

The Treasury

South Canterbury Finance Limited Information Release

Release Document

April 2011

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- [1] 9(2)(a) - to protect the privacy of natural persons, including deceased people
- [2] 9(2)(b)(i) - to protect trade secrets
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In preparing this Information Release, the Treasury has considered the public interest considerations in section 9(1) of the Official Information Act.

Treasury Report: Retail Deposit Guarantee - South Canterbury Finance (SCF)

Date:	28 August 2009	Report No:	T2009/2028
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Action Sought

	Action Sought	Deadline
Minister of Finance (Hon Bill English)	<p>Note that the situation in relation to SCF has recently changed, raising questions about the status of their letter to you, the Advisory Board that was established to oversee restructuring and our contacts within SCF.</p> <p>Note that you may receive a letter today clarifying the present situation from SCF.</p> <p>Note that over the past week, options have been further explored and we are not proposing any Government support by way of guarantee or equity injection into SCF.</p>	31 August 2009

Contact for Telephone Discussion (if required)

Name	Position	Telephone	1st Contact
Brian McCulloch	Director	[1]	
Joanna Gordon	Manager		✓

Minister of Finance's Office Actions (if required)

Please refer a copy of this report to the Prime Minister and the Minister of Commerce.

Enclosure: Yes

Treasury Report: Retail Deposit Guarantee - South Canterbury Finance (SCF)

Executive Summary

South Canterbury Finance (SCF) had written to you seeking Crown assistance to enable it to secure needed capital.

However, we were advised yesterday afternoon (27 August 2009) that two SCF directors have resigned:

- Stuart Natrass – Independent Director. Mr Natrass sent the letter to you on behalf of SCF. As such, the status of the request from SCF is now unclear and we are seeking to have it clarified; and
- Robert White – Director.

We also understand that SCF is seeking alternative advice and exploring other avenues to raise equity for SCF than has been the case over the past week. We also understand that Forsyth Barr are now advising on restructuring, which raises the question as to the status of our previous interlocutors on this – Cameron Partners - and we have been contacted by [1] of Harnos Horton Lusk (Auckland), [1], in relation to SCF matters. In addition to Treasury needing to establish new contacts on key issues with SCF, these changes also raise questions about the status of the Advisory Board that was established to investigate restructuring options in SCF.

At this point, we are seeking to clarify the status of the SCF letter to you and also to establish our new contact points within SCF and their agents, including clarification of the status of the Advisory Board investigating restructuring options. Contact with Cameron Partners today has confirmed they have an ongoing role in SCF's equity raising plans. We have requested that SCF write to you and Treasury to outline SCF's present position. This letter may reach you today.

Until the SCF situation is clarified, we are unable to advise on any specific proposals that have come from SCF. Our expectation is that these recent changes are unlikely to change the underlying issues within SCF. However, we will need to understand any new proposals being put forward and the extent to which that might change the assessment of regulators (Companies' Office, Security Commission) and how any changes might affect the risks to the Crown.

We have undertaken considerable work over the past week to explore options in relation to SCF. While putting any response to the SCF letter on hold for the time being, this report updates you on progress on these options and our assessment of the approach the SCF had made, for your information.

The four basic options for the Crown are:

- Take no action and let the entity run on, probably into receivership;
- Initiate statutory management before the point of receivership is reached;
- Provide government support; or
- Some level of Crown equity injection.

We recommend against offering the government support to SCF in the form of a guarantee or equity injection. This would effectively give a guarantee to US lenders ahead of other creditors and does not ensure that the entity will not ultimately fail anyway, with the guarantee being called. We are not confident in the success of current equity raising plans. A letter of response to SCF was drafted for your consideration.

We also recommend against proposing a Crown equity injection. This is because the outcome for the Crown is likely to be worse than the alternative of statutory management. In addition to the uncertainty around the real extent to the funds that would be required to stabilize the company (our current estimates are just that and in no way reflect due diligence, which would take some time), the equity injection is unlikely to be able to have sufficient controls attached to it for prudent use of taxpayer funds without also potentially triggering action by the Trustee (who is required to ensure that all creditors are treated equally), and the relationship with the company and its management is likely to be extremely difficult, which yesterday's events would tend to support.

Absent government support or a Crown equity injection, we expect that SCF will continue to try to find a private sector solution. If this fails, they might come back to the Crown again. Given the recent events, it is more likely that you or the Prime Minister could be approached directly by SCF (directly or via their new agents) for support.

Both receivership and statutory management will result in the guarantee being called, requiring a Crown pay out to depositors in the region of \$1,800m (plus a further amount of around \$90m for payment of interest on acceleration). Receivership would see recoveries of \$800m to \$1,000m over about 2 years (net cost \$900m-\$1000m). Statutory management might see recoveries of \$1,000m to \$1,300m (net cost of \$500m-\$900m), but probably over a longer time period, which allows a more cautious approach to asset realization. We stress that these estimates are very much broad-brush at this stage, based on analysis carried out so far by our investigator.

The Registrar of Companies and the Securities Commission are aware of developments in this matter. In the event that statutory management were to be considered, it should be noted that a corporation is placed into statutory management by an Order in Council made by the Governor General on the advice of the Minister of Commerce (Hon Simon Power), on the recommendation of the Securities Commission.

Communications

The communication from SCF was endorsed "Strictly Private and Confidential". We recommend no publicity on this issue at this stage. All these matters are commercially sensitive and we would also remind you of the need to pay attention to Securities Markets Act obligations in dealing with this matter.

Recommended Action

We recommend that you:

- a **note** that events yesterday (27 August 2009) have raised questions about the status of the SCF letter to you, the Advisory Board that had been established to restructure SCF and will require Treasury to establish new contacts with SCF;

Agree/disagree.

- b while based on an approach whose status is now unclear, **agree** not to propose a Crown equity injection in South Canterbury Finance;

Agree/disagree.

- c **refer** a copy of this report to the Minister of Commerce (Hon Simon Power);

Agree/disagree.

- d **refer** a copy of this report to the Prime Minister.

Agree/disagree.

Joanna Gordon

**Manager, Financial Markets and Institutions, Economic Performance Group
for Secretary to the Treasury**

Hon Bill English
Minister of Finance

Treasury Report: Retail Deposit Guarantee - South Canterbury Finance

Purpose of Report

1. This report provides:
 - an update on the current situation with South Canterbury Finance (SCF); and
 - an assessment of options for the Crown looking forward.
2. We will let you know when we have clarified the outcome of recent developments as they become available.

Current Situation

3. The current situation is:
 - SCF is one of the larger finance companies and, despite its recent credit downgrade; it has been generally well regarded for its management. Nonetheless, its loan book has deteriorated substantially over the past year, is illiquid, and lacks profitability looking forward. Based on the discussions we have had and the results from our investigator, we view the difficulties ahead more seriously than the board currently seems to.
 - SCF is in negotiation with a prospective capital provider to inject maybe \$100m. This might be finalised around September 7th. We view this as a first step in a long process of recapitalisation and restructuring.
 - Capital raising depends on US private placement lenders (US\$100m) not exercising their option to require repayment in mid-November (which arose because of the recent credit downgrade). There are five individual investors, each of whom can act independently to require repayment of their own investment. In the event of SCF failing, they would rank alongside other creditors.
 - Yesterday afternoon (27 August 2009), were advised that two SCF directors have resigned:
 - Stuart Natrass – Independent Director. Mr Natrass sent the letter to you on behalf of SCF. As such, the status of the request from SCF is now unclear and we are seeking to have it clarified; and
 - Robert White – Director.
 - We also understand that SCF is seeking alternative advice and exploring other avenues to raise equity for SCF than has been the case over the past week. We also understand that Forsyth Barr are now advising on restructuring, which raises the question as to the status of our previous interlocutors on this – Cameron Partners - and we have been contacted by [1] of Harnos Horton Lusk (Auckland), [1] in relation to SCF matters. In addition to Treasury needing to establish new contacts on key issues with SCF, these changes also raise questions about the status of the Advisory Board that was established to investigate restructuring options in SCF.

- SCF had written to you seeking:
 - Crown assistance to ensure that the US private placement option is not called and;
 - extension of the deposit guarantee scheme (which has now been announced since they wrote the letter).
 - At this point, we are seeking to clarify the status of the SCF letter to you and also to establish our new contact points within SCF and their agents, including clarification of the status of the Advisory Board investigating restructuring options. Until this occurs, we are unable to advise on any specific proposals that have come from SCF. Our expectation is that these recent changes are unlikely to change the underlying issues within SCF. However, we will need to understand any new proposals being put forward and the extent to which that might change the assessment of regulators (Companies' Office, Security Commission) and how any changes might affect the risks to the Crown.
 - As previously advised, a key checkpoint is Friday August 28th, when SCF is required to make announcements of its financial results to the NZX.
4. During the course of this week, we have had discussions with the SCF board and management, their advisers (Cameron Partners and Deloitte), bankers (BNZ) and trustee (Trustees Executors Limited), as well as the prospective capital provider. In addition, we have an investigator (Korda Mentha) in place at SCF, appointed under the deed of guarantee. The investigator has provided a draft report which we expect will be finalised next week.
 5. BNZ indicated that, while they were unlikely to initiate receivership or other measures, they also were not contemplating being part of any support or rescue package.
 6. Our ability to consult more widely is limited by the commercial sensitivity of the issues. However, we have canvassed potential solutions to the SCF issue with some of the major banks. Their perspective is quite clear. They no longer regard SCF as a bankable proposition. Existing credit facilities have been frozen and no new credit will be forthcoming for the business in its present form. As regards equity injections or a potential takeover, there is no appetite to take on the whole business. In a breakup scenario, however, the banks would potentially be interested in some of the better quality parts of the loan portfolio.

Wider issues

7. Asset markets: SCF is a significant investor in the South Island economy, with emphasis in the rural sector. Its progress therefore will have significant public interest. However, so long as there is a sensible realization of the assets, we do not see significant implications for asset markets.
8. Finance industry: There are other fragile finance companies as well as SCF. However, we see the possibility of a contagion effect is limited by the recently announced extension of the deposit guarantee and by other actions the Crown could take if this became evident.
9. There has been discussion in various quarters about the possible establishment of a larger financial institution, possibly a bank, from a rationalisation and consolidation of some of the larger finance companies, including SCF. We have not been engaged directly in those discussions.

Assessment of Options

10. The four basic options for the Crown are:
 - Take no action and let the entity run on, probably into receivership;
 - Initiate statutory management;
 - Provide government support; and
 - Some level of Crown equity injection.
11. Our criterion for evaluation is that the best result is obtained for the Crown finances (i.e. the taxpayer) and for the economy overall. In particular, a government intervention would need to be clearly better than not intervening and leaving events to run their course. The precedent effect that any decision might have for government response to other similar entities should also be considered.
12. In relation to direct assistance from government to firms, we have previously proposed that any government direct assistance should focus on maintaining economically critical operations, not protecting corporate form or shareholder value. We have recommended assistance only be considered in line with the following principles:
 - I. There would be substantial disruption to the economy or society if the firm's critical operations ceased abruptly;AND / OR
 - II. The firm considered has major backwards and forwards linkages (other firms rely on this firm as a major purchaser or supplier of goods and/or services) and if service delivery failed there would be substantial irreversible impacts;FOR BOTH I and II, III must be met:
 - III. Established commercial law remedies for dealing with corporate failures would not be sufficient to prevent the disruption of operations.

Receivership

13. Receivership of SCF could be initiated by the trustee for the debenture holders at any time. Indications are that the trustee has concerns as to the current position of the company. We understand that they have plans in place in case they decide to move to a receivership. However, at this stage, they are waiting to see how events unfold.
14. SCF going into receivership would be a "default event" under the guarantee and would require the Crown to pay out to depositors.

Readiness:

- Systems are being put in place in Treasury to manage a payout process to depositors. In the "best case" scenario, we would expect initial processing to first payout to take 6 to 8 weeks.

Fiscal implications:

- \$1,800 million immediate payout to 38,000 depositors
- Net cost to Crown \$800m to \$1,000m over about 18 months
- Net cost could be around \$90m higher for payment of interest on acceleration.

Statutory Management

15. A corporation is placed in statutory management by an Order in Council made by the Governor-General on the advice of the Minister of Commerce following a recommendation from the Securities Commission.
16. The appointment of a statutory manager puts in place a moratorium which suspends indefinitely the rights of secured and other creditors and can provide time to establish a clearer picture of the position of a corporation, and allow the affairs of the corporation and the interests of all creditors or members of the corporation to be addressed in a more orderly and expeditious way. The powers of the statutory manager are very wide. The Corporations (Investigation and Management) Act gives guidelines for the exercise of these powers in the interests of creditors, shareholders, beneficiaries, and the public interest. Ultimately, payments to creditors of the corporation are made in accordance with the normal priorities.
17. Statutory management is a measure of last resort. The situations where such a step is in prospect are likely to require swift action to preserve the interests of the corporation's shareholders or creditors, or beneficiaries, or the public interest. Urgent measures such as emergency meetings of Cabinet and the Executive Council may be required so that it can be implemented effectively at short notice.
18. Given the wide powers that could be invoked under statutory management, especially over the affairs of "associated persons", we expect that SCF would be seeking to avoid it.
19. SCF going into statutory management would cause a "default event" under the guarantee and require the Crown to pay out to depositors.

Readiness:

- Processes around a statutory manager are being developed.
- Systems are being put in place in Treasury to manage a payout process to depositors. In the "best case" scenario, we would expect initial processing to first payout to take 6 to 8 weeks.

Fiscal implications:

- \$1,800 million immediate payout to 38,000 depositors
- Statutory manager might require some working capital.
- Net cost to Crown \$500m to \$800m over 2 to 3 years
- Net cost could be around \$90m higher for payment of interest on acceleration.

Government Support

20. The SCF letter sought some sort of guarantee or underwriting to ensure that the US\$100m private placement is not called.

21. This may enable the private capital raising to go ahead. However, it effectively gives a guarantee to US lenders ahead of other creditors and will not ensure that the entity does not ultimately fail anyway, with the guarantee being called.

Fiscal implications:

- Adds a contingent liability for the Crown of US\$100m
 - Might reduce the likelihood of the deposit guarantee being called.
22. There may yet be valid arguments to give support to an industry consolidation but these should not be put on the table until the SCF situation has been resolved. There will be a stronger argument to assist companies caught in the backwash of an SCF failure than to assist SCF itself.
23. A number of the issues covered in the equity injection section of this report (below) apply to this case. This option is not supported as our assessment is that we are not confident in there currently being a viable, feasible restructuring plan that the board and management of the company implementing. Currently, the amount of equity being sought from private partners would not appear to be sufficient to support a sustainable package of reform.
24. While this assessment could change if significantly different actions were proposed and taken by SCF, our current view is that SCF is not a viable business medium to long term. Yesterday's events may take us even further away from arriving at a point where we could expect and have confidence in a realistic, viable plan for SCF being developed and successfully implemented.

Crown Equity Injection

25. Crown equity injection could be either an outright acquisition of the business, or becoming a minority shareholder along with other capital providers.

Outright acquisition

- Would need enough of a capital injection to cure current covenant breaches and ensure solvency. Maybe \$300m to \$400m.
- Would create a range of issues under the deed, including that it might trigger the guarantee anyway.
- Likely to put the Crown in a worse financial position than statutory management, unless it could be done without triggering the guarantee, thereby avoiding the upfront Crown payout to depositors.
- In normal circumstances, an equity injection would require a more detailed due diligence than has been carried out so far. This would take some weeks to complete. This would be needed in order to be clear about what the Crown is letting itself in for.
- Does not have an obvious exit strategy.

Equity injection as a minority shareholder along with other capital providers

- Same issues as an outright acquisition, except less control and possibly less capital requirement.
 - Unattractive for the Crown because of the link to the Crown guarantee.
26. Crown acquisition or equity injection to SCF might be considered if there was a stronger underlying business that could be salvaged and sold on, or sold into the new larger entity they have in mind. However, with the poor quality of a large part of the SCF book, the downside risk to the Crown is high. Further, a financially realistic Crown equity solution would require recognition from the SCF board that there currently is no

equity left in the business, which does not appear to be the board's current presumption.

27. We recommend against proposing a Crown equity injection. This is because the outcome for the Crown is likely to be worse than the alternative of statutory management. There are significant risks associated with this option (and the guarantee proposal above):
- Following further investigation, but in no way representing a due diligence process, there still exists considerable uncertainty as to the real extent to the funds that would be required to stabilize the company. As a result, the Crown is likely to incur liabilities over and above those currently guaranteed under the DGS.
 - Proposed restructuring plans are still developing. It is still not clear that the extent of the problems and their severity is fully acknowledged and being addressed through the process that will stabilize the company long term. We have significant doubts as to whether the current board and management are capable of turning the company around.
 - An equity injection is unlikely to be able to have sufficient controls attached to it for prudent use of taxpayer funds. There is also the risk that the Crown is implicitly required to guarantee non-DGS guaranteed amounts (which we estimate could be in the region of \$215m), including to non-New Zealand investors, deposits over \$1 million, related parties, and trade creditors. This arises in part from the requirements of the trust deed and the Trustee's obligation under the deed to treat all security holders equally.
 - The relationship between the Crown with the company and its management is likely to be extremely difficult. Yesterday's events would tend to support this concern.
28. If SCF could be saved, then the Crown could recoup the money it invests. However, the extent to which restructuring will have costs and the ultimate success of this restructuring is still risky. In which case, the guarantee may still be called. As noted above, we have talked with potential interested parties who would be reluctant to participate in similar arrangements for similar reasons. In summary, equity support options lack control and is likely to involve difficulties with the relationship with management while still potentially triggering an event of default. The complexity of the potential arrangements (e.g. joint partnerships) is such that the transaction costs make the proposal unattractive.

Consultation

29. The Reserve Bank and the Companies Office are in regular contact with us on this issue. They have been consulted in the preparation of this report. DPMC has been kept informed.