2007/08 Financial review of the Ministry of Economic Development

Report of the Commerce Committee

Contents

Ministry of Economic Development

Recommendation

The Commerce Committee has conducted the financial review of the 2007/08 performance and current operations of the Ministry of Economic Development, and recommends that the House take note of its report.

Introduction

The Ministry of Economic Development's overall aim is to help develop an internationally competitive and sustainable economy. In 2007/08 its work in support of this goal focused on:

- improving the investment environment for New Zealand firms
- improving the quality and reliability of infrastructure services
- promoting sustainable businesses
- developing an overarching plan for Auckland's strategy and governance
- improving international links.

In the year ended 30 June 2008 the ministry's total revenue was $131.559 million and total expenditure was $131.940 million. The resulting net deficit of $381,000 accorded with the ministry's long-term strategy to reduce the balances in the various memorandum accounts it administers[1].

Financial and service performance

For the year ended 30 June 2008 the Office of the Auditor-General assessed the ministry's management controls as "very good" and its financial information systems and controls as "good". We were advised by the office that some improvements were needed in procurement practices, but that the new procurement policy is sound. We agreed with the office that the annual report is clearly presented.

Responding to the financial crisis

We explored with the ministry the steps it is taking in response to the financial crisis, and how this has affected its operational priorities. The ministry noted that New Zealand had started to experience an economic downturn as a result of structural imbalances even before the global crisis hit, and the ministry had been continually reviewing priorities over the past year, in consultation with the Treasury, the Reserve Bank of New Zealand, and

[1] Memorandum accounts record the accumulated surpluses and deficits for outputs administered by the ministry that operate on a full cost recovery basis, such as the registration of intellectual property rights and management of the Crown Mineral Estate. An over-recovery of costs in earlier periods can lead to surpluses that are reduced by holding charges at less than the level of expenditure for a time.

other public-sector agencies, to develop a coordinated Government response as conditions worsened.

One important focus of the ministry's work has been reviewing the regulatory environment with a view to easing the costs of doing business. It has worked with the industry-led Capital Market Development Taskforce since it was set up in July 2008, and has helped to develop proposed legislation designed to make it easier for businesses to raise capital.[2] We asked to be kept informed of progress in considering and implementing the recommendations made by the Capital Market Development Taskforce in its November 2008 interim report.

The ministry has also been reviewing its business assistance services to ensure they are well matched to the needs of firms, and that they provide value for money. The ministry considered that some shifts in emphasis might be needed to accommodate issues of particular concern to businesses, such as access to credit and cash-flow management, but generally its services appeared to be appropriately targeted. We believe it is imperative to ensure that these business assistance services are meeting the needs of firms.

In the international area, the ministry is working with New Zealand Trade and Enterprise to decide whether its work should focus more on consolidating New Zealand's presence in international markets rather than trying to expand into new markets.

The ministry reported that its role in data collection had increased in importance since the economic downturn. With the need to react quickly as conditions change, businesses need to have access to up-to-date economic and financial market data. The ministry provides such data through its online business services.

The ministry noted that its priorities continue to evolve as the Government develops initiatives linked to the job summit. We asked about possible assistance to individual firms and were told that a broad policy framework is being developed for the circumstances, if any, in which Government intervention in an individual business might be appropriate, and the form such intervention might take. On the basis of overseas examples, relevant considerations could include whether a firm played a systemic role in the economy, that is, whether its activities significantly affected other market participants, and whether a firm was sustainable. The ministry stated that there were different forms of intervention, including expediting the flow of resources from an area of low growth to one of high growth.

Implications for work programme and resources

The ministry is reprioritising its work programme and has cancelled some projects on the instruction of the new Government. The ministry cited cancellation of the Buy Kiwi Made campaign and the removal of the biofuels sales obligation as decisions by the incoming Government that had freed departmental resources for deployment to other areas. While the Government is still reviewing its policy approach in a number of areas, the ministry expects to be able to reallocate its resources to meet changing policy priorities.

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[2] The *Securities Disclosure and Financial Advisers Amendment Bill*, introduced to the House on 18 February 2009.

We were assured by the ministry that adjustments in its operational priorities were unlikely to result in cuts to the services it provides to businesses, which are mostly prescribed by statute, although it was seeking cost savings where possible, for example by making more use of online facilities.

The ministry expects to be able to manage with existing resources, particularly given the need to reduce the overall level of Government debt. Staff levels may fall through normal attrition. The staff turnover is currently 12 percent, compared with 18 percent in 2007/08.

Some members would be concerned if the ministry's work in response to the current crisis caused slippage in other parts of its work programme that are important for rebuilding the economy and raising productivity in the longer term.

Low emissions energy

We asked the ministry whether its work on low-emissions electricity generation had assumed a lower priority in the light of the need to respond to the financial crisis. We were told that the Government was still reviewing its priorities in this area, and had yet to decide on the relative weighting it would give to three critical factors in the electricity sector: security of supply; competitive pricing; and minimising impacts on the environment. However, the ministry believed that the price of carbon could well drive a move toward renewable energy sources over time.

Interests of regions and small and medium enterprises

We observed that there was a public expectation of the Ministry of Economic Development to be responsive to the varied development needs of New Zealand's regions. The ministry said that it tends to work on a sector rather than a regional level, but also gathers information about issues of importance to regions from the regional offices of New Zealand Trade and Enterprise and other agencies, and sought to respond to them. For example, it is seeking means of maintaining the level of inbound tourism, which is also of strong interest to small and medium enterprises. Assistance to these enterprises is available through the Escalator and Incubator programmes managed by New Zealand Trade and Enterprise.

Progress on Auckland's infrastructure

One of the ministry's key priorities in 2007/08 was the development of an overarching plan for Auckland's strategy and governance (One Plan). We were told that an initial version of the One Plan setting out infrastructure priorities was completed in 2008, and the ministry is working with the Government to decide the next steps. The ministry could not comment on the priority that might be given to developing an integrated public transport scheme.

Investment in venture capital

In the current economic climate firms may find it more difficult to raise venture capital. The ministry acknowledged that the New Zealand Venture Investment Fund was of limited benefit in the current circumstances when matching private sector funding was not forthcoming, but said that it should assume more importance as New Zealand begins to emerge from the recession. We sought further information about the fund's history and current status.

Progress on broadband

We were interested in the ministry's view that deregulation has allowed more competition in the telecommunications sector and consequently healthier private-sector investment than previously. We also noted that it sees a case for even more investment in technology such as high speed broadband given New Zealand's small size and remoteness.

We agree that the key issue for the Government is how to encourage an acceleration of investment beyond what the market is likely to deliver on its own. We asked the ministry to advise us on the time frames for implementation of the new Government's broadband policy.

Security of electricity supply

An unappropriated expenditure of $16.763 million in Vote Energy reflected the need to operate the Whirinaki reserve generating plant more than expected in late 2007/08. This was, in turn, due to an exceptionally dry autumn and winter. The Electricity Commission had arranged an independent investigation into the circumstances of last winter's electricity situation.

Investment in oil and gas exploration

We are aware of efforts by the ministry to promote international investment in oil and gas exploration by commissioning initial seismic studies of New Zealand's offshore fields. It has spent $21 million over the past four years on seismic mapping of the Raukumara and Northland offshore blocks, which are now generating significant interest among major investors from several countries, including China. We look forward to updates on how this will benefit New Zealand.

Free trade with China

We are pleased by evidence that the free trade agreement with China is already starting to benefit New Zealand manufacturers, and note that an independent overseas report has estimated the likely net benefit to New Zealand at $450 million. Some of us are concerned, however, about the adequacy of current arrangements for ensuring that imported products meet New Zealand standards. At present the onus appears to be on individual importers to warrant that products meet New Zealand standards, with the task often falling to local manufacturers to advise of breaches. Some of us believe that a stronger system of official border policing is warranted. The ministry undertook to follow up this issue.

Copyright legislation

We told the ministry that we shared the widespread public concern about the workability of section 92A of the Copyright (New Technologies) Amendment Act 2008, due to come into force very shortly. The ministry confirmed that it was giving high priority to working with Ministers to resolve the issue.

Finance company failures

As part of our review we sought a briefing from the Ministry of Economic Development on finance company failures. We were provided with a report from the Registrar of Companies which is worth bringing to the attention of House and so is appended to this report.

Appendix A

Approach to this financial review

We met on 19 February, and 5 and 12 March 2009 to consider the financial review of the Ministry of Economic Development. We heard evidence from the Ministry of Economic Development and received advice from the Office of the Auditor-General.

Committee members

Hon Lianne Dalziel (Chairperson)
John Boscawen
Charles Chauvel
Clare Curran
Te Ururoa Flavell
Jo Goodhew
Melissa Lee
Peseta Sam Lotu-Iiga
Katrina Shanks

Evidence and advice received

Ministry of Economic Development, Annual Report 2007/08.

Ministry of Economic Development, Statement of Intent 2008/2011.

Office of the Auditor-General, Briefing on the Ministry of Economic Development, dated 19 February 2009.

Ministry of Economic Development, Departmental response to the committee's written questions, dated 2 March 2009.

Appendix B

Finance company failures – observations of the Registrar of Companies

Introduction

This report is in response to your request for some insight from the Registrar of Companies regarding the collapse of the finance companies between 2006 and 2008. We set out below a summary of our observations on the elements of the supervisory framework and note where we believe it was inadequate, or where it failed to address the risks inherent in the business model adopted by these companies.

We have included the failure of the Blue Chip property investment group of companies in this report given the scale of investor loss, and because the franchise's business model and subsequent collapse shared some of the same characteristics as the finance companies.

Finance companies emerged as mezzanine financiers essentially to the property market. In the late 1980s, this role was performed by contributory mortgage companies such as Registered Securities Limited and Landbase Nominee Company Limited. Contributory mortgage companies collapsed in circumstances very similar to those experienced by the finance company sector. The business model for contributory mortgage companies morphed into the finance company model, with many of the same players involved in either the borrowing or lending roles.

Business model issues

Corporate Governance: The quality of corporate governance is a key factor to be considered in our attempt to understand the reasons for the failure of the finance company industry. In a number of cases, these companies were dominated by a chief executive who was the principal architect of the company's modus operandi. The boards tended to lack the breadth of experience and skills required to oversee the scale, complexity and characteristics of financing operations. Too often directors were not adequately informed, misled or failed to take sufficient interest in the affairs of the company. There is also a pattern of the company's CEO or directors having been involved in previous financial industry failures.

For example:

- Bridgecorp founder Rod Petricevic was involved in the $250 million failure of Euro National in the late 1980's
- Michael Reeves of Lombard Finance and Investments Limited had a troubled history with contributory mortgage schemes and pleaded guilty in 2006 to a breach of the Securities Act 1978
- Roger (Kenneth) Moses of Nathans Finance NZ Limited was also involved in the failed contributory mortgage broking firm Reeves Moses Hudig.

Treatment of non-performing loans: Nearly all finance companies engaged in the practice of rolling-up a non-performing loan into a new loan, which included the original principal and the principal/interest arrears. The effect of this was to reduce or eliminate loans in default, thereby masking the true performance of the loan portfolio. Several companies reported low or nil defaults in their disclosure documents off the back of this practice, effectively misleading investors as to the quality of the company's lending practices and performance. (Harrison J commented on such practices in paragraphs 12 and 13 of his judgment in the matter of the receivership of Capital + Merchant Finance Limited.)[3]

Lending practices: A number of the finance companies engaged in excessive related-party lending with investors funds, often in circumstances where funding for the particular venture could not be sourced from conventional funding sources. In some cases, the only objective of entering into one of these transactions was to benefit one of the directors (or interests associated with the directors) or prop up a poor performing investment.

For example:

- we understand prior to receivership, Nathans Finance NZ Limited (in Receivership) provided $171 million of debt to related company VTL Group Limited, parties associated with it and various VTL franchisees. Out of total loans of $176 million, Nathans had only six loans to unrelated third parties totalling $5.3 million. The receiver has confirmed that the loans to VTL and its subsidiaries are unlikely to be recovered
- the receivers of Capital + Merchant Finance Limited (in Receivership) report that there were six (6) related party loans recorded in the company's loan book totalling $37.6 million at the date of their appointment. The borrowing companies were controlled by the directors, Tallentire, Douglas or Nicholls, individually. Two of the related debtor companies are in the process of being wound up by the court. During the course of their investigations, the receivers identified a number of other loans totalling $41 million which contain "related party elements". They recovered $1.75 million from those loans and the balance has had to be written off.

Concentration of loan risk: The largest finance companies often had significant reliance on the success of one industry and/or a very small group of borrowers. By way of example, the loan books of Bridgecorp and Lombard Finance Limited were heavily weighted to the speculative end of the property market. The exposure of these finance companies was such that they had no choice but to continually roll over poor performing loans until the borrower's development project could be completed. Bridgecorp's single largest loan exposure was $50 million invested in the yet to be completed Momi Resort project in Fiji. The Brooklyn Rise apartment development in Wellington accounted for almost 30% of Lombard Finance's loan book. The significantly impaired $42 million Brooklyn Rise loan was part of a loan book of which 80% was lent to just five borrowers.[4]

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[3] Judgment of Harrison J in the High Court of New Zealand, Auckland Registry, between CAPITAL+MERCHANT FINANCE LTD And Anor V FORTRESS CREDIT CORPORATION And Ors, CIV 2007-404-007298 [29 November 2007].

[4] Ibid, paragraph 15.

Repayment: It is our understanding that a number of the failed finance companies were in the end acting in a similar manner to ponzi schemes. In many cases, funds received for investment from new investors were used to repay the maturing loans of existing investors. In these circumstances the companies continued taking in funds many months after their position was irreversible, thus exposing investors to immediate losses.

Trustee supervisory model

There are effectively five trustee companies in New Zealand. Of these, Perpetual Trust Limited (Perpetual) and Covenant Trustee Company Limited (Covenant) were the appointed trustees of at least 25 of the failed finance companies (as illustrated in the table attached as Appendix C). This degree of involvement raises issues as to the quality of due diligence at the time of their acceptance of the assignment, and in particular the extent to which they accepted circumscription of their powers in relatively weak and potentially ineffective trust deeds.

Capability: In our view, Covenant and Perpetual were slow to detect adverse financial issues developing and they responded too timidly to circumstances where investors' interests were being put in jeopardy. Covenant and Perpetual did not appear to have enough sufficiently experienced staff, or adequate understanding of the risk profile of finance company lending, to deal effectively with what turned out to be widespread failure within their finance company client list.

Trust Deed covenants: In our view, the covenants in the Trust Deeds agreed between some of the finance companies and their trustees were too weak given the risks the companies were assuming and the activities they were engaged in. In many cases the Trust Deeds lacked a description of "enforcement events", leaving the trustees with insufficient powers to take action and a limited ability to intervene when solvency issues arose. Some of these matters have now been remedied.

Trustee reporting: Trustees are required by section 11 of the Corporations (Investigation and Management) Act 1989 to notify the Registrar of Companies (the Registrar) if a company has breached, or is likely to breach in a significant respect, the terms of a Trust Deed.

Invariably breach notifications were only received by the Registrar on, or about, the date of the actual appointment of a receiver. Either the trustees believed no qualifying breach had occurred before then (which seems unlikely given the scale of the collapses) or they did not discover any breach at all. In these cases, little could be done in response because the company was already past the point of no return financially by the time the Registrar received a section 11 notice. A case study of the events leading up to the collapse of a selection of finance companies to ascertain exactly when Trust Deed covenants were breached, the nature of that breach and whether any breaches were previously waived by the trustee may prove informative.

Corporate substance: Trustee company ownership has changed significantly in recent years and now bears little resemblance to the "institutional strength" the public perceive them to have. For example, Perpetual is wholly owned by NZX-listed Pyne Gould Corporation Limited, Graham Miller is the controlling shareholder of Covenant and Trustees Executors

Limited is owned by US-based investment firm Sterling Grace Corporation. Any decision-making around the future of the trustee supervisory model should take this into account.

Accountability: Trustee accountability is relatively weak. Shortcomings in the performance of a trustee company are unlikely to be uncovered or pursued by receivers who are appointed by the trustees, and who look to trustees for further assignments. We understand receivers are uncertain as to their standing to consider such issues. There is therefore, in practical terms, no real avenue for investors for examination of the performance of trustees or to pursue redress for negligence in the performance of their duties.

The role of auditors

For investors, auditors are also an important feature of the securities market supervisory framework. As illustrated in the table attached as Appendix C, it is clear that the Big Four accounting firms (Deloitte, Ernst & Young, Pricewaterhouse Coopers and KPMG) were not particularly interested in finance company audit appointments. As far as we are aware, KPMG was the only Big Four firm to act as auditor for more than one finance company. There was a significant concentration of audit appointments within second-tier accounting firms such as BDO Spicers, Staples Rodway and Hayes Knight. Issues arose as to whether they had sufficient capability and experience to conduct the initial due diligence for the assignment and to audit such complex and elaborate company and business structures.

Our concern is illustrated by the action taken against the auditors of National Finance Limited, O'Halloran & Co, for failure to exercise due care and diligence and failure to comply with the Institute of Chartered Accountants' technical audit standards. The auditors pleaded guilty to a breach of the Institute's Code of Ethics and were ordered to pay over $130,000 for the costs of the hearing. It has been reported that the Institute of Chartered Accountants is now looking at the audits of all failed finance companies.

As a general observation, the audits of many of these finance companies lacked the rigour and analytical depth one would expect for entities managing substantial public investments. There is a view among receivers that if they had been rigorously audited, it is unlikely many of the failed finance companies would have continued in business for as long as they did. The judgment of Harrison J in the Capital + Merchant Finance case is illustrative of the weaknesses in the governance and supervision of finance companies (in particular please see paragraphs 55, 56 and 58).

General

Disclosure: Unlisted issuers are not subjected to a continuous disclosure regime and in most cases a prospectus is only filed (and renewed) with the Registrar twice a year. Where funds have been raised from the public, there is a view that some form of continuous disclosure model should apply to the issuing entity.

Securities Act: The Blue Chip property investment products were structured in a form to fall outside the prospectus requirements of the Securities Act 1978, but for many investors there was never an intention to be locked into the property linked to their investment. The company's promotional efforts also conveyed this flexibility. The scheme was of a form and scale which warranted a prospectus or equivalent regime. Rather than attempt to prescribe all the circumstances where a prospectus and/or the Securities Act should apply, there may be merit in allowing the Securities Commission to "call in" a scheme which on its face is exempt and apply the Act's disclosure requirements subject to a right of challenge by the issuer.

Repayment moratoria: We understand investors in nine finance companies have approved a restructure and/or moratorium on maturing loan repayments for periods of up to five years. There is no regulatory oversight of these moratoria, matters being left with the companies, their trustees and the affected investors. The various moratorium proposals have been the subject of some criticism, however investors have agreed to delayed repayment plans approved by the company's trustee so there is no reason or room for a regulatory agency to intervene. Some observers have expressed concern that moratoria avoid the accountability and inquiry that directors and others may face in a receivership or liquidation situation. There is an emerging trend of a number of moratorium proposals failing to meet the forecast expectations on which they were offered to investors.

Neville Harris
Registrar of Companies

Appendix C

Failed finance companies – as at February 2009

In Receivership	Trustee	Auditors
National Finance 2000 Ltd May 2006 (and in Liquidation)	Covenant Trustee Company Limited	O'Halloran & Co Chartered Accountants
Provincial Finance Ltd June 2006	Perpetual Trust Limited	Ernst & Young Chartered Accountants
Western Bay Finance Ltd August 2006	Covenant Trustee Company Limited	Ingham Mora Chartered Accountants
Bridgecorp Ltd July 2007 (and in Liquidation)	Covenant Trustee Company Limited	PKF Chartered Accountants & Business Advisors
Nathans Finance Ltd August 2007	Perpetual Trust Limited	Staples Rodway
Five Star Consumer Finance Ltd August 2007	Covenant Trustee Company Limited	BDO Spicers Chartered Accountants & Advisors
Five Star Finance Ltd September 2007 (and in Liquidation)	*NO PROSPECTUS	
LDC Finance Ltd September 2007	Perpetual Trust Limited	Sherwin Chan & Walshe
Finance and Investments (Partnership) September 2007	* NO PROSPECTUS	
Clegg & Co Finance Ltd October 2007	Covenant Trustee Company Limited	Hayes Knight Audit Chartered Accountants & Business Advisors
Capital + Merchant Investments Ltd **Capital + Merchant Finance Limited** November 2007	Perpetual Trust Limited	BDO Spicers Chartered Accountants & Advisors
Numeria Finance Ltd December 2007	Perpetual Trust Limited	BDO Spicers Chartered Accountants & Advisors
Lombard Finance and Investments Ltd April 2008	Perpetual Trust Limited	KPMG Chartered Accountants
Kiwi Finance Ltd April 2008 (and in Voluntary Administration)	Perpetual Trust Limited	Silks Chartered Accountants
Fairview NZ Ltd (formerly Cymbis)	Perpetual Trust Limited	BDO Spicers Chartered Accountants &

May 2008		Advisors
Belgrave Finance Ltd May 2008	Covenant Trustee Company Limited	Hayes Knight Audit Chartered Accountants & Business Advisors
Dominion Finance Group Ltd September 2008	Perpetual Trust Limited	BDO Spicers Chartered Accountants & Advisors
All Purpose Finance Limited November 2008	Trustees Executors Limited	PricewaterhouseCoopers
In Liquidation		
Five Star Debenture Nominee Limited November 2007	* NO PROSPECTUS	
In Moratorium/Frozen repayments		
Beneficial Finance Limited	Covenant Trustee Company Limited	BDO Spicers Chartered Accountants & Advisors
Geneva Finance Limited	Covenant Trustee Company Limited	Staples Rodway
OPI Pacific Finance Ltd	Perpetual Trust Limited	Sherwin Chan & Walshe
MFS Boston Limited	Perpetual Trust Limited	Markhams MRI Auckland
St Laurence Limited	Perpetual Trust Limited	KPMG Chartered Accountants
Hanover Finance Ltd	Perpetual Trust Limited	KPMG
North South Finance Ltd	Covenant Trustee Company Limited	BDO Spicers Chartered Accountants & Advisors
Dorchester Finance Ltd	Perpetual Trust Limited	Staples Rodway
Strategic Finance Limited	Perpetual Trust Limited	BDO Spicers Chartered Accountants & Advisors
Orange Finance Ltd	Covenant Trustee Company Limited	Grant Thornton

Blue Chip		
Northern Crest Investments Ltd		BDO Spicers Chartered Accountants & Advisors