see depositors make losses above a minimum that covered the deposits of the typical depositor completely. Those exposed would be the richer depositors who perhaps could be expected to have the time to realise and monitor the risks they were facing and hence their losses would be politically acceptable. In the GFC this rapidly became untrue and all or almost all losses were met. While this is understandable in a time of crisis it has two downsides. The first is that those without explicit insurance will be prepared to gamble that they have implicit insurance in the event of major problems and hence will take even less care in managing their risks. The second is that there has been no move to unwind the special increases in coverage and move back to normal times. This is surprising and represents a clear move away from market discipline.

The normal aspect of market discipline that weakens governance mechanisms in banks is the difficulty of exit for any but the smallest banks.[73] The GFC reinforced this experience with many bailouts including in the US for large institutions. The finance company experience in New Zealand at least confirmed that exit there was not impeded, even by the introduction of deposit guarantees. Ironically, taking some earlier steps to halt contagion might have stopped failure spreading round the whole sector. New Zealand has however responded by taking the steps necessary to make resolution of all banks, irrespective of size, possible either individually or should the sector as a whole be challenged, as was the case for some countries in the GFC. Their 'Outsourcing'[74] and Open Bank Resolution[75] policies set up a framework where all banks have to be not merely locally incorporated and capitalised but have to capable of operating on their own by the end of the 'value day' (the equivalent of the proverbial weekend used to resolve banks in other countries) should their parent or a major supplier collapse. In this case it would be the statutory manager who would take over the back and resolve it in this short period. The form of resolution expected, if outright closure was thought too costly, is a write down of creditors' claims, in order of priority, to the point that the bank is solvent again on a conservative valuation.[76] Shareholders would be written down to zero. All parties would be subject to appropriate compensation if the write downs proved to be too large.

In May 2011 the Financial Markets Authority came into operation in New Zealand, replacing the Securities Commission. It has both stronger powers and a wider range of responsibilities, in many ways similar to its counterpart ASIC in Australia. It has been active in investigating the finance company failures and in bringing cases of suspected fraud to court. The RBNZ has also taken on prudential responsibility for the non-bank deposit takers but these will still be the primary responsibility of the trustees with the RBNZ in more of a monitoring role and not as the supervisor. It remains to be seen whether new firms will emerge in this sector and whether those firms will avoid the mistakes of their predecessors. It is more likely that these riskier areas of finance will be picked up by bank subsidiaries and that range of depository institutions will remain smaller. This should reduce the threat to financial stability but it was a similar concentration on the banks following the crisis of the late 1980s, which resulted in the growth of the non-bank deposit takers in the first place.[77]

Table 1

Financial system liabilities

As at 31 December $bn	1990	1995	2000	2007	2008	2009	2010	2011*
Banks								
Households	24	32	41	79	90	93	98	100
Other residents	29	35	54	98	113	102	101	106
Non-residents	11	22	56	111	128	132	128	121
Other liabilities and equity	14	14	29	41	69	51	52	58
Total	78	103	180	329	400	377	380	384
Other non-bank lending institutions								
Households	2	3	5	12	9	9	7	7
Other residents	3	2	4	8	7	6	7	6
Other liabilities and equity	1	1	1	12	10	9	7	6
Total	6	6	10	31	27	24	21	20
Funds under management								
Household assets	26	42	56	64	54	61	64	66
Other sector assets	1	1	5	8	8	8	8	8
Total	27	43	61	72	62	68	72	74
Total financial system liabilities	111	152	251	433	489	469	472	478

Source: Reserve Bank of New Zealand Financial Stability Review November 2011.

Table 2: Summary of Troubled NZ Financial Institutions before September 2008

	Institution	Date failed	Status at October 2008)	Deposits at risk (NZDmn)
1	National Finance 2000 Limited	May 2006	receivership	25.5
2	Provincial Finance Limited	Jun 2006	receivership	296.0
3	Western Bay Finance Limited	Jul 2006	receivership	48.0
4	First Step Trusts	Nov 2006	closed	457.0
5	Bridgecorp Limited	Jul 2007	receivership	458.7
6	Bridgecorp Investments Limited	Jul 2007	liquidation	29.0
7	Nathans Finance NZ Limited	Aug 2007	receivership	174.0
8	Chancery Finance Limited	Aug 2007	liquidation	17.5
9	Property Finance Securities	Aug 2007	moratorium	80.0
10	Five Star Consumer Finance Limited	Aug 2007	receivership	54.0
11	Antares Finance Holdings Limited	Aug 2007	liquidation	3.2
12	Five Star Finance Limited	Jun 2008	liquidation	43.0
13	LDC Finance Limited	Sep 2007	receivership	22.0
14	Finance & Investments	Sep 2007	receivership	16.0
15	Clegg & Co	Oct 2007	receivership	15.1
16	Beneficial Finance Limited	Oct 2007	moratorium	12.7
17	Geneva Finance NZ Limited	Oct 2007	moratorium	51.0
18	Capital + Merchant Finance Limited	Nov 2007	liquidation	167.0
19	C&M Investments Limited	Nov 2007	receivership	1.5
20	Numeria Finance Limited	Dec 2007	receivership	6.7
21	OPI Pacific Finance Limited	Mar 2008	liquidation	335.0
22	Boston Finance Limited	Mar 2008	receivership	24.0

	Institution	Date failed	Status at October 2008)	Deposits at risk (NZDmn)
23	ING funds x2	Mar 2008	suspended	520.0
24	QED. Limited	Mar 2008	liquidation	4.5
25	Lombard Finance & Investments Limited	Apr 2008	receivership	111.0
26	Kiwi Finance Limited	Apr 2008	receivership	1.7
27	Tower Mtg+ Fund	Apr 2008	closed	242.0
28	Cymbis / Fairview	May 2008	receivership	6.9
29	Belgrave Finance	May 2008	receivership	20.5
30	IMP Diversified	Jun 2008	moratorium	15.8
31	Dominion Finance	Jun 2008	liquidation	232.0
32	North South Finance	Jun 2008	receivership	100.0
33	St Laurence	Jun 2008	receivership	253.0
34	Dorchester	Jun 2008	moratorium	176.0
35	Canterbury Mtg Trust	Jul 2008	closed	250.0
36	Hanover Finance	Jul 2008	moratorium	465.0
37	Hanover Capital	Jul 2008	moratorium	24.0
38	United Finance	Jul 2008	moratorium	65.0
39	Guardian Mtg Fund	Jul 2008	closed	249.0
40	Totara Mtg Fund	Jul 2008	closed	60.0
41	AMP NZ Property Fund	Aug 2008	suspended	419.0
42	AXA Mtg bonds	Aug 2008	closed	117.0
43	Strategic Finance	Aug 2008	liquidation	391.0
44	St Kilda	Aug 2008	receivership	6.9
45	Compass Capital	Aug 2008	receivership	15.0
46	Waipawa Fin	Aug 2008	liquidation	20.0
			Total	**6,102.2**

Source: (Office of the Auditor General, 2011)

Table 3 Finance Company Failures in New Zealand Following the Deposit Guarantee

Company	date of failure	payout $mn	depositors
Mascot Finance Limited	2 March 2009	70.0	2,494
Strata Finance Limited	23 April 2009	0.5	17
Vision Securities Limited	1 April 2010	30.0	967
Rockforte Finance Limited	10 May 2010	4.0	66
Viaduct Capital Limited	14 May 2010	7.6	88
Mutual Finance Limited	14 July 2010	9.2	329
Allied Nationwide Finance Limited	20 August 2010	131.0	4,094
South Canterbury Finance Limited	31 August 2010	1,580.3	30,404
Equitable Mortgages Limited	26 November 2010	140.2	3,852
TOTAL		**1,972.8**	**42,311**

References and Notes

[1] Dalla Pellegrina, L. and Masciandaro, D. (2011). Good Bye Light Touch? Macroeconomic Resilience, Banking Regulation and Institutions, Paolo Baffi Centre Research Paper 2011-109, Bocconi University

[2] Part 4 of the Reserve Bank of New Zealand 1989 Act prohibits entities from using the words 'bank', 'banker' or 'banking' and their derivatives in their name or title. (RBNZ, 2011).

[3] Reserve Bank of New Zealand (2011) *Bank Registration and Supervision,* BS1, Wellington: RBNZ available at http://www.rbnz.govt.nz/finstab/banking/regulation/3272066.pdf.

[4] Wilson, W., Rose, L. and Pinfold, J (2012). Best Practice Corporate Governance? The Failure of Bridgecorp, ch.4 in D G Mayes and G E Wood, *Improving the Governance of the Financial Sector*, Abingdon: Routledge.

[5] Southland Building Society became a bank in 2008, the Cooperative Bank was formed in 2011 from the major cooperative financial company and Heartland Bank in 2012 from a group of financial entities. There is no relationship between the Cooperative Bank and the bank with the same name in the UK which has had problems, although of course they have the same intellectual origins.

[6] This includes the directors of Bridgecorp, which is the subject of an extensive study by Wilson et al. op.cit.

[7] One might wish to attribute much of the strength of the four main (Australian owned) banks to the supervisory regime imposed on their parents by APRA (the Australian Prudential Regulation Authority).

[8] Mortlock, G. (2012) Comments in ch.6 in D G Mayes and G E Wood, *Improving the Governance of the Financial Sector*, Abingdon: Routledge.

[9] Hoskin, K and Woolford, I (2011). A Primer on Open Bank Resolution, *Reserve Bank of New Zealand Bulletin*, vol.74(3), pp.5-10, offers a helpful description.

[10] Office of the Auditor General (2011) *The Treasury: Implementing and Managing the Crown Retail Deposit Guarantee Scheme*, available at http://www.oag.govt.nz/2011/treasury (last accessed 14 August 2014).

[11] Wood, G.E. (2012). Efficiency, stability and integrity in the financial sector: the role of governance and regulation, ch.7 in D G Mayes and G E Wood, *Improving the Governance of the Financial Sector*, Abingdon: Routledge.

[12] Dowd, K (1992). *The Experience of Free Banking*, London: Routledge.

[13] There is an excellent debate on the issue in the May 1996 issue of *The Economic Journal*, with papers by Dowd, Dow and Benston and Kaufman.

[14] There is one crucial difference between the finance company sector in New Zealand in the run up to the GFC and the 'free banking' era in the nineteenth century and that is limited liability. The owners of the finance companies were able to extract large payments before failure and then lose all value in their shares, while under unlimited liability the owners had to pay out all creditors in full – a process which bankrupted most of them in the case of the City of Glasgow Bank, which was the last example. The incentive for prudence is thus much greater in the second case.

[15] The non-bank lending sector was 9.2% of total lending in 2006, of which 80% was accounted for by finance companies, divided roughly equally between those that took deposits from the public and those that did not

[16] One interesting example is the largest finance company, UDC Finance, which has been a subsidiary of ANZ, one New Zealand's four large banks, since 1980. It has remained strong throughout the period and currently has an AA- rating from S&P. It specialises in business finance and motor vehicle finance. It illustrates that a well-managed company can handle such risks. But having a major financial institution to fall back on, even if ANZ does not nominally guarantee its debts, is no doubt a help in obtaining funding.

[17] It was originally thought that it would not be necessary to insist on the Basel standards as markets would penalise banks which did not adhere to considerably harsher standards. However, it was then realised that international credibility and reputation might suffer for the banking sector as a whole if this was not required.

[18] Pillar 3 in the Basel II/III recommendations, for example.

[19] The level of detail required is considerable as can be seen the regulation covering disclosure which itself has some 83 pages.[17]

[20] Reserve Bank of New Zealand (2012) Registered Bank Disclosure Statements (New Zealand Incorporated Registered Banks) Order 2012, available at http://www.rbnz.govt.nz/finstab/banking/regulation/4350353.pdf (last accessed 4 April 2013).

[21] Although Pillar 3 of Basel II introduced an element of disclosure to encourage market discipline, less information was required, the information was rather less relevant, less frequent and less audited.
[22] Schedule 2 of the Securities Regulations 1983 covers the prospectus and Schedule 3d the investment statement required. Prospectuses have to be registered with the Companies Office on an annual basis.
[23] See Wilson et al., op.cit. and the original legislation.
[24] Had some of the many more sophisticated models of macroprudential risks that have emerged in the last few years since the onset of the GFC been in place then, it is possible that the RBNZ might have taken a different view of a sector that amounted to approaching 10% of the market.
[25] Diplock, J. (2012). Time for a Paradigm Shift in Thinking, ch 11 in D G Mayes and G E Wood, *Improving the Governance of the Financial Sector*, Abingdon: Routledge.
[26] Wilson et al. op.cit. gives a number of examples of the weakness of the powers of the Securities Commission. While the Commission could suspend a prospectus for 14 days it was not empowered to inform investors of the suspension, it could only inform of withdrawals.
[27] Sheppard, B. (2012). Fundamental Problems with the Governance of the Financial Sector, ch.2 in D G Mayes and G E Wood, *Improving the Governance of the Financial Sector*, Abingdon: Routledge.
[28] Littrell, C. (2012). Cultural Considerations for Prudential Supervisors, ch.12 in D G Mayes and G E Wood, *Improving the Governance of the Financial Sector*, Abingdon: Routledge.
[29] UDC Finance being the main exception.
[30] Blue Chip Investments is perhaps the best known case. http://www.nzherald.co.nz/the-tangled-web-of-blue-chip/news/headlines.cfm?c_id=1501803 provides links to many aspects of the story.
[31] Lusardi, A. (2011). Financial Literacy Around the World: an Overview, NBER Working Paper no. 17107, June.
[32] New Zealand comes out top in a World Bank comparison of 14 countries.
[33] Xu, L. And Zia, B. (2012) Financial Literacy Around the World: An Overview of the Evidence with Practical Suggestions for the Way Forward, World Bank Policy Research Working Paper 6107, June.
[34] Wilson et al. op. cit; Sheppard op. cit.
[35] This failure to monitor under the disclosure regime applied also to banks. See McIntyre, ML., Tripe, DW., & Zhuang, X. (2009). Testing for effective market supervision of New Zealand banks. *Journal of Financial Stability*. 5(1), 25-34 for an assessment.
[36] Wilson et al. op. cit.
[37] There was a small spurt in interest rates in New Zealand immediately before the GFC with a rise of a further 1% in mid-2007.
[38] The interest that the borrower owes on the loan is simply accumulated and has to be repaid, along with the loan, when the project in completed and the developer is paid.
[39] Wilson et al. op. cit.
[40] The current framework for regulating non-bank deposit takers is explained in Barker, F. and Javier, N. (2010) 'Regulating non-bank deposit takers', *Reserve Bank of New Zealand Bulletin*, 73(4), 5-18.
[41] Office of the Auditor General op. cit.
[42] Tripe, D. (2014) 'Regulation in New Zealand banking and financial services', pp.39-49, in *Flawed Theory – Failed Practice: Light-handed regulation in New Zealand*, Wellington: New Zealand Fabian Society, provides the following analysis (pp.43-4):

> 'In a significant number of cases we thus found people associated with the property investments and development businesses getting involved in owning and managing finance companies, with funds being lent to associates (although not necessarily defined as such) and a number of other practices which might be perceived as "looting" (in the sense of Akerlof and Romer, 1993). In many cases there was nothing illegal about the transactions that were entered into: it is arguable that the regulatory structures applying around such activities did not provide sufficient constraints to prevent the owners and managers of finance companies applying the funds invested with them towards their own enrichment.
>
> The ineffectiveness of the regulatory environment for non-bank deposit takers, finance companies in particular, was highlighted by the wave of failures that began in 2006. For some of the earlier failures problems appeared to be in weaknesses in management and losses to depositors were not particularly severe, but as the plague of failures persisted it became evident that there were significant gaos in the regulatory architecture which appeared to have exacerbated losses for investors. In a small number of cases directors of failed finance companies have faced prosecutions for fraud or breaches of the Securities Act but there has been a general acknowledge that regulatory weakness was a major contributor to losses.'

(Akerlof, G. and Romer, P. (1993) 'Looting: the economic underworld of bankruptcy for profit', *Brookings Papers on Economic Activity*, 1991(2), 1-60. George Akerlof won the 2001 Nobel Memorial Prize in Economic Sciences.)

[43] *Inquiry into Finance Company Failures*, Report of the Commerce Committee, presented to the House of Representatives, October 2011.

[44] Commerce Committee op.cit., p.16.

[45] Commerce Committee op.cit., pp.10-11.

[46] Sheppard op.cit.

[47] Sheppard op.cit.

[48] Auditors are now subject to supervision by the Financial Markets Authority following the passing of the Auditor Regulation Act 2011.

[49] Hughes, S. (2012) 'Finance firm debacle shows light touch failed', *The New Zealand Herald*, January 2, B14.

[50] Commerce Committee op.cit., p.17.

[51] Sheppard op. cit.

[52] See Wilson et al. op.cit. for the case of Bridgecorp.

[53] Garcia, G.G.H. (2012). 'Missing the Red Flags', ch.10 in D G Mayes and G E Wood, *Improving the Governance of the Financial Sector*, Abingdon: Routledge.

[54] FSA (2008) The Supervision of Northern Rock: a Lessons Learned Review, Financial Services Authority Internal Audit Division, available at http://www.fsa.gov.uk/pubs/other/nr_report.pdf

[55] Schich, S. (2008), *Financial Crisis: Deposit Insurance and Related Financial Safety Net Aspects*, Financial Market Trends, OECD, available at: http://www.oecd.org/dataoecd/36/48/41894959.pdf (last accessed 14 August 2014) sets out the changes that occurred in the second half of 2008.

[56] Bollard, A (with Gaitanos, S) (2010) *Crisis: One Central Bank Governor and the Global Financial Collapse*, Auckland: Auckland University Press. (See pp.60-66.)

[57] Stopping a run only requires the insurance of existing deposits.

[58] This whole episode has been subject to a critical review by the Auditor-General op. cit.

[59] It would have been cheaper had the Crown merely closed down all the finance companies at risk and paid out all depositors in full at the time it offered insurance, and then succeeded to their claims in the ensuing insolvencies.

[60] A review of the experience of Australia and New Zealand in the GFC is available in Brown, C., Davis, K., Lewis, M. and Mayes, D.G., 'The Global Financial Crisis and Financial Regulation in The Antipodes, pp. 267-327 in R. Litan (ed.) *World In Crisis: Insights from Six Shadow Financial Regulatory Committees From Around the World*, Wharton Financial Institutions Center, University of Pennsylvania, available at http://finance.wharton.upenn.edu/FIC/FICPress/crisis.pdf (last accessed 14 August 2014).

[61] The deposit guarantee was rapidly amended on 28 October, both to include deposits in branches of foreign banks and to cap the non-contributory scheme at AUD1mn. Above that banks could apply for coverage at a risk-weighted fee. While the initial terms of the retail guarantee were temporary it was clear that a permanent scheme would be established at the end of the crisis period in 2011.

[62] On 15 October it was announced that unrated institutions and those with a rating below BB had to pay a premium on any increase in deposits. Australia also introduced a premium if deposits grew by more than 10 per cent. This was also introduced in New Zealand, with a ratings-based tariff.

[63] Schwartz, C. (2010) 'The Australian Government Guarantee Scheme', *Reserve Bank of Australia Bulletin*, March, pp.19-26.

[64] The Australian scheme was changed on 24 October, capping the free deposit guarantee at AUD1mn and providing guarantees for larger deposits according risk-weighted fees. These changes came into force on 28 November.

[65] While there is still considerable responsibility on the trustee rather than the Reserve Bank for supervision, the overall responsibility for conduct of business has now been taken over by the Financial Markets Authority, which came into being on 1st May 2011. Thus between them the sector is now covered in a much more straightforward manner even though the framework is still 'light-handed' by international standards.

[66] Having an institution fail so soon after admission not surprisingly resulted in an outcry and was a major reason for the Auditor General being required to conduct a review of the deposit guarantee scheme, Office of the Auditor General, op.cit..

[67] As of August 2014 the saga has not yet come to an end, the statutory manager is still trying to recover some funds and the three main directors involved are in the last stages of their trial for fraud.

[68] Of course when a company fails that source of income disappears for the owners and where directors have been successfully prosecuted for fraud it has been possible to claw back at least some of the lost funds. Even where there is no fraud the reputation of the directors is likely to be impacted and with the introduction of fit and proper persons tests they may be prevented from repeating their poor management of others' funds.

[69] Davis, K. (2012) 'Bank Governance: What Do We Know, What Should We Do?' ch 5 in D G Mayes and G E Wood, *Improving the Governance of the Financial Sector*, Abingdon: Routledge.

[70] Wilson et al. op.cit.

[71] Batchelor, R. A. (1985). 'The Avoidance of Catastrophe: Two Nineteenth-century Banking Crises', in F. Capie and G. E. Wood, eds., *Financial Crises and the World Banking System*, pp.160-180, New York: St. Martin's Press

[72] The Parliamentary Inquiry into the Finance Company Failures (Commerce Committee, op.cit., p.22) concludes that improving investors' understanding 'is probably the most important area where work is still needed'.

[73] Wood op. cit.

[74] Reserve Bank of New Zealand (2006) *Outsourcing Policy*, BS11, Wellington: RBNZ, available at http://www.rbnz.govt.nz/finstab/banking/regulation/bs11.pdf (last accessed 4 April 2013).

[75] Hoskin and Woolford op. cit.

[76] Hoskin and Woolford op. cit.

[77] Tripe, op.cit.