21 February 2021

David Hargreaves
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Reserve Bank of New Zealand
Wellington 6140

By email: dta@rbnz.govt.nz

Dear David,

SUBMISSION ON THE DEPOSIT TAKERS BILL: NO DEPOSIT INSURANCE FOR FINANCE COMPANIES

About the Submitter

1. This submission has been prepared for the *New Zealand Taxpayers' Union* by Research Fellow Jim Rose. Jim is an economist with three decades experience in the public sector in New Zealand and Australia. He has worked at the Ministry of Business, Innovation and Employment, the Department of Labour, the Ministry of Social Development, and the New Zealand Treasury, and in Canberra for the Productivity Commission, the Department of Prime Minister and Cabinet, and the Department of Finance. Jim has Masters degrees in economics and in public policy from the Australian National University and from the National Graduate Institute for Policy Studies in Tokyo respectively.
2. Founded by David Farrar and Jordan Williams in 2013, the *Taxpayers' Union's* mission is Lower Taxes, Less Waste, More Transparency.
3. We enjoy the support of some 170,000 registered members and supporters, making us the most popular campaign group championing fiscal conservatism and transparency. We are funded by our thousands of donors and approximately five percent of our income is from membership dues and donations from private industry.

4. We are a lobby group not a think tank. Our grassroots advocacy model is based on international taxpayer-group counterparts, particularly in the United Kingdom and Canada, and similar to campaign organisations on the left, such as Australia's Get Up, New Zealand's ActionStation, and Greenpeace.
5. The Union is a member of the World Taxpayers Associations - a coalition of taxpayer advocacy groups representing millions of taxpayers across more than 60 countries.
6. We give permission for the Reserve Bank to publish this submission.

Scope of submission

7. This submission on behalf the *Taxpayers' Union* is limited to opposing the proposal in the exposure draft of the Deposit Takers Bill to offer Crown deposit insurance to finance companies. No opinion is offered on issues raised in the exposure draft that are not connected to deposit insurance for finance companies except for a short discussion on the pricing of Crown deposit insurance.

Executive summary

8. This submission contends that implementing deposit insurance for finance companies would be a short-sighted policy and must be considered a policy option distinct from deposit insurance only for banks.
9. Finance companies operate within a different set of moral hazard concerns than banks do, which deposit insurance schemes interact with to drive the sort of risk-seeking behaviour that makes the guarantee more likely to be activated.
10. Economic stability is, however, not protected by deposit insurance for finance companies, in the same way is it may be for banks.
11. In New Zealand, finance companies now make an even smaller proportion of capital markets than they did prior to the Global Financial Crisis (GFC). The deposit guarantee scheme put in place for finance companies then was of dubious value, even with their larger share of the market in 2008.
12. The Reserve Bank Governor would be placed in an unenviable position as regulator for finance company deposit insurance, as that portion of the market is regularly plagued by scandal and Serious Fraud Office investigations.
13. While there is valid debate as to the correct policy balance for insuring deposits in banks, the case is settled that finance companies should not be included in a scheme such as the one proposed. It is recommended that finance companies be removed from the Draft Bill.

Finance companies are inherently risky

The Auditor-General’s 2011 report goes unremembered

14. The previous Crown deposit guarantee scheme is barely mentioned in the thousands of pages sent to the Minister and the Cabinet as part of the review of the Reserve Bank legislation. This is especially disappointing considering the highly critical remarks in the Auditor-General’s 2011 review of the implementation of the 2008-2011 retail deposit guarantee scheme by the Treasury.

15. Now as then, the Treasury and the Reserve Bank appear to be aloof to the mercurial nature of deposit insurance as a policy instrument. It can bite back at the taxpayer big time as the 2008-2011 scheme certainly did. The proposed deposit guarantee has not been jumbled together in a few days as was the guarantee cobbled together at the height of the GFC. This reincarnation is years in the making.

16. The Auditor-General’s 2011 review found that the Treasury was focused on how to pay out depositors with little regard to how to reduce risk to the Crown by offering deposit insurance to failing finance companies. Indeed, the Crown deposit guarantee was renewed for South Canterbury Finance despite the Treasury having concluded at the time that the finance company was likely to fail.

    > *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 (Auditor-General 2011, p.103).*

17. Would a fair deposit insurance premium towards the end be perhaps up to one-half of South Canterbury Finance’s deposits under a Crown guarantee? To quote the Audit report again:

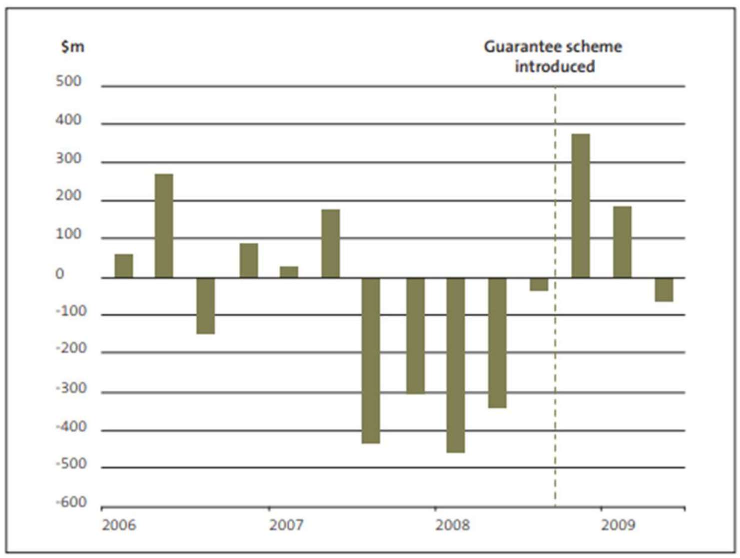
    > *The Treasury’s monthly financial statements did not include any provisions for payouts under the Scheme until June 2009, when the provision was estimated at $0.8 billion. The Treasury knew before June 2009 that further failures of finance companies were likely, so this information should have been better reflected in the monthly financial statements earlier than June 2009 (Auditor-General 2011, p.94).*

18. About $1.6 billion of the $2 billion in initial losses to the Crown from the deposit guarantee scheme was from the failure of South Canterbury Finance. The Treasury didn't face up to the facts as early as it should have with the 2008-2011 Crown deposit guarantee to finance companies. History is repeated.

Deposits flooded into finance companies off the back of the 2008 Crown guarantee

19. After bleeding money in 2007 and 2008, there is a surge in deposits after the 2008 Crown guarantee for finance companies, as in the chart below from the Auditor-General (2011). South Canterbury Finance grew by 25% in deposits after the Crown Guarantee (Auditor-General 2011); deposits in South Canterbury Finance increased from $75 million in 2004 to $2 billion in 2008 (O'Sullivan 2015); another company grew from $800,000 in deposits to $8 million in deposits off the back of the Crown guarantee (Auditor-General, 2011).

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.

20. There is little discussion in the Treasury and Reserve Bank papers of the implications of the guarantee for a resurgence of investor interest in what is an intrinsically more risky sector. There is no mention in the Reserve Bank legislation review papers of the massive surge in investment, as shown in the above chart. Instead of bleeding $500 million every quarter as in the lead up to the GFC, $600 million flooded back into the sector off the back of the Crown guarantee.

Depositors chase riskier returns when government insured

21. The proposition that depositors will invest in higher-risk returns if they are government insured is well-established in the deposit insurance literature. The burst of deposits back into the finance company sector after the government guarantee in New Zealand is not an anomaly to be dismissed. Instead, a resurgence in growth in the finance company sector is inevitable if the draft Bill continues to include deposit insurance for the sector.

22. Martin, Puri, and Ufier (2018) examined the daily account level balances of a distressed bank in the USA at the height of the GFC. They studied the outflow (bank run-off) of uninsured depositors and the inflow (bank run-in) of insured deposits as this bank was in its death throes. The maximum level of federal deposit insurance increased from $100,000 to $250,000 per account holder as a stabilisation measure at the height of the GFC in 2008.

23. Martin, Puri, and Ufier (2018) found that this failing bank was able to replace about 1/3rd of its depositor base in its last year of life, despite public knowledge of the intensive revelatory scrutiny of its declining condition. Much of these new deposits came in in the last 90 days of the bank. The bank's regulatory filings spoke of being significantly undercapitalised and then critically undercapitalised financial states. The new deposits were almost all term deposits paying slightly above market interest rates and were just under the Federal Deposit Insurance Corporation insurance limit. These deposits initially bunched at the $100,000 dollar limit, then bunched at the $250,000 insurance limit when this limit was increased at the height of the GFC in October 2008.

24. Iyer, Jensen, Johannesen and Sheridan (2019) had access to all personal deposit accounts and their balances in Denmark when they studied changes in deposit insurance for Danish banks. The Danish government guaranteed all bank liabilities in 2008. Prior to the GFC, deposit insurance was limited to 300,000 Danish kroner. The Danish government later limited deposit insurance to 750,000 Danish kroner in 2011. The Danish government also named six Danish banks as too big to fail.

25. Iyer, Jensen, Johannesen and Sheridan (2019) found that for the banks that were not too big to fail, accounts clustered around the insurance limit of 750,000 Danish kroner. There was no similar bunching of deposits at the deposit insurance limit for the six banks deemed too big to fail. They also found the deposits above the insurance limit of 750,000 Danish kroner halved in the banks not too big to fail but fell only by 20% in banks that were marked by the Danish government as too big to fail.

26. The record with the Crown deposit guarantee scheme between 2008 and 2011 and the overseas experience with changes in deposit insurance limits show conclusively that investors will run back into the sector if the finance companies are once again provided with Crown deposit insurance.

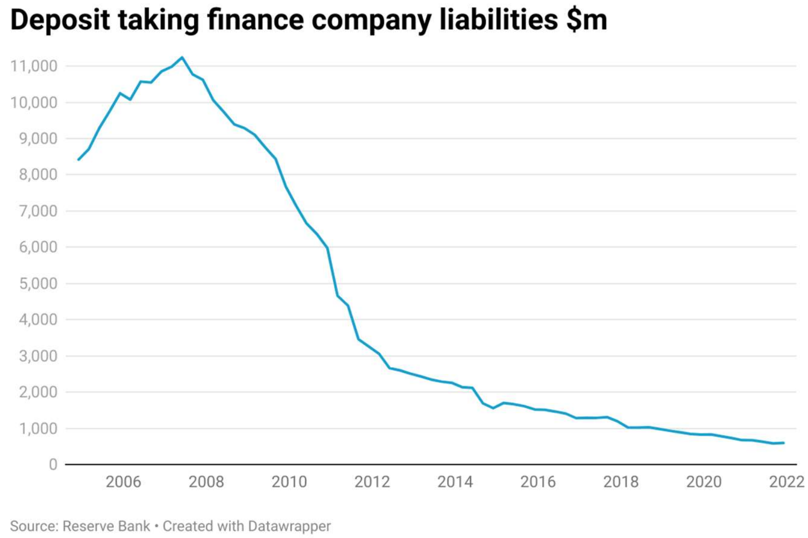
Finance companies dwell at the very margins of the financial system

27. But the biggest error of all is repeated, both now and back at the height of the GFC, finance companies are being included in the deposit guarantee scheme very much as an afterthought. Obvious arguments as to why they should not be included have been missed. To begin with, 28 finance companies had failed in the preceding two years with no implications for financial stability. At their peak, there were about 65 finance companies in the country. Half of them failed inside two years with no implications for the stability of the banking system or public policy. As the then Secretary to the Treasury and then the Governor of the Reserve Bank reflected later on his crisis management decision making about the finance companies:

> *At the end of 2006 and in early 2007, we started to hear about property finance companies in trouble. Most were very small, and as individual failures they did not greatly concern us. But in the second half of the 2007, bigger finance companies started to fall like flies. As each one entered into liquidation, receivership or moratorium, media speculation turned to the next. We saw angry scenes of elderly debenture holders haranguing hapless managers at meetings. The pattern seemed clear: poor governance, spider-web company structures, vulnerable business models, mismatched balance sheets, bad management and inadequate supervision by the trustee companies.*
>
> *At the Reserve Bank we started to worry: were the combined failures big enough to lead to a deposit run on the banks? The answer seemed to be no, in fact the banks were benefitting from a flight to quality. Did the failures point to fragile business models and practices in the banks themselves? Again, we thought not, the banks being much more sophisticated organisations than many finance companies (Bollard 2012*

28. There are now five finance companies in New Zealand with their asset-based barely exceeding $1/2 billion, less than 1/20th of the deposit base of the sector prior to the GFC as the chart below shows. The inclusion of finance companies in the Crown guarantee was a dubious decision in 2008 when the finance company sector was more than 20 times its current size. Five tiny finance companies plus a Christian charity engaged in social lending are irrelevant to the stability of the New Zealand financial system. These five and a Christian charity lender are all that is left of a sector that grew by 1/3rd in the

four years before the GFC, by $4 billion, then quickly shrunk by nearly 90% in the aftermath of the GFC and then continued in a further long decline.



29. The above chart shows that the finance company sector has halved in size since the review of the Reserve Bank Act started after the 2017 General Election. The sector is now a tiny part of the financial system.

Finance companies are vulnerable to Ponzi scheme

30. There have been one or two Ponzi scheme prosecutions by the Serious Fraud Office almost every year since the GFC, according to an Official Information Act Response from that Office. There is no mention of Ponzi schemes in the consultation documents written by the Treasury or Reserve Bank.

31. The Serious Fraud Office has not received any communication from the Treasury in recent years about criminal offending in the finance company sector according to a 16 September 2020 Official Information Act response. There is no mention in the Treasury and Reserve Bank papers on deposit insurance in the finance company sector of the 20 convictions obtained by the Serious Fraud Office against nine finance companies between 2007 and 2010. The South Canterbury Finance prosecutions over a $1.6 billion fraud came later.

32. After the South Canterbury Finance prosecution and 20 other successful prosecutions, it was a basic responsibility of the Treasury and Reserve Bank to go to the Serious Fraud Office for advice on the extent of sharp practice in the finance company sector. The Treasury is letting taxpayers down.

Not enough separation of ownership and control in finance companies

33. Fraud is more likely in the finance company sector because they are owner-operated concerns or privately held. The owners can directly benefit by resort to a Ponzi scheme. Ponzi schemes such as the Bernie Madoff scheme was a response to declining deposits. New deposits are paid out as returns on the investment in the hope that things will turn around shortly, but they rarely do.

34. The banks are run by professional staff who do not want to jeopardise their careers with sharp practice. Indeed, bankers are notoriously conservative; the origin of the bonus culture in banking was to find some way for the shareholders in a bank to introduce a little bit more risk into the lending decisions of the bank's managers (Laeven 2013). Banks have professional and independent auditors, both internal and external, as well as overseas owners keen to protect their global brands. There is also no way for miscreant staff to divert the proceeds of a Ponzi scheme into their pockets. None of these safeguards apply to the finance company sector. The more than 20 prosecutions in the finance company sector after the introduction of Crown deposit guarantee scheme should make the Treasury, the Reserve Bank, and ministers wary of the sector.

35. Fraud at the fringes of the financial sector is not rare overseas. The American taxpayer paid out over $150 billion in the 1980s on deposit insurance to their equivalent of our building societies. At least $53 billion was lost to 1,000 Saving and Loan (S&L) associations, where there were fraud convictions (Akerlof and Romer 1993). The failure of thousands of these savings and loan associations had no implications for the stability of American banking (Gorton and Tallman 2018). The era was known as the Great Moderation because the sustained real GDP growth between 1983 and 2007 was punctuated by only two short recessions.

Reserve Bank not the desirable regulator

Staving off the breath of scandal

36. The Government is borrowing $50 billion from the Reserve Bank to finance the COVID-19 spend-up. The Crown's reputation as a sovereign borrower cannot be put at risk by ministers having to discipline the Reserve Bank Governor for signing off on deposit insurance for what turned out to be yet another finance company Ponzi scheme. There were five criminal prosecutions of Ponzi schemes in 2013 alone and four more in the next year. The Governor cannot testify regularly in court and to select committees about signing off on yet another Ponzi scheme without job consequences.

37. The Reserve Bank must be beyond reproach. Our Reserve Bank can lend $50 billion to the Government without igniting inflationary expectations because of credibility of an inflation targeting regime built up over the last 30 years. Our reputation for keeping inflation low and never monetising debt could evaporate if governors are fired with signing-off on Ponzi schemes given yet again as the reason.

Let the Treasury carry the can

38. As a precaution against even the breath of a finance company Ponzi scheme scandal touching the Reserve Bank, the administration of any deposit insurance scheme should be squarely the responsibility of the Treasury. The international reputation of our Reserve Bank for independence and inflation targeting cannot be placed at risk because of a need to consider dismissing a Governor who yet again signs off on what turns out to be a Ponzi scheme. In contrast, a sacking of the Secretary of the Treasury for unwittingly signing off a deposit guarantee for what became a Ponzi scheme will not jeopardise the credibility of our inflation targeting regime.

The missing witness

39. When the South Canterbury fraud prosecution finally came before the courts in 2014, the Secretary to the Treasury was described as the missing witness because the Crown did not offer him as a witness (O'Sullivan 2014). Justice Paul Heath acquitted three defendants on the central charge of deceptive conduct to enable the finance company to join the Crown Retail Deposits Guarantee Scheme. His Honour the Judge wrote:

> *In the absence of evidence from the Secretary, I could not exclude the reasonable possibility that he would have signed the guarantee deed on 19 November 2008, even if the Crown was right about the alleged material omissions. That is why I found Messrs Sullivan, White and McLeod not guilty on count 10 (O'Sullivan 2014).*

40. Justice Heath said that irrespective of the company's position, the Treasury might have allowed South Canterbury Finance into the deposit guarantee scheme to maintain public confidence and to avoid capital flight to Australia where a similar deposit guarantee scheme had been introduced and because no applications by finance companies to join the deposit guarantee scheme had been refused previously due to a lack of creditworthiness or poor business practices (O'Sullivan 2014). The Judge was an astute observer about the mixed motives a Treasury Secretary might have when signing guarantees for banks and finance companies at the height of a financial crisis. The need for decisiveness at the behest of ministers under great stress may render moot the scrutinising of the

creditworthiness of each deposit taker seeking a Crown guarantee. The Governor of the Reserve Bank cannot be put in the position of being a missing witness at a later fraud trial.

Finance companies and deposit insurance schemes: A brief history

Deposit insurance had an inauspicious start

41. The proposed extension of deposit insurance to the finance company sector is not the extension of the tried-and-true policy instrument; deposit insurance is not a safe pair of hands. These schemes have always had an ambiguous reputation. Reasonable people can disagree on its merits for banks. The question is does moral hazard offset any stabilising influence deposit insurance might have in a banking crisis (Allen, Carletti, Goldstein and Leonello 2018; Gorton and Winton 2003). This ambiguous reputation is not gleaned from the thousands of pages of writings of the Treasury and Reserve Bank as part of the Reserve Bank Act review.

42. Federal deposit insurance was the only bill in the New Deal 100 days legislation opposed by President Roosevelt, the Treasury, the Federal Reserve Board, and the American Bankers Association (Calomiris and White 1994). In the depths of the Great Depression, on the heels of the four day federal bank holiday and off the back of many thousands of banks closing, the Roosevelt administration regarded deposit insurance as a too risky a bet in the deepest financial crisis in American history. The congressional and public debates in 1933 were sophisticated as they are now regarding the issues of moral hazard and adverse selection (Calomiris and White 1994). It was well known that the eight state deposit insurance schemes failed because of fraud and risky lending by the banks. When deposit insurance by the state governments was voluntary, only the riskier banks joined, and they were more likely to fail after joining (Calomiris and White 1994).

43. Federal deposit insurance was enacted on the 151st attempt; 147 of the previous 150 bills did not even get out of committee. Deposit insurance was a backroom deal to keep in business the tens of thousands of American banks that only had one office and highly undiversified lending portfolios (Calomiris and White 1994). Most of America's 40,000 banks in the mid-1920s had only one office. Of the over 9,000 banks that failed between 1929 and 1993 in the Great Depression, barely a handful of the failed banks were banks with branches (Calomiris 2009, 2011, 2013). Deposit insurance took effect in 1934 which is after US banking had stabilised in the Great Depression (Gorton and Winton 2003). The better policy choice came a one-half a century later with the repeal of state and federal restrictions on intrastate and interstate branching to allow for a diversification of lending portfolios. Deposit insurance was not the first best policy choice from its start.

Oh Canada

44. Canada was the next country to have adopted deposit insurance in 1967 for banks and mortgage companies. Again, it was a backroom deal where mortgage companies obtained federal deposit guarantees in return for not opposing the entry of trading banks into the mortgage business (Carr, Mathewson and Quigley 1995). A glaring anomaly in debates about banking crises is the tenacious stability of the Canadian banking system. The last bank failure, bar one, in Canada was in 1923. Canada's banking system sailed through the Great Depression and the GFC because it had large banks with diversified loan portfolios (Bordo and Redish 1987; Bordo, Redish and Rockoff 2015).

When deposit insurance became a purely good thing for banks

45. The academic reputation of deposit insurance picked up no end with the papers by Bryant (1980) and Diamond and Dybvig (1983). Banks have a maturity mismatch in their balance sheets, which they say is to blame for bank runs. Deposits are payable on demand, but most of these deposits were financing long-term loans. Diamond and Dybvig (1983) argued that if too many depositors suddenly seek to withdraw, the bank will run out of cash despite being solvent. In a run, depositors are not reacting to news about the quality of the bank's portfolio. Instead, they are withdrawing because they see others doing so and do not want to be left with a deposit in a bank with no cash reserves. The bank then fails because a depositor panic forces the bank to sell good assets in a fire-sale.

46. Importantly, in the Diamond-Dybvig model of bank panics, if there is government-supplied deposit insurance, depositors do not initiate bank runs, as they trust that their deposits are safely insured by the taxpayer. The icing on the cake is that the deposit insurance under this Diamond-Dybvig scenario costs the taxpayers nothing because there are no bank panics to stem.

Bryant-Diamond-Dybvig bank runs everywhere?

47. During the GFC, many governments seemed to see Diamond and Dybvig type panic-based bank runs everywhere and used guarantees to quell the panic. As Sargent (2010) observed:

> *When monetary policy authorities, deposit insurance authorities and others looked out their windows in the fall of 2008, they saw Bryant-Diamond-Dybvig bank runs all over the place. And the logic of the Bryant-Diamond-Dybvig model persuaded them that if they could arrest the runs by effectively convincing creditors that their loans—that is, their short-term deposits—to these "banks" were insured, that could be done at little or no eventual cost to the taxpayers. You could nip the run in the bud and really prevent the next Great Depression. This is a very*

> *optimistic view of those 2008 interventions enlightened by the Bryant and Diamond-Dybvig model.*

48. Reasonable people can disagree whether offering a government guarantee to the retail and wholesale deposits of banks and shadow banks was wise at the height of the GFC. It is very much a rear-guard action to argue that five finance companies that now barely cobble together $1/2 billion in assets warrant the attention of the Minister of Finance when planning for the next financial crisis. The purpose of both the preceding and the coming discussions of deposit insurance for banks is to show that setting up a deposit insurance scheme is a nuanced policy trade-off for banking but not so for finance companies. Finance companies are a sideshow in any financial crisis and certainly never seed a banking crisis.

When deposit insurance is a pure bad for banks

49. Diamond and Dybvig were well-aware of the risk of moral hazard. They recommended a 1978 paper by Kareken and Wallace on deposit insurance because that paper was about what Diamond and Dybvig left out: moral hazard. Sargent (2010) summarises the Kareken and Wallace modelling as follows:

> *Kareken and Wallace compare that no-deposit-insurance situation to another situation in which a government agency provides deposit insurance that is either free or is priced too cheaply, meaning that it's not priced with a proper risk-loading. Kareken and Wallace show that in that situation, banks have an incentive to become as risky as possible, and as large as possible. Therefore, with a positive probability, banks will fail and taxpayers will have to compensate banks' depositors. It is in banks' shareholders' interest that the banks organize themselves this way. This lets them gamble with the insurers' and depositors' money. The Kareken and Wallace model's prediction is that if a government sets up deposit insurance and doesn't regulate bank portfolios to prevent them from taking too much risk, the government is setting the stage for a financial crisis (Roleck 2010).*

50. From this angle, deposit insurance is now a pure bad that encourages risk-taking and crises unless bank portfolios are successfully regulated. The literature on regulation of bank portfolios is one of profound subtlety, where the correct amount of capital banks must hold is subject to intense debate (Aiyar, Calomiris and Wieladek 2015). The spotty record of regulators before the GFC also throws doubt on their ability to do better next time (Calomiris 2011, 2013). It is still debated as to whether the regulatory response to the GFC made things worse rather than better (Tarullo 2019).

Insured deposit takers take more risks

51. Gropp, Gruendi and Guettler (2014) studied the response of 452 German savings banks after government guarantees were removed, following a lawsuit in the European Court of Justice in 2001. As a group, savings banks in Germany have assets totalling 1 trillion Euro and 22,000 branches. Gropp, Gruendi and Guettler (2014) found that the German savings banks cut off their most risky borrowers and raised interest rates to the rest after the guarantee was removed. There were no similar effects in the control group of German banks to whom the guarantee was not applicable.

52. Lambert, North and Schuwer (2017) looked at what happened to insured deposits in 1,300 federally insured banks in the USA when their deposit insurance coverage was increased in October 2008 from $100,000 to $250,000. For some banks, the amount of insured deposits increased significantly. The most affected banks were found to increase their loans to risky commercial real estate, when compared to those banks that were largely unaffected by the deposit insurance limit change.

Risk-inviting rules of the game

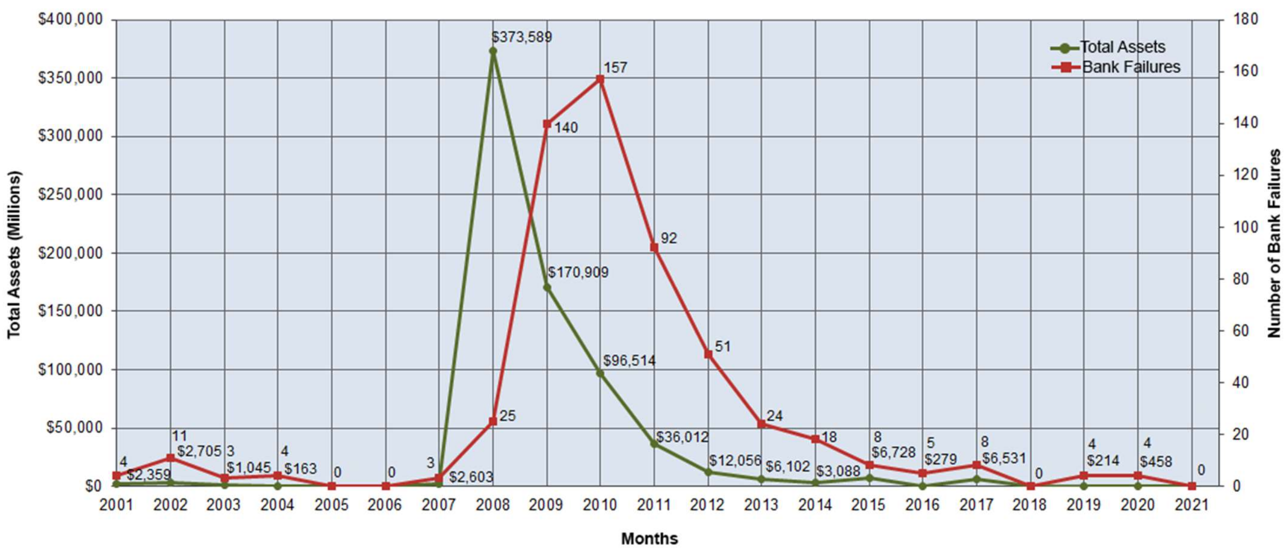
53. The studies by Martin, Puri, and Ufier (2018), Iyer, Jensen, Johannesen and Sheridan (2019), Gropp, Gruendi and Guettler (2014) and Lambert, North and Schuwer (2017) show that depositors chase down government insured higher returns and that bankers take more risks when deposits are insured. The papers published by the Treasury and Reserve Bank to justify deposit insurance just don't pick up on the nuances in the theoretical and empirical literature such as summarised by Thomas Sargent:

> *So, of those two models, the Kareken-Wallace model makes you very cautious about lender-of-last-resort facilities and very sensitive to the risk-taking activities of banks. The Diamond-Dybvig and Bryant model makes you very sensitive to runs and very optimistic about the ability of insurance to cure them. Both models leave something out, and I think in the real world we're in a situation where we have to worry about runs and we also have to worry about moral hazard (Roleck 2010).*

54. The policy trade-off regarding deposit insurance for banks is staving off bank runs while inviting banks to take on more risk in their lending. This is a far greater risk for US banks than for New Zealand banks, because the US still has thousands of small banks with less diversified loan portfolios (Calomiris 2008, 2011, 2013; Gorton and Winton 2003). The number of federally insured commercial banks in the US was 14,146 in 1934, 14,384 in 1975, 8,300 in 2000 and 4,377 in 2020. So many small banks in the US with few, if any branches, is why bank panics and bank runs are regarded as very much an American phenomenon in the economic literature, as Gorton and Winton (2003) explains:

On the basis of the stylized facts about cross-country banking history … it would seem straightforward to observe that banks are not fundamentally flawed institutions. In fact, it does not seem to be an exaggeration to say that most of the theoretical work on panics has been motivated by the USA experience, which has then been incorrectly generalized. Panics simply are not a feature of most economies that have banks. The world is more complicated; industrial organization seems to be at the center of the incidence of panics. Not surprisingly, therefore, almost all the empirical work on panics has been on the USA experience. Until bank "crises" around the world in the last ten years, there simply has not been much else to study (Gorton and Winton 2003, p. 508).

55. A British banking scholar would be likely to remember the names of each of their banks that failed over the last 200 years. By contrast, banks fail every year in the USA, as in the Federal Deposit Insurance Corporation chart below. 1,617 federally insured banks failed between 1980 and 1994 (Hane 1998).



(Source: Federal Deposit Insurance Corporation)

56. There were many more banking crises over the last 40 years around the world. Their most common cause was ever more generous safety nets, including the moral hazard risks arising from the proliferation of deposit insurance starting in the 1970s and 1980s. The leading scholar in the field finds:

Recent research that investigates the determinants of banking fragility across different countries in the current era reaches a similar conclusion: the expansion of government-

sponsored deposit insurance and other bank safety net programs throughout the world in the past three decades accounts very well for the increasing frequency and severity of banking crises in the current era. Empirical studies of this era of unprecedented frequency and severity of banking system losses has concluded uniformly that deposit insurance and other policies that protect banks from market discipline, intended as a cure for instability, have instead become the single greatest source of banking instability (Calomiris 2009).

57. The exposure draft of the Deposit Takers Bill plans to extend to the finance company sector what is a contentious policy instrument in the banking sector. Deposit insurance invites risk-taking but its redeeming feature is once the banking crisis it seeded occurs, it may quell a bank run or panic. When pondering deposit insurance for banks, the trade-off between the incentive to take more risks and seed a crisis must be weighed against the stabilising influence of deposit insurance when there is a crisis and the possibility of bank runs (Allen, Carletti, Goldstein and Leonello 2018; Gorton and Winton 2003).

58. Most countries initially manage banks in distress through the lender of last resort function. The central bank lends to a bank in distress against good collateral at a high rate (Bordo 1990, 2018; Gorton and Metrick 2013). The Reserve Bank would help a bank through its difficulties while its loans are restructured and the bank perhaps recapitalised. Any risk from lending against compromised assets of the distressed bank is factored into the interest rate charged with the capital base of that bank acting as a buffer against further losses on a lender of last resort loan. No one suggests that finance companies should have lender of last resort access.

No crisis management trade-off for finance companies

59. Reasonable people can disagree on whether deposit insurance destabilises the financial system by incentivising risk-taking more than it stabilises it by calming potential bank panics during a crisis:

Theory suggests that deposit insurance can either increase or decrease banking system risk. On the one hand, credible deposit insurance can make the banking system more stable by reducing liquidity risk. It does so by removing the incentive of depositors to withdraw funds from banks when bank risk increases. On the other hand, deposit insurance may be a source of "moral hazard"—it may increase the risk appetite of banks because their ability to attract deposits no longer reflects the risk of their portfolios. Deposit insurance can also cause "adverse selection," including as the result of unwitting increases in risk when the absence of market discipline permits poor risk managers to operate banks. If the capital position and asset risk of banks are

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not regulated and supervised carefully, the insurance-induced risk taking may increase insolvency risk and undermine financial stability in the long run, despite the liquidity risk reductions that deposit insurance creates (Calomiris and Chen 2020).

60. The debate over deposit insurance for banks is nuanced. Observers must listen carefully to the competing arguments before making up their mind (Demirgüç-Kunt, Kane, and Laeven 2008; Calomiris and Jaremski 2016). Listeners to any debate must also guard against the protagonists making incorrect generalisations from the uniquely fragile US banking system, past and present (Gorton and Winston 2003). No such policy trade-off exists between moral hazard and better crisis management for deposit insurance for finance companies.

The New Zealand situation

Just moral hazard

61. The five finance companies with barely $1/2 billion in assets between them will have no role in future financial crises. The sector is one-twentieth of its size at the eve of the GFC. The only policy issue here is that deposit insurance will encourage greater risk taking when finance company deposits are insured. What do taxpayers get back in return for this windfall to the finance company sector other than grief when taxpayers' money is already short because of the COVID-19 debt crisis? The higher returns in the sector come off the back of greater risk taking. At some point, we must expect the investor to beware.

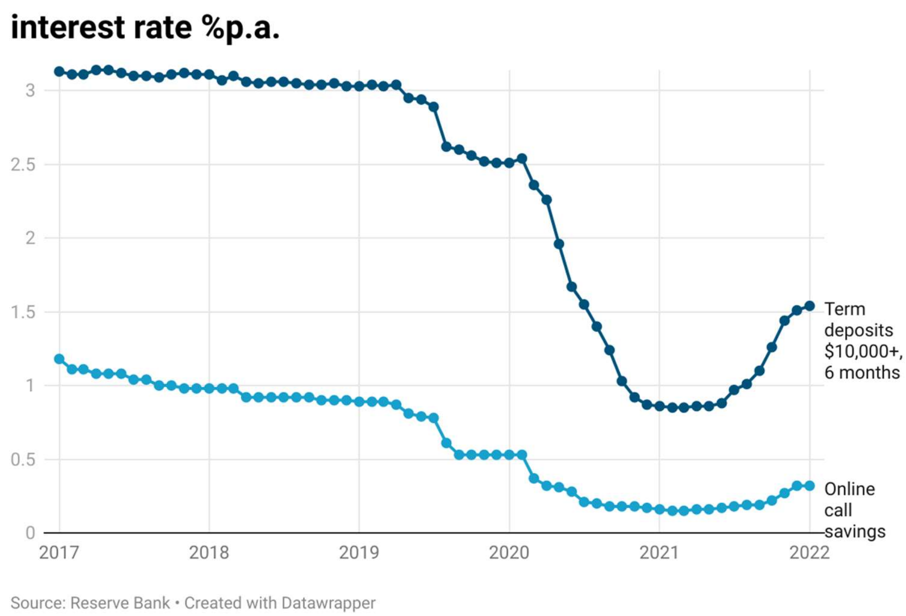
How much?

62. The discussion of the deposit insurance premium in the papers by the Treasury and the Reserve Bank focused on how long it will take to build a fund of a certain size relative the deposits to be insured. The Bank refers to 0.2% per year as a reasonable rate for the deposit insurance premium:

    Looking at countries with banking systems and per capita GDP similar to New Zealand, a target size for a domestic insurance scheme of 2 percent of insured deposits would be large. At a per-depositor insurance limit of $30,000-$50,000, this implies an insurance fund of around $2-3 billion (Table 5B). The Review Team estimates this could be built up over a decade through a levy of 5 percent of the banking sector's annual profits, or a premium of 20 basis points on banks' insured deposits (Reserve Bank 2019, p. 92)

63. That was in 2019. A deposit insurance premium of 20 basis points is now about equal to the current return on an online call account – see the chart below. The same chart shows that term deposit rates

are closing in on the 20 basis points deposit insurance premium and that narrowing gap charted is before tax. Interest rates on term deposits and on online call accounts dropped by about two thirds over the course of the review of the Reserve Bank legislation which started after the 2017 election. Deposit insurance has gone from clipping a small part of the interest return on deposits in 2019 to taking most or all of it in 2022.



64. The estimate of 20 basis point deposit insurance premium was off the back of advice from the Reserve Bank to have a deposit insurance limit per depositor of $30,000 to $50,000. The Government is planning a much larger deposit insurance limit of $100,000. It will either take many decades to build up to the reserve fund target or deposit insurance premiums must be much more than 20 basis points.

65. As it stands, taxpayers will not know how much they will pay for deposit insurance until the Minister of Finance issues a Statement of Funding after the Bill is enacted. Only then will depositors at banks, building societies, credit unions and deposit taking finance companies know how much they will pay and how quickly the Minister wants to accumulate the fund to a fully funded level of deposit insurance. That is unsatisfactory.

Government insured junk bonds

66. The interest rate paid by finance companies on six-month deposits is about twice that of banks. A fair insurance premium for deposit takers in the finance company sector would be large given their previous experience with risky lending, with related party lending and exposure to real estate

development. Prior to the GFC, all but five of the sixty odd finance companies lacked a credit agency rating. The majority now do have credit ratings at a BB standing or less; see the table below.

Finance company	Credit rating agency	Rating and outlook
Christian Savings Limited	Fitch Ratings	BB, Stable
FE Investments Limited (in receivership)	n/a	Credit ratings have been withdrawn
Finance Direct Limited	n/a	Exempt
General Finance Limited	Equifax	BB-, Positive
Gold Band Finance Limited	n/a	Exempt
Liberty Financial Limited	Standard & Poor’s	BBB-, Stable
Mutual Credit Finance Limited	n/a	Exempt
Xceda Finance Limited	Equifax	B, Stable

Source: Reserve Bank

67. The BBB credit rating suggests investment grade; BB means a higher probability for default. BB and B bonds fall in the category of junk bonds, high-yield bonds or speculative instruments. The B rating suggests a company can meet its financial commitments but may be left highly exposed to adverse economic conditions. For Moody's, BB and B bonds are speculative and "subject to a substantial risk of defaulting on certain senior operating obligations and other contractual commitments." South Canterbury Finance was BBB rated when its deposits were guaranteed by the Crown in 2008.

68. It is a disservice to the taxpayer to contemplate deposit insurance for a sector that trades in what is mostly junk bonds. The previous pages presented ample evidence that investors watch deposit interest rates keenly especially if higher but riskier returns that are government insured come on the market. Crown deposit insurance will certainly encourage many retirees to re-enter the sector. Who wouldn’t be tempted to double the returns on their retirement savings for no extra risk because of the

proposed Crown deposit guarantee? A canny retiree would deposit $100,000 with each of the five finance companies to bet on a sure thing.

Yours sincerely,
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