The Treasury: Learning from managing the Crown Retail Deposit Guarantee Scheme

Progress in responding to the Auditor-General's recommendations

Published under section 21 of the
Public Audit Act 2001.

March 2014

ISBN 978-0-478-41062-4 (online)

Introduction

1.1 In October 2011, we published our report of our performance audit of the Treasury's management of the Crown Retail Deposit Guarantee Scheme (the Scheme). The Scheme was put in place in October 2008 as part of the Government's response to the global financial crisis. We made four recommendations for the Treasury to prepare it for other potentially large and complex initiatives that might require rapid implementation.

1.2 Generally, the work that the Treasury has done so far and is continuing to do should provide better resilience to pressure on the economy and clearer lines of action in the event of another financial crisis.

1.3 Our recommendations did not address issues of policy because that is beyond our mandate. However, the Treasury has given serious thought to the policy implications of some of our findings.

1.4 The Treasury and the Reserve Bank of New Zealand (the Reserve Bank) have been working together since 2010 on a significant body of work that should help to address issues we noted in our report.

1.5 How effective the Treasury's work is can only be tested in a real crisis situation. It is important that the governance roles and responsibilities for the Treasury, the Reserve Bank, and the Minister of Finance in the event of another financial crisis are clear.

Background

1.6 In September 2008, the collapse of the major American bank Lehman Brothers propelled the world into a global financial crisis. On Sunday 12 October 2008, the Government decided that it needed to implement a form of retail deposit guarantee scheme to avoid a flight of funds from New Zealand institutions to those in Australia. It needed to do this urgently: the Scheme was designed and announced that same day. The Scheme was to assure the public that the money eligible people had deposited or invested (up to a cap of $1 million each) with particular financial institutions was safe.[1] At its peak, the Scheme covered deposits to the value of $133 billion.

Our performance audit – rationale and scope

1.7 The Treasury is responsible for maintaining New Zealand's macroeconomic stability, in conjunction with the Reserve Bank. Because of the Scheme's significance for our economy at the time and the amount of money involved, we carried out a performance audit of how effectively and efficiently the Treasury implemented and managed the Scheme. We also provided an independent record

1 See www.treasury.govt.nz/publications/informationreleases/guarantee/index.htm#20oct.

of the history of the Scheme. We considered all types of financial institutions covered by the Scheme. However, we chose to focus on finance companies (non-bank deposit takers) because of the significant payments made under the Scheme in response to the failure of nine of these financial institutions.

1.8 In our report, we noted that the Scheme achieved its goal, and was successful in preventing bank failure. However, we also noted that there were practical challenges in implementing the Scheme. The speed with which the Scheme was designed and implemented demanded a disciplined project management approach with formal and comprehensive management disciplines, and strategic oversight. In our view, this was not evident.

Our recommendations

1.9 We made four recommendations for the Treasury to prepare for other potentially large and complex initiatives that might require rapid implementation. The important premise underlying our recommendations is for the Treasury to demonstrate its readiness to deal with another event similar in effect on the economy to the global financial crisis or the failure of a major financial institution. Our recommendations were for the Treasury to put in place a more disciplined approach to project planning for large-scale initiatives. Our recommendations included:

- setting up project planning and monitoring frameworks with an approach to crisis management planning (our first and second recommendations);
- carrying out a formal post-project review after implementing any significant policy initiatives (our third recommendation); and
- recording lessons learned from its work on South Canterbury Finance Limited (our fourth recommendation).

1.10 We noted that our fourth recommendation could take the form of a framework for dealing with distressed institutions.

1.11 The Treasury has responded directly to our first two recommendations and more generally to the premise underlying our recommendations. As well as reviewing the progress that the Treasury has made on implementing our recommendations, we also considered the work that the Treasury has done to provide more general financial stability, including work to prepare for the potential failure of major financial institutions, such as a major bank.

The Treasury's progress in implementing our recommendations about project management

1.12 For this progress report, we sought assurance that the Treasury has developed a disciplined, proactive approach to project planning and management that it could follow in crisis situations.

1.13 The Treasury has responded positively to our recommendations about improving project management and implementing a planning, monitoring, escalation, and reporting framework. The Treasury has adopted the PRINCE2 methodological framework for project management and is working on embedding a more regularised approach to planning, monitoring, reporting, and reflecting on lessons learned. We reviewed documents for the Financial Stability Key Initiative that showed this (see paragraphs 1.18-1.20). As part of embedding this approach, the Treasury intends to provide its staff with information about the benefits of project management and the support and tools available. It also intends to provide practical examples of how project management has already benefited Treasury initiatives.

1.14 The Treasury used AMI Insurance as an example to show us how it has applied a more controlled approach to support a major distressed institution. In our view, a carefully thought-out response is evident. The Crown has sought to minimise risk to public funds and, at the same time, has provided support that mitigated the immediate risk of AMI Insurance failing. This provided important assurance to insurance holders in Christchurch, at a stressful time, that their claims would be met.

Case study: AMI Insurance – dealing with a distressed institution in a time of crisis

AMI Insurance was a major insurer in Canterbury. Although AMI was considered a prudent operator, it was not certain that it would be able to cover all the claims it had received after the Canterbury earthquakes. It approached the Government for financial support. The Treasury's approach was on an "as needed" basis for support, taking control only if AMI did not find another investor in time to resolve its solvency problems. This meant that the Crown did not have to exercise immediate control, which would have meant taking the burden of risk.

The Crown provided an incentive to AMI: find a long-term investor to avoid the unattractive (to AMI) situation of removing AMI's board of directors. Further contingencies were put in place, including requiring AMI to meet multiple sets of conditions from the Reserve Bank. The eventual resolution was that AMI found a purchaser for its other, more saleable, business, with the Crown taking ownership of the part of AMI's business that dealt with Canterbury earthquake claims (now called Southern Response Earthquake Services Limited). Southern Response can claim on the Crown only once its own reinsurance and other reserves are substantially exhausted. This has resulted in assurance to insurers that claims will be met, with less cost to the public than a "bailout".

1.15 The Treasury has not carried out a separate piece of work, as suggested in our fourth recommendation, to document its analysis and thinking around its dealings with South Canterbury Finance Limited. Nor has the Treasury carried out a formal post-project review of lessons learned from the Scheme.

1.16 The Treasury's reasons for this include that:

- the Treasury considered many of the risks and issues arising from the original scheme when working on the extended scheme in 2009;
- there are now fewer non-bank deposit takers that could pose similar risks;
- the unique nature of the Scheme limits the extent of lessons that could be applied to a future scheme; and
- specific lessons are being covered in detail in the work within the Trans-Tasman Banking Council and the Financial Stability Key Initiative.

1.17 The Treasury has seriously considered the lessons learned in various ways from both the global financial crisis in general and the Scheme in particular. Applying these lessons should help the Treasury to manage future situations involving distressed institutions. The Secretary to the Treasury outlined some of these lessons from the global financial crisis in a speech in July 2013.[2] He noted that learning from the experience is not finished.

The Treasury's progress in strengthening resilience to major pressure on the economy

The Financial Stability Key Initiative

1.18 The Treasury has used the lessons learned from the global financial crisis and the Scheme to inform the development of its Financial Stability Key Initiative. The Initiative aims to:

- create a broad framework with robust and workable arrangements to limit future risks; and
- better manage risks that do arise.

1.19 The Treasury has carried out much work on the Financial Stability Key Initiative. The Project Plan for the initiative contains milestones, a risk register, a breakdown of resources and costs, and quality controls. The Project Plan has high-level sponsorship and robust reporting mechanisms within the Treasury and with the Reserve Bank.

2 The Treasury (July 2013), "Reflections on, and Some Lessons from, the Global Financial Crisis", speech delivered by Gabriel Makhlouf, Secretary to the Treasury.

1.20 Work on the Initiative continues but some major progress has been made, including:

- signing a memorandum of understanding with the Reserve Bank, including financial stability arrangements (general and macro-prudential);
- working with the Australian Treasury on crisis management arrangements; and
- improved project management practices to strengthen risk identification, communication, and planning to deal with other unexpected events (such as natural disasters).

Working with the Reserve Bank

1.21 In our 2011 report, it was our view that the Treasury could have more carefully considered whether it needed greater powers for more direct control of distressed institutions. In the context already discussed, the Treasury has reviewed the limitations of the Scheme, including carrying out work to determine the necessity and nature of any future guarantees as well as any other means of control.

1.22 The Treasury considers that it is now in a better position to deal with potential shocks to the economy, such as the failure of major financial institutions. The Treasury has worked with the Reserve Bank on initiatives that are intended to mitigate and avoid, as far as possible, the risk of bailouts and guarantees. The initiatives include implementing aspects of Basel III (an international regulatory framework for banks), introducing a new macro-prudential framework, and developing robust tools in the event of bank failure, such as the Open Bank Resolution. The Treasury and the Reserve Bank are continuing to work together to clarify the governance roles and responsibilities of the Treasury, the Minister of Finance, and the Reserve Bank in the event of a potential major bank failure.

About the Open Bank Resolution

The Open Bank Resolution forms an important part of the framework for dealing with distressed institutions. The Open Bank Resolution was implemented in June 2013 and broadens the Government's range of options for responding to a bank failure. The Open Bank Resolution is intended to reduce the expectation and likelihood of bailout, which has been evident since the global financial crisis (the "implicit guarantee").

The Open Bank Resolution, if implemented when a bank fails, is designed to ensure that losses are first borne by shareholders. It allows a "conservative" portion of depositors' and creditors' funds to be frozen to cover any remaining losses, if necessary. This is put in place overnight, but allows the bank to open the next day so that depositors have access to the unfrozen portion of their deposits. This initial freeze, followed by gradually releasing the frozen part of depositors' funds (if and when that is warranted) is intended to control Crown risk. Ongoing Crown risk would then be controlled by replacing the existing management team with a Crown-directed statutory manager. See "Open Bank Resolution (OBR) policy – Q&A" on the Reserve Bank website (www.rbnz.govt.nz) for further details.

Working with the Trans-Tasman Banking Council

1.23 The New Zealand and Australian Treasuries have been working together since 2005 to identify the main risks to financial stability and options for dealing with those risks. This work has been carried out through the Trans-Tasman Banking Council, underpinned by a "Memorandum of Cooperation".[3] Since 2008, the Council has been working with increased focus on crisis management arrangements in the event of a bank failure. This work is intended to provide a better range of options for dealing with crises affecting Trans-Tasman Banking Group institutions, such as the four largest banks in New Zealand.[4] This groundwork is intended also to provide a sound platform for better planned and co-ordinated action in response to a future crisis than was apparent in 2008.

1.24 We reviewed internal documents that show consideration of options for addressing future crises, such as potential major bank failure. Actions include carrying out crisis simulation exercises (one in 2011 and another to take place in the future), and continuing to work with the Trans-Tasman Banking Council to test trans-Tasman financial crisis management co-ordination. Some progress has been made working through the challenges towards joint action with Australia and the Treasury considers that the work programme will evolve over time.

Being proactive and alert

1.25 In our 2011 report, it was our view that the Treasury could have been much more proactive and prepared for an event that would strongly affect the economy, such as the global financial crisis. In our view, closer observation of overseas developments with the global financial crisis and a better understanding of overseas responses would have better prepared the Treasury to implement the Scheme.

1.26 We note that the Secretary to the Treasury acknowledged in his speech in July 2013 that New Zealand was neither aware nor alert enough to deal with the influence of overseas financial systems and markets. He noted that New Zealand needs to strengthen interconnectedness with its overseas counterparts and improve its understanding of interrelated risks by co-ordinating its policies and strategies to contain these risks and prepare for contingencies.

1.27 We note that other lessons acknowledged by the Secretary to the Treasury were:

- better understanding the signs of trouble; and
- that the different arms of economic policy need "to work in the same direction as much as possible…[involving] far closer co-ordination between monetary and fiscal policy".[5]

3 Available at the Council of Financial Regulators website, www.cfr.gov.au.

4 New Zealand's four largest banks are subsidiaries of Australian-owned banks.

5 The Treasury (July 2013), "Reflections on, and Some Lessons from, the Global Financial Crisis", speech delivered by Gabriel Makhlouf, Secretary to the Treasury.

1.28 We agree with the Secretary to the Treasury that, as far as it can, the Treasury needs to ensure greater co-ordination of its policy streams to build preparedness for, and resilience after, any future financial crises.