Chronology of South Canterbury Finance Limited in the Crown Retail Deposit Guarantee Scheme

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THE TREASURY
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This document provides a summary history of the participation of South Canterbury Finance Limited (SCF) in the Crown Retail Deposit Guarantee Scheme (DGS).

It spans the time from the establishment of the DGS in October 2008 through to the appointment of receivers to SCF in August 2010.

Contents

Summary Timeline

Date	Event
12 Oct 08	DGS announced.
19 Nov 08	SCF retail guarantee deed signed.
16 Dec 08	SCF Crown wholesale facility application declined.
30 Jun 09	Interest in Dairy Holdings transferred to SCF
13 Aug 09	S&P rating downgrade to BB+.
15 Oct 09	Agreement with USPP note holders for repayment.
11 Dec 09	SCF revised guarantee deed signed.
29 Dec 09	Sandy Maier appointed as CEO.
26 Feb 10	Early full repayment of USPP facility.
28 Feb 10	Scales & Helicopters NZ transferred to SCF.
2 Mar 10	S&P rating downgrade to BB.
1 Apr 10	SCF extended guarantee deed signed.
9 Apr 10	SCF released half-year financial statements to 31 December 2009.
28 May 10	S&P rating downgrade to B+.
20 Jun 10	Hubbard statutory management announced.
21 Jun 10	S&P rating downgrade to B-.
20 Aug 10	S&P rating downgrade to CC.
31 Aug 10	Appointment of receivers to SCF.

Retail Guarantee Scheme Application

Original Guarantee

The Minister of Finance announced the establishment of the Crown Retail Deposit Guarantee Scheme on **12 October 2008**. In **October 2008**, the Minister delegated to the Secretary to the Treasury the authority to give in writing guarantees as part of the management and administration of that Scheme, such guarantees to be in such form as the Secretary to the Treasury may from time to time determine. On **22 October 2008**, the Minister issued Policy Guidelines for officials to use when assessing applications. The Policy Guidelines set out what types of institution would be eligible for the guarantee and what criteria and other factors may be considered by officials when assessing an application.

SCF applied for a guarantee under the Retail Deposit Guarantee Scheme on **14 October 2008**. Further information was sought routinely during the processing of the application. The Reserve Bank reviewed the application and obtained further information, including a letter from the trustee, Trustees Executors Limited dated **4 November 2008**, which raised no issues of concern. The Bank provided advice to Treasury on **6 November 2008** that SCF met all of the relevant criteria set out in the Policy Guidelines. The Bank further confirmed that it had no reason to believe that SCF should not be invited to enter the DGS.

Having taken this information and the Policy Guidelines into account, and having made an assessment of the public interest generally, the Treasury decided to approve the application on **19 November 2008.** The guarantee deed was then signed and posted on the Treasury website.

Revised Guarantee

On **11 December 2009**, a new guarantee deed between SCF and the Crown was signed. This was part of a process in which all guaranteed entities were offered to replace their original deeds with revised deeds that provided greater flexibility for deposit taking entities and improved consistency between the original scheme and the extension scheme that would continue after 12 October 2010. The revised guarantee deed allowed institutions to issue both guaranteed and non-guaranteed debt.

The revised guarantee deed took effect from **1 January 2010** and would expire on 12 October 2010, as did the original guarantee.

SCF subsequently issued a prospectus that made provision for the issue of both guaranteed and non-guaranteed debt under the revised deed.

Wholesale Funding Guarantee Facility

On **1 November 2008**, the Minister of Finance announced the establishment of the Crown Wholesale Funding Guarantee Facility. On **4 November 2008**, the Minister delegated to the Secretary to the Treasury the authority to give in writing guarantees as part of the management and administration of that Facility, such guarantees to be in such form as the Secretary to the Treasury may from time to time determine. On **7 November 2008**, the Minister issued Policy Guidelines relating to the exercise of discretion under that delegated authority.[1] The Policy Guidelines set out the types of institutions that should be eligible for the guarantee and what criteria and other factors may be considered by officials when assessing applications for inclusion in the scheme and issues of securities under the scheme.

A completed application from SCF to join this Facility was received by Treasury on **26 November 2008**. SCF also advised that it had plans under way for a 5-year wholesale issue of up to $400 million for which it would seek an Eligibility Certificate once the Facility was in place.

The Reserve Bank reviewed the application and provided advice to Treasury on **11 December 2008** that SCF:

- Held the following long-term issuer credit rating: BBB- from Standard & Poor's.
- Was not in breach of any prudential supervision direction, notice or requirement under the Reserve Bank of New Zealand Act 1989.
- Carried out substantial borrowing and lending operations in New Zealand involving non-related entities.
- Issued senior negotiable or transferrable debt securities in wholesale financial markets or guarantees the issue by wholly owned subsidiaries of senior negotiable or transferrable debt securities in wholesale financial markets.

However, the Reserve Bank went on to state it considered that SCF did not hold a suitable level of capital above regulatory minima:

> *Based upon publicly available information provided by the Entity, the Entity's Tier One capital ratio is less than 6.4% at June 2008. At end-October, the Bank estimates that this ratio – excluding charges for commitments, operational risk, and market risk – has fallen below 5.3%. Including these charges would likely leave the Entity's tier one capital ratio at less than 5%. The Policy Guidelines agreed by the Minister of Finance on 7 November 2008 indicate that an appropriate level of capital for registered banks may be 6 percent of Tier One capital ratio.*

Holding a suitable level of capital above the current regulatory minima was a relevant criterion in the Policy Guidelines. Non-bank deposit-taking institutions would be expected to hold a level of capital several percentage points above that acceptable for banks.

[1] The Policy Guidelines were revised on 23 December 2008. The revision would not have affected the outcome of SCF's application.

On **16 December 2008**, Treasury decided to decline the application. SCF was advised accordingly:

> *The Reserve Bank advised us that a reasonable level of capital for non bank entities for this purpose should be at least 8% tier one capital calculated on the Basel II standardized approach. The policy guidelines for the wholesale guarantee facility indicate a cut off level of 6% tier one capital for banks. You have indicated that South Canterbury Finance's level is around 6.73%. A 0.73% margin above the requirement on banks is, in the Bank's judgment, insufficient for this business and the level should be at least 8%. In deciding to decline the application, we considered the issues and decided that we had no reason to differ from the assessment of the Bank.*

SCF Financial Statements

31 December 2008 Audited Half-Year Financial Statements

The audited financial statements were finally completed on **30 July 2009** and included in an amended prospectus on that date. The audit was completed by Timaru chartered accounting firm, Woodnorth Myers, which had been SCF's auditor for a number of years. The audit opinion was unqualified.

30 June 2009 Audited Annual Financial Statements

SCF announced its unaudited results for the 30 June 2009 year on **28 August 2009**. The final audited financial statements were released on **1 October 2009**. This audit was completed by Woodnorth Myers and was reviewed by the Institute of Chartered Accountants as part of a process of reviewing all major finance company audits carried out by its member's firms. The audit opinion was unqualified but included a paragraph referring to fundamental uncertainty regarding going concern.

31 December 2009 Audited Half-Year Financial Statements

On **30 October 2009**, Ernst & Young were appointed as auditors, replacing Woodnorth Myers. Ernst & Young completed an audit of SCF's financial statements for the 6 months to 31 December 2009.

On **1 March 2010**, SCF announced preliminary unaudited results. This included an increase of $180 million in the provision for losses on impaired or non-performing assets. It was also announced that the acquisition of the interests in Helicopters NZ and Scales Corporation in February 2010 had meant that SCF would have been in breach of two of the covenants in its trust deed, and that the Trustee had granted a waiver of compliance until the 30 June 2010 financial statements.

The half-year financial statements were released on **9 April 2010**, having been given a grace period from the NZX reporting deadline of 31 March 2010. On **12 April 2010**, a new prospectus was registered, including the audited financial statements. The audit opinion was unqualified but made reference to fundamental uncertainties relating to going concern and to valuation of advances.

The Trustee granted a waiver, until 31 May 2010, from compliance with the risk-weighted average ratio covenant that was breached as a result of the increased provisions and write downs. This waiver was later extended to 31 August 2010.

30 June 2010 Audited Financial Statements

The audited financial statements for the 30 June 2010 year were still in preparation when SCF went into receivership in August 2010.

Extended Guarantee Application

The Government announced on **25 August 2009** that it would extend the retail deposit guarantee scheme with a scheme with new terms and conditions starting from the expiry of the original scheme on 12 October 2010 and extending to 31 December 2011. Legislation under which the extended scheme would operate was passed into law on **12 September 2009**: the Crown Retail Deposit Guarantee Scheme Act 2009.

SCF initially applied for the extended scheme on **19 January 2010**. Further information was obtained from SCF and, in assessing the application, Treasury obtained information from other sources, including the directors (**31 March 2010**), the auditors (**29** and **31 March 2010**), the trustee (to the Reserve Bank on **23 February 2010** and directly on **31 March 2010**), the Reserve Bank (**1 March 2010**), the Companies Office (**15 March 2010**) and the Securities Commission (**9 March 2010**).

Treasury considered the information and decided to approve the application on **1 April 2010** and the guarantee deed was signed and posted on the Treasury website. On **17 June 2010**, a supplemental deed for the extended scheme was signed to amend some unintentional errors in the deed that had been signed.[2]

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2 This related to the definition of “Excluded Debt Security”. This was a common correction across the deeds that had been entered into.

Recapitalisation Proposals

Treasury was first briefed by Allan Hubbard and Lachie McLeod on **22 January 2009** about plans SCF was making for restructuring and recapitalisation. The plans involved acquisition by SCF of businesses within the Southbury Group (Helicopters NZ, Scales Corporation and Dairy Holdings), repayment of loans, sale of real estate loans, and an increase in ordinary capital. SCF was advised on **23 January 2009** that prior consent on behalf of the Crown under clause 6.2 of the Deed of Guarantee would be required for these transactions.

In **December 2008**, SCF entered into a security sharing agreement with Southbury amounting to $89.6m. There was a further transaction relating to the purchase of listed equity investments in **January 2009**. Prior Crown consent was not obtained for either transaction. These transactions were brought to Treasury's attention in **April 2009** and SCF was notified of the requirements under the Deed of Guarantee on **21 April 2009**.

In **March 2009**, Southbury Group introduced $20 million new capital to SCF. This was followed on **30 June 2009** by the acquisition of Southbury's 33.6% interest in Dairy Holdings Limited for $75.73 million, being $40 million new capital and $35.73 million cash. This required an opinion from an independent expert approved by the Crown that the transaction was at an arm's length basis and represented fair value for SCF. This opinion was received on **29 June 2009** which confirmed that the transaction was at an arm's length basis and represented fair value for SCF.

On **14 August 2009**, Mr and Mrs Hubbard agreed to guarantee up to $25 million of a schedule of SCF loans, backed by the assets of Northwind Holdings (2009) limited, which at that time was owned by the Hubbards. On **9 June 2010**, their shareholding in Northwind was transferred to Messrs Bradley and Morris without advice to the Crown.

Southbury Corporation Limited was incorporated on **24 September 2009** as a wholly owned subsidiary of Southbury Group Limited. Southbury Corporation was intended to become the vehicle for an eventual IPO of the interests of Southbury, including SCF. However, a proposed issue to the public of preference shares that was to take place by **April 2010** did not eventuate.

SCF announced on **11 October 2009** that its undrawn $100 million bank credit facility was being withdrawn and would be replaced by a $75 million facility with NZ Credit Fund. This was executed on **29 October 2009** with Torchlight Credit Fund.

In letters dated 14 December 2009 and 21 December 2009, followed by a director's certificate on **29 December 2009**, SCF sought Crown consent for a series of related party transactions in which ownership of SCF would be transferred to Southbury Corporation, SCF would guarantee up to $50m of convertible notes issued by Southbury Corporation, and ANZ would be given $40m priority ahead of SCF to securities issued by Southbury Group. The issue of notes was planned to be the pre-cursor of an initial public offering being planned for April 2010. Treasury gave Crown consent on

29 December 2009 and the transactions were completed on **31 December 2009**. On **18 January 2010**, the shareholding in SCF was transferred from Southbury Group Ltd to Southbury Corporation Ltd.

SCF's application on **19 January 2010** for the extended guarantee listed the following capital contributions that had been made since the original guarantee came into force:

27 Feb 09	$20 million
30 Jun 09	$40 million
31 Dec 09	$20 million
13 Jan 10	$6 million
19 Jan 10	$0.4 million

On **21 January 2010**, the constitution of SCF was amended to allow transfer of shares that were subject to a security interest. The purpose of this was to facilitate potential restructuring proposals.

On **16 February 2010**, SCF and advisers Forsyth Barr presented to Treasury a recapitalisation proposal they were working on that involved, first, acquisition by SCF of 100% of Helicopters NZ and 64% of Scales Corporation from Southbury Corporation for $152 million of SCF shares and, second, acquisition by SCF of the assets of Strategic Finance Limited for $220 million in cash, SCF debentures and SCF preference shares.

On **28 February 2010**, Southbury Corporation sold its 100 per cent shareholding in Helicopters NZ and 64 per cent of Scales Corporation to SCF. The total purchase price of $162.5 million was satisfied by the issue of SCF shares and the payment of $10 million cash. Independent experts approved by the Crown that the transactions were conducted on an arm's length basis and represented fair value for SCF.

On **1 April 2010**, SCF announced that Torchlight Fund No. 1 LP would invest $22 million in Southbury Corporation secured convertible notes that, in turn, would be invested by Southbury Corporation into SCF. Torchlight Fund had an option to increase this to $37.5 million.

On **25 May 2010**, Treasury gave Crown consent to two proposals by SCF to: (a) a “deposit reinvestment offer” that would allow investors in unsecured SCF deposits effectively to extend the maturity date of their investments; and (b) allow the maturity date of some of the listed secured bonds to be extended.

On **31 May 2010**, the Crown declined to consent to a proposed transaction involving the guarantee by SCF of a new issue of convertible notes by Southbury Corporation. The proposed transaction was withdrawn by SCF.

On **4 June 2010**, Treasury gave conditional consent to a transaction in which Torchlight Security Trustee Limited (Torchlight) would acquire $100 million of secured bonds in SCF, being $75 million obtained from NZ Credit Fund (being the facility that had been provided since October 2009) and $25 million issued as new bonds by SCF. All $100 million would mature on 30 November 2011 and would be secured by a prior charge in the debenture trust deed.

On **14 July 2010**, SCF advisers and a potential investor presented to Treasury an initial recapitalisation proposal on which they were working. This involved separating the operations into a “Good Bank”, “Bad Bank” and investment division. Under the proposed transaction, the Crown was expected to:

- purchase the residual assets of the “Bad Bank” at the end of 2011;
- provide any consents that would be required under the guarantee deed; and
- provide a line of liquidity support in case SCF ran out of liquidity before the deal was completed.

The proposal evolved over the following weeks and a final proposal based on the same structure was submitted to Treasury on **18 August 2010**. Under the final proposal the Crown would have been required to:

- fund a majority of the assets in the “Bad Bank” and fully underwrite any losses;
- agree to a four month period of due diligence during which the bidder would determine the final composition of the “Bad Bank”;
- fund (via a loan) repayment of all prior charges;
- agree to purchase at book value certain investment assets in the event that the bidder could not gain any necessary regulatory consents;

Following analysis by Treasury and external advisers, the Crown declined to support the proposal and that decision was communicated to SCF on **27 August 2010**.

On **28 August 2010**, Treasury received a further offer to purchase all the assets of SCF in the event that SCF was placed into receivership. The offer comprised an initial upfront payment with the remainder of the purchase price payable in instalments over the term of the sale and purchase contract.

SCF was placed into receivership on **31 August 2010**. The receivers of SCF subsequently declined the offer and Treasury agreed with that decision.

Receivership

In parallel with engaging with SCF and their advisors as the recapitalisation proposals evolved over **July and August 2010**, Treasury developed a strategy to mitigate risk and minimise cost in the increasingly likely event that SCF went into receivership. This included:

- a pre-audit of SCF's debenture register;
- receivership scenarios, assessment of insolvency triggers and value optimisation;
- developing the possibility of Crown finance post-receivership to allow either part or full repayment of debenture holders; and
- considering options under the revised deed to limit post acceleration interest on deposits received on or after 1 January 2010.

On **27 August 2010**, a trading halt on listed SCF securities was announced by SCF to the New Zealand Stock Exchange.

SCF announced on **31 August 2010** that it had been unable to complete a recapitalisation and restructure and that, as a result, it remained in breach of its trust deed covenants. Accordingly, Trustees Executors appointed Kerryn Downey and William Black, of McGrathNicol receivers of SCF.

Crown Financial Statements and Provisions

Starting from the Crown financial statements for the year ending 30 June 2009, the assessment was made that SCF was "more likely than not" to default under the DGS. A provision was therefore required to be assessed for inclusion as a liability in the financial statements. The provision was then reviewed and adjusted as appropriate on a monthly basis.

Financial Statements Date[3]	Deposits $m	Crown Loss Given Default $m	Expected Failure Date
Jun 09	1,855	507	--
Sep 09	1,874	507	--
Oct 09	1,832	480	--
Nov 09	1,790	478	--
Dec 09	1,746	533	Jun 10
Jan 10	1,739	518	Jun 10
Feb 10	1,712	545	Jun 10
Mar 10	1,707	571	Jun 10
Apr 10	1,700	570	Jul 10
May 10	1,717	613	Aug 10
Jun 10	1,611	559	31 Aug 10

Note: The estimates of "Crown Loss Given Default" shown below are as made at the time based on the information then available. It became clear as progressively better information came to light, such as through investigations, that these estimates did not necessarily reflect the actual cost to the Crown if SCF had failed at that time.

3 There are no rows for July and August because Crown financial statements are not published for those months.

S&P Ratings Actions

17 Dec 06	Assigned **BBB-** Stable *"'BBB-' rating assigned to New Zealand's South Canterbury Finance Limited on strong business profile."*
27 Feb 07	Affirmed at **BBB-** Stable
29 Aug 07	Affirmed at **BBB-** Stable *"South Canterbury Finance Ltd rating unchanged after strong operating performance."*
7 Apr 08	Affirmed at **BBB-** Stable
26 Jun 08	Affirmed at **BBB-** Stable *"… sound business profile and good domestic operational geographic diversity, which underpins its market position as one of the largest New Zealand-owned finance companies. The company's stable profitability track record and sound credit-loss experience, combined with its improved funding and liquidity diversification over the past year also support the rating."*
7 Jul 09	Affirmed at **BBB-** but with Credit Watch Negative *SCF "… placed on CreditWatch Negative on deterioration in credit profile."*
13 Aug 09	Downgraded to **BB+** with Negative Outlook (i.e. 1/3 likelihood of a downgrade in the next 12 months).

21 Sep 09	Put on Credit Watch Negative (i.e. 1/2 likelihood of a downgrade in the next 3 months). *"Any withdrawal of the US private placement support would probably cause a downward ratings revision by multiple rating notches into the 'B' rating range."*
23 Dec 09	Removed from CreditWatch Negative and affirmed at **BB+** with Outlook Negative.
2 Mar 10	Downgraded to **BB** with CreditWatch Negative *"CreditWatch with negative implications mainly due to stakeholder uncertainty in reaction to high loan-loss provisions that could negatively impact liquidity and recapitalisation initiatives."*
5 May 10	**BB** rating remains on CreditWatch Negative *"… pending greater clarity of information."*
28 May 10	Downgraded to **B+** on CreditWatch with Developing Implications
21 Jun 10	Downgraded to **B-** with CreditWatch Negative *"Ratings lowered on credit concern about key shareholder."*
20 Aug 10	Downgraded to **CC** with CreditWatch Negative.
30 Aug 10	Downgraded to **D** following appointment of receiver.

Governance Changes

28 Aug 2009	Resignation of independent directors Nattrass and White.
20 Oct 2009	Appointment of directors McLaughlan, Baylis and Shale.
30 Oct 2009	Appointment of new auditors Ernst & Young.
26 Nov 2009	CEO Lachie McLeod resigned.
21 Dec 2009	CFO Graeme Brown resigned.
23 Dec 2009	CEO Sandy Maier appointed, replacing Lachie MacLeod.
21 Apr 2010	Resignation of Kevin Gloag, GM Funding
28 May 2010	Hubbard resigned as director.
31 May 2010	Sullivan resigned as director.
9 Jun 2010	Baylis announced as independent chair of board.
20 Jun 2010	Hubbard statutory management announced.
8 Jul 2010	New senior management appointments.
31 Aug 2010	Appointment of receivers.

Investigator Reports

Korda Mentha was engaged to complete a series of investigations over the period from July 2009 to August 2010.

The following reports were produced:

Date	Content
17 Jul 09	Funding overview; covenants; ratings implications; payment processes; market segment exposures.
18 Aug 09	Group structure and governance; financial position and covenant compliance; loan management systems; impairment; liquidity; restructuring; potential for default.
4 Sep 09	SCF overview; loan book review; liquidity factors; restructuring initiatives.
14 Jun 10	Phase 1: Reconcile DGS reporting; identify related party exposures; liquidity; strategic plans; management & governance.
8 Jul 10	Phase 2: Investment values; related party exposures; future control of business.
Jul 10	Receivership overview; insolvency triggers; optimising value.
26 Aug 10	Receivership scenarios; review of recapitalisation proposals.

Financial and Risk Monitoring

The Reserve Bank was contracted by Treasury to provide monthly monitoring reports for each guaranteed entity from February 2009. The Reserve Bank obtained information from each company and from its trustee. Given the time required for the company to compile the information following each month end and submit to the Reserve Bank for analysis, the reports were provided to Treasury two months in arrears.

Monthly monitoring reports for SCF were received for the periods from February 2009 through to May 2010.

The monitoring reports covered: ownership, liquidity, monthly movements, estimated loss in the event of company failure, capital prudential calculations, and risk ranking.

The Reserve Bank also provided monthly relative risk rankings for the guaranteed entities from January 2009.

SCF's relative ranking moved as follows:

Date Range	Ranked between
Jan 09 to May 09	11th & 13th
Jun 09 to Aug 09	7th & 8th
Sep 09 to Dec 09	2nd & 3rd
Feb 10 to Jul 10	1st & 2nd