TE TAI ŌHANGA
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Media statement

A Guaranteed Reality Check

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Gabriel Makhlouf, Acting Secretary to The Treasury

In the wake of the South Canterbury Finance receivership, Treasury Deputy Chief Executive Gabriel Makhlouf provided the following article to newspapers around New Zealand.

After the collapse of South Canterbury Finance (SCF) there have been questions asked, conclusions drawn and advice offered - mostly with the benefit of perfect hindsight.

Hindsight often makes people believe that past events were more obvious or predictable than they were in reality.

The need for a deposit guarantee

Let's remember what really happened. In late 2008, the world's financial systems were in crisis. People talked of putting their money under a mattress rather than trust it to a bank, credit union, building society or finance company. But money has to be available and has to move around. When money froze, thousands of businesses faced the frightening prospect that they could no longer access finance. Essential day-to-day activities that rely on the financial system started grinding to a halt.

The Government reacted to that by putting in place the deposit guarantee scheme (DGS) in October 2008, as an emergency measure to ensure confidence in our financial system. The DGS needed to cover a large part of the financial system in order to provide the necessary confidence, so finance companies were included.

Without a sufficiently broad DGS, it is likely that New Zealand would have suffered more costly damage than the amounts that taxpayers have paid out under the scheme. Countries that didn't move fast enough to restore trust and confidence went deeper into recession than New Zealand and experienced more business failures, job losses and wealth destruction than happened here.

Wider perspective on events

SCF met all the eligibility criteria for a Crown guarantee and was admitted to the DGS in mid-November 2008, along with 23 other financial institutions that had already signed up by then. New Zealand's banking and finance sector was sound at that time but people didn't trust it. Another 40 financial institutions had signed up by the end of that year.

SCF's collapse is a failure in one company in part of a much larger and otherwise sound financial system. Our banking and financial system contains about $330 billion of deposits and the Crown has guaranteed deposits of $133 billion in 72 participating institutions.

An inevitable consequence of having a guarantee is that you may have to make good on it. We always thought it was likely that we would have to pay and the Crown set money set aside to do so. That amount was published and updated regularly in the Crown's financial statements and regularly reported by news media. In total, taxpayers are on the hook for about $1.9 billion to honour guarantees, but we estimate that the Crown will get back about $1.1 billion from receiverships.

What is the Crown guarantee?

To be effective, a guarantee needs to be reliable and solid. The DGS is based on real commitments and conditions, with perhaps the most important being that once the guarantee was made, it couldn't be revoked for existing depositors. Even if SCF had been withdrawn from the DGS, guarantees made to thousands of existing SCF depositors would have continued until the DGS expired.

The DGS was never designed to stop finance companies from collapsing. It is a guarantee to repay depositors when a collapse happens. If we could prevent collapses we wouldn't need the DGS! Collapses are a usual part of the cycle of renewal in a dynamic economy. The underlying cause of SCF's collapse was that it had too many loans that its customers couldn't repay. SCF's business was broken and that isn't the fault of depositors or the guarantee.

Character in adversity

Some people have said that alarms were ringing at SCF for a long time and so the Treasury should have headed for the exits. But the useable exits were blocked because the guarantee couldn't be revoked for existing depositors. If the guarantee was a flimsy promise we could dodge away from, then it wouldn't provide the necessary trust and confidence.

Notwithstanding SCF's collapse, confidence and trust are growing. The current scheme expires on 12 October 2010 and a much smaller extended DGS will start in its place. The extended DGS will end in December next year. However, SCF depositors didn't end up being covered by the extended DGS and SCF's participation in the extended DGS is now a footnote in history.

Given the alternatives New Zealand faced and the need to balance competing needs, the DGS worked well for taxpayers, the economy and depositors with SCF and other finance companies.

Please also read: South Canterbury Finance - Repayment Information for Depositors

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