THE TREASURY
Kaitohutohu Kaupapa Rawa

Treasury Report: Treasury Report - SCF Resolution Options

Date:	24 August 2010	Report No:	T2010/1586

Action Sought

	Action Sought	Deadline
Minister of Finance (Hon Bill English)	**Note** that following discussions with SCF, Treasury has undertaken an initial assessment of recapitalisation options. **Note** that compared to receivership, the SCF recapitalisation proposals may not offer a significant reduction or immediate certainty in relation to expected fiscal costs under alternative options. **Note** that the estimated fiscal costs under alternative options are currently only indicative as a final proposal has not been received from SCF. **Note** that Crown support to recapitalise SCF would raise important policy risks including the potential to adversely influence business incentives. **Note** that Treasury will report to you once a final proposal has been received from SCF **Note** that officials would like to meet to discuss this report with you and will liaise with your office to arrange a suitable time. **Forward** this report to the Prime Minister for his information.	

Contact for Telephone Discussion (if required)

Name	Position	Telephone	1st Contact
John Park	Manager, Deposit Guarantee Scheme	*[Withheld under s.9(2)(a)]*	✓
Joanna Gordon	Manager, Financial Markets		

Minister of Finance's Office Actions (if required)

If the Minister agrees forward this report to the Prime Minister for his information.

Enclosure: **Yes (attached)**

24 August 2010

Treasury Report: Treasury Report - SCF Resolution Options

Executive Summary

South Canterbury Finance (SCF) is currently only operating with the benefit of a waiver from Trustee Executors Limited (TEL) in relation to a breach of its capital ratio. The waiver expires on 31 August 2010. In the absence of agreement on a recapitalisation by that date it is expected that SCF will be placed into receivership, resulting in a call under the Retail Deposit Guarantee Scheme (DGS).

The Treasury currently estimates the Crowns' net fiscal cost (excluding the cost of delivering a payout) under receivership at $665m comprising a credit loss of $560m and post-default interest of $105m. The Crown Accounts fully provide for the expected net cost.

Treasury has been engaged in discussions with SCF in relation to a number of recapitalisation proposals in order that it is positioned to provide advice should a firm proposal eventuate. The most likely form of any recapitalisation transaction would require Crown support to proceed and based on current information, Treasury considers that recapitalisation would offer limited fiscal cost savings while exposing the Crown to significant policy risks.

Based on the indicative proposals discussed with SCF, Treasury's preliminary view is that the fiscal costs under recapitalisation could be approximately $20m to $80m lower than the costs under receivership (exclusive of post-default interest costs).

However, the recapitalisation proposals discussed with SCF do not currently provide immediate contractual certainty over the actual fiscal cost to the Crown. Key uncertainties include:

- In the event the Overseas Investment Office (OIO) approval is not received for the sale of Scales and Dairy Holdings (both have significant rural land holdings), the Crown would be required to purchase these assets at current book value;
- The size and composition of the "Bad Bank", and therefore the Crown's expected loss in relation to Bad Bank, will not be settled until 31 December 2010.

Crown support for any recapitalisation proposal would raise important policy risks with the potential to adversely influence business incentives, including:

- Changing the incentives upon firms, both within the guarantee and outside of it to seek private sector solutions ahead of government ones;
- Raising fairness issues, including why the Government has stepped in to prevent SCF from defaulting, when it has allowed other entities to default.

The costs under receivership are also high and uncertain, as reflected in the current provision in the Crown Accounts. Options to mitigate those costs also raise important policy risks including that active Crown involvement in receivership could be interpreted as signalling that the Crown considers standard corporate resolution processes fail to deliver good outcomes for creditors.

Both recapitalisation and post default interest mitigation options would raise issues in relation to equitable treatment of investors in other entities by effectively "making whole" ineligible depositors in SCF (including related parties, deposits over $1 million, non-tax residents/ citizens and financial institutions). Recapitalisation would also "make whole" other unsecured creditors who would likely experience a total loss under receivership.

We expect to receive a recommended recapitalisation proposal from SCF by Wednesday 25 August. Following that, Treasury will provide final advice in relation to any proposal including analysis of the risks and issues associated with the transaction

We have provided you with advice about options the Crown has to reduce post-default interest payments under the DGS (TR2010/1509 refers). We are drafting a paper to Cabinet to facilitate pre-positioning these options. There are a number of steps the Crown could take after a receiver has been appointed to mitigate fiscal costs associated with the DGS. We are drafting a Treasury Report on these options this week.

Recommended Action

We recommend that you:

a. **Note** that following discussions with SCF, Treasury has undertaken an initial assessment of recapitalisation options.

b. **Note** that compared to receivership, the SCF recapitalisation proposals may not offer a significant reduction or immediate certainty in relation to expected fiscal costs under alternative options.

c. **Note** that the estimated fiscal costs under alternative options are currently only indicative as a final proposal has not been received from SCF.

d. **Note that** Crown support to recapitalise SCF would raise important policy risks including the potential to adversely influence business incentives.

e. **Note** that Treasury will report to you once a final proposal has been received from SCF

f. **Note** that officials would like to meet to discuss this report with you and will liaise with your office to arrange a suitable time.

g. **Forward** this report to the Prime Minister for his information.

John Park
Manager, Deposit Guarantee Scheme
for Secretary to the Treasury

Hon Bill English
Minister of Finance

Purpose of Report

1. the purpose of this report is to:

   - provide an outline of the options available to the Crown to resolve its contingent liability under the Retail Deposit Guarantee Scheme (DGS), either prior to receivership or in the event of receivership, and to identify the difficult trade-offs between the fiscal implications and the policy consequences associated with these options;

   - Provide an update in regard to the current timing of decisions that will have to be made in regard to the recapitalisation or receivership of South Canterbury Finance (SCF) (refer Appendix 2).

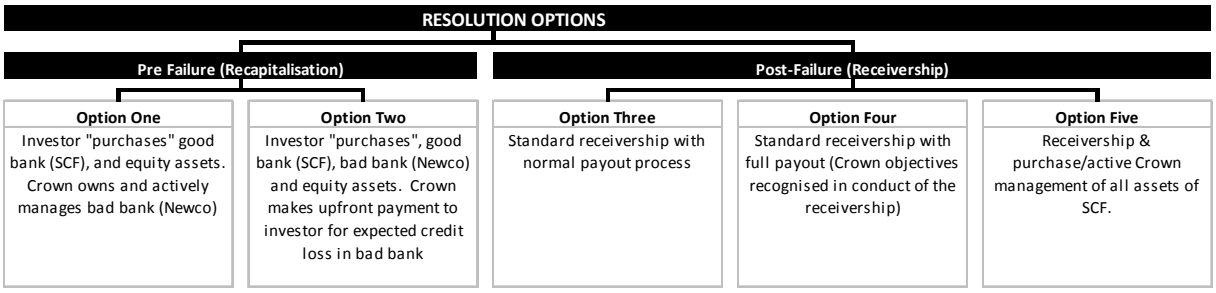
Analysis

Situation facing South Canterbury Finance Limited.

2. SCF is currently only operating with the benefit of a waiver from Trustee Executors Limited (TEL) in relation to a breach of its capital ratio which expires on 31 August 2010. In the absence of an agreed recapitalisation, TEL is expected to appoint receivers to SCF on 31 August 2010. The Treasury currently estimates the Crown's net fiscal cost under receivership at $665m comprising a credit loss of $560m and post default interest of $105m. The Crown Accounts fully provide for the expected net cost to the Crown.

3. The Crown will face a significant net fiscal loss under any of the options currently available. At the same time, options to reduce the net fiscal cost all involve difficult policy choices. The first decision is whether or not the Crown considers that further intervention in relation to SCF is appropriate in order to reduce the estimated fiscal cost to the Crown. If further intervention is considered, the choice is then between pre default options (recapitalisation of SCF) or post default options (under receivership).

4. The Crown has a range of potential pre- and post-failure resolution options (see Appendix 1 include for additional detail. Each of these options is discussed in the body of this report.



Pre Failure - Recapitalisation Options

Structure of recapitalisation proposals and commercial assessment

5. The Treasury have been in discussion with SCF in relation to potential recapitalisation transactions and has received two indicative proposals (from one bidder) for consideration which tentatively indicates a fiscal cost to the Crown of between $480m and $560m respectively. Proposals from a further two bidders are expected by 25 August 2010.

6. The concept behind both proposals is a variation on a common theme, involving a structural separation of SCF into three legal entities and acquisition of the commercially viable components by a new shareholder:

   - Good Bank (SCF), which will hold the good loans and the "core" business asset of SCF, and will be owned by the investor;

   - Equity investments, which will hold the investment assets, will be owned by the investor (Helicopters, Scales and Dairy Holdings). In the event Overseas Investment Office (OIO) approval is not received for the sale of Scales and Dairy Holdings (both have significant rural land holdings), the Crown would be required to purchase these assets at current book value; and

   - Bad Bank (Newco), which will hold the non-performing, related party and impaired loans. Newco will be effectively owned and managed (through professional management) by the Crown. In the proposal discussed with SCF, the composition and size of bad bank is subject to a formula that allows for a 10% increase in the size of the bad bank over and above initial estimates, should the credit quality of the good bank not meet the criteria of the investor following thorough due diligence with a final determination by 31 December 2010. It is expected that the Crown would be locked into that arrangement without room to negotiate.

7. Because of the uncertainty regarding the composition and size of the Bad Bank and ultimate ownership of the equity assets, there is no contractual certainty as to the ultimate fiscal outcome of the recapitalisation at the time it was agreed. For the purposes of calculating initial estimates of the potential fiscal cost, Treasury has therefore assumed that the size and composition of the bad bank is at the top end of the possible range and that OIO consent is not received for the sale of Scales Corporation and Dairy Holdings.

8. Under the proposals discussed with SCF, existing ordinary shareholders would be effectively eliminated along with existing Perpetual Preference Shareholders. New equity will be introduced by the investor to Good Bank (SCF) and the Equity Investments. SCF would continue as a finance company and would be responsible for repayment of all outstanding debentures as they fall due, although under the proposal discussed, SCF would withdraw from the retail funding market (and the DGS, excepting in relation to existing deposits as at the date of withdrawal). The Crown would effectively purchase the assets in NewCo and manage the recoveries from this book with the help of specialist asset managers to maximise the recovery from this book.

9. The second recapitalisation option is an extension of the first and involves the investor retaining the Bad Bank and the Crown paying the investor an amount that effectively compensates them for the embedded losses in the Bad Bank. The effect would be that the Crown would no longer be involved with the recovery of the assets in the Bad Bank, but this would be expected to come at a significant fiscal cost due to the risk transfer that takes place.

10. The indicative approach to determining the value of the Bad Bank under option two suggests that this may involve a higher fiscal cost than could be achieved under receivership. The higher cost reflects that the bidder has not completed thorough due diligence as well as the desire for a commercial rate of return. For the Crown, the primary benefits are certainty in relation to its liability and that it will have no ongoing involvement with SCF after 31 December 2010 when the final valuation of the Bad Bank is confirmed.

11. The difference in fiscal costs between recapitalisation proposals and receivership (exclusive of post-default interest) are the result of:

- the negative impact of receivership on SCF's assets held for sale (assets acquired under enforcement) which would not occur in recapitalisation;
- the negative impact of receivership on SCF's fixed assets which would not occur in recapitalisation;
- *[Withheld under s.9(2)(b)(ii)]*
- New private sector equity being injected.

<u>Other policy trade-offs</u>

12. Alongside the commercial assessment of the SCF recapitalisation proposals, Ministers need to be aware of the broader policy tradeoffs that entertaining such a proposal would raise. These include:

- impact on the economy;
- precedent and business incentive effects;
- issues of fairness; and
- other policy issues, including Overseas Investment Act (OIA) implications.

Impact on the economy

13. In relation to direct assistance from government to firms, during the crisis we previously proposed that any government direct assistance should focus on maintaining economically critical operations, not protecting corporate form or shareholder value. We 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.

14. Our view is that the failure of SCF would not meet these tests. We understand that the Reserve Bank of New Zealand (RBNZ) view is that SCF is not systemically important to the New Zealand economy or financial system. The only possible repercussion would be the impact of a SCF failure on other parts of the financial system, specifically on depositor confidence in other non-bank deposit takers (NBDTs). The RBNZ would not consider that the impact (of such further loss of confidence) on the wider financial system to be material and nor would they consider the impact of failure on the local economy to be material.

Precedent and business incentive effects

15. If the government did agree to one of the recapitalisation proposals this may be expected to alter incentives upon all firms, both within the DGS and outside of it, to seek private sector solutions ahead of government ones. If the government is seen to be interested in such proposals we would expect this to encourage a greater number of such approaches in future. In acting to prevent default, it could also be seen to undermine standard corporate resolution processes.

Issues of fairness

16. Recapitalising SCF would be expected to raise issues of fairness, including why the government has stepped in to prevent SCF from defaulting, when it has allowed other entities under the guarantee and outside of it to default. The re-capitalisation proposal would prevent an estimated $30 - $40m of ineligible depositors (including related parties, deposits over $1 million, non-tax residents/ citizens, and financial institutions) from suffering losses they would almost certainly suffer in the absence of this intervention. These proposals would therefore place ineligible depositors in SCF in a better position than other similar classes of creditors in firms that have defaulted (or default in future) under the DGS.

17. The preservation of ineligible creditors potentially results in a significant change in incentives on firms in the DGS, especially Directors and Trustees. While an incentive already exists to consider triggering a call on the guarantee prior to expiry, the risks are increased if ineligible creditors were or were perceived to be protected
[Withheld under s.9(2)(d)]

Other policy issues

18. There are particular regulatory risks around the recapitalisation options, primarily in regard to the Overseas Investment Office (OIO) consent (due to the large land holdings in Scales Corporation and Dairy Holdings) and the Reserve Bank of New Zealand (RBNZ) (specifically the capital adequacy and related party guidelines requirements). If the potential purchasers were prepared to inject sufficient capital, together with a restructuring of the business, then capital adequacy could be resolved. Compliance with the NBDT related party regulations would also require a very significant capital injection and / or restructure by the potential purchasers however, failure to gain OIO consent is expected to result in the Crown being required to acquire the affected assets (Scales and Dairy Holdings).

19. A range of other regulatory and other consents are required for the transaction to proceed including from the Takeovers Panel, Trustee, NZDX listed bondholders and shareholder. An analysis of the regulatory risks will be provided as part of detailed advice around an individual proposal as required.

Other risks

20. The recapitalisation proposals have been progressed within a relatively short time frame and as such, involve a range of uncertainties in relation to the fiscal outcome. That reflects that none of the parties involved have undertaken thorough due diligence on all aspects of SCF.

21. For the Crown this means that:

- the fiscal outcome is uncertain;
- the expected fiscal outcome will not be clear until at least 31 December 2010; and
- it is likely that the actual fiscal cost is higher than would result if more time was available, especially under option two.

22. If the Crown were to consider supporting a recapitalisation option, the time available to negotiate an agreement is limited. Treasury assumes that a heads of agreement is required by 27 August 2010 at the latest and this presents additional risks.

23. There is potential to allow additional time to enable the recapitalisation proposals to be more clearly defined. To achieve this, we consider that the Crown would be required to underwrite SCF's liquidity during that time and note that even with Crown support; SCF would also need to gain NZX agreement to postponing publication of its interim results to 30 June 2010, together with support of the Trustee and Directors.

24. Treasury does not recommend seeking additional time or supporting a request for additional time if this were to arise. Crown liquidity support would raise issues in relation to repayment of ineligible creditors during the period of liquidity support (see paragraph 29) that could potentially lock the Crown into a full repayment option, may weaken the Crown's negotiating position and in the event a suitable proposal could not be agreed, risk the perception that the Crown was in part responsible for the failure of SCF.

25. We note that if the Crown decides to support a recapitalisation, there will be a requirement for liquidity support, either directly or indirectly, over the period between announcement of the recapitalisation and expected settlement in mid September 2010.

Post Failure - Receivership Options

26. Treasury has undertaken further work in relation to asset recovery options and likely outcomes from alternative strategies. A report will be provided alongside reports on the recapitalisation proposals.

27. The difference in fiscal costs between recapitalisation (option one) and receivership (options four and five), exclusive of post-acceleration interest, is due to:

- the impact of receivership on the value of SCF's assets held for sale (assets acquired under enforcement);
- the impact of receivership on the value of SCF's fixed assets;
- a differing view on the value of Helicopters (Scales and Dairy Holdings are assumed to be "put" back to the Crown); and

- new private sector equity being injected.

Structure overview

28. Treasury is pre positioning for three potential options to mitigate the fiscal costs associated with the failure of SCF should it enter receivership. The three options are summarised below.

Standard receivership with normal payout process (option 3)

29. This option would involve:

- The assets of SCF being realised in receivership at a fiscal cost to the Crown of $560m.

- A loan to the receiver being made to payout the prior ranking charges, which would ensure that the prior ranking charges do not accrue default interest or appoint a receiver over the top of the Trustee appointed receiver to "liquidate" assts at below market value to repay their lending facilities (TR2010/1509 refers).

- No mitigation strategy other than enforcing the provisions of the revised deed would be used to reduce the fiscal cost of post-default interest of $105m, and a standard payout process would be used. Only limited opportunities exist to ensure claims under the DGS are made in a timely manner. A lengthy payout will add to ongoing management requirements. The receivership would be expected to last for four years. However, this is dependent on market conditions and may take longer.

- The receivership being run on a commercial basis, involving some consultation with the Crown as the major beneficial creditor of the receivership. Due to the assets being realised by the receiver on the open market, there is a high level of uncertainty over the actual fiscal cost of this option. Similar uncertainty also exists in relation to the eventual cost of post-default interest.

Standard receivership with full payout (option 4)

30. This option would involve:

- Full payment of prior charges as outlined above.

- Full payout of debenture holders on day one of the receivership to mitigate the fiscal cost of post-default interest (TR2010/1509 refers). Payment on day one represents the ideal however the actual timing would be subject to agreement from the Trustee.

- Affords greater opportunity for the Crown's objectives to be accommodated in the receivership as the Crown is the sole effective beneficiary of the receivership.

Receivership and purchase/active Crown management of bad bank (option 5)

31. This option would involve an extension of the above option with the Crown acquiring the assets of SCF from the receivers (with payment via forgiveness of the debt the Trustee has to the Crown). The effect of this is full Crown control over realisation of all of SCF's assets, both performing and non-performing.

Policy implications

32. There are a range of different options for Crown involvement in the receivership of SCF (see Appendix 1). Under option three there are a number of risks and policy implications that may arise, in particular in the event that a significant proportion of eligible creditors choose to delay claiming under the guarantee. In that event, even if the Crown is effectively the majority beneficial creditor its legal interest is indirect as compared to the direct legal interest of debenture holders.

33. Under the above circumstances, there is a risk that the Crown usurps the contractual rights of debenture holders if it attempted to influence the conduct of receivership towards an outcome that better suited the Crown, but could be seen as potentially contrary to the interests of other creditors under the Trust Deed.

34. Repaying all creditors on day one of the receivership to minimise post default interest could expose the Crown to accusations of differential treatment in respect of other failed finance companies. Full payout (options four and five) involve identical policy considerations to recapitalisation in relation to the repayment of ineligible creditors.

35. We would not recommend purchasing assets outside of the receivership unless receivership processes were clearly failing to deliver a result and that the Crown could clearly do better. That option could be interpreted as signalling the Crown considers standard corporate resolution processes fail to deliver good outcomes for creditors.

36. The same issues may also arise under option four where the Crown is clearly the sole beneficiary of receivership and a more active role may therefore be possible. However, we note that in the private sector, an active role for the sole beneficial creditor would not be at all unusual.

37. We also note that there are potential policy and other risks in relation to Crown involvement in the receivership under option three.

Future advice and decisions

38. Treasury will report back during this week on a final recapitalisation proposal once that is received from SCF. There remains a chance that SCF will seek liquidity support from the Crown again. We will provide you with a Treasury Report in regard to any request we receive for liquidity support.

39. You have asked us to pre-position to remove prior charges and for ‘full payout’ thereby keeping open your choice to either select full payout or standard payout processes when, and if, the time comes (TR2010/1509 refers). We will provide you with a Cabinet Paper covering both of these options this week.

40. A decision on whether to progress immediate repayment of prior charges will be required by 30 August 2010. Similarly, if the Crown wishes to pursue full repayment, a decision by 30 August 2010 would deliver the maximum fiscal benefit however a decision could be deferred until such time (potentially within a month of receivership) as payout under the guarantee is ready to commence.

41. A decision on Crown acquisition of assets under receivership does not need to be taken now and if there is interest in considering this option, further work would be recommended to clarify potential risks and undertake a formal assessment of implementation and ongoing management requirements.

Appendix 1

	RESOLUTION OPTIONS				
	Pre Failure (Recapitalisation)		Post-Failure (Receivership)		
Option	**Option One**	**Option Two**	**Option Three**	**Option Four**	**Option Five**
Structure	Investor "purchases" good bank (SCF), and equity assets. Crown owns and actively manages bad bank (Newco)	Investor "purchases", good bank (SCF), bad bank (Newco) and equity assets. Crown makes upfront payment to investor for expected credit loss in bad bank	Standard receivership with normal payout process	Standard receivership with full payout (Crown objectives recognised in conduct of the receivership)	Receivership & purchase/active Crown management of all assets of SCF.
Good Bank Ownership	Owned by investor	Owned by investor	In receivership	In receivership	Assets are Crown managed / owned
Equity Assets Ownership	Owned by investor	Owned by investor	In receivership	In receivership	
Bad Bank Ownership	Owned by Crown	Owned by investor	In receivership	In receivership	
Payout Type	Ineligibles under previous / current defaults	Ineligibles under previous / current defaults	Eligible Only	Eligibles and ineligibles (including under previous / current defaults)	Eligibles and ineligibles (including under previous / current defaults)
Fiscal Cost (PAI)[1]	Nil	Nil	$105m	Nil	Nil
Fiscal Cost (Credit)[2]	$480m	$560m	$560m	$530m	$500m
Treasury Costs (Payout)	Nil	Nil	$10m	$1m	$1m
Payment of ineligible creditors[3]	$20m	$20m	$0	$20m	$20m
Total estimated cost[4]	$500m	$580m	$675m	$551m	$521m
Fiscal Certainty - Credit Loss	Low until financial close on 31 December 2010	Low until financial close on 31 December 2010	Low	Low	Low
Fiscal Certainty - Post Acceleration Interest	Certain (nil cost)	Certain (nil cost)	Low	High	High
Policy Risks	Very High	Very High	Nil	Medium	Medium/High
Regulatory Risks (including Overseas Investment Office)	Very High	Very High	Nil	Nil	Nil
Treasury Costs (Asset Management/Receivership)	High	Low	Low	Medium	High
Potential Ministerial Involvement	High	Low (initially Medium)	Very Low	Low	Medium/High
Expected Resolution Duration	Long (48 months)	Short (4 months)	Long (48 months)	Long (48 months)	Long (48 months)

Notes:

1. Does not include any allowance for the post acceleration interest costs that would be incurred if eligible debenture holders enaged in significant gaming.
2. These are preliminary estimates based on indicative proposals discussed with SCF (final proposals have not been received) and are only intended as a guide to the potential outcomes achievable under the alternative options.
3. Assumes that for those options where ineligible creditors under the DGS are made whole or repaid in full under payout, the Crown also makes whole ineligible creditors of entities that have previously failed under the DGS or are expected to fail in future.

4. The total estimated cost does not include the expected ongoing costs that would be associated with either ownership of the Bad Bank (option 1)or Crown purchase and management of SCF's asses (option 5).

Appendix 2

Timetable for week beginning 22 August 2010

Tuesday 24 August

- Treasury Report on SCF Resolution Options.
- Recapitalisation proposal from potential bidders received by Treasury and evaluated.
- Treasury Report(s) to follow.

Wednesday 25 August

- Cabinet Paper in relation to post-default interest options.
- Recapitalisation proposal from potential bidders received by Treasury and evaluated.
- Treasury Report(s) to follow.
- Treasury Report on receivership strategies

Thursday 26 August

- Draft Cabinet Paper in relation to recapitalisation if required.

Friday 27 August

- Heads of Agreement (recapitalisation) finalised and/or signed if required.
- Announcement of recapitalisation if required.

Indicative Timetable from an including week beginning 30 August 2010

Monday 30 August

- Funding facility (interim) pending settlement of recapitalisation (assuming it proceeds), including in relation to repayment of prior charges and NZDX listed bonds.
- Cabinet consideration of options to reduce post-default interest (if required).

Tuesday 31 August / Wednesday 1 September

- Receivership announced (assuming no recapitalisation.)
- Repayment of prior charges and / or full payout (if approved.)

Mid September

- Final documentation and settlement of recapitalisation (assuming it proceeds), subject to any final adjustments on 31 December 2010 (depending on the successful bidder.)

October – December 2010

- OIO decision on Scales / Dairy Holding - potential sale to Crown if not approved.

31 December 2010

- Final settlement of recapitalisation (depending on the successful bidder.)