The Treasury

South Canterbury Finance Limited Information Release

Release Document

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

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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.

RECOMMENDATION FOR RETAIL DEPOSIT SCHEME PROVISIONING

For the Month Ending September 2009

Agreed by the Treasury DGS Provisioning Committee on [XX October 2009]
Prepared by Craig Murphy , Senior Analyst, DGS Team, The Treasury

INTRODUCTION

Company Name (credit rating if available)	Treasury Estimated loss-given default (July 2009)	Plus Post Acceleration Interest	Treasury Estimated loss-given default (July 2009)
GROUP ONE - HIGH RISK INSPECTED ENTITIES			
South Canterbury Finance Limited (BB+/Negative/Aug 09)	507	160	667
Vision Securities Limited	25	2	27
SUB TOTAL	**532**	**162**	**694**
GROUP TWO - HIGH RISK SMALL ENTITIES			
[3]	1		
Mutual Finance Limited	2		
[3]	4	5	18
Viaduct Capital Limited	6		
[3]	-		
SUB TOTAL	**13**	**5**	**18**
GROUP THREE - SMALL ENTITIES (SUB $20M IN DEPOSITS) NOT EXPECTED TO HAVE SOUGHT A CREDIT RATING			
[3]	-		
	0		
	-		
	-		
	-		
	-		
	-		
	-		
	-		
	-		
	-		
	-		
	-	12	14
	-		
	2		
	-		
	-		
	-		
	-		
	0		
	-		
	-		
	-		
	-		
	-		
SUB TOTAL	**2**	**12**	**14**
GRAND TOTAL	**547**	**179**	**726**

This table calculates the recommended Retail Deposit Guarantee Scheme provision for the month ending September 2009.

In the completion of the provisioning recommendation Treasury has used information collected under the monthly monitoring conducted by the Reserve Bank of New Zealand ("RBNZ") as required under statute. In addition, the RBNZ are contracted by The Treasury to provide an assessment of the possible loss to the Crown in event of default of an entity.

To arrive at a loss on liquidation of an entity, the RBNZ undertakes a loss given default assessment of the loan book to arrive at a discounted loan book, which is then added together with other assets held by the entity (after discounting) to form a total asset position. Total assets are then applied to the Total liabilities to assess the equity shortfall (if any) and the Crown's loss under a liquidation scenario.

In addition, qualitative information is provided by RBNZ based on discussion with the Trustees and other knowledge of the industry.

The RBNZ model output is then reviewed by The Treasury to assess the appropriateness of the indicated loss given the additional information held by The Treasury from inspection reports, information directly sourced from other market participants (government agencies, banks, professional services firms etc) and the entity. Adjustments are made if required, and the provisioning number and rationale for provisioning is presented to the provisioning committee to assess the probability of default and agree the appropriate level of provision. Post acceleration interest is added to the provision to form the final level of the provision.

The provision for September 2009 has been revised downward from the provision of $816m (agreed at the Treasury DGS Provisioning Committee on 23 September 2009 for June 2009) to $725m.

The provision recommendation by The Treasury DGS Provisioning Committee Provisioning for June 2009 (and for inclusion in the Crown Financial Statements) was on the basis -"without extension" due to the following:

- As at the 30th of June 2009 it was uncertain whether or not an extension would be approved;
- If an extension was approved, the key terms of an extension were uncertain at that date;
- Therefore, the fiscal outcomes of any extension were not able to be clarified; and

The announcement to extend to the Deposit Guarantee Scheme ("DGS") was announced on the 25 of August 2009, thus the provision recommendation or September 2009 has been made on the basis of with an extension.

Key changes are that Equitable Mortgage Limited ($27M), Allied Nationwide Finance Limited ($55M), [3]) are not included in the provision, as it is not considered probable that they will fail with an extension of the guarantee. The provision for the Group Two and group Three entities remains unchanged.

SOUTH CANTERBURY FINANCE LIMITED

INFORMATION

In the completion of the provisioning recommendation Treasury has relied on:

1. The Reserve Bank of New Zealand ("RBNZ") monthly monitoring;
2. Information requested directly from South Canterbury Finance Limited ("SCF);
3. The KordaMentha inspection report; and
4. Information directly sourced from other market participants (Government Agencies, Banks, Professional Services Firms etc).

ISSUES

SCF is the largest finance company in New Zealand with a total lending book of $1,687m and a Crown Guaranteed deposit book of $1,855m covering in excess of 40,000 depositors.

SCF has grown rapidly over the past five years, and its policies and procedures have not kept pace with the growth. Overall, the management, risk management and lending of SCF is below the standard KordaMentha would expect of an organisation of SCF's size.

SCF book covers most sectors, but key issues are in the Business ($555m) and Property ($542m) books. The key characteristics of the Property and Business books is the absence of covenants, annual reviews, valuations, high levels of capitalised interest, second charges, and a lack of risk grading. These are generally characteristics of poor lending practices. It is KordaMentha's assessment that a total of $1,100m of SCF lending is illiquid, the bulk of which is in the Property and Business books.

SCF have adopted an impaired asset expense of $106m for the year ending June 2009. KordaMentha estimate that this could be as high as $209m, and have identified an additional $233m of lending that exhibit signs of impairment. It is worth noting that KordaMentha have sampled SCFs book, and the quality of the information and state of the files have hampered their review. A full review could identify further impaired assets

If SCF provisioned at the level KordaMentha recommended there would be $101m of equity remaining in SCF (pre underwrite of $25m), which would put SCF in breach of its trust deed. SCF has several equity investments which were assessed by RBNZ at nil value. This has been revised based on information in the investigators reports to a recovery of 15% ($61m).

SCF requires additional cash equity injection to maintain sufficient capital levels and liquidity due to impairment of assets. Although discussed, Alan Hubbard is not believed to be in a position to inject sufficient equity into SCF to ensure its survival. Both major asset quality and subsequently equity issues lead to the conclusion that it is probable they will default under the existing Crown Guarantee .

Subsequent to 30 June, S&P have downgraded SCF to BB+ negative outlook on the 21st of September with out the resolution of several outstanding issues SCF will be potentially downgraded by S&P to BB- (making SCF ineligible for the extended DGS). Current issues include:

1. Getting a new prospectus issued;
2. Gaining the continued support of the USPP;
3. Gaining the continued support of their Bankers;
4. Gaining an injection of new equity; and
5. Appointing two independent Directors.

RECOMMENDATION

Based upon the information held by Treasury and the issues outlined above, it is considered probable that SCF will default under the existing Crown Guarantee and therefore a provision of $667m is required.

The RBNZ loss given default has reduced from June 2009 due to the reduction in "impaired" and "capitalising" loans. Given the information Treasury has which indicates that the risk profile of SCF has not changed the RBNZ loss given default has been adjusted to the June 2009 level.

The quantum of the provision recommended is $667m, being the Crowns Share of the loss given default of $507m plus an allowance for post acceleration interest $160m.

ASSETS		LIABILITIES	
Trade Creditors (@ 50%)	8	Guaranted Deposits	1,874
Fixed Assets (@ 10%)	12	Liquidation Costs (@ 5% of Book)	5
Equity Investments (@ 25%)	22	Other Liabilities (inc Bank Funding)	212
Cash (@ 100%)	121	**Total Liabilities**	**2,091**
Other Liquid Assets (@ 80%)	-		
Other Assets (@ 15%)	63	**Equity (Loss)**	**(566)**
Net Loan Book	1,298		
Total Adjusted Assets	**1,525**	**Total Adjusted Assets**	**1,525**
		Crown Share of Loss	**(507)**
		Post Acceleration Interest	**(160)**
		Total Crown Loss	**(667)**

VISION SECURITIES LIMITED

INFORMATION

In the completion of the provisioning recommendation Treasury has relied on:

1. The Reserve Bank of New Zealand ("RBNZ") monthly monitoring;
2. The Deloitte inspection report;
3. Information requested directly from Vision Securities Limited ("VSL") and
4. Information directly sourced from other market participants (Government Agencies, Banks, Professional Services Firms etc).

ISSUES

VSL is a mezzanine property finance lender with a book of $34m, made up of 16 loans.

The key metrics of the VSL book are:

- 60% of the book is completed stock or land banks;
- 80% of the book is due to expire before 31 December 2009;
- 20% of the book is active land developments;
- 97% of the book has interest capitalising;
- 78% are second mortgages, but an additional 19% are first and second mortgages are duel first and second mortgages; and
- Many loans are subordinated and postponed, and in some cases VSL are paying the first mortgagee's interest.

VSL has no banking facilities, but does have $10m in cash, and this is being consumed at a rate of $0.300m to $0.500m per month due to operating costs and the payment of first mortgagee interest. VSL are not getting and "cash" from any of their loans. At this rate, VSL have approximately two years before they run of cash.

VSL has a significant profitability issue that will lead to its failure.

VSL has a provision for impaired loans of $2m in its annual accounts to 31 March 2009. Deloitte have an initial view on the likely level of provisioning required which is between $19m and $28m. This will make VSL insolvent.

VSL has a significant asset quality issue and subsequent equity issue, lead to the conclusion that it is probable they will default under the existing Crown Guarantee.

VSL is not expected to gain a BB credit rating from Standard and Poor's. This would rule VSL out of the extension to the Government Guarantee scheme, and will significantly effect investment and reinvestment rates in VSL.

$24.5 million (65.8%) of VSL's secured debenture stock is due to mature before October 2010, the expiry date of the Crown guarantee. The repayment of this level of debenture funding will crystallize a significant liquidity issue for VSL, as the asset quality of VSL's book is such that they will not be able to liquidate their assets to repay the debenture holders.

Therefore VSL also has a significant liquidity issue that lead to the conclusion that it is probable they will default under the existing Crown Guarantee.

VSL is to enter a recapitalization plan which would see VSL will purchase from Arrow International Group Limited $5m of shares in the related company Vision Senior Living Limited essential for a nominal price (nil).

The completion of the transaction will be conditional on several events, which may include a BB rating - which is highly unlikely. It is very unlikely that the recapitalization plan will take place, and if it does it will not be enough to save VSL given its considerable asset quality issues.

RECOMMENDATION

Based upon the information held by Treasury and the issues outlined above, it is considered probable that VSL will default under the existing Crown Guarantee and therefore a provision of $27m is required.

The RBNZ loss given default has reduced from June 2009 due to an increase in cash held which was greater than the reduction in the value of the loan book. Given the information Treasury has which indicates that the risk profile of VSL has not changed the RBNZ loss given default has been adjusted to the June 2009 level.

The quantum of the provision recommended is $27m, being the Crowns Share of the loss given default of $25m plus an allowance for post acceleration interest $2m.

ASSETS		LIABILITIES	
Trade Creditors (@ 50%)	0	Guaranted Deposits	37
Fixed Assets (@ 10%)	-	Liquidation Costs (@ 5% of Book)	2
Equity Investments (@ 25%)	-	Other Liabilities (inc Bank Funding)	1
Cash (@ 100%)	13	**Total Liabilities**	**40**
Other Liquid Assets (@ 80%)	-		
Net Loan Book	1	**Equity (Loss)**	**(27)**
Total Adjusted Assets	**13**	**Total Adjusted Assets**	**13**
		Crown Share of Loss	**(25)**
		Post Acceleration Interest	**(2)**
		Total Crown Loss	**(27)**

GROUP TWO - HIGH RISK SMALL ENTITIES

INFORMATION

In the completion of the provisioning recommendation Treasury has relied on:

1. The Reserve Bank of New Zealand ("RBNZ") monthly monitoring;
2. Information requested directly from the entities; and
3. Information directly sourced from other market participants (Government Agencies, Banks, Professional Services Firms etc).

The entities in group two are:

1. [redacted] [3]
2. Mutual Finance Limited;
3. [redacted] [3]
4. Viaduct Capital Limited ; and
5. [redacted] [3].

ISSUES

All five of these entities are on the high risk watch list for RBNZ due to significant credit and/or liquidity concerns. It is reasonable therefore draw a conclusion that these entities will not get a BB credit rating.

It is considered probable that these will default as significant liquidity issues would be crystallized early next year as the maturing debenture "wall" hits". The asset quality of these entities is poor and as such they will not be able to liquidate their assets to repay the maturing debt.

These entities are not be expected be eligible for the extension of the deposit guarantee scheme. Being ineligible would effect investment and reinvestment rates for these entities and crystallize a significant liquidity issue early next year as the asset quality of these entity is poor and as such they will not be able to liquidate their assets to repay the maturing debt.

Thus, these entities are expected to fail.

RECOMMENDATION

Based upon the information held by Treasury, and the issues outlined above, regardless of extension option it is considered probable that all five entities default under the existing Crown Guarantee and we should provision $17m.

The quantum of the provision is recommended is to be the RBNZ loss given default calculation of ($12m) plus an allowance for post acceleration interest ($5m).

GROUP THREE - SMALL ENTITIES (SUB $20M IN DEPOSITS)

INFORMATION

In the completion of the provisioning recommendation Treasury has relied on:

1. The Reserve Bank of New Zealand ("RBNZ") monthly monitoring;
2. Information requested directly from [redacted]) and
3. Information directly sourced from other market participants (Government Agencies, Banks, Professional Services Firms etc).

ISSUES

It is expected that the 25 group three entities will fail.

With the extension of the guarantee, the failure of the 25 entities is expected to be brought about as they are unlikely to be eligible for the extended Guaranteed due to their size (sub $20m entities) and not seeking/receiving a BB credit rating.

Without the deposit guarantee scheme, these entities would be competing for deposits against other Finance Companies, Buildings Societies and Credit Unions, who hold a Crown Guarantee. Therefore it is highly likely that a significant liquidity issue would be crystallized early next year as the maturing debenture "wall" hits" and these entities will default

Some of these entities such as the [redacted] and others may be able to either get a BB rating or survive outside of the guarantee. Although this is considered possible, it is not probable without some sort of significant change to their capital structure or a very strong mutual model.

The 25 entities in Group Three have a potential significant liquidity issues and are therefore it is considered probable that they will default.

In addition, the size of these entities make it very hard for them to provide a customer proposition that is competitive with larger financial institutions and survive given the current financial climate.

The timing of the failures is unknown, but there are several key events that could prompt a breach of the Crown Guarantee and trigger a payout.

The key events that may be a catalyst for their failure over the next 6 to 8 months include:

1. Provision of the RBNZ Risk mitigation strategy to the Trustee (from Sept 2009);
2. The renewal of their prospectus (from Sept 2009);
3. The completion of their annual accounts (from Sept 2009);
4. The "maturity wall" (Nov 2009, Apr 2010 and Sept 2010); and
5. The failure to obtain a BB credit rating by March 2010 (deadline for RBNZ requirement for a credit rating).

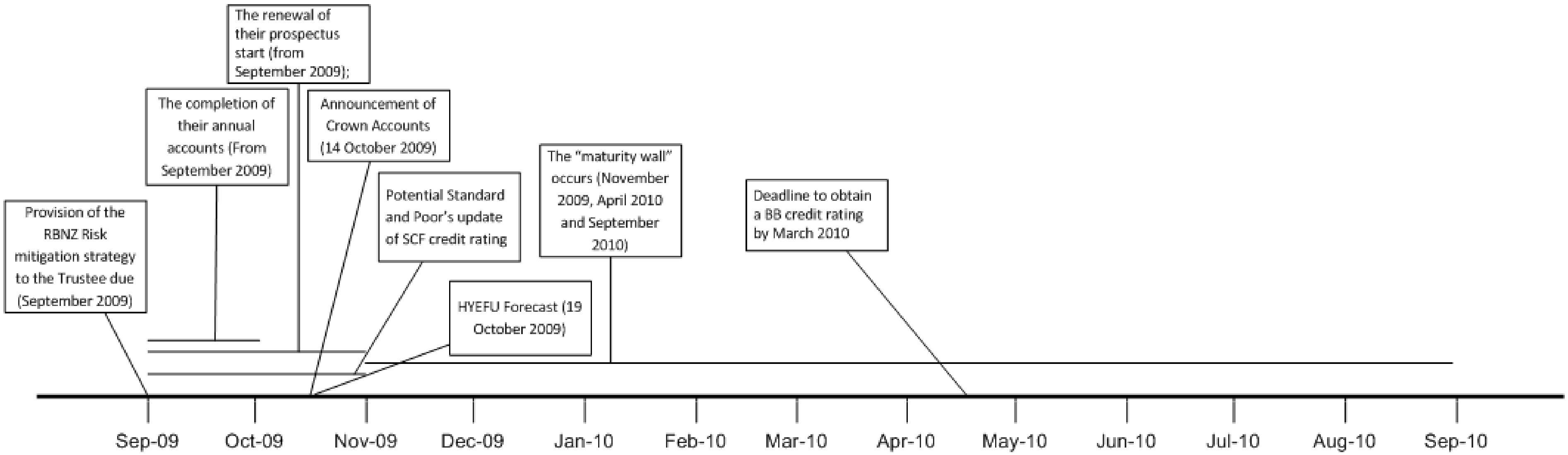
Thus, it is considered probable that all 25 entities in Group Three will default.

RECOMMENDATION

Based upon the information held by Treasury, and the issues outlined above, regardless of extension option all 25 entities are considered probable to default under the existing Crown Guarantee and we should provision $14m in total for all 25 entities.

The quantum of the provision is recommended is to be the RBNZ loss given default calculation of ($12m) plus an allowance for post acceleration interest ($2m).

Timeline of Key Events



Provisioning Process Outline