The Treasury

South Canterbury Finance Limited Information Release

Release Document

April 2011

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Key to sections of the Official Information Act 1982 under which information has been withheld.

Certain information in this document has been withheld under one or more of the following sections of the Official Information Act, as applicable:

[1] 9(2)(a) - to protect the privacy of natural persons, including deceased people

[2] 9(2)(b)(i) - to protect trade secrets

[3] 9(2)(b)(ii) - to avoid unreasonable prejudice to the commercial position of the person who supplied the information or who is the subject of the information

[4] 9(2)(ba) - to protect information that is subject to an obligation of confidence, or that was or could be provided under legal compulsion, where making the information available would be likely to prejudice the supply of similar information and it is in the public interest for that information to continue to be supplied

[5] 9(2)(d) - to avoid prejudice to the substantial economic interests of New Zealand

[6] 9(2)(g)(i) - to maintain the effective conduct of public affairs through the free and frank expression of opinions

[7] 9(2)(h) - to maintain legal professional privilege

[8] 9(2)(i) - to enable the Crown to carry out commercial activities without disadvantage or prejudice.

Where information has been withheld, a numbered reference to the applicable section of the Official Information Act has been made, as listed above. For example, an [8] appearing where information has been withheld in a release document refers to section 9(2)(i).

In preparing this Information Release, the Treasury has considered the public interest considerations in section 9(1) of the Official Information Act.

HOW THE NUMBERS STACK UP

SCF

- Inspector's initial report almost complete (final available Monday 17th). Primary purpose was for provisioning. Likely to be best information on firm up to 14 August but still some areas where not able to assess the potential liabilities
- Downgraded to non investment grade (BB+ (Negative outlook) by S&P yesterday
- Management team in two camps – some acknowledgement of a significant problem (but probably not how significant); optimists/denial
- Historically very poor governance around lending. Inspectors and others see this as a significant problem
- Big South Island player

The numbers:

Liabilities	Total $m	Total %	
Guaranteed Deposits	$ 1,876	88%	~ 30,000 - 40,000 depositors
USPP	$ 125	6%	
Other	$ 127	6%	
Total	$ 2,128	100%	
Equity (prior to 30 June 2009 final provisions)	$ 234		

Loans	Total $m	Total %	KM Impaired $m	KM At Risk $m	Total Impaired or at risk $m	Total Impaired or at risk %	Not at risk or impaired $m
Business	$ 555	33%	$ 44	$ 74	$ 118	21%	$ 437
Property	$ 542	32%	$ 202	$ 149	$ 351	65%	$ 191
Rural	$ 153	9%	$ 40	$ 9	$ 49	32%	$ 104
Other							
Plant & Equipment	$ 260	15%					
Consumer	$ 76	4%	$ 26	$ -	$ 26	6%	$ 414
Southbury (related)	$ 104	6%					
Total	$ 1,690	100%	$ 312	$ 232	$ 544	32%	$ 1,146

Other Assets	Total $m	
Shares and Investments	(KM have not yet completed their review of these assets)	
Inv in Subs and Associates	$ 51	
South Island Farms (69% shareholding)	$ 86	A similar question (as below) may arise in respect of these shares
Dairy Holding (35% shareholding)	$ 76	RB analysis has questioned the value of these share o/a soft prices for dairy farms
Listed Bonds and Shares	$ 112	
Unlisted Shares	$ 6	
Total	$ 331	

- On a going concern basis and before impairment / fair value adjustments in regard to SCF's share and investment assets, KM estimate that additional lending provisions between $100 - $170m are required. The effect of that would be to reduce net equity from $234m to between $134m - $64m.

- Any further adjustments in regard to shares and investments could push the lower end of that range to $0 or result in negative equity.

Expected Loss

- The Crowns expected loss in the event of default has been assessed using the $464m ELGD calculated by the RBNZ (using standardised "haircuts" to calculate expected loan realisations net of realisation costs) plus:
  - our assessment of a reasonable level of impairment charges based on the KM report, being $158m.
  - The expected cost of post acceleration interest, being $66m

- The result is a total expected cost to the Crown of $688m (assuming the $48m tax assets is recoverable)

Comments

- The estimated cost of post acceleration interest is a real cost to the Crown that is avoidable if receivership / SM can be avoided

- Guaranteed deposits account for ~93% of SCF's liabilities:
  - The Crown therefore already has an effective "equity risk" on realisation as 93% of any shortfall on realisation in excess of shareholders funds will be bourne by the Crown

Nexus around SCF

- Four main parties (Hubbard, Southbury, [3] SCF). Of these only one in addition to SCF that we have any visibility into – [3]

Page 3 deleted: [3]

[3]

Crown ELGD and Provisioning against the Guarantee across all Gauranteed Entities

- As at 30 June, Treasury have reviewed the likelihood of default for all guaranteed entities and have determined 6 entities (including SCF and [3] have a probably of default > 50%
- As a result it has been necessary to make specific provision in the Crown accounts for the $1,033m of expected losses
- We have also made a portfolio provision of $23m for potential losses associated with remaining entities in the scheme.
- The provisioning has been undertaken assuming no extension to the current guarantee however even with extension, we are of the view that any reduction in the level of proposed provisioning would be neglible.

Extension of the retail deposit guarantee

- Knife edge call but favoured extension on basis that this would allow tidy workout
- Workout now more likely to occur before October 2010, so benefits of extension highly unlikely to be gained. Crown may look to be assessing risk poorly through extension given likely events
- Extension will not make any difference to SCF's situation

SCF OPTIONS

- Let go: receivership and payout
  - economically sound decision but significant fiscal cost
  - gross liability (payout to depositors) of 1.9bn, net loss after recoveries - ~$700m plus – may be higher depending on asset quality, actions of prior security holders and speed of realisation
  - slower realisation may significantly reduce losses e.g. from ~$700m plus to perhaps ~$200m if woked out over 5 – 10 years
  - could consider some sort of asset management facility to mitigate losses through fire sales of assets but a call on that would not be required immediately.
  - would weaken others in the nexus and potentially overall confidence in finance companies. (re-investment rates / new deposit flows have already declined across the sector)
- Statutory Management – payout
  - “normal” solution
  - gross liability (payout to depositors) of 1.9bn, net loss after recoveries - ~$700m plus – may be higher depending on asset quality, actions of prior security holders and speed of realisation
  - slower realisation may significantly reduce losses e.g. from ~$700m plus to perhaps ~$200m if woked out over 5 – 10 years
  - some control over workout process and / or take a longer term view on recovery but would be constained somewhat by other creditors in the mix
  - balancing that is the ongoing fiscal cost associated with funding workout assets over a longer time frame
  - could again consider some sort of asset management facility to mitigate losses through fire sales of assets but a call on that would not be required immediately
  - could look at options to buy out other creditors to be the only interest.
  - can cover other entities in the nexus and let the healthy bits go relatively quickly.
- Ownership interest – inject equity.
  - potential significant subsidy to existing shareholders (cf guarantee scheme protected eligible depositors but not the company / shareholders)
  - may cost $250 - $400m,
  - establishing appropriate governance could be much more difficult with existing shareholders still in the frame – governance is slowly improving but significant change still required
  - Crowns’ risk not ring fenced – company still trading and lending and possible that Crown could face a larger loss in future (considered unlikely but a risk nonetheless).
  - avoids payout immediately but low / no new deposits / re-investment rates could see the Crown eventually funding the entire business
  - Could still end up on SM and for payout
  - *Least desirable of all solutions*
- Own – control
  - Purchase existing shares at nominal consideration - $1
  - Would need to inject additional equity potentially in the range of $250 - $400m

- Would not need to payout immediately but low / no new deposits / re-investment rates could see the Crown eventually funding the entire business
- Would need to complete due diligence, but not necessarily in relation to the loan book as the Crown is already carrying ~90+% of the “equity” risk
- Overcomes issues associated with a longer term workout of problem loans / conflict with rights of other creditors under SM or receivership in that regard
- Need to replace parts of management and insert own team
- There are risks associated with Crown ownership