

Controller and Auditor-Generals Report Misses the Point

The rushed Crown Retail Deposit Scheme introduced by the previous government at the onset of the 2008 general election campaign has cost taxpayers about \$2 billion to date of which about \$0.9 billion may yet be recovered according to a report this month by the Controller and Auditor General.

Since the fee income for the Crown to 30 June 2010 was only \$237 million, it looks like taxpayers have been taken to the cleaners (yet again) for of the order of \$0.9 billion.

An informative inquiry by the Controller and Auditor-General into whether the decision to adopt the scheme was in the public interest and why the loss has been so much greater than fee income would have been useful.

Unfortunately, the Controller and Auditor-General's report largely botches the first question and ignores the second.

The scheme imposed an enormous potential liability on taxpayers, covering deposits of \$133 billion at its peak. Section 65ZD of the Public Finance Act sets the hurdle for assessing such guarantee decisions. It provides that the Minister of Finance may give a guarantee in writing if it appears to the Minister to be "necessary or expedient in the public interest" to do so.

The Act's presumption that a Minister of Finance should not provide guarantees without good reason has a sound basis. A Crown guarantee shifts risks from a private party to the Crown, but governments commonly lack the information and incentives necessary to price risk accurately. Under-pricing of risk and non-transparent wealth transfers are the likely result.

Under-priced government guarantees for financial instruments potentially undermine the stability of the financial system by inducing excessive risk taking. The precedent created by the adopted scheme is very troubling in this respect.

The report considers the "necessary in the public interest" test and concludes that the scheme was justified because no run on the banks occurred, the economy was stabilised and some finance companies survived.

None of these reasons stacks up. First, the scheme cannot be given any credit for preventing the feared flight of deposits to Australia because under our freely-floating exchange rate regime the fear could never be realised. (Anyone wanting to exchange a New Zealand dollar asset for an Australian dollar asset must find a buyer for the New Zealand asset. As a result there can be no net outflow of funds from the banking system.) Second, credit for boosting confidence in the banks can be more readily attributed to the separate wholesale guarantee scheme since this scheme dealt directly to the real threat that the banks faced – the freezing up of the global wholesale market. Third, sound finance companies would plausibly have survived in the complete absence of a retail deposit scheme.

The largely ignored second question was whether the guarantee was under-priced for no good public interest reason. It is clear now that it was knowingly under-priced. On 10 October 2008, officials put a ball-park \$1.6 billion figure on the cost of a wide-ranging retail deposit guarantee.

Officials proposed charging risk-related fees to those taking up the guarantee offer. An additional reason was the fear that deposits would otherwise move perversely from low-risk banks to higher risk non-banks.

Yet from 12 October the government determined to offer retail deposit guarantees with no charge to non-bank deposit-taking institutions. Given the known condition of those institutions this was a major expenditure decision.

On 15 October 2008, the Treasury estimated that the chosen guarantee scheme could cost between \$462 million and \$945 million. In the fully-audited Crown financial statements for 30 June 2009 the liability was estimated to be \$0.8 billion. (The eventual losses from South Canterbury Finance were larger than were implicit in this calculation, but this is a case of being wise after the event.)

So what justified the failure to charge a fee commensurate with the anticipated losses? The Auditor-General's report is largely silent on this question. It euphemistically observed that "the Minister [of Finance] preferred a flatter fee structure". Well, what was the public interest justification for this preference?

If there was no good public interest reason for imposing a cost of the order of \$1 billion on taxpayers, what might be done to reduce the risks of this happening again? Unfortunately, this is not a question that the report considers.

Given this ministerial decision it seems particularly unfair to criticise Treasury for presiding over the very deposit growth that it sort to avoid. What else was it meant to do?

Similarly, castigating Treasury for alleged process failings makes little sense if they made no material difference to the outcomes that were dictated by the original ministerial decision.

In short, an awful precedent has been set for taxpayer bailouts for investors who have chased higher returns and the question of whether there was a good reason for the failure of the government to price risk accurately has yet to be answered satisfactorily.

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