New Zealand government bails out collapsed finance company

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New Zealand's second biggest nonbank finance company, South Canterbury Finance (SCF), was placed in receivership on August 30. The private company, which is based on the country's South Island, told the New Zealand Stock Exchange it had been unable to complete a recapitalisation to meet its financial obligations.

Despite the failure, investors' money, including premium interest at about 8.4 percent, is protected under a government-backed retail deposit guarantee. The conservative National Party-led government took less than 24 hours to announce it would commit $NZ1.6 billion to ensure that all 35,000 depositors and stockholders were repaid "in an orderly and prompt manner". The opposition Labour Party endorsed the move.

About $600 million—a third of SFC's loan book—is tied up in "toxic" loans which the guarantee will also cover. Finance Minister Bill English said the government was moving to quickly pay depositors, "minimise costs to taxpayers" and "ensure minimum disruption to the wider economy". It is the country's costliest publicly-funded bailout, dwarfing the $600 million Bank of New Zealand rescue in 1990. According to economist Rod Oram, the package amounts to more than 1.3 percent of GDP and exceeds the net growth of the New Zealand economy over the past three years.

SCF, which touted itself as a solid "heartland" financier for South Island rural businesses, lent more than $100 million to a hotel redevelopment, luxury townhouses and bars in Auckland, and to property developers in Queenstown unable to find alternative funding. Its dubious property deals extended to Australia and Fiji. There was also $300 million in impaired related-party loans to other companies belonging to SCF owner Alan Hubbard, reputedly the South Island's richest individual. Hubbard's business affairs have been under statutory management and Serious Fraud Office investigation since June.

Nearly 50 finance companies have collapsed in New Zealand since 2006, with accumulated losses of $NZ6 billion. SCF will be the eighth company to trigger the guarantee scheme, which has now absorbed $247.5 million of public money. At present the guarantee protects deposits up to $1 million per investor, but this is about to be reduced to $250,000.

The guarantee was put in place by the previous Labour government, with the National Party's backing, in the midst of the October 2008 elections and the global financial crisis. Billed as a "temporary" provision, it was introduced to stop a run on New Zealand banks and finance companies following the Australian government's introduction of a guarantee for its banks. The scheme was due to end next month, but the government has extended it for "approved" companies through to the end of next year.

While SCF investors are assured of their money, those involved in the majority of the finance company collapses have got nothing. Up to 100,000 bankrupted small investors include many elderly people whose life savings and retirement income have evaporated.

SCF chief executive Sandy Maier admitted that signing up to the guarantee scheme had allowed the company to aggressively pursue high-risk investments. Investors were offered high returns with the assurance that they would get their money back whatever happened. According to the economist Oram, the guarantee saw money "pour in" to SCF, as the company became ever more "reckless".

The National government knew exactly what was going on, but did nothing to stop it. Speaking on Radio NZ, Finance Minister English admitted that government advisors had been involved with SCF for 12 months. Questioned about the propriety of letting the impending disaster run its course, English dismissively declared that this was always a possible consequence of the guarantee. According to the *NZ Herald's* business editor, Liam Dann, the government had "rushed" SCF into the safety of the scheme earlier this year precisely because it knew "it was a goner without the guarantee". Six weeks later, Standard & Poors downgraded SCF's credit rating to a level that would have made it ineligible to join.

Previous company failures have involved fraud, criminality and corruption. So far, 29 directors have faced charges covering $2 billion in investors' funds. Seven companies have been pursued by the Securities Commission or the Serious Fraud Office. Last month, directors of Five Star appeared in an Auckland court to face more than 100 Crimes Act charges involving related-party lending, breaching the company's trust deed and dishonestly using documents.

In testimony to the Parliamentary Commerce Committee in 2009, the Registrar of Companies, Neville Harris, issued a scathing criticism of the finance companies, auditors who acted in league with them and regulators who failed to provide adequate oversight. Harris noted that nearly all the companies had engaged in the practice of rolling-up non-performing loans into new ones, including the original principal and principal/interest arrears, thereby masking their true performance. According to Harris, "a number of the failed finance companies were…acting in a similar manner to a Ponzi schemes"—using money from new investors to repay maturing loans of existing investors.

Prior to the SCF collapse, the 82-year-old Hubbard enjoyed a reputation for personal reliability, stability and frugal dealings in the Canterbury region, where his companies were a financial backbone. Unlike other financiers, he was not given to ostentatious displays of personal wealth. When the government instigated statutory management proceedings in June, hundreds of residents in the provincial centre of Timaru marched through the town to demonstrate support for him.

However, irregularities are now surfacing. Financial commentator Bernard Hickey noted in the *NZ Herald* that Hubbard had failed to declare that the Bank of New Zealand had summarily pulled its funding line in mid-2009, and accountants Ernst and Young had overvalued SCF assets by at least $43.7 million in accounts prepared in 2008-9. A 2009 equity injection had been misrepresented as "fresh money" when it was "nothing more than a merry-go round of assets for shares".

Whatever the immediate causes of the SCF collapse, its rise and fall is intimately bound up with international processes centred on the vast expansion of fictitious capital. New Zealand finance companies, which number over 200, prospered like their international counterparts during the first half of the decade amid the turn globally toward financial parasitism and the booming property bubble.

These corporations took advantage of market deregulation and an influx of overseas loan money to establish a significant presence, supplying loans to consumers, small and medium enterprises and development projects that the major banks were unprepared to support. According to a recent Massey University research paper, "Examination of NZ Finance Company Failures; the Role of Corporate Governance," they typically raised funds from the public, taking deposits in the form of fixed-term loans for one to three years, secured by a general charge over the assets of the firm and attracting investors by offering interest rates higher than those of the banks.

The expansion was rapid. Total assets of large finance companies rose from less than $2 billion in 1998 to a peak of $9 billion in 2007. Many over-extended themselves. When Capital and Merchant Finance collapsed in 2007, it had a debt-equity ratio of 17.7. At that time, the industry considered the "safe" figure to be six. SCF was part of the explosion of riskier investments, unbridled credit expansion and insatiable demands for investor returns. In 2000, the company had $400 million in assets, but nine years later this had multiplied by 450 percent.

The edifice began to unravel in 2006 with three firms active in the financing of used cars—National Finance, Provincial Finance and Western Bay—forced into receivership. As New Zealand entered recession in 2007, four more were placed in receivership. By the end of that year, the situation had deteriorated with 20 percent of total finance company deposits at risk. With the onset of the global financial crisis in 2008, the number of failed finance companies sharply rose to 48, with over $6 billion in depositors' funds at risk and many other companies facing substantial liquidity problems.

For all the claims about an economic recovery, the SCF failure shows that the deck of cards is continuing to tumble. Meanwhile, attacks on jobs, wages and living standards are being ratcheted up to pay for the crisis and bailouts. Prime Minister Key and Finance Minister English stressed last week that teachers and hospital workers who are involved in industrial action over contract disputes will be expected to settle for paltry pay increases this year. Attacking a recent vote by teachers to strike for a day on September 15, Wellington's *Dominion Post* intoned in a recent editorial that the teachers needed to appreciate that the "cupboard is bare".