New Zealand's Overseas Debt, the Banks, and the Crisis

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Guaranteeing Banks' Borrowing

On 1 November 2008 the New Zealand Government radically changed course on its long-standing fiscal strategy and its avoidance of overseas borrowing, setting aside in the process any constitutional checks and balances on giving public subsidies to foreign capital, all in the middle of the weekend before the General Election, and with minimal public disclosure and no effective public debate. The beneficiaries of the sudden taxpayer largesse were the major banks, and the form of assistance was a government guarantee on the wholesale funding of those banks' balance sheets. The decision was bipartisan, in the sense that John Key (then leader of the opposition) was even more keen to help than Michael Cullen, then Minister of Finance. Parliament has yet to have a serious debate on the guarantee issue, and probably won't until (unless?) the costs start to escalate, since both major parties were implicated in the decision.

The big banks operating in New Zealand are owned by Australian parents. New Zealand ownership of banks these days is limited to small fry like Kiwibank, TSB and the Southland Building Society. So the story of the Government wholesale funding guarantee is a story of New Zealand taxpayers being asked to pick up the funding risks of foreign-controlled private businesses. The justifications offered by the bank spokespersons and on the New Zealand Treasury website are uninformative and generally unconvincing.[1]

Needless to say it was the banks themselves which, under cover of rushed commitments by governments in the USA and Australia in late September and early October 2008, raced in to ask the New Zealand Government to guarantee their offshore borrowing. Most local media coverage at the time[2] effectively assumed that

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[1] See Geoff Bertram, "The Banks, the Current Account, the Financial Crisis and the Outlook", *Policy Quarterly* 5(1): 9-16, February 2009, pp.14-16 for discussion of a list of claimed reasons. Parts of this article are based on that earlier piece. For the official documentation go to http://www.treasury.govt.nz/economy/guarantee/wholesale .

[2] With the honourable exception of Brian Fallow in the *New Zealand Herald*.

because the financial crisis in the USA had a global dimension, New Zealand should just copy what the Bush administration was doing without looking at the detail. Many local commentators also took for granted that since the Government had already moved (on 12 October[3]) to guarantee local-currency retail deposits of up to $1 million in the banks and approved finance companies[4], extending the guarantee arrangement to wholesale funding in foreign currencies was simply a change in degree, not in kind.

Wrong.

The effect of the wholesale guarantee is that when the banks go off to New York or London to sell taxpayer-guaranteed commercial paper to overseas investors, they are no longer selling private IOUs. They are selling New Zealand Government debt in disguise. The security the investors get for the money they lend is not the credit-worthiness of the banks that nominally issue the paper. It's the ability of the New Zealand Government to raise revenue from the taxpaying public to pay off the debts, if the banks go under. There's no doubt that the overseas investors are happier to lend to a highly-rated sovereign borrower than to Australian private banks, and it may well be true that the procedure lowers the cost of the banks' funding (though how much of that cost saving comes through to New Zealand borrowers rather than going to the shareholders as extra profit is pretty difficult to work out). But the risk the Government is running on behalf of the New Zealand public is that once the banks have rolled over their existing loans and replaced them with new guaranteed ones (a process which should be completed in the next year), a worsening of the international financial situation that takes down any one of the major banks will leave taxpayers directly liable for its offshore borrowings, which means billions of dollars in foreign currency.

The worst-case consequences of a global financial crash with the wholesale guarantee in place would blow away the Cullen superannuation fund several times over. So do we trust our officials and politicians to get it right? Do the banks in New Zealand

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[3] For documentation of the retail deposit guarantee go to http://www.treasury.govt.nz/economy/guarantee/retail

[4] The approved list is at http://www.treasury.govt.nz/economy/guarantee/retail/approved . The first approved company to go under and trigger the guarantee was Mascot Finance in March 2009.

really need a wholesale guarantee at all? Why should the banks not pay the going market rate for commercial credit, if they continue to go overseas to fund their New Zealand dollar lending activities? Do they really have to go overseas at all to fund their balance sheets? These are the sort of questions addressed in this article.

The official story is still that we can all relax because everything is fine. The banks are to pay allegedly handsome fees for accessing the guarantee (less handsome since Treasury halved the fees a month ago[5]) and the Treasury view is that the contingent liability for taxpayers is so "remote" that it "do[es] not meet the definition of contingent liability"[6]. It was therefore entered as a zero in the Crown financial statements for March 2009 - which, coincidentally, was the month in which the first guaranteed finance company went under, triggering a retail deposit guarantee[7]. Treasury now concedes there may be more to follow.

Since the contingent liability will come home to roost in the Government's overseas debt, the place to start the analysis is New Zealand's international indebtedness.

A Brief History of the Overseas Debt

New Zealand's overseas indebtedness has waxed and waned over the past century, but it is currently at a historically fairly high level, around 90% of GDP. Chart 1 shows the long-run trends. From the late 1800s to the mid 1930s the Government's offshore debt was between 60% and 90% of GDP and private offshore ownership of the

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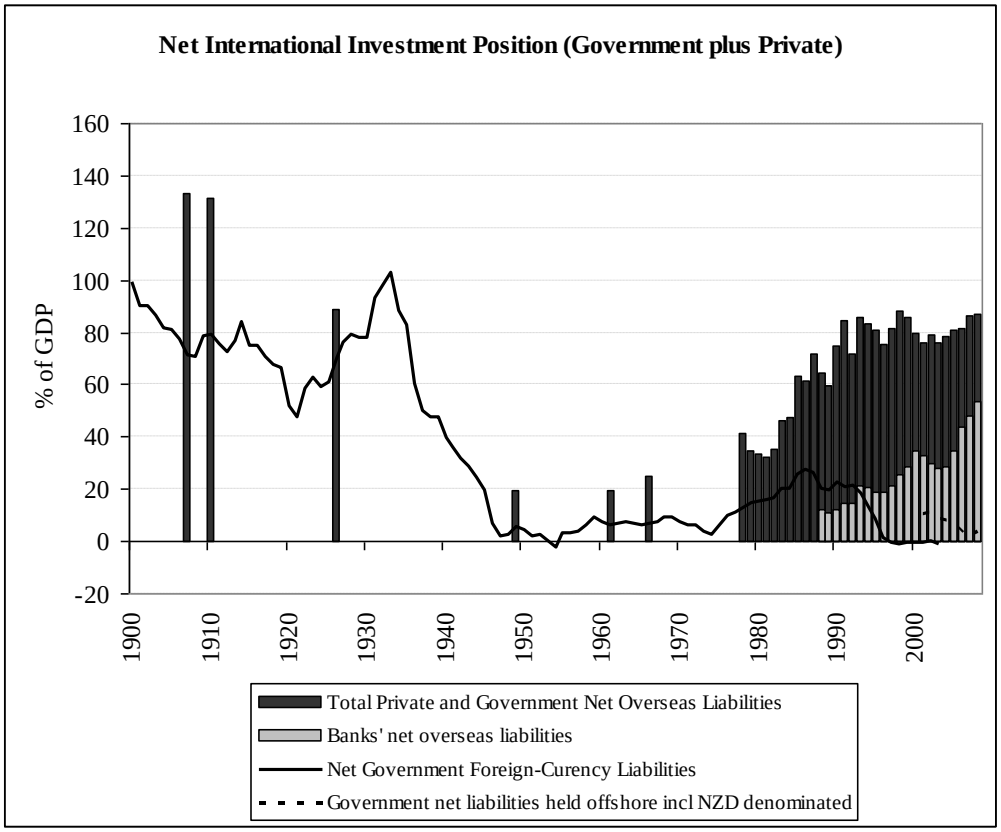
5 http://www.nbr.co.nz/article/treasury-concedes-original-bank-guarantee-fees-too-high-39939

6 http://www.treasury.govt.nz/government/financialstatements/monthend/pdfs/fsgnz-7mths-jan09.pdf p.30.

7 The example of Mascot Finance is illuminating in exposing the hollowness of official reassurances. As the *Dominion Post* reported on 4 March 2009, "Mascot Finance was put into receivership only seven weeks after securing a guarantee. At the time Mascot signed up for the guarantee it had stopped taking deposits and was 'reviewing' its future. But it was not in breach of its trust deed and had significant cash reserves, the Treasury said." Adam Bennett in the *New Zealand Herald* of 3 March 2009 revealed that "Treasury 'had no idea' of Mascot Finance's woes". The Treasury notice of the collapse is at http://www.treasury.govt.nz/economy/guarantee/pdfs/dgs-notice-mascot-ind-v2.pdf. Treasury thinks the cost to taxpayers will be less than the $70 million owing to depositors: "While the company has $70 million in debenture holders, the cost to the Government is likely to be less than this, as remaining assets are also applied to satisfy the debt and the guarantee is for eligible deposit holders only." http://www.treasury.govt.nz/government/financialstatements/monthend/pdfs/fsgnz-7mths-jan09.pdf p.31.

economy was another 50% of GDP approximately. Then official debt was almost all paid off following Walter Nash's famous London trip of 1938 to confront the Bank of England, and after the First World War the private overseas ownership of New Zealand assets dropped to around 20% of GDP, a ratio which held fairly steady until the 1960s before rising gradually over the following decade. The sharp rise in the country's international indebtedness 1974-1988 was led by renewed Government borrowing, with private-sector external net debt (including foreign equity ownership) falling as a ratio of GDP until Labour took power in 1984 and then picking up as Roger Douglas' policies took hold..

Chart 1

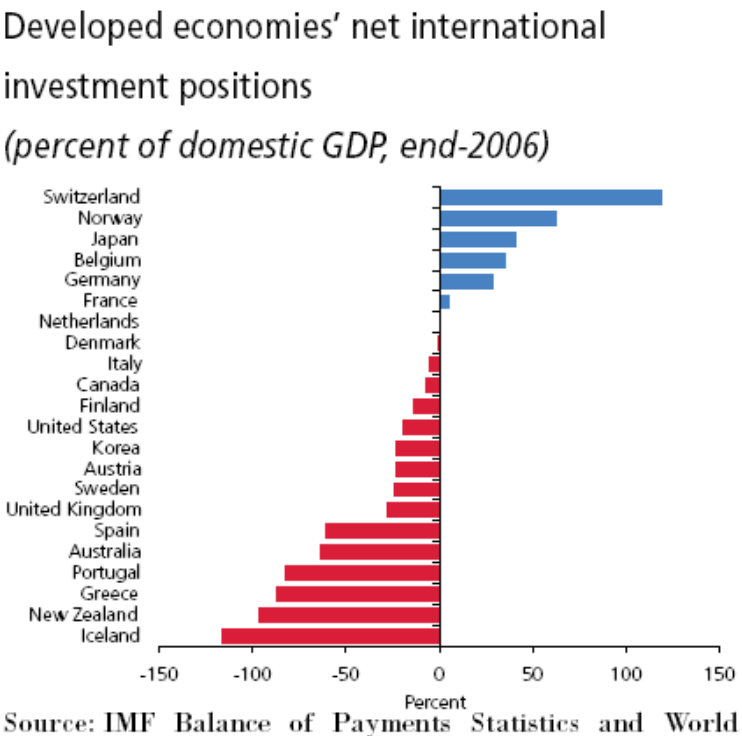


After peaking in 1986-87, Government debt began to drop out of the picture as the country's overseas indebtedness was privatised, along with (and to a considerable extent because of) the sale of state-owned assets. The decade of rising net debt from 1986 to 1996 in Chart 1 was driven mainly by foreign direct investment as overseas investors picked up the bargains tossed onto the table by privatisation with deregulation. By 1996-97 the New Zealand Government no longer owed any net debt in overseas currency, although its local-currency bonds continued to be bought and

held by overseas investors, and some public-sector agencies including the Reserve Bank hold foreign-currency assets, making the net position of the public sector somewhat murky.[8]

New Zealand's indebtedness is thus no longer (at least for the moment) a matter of Government finances. Yet this country is still one of the most highly indebted in the OECD. Chart 2, from a December 2008 Reserve Bank study[9], shows New Zealand ranked just above Iceland.

Chart 2



Source: IMF Balance of Payments Statistics and World Economic Outlook.

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8 Reconstructing reliable figures on the net public overseas debt is a considerable task which is not undertaken here. Chart 1 uses the net public external debt data from the Statistics New Zealand Infoshare website, which shows net public external debt as 3.5% of GDP at March 2008. This does not reconcile with the RBNZ statistical datasets, probably because it excludes government bonds "held for non-residents" by New Zealand-based agents. RBNZ Table D0 at http://www.rbnz.govt.nz/statistics/govfin/d0/hd0.xls indicates that at February 2009 there are still $15.5 billion of Government securities held "for non-residents" which may (but quite possibly does not – a matter for further resewarch) include the $9 billion held by identified non-residents in Table D2 at http://www.rbnz.govt.nz/statistics/govfin/d2/hd2.xls. This of course is still a gross figure; public-sector overseas assets (including those held on the RBNZ balance sheet) would have to be netted out to get the net public external debt. .

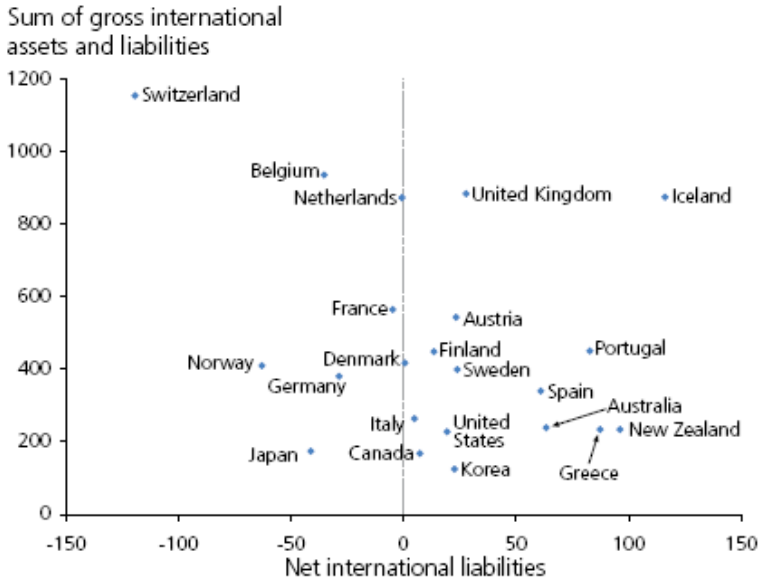
9 Paul Bedford, "The Global Financial Crisis and is Transmissions to New Zealand – An External Balance Sheet Analysis", *RBNZ Bulletin* December 2008 pp.18-29. The chart is from p.19.

Before concluding that New Zealand is another Iceland crisis in the making[10], it has to be noted that the net debt position is only half the story, because it is the difference between two much bigger numbers – gross assets and gross liabilities. Chart 3, also from the December 2008 Reserve Bank study, plots both dimensions (net debt and gross leverage) for the developed countries. It shows that New Zealand, Australia and Greece are heavily indebted in the net sense, but are not heavily leveraged – that is, the extent to which they have been drawn into globalised finance, and hence exposure to its crises, is limited, especially compared with Iceland where the sum of gross assets and liabilities was between 800 and 1000% of GDP.

Chart 3

Developed economies' net indebtedness and international financial leverage

(percent of domestic GDP, end-2006)



Note: Country sample as in figure 2, excluding extreme outliers Luxembourg and Ireland.

Source: IMF Balance of Payments Statistics and World Economic Outlook.

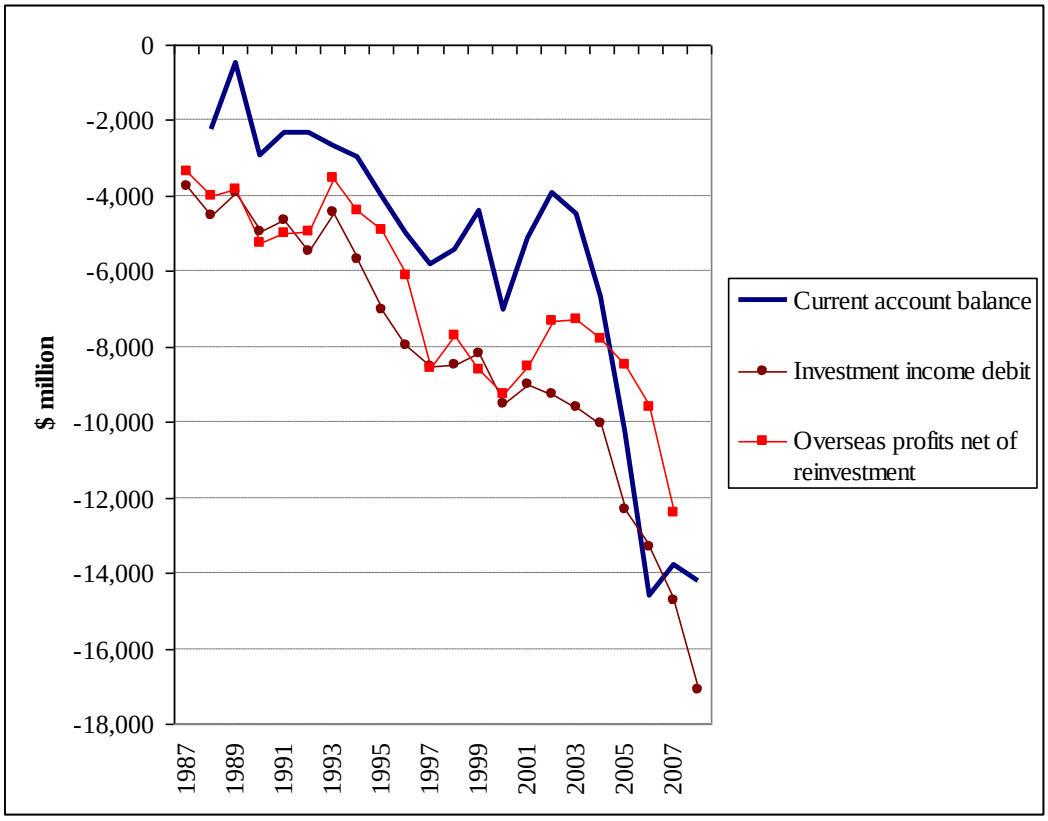
10 Michael Lewis, "Wall Street on the Tundra", *Vanity Fair* April 2009, http://www.vanityfair.com/politics/features/2009/04/iceland200904?printable=true&currentPage=all .

The banks and the current account of the balance of payments

What has been driving the debt up in the past two decades is a sort of pyramid scheme that New Zealand residents have been running with the rest of the world, with the banks as promoters and middlemen. The overseas debt grows each year by an amount equal to the current-account deficit on the country's balance of payments. That deficit is in turn almost exactly equal to the annual cost of servicing the outstanding debt; see Chart 4. Basically New Zealanders have been borrowing to pay the interest on past borrowings; or to put the same thing another way, once debt servicing has been looked after, households' living standards have been based on debt-funded consumption spending.

Chart 4

The Current Account Deficit, Investment Income Account Debits (gross and net) on the New Zealand Balance of Payments, and Debits Attributable to the Banks: March years 1987-2008



Sources: Statistics New Zealand, Tripe (2004) Table 2, David Tripe for updated data.

In the long run, such a process of borrowing to fund current consumption has to come to an end, as the growing stock of debt reaches the limit of what can sustainably be serviced. New Zealand home-owners may not yet have quite hit that ceiling, but they have been getting closer to it over the past decade as they borrowed against the rising market value of their houses. The downturn in house values as the bubble bursts is now eroding the security that underwrote the borrowing spree, and consumers have started cutting back their spending and raising their savings rate in order to strengthen their individual balance sheets. To the extent that this means less imports, the cut in consumption contributes to a much-needed rebalancing of the New Zealand macro-economy, which may eventually yield a trade surplus sufficient to service the country's debt without running up yet more debt. But falling consumption also translates to lower production and more unemployment in New Zealand.

The macroeconomic options for New Zealand now boil down to three: if the private sector does not continue to increase its overseas indebtedness, then either Government must return to borrowing offshore on a large scale, or the balance of payments current account deficit will have to be eliminated. The rest of this paper focuses on the private borrowing channel, where the Australian-owned banks have served as willing intermediaries and profited handsomely in the process. That party is now almost certainly over, but the hangover is just starting.

The past decade's growth of New Zealand's overseas debt has been driven by the banks. In 1988 the banks' net offshore debt (that is, their non-resident funding minus their claims on foreigners) was 12% of New Zealand's GDP and 19% of total net debt (C hart 1). By early 2008 this had risen to 54% of GDP and 62% of the total net debt. In June 2008 as the global financial meltdown got fully underway, the banks accounted for 72% of the country's total net indebtedness, on the Statistics New Zealand data for the international investment position, or (more correctly) 84% if we take account of the Australian banks' equity stakes in their New Zealand subsidiaries. (Table 1).

Table 1: New Zealand International Investment Position at June 2008, NZ$million

New Zealand's International Assets	
Equity assets	52,098
Lending	77,683
Banks	***21,723*** ←
General government	*8,976*
Monetary authorities	*20,210*
Other sectors	*26,774*
Total international assets	**129,780**
New Zealand's International Liabilities	
Equity liabilities	63,115
of which banks	*17,300* ←
Borrowing	225,858
Banks	***138,881*** ←
General government	*17,574*
Monetary authorities	*273*
Other sectors	*69,131*
Total international liabilities	**288,974**
New Zealand's Net International Asset Position	
Net position of the banks: lending only	**-117,158**
Net position of the banks including parents' equity in NZ subsidiaries	**-134,458**
Net international equity	**-11,018**
Net international debt	**-148,176**
Net international asset position	**-159,194**

Source: Statistics New Zealand, *Hot off the Press*; bank disclosure statements at www.rbnz.govt.nz

Who's who in the banking sector

There are basically three classes of financial institutions in New Zealand: the locally-incorporated banks which sit on the commanding heights, the finance companies that scavenge around their feet, and the local branches of overseas-incorporated banks. The 1980s and 1990s saw the rise of the five major banking groups to dominant status at the expense of finance companies, building societies and other informal arrangements. By the mid 1990s the major banks held over half of households' financial wealth, provided 70% of household credit and 80% of business credit, and accounted for over 85% of the assets of all deposit-taking institutions.[11]

The continued dominance of the major banks is clear in Table 2 which sets out figures for the nineteen registered banks operating in New Zealand in 2008. Seven of these are locally incorporated (which is a requirement in order to operate a retail banking business); the other twelve are branches of overseas banks engaged in wholesale lending and investment finance for large corporates. ANZ-National, ASB, Bank of New Zealand, and Westpac are locally-registered and their operations dominate the sector. Kiwibank, Rabobank, TSB and Southland Building Society are minor players in the retail sector with less than 2% of bank assets each.

Table 2: Registered Bank Data

	Assets NZ $billion	Net after-tax profit, 12 months to September 2008	% of total assets
New Zealand Incorporated		.	
ANZ National Bank Limited	122.9	1,163	34.3
ASB Bank Limited	62.9	485	17.6
Bank of New Zealand	64.2	785	17.9
Kiwibank Limited	8.2	35	2.3
Rabobank New Zealand Limited	5.5	34	1.5
Southland Building Society	*		
TSB Bank Limited	3.4	42	0.9
Westpac New Zealand Limited	52.3	559	14.6
Total	**319.4**	**3,103**	**89.2**

[11] Clive Thorp, "Financial Intermediation Beyond the Banks", *RBNZ Bulletin* 66(2): 18-28, p.18.

Overseas Incorporated			
Total assets after netting out locally-incorporated	**38.6**		**10.8**
Total, all registered banks	**358.0**	**3,874**	**100**

* Newly registered 2008.

Source: RBNZ http://www.rbnz.govt.nz/statistics/banksys/index.html

All five major banks operating in New Zealand are owned overseas, primarily in Australia. From the point of view of the Australian regulator - the Australian Prudential Regulation Authority (APRA) - they are "affiliates" of the parent banks for regulatory purposes, and the parents are restricted in the amount they are allowed to advance to their New Zealand subsidiaries by Australian Prudential Standard 222 section 32[12]. What this means in practice is that if the banks want to expand their lending to New Zealand households and firms beyond the amounts that other New Zealand households and firms are willing to deposit with the banks, then they can get funding from their Australian parents only up to the limit set by APS 222. Further expansion of lending then has to be funded from some other offshore source. That other source has been the offshore market for 90-day and similar commercial paper.

The Increasing Forex Exposure

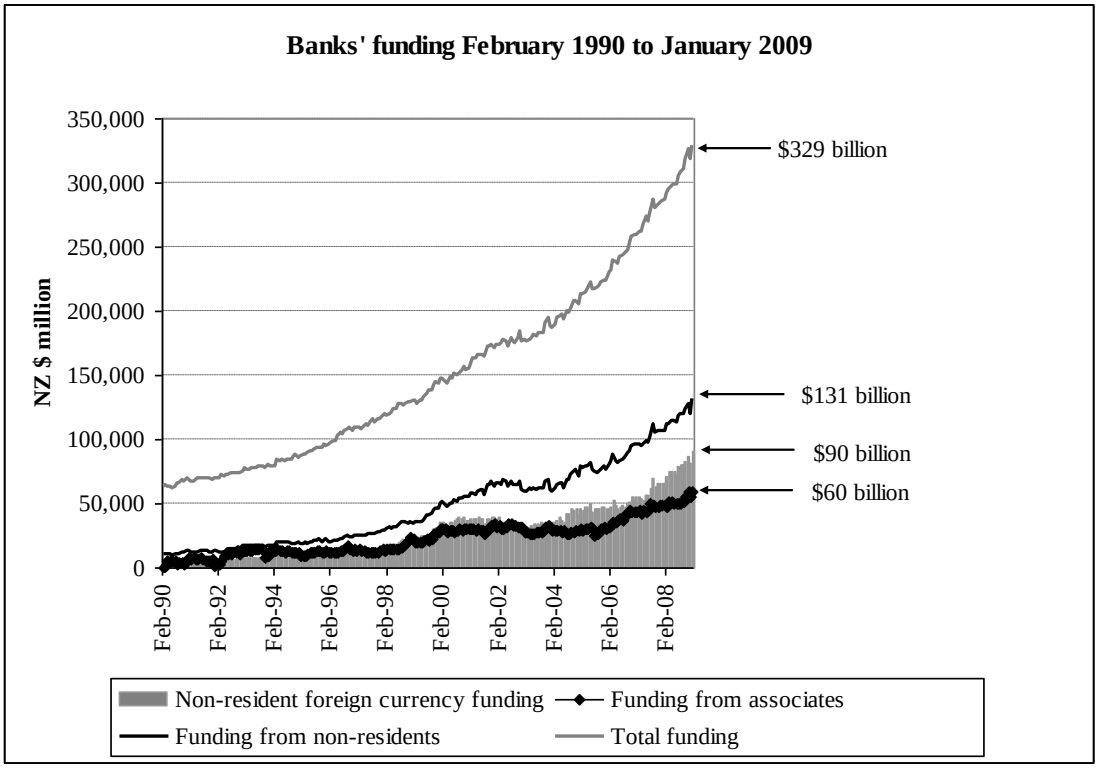
The bank lending surge since 2000 coincided with a period when global financial markets were overflowing with funds looking for willing borrowers. More and more of the funding liabilities on the banks' balance sheets therefore came to consist of overseas currency raised on the commercial paper markets in New York and London.

Chart 5 shows the changing structure of the banks' funding liabilities over the past two decades. At the end of January 2009 the total funding liabilities were $329 billion of which $131 billion, or 40%, was from offshore. Of this, $60 billion was from "associates" (basically, the parent banks in Australia) and $71 billion was from other offshore sources. $90 billion of the offshore funding was in foreign currency. The available statistics do not enable that foreign currency funding to be decomposed

12 http://www.apra.gov.au/ADI/upload/APS-222-January-2009.pdf

between associates and other offshore investors, but these figures do enable us to set the boundaries with reference to Chart 5. If all associates' funding is in foreign currencies, then the banks' direct exposure to the foreign money market is $30 billion. If all $60 billion of associates' funding were in New Zealand dollars then the exposure would be $90 billion, but Table 3 below indicates that there are only $39 billion of non-resident NZD liabilities, which means that associates' foreign-currency funding is not less than $20 billion and thus indicates a possible upper-bound figure of $70 billion for the exposure.

Chart 5



Source: RBNZ Table C4 http://www.rbnz.govt.nz/statistics/monfin/

To those who were worried about the resulting exposure of the New Zealand banking system to a contraction in that market, the comfortable answer was provided that all the foreign-exchange exposures were "fully hedged", which seemed to suggest that if one set of foreign currency loans matured and had to be repaid while new foreign loans were not available, the banks would simply raise NZD funding, convert it to foreign currency under the hedging arrangements, and pay off the loans. In other

words, so long as a supplier of NZD funds was in existence, the banks should be able to switch from foreign currency to local-currency funding for their local-currency loans.

In May 2008, the Reserve Bank of New Zealand set up a special facility to enable precisely this process to occur. The Bank stood willing to accept high-grade mortgage securities as collateral against an extension of NZD credit to the trading banks. The banks have possibly as much as $120 million worth of such mortgages on their books as assets, which would be more than enough to pay down their outstanding 90-day foreign-currency borrowings from the overseas markets. Insolvency is nowhere in sight: no toxic assets, adequate capital and reserves, virtually nothing on the balance sheet to show why with liquidity support from the Reserve Bank there is any possible problem the banks cannot deal with on their own.

I say "virtually nothing" because the consolidated balance sheet of the New Zealand banking sector in Table 3 below does have a conspicuous currency mismatch: about $80 billion more foreign currency liabilities than foreign currency assets.

A primer on fractional-reserve banking in an open economy

As financial intermediaries, banks are generically in the business of borrowing from one group at the lowest available interest rate, to lend to another at a higher interest rate. Usually the borrowing consists of taking deposits from a wide range of customers, and lending out the deposited funds at the higher rate. Deposit liabilities are generally shorter-term than the loan assets, which means that a typical bank always faces some risk that depositors may want to take their money out faster than the bank can recover funds from maturing loans. Banks therefore hold some reserves to cover against funding shortfalls; under normal circumstances these are typically well below 10% of total liabilities.

The simple textbook bank balance sheet thus contains four items which balance up:

Liabilities		Assets
Deposits		Loans
Capital		Liquid reserve assets
Total liabilities	=	Total assets

When a bank makes a loan, this appears as an asset in the bank's balance sheet, and the stream of interest payments on the loan is recorded by the bank as income from that asset. The funding for the loan is recorded as a liability in the balance sheet. This is all simple and straightforward when the bank is a locally-owned entity in a closed economy. Then all assets and liabilities are in the same currency, the capital and reserves backing up the operation are locally owned, and the regulatory authority and central bank (the issuer of local currency or "high powered money") are local.

In even this simple theoretical world, crisis for a bank can arise from two directions. On the liabilities side, a bank can face a run on deposits which it has to meet from its liquid reserves. If the reserves are inadequate and outstanding loans cannot be called in fast enough, then the bank faces a liquidity shortfall and will "fail" to pay its depositors. It may then have to be wound up, or placed in receivership until the value of its assets can be realised by sale or through the maturing of loans.

On the assets side, problems arise if loans turn bad – which can happen if, for example, the borrowers who use the funds to purchase real assets such as land, houses or productive equipment are subsequently unable to pay the interest, and at the same time the resale value of the real assets drops so that the loan amounts cannot be recovered by foreclosure. In this case the bank's deposit liabilities remain the same but the falling value of assets has to be matched on the balance sheet by a fall in capital, which represents the shareholders' equity in the bank. Beyond the point where capital is driven down to zero, the bank is insolvent in the sense that it has no long-run means of paying out its depositors, unless it can attract new capital with which to acquire more and better assets.

This distinction between illiquidity and insolvency is an important one in comparing the US banking problem with the situation in New Zealand. US banks and other

financial institutions, having engaged in sub-prime lending against the security of houses whose value has collapsed leading the borrowers to default on payments, are faced with insolvency unless some outside party (such as the US taxpayer) buys up enough of the toxic assets to restore the balance sheet at least to zero balance (in which case the shareholders' shares are worthless but deposit liabilities are covered). The New Zealand banks, however, have not engaged in lending beyond prudent limits, if by "prudent" we mean within the capacity of borrowers to meet the servicing costs under normal conditions. Until and unless house prices here drop 20-30%, most mortgage borrowers will still have positive equity; and so long as they have jobs and incomes, most of them will remain able to pay the costs of their debt. And besides, New Zealand home owners do not enjoy the ability of US residents to simply walk away from a mortgaged property and leave the lender to pick up the tab, and this is another factor contributing to the strength of the asset side of the banks' balance sheets here compared with the USA.

Now extend the analysis to an open economy where the bank takes deposits in foreign currency, converts the proceeds to local currency, and lends out the local currency. Obviously the bank will make a profit if the local currency gains in value against the foreign currency, and will lose if the exchange rate goes the other way. It makes obvious sense to protect against this by taking out a hedge contract which ensures that the balance sheet position can be unwound at a predetermined exchange rate. The hedging arrangements will be "off balance sheet", but they should ensure that there are no major risk exposures hidden from the reader of the balance sheet.

On and Off the Balance Sheet

Table 3 has the consolidated balance sheet for the New Zealand banks as a group. What is striking about these figures is the lack of any apparent basis for a sense of crisis sufficient to justify taxpayer resources being committed to wholesale deposit guarantees. On the September 2008 data, the banks held just over $300 billion of New Zealand dollar assets plus $60 billion of claims in foreign currency. Against this $360 billion of assets, they had nearly $220 billion of New Zealand dollar deposits and $22.5 billion of capital representing the shareholders' stake in the businesses.

Table 3

	Liabilities, capital and reserves	Aug-08	Sep-08		Assets	Aug-08	Sep-08
	NZ dollar funding				**NZ dollar claims**		
1	NZ resident	177.6	179.6		NZ resident (Non M3)	277.2	277.9
2	Non-resident	40.0	39.0		Non-resident	7.6	9.0
3	Total 1+2	**217.6**	**218.6**		Sub-total to here	***284.9***	***286.8***
					NZ resident (M3 institutions)	15.0	15.1
					Total	**299.9**	**302.0**
	Foreign currency funding				**Foreign currency claims**		
4	NZ resident	10.2	9.9		NZ resident	4.0	4.2
5	Non-resident (?all wholesale?)	80.1	80.7		Non-resident	11.6	6.6
6	Total 4+5	90.3	90.7		Total	**15.6**	**10.8**
7	Capital and reserves	22.6	22.5		Foreign currency fixed assets and equity investment	0.1	0.1
8	Other Liabilities	19.6	27.9		Shares in NZ companies	0.4	0.4
					Other Assets	**25.4**	**35.0**
					NZ Government bonds and Treasury bills	1.5	1.4
					NZ notes and coin	0.5	0.5
					Claims on the Reserve Bank	6.7	9.3
	Total liabilities	**350.1**	**359.6**		**Total assets**	**350.1**	**359.6**
	Memo items:				Memo items:		
9	funding from associates	50.7	50.4		financial claims on associates	7.1	6.6
#	total non-resident funding	120.1	119.7		total non-resident claims	19.2	15.6

None of these items present any problem at present; there is no burden of toxic assets and the local deposit funding is secure (and made more so by the retail deposit guarantee on deposits up to $1 million announced by the government on 12 October 2008). So far so good.

Of the remaining $120 billion of "foreign currency funding", $10 billion is owed to New Zealand residents and probably at least $10 billion of the "other liabilities" can safely be ignored. That leaves $100 billion of offshore liabilities, within which is (see

above) $30 billion-$70 billion of (mostly short-term) debt outstanding in New York, London, and possibly other international financial markets.

If, as has always been claimed, these liabilities are "fully hedged", the uninitiated might well suppose that somewhere out there are counterparties with a contractual obligation to provide the banks with all the foreign currency required to pay off the loans as they mature, at a pre-set exchange rate. If the banks can't roll over their loans as they expire, surely (the uninitiated[13] might think) they can pay them off simply by raising funds in New Zealand and using these to exercise the hedge contracts? Even $70 billion is far less than the amount available to the banks from the RBNZ under the latter's May 2008 mortgage-swap-window arrangement[14]. So if, in October 2008, the banks reported difficulty in rolling-over their 90-day commercial paper, the obvious response from Government would have been that they should turn to the RBNZ for liquidity and exercise their hedge contracts to exit their foreign currency exposures.

There would obviously be some interesting collateral effects – the RBNZ would have to issue a large tranche of new bonds to mop up the New Zealand dollars created; and the exchange rate of the New Zealand dollar would presumably take a hit (not necessary a catastrophic one, since a significant tranche of the country's overseas debt would be being eliminated along with a corresponding part of the current account deficit, so that forward-looking investors might well think the New Zealand economy's future looked much improved). But – and this is the central point – the problem would be resolved through the normal process of exercising commercial contracts freely entered into by the parties, with no involvement of the fiscal authorities. The banks' collective balance sheet would move from having a huge mismatch between foreign-currency liabilities and foreign-currency assets (with all

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13 Until I started the research for this paper, I was myself one of these simple souls.

14 A guess at outstanding residential mortgages is about $160 billion, of which up to $120 billion are "solid" in the sense that they represent less than 80% of the value of the respective properties. After the RBNZ has taken off a "haircut" on this, there should still be up to $100 billion of assets on the banks' books which can be converted to NZD liquidity by completing some administrative procedures with the RBNZ.

the attendant risks this involves) to a roughly balanced currency composition of assets and liabilities[15].

New Zealand Herald economics editor Brian Fallow pointed to precisely this mechanism in an article before the wholesale funding guarantee was introduced[16]:

> Extending a Government guarantee to banks' wholesale sources of funding makes sense only if it is the lesser evil of something very evil indeed.
>
> Its defenders insist the alternative is that a key source of funding dries up, which would require a savage contraction in the availability of credit to New Zealand households and businesses, and take the recession to a whole new level of pain.
>
> The overseas commercial paper markets, from which the banks derive on average … about a fifth of their funding, are frozen, posing an obvious problem for the banks when they need to roll over that borrowing…. No one really knows how long this market will remain dysfunctional.
>
> Ah yes, say the banks, but even when the market starts functioning again, New Zealand banks won't be able to compete for funding with issuers that have Government guarantees. Not even with their clean balance sheets and high credit ratings.
>
> Even if that turns out to be true, they have an alternative source of funding to tide them over.
>
> It's called the Reserve Bank, which has announced facilities to lend them money, on security, as the lender of last resort. There was no mention of this in John Key's "we've got to do this and we've got to do it fast" press conference on Sunday.
>
> There is a world of difference between guaranteeing the retail deposits of New Zealanders and guaranteeing wholesale funding extended by the very Northern Hemisphere banks whose disregard of risk has brought the world to this pass.

What was it, then, that made it impossible for the banks simply to use Reserve Bank advances to pay down their offshore debts? After all the hoopla about floating exchange rates and financial market globalisation, why did the much-hyped hedging arrangements not provide a hedge?

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15 As a Reserve Bank *Bulletin* article noted in December 2008, "Adverse valuation effects … can … be hedged by matching the currency composition of international assets and liabilities". (Bedford *op.cit.* p.20)

16 "Aussie Banks Hide While We Panic", *New Zealand Herald*, 21 October 2008.

Here we encounter a gaping hole in the New Zealand regulatory net, such as it is. The bank's hedges, it turns out, are not hedges at all in the normal sense of the word. The New Zealand banks did not protect their ability to repay their foreign-currency borrowings by taking out simple insurance contracts. They plunged into the arcane world of swaps and derivatives, far from any regulator's scrutiny and with only a bare flicker appearing on the information-disclosure screen. As Bedford describes it (emphasis added)[17],

> Heavy reliance on short-term international debt … entails substantial rollover risk. Although a remote possibility in normal circumstances, the recent financial market turmoil demonstrates that, in the event of an especially severe global financial shock, even a fundamentally creditworthy country may not be able to refinance maturing international debt at *any* price. The resulting net capital outflow would place downward pressure on the exchange rate and likely trigger significant economic disruption. It is critically important, therefore, to conduct rigorous analysis of the potential for rollover risks of this kind to crystallise and also develop contingency arrangements to cater for the effective closure of key international credit markets.
>
> [There are] a variety of channels through which instability in the international financial system can affect the external balance sheet and the net IIP – falling asset valuations, higher cost and/or reduced availability of international credit, and the impact of movements in the exchange rate. An effective hedging strategy can, in principle, offset the effect of the third of these channels…
>
> [New Zealand's] total stock of foreign-currency debt outstanding amounted to nearly 60 percent of GDP in the second quarter of 2008, with the banking sector accounting for a sizable fraction…. **Most of the associated exchange rate risk is hedged using financial derivatives. The annual hedging survey conducted by Statistics New Zealand indicates that, in March 2008, more than 80 percent of gross foreign-currency debt was hedged using derivatives**, with a further 11 percent hedged 'naturally' against assets or other receipts.
>
> The four largest New Zealand banks obtain offshore (debt) funding in two ways. First, as noted in section 3, they receive funds directly from their Australian parents, typically in the form of a 'loan' between the parent institution and its New Zealand subsidiary. Second, **the banks issue substantial quantities of debt securities in international credit markets. Although these securities could, in principle, be denominated in New Zealand dollars (NZD), in practice the banks have been able to achieve a lower overall cost of funding by issuing in US dollars or euros and subsequently swapping the proceeds into NZD. The counterparty to the swap transaction is typically a highly-rated supranational institution that has been able to use its strong credit standing to issue NZD-denominated bonds in, for example, the Japanese retail market (Drage *et al.*, 2005). The swap also ensures that the exchange rate risk associated with the banks' foreign-currency borrowing is hedged**.

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[17] Paul Bedford, "The Global Financial Crisis and is Transmissions to New Zealand – An External Balance Sheet Analysis", *RBNZ Bulletin* December 2008 pp.18-29, pp.21 , 23-24.

To translate: the banks got themselves into a critical situation in the commercial paper markets last October because they had been cutting their cost of offshore funding by doing complex off-balance-sheet swap deals that made them bigger profits than just borrowing New Zealand dollars up-front. This process, alas, involved taking on major exposures in foreign currency against which the banks failed to arrange protection for themselves. Hence their plea for the New Zealand taxpayer to ride to their rescue.

The point here is that it was cheaper to raise funds by the roundabout route precisely because the banks were taking on a large slab of extra risk, accepting a mismatch of maturity dates between the foreign-currency loans they raised and the counterpart transactions by which they swapped those loans into New Zealand dollars. The risk of the global financial market freezing up was a contingency against which the banks took out no protection. (Presumably they considered the contingency "too remote" to worry about, the same position now adopted by the New Zealand Treasury with regard to taxpayers' exposures.) When the markets actually did freeze up the banks' next move was clear and simple: the uncovered risk the banks had been taking a profit on was in fact a gun pointing at the head of the New Zealand economy and Government. The payoff from that leverage is the wholesale funding guarantee, which has shifted the banks' funding risk onto New Zealand taxpayers.

The detail

Foreign-exchange swaps are a way for two institutions to benefit mutually from their different borrowing power in different markets[18]. The "highly rated supranational institution" in Bedford's passage above might be, for example, the World Bank. Because it is bigger and has a more heavyweight profile in international markets, the World Bank can raise NZ dollar loans ("Eurokiwis) in offshore markets such as Japan at a lower interest rate than a New Zealand-based bank can do. At the same time the New Zealand bank can borrow US dollars in the New York or London market at

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[18] The description which follows is loosely based on Roger Bowden and Jennifer Zhu, *Kiwicap: An Introduction to New Zealand Capital Markets*, 2nd edition, Dunmore Press 2005, pp.210-213.

much the same interest rate as the World Bank. The World Bank needs US dollars and the New Zealand bank needs New Zealand dollars; the cheapest way for both of them to get what they need is for the World Bank to borrow the NZ dollars and the New Zealand bank to borrow the US dollars, following which they swap the loan proceeds by lending to each other at interest rates that share the overall gain due to the World Bank's ability to pay a lower interest rate on Eurokiwis. The World Bank ends up with US dollars at a rate below what it would have to pay if it went direct to the market for those dollars; and the New Zealand bank gets New Zealand dollars at an interest rate below what it would have to pay to borrow the money directly.

To this point there is no problem. The New Zealand bank's balance sheet shows its funding as a US dollar liability, and the separate deals by which those US dollars were converted into New Zealand currency, to be lent out domestically, are off-balance-sheet and out of sight. The shareholders (in Australia) are better off because funding costs are lower and so profits on the bank's lending business are higher than they would otherwise be. The World Bank is happy because its borrowing costs are also lower.

The problem is the maturity dates of the various deals. The New Zealand bank will borrow the US dollars for a 90-day term by issuing commercial paper, and so will have to roll over the loan every three months, while the World Bank wants long-term funding for its operations - say three years. Then the New Zealand bank has to be successful in rolling-over its US dollar debt (4x3)-1 = 11 times before the swap deal matures and the World Bank repays the US dollars. If the New Zealand bank faces a frozen market during the three-year term of its loan to the World Bank, it is stuck with a foreign currency exposure that it cannot meet on time.

This maturity mis-match is inherent in the procedure chosen by the New Zealand banks to fund the liabilities side of their balance sheets. The foreign currency to repay their borrowings will come to hand in due course – but not in time to cover an emergency such as September-October 2008. The NZ bank could deposit a slab of its mortgage assets with the Reserve Bank in exchange for NZ dollar funds, exchange these to US dollars on the open foreign exchange market, and pay off the maturing 90-day debts, but in the process it would drive the New Zealand dollar exchange rate

down against itself, and force the RBNZ to expand its balance sheet. The alternative is for the New Zealand Government to guarantee new offshore fund-raising in US dollars, roll over the maturing loans, and hope to hold the line through to the maturity date of the other side of the swap deal, at which point the originally-borrowed US dollars return to the bank and the overall position can be liquidated.

The bank can credibly threaten to restrict its domestic lending and trigger an economic contraction if it is forced to go the more costly route via the RBNZ discount window. In contrast, a Government guarantee can be made subject to various conditions regarding the bank's lending behaviour while the guarantee is in place, and can carry an impressive-looking price tag (since even a tiny percentage of huge gross amounts will look large). These essentially seem to have been the calculations behind the wholesale funding guarantee scheme announced on 1 November 2008, in the middle of the weekend before the General Election.

To evaluate the contingent liability for taxpayers, one has to envisage two possible states of the world economy. In one scenario, the October 2008 meltdown was a one-off event never to be repeated; the wholesale guarantee was therefore merely a confidence-booster while the banks got their funding back on track, and the outcome would be that the banks would make it through to the maturity dates of their swap contracts while the Government collected its fees. By taking that view, the Government would be gambling on the global crisis being shortlived.

In the alternative scenario, financial crisis is persistent and recurrent, and the effect of a wholesale funding guarantee is that New Zealand taxpayers carry substantial risks on behalf of the banks' Australian owners. The whole house of cards could come down before the swap contracts mature, leaving the New Zealand Government forced to go offshore to borrow foreign currency to meet its guarantee obligations. The privatisation of the overseas debt that was such a striking feature of the 1985-1995 period would be rapidly reversed and New Zealand would be back to heavy sovereign indebtedness. The only comfort to be taken would be that the Reserve Bank might well put statutory managers into the defaulting banks to seek to recover the taxpayers' losses – but partial or full nationalisation of foreign-owned banks is a very different matter from the same action applied to a domestically-owned institution.

Which scenario was the New Zealand Government gambling on when it committed taxpayers to underwrite the banks' funding? The answer is to be found in the notes to the December 2008 Crown Financial Statements, page 32 note 20:

> As the likelihood that the guarantees will be called is considered remote, they do not meet the definition of a contingent liability and is [sic] therefore excluded from the statement of contingent liabilities and assets on page 23.

The note went on to state that retail deposits in 64 institutions, totalling $126 billion, had been guaranteed by 31 December 2008, but that no wholesale securities had yet been guaranteed.

By March 2009, Treasury's note 20 to the Crown financial statements had been subtly modified[19]:

> The likelihood that the guarantees will be called is considered remote. Therefore they do not meet the definition of a contingent liability and are excluded from the statement of contingent liabilities and assets on page 23. However if a guarantee is not considered remote a provision will be made for any potential loss in these financial statements.

Before the ink was dry on this statement, Mascot Finance Ltd went into receivership owing debenture-holders $70 million for which taxpayers are now liable.[20] Treasury acknowledged "there may well be others". So much for the "remoteness" of the risk on the retail deposit guarantee.

What then of the wholesale funding guarantee on foreign currency borrowings? By February 2009 three of the major banks – BNZ, ANZ-National, and Westpac – had signed up for the scheme[21]. By early March the BNZ had secured actual guarantees on US $280 million of new borrowings.[22] The global financial situation remained extremely weak, and the maturity profiles of the banks' funding had shortened

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19 http://www.treasury.govt.nz/government/financialstatements/monthend/pdfs/fsgnz-7mths-jan09.pdf p.30.

20 http://www.treasury.govt.nz/economy/guarantee/pdfs/dgs-notice-mascot-ind-v2.pdf , and Adam Bennett,"Treasury 'had no idea' of Mascot Finance's woes", *New Zealand Herald* 3 March 2009.

21 http://www.treasury.govt.nz/economy/guarantee/pdfs/wfgf-anz-deed-v2.pdf , http://www.treasury.govt.nz/economy/guarantee/pdfs/wfgf-bnz-deed-v2.pdf, http://www.treasury.govt.nz/economy/guarantee/pdfs/wfgf-west-deed.pdf .

22 http://www.treasury.govt.nz/economy/guarantee/pdfs/wfec-bnz-2b.pdf and http://www.treasury.govt.nz/economy/guarantee/pdfs/wfec-bnz-2c.pdf .

substantially as they rolled over debt on less and less favourable terms. The likelihood of a wholesale guarantee being called gets less remote by the month.

Privatise the gains, socialise the losses

A tendency to socialise the banking system's losses and risks, while leaving their managements unscathed and shareholders protected as much as possible, has been a common theme across the major western economies in the past six months. In the USA, hundreds of billions of dollars of tax funds raised from the mass of the population have been channelled into bailouts for the rich, the insiders, and the "too big to fail". In New Zealand's case the process was more subtle, involved a different part of the banks' balance sheets, and confronted taxpayers with a contingent liability rather than a direct call on their cash. So both the problem and the policy response are different in New Zealand (and Australia) from what has been happening (and featuring in the media) in other developed economies.

An increasingly common complaint about the bank bailouts in the USA is that public money is handed over to private organisations to manage, without enough safeguards and without sufficient constraints on the subsequent behaviour of the "insider" bank managements regarding what they do with the funds.

In the New Zealand case the issue is not that taxpayer cash has been handed over. It is that taxpayers have given the banks an underwriting guarantee with few apparent safeguards, and with no apparent conditions placed on how the banks are to use the guarantee to restructure their balance sheets over the period while the guarantee lasts. The opportunity seems to exist to bring the country's overseas debt down sharply, and in the process to move towards solving the current-account deficit problem that has plagued the economy for decades, by cutting net investment income debits as debt servicing costs associated with the banks' balance-sheet liabilities become payable domestically in New Zealand dollars, rather than offshore in foreign currency. The currency mismatch on the banks' balance sheet looks an obvious target for policy.

But having kept the Australian shareholders safe, the representatives of the New Zealand taxpayer seem to have no desire to influence the future evolution of banking

in this country. Treasury is content to collect fees on the guarantees and to impose prudential safeguards. The Reserve Bank insists that the guarantees are fiscal policy and so not its business (let alone its responsibility). No other Government agency seems interested (though the Auditor General might care to check out the Treasury's view on the contingent liabilities associated with deposit guarantees).

It's time for more robust public debate about how a major bank failure that triggered a guarantee would play out under the Public Finance Act. The Reserve Bank would have power to put in a statutory manager and to keep the bank trading, but actual nationalisation of a major bank (effectively removing it from the control of its parent), which might be the appropriate course of action, would require political will and decisiveness, potentially in the face of a full-scale confrontation with Australia. If the New Zealand Government has a contingency plan, it would be reassuring to know about it. If it is relying on Treasury advice that there is no contingent liability, a wake-up call may be in order.