DFC NZ – a cautionary tale of one company's financial failure*

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Abstract

We provide a case study of the failure and statutory management of DFC NZ Ltd, formerly the government-owned Development Finance Corporation. The failure of DFC NZ reflected pressures both on the liability and asset sides of its balance sheet, with the latter proving particularly problematic. DFC NZ was heavily exposed to central business district property development and the agricultural sector, both sectors contracted markedly in the wake of the 1987 share market crash. While DFC NZ was in (quasi) private sector control, many of its investment problems resulted from its heritage as a development finance institution.

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JEL Codes: G33, N27, E32, E12

1 Introduction

This article is a case study of the failure of DFC New Zealand Ltd in 1989. Although DFC New Zealand Ltd was not a registered bank, it was a 'specified institution' as it was an authorized dealer in foreign exchange (section 38K, Reserve Bank Amendment Act 1986). As a specified institution DFC New Zealand Ltd was therefore subject to prudential supervision (section 38I). The Reserve Bank's legislation was substantially revised in 1989. Under the Reserve Bank Act (1989), which came in to force in February 1990, greater regulatory emphasis was placed upon registered banks, as opposed to other financial institutions.

*The views expressed in this paper are those of the author(s) and do not necessarily reflect the views of the Reserve Bank of New Zealand.

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Consequently, in December 1988 DFC New Zealand Ltd applied to become a registered bank.

The recognition of DFC New Zealand Ltd's insolvency was arguably prompted by its application for Bank registration. Discussions with regulators prompted a managerial review of DFC New Zealand Ltd's loan portfolio, which took place in August and September 1989. This review led management to conclude that DFC New Zealand needed a large capital injection if it was to continue operating. Approaches were made to both its shareholders and to the New Zealand government (as its former owner), but no assistance was forthcoming.

Ultimately, DFC New Zealand Ltd was placed in to statutory management under section 38R of the Reserve Bank of New Zealand Amendment Act (1986).[1] In a post-mortem in 1991, the Governor of the Reserve Bank of New Zealand, Don Brash, implicitly suggests that statutory management was deployed because "[t]he reputation of New Zealand and its financial system were very much at stake" (Brash 1991). The reputational consequences of DFC New Zealand's failure were large because it was a leader in the development of swap and options markets in New Zealand, and played an innovative role in mediating funds from abroad.

In this article we view the failure of DFC through the lens of Hyman Minsky (eg Minsky, 1982, 1986). Mehrling (1999,2000) provides a succinct characterisation of Minsky's view that the 'essential' element of capitalism is the financial flows (obligations) entailed by ones' asset portfolios and liabilities. These financial flows connect economic activity from one period to the next. The capital value of assets simply reflects expectations about the future financial flows attached to such assets, but such expectations may be subject to Keynesian animal spirits. Minsky particularly emphasizes that 'good times' can lead to euphoric expectations, and that economic agents might take on greater financial obligations (eg debt) to purchase assets. Financial life gets particularly interesting when cash flows do not meet initial expectations, because then alternative means must be found to validate obligations, for example by selling assets to meet cash obligations or by obtaining liquidity from financial institutions. If the expected cash flows fail to materialize then asset values will also tend to fall. Deflation in asset values may arise as firms conduct 'fire-sales' of assets in order to meet their financial obligations, and declines in asset values will affect the solvency of firms holding similar assets. In turn, given that lending is often secured, this may give rise to the financial accelerator effects described by Bernanke, Gertler, and Gilchrist (1996). Minsky also identifies the propensity for financial 'layers' to develop, making multiple entities vulnerable to disruptions in payment flows.

This case study of DFC New Zealand Ltd exhibits many of the features described above – euphoric expectations, financial shocks, collapses in asset values, and fire-sales. The layering of chains of financial dependence between different financial entities is also a strong element of the story.

On one level, the failure of DFC New Zealand Ltd is simply an interesting

[1] Interestingly, if DFC had failed after February 1990 it might not have been possible to use the corresponding section in the 1989 Act since it only applied to registered banks.

historical interlude. Yet on another level it offers a metaphor for more recent developments in the global financial crisis. Concerns about mis-priced assets, informational asymmetries, liquidity, and the collateralisation of debt obligations, have all become prominent once again. The resolution of the global financial crisis has not played out in its entirety, whereas we have the benefit of more than twenty years of hindsight to understand why, and how, DFC New Zealand Ltd failed. DFC New Zealand Ltd may thus provide insight into more recent economic developments.

Section 2 details the origins of DFC NZ Ltd – its transformation into a state-owned enterprise, and its eventual privatisation; section 3 discusses the demise of DFC NZ Ltd. Section 4 discusses the connections to the firms that failed during this period, and section 5 discusses DFC New Zealand's portfolio of assets, which ranged from equity through to secured loans. Lastly, section 6 concludes.

2 DFC New Zealand Ltd

The Development Finance Corporation was originally established by an Act of Parliament in 1964 to encourage investment by providing financial assistance and financial advisory services to industry (Department of Statistics 1977, p. 738). The assistance took the form of both loans and equity. As such, the Development Finance Corporation was part of the Government's attempt to direct lending into specific areas, in order to correct perceived financial market failure.[2] It was thought that high risk and small ventures were being neglected by financial institutions, a view that was still being expressed some 30 years later (eg Young 1994). Originally, the Development Finance Corporation was owned by private Banks, the Reserve Bank, and the New Zealand government, but the government assumed sole ownership in 1973. For a period of time, the Development Finance Corporation enjoyed the benefit of a government guarantee, though this was withdrawn for all debt issued after 1977. Although Government-owned, the DFC's access to the Government as a source of funds was curtailed in the 1970s and instead DFC financed its activities by accessing international financial markets (DFC New Zealand Ltd 1988, p. 6). This reliance on international finance was undoubtedly the main reason why the DFC was the first New Zealand entity after the Government to have an international credit rating.

The deregulation of New Zealand financial markets in the mid-1980s reflected greater faith in the ability of markets to correctly allocate resources. The abandonment of direct credit controls and the emphasis on the efficiency of markets reflected a shift away from the market failure arguments that had previously been used to justify the establishment of 'a development finance institution'. In response to this anomaly, and because of fiscal pressures associated with high

[2] Henceforth we will refer to the incorporated company as DFC New Zealand or DFC NZ, and refer to the statutory body as DFC.

public debt, the DFC was transformed into a state-owned enterprise, DFC New Zealand Ltd, from 1 April 1987.

Plans were made to privatise the newly formed state-owned enterprise. It was initially anticipated that the New Zealand government would retain an equity share in DFC NZ Ltd whilst issuing shares to the public; at one stage a merger with the Trust Bank Group was discussed though subsequently rejected from the Trust Bank end (Dey 1989, p. 15).

In June 1988 the Government announced that it would sell 80 percent of DFC NZ to the National Provident Fund (NPF) and the remaining 20 percent to Salomon Brothers. Upon purchasing DFC NZ Ltd the National Provident Fund and Salomon Brothers strengthened DFC NZ Ltd's capital base by issuing a further 45 million $1 shares at face value. It was intended that 20 percent of the capital would later be sold to senior management and staff.

The National Provident Fund was established in 1911 to provide superannuation for the general public (Department of Statistics 1977, p. 170). NPF was a unique insurance provider in that payments to beneficiaries were guaranteed by the government (section 71, National Provident Fund Act 1950). NPF purchased DFC NZ to diversify its financial holdings, while Salomon Brothers, the New York-based investment bank, regarded their shareholding in DFC NZ as a strategic foothold in the New Zealand market. The sale of DFC was agreed after a process of due diligence had been undertaken, establishing DFC New Zealand Ltd's value to the purchasers (Hansard 1989a, p. 13351). The total price, to be paid in US dollars in December 1988, was NZ$111.28 million (DFC New Zealand Ltd 1988, p. 1; Reuters 1988).

It is interesting to note that DFC NZ was bought at a discount to its net asset backing, despite the fact that DFC NZ Chairman Malcolm McConnell stated in the 1987 annual report that the board had "taken the opportunity provided by the change in legal status from statutory corporation to limited liability company, to establish the strongest possible platform for the new company... by ensuring that all assets which might not perform in accordance with the new company's requirements were written down" (DFC New Zealand Ltd 1987, p. 1). With the benefit of hindsight, it is rather ironic to read that: "[d]irectors have maintained DFC's relatively conservative accounting policies of previous years and, *coupled with a rigorous approach to prudential management*, this has ensured that the profit result is based on high quality earnings." (DFC New Zealand Ltd 1987, p. 1, emphasis added).

The National party opposition was highly critical of the sale price because management was to purchase 20 percent of DFC New Zealand Ltd at a later date; the National party opposition believed DFC New Zealand Ltd was being deliberately under-priced to advantage the senior management who would later purchase a share of the institution (New Zealand Government 1989, p. 12875). With the benefit of hindsight, this under-pricing view could not have been more mistaken.

3 DFC NZ Ltd's demise

DFC New Zealand Ltd's existence as an independent company was of short duration – the NPF-Salomon Brothers board issued just one annual report, in March 1989. In this report much was made of the privately-owned institutions' new orientation, which included DFC NZ's application for registered bank status (DFC New Zealand Ltd 1989, p. 4). Registration would have facilitated international activity by reducing the risk-weighting attached to funds (White 1992b, p. 184) and would have provided an alternative signal of quality – perhaps offsetting the deteriorating signal provided by DFC's falling credit rating.

As part of the Bank registration process the Banking Supervision Department of the Reserve Bank requested an independent evaluation of DFC NZ's lending portfolio (The Press 1989b, p. 3). DFC NZ did not comply with this request, but instead undertook a management review in August and September 1989, which indicated that the company was close to, if not actually, insolvent. DFC NZ's board appealed to the National Provident Fund for further equity, but was refused. DFC NZ's board then approached the government for a guarantee, but was again refused (New Zealand Government 1989, p. 12876). On 2 October 1989 DFC NZ advised the Reserve Bank that it had limited liquidity and was technically insolvent and, given the Government and NPF refusals, it asked to be placed into statutory management, which it was on 3 October 1989.

DFC NZ Ltd's failure resulted from its historical background, internal characteristics, and the external institutions and environment within which it operated. It reflected both liability and asset pressures, which in turn resulted from both domestic conditions and international practices. DFC NZ was a small institution, by both national and international banking standards.

DFC NZ Ltd endeavoured to enter the retail market, but it discovered that it did not have a competitive advantage in the area of personal investments, because of high transaction overheads (Reuters 1989b). Consequently, it was forced to rely heavily on wholesale funds to support its on-lending activities. As such it can be considered to be one of Minsky's financial 'layers': DFC NZ offset informational asymmetries between borrowers and lenders, reducing the cost of financing certain assets, by providing an implicit guarantee of their quality, through its own equity (see Minsky 1982, pp. 213–214). DFC NZ also provided foreign depositors with a degree of diversification – rather than simply being exposed to a single counter-party, foreign depositors were implicitly exposed to the portfolio of assets held by DFC NZ.

Although DFC NZ Ltd was often labelled an 'investment bank' this was something of a misnomer, as most of its activities centred not around fee-based services, but around lending and equity-participation in high-risk areas. DFC NZ was, as its previous name suggested, a development finance institution. However, because it was primarily funded by accessing international wholesale financial markets, DFC NZ was also "a leader in the development of the swap and option markets in New Zealand" (Brash 1991) and thus on one level was a highly sophisticated financial entity.

In 1988 51 percent of DFC NZ's loan and deposit liabilities (excluding its

Table 1: DFC NZ Ltd Liabilities: 1987-1990

	1986 $000	1987 $000	1988 $000	1989 $000	1990 $000
Shareholders Funds	100,076	130,125	143,335	181,298	(843,972)
Subordinated and Perpetual Debt	176,632	230,973	340,519	200,533	
Local Currency Loans and Deposits	631,430	773,067	979,355	718,476	441,503
Foreign Currency Loans and Deposits	696,248	1,119,695	1,019,149	1,432,792	1,605,195
Less Unamortised borrowing costs	(35,947)	(30,207)	(21,466)	(12,669)	(2,397)
Other Liabilities	186,343	270,203	226,550	217,243	25,645
Total Liabilities	1,578,150	2,439,515	2,589,948	2,881,146	1,656,507

Following the accounting convention, parentheses indicate negative numbers. Source: DFC NZ Ltd Annual Reports, various years.

subordinated debt) were derived from foreign currency notes and deposits. By 1989 this ratio had risen to 66.6 percent and in absolute terms had increased from $1.019 billion to $1.432 billion (see Table 1). This expansion in foreign liabilities coincided with an overall expansion of DFC NZ's balance sheet. During the 1988 financial year DFC also liquidated a considerable proportion (circa 58.5 percent) of its short term securities. However, these subsequently rebounded in the following year up from the low of $349m to $629m, though this must be considered in the context of DFC NZ's expanding balance sheet and relatively high inflation during this period.

The growth of both subordinated debt and foreign lending over the above period is very apparent. As chief executive Murray Smith notes in the 1988 Annual Report, difficult and competitive trading conditions were decreasing profit margins (DFC New Zealand Ltd 1988, p. 6; see also DFC New Zealand Ltd 1987, 1989). To maintain the same degree of return on its equity DFC New Zealand Ltd was expanding its balance sheet and this expansion was achieved by sourcing funds from international markets (for a corporate example of the need for leveraging see McDonald 1988, p. 43). Growth in earnings makes it appear that the shareholders' funds-asset ratio has improved in 1988 (to 5.5 percent from 5.33 percent in 1987) and improved again in 1989 (up to 6.3 percent), but the negative shareholder's funds in 1990, which took into account huge bad loan provisions, demonstrate how ephemeral such appearances may be.

A maturity profile provided in the 1989 Annual Report provides additional insight into DFC NZ Ltd's liabilities. It indicates that as of 31 March 1989 $1.792 billion of DFC NZ Ltd's current liabilities were at call or matured within six months. These short-dated liabilities amounted to 67.9 percent of total liabilities (comprising some $2.678 billion, excluding shareholder's funds). On the other side of the balance sheet, assets maturing within the same period accounted for just 37.5 percent of total assets DFC New Zealand Ltd 1989, p. 39). Unfortunately, maturity profiles of previous years are unavailable and the following Annual Report reflects the dramatic re-evaluation of assets that occurred in statutory management making a comparison of this profile rather meaningless. The preponderance of short-dated liabilities meant that DFC New Zealand Ltd was vulnerable to any funding problem, ie rollover risk.

Originally, DFC NZ was able to borrow successfully in international money markets because it was Government-owned. Under Government ownership it had an AA- credit rating from Standard and Poors Corporation for its subordinated perpetual debt. In July 1988, in response to the sale announcement, Standard and Poor's Corp downgraded DFC NZ Ltd's subordinated debt to A- from AA-, a rating change with which Murray Smith was not dissatisfied (New Zealand Herald 1988b, p. 4). As a small institution dependent on wholesale funds it was important for DFC NZ Ltd to maintain both a good credit rating and strong capital adequacy to ensure depositor confidence; capital adequacy and the BIS guidelines that were being developed with respect to capital adequacy feature prominently in DFC NZ Ltd's annual reports (1988, pp. 13-18; 1989, pp. 3, 6-8, 42-43). To maintain its debt-equity rating DFC NZ Ltd was using subordinated capital to provide tier two capital.

Tier two capital – comprising general provisions, subordinated and perpetual debt – amounted to $110.65 million of the $291.95 million that DFC New Zealand counted as capital in its 31 March 1989 balance sheet. The tier one capital adequacy ratio was 5.67 percent (compared to a BIS recommended minimum of 4 percent) and tier two capital provided a further 3.52 percent, boosting the total to 9.28 percent from the previous year's 8.28 percent.

The importance of retaining tier two capital is apparent if these ratios were to be maintained and, reassuringly, John Perham, the National Provident Fund-appointed chairman, announced in the 1989 Annual Report (p. 7) that DFC NZ Ltd had "retained all long-term funding previously available to it under Government ownership", this despite the fact that the subordinated perpetual debt-holders could require DFC NZ Ltd to repurchase these notes given that the New Zealand Government had ceased to control 51 percent of the company.

What was not made clear by John Perham was that this right was exercisable on 29 May 1989 or 29 November 1989 (Note 3, "Notes to the Financial Statements," DFC New Zealand Ltd 1989, p. 34; see also p. 45). From the Annual Report provided by the statutory managers in 1990 one learns that the entire tranche of subordinated perpetual floating rate debt was presented to DFC Overseas Investments Ltd for repayment in May (DFC New Zealand Ltd 1990, p. 16). At balance date this amounted to $142.07 million of DFC NZ Ltd's subordinated debt. Without this funding, subordinated debt drops from $320.5 million to $178.43 million. However, even if this repayment had occurred earlier DFC NZ Ltd's capital adequacy would have remained unchanged because only $90.65 million of the total subordinated debt was being recognised for the purposes of calculating tier two capital. The amount of subordinating debt that could be recognised was constrained to 50 percent of the recognised tier one capital and as tier one capital amounted to $181.3 million, only $90.65

million of the total $320.5 million of subordinating debt could be recognised as tier two capital. The rest of tier two capital, $20 million, came from general (not specific) provisions. However, it should be noted that the ability to obtain the non-perpetual subordinated debt would likely have been constrained if DFC NZ had not had the perpetual subordinated debt. Even though the capital adequacy ratios remained unchanged, the reduction in subordinated perpetual debt still represented a significant decline in funding and, being subordinated, it weakened the security of all other senior debt holders. In effect, the subordinated perpetual debt lenders jumped to the top of the repayment queue, whereas previously only equity holders would have had lower priority for repayment.

Two further aspects of DFC New Zealand Ltd's capital adequacy should be noted: first, the expansion of DFC NZ's balance sheet would have been severely impeded without the initial NPF-Salomon Brothers $45 million capital injection; second, it would have been more difficult to achieve an adequate capital adequacy ratio if DFC NZ had not been able to divest itself of its equity investment. These assets, including provisions, were valued at $231.8 million in the 1988 balance sheet. According to John Perham, the divestment was 'vindicated' by the capital adequacy framework announced by the Reserve Bank, within which any equity participation in excess of 10 percent (as many of DFC NZ's holdings were), was to be deducted from qualifying capital (analogous to the free resources ratio requirement described by Hall 1987, p. 7). These assets were transferred at book value to Stratacorp Financial Ltd – a National Provident Fund subsidiary, though Stratacorp Financial Ltd had a $90 million debenture with DFC New Zealand Ltd (The Press 1990, p. 15), and it appears that a considerable proportion of these assets were merely being transferred from the equity section of DFC's assets to the loans and advances section.[3]

Although DFC New Zealand Ltd did register an after-tax loss of $4.92 million in March 1989 it does seem unusual that the entire tranche of subordinated perpetual debt should be presented for repayment, particularly since DFC still retained a solid investment rating – it was not until August 1989 that Standard and Poor's Corp lowered DFC NZ Ltd's subordinated debt rating to BBB- (a junk bond rating; Blitzer 1992, p. 537) from BBB (Reuters 1989c). As William Chambers of Standard and Poor's notes, the difference between incremental credit-rating categories is minimal (Chambers 1988); from a 'rational' perspective one would not expect a significant change in funding from incremental credit-rating changes. However, Eiteman and Stonehill (1989, p. 272) provide an invaluable insight. They suggest that:

> "Purchasers of Eurobonds do not typically rely on bond-rating services or on detailed analyses of financial statements. General reputation of the issuing corporation and its underwriters has been the major factor in obtaining favourable terms. For this reason,

[3] The newspaper report could not be confirmed by searching Stratacorp Financial's company file because as of July 1994 the file had been 'misplaced' within the Justice Department. Stratacorp was, however, listed in Fernbank's receiver's *Payments Abstracts* as a source of funds, so this claim is credible.

> larger and better-known multinational firms, *state enterprises* and sovereign governments are able to obtain the lowest interest rates." (Italics added.)

It thus seems that the privatisation of DFC New Zealand Ltd was the decisive factor in the withdrawal of support for subordinated perpetual debt. DFC NZ Ltd's small loss and the general malaise of the New Zealand economy would only have strengthened the incentives for such a move.

However, the nature of the Government's divestment of DFC New Zealand Ltd might have been expected to cloud any such decision. According to Moody's: "Because the Government guarantees NPF's payments to contributors... many investors must have assumed that the Government would step forward to support DFC in a crisis, especially since the weakness in DFC's loan portfolio was created primarily during the period of Government ownership" (quoted in The Dominion 1989a, p. 17). By providing both a $200 million line of credit and a memorandum stating that DFC New Zealand Ltd had its full support, NPF further increased the ambiguity of DFC NZ's status. In July 1988 Murray Smith, wrote to NPF Chief Executive John Perham, stating: "The confirmed firm stand-by commitment of $200 million from NPF has assisted DFC management materially in our dealings with rating agencies over the past few days" (quoted in Hansard 1989b, p. 13085). The nature of this support was not made clear, in that the NPF decided to review the provision of this credit facility annually, and finally withdrew the facility in June 1989 without informing the rating agencies *[Revise citation.]*(Hansard 1989b, p. 1724, The Press 1989a, p. 45; Hansard 1989b, 13085).

After DFC NZ's failure the Finance Minister, David Caygill, claimed to have been advised that the facility had been withdrawn because: (1) DFC NZ had indicated it did not anticipate any need for the facility, (2) no use had been made of the facility, and (3) "other substantial measures of liquidity and capital adequacy support had already been made" – presumably referring to the initial $45m capital injection (Hansard 1989b, p. 1725). As Chairman of DFC NZ, Mr Perham must have known that all perpetual debt had been withdrawn in May, so it is hard to believe such justifications. John Perham also wrote to Keith Sutton (acting Chief Executive of DFC NZ) saying that the withdrawal of funding "should not be seen as a major shift in National Provident Fund policy" (quoted in Hansard 1989b, 13085). It is easy to regard this statement with a great deal of cynicism given the potential liquidity problems that one might reasonably have expected to eventuate in the light of the repayment of subordinated perpetual debt.

The ambiguity over DFC's status would only have been exacerbated by the fact that David Caygill spoke in Hong Kong at a DFC NZ book promotion in September 1989 at which he praised DFC NZ as one of New Zealand's leading financial institutions – though he also apparently pointed out that DFC NZ was not Government guaranteed (Hansard 1989a, p. 13410). Caygill was unaware at this stage that the NPF loan facility had ever been offered by the NPF and was also oblivious to the fact that it had been withdrawn several months earlier

(Hansard 1989c, p. 13205). Smellie (1990, p. 21) notes that many of DFC's mainly Japanese creditors were angry in the wake of the Crash because they were under the (false) impression that their loans were Government guaranteed (see also Reuters 1991). If foreign institutions were operating under this misconception, it would have had a significant impact on their willingness to hold subordinated debt (as should have the clause invoked by perpetual debt-holders, which was publicised in prospectuses).

DFC New Zealand Ltd's funding problems played an important part in the events of 1989. The withdrawal of perpetual debt and the withdrawal of the NPF loan facility played an important role in creating the liquidity problems that led to DFC NZ's statutory management. Yet without similar pressures on the asset side of the balance sheet, liquidity problems arising from liability pressures are likely to have been significantly reduced, a point discussed further in the next section.

4 Asset quality, solvency and liquidity

Although funding was a major part of DFC New Zealand Ltd's trouble in 1989, it is extremely unlikely that liability shocks would have been sufficient to force DFC NZ into statutory management if its assets had actually been of good quality. As Minsky (1982, p. 146) appreciates, firms are permitted to exist in the economic sphere provided they fulfil two monetary-based criteria: they must be solvent (their assets must be greater than their obligations; a stock criterion) and they must be liquid – they must be to able to meet their obligations as these obligations fall due; a flow criterion (see also Grady and Weale 1986, p. 154). In a leveraged situation financial institutions play a central role in enabling firms to fulfil the latter condition. Firms borrow money to fulfil their cash flow obligations as these obligations fall due. Typically a firm's financial obligations to financial institutions will far outweigh their obligations to any other party.

If a firm is solvent, financial institutions can make money by providing the firm with financial assets (cheque deposits or cash) that enable other obligations to be fulfilled. Financial institutions can (virtually) always provide a firm with the liquidity to meet their other obligations – regardless of a firm's solvency – though if a firm is in fact insolvent a financial institution would risk its obligation becoming worthless if the insolvency is recognised, due to the illegal nature of an insolvent firm trading. Even secured creditors may suffer a repayment shortfall if they lend to insolvent firms. The essential point is that the National Provident Fund or other financial institutions would have found it profitable to provide DFC NZ Ltd with liquidity – it would have made commercial sense to enable DFC New Zealand Ltd to meet its liabilities and to enable it to retain its asset portfolio – provided that it was anticipated that the asset portfolio would eventually be able to meet its contractual (financial) obligations. That other financial institutions chose not to lend to DFC NZ implies that DFC NZ's solvency was not sufficiently assured to warrant the risk of lending it further funds.

The Reserve Bank registration requirements prompted a management review of assets in September 1989. Peter Ferguson, general manager of corporate lending, died in May 1989 and Murray Smith (DFC chairman and a member of its Financial Risk Management Unit) resigned (or was fired, Grainger 1989) from DFC New Zealand Ltd in April 1989; removing their input may have prompted a more caustic review of corporate and other lending. DFC NZ's management review indicated that the company was, perhaps, marginally solvent (Pirie 1989). By way of contrast, the review by statutory managers and J.P. Morgan Ltd indicated that provisions of several hundred million ($869.873 million) needed to be made for the loan and advances portfolio (DFC New Zealand Ltd 1990, p. 5). Risk assessment and the loan and advances portfolio are now considered further.

5 DFC New Zealand's asset portfolio

5.1 Risk Assessment

DFC NZ's former institutional role meant that it provided finance to projects that were higher in risk than those typically funded by other financial institutions (see New Zealand Herald 1989a, p. 8); its higher funding costs also meant that it required a higher return which usually entailed a risk trade-off. Its former development role meant that it had to be capable of making assessments regarding new ventures to be able to make good investment decisions. Indeed, DFC NZ Ltd prided itself on its risk assessment and management skills (DFC New Zealand Ltd 1987, p. 2). In 1987 a 'Financial Risk Management Unit' was established to monitor and manage risk. The role of the risk unit and the various risks (liquidity, interest rate, currency and credit risks) that DFC NZ was exposed to were categorized in some detail in the 1988 Annual Report (DFC New Zealand Ltd 1988, pp. 6,12-18). In the same year Malcolm Allan, DFC NZ's 'financial risk manager' presented a paper to a conference on risk management (Accountant's Journal 1988, pp. 4-5). In this paper Allan noted the risk-return trade-off mentioned above and suggested that liquidity risk was the most significant risk contributing to bank failure.

With hindsight it appears that elements of DFC New Zealand's risk management were particularly ineffective, DFC NZ Ltd's risk assessment skills were strongly criticized by the Governor of the Reserve Bank of New Zealand after its demise (Brash 1991, p. 62). Note 22 in the 1989 annual report (which has no equivalent in earlier reports) has a consolidated, segmented income and balance sheet. This note breaks DFC's activities down into various operational areas: Treasury; Corporate Lending; and Investment Banking (DFC New Zealand Ltd 1989, p. 40). This note demonstrates that DFC NZ's 1989 before tax loss was incurred in the Corporate Lending segment (-$32.54m), outweighing profits in the other two segments ($9.76m in Treasury and $13.40m in Investment Banking). This suggests that currency and interest rate risks were being adequately managed, and (given the subsequent corporate failures with which DFC was associated) suggests that DFC NZ's assessment of credit risk was the principal reason for its failure. The decision to honour DFC's off-balance sheet transactions and the sale of DFC's swap book to Barleys Bank Plc supports the conclusion that some of the investment banking type roles were being conducted quite successfully.

Brash (1991) identifies a number of specific faults with DFC's credit risk management. He notes that loan reviews were often undertaken by the person who authorized the loans, increasing the potential for principal-agent problems within the firm. Loans were restructured, sometimes zero-interest rated or had interest capitalized, and DFC NZ had a number of large exposures and grouped counterparty exposures. These weaknesses made DFC NZ vulnerable to the asset deflation postulated by Minsky, indeed interrelated exposures are an important part of Minsky's dynamic perspective – adequate information systems might be expected to hinder the development of portfolios susceptible to the linkages problem described by Minsky. Mortlock (1994) notes that the incentive structure faced by staff within the DFC encouraged an increased volume of loans, but did not take account of the quality of these loans and Brash (1991, p. 62) states that DFC's management information system was deficient until 1988 but, again, this assessment is with the benefit of hindsight. The NPF-Salomon purchase of DFC NZ was not arranged until June 1988 yet these deficiencies were not realized, nor were reservations publicly expressed about these internal structures, by either the Reserve Bank of New Zealand, ratings agencies or DFC NZ's auditors, the (Government) Audit Office.

5.2 Industry exposures

Sixty seven per cent of DFC NZ's assets were employed in corporate banking and lending, with a considerable exposure to the sectors identified earlier. In 1987 Peter Ferguson likened DFC NZ's lending to a rifle as opposed to a shotgun (Gasson 1987, pp. 25–26). 'Selectivity' in portfolio choices, although not necessarily undesirable (e.g., if based on superior knowledge), makes a portfolio vulnerable to downturns in the industries that dominate one's portfolio, and this is precisely the problem that DFC New Zealand faced. The industries mentioned by Gasson (1987, p. 26) with which DFC NZ was identified included: horticulture (specifically kiwifruit), apiaries, deer, alpacas, bloodstock, angora goats, tourism ventures and commercial and industrial property. Brash (1991, p. 62) and Smellie (1991), note that the 'tourism' loans were often for hotels, etc and as such were also affected to some degree by the property market. DFC NZ was thus vulnerable to precisely the sectors that contributed the most significant number of corporate failures during this period. In a number of cases DFC NZ had assets of different levels of risk with the same institution ranging from ordinary shares, preference shares, unsecured loans, to loans secured by mortgages and debentures (e.g., Agricola Resources Ltd.) Although DFC NZ had instruments of various risk with these corporate identities the exposures were still to the same counter-parties. These relationships are now discussed more fully.

5.3 Corporate exposures and related parties

DFC NZ's annual reports were used to identify those companies in which DFC New Zealand had an equity share. These reports did not reveal a great deal between 1988 and 1989 because the bulk of DFC NZ's shareholdings were transferred to Stratacorp Financial Ltd (the National Provident Fund subsidiary) prior to the 1989 balance date. Several shareholdings acquired in 1988 were thus never explicitly mentioned in DFC NZ's Annual Reports. A combined keyword search of textline (an electronic database of newspaper articles) was also used to establish connections between DFC NZ and an abbreviated list of company failures. A manual search through the company records held at the Justice Department was also undertaken.

DFC New Zealand seems to have had a deliberate policy of equity-participation in the firms to which it lent; in part this reflected their earlier development role in which the returns in the early stages of projects could not always be guaranteed. On a number of occasions DFC took equity positions in companies to 'protect its position' – equity enabled DFC to place staff on the boards of companies to which it had lent money, e.g., Primacq Holdings Ltd, Wellcare Corporation Ltd and Cruise Corporation Ltd (Peterson 1988, 4; National Business Review 1989d, p. 1). This approach may be beneficial if it reduces the informational asymmetry between the borrower and DFC NZ, and the debtor may also have benefitted from DFC NZ's risk and project appraisal skills. However, taking up equity in exchange for debt also reduces the incentive to critically examine the solvency of the institution and hence the likelihood of repayment. It has also been argued that such relationships may have made DFC NZ vulnerable to 'capture' by the companies it was financing, since further lending could be requested to avoid the liquidity problems that one's equity investments would otherwise face (Smith 1994). Naturally the success of such strategies is short-term if the investments are non-performing.

The search for DFC NZ-linked firms drew attention to the following companies, some of which have been mentioned previously:[4]

Loans (Direct, to Directors, and to Subsidiaries): Angus Corporation Ltd; Beef City Holdings Ltd; Bexley Corporation Ltd; Chase Corporation Ltd; Clearwood Thoroughbred Stud Ltd; Cory-Wright and Salmon Ltd; Crowe Corporation Ltd; Equiticorp International Plc; Holdcorp Group Ltd;[5] Horner Greenlees Ltd; Investment Finance Corporation Ltd; Kaurex Corporation Ltd; Kearns Corporation Ltd; Mainstay Properties Ltd; McConnell Dowell Corporation Ltd; Maxwell Marine Ltd; Pacer Kerridge Corporation Ltd; Prime West Corporation Ltd; Prudential Building and Investment Society of Canterbury Ltd; Robt. Jones Investments Ltd; Qintex Australia Ltd (Australia); Richmond Smart Corporation Ltd; RW Saunders Ltd; Smiths City Group Ltd;[6] Wilkins and Davies Ltd, and Woodstock Investments Ltd.

[4] Successful companies/subsidiaries, like U-Bix Business Machines Ltd, have been ignored.

[5] Holdcorp Group Ltd's subsidiary Highview Stud Ltd repaid its DFC loan upon being sold.

[6] DFC New Zealand was one of many financial institutions which held listed Smiths City debentures.

Equity Participation (and Loans to): Advantage Corporation Ltd; Agricola Resources Ltd; American Strategic Investments Ltd; Ararimu Holdings Ltd, Argus Questar Corporation Ltd; Cruise Corporation Ltd; Eastern Equities Ltd; PrimAcq Holdings Ltd; Venture Pacific Ltd; amd Woodcorp Holdings Ltd.

American Strategic Investments Ltd and Qintex Australia Ltd are unusual in that they were not New Zealand listed companies. Qintex Australia Ltd received funds from DFC New Zealand Ltd at the behest of Salomon Brothers in the form of a short term loan of approximately A$100 million (The Press 1990). Qintex failed soon after this finance had been provided. Cook Islands-registered American Strategic Investments Ltd was taken over from, among others, Equiticorp Holdings Ltd. American Strategic Investments Ltd was to be used as a vehicle for overseas investment transactions, but the rationalization of DFC New Zealand's corporate structure in 1988 instead resulted in its liquidation. As American Strategic Investments was purchased at a price below net asset backing, its liquidation should not have seriously affected DFC's financial position.

McConnell Dowell was another company that survived this period, but DFC NZ's relationship with this company merits attention given its involvement in construction. Many of the companies listed above were, like McConnell Dowell Corporation Ltd, directly or indirectly connected to the property market, four of these: Richmond Smart Group Ltd, Pacer Kerridge Corporation Ltd, Robt. Jones Investments Ltd, and Chase Corporation Ltd, were among the largest property developers and investors in the country. Of these four companies, only Robt. Jones Investments Ltd survived, though with a much reduced capitalization.

Ararimu Holdings Ltd, Kaurex, Eastern Equities Ltd (formerly Eastern Deer), Horner Greenlees, Crowe Corporation Ltd, Woodstock Investments and Agricola Resources Ltd were resource-based companies, primarily involved in deer, goats and kiwifruit. It should be noted that not all of the companies listed above contributed to DFC NZ's failure, for instance DFC NZ's statutory management preceded Maxwell Marine's receivership by a year and a half.

The ownership and financial relationships that exist between the various companies are dynamic and evolve over time. Unfortunately, the available data mean that one can only obtain static snapshots. This study seeks to highlight some key facts from the relationships involved between these entities, and place these observations in the context of Minsky's financial instability hypothesis.

Certain elements of Minsky's hypothesis recur repeatedly in the relationships between DFC NZ and the companies listed above, and certain problems characterize many of DFC NZ's interactions. In keeping with Minsky's hypothesis many of the companies were inter-linked, increasing the (indirect) impact on DFC NZ of certain company failures. A number of firms were placed into receivership or statutory management because of their ownership linkages with other firms. Sometimes the parent company was the primary source of liquidity and this meant the subsidiary company could not function without the parent company's support. On other occasions the subsidiary was the most important asset of the parent company and creditors appointed receivers to safeguard their position, for instance, through cross-guarantees provided by the subsidiary. Secondly, many of the companies suffered *capital* losses in the agricultural and property sectors, reflecting changing expectations regarding the value of the assets in question. The importance of solvency in ensuring liquidity means that fluctuations in capital values are particularly important.

For DFC NZ the most prominent cash flow shocks related to declines in income and capital values – which had to be recognized in financial accounts (creating an implicit flow), rather than the interest rate shocks emphasized by Minsky. The impact of financial quantity shocks cannot be generalized for all cases but anecdotal evidence from Hawkins and McLauchlin (1989), McDonald (1988), and Agricola Resources Ltd's experience with DFC NZ (see below) all indicate that banks did seek to constrain, and reduce, their lending after the 1987 stock market crash. The criticism of DFC NZ's internal control systems and the problems they experienced with corporate lending reflects the difficulty of valuing assets. Additionally, certain aspects of DFC NZ's relationships helped to obscure 'appropriate' capital values. White (1992a, p. 190) notes that "lending by a bank to non-bank commercial interests connected to itself may not always be provided on arms length terms." DFC NZ had many such commercial connections because of its former institutional role and these arrangements seem to have worked against both DFC NZ and the commercial counter-parties on different occasions. Many of the problems discussed by de Juan (1991, pp. 3-5) – risk concentration, connected lending, ineffective recovery, over-extension and quick growth, and overly optimistic assessment – also contributed to DFC NZ's problems. Minsky's emphasis on (expectational) euphoria is reflected in the latter two elements.

One of the more interesting observations to make about DFC NZ, particularly in the light of its application for registered bank status, is that it had exposures in excess of $100 million to each of the following entities: McConnell Dowell Corporation through its subsidiary Benjamin Developments Ltd ($180 Million to construct the Pacific/Robert Jones/Coopers and Lybrand Tower,[7] Qintex Australia Ltd (AUD$100 million as mentioned above) and Robt. Jones (Harbour Tower) Ltd ($289 million to purchase Harbour Tower in Wellington, the building leased by DFC NZ, and 44 Wall St, Robt. Jones Investments largest acquisition). At face value these relationships violated the Reserve Bank's risk concentration limits for single parties (set at 40 percent of capital), which in DFC New Zealand's case would have approximately amounted to $72.5 million in 1989.[8] However, in mitigation, it is not possible to ascertain the extent to which DFC New Zealand operated syndicates to finance these ventures (that they did so is definitely implied by the debenture/mortgage documents held in

[7]The project was initially called the Pacific Tower. Robt. Jones (Pacific) Ltd acquired naming rights to the building with its agreement to purchase and it was subsequently renamed Coopers and Lybrand Tower after Robt. Jones (Pacific) repudiated the purchase agreement.

[8]The 40 percent limit was high by international standards, reflecting the particular characteristics of the New Zealand market. Polizatto (1992, p. 290) suggests the limit should be no greater than 25 percent.

Benjamin Developments company file, AK 400934).[9]

DFC New Zealand Limited had another notable single exposure to PrimAcq Holdings Ltd. In October 1988 DFC Financial Services Ltd purchased 30 percent of PrimAcq's capital and syndicated a $50m debenture secured on the Majestic Tower (Wellington's largest building and PrimAcq's major asset). This debenture secured funds provided by NZI Bank Ltd, NZI Securities Ltd, the Bank of New Zealand (the BNZ), DFC Financial Services Ltd, and Mainzeal Group, the latter being the firm responsible for the construction of the Majestic Tower. PrimAcq Holdings 1987 Annual Report indicated that DFC NZ arranged and underwrote a $125m loan facility. Byrnes (1988, pp. 9,12) suggests that much of the finance was expected to come from overseas, though it is not clear from PrimAcq's company file whether or not this actually occurred. Such a guarantee would have been an off-balance sheet transaction. As a result of these relationships DFC NZ was significantly exposed to *single* buildings. In the case of the Majestic Tower which was later relinquished to DFC NZ, approximately half the floors remained vacant even in *1994* (personal observation).

After DFC NZ was placed into statutory management and shortly after its debt had been restructured in October 1990, an NPF subsidiary, Greenbird Holdings, arranged to take over DFC NZ's financing of the Coopers and Lybrand Tower. Greenbird supplied a principal amount of $134 million to enable DFC NZ to be repaid and the building to be completed. Braddell (1990, p. 3) reported that the DFC NZ facility had been drawn down by more than $90 million to finance the construction the $240 million building.[10] The NPF refused to comment on whether or not the financing was undertaken at a discount, saying that it was to facilitate DFC NZ's statutory management (Braddell 1990, p. 3). The interest charged on the Greenbird loan was 18 percent. In September 1990 only 5.5 percent of outstanding loans were being charged comparable, or higher, rates of interest by registered banks (RBNZ 1990, p. 440) – which perhaps explains why it was refinanced by a BNZ-led syndicate of 21 financial institutions soon after.

McConnell Dowell Corporation had arranged for Robt. Jones (Pacific) Ltd to purchase the building on completion but, with the drop in property values that occurred in the Auckland CBD, Robt. Jones disputed the characteristics of the building to enable it to withdraw from the contract. The dispute resulted in substantial litigation, and ultimately the legal dispute cost the successor to Robt. Jones, Tasman Properties, $30.5 million (Sanders 1995). On other occasions Robt. Jones Investments (or its subsidiaries) pulled out of conditional

[9] AK 400934 is Benjamin Developments Ltd's compnay file number. The file is available at the Justice Department Office at which it is registered. In this case AK refers to an Auckland-registered company, CH refers to Christchurch and so forth. There are approximately 10 regional offices that store files. Dead files (for companies struck off the register) from the Wellington Office are stored in Christchurch.

[10] The value of the building was variously described as: approximately $245 million (Robt. Jones Investments Ltd 1991, p. 63), $240 million (McConnell Dowell Corporation Ltd 1989, p. 22), around $200 million (McConnell Dowell Corporation Ltd 1989, p. 9), and $185 million (McConnell Dowell Corporation Ltd 1990, pp 3–4). The $200 million quote seems to refer to the construction costs, the later $185 million could refer to either cost or sale price.

purchase agreements because of inadequate occupancy levels (see New Zealand Property 1988c, p. 11). The nature of the dispute for the (subsequently-named) Coopers and Lybrand Tower – the fact that it was based on technical characteristics rather than occupancy levels – may have been because McConnell Dowell did not anticipate having a problem leasing the tower, partly because the NPF was considering taking space in the building. Eventually, as underwriter of the project, the National Provident Fund took possession of the building. In December 1988, when the finance and underwriting for the building was initially provided, DFC NZ was an NPF subsidiary, which highlights some of the complex interdependencies between the various parties.

McConnell Dowell had $31.5 million of equity in this project, which amounted to about 15 percent of the total funds involved.[11] The importance of prearranged sales and underwriting agreements is apparent given that by August 1990 CBD prices had fallen by approximately 30 percent (Morgan 1990, p. 51; see also New Zealand Valuers' Journal 1989, p. 25). Because the underwriters purchased the building, McConnell Dowell Corporation was forced to write down the value of the tower by $48.196 million (McConnell Dowell Corporation Ltd 1991, p. 3). The National Provident Fund, again as underwriter, also took possession of Kupe Group's Central Tower at 75 percent *of cost*, even though it was nearly fully leased – Kupe Group lost $46 million as a result of this sale (Kupe Group Ltd 1990, p. 3). Similarly, the deteriorating property market in Wellington forced PrimAcq Holdings to write down its investment in the Majestic Tower by $24.5 million, which contributed the bulk of its 1990 loss (Braddell 1990, p. 3). In October 1990 DFC NZ took control of the Majestic Tower because of PrimAcq's insolvency (DFC New Zealand Ltd 1991, p. 3). The 30 percent of PrimAcq's equity that DFC NZ had acquired in October 1988 was among the equity holdings passed to Stratacorp Financial (the NPF subsidiary) before the beginning of DFC NZ's financial year in March 1989 and so no direct losses were made on this investment.[12]

DFC NZ's exposure to Robt. Jones (Harbour Tower) was another notable failure. DFC NZ's subsidiary Caycorp Investments sold the Harbour Tower to Robt. Jones (Harbour Tower), providing the finance to do so through Robt. Jones (Acceptances) Ltd.[13] (Again, this transaction has a window-dressing element to it, the fixed asset was transformed into a loan.) At the same time it also lent significant funds to Robt. Jones (Harbour Tower) to facilitate the purchase of 44 Wall St, Robt. Jones Investments' 'flagship building'. However, DFC NZ only had a second mortgage on this New York property and poor occupancy levels resulted in its being relinquished to the first mortgagee, with DFC NZ

[11] Construction value estimated as the sume of the DFC loan facility (maximum $180 million) and the McConnell Dowell equity ($31.5 million in preference shares).

[12] The National Provident Fund contributed considerably to DFC NZ's loan restructuring scheme, and it appears that Stratacorp Financial fulfilled its loan obligations to DFC as part of this agreement, accepting the capital losses associated with the decline in value of the equity that had been transferred to it.

[13] It is also interesting to note that DFC NZ purchased this building from the construction firm Mainzeal, which was also involved in the construction of PrimAcq's Majestic Tower (Mainzeal Properties Ltd 1987).

losing $30 million as a result (The Dominion 1992, p. 16). DFC Investments had taken cumulative preference shares in Robt. Jones (Acceptances) Ltd and these funds were on-lent to Robt. Jones (Harbour Tower) Ltd and were secured by a debenture. Unlike the two mortgages for the $220 million lent directly to Robt. Jones (Harbour Tower), the debenture was not guaranteed by the parent company, Robt. Jones Investments Ltd. Consequently, Robt. Jones Investments could afford to cut Robt. Jones (Harbour Tower) and Robt. Jones (Acceptances) loose. The huge losses in all of these companies show how significantly expectations diverged from outcomes in both the construction and property investment sectors, which is particularly suggestive of euphoria.

Ken Wikeley, managing director of PrimAcq elaborated PrimAcq's corporate strategy in September 1987. The core of PrimAcq's strategy revolved around New Zealand property development (Wikeley emphasized large projects in excess of $100 million, like the Majestic Tower), but moves were being made to broaden PrimAcq's focus by diversifying into financial services. A move into the Australian property market, to undertake projects similar to the Majestic Tower), was also considered (McManus 1987, p. 7). With hindsight, it is clear that the actual and proposed diversifications were into areas that suffered shocks not unrelated to that of PrimAcq's core area. Similarly, many other New Zealand companies, particularly property companies, experienced significant problems that arose from Australian diversifications.

PrimAcq Holdings also provides a connection to a group of Christchurch property companies that began to suffer problems shortly after the Crash. In 1988 PrimAcq Holdings had an extraordinary $6.865 million loss on its divestment of 25 percent of Prime West Corporation. Payments were suspended for the pre-Crash sale after financial support for the purchase was withdrawn (New Zealand Company Register, 1989: 184). This highlights the sequential nature of many transactions and illustrates that entities may remain vulnerable long after negotiations have been concluded.

Prime West Corporation, like the companies discussed so far, was primarily involved in the property sector. However, unlike the companies already discussed, Prime West Corporation's property investments were primarily situated in the Christchurch CBD (Prime West Corporation Ltd 1987). Although DFC Financial Services Ltd had previously had a lending relationship with Prime West it was not directly exposed to Prime West at the time of its receivership in September 1988, loans having been satisfied early in 1987. Instead Prime West was sourcing funds from six other financial institutions: the BNZ provided the bulk of Prime West's finance, with support from Westpac Securities, Equiticorp Holdings Ltd, Australian Guarantee Corporation (NZ) Ltd, National Westminster Finance N.Z. Ltd and Westland Savings Bank.

In the three year period 1986-1988 Prime West's current liabilities expanded from $4.838m to $50.76m, because of a massive spate of debt-financed investment (New Zealand Company Register 1989, p. 185, Prime West Corporation Ltd 1987, p. 13). Prime West Corporation's receivership in September 1988, occurred approximately six months after it recorded a $9.8 million operating loss. This loss was exacerbated by an extraordinary loss of $6.5701 associated

	1985 ($M)	1986 ($M)	1987 ($M)
Current Liabilities	0.338	6.825	8.291
Term Liabilities	4.142	15.763	32.267
Shareholders Funds	8.214	16.533	15.055
Total	12.694	39.121	58.279

Table 2: Table 7.9 Abbreviated Mainstay Properties Balance Sheet
Source: Mainstay Properties Annual Reports, various years.

with the writedown of Prime West's share portfolio, mainly shares in Aden Corporation (see section 7.3.1) and 10.2 percent of Mainstay Properties (New Zealand Herald 1988c, p. 3). Receivers sought to repay Prime West's liabilities through selling assets. Prime West Corporation's receivership contributed to the malaise that was beginning to affect the Christchurch property market, indirectly affecting other companies with which DFC Financial Services Ltd was related. In particular it affected Mainstay Properties Ltd, Kearns Corporation Ltd and Advantage Corporation Ltd, all of which had substantial property holdings in Christchurch.

Mainstay Properties, like Prime West Corporation, was a property development and investment company with the bulk of its assets located in Christchurch. In a similar time-frame and also relying heavily on debt-finance, Mainstay extended its portfolio of property assets. In 1986 Mainstay sold the Farmers Trading Company site in the Christchurch CBD to Chase Corporation for a price of $21.2 million, for an $8.2 million capital gain with payments spread from 1987 through to 1989 (Mainstay Properties Ltd 1986, p. 10).

In July 1987 Mainstay acquired a number of Christchurch CBD properties from Chase Corporation for precisely the same amount, $21.2 million. The acquisition of this property was financed by Equiticorp Holdings and involved four payments, the last of which was to be made on 31 December. 1989. These transactions suggest an absence of direct cash flow between the two property companies. However, such transactions 'exposed' the new higher capital values as discussed by (White 1992c, p. 268, Note 7).

Mainstay's earlier financial relationships with BNZ and Westpac were largely satisfied by the end of 1987. In September 1987 a group of Advantage Corporation directors took control of Mainstay and this heralded the development (and continuation) of a financial relationship with DFC Financial Services Ltd. DFC NZ had in fact provided the financial resources which allowed Messrs O'Malley, De Vere, Standage and Cousins to take control of Mainstay (The Press 1993). To enable the directors to repay their obligations they arranged for Mainstay Corporation to 'merge' with Advantage Corporation. In effect, this meant the above directors (and manager) sold their stake in Advantage Corporation to Mainstay Properties for $15.1 million.[14] This offer price was independently as-

[14]Coal and Energy N.Z. Ltd was used as a back door listing for Advantage Propoerties Ltd in August 1987, at which time DFC's pre-receivership debt in Coal and Energy N.Z. Ltd was converted to equity. With the additional capital that DFC subscribed for DFC had a 12.6

sessed by Equiticorp Holdings Ltd at 12 cents per share. The sale was arranged in September-October 1987 – just prior to the Crash (New Zealand Herald 1988a, p. 10). After the Crash Advantage Corporation shares were trading at just 5 cents per share (New Zealand Property 1988a, p. 19). In the year ended 31 December 1987 Mainstay wrote off $10.43 million of goodwill associated with the purchase of Advantage Corporation (Mainstay Properties Ltd 1987, p. 18).

Mainstay and Advantage's relationship with Equiticorp illustrates the co-dependency of the corporations under examination. Equiticorp was a major source of finance, a major source of financial expertise and was also the major tenant in Avon Towers (renamed Equiticorp House), one of Mainstay Properties' largest buildings in the Christchurch CBD (New Zealand Property 1987, p. 21). Equiticorp was placed into statutory management on 22 January 1989.

Advantage Corporation's major activity was the construction of the tallest building in the South Island, the Price Waterhouse Centre in Armagh St in the Christchurch CBD. Advantage contracted with Wilkins and Davies Ltd to construct the building. At the time of receivership Advantage's major asset was its shareholding in One One Nine Ltd, which was, by that time, the joint venture company responsible for completing the $60-64 million building (Eagles and Rennie 1987, p. 7, New Zealand Property 1988c, p. 3). Advantage's One One Nine shareholding made up $3.25 million of Advantage's total assets of $5.934 million. In the wake of Advantage's receivership DFC NZ required Wilkins and Davies Ltd to guarantee the DFC NZ funding provided to complete the building. Unfortunately, the $60-64 million price tag proved to be wildly optimistic. Following DFC NZ's statutory management NZI Bank put One One Nine Ltd into receivership and, as first mortgagee, sold the building to NZI Corporation for $29 million, which covered NZI Bank's lending, but, according to Wilkins and Davies' and One One Nine Ltd's Statement of Affairs (AK 073809; AK 389287), left DFC NZ with a $13.5 million shortfall (guaranteed by Wilkins and Davies). The receiver's redraft of Wilkins and Davies' Statement of Affairs indicated that debenture-holders and unsecured creditors (DFC NZ included) would receive nothing – Wilkins and Davies was subsequently wound up in April 1990.

Mainstay's receivership had similar consequences.[15] Properties were sold by the receivers at a significant discount to original asking prices: 204 Hereford St was sold for $1.435 million compared to the original asking price of $1.9m, 255 Madras St (bought for $1.59m) was sold for $900,000 (New Zealand Property, April 1989a: 10; New Zealand Property, January 1989: 14-15). In the Receiver or Manager's Abstract of Receipts and Payments (14/1/88 to 12/4/90), S.J. Tubbs, Mainstay's receiver, estimated realisables at $19.705m rather than the $35.35m suggested by the directors' November 1988 Statement of Affairs (CH 203013). The properties sold during this period, valued at $16.25m by the

percent shareholding with a par value of $1.33 million.

[15] Mainstay was in breach of section 133 of the Companies Act (1955) in that it failed to provide copies of the balance sheets presented to the company in general meeting, pursuant to section 152 of the Companies Act (1955). Many other companies were observed to be in default of this section.

	1985 ($M)	1987 ($M)	1988 ($M)
Current Liabilities	2.841	6.129	12.967
Term Liabilities	0.272	3.191	2.960
Shareholder's Funds	2.183	6.028	7.734
Total	5.297	15.348	23.686

Table 3: Table 7.10 Abbreviated Balance Sheet Kearns Corporation Ltd Source: Kearns Corporation Ltd Annual Reports, various years.

directors, had yielded only $8.715m. S.J. Tubbs estimated DFC NZ's shortfall at $8.8 million dollars. Vacancy rates continued to increase in the Christchurch CBD during this period, up to 15-17 percent in April 1989 (Ward 1989, p. 30) and yet office towers were still being completed (e.g., Robert Jones House, Jenkins 1989, p. 8).

Kearns Corporation and the Prudential Building and Investment Society of Canterbury provide similar evidence of increased borrowing to increase earnings. In 1985 $3.07 million of Kearns Corporation's $4.9 million current assets were secured advances (the bulk of the rest being development properties). In the next financial year, Kearns' finance advances amounted to $11.47 million, with a further $2.1 million invested in bloodstock. This big jump in lending and assets was initially made possible by finance provided by Equiticorp Holdings Ltd, which at the time was a substantial shareholder in Kearns Corporation. However, mortgages from the latter were satisfied in September 1987 and January 1988 and the predominant source of finance became Brookstock No. 17 Ltd, a channel for funds from DFC Financial Services Ltd (though Equiticorp continued supplying funds to Kearns subsidiaries). In March 1988 Equiticorp and Troy Capital Ltd sold their 35 percent stake in Kearns to a New Zealand subsidiary (Duke Securities Ltd) of Duke Group Ltd, an Australian Investment Bank.

Kearns' financial reports provide an interesting example of how higher asset values enabled companies to increase their borrowing, the kind of action that Minsky predicts. In the 1985 Annual Report land owned in Waltham road was valued at $320,000, the buildings a further $75,100, making a total of $395,100. At the next reporting date (31 March 1987) the land was revalued at $543,000 while the buildings were valued, after depreciation, at $81,268, for a total of $624,268 – a revaluation gain of 58 percent after depreciation in only fifteen months. In July 1987, four months after this very favourable revaluation, Brookstock No. 17 Ltd provided a mortgage of $475,000 with the Waltham St properties as security. The mortgage extended was thus 20 percent above the 1985 valuation. Although this loan was repayable on 17 July 1988, the charge over this property was not satisfied until 29 October 1991. The 1988 Annual Report states that: "Land and buildings have been revalued according to independant [sic] values dated 31 March 1987 with subsequent purchases at cost" (Kearns Corporation Ltd 1988, p. 11) – the property portfolio was not revalued to reflect any change in value over the 1987/88 financial year. Although the transaction described above was not sufficiently large to cause Kearns' failure, many of the losses sustained by both Prudential and Kearns were on funds lent on property. Inadequate appraisal and changing perceptions of asset values was thus one of the main reasons for the failure of these companies.

Kearns Corporation and Martin Leo Coffey (Kearns Corporation chairman) established their undisputed control over the Prudential Building and Investment Society of Canterbury with the purchase of Advantage Corporation's Prudential shareholding (New Zealand Herald 1988d, p. 6). In January 1988 Kearns Corporation (and its Action Finance Subsidiary) sold Brookstock No. 17 to Prudential (CH 338765). In August of that year Kearns Corporation shareholders agreed to acquire Chairman Martin Coffey's majority holding in the Prudential Building and Investment Society of Canterbury (New Zealand Herald 1989d, p. 4).

Prudential, like Kearns, expanded its liabilities with DFC Financial Services Ltd and (among other things) lent to people requiring residential mortgages. Between the 1986 and 1988 Annual Reports Prudential's liabilities, income, and assets increased massively – primarily because of an increase in short term deposits ($26.4m in June 1988 up from $4.96m in December 1986) and because DFC Financial Services Ltd had provided, by December 1987, a $5 million loan facility which had increased to $10 million by June 1988 (BS 1925/1). In February 1989 it was reported that, following an investigation by the Registrar for Building and Investment Societies, Kearns Corporation and Prudential had been instructed to restructure their complex relationship, arranging external finance for the $12.46 million that Kearns's had borrowed from Prudential (National Business Review 1989e, p. 4, New Zealand Company Register 1989, p. 189)

The Registrar's investigation prompted an amendment to a 5th December Prospectus issued by Prudential. This meant that the content of the mortgages and loans to Kearns and its subsidiaries were detailed more fully. A considerable proportion of these funds were secured by commercial property. Additionally, $2.03 million was secured by an amount due from Duke Securities for unpaid Kearns shares (Document 71, BS 1925/1).BS in the company register indicates that Prudential was a building society. In the final analysis Duke Group Ltd (Australia) simply let its subsidiary be liquidated, losing merely the $2 in capital that it had invested in its subsidiary, after it became apparent that Kearns Corporation shares were not worth the agreed price (National Business Review 1989b, p. 2). $725,000 of the funds from Prudential were channelled into Kearns subsidiary Capitalcorp Properties (renamed Entrecorp Properties), secured against development properties. Other funds were deposited with another Kearns subsidiary, Action Finance, and were unconditionally secured by Kearns Corporation. In turn Action Finance had a $1.944 million current account with Leaseco Finance Ltd, yet another Kearns subsidiary (CH 136731, DOC 52). Leaseco Finance Ltd also had a floating debenture in favour of Equiticorp Securities Ltd. The relationships described here thus provide support for Minsky's description of 'financial layering'. This examination indicates that low risk entities (banks) were lending wholesale funds to entities such as DFC NZ and Equiticorp who on-lent funds to institutions like Prudential, who were in turn on-lending to marginal sources of finance – the riskiest and most expensive sources – like Action Finance and Leaseco Finance Ltd.

Action Finance also funded a Hong Kong Pacific Merchant Finance attempt to take control of Crowe Corporation (the goat company, see section 7.3.1), a move that was designed to restructure the company to take advantage of its tax losses (New Zealand Company Register, 1989: 115). Action, Finance also lent money to Hong Kong Pacific Ltd, with whom Crowe Corporation had a current account (CH 153525: Receivers' Report and Statement of Affairs). Several months after Crowe Corporation's July 1988 receivership, Action Finance appointed receivers to Hong Kong Pacific and Hong Kong Pacific Merchant Finance (New Zealand Gazette 1988, p. 3094). It is clear that the 'domino effect' did occur during this period.

Coincident with the appointment of liquidators for Prudential, DFC NZ appointed receivers to Brookstock on 24 February 1989. On the morning of the same day directors of Kearns Corporation and Prudential (specifically Martin Coffey and Peter Roberts), transferred an $18 million portfolio of properties to Brookstock No. 17 from Prudential in exchange for an unsecured obligation. They did so in order to ensure that Brookstock No. 17 would have enough assets to satisfy the $12 million debenture that they (and Frederick Morris, a third Kearns director) had guaranteed (see BS 1925/1, Document 71, p. 7). The directors were endeavouring to manipulate the priority of claims on the assets of the company to prevent themselves from being personally liable as guarantors. Ownership of these assets was subject to considerable dispute (eventually settled between Prudential and DFC NZ) and the above directors were convicted of criminal charges, for failing to act on behalf of Prudential's shareholders (New Zealand Herald 1991b, p. 2). In the June 1987-September 1988 period Brookstock No. 17 Ltd borrowed $28.57 million from DFC Financial Services Ltd. The abstract of receiver's payments indicates that DFC Financial Services Ltd was repaid $10.1 million from Brookstock; it is not clear how successful DFC NZ was in enforcing the guarantee, in litigation over their role as guarantors the directors suggested that enforcement of the guarantee would bankrupt them. Because of the litigation involved with the transfer of assets, Kearns' directors refused to meet their obligation under the Companies Act to provide a Statement of Affairs.

A similar on-lending type relationship existed between DFC NZ and Investment Finance Corporation Ltd (IFC). IFC proved to be a poor investment vehicle: in the fifteen months to 30 June 1986 IFC made a loss of $4.06 million, the following year a loss of $5.622 million was made – both losses occurred before the October 1987 stock market Crash when the capital value of the sharemarket as a whole was increasing (Investment Finance Corporation Ltd 1987). These losses were in part incurred through IFC's 6 percent holding in Woodstock Investments Ltd, discussed below. Receivers were appointed to IFC in December 1987, IFC was thus at the forefront of the wave of failures that were to ensue in the following years. Although the directors' Statement of Affairs indicated that debenture holders were expected to be paid in full, with hindsight their estimate of the realizable value of IFC's assets seems hopelessly optimistic.

Debenture holders were owed \$34.042 million, assets were projected to realize \$53.11 million, but IFC's Receivers' or Managers' Abstract of Receipts and Payments indicates that payments by 23 December 1993 amounted to only \$18.799 million (AK 208785).

That DFC NZ's failure was closely related to the fortunes of the property market has already been established. By 1990, DFC NZ had acquired approximately 200 properties located throughout the country, which it attempted to dispose of in a number of ways, primarily by tender and auction (see The Press 1991a, 1991b, 1991c, 1991d). Approximately 65 percent was commercial property with a further 25 percent industrial (Reuters 1989a). The bulk of DFC NZ's property portfolio was located in the northern half of the North Island (Reuters 1989a). Document 77 in DFC NZ's company file (WN 341918) provides an indication of the extent of the decline in property values that were being accepted. Hodder and Tolley (S.I.) Ltd defaulted on a \$478,624 mortgage on Wellington property and a retired couple purchased the property from DFC NZ for \$225,000, less than 50 percent of the amount that had originally been lent on the property.

It was noted above that DFC NZ had financial relationships with Pacer Kerridge, Chase Corporation, Richmond Smart Corporation and Woodcorp Holdings Ltd, but it has not been possible to ascertain a great deal about their financial relationships with DFC NZ. Their involvement in the property sector is a well-established fact, but because none of these companies was placed in receivership there are no Statements of Affairs detailing the linkages between the various financial entities. It is disappointing that the statutory managers of those companies placed in statutory management under the Corporations (Investigation and Management) Act did not feel obliged to provide similar information (unlike DFC NZ's statutory manager who provided much more information). This deficiency is similarly observed in section 205 agreements under the Companies Act (1955) and in liquidations, both voluntary and involuntary. Having said this a number of observations can still be made.

Richmond Smart Corporation was placed in statutory management because no creditor had a cross guarantee from the parent company, yet in February 1989 many of the subsidiaries were being placed into receivership (by the BNZ). This also means that the charge documents (debentures and mortgages) are scattered among the company records of its 95 subsidiaries. In a mortgage registered in May 1986 Equiticorp Securities Ltd, Broadbank Corporation Ltd, Saudi New Zealand Capital Corporation Ltd and the Development Finance Corporation Ltd provided an \$18 million loan facility to Smart Group Securities Ltd, though its capitalization was in fact a mere \$100,000. Up until May 1988 this company was actually owned by Susan and Stephen Smart, at which point ownership was transferred to Smart Group (NZ) Ltd.[16] This facility confirmed that a financial relationship existed between DFC NZ and Richmond Smart Group, but it was thought impractical to systematically establish all the charges written in favour

[16]Smart Group (N.Z.) Ltd was owned by Smart Corporation Ltd, which was merged with Richmond Developments Corporation Ltd early in 1988.

of DFC NZ (as this would have involved searching 95 subsidiary company files). Richmond Smart was also in breach of section 135 of the Companies Act (1955), as it failed to provide copies of its balance sheet to the registrar.

In June 1988 Richmond Smart's property portfolio was valued at $245.8 million (New Zealand Property 1989e, p. 3). The statutory managers of Richmond Smart responded in a manner consistent with receivership, attempting to rationalize debt levels by selling assets with numerous divestments being recorded in (New Zealand Property 1989c, 1989h, 1989g, p. 7; 1989f, p. 6; etc) recovering more than $38 million in just the sales cited specifically. New Zealand Property (1989c) indicated that the sale of 58 Wellesley St was thought to have been facilitated by transferring a DFC NZ mortgage to Newlands Investments Ltd. Of Richmond Smart's $275 million in liabilities approximately $100 million was owed to the BNZ. (The BNZ was one of the financial institutions most severely affected by the downturn.) Equiticorp Industries Ltd owned 16.28 percent of Richmond Smart's capital; a proposed buy-out of Stephen Smart's shareholding in January 1988 fell through because of Equiticorp's statutory management on 24 January. As was the case for Kearns Corporation, Equiticorp had also provided debt finance.

One of the more interesting things to note about Richmond Smart's statutory management and its drop in share price is that DFC NZ bankrupted Susan and Stephen Smart because of a $1.6 million debt incurred by the Smarts which had been secured against Richmond Smart shares. In 1989 with Richmond Smart shares valued at just 2 cents each the 3 million shares used as security had a realizable value of only $60,000 (Dey 1989, p. 15). DFC NZ's money provided Stephen Smart with control over the company, but did not endow him with the knowledge and foresight to ensure that the company was profitable. Lending secured against shares at a fixed interest rate appears particularly stupid, unless additional security is provided, because one absorbs the same likelihood of default (the down-side) without the compensating benefits of extraordinary gains – it makes more sense to purchase the equities oneself.

Similar problems, in terms of available information, were also experienced with Chase Corporation, including breaches of Section 135 of the Companies Act (1955) for the years 1988 onward. Balance sheet information from 1987 indicates that Chase Corporation had $1.61 billion in investment property and property under development. A further $485.2 million were invested in equity investments. Current assets amounted to an additional $1.4 billion dollars.

The explosive growth in Chase Corporation's balance sheet reflected a considerable increase in debt, but also, in this pre-Crash period, an equally explosive growth in capital, much of which was issued and exchanged directly for the assets in question. Investment companies were able to issue shares to fund their acquisition programmes because shares were perceived as being effective stores of value – the Crash rudely shattered any misapprehensions about the stability of capital values. Between 31 March 1986 and 30 June 1987 issued capital increased from $18.55 million to $57.48 million, a threefold increase (Chase Corporation Ltd 1987, p. 2 in 'Financial Statements'). In the 1988/89 financial year 11.17 million ordinary shares (at 20 cents) were issued in lieu of dividends, 34.14 million were placed directly and a further 57.16 million cumulative preference shares were issued at 50 cents (at a 30 cent premium), a marked drop on the two preceding years (New Zealand Company Register 1989, p. 52). The relatively small capital issue during this year and the use of cumulative preference shares reflected changing attitudes towards the risks associated with ordinary shares. Issuing shares instead of dividends was a not uncommon practice in pre-Crash New Zealand (with a beneficial impact on cash flow), partly because of the double incidence of taxation on dividends.

Chase Corporation's pre-Crash problem in the investment and property markets was to establish appropriate offer prices for capital assets that yielded a stream of income into the future. Once again the stock market Crash and the decline in the property market in both New Zealand and Australia dealt a severe blow to accepted capital values, in some cases the realizable values of assets recorded in the 1989 report were below the value of debts secured against them (New Zealand Company Register 1990, p. 52). Even before the property market experienced its worst declines, Chase provides an example of 'euphoric' expectations that lead to decision reversals: Chase Corporation abandoned a shopping centre development project in Newtown, a suburb of Wellington, placing the land involved back on the market for \$500,000 – though the land had reportedly been acquired for \$600,000 (New Zealand Property 1988b, p. 1).

By 1989 conditions had worsened even more for Chase Corporation. Abnormal provisions for property in the 1989 year amounted to \$131.3 million, extraordinary losses of \$505.4 million contributed to a total loss of \$841.37 million. The \$31.7 million loss in 1988 looks rather trivial by comparison. Between 1988 and 1989 current liabilities sky-rocketed from \$0.52 billion to \$2.04 billion. Planned assets sales to reduce debt proved difficult to implement in the first half of 1989 and this led to the appointment of statutory managers to Chase Corporation's property arm in July (New Zealand Company Register 1990, p. 52). In August 1990 Chase Corporation established a scheme of arrangement with its creditors in an attempt to provide unsecured creditors, including European bond-holders, with some kind of return (Companies Office file AK 064913; New Zealand Company Register, p. 52). Charges over Chase Corporation Ltd's assets indicated that DFC NZ and a DFC NZ subsidiary, Momoe Investments Ltd had a financial relationships with Chase, secured against the Mid-City Centre development in Manners-Willis St, but it is not possible to ascertain much more about this relationship.[17]

Continuing with the property theme, one can find repeated examples of 'incestuous deals' which obscured the value of both transactions and financial assets (see Earl 1990, p. 289). The Chase-Mainstay transaction in Christchurch CBD provides one example, DFC NZ's relationship with Argus Questar Corporation provides another.

Argus Questar was formed from a merger between Argus Corporation, Hobson Corporation (both property), and Questar Corporation (leisure/tourism) in November 1987. Prorada, a subsidiary of Brierley Investments Ltd (one of

[17] The Mid-City Centre is a combination of inner city retail, office, and cinema space.

the few investment companies to prosper throughout this period), had a 39.5 percent interest in the new, merged company, while DFC New Zealand had approximately 12.7 percent and was Argus Questar's principal financier. In 1987 a joint venture between DFC NZ and Argus Questar management arranged to purchase Brierley Investments' shareholding in Argus Questar (New Zealand Company Register 1988, p. 27). DFC NZ's shareholding is not however recorded in DFC's 1987, 1988 or 1989 annual reports. In May 1989 DFC appointed receivers under a debenture agreement dated 30 March 1989. Of the $39.6 million lent by DFC NZ only $14.296 million was secured, the bulk of this security being provided by debtors and shares (AK 013031, Statement of Affairs). Rainbow's End, a holiday fun park, was a big recipient of funds from Argus Questar, the $19.89 million lent to Rainbow's end was not expected to be recovered. The $16.4 million on-lent to Questar Marine Ltd was also thought to be irrecoverable. DFC NZ subsequently purchased Kelly Tarlton's Underwater World and four properties from the receivers soon after they were appointed (New Zealand Herald 1989b, p. 1). In effect this would have enabled Argus Questar to pay DFC NZ out, but also saddled DFC NZ with assets unrelated to its core financial business. (The purchase of property may have compounded DFC NZ's problems later, with the downturn of the property market.)

Pacer Kerridge's main activities were property ownership and development, cinemas and associated entertainment services, standard bred bloodstock activities, and a diverse number of other ventures. In 1988 Pacer Kerridge Corporation had one of the largest property portfolios in the country (New Zealand Company Register 1989, p. 172). DFC NZ's purchase of several Pacer Kerridge cinemas around the country provides another fine example of an 'incestuous deal'. This deal was accompanied by a five year Pacer Kerridge lease on the cinemas and an option to repurchase the properties within two years (New Zealand Property, p. 3; Dun and Bradstreet International). Such a transaction would normally involve a discount on the initial sale price. In the light of the subsequent decline in property values one can only wonder whether the $2 million price tag was at a sufficiently high discount.

DFC NZ informed the stock exchange that all Pacer Kerridge's contingent liabilities had been eliminated as well as some debt, and the term of a loan was extended by two years (New Zealand Property 1989a, p. 2). Essentially this transaction made the property more liquid than it would otherwise have been and allowed Pacer Kerridge to delay settling certain financial obligations. This transaction could also be regarded as a subtle form of queue-jumping, i.e., better priority was gained in the (possible) event of Pacer Kerridge being placed in receivership or liquidation. The precise benefits depend on the nature of the security held over these assets, which it has not been possible to ascertain. However, the content of this transaction is far more complex than the above summary suggests. The contingent liabilities referred to by DFC NZ consisted of a Pacer Kerridge guarantee of a $5 million loan made by DFC NZ to executive director David Phillips. The Justice Department laid charges against David Phillips under section 189 of the Companies Act (relating to the fraudulent transfer of company property on his own behalf vis-à-vis section 461A). It was

	1989 ($M)	1990 ($M)
Property Assets	83.698	79.893
Total Assets	142.287	104.580
Share Capital	99.825	99.825
Reserves	(59.513)	(98.501)
Current Liabilities	19.571	5.465
Bank Liabilities	84.810	96.170
Term Liabilities	0.343	1.611

Table 4: Abbreviated Pacer Kerridge Balance Sheet
Following the accounting convention, parentheses indicate negative amounts. Source: Pacer Kerridge Ltd Annual Reports, various years.

alleged that Phillips had on-lent the funds acquired from DFC NZ to various staff purchase schemes[18] to enable the schemes to purchase shares from himself at an inflated price, which involved money being credited to his account at Pacer Kerridge Finance (presumably coming from the staff scheme's account). These funds were then used to acquire the Berkeley Theatre from Pacer Kerridge, which was sold to DFC NZ to satisfy a margin call on shares relating to the initial $5m loan (presumably because the shares used to secure the loan had dropped in value) (Porter 1989, pp 1-2).

Section 189 of the Companies Act would have disqualified David Phillips, his brother and fellow director Stephen Phillips and a third former director, Ian Shaw, from acting as directors. As Phillips was still acting as a director of (delisted) Pacer Kerridge in 1992 one must surmise the charges were not successful. Note 15 to the 1990 accounts reveals that competing claims between Phillips and Pacer Kerridge, some of which involved the DFC NZ settlement, were settled by a deed of forgiveness between the two parties. Part of Pacer Kerridge's claims referred to Phillips' interests in bloodstock syndicates promoted by a Pacer Kerridge subsidiary.

Following the Crash, Pacer Kerridge sought to reduce its liabilities, primarily by selling property assets, including a number of cinemas located around the country. Shareholders funds, as represented by the sum of issued capital and reserves, fell from $160.905 million in October 1988 to $40.312 million in October 1989 (New Zealand Company Register 1991, p. 99).

The bottom line loss of $78.16 million was mainly due to extraordinary losses of $29 million in advances to staff share schemes (recall the transaction discussed above), a $10.4 million write down on bloodstock, a $14.5m loss resulting from the sale of Madison Corporation (in receivership) and $7.9 million lost on an investment in an associate company, probably the 25 percent owned in the merchant banking and stockbroking firm Merchant Capital (NZ) Ltd which was placed in receivership in August 1989 (Pacer Kerridge Corporation, p. 9, Note 5; New Zealand Company Register, p. 148). However, asset revaluations were not

[18] David Phillips was also a trustee of some of the staff share purchase schemes, which helped facilitate control of the company.

recognized in the profit and loss accounts (Pacer Kerridge Corporation 1990, p. 8, Note 1B(iii) and Note C), and these reduced equity by an additional $58.141 million. A $42.459m loss was realised on properties divested during this period, losses that would not be reversed in any subsequent period by an improving market. Properties that were retained were devalued by a further $15.682m (Pacer Kerridge Corporation 1990, p. 10, Note 7A). Table 4 above illustrates the problems that continued to occur in the 1989/90 financial year: operating losses meant that interest rate costs had to be absorbed through further borrowing; bank liabilities rose by just under $12 million whilst the property portfolio remained static. Equity of $160.9 million disappeared in two years as a result of interest costs, operating losses and a property and investment portfolio whose value also declined.

Woodcorp Holdings Ltd provides a similar example of a buy-back scheme. DFC Financial Services Ltd established a lending relationship with Woodcorp Holdings Ltd in 1987 and in April 1988 it purchased 19.5 percent shareholding of Woodcorp's capital. On 3 October 1989 – the day statutory mangers were appointed for DFC NZ – it was announced that DFC NZ had purchased Woodcorp House (a commercial building in Rotorua) in exchange for the cancellation of Woodcorp's debt with DFC NZ (New Zealand Property 1989b, p. 12). Previously the building had been on the market for $17 million, but no other buyer had been found at this price. Again, this type of transaction allowed DFC NZ to delude itself that it had quality assets at least equal to their book value. DFC NZ's statutory management in October 1989 meant that, once again, Woodcorp House was put up for sale (The Press 1991d, p. 45). The theatres acquired from Pacer Kerridge Corporation were also sold by DFC NZ's statutory managers (The Press 1991a, p. 42).

Woodcorp Holdings Ltd also provides evidence of a Ponzi-type transaction. DFC Financial Services Ltd's first charge was secured by a mortgage in February 1988. This mortgage was subject to a memorandum of variation in May 1988 whereby the principal was doubled to $10.5 million. This document also provided DFC Financial Services Ltd with the right to withdraw money from this loan in June and September to meet loan payments on a previous mortgage agreement – should they not be met by Woodcorp Holdings as the mortgagor (Annex 'A', Variation of Mortgage dated 4/5/1988, AK 336814, Manor Inns Group Ltd formerly Woodcorp Holdings Ltd).

Woodcorp Holdings Ltd also illustrates another of the problems that Minsky was concerned with. DFC was a financial institution with fixed (as opposed to contingent) nominal interest payments on its borrowed funds. Yet DFC NZ's equity investment in Woodcorp Holdings, and similarly DFC Ventures' investment in Eastern Equities Ltd (used to finance a controlling interest in Hawkes Bay Transport Ltd), entitled DFC NZ to contingent cash flows. In 1988 and 1989 neither company yielded dividends (New Zealand Company Register 1991, pp. 45, 142). This meant that the cost of funds invested in these companies had to be met from other projects and loans, one can see the perverse incentives that existed to speculate in risky assets to generate an adequate average return. At the end of 1988 DFC Ventures only controlled 48.7 percent of Eastern Equities, down from the 57.66 percent held in 1987 (New Zealand Company Register 1988, p. 93; New Zealand Company Register 1990, p. 69). That this was not an insignificant investment is made clear by the fact that the 7 million Eastern Equities shares were purchased by DFC Ventures for 75 cents each (New Zealand Company Register 1989, p. 72). Similarly, the par value of DFC NZ's Woodcorp holdings was approximately $3.3 million. In January 1989 both these shareholdings were transferred to the NPF subsidiary Stratacorp Financial Ltd New Zealand Herald (1989c, p. 3). However, as discussed previously, DFC NZ retained an exposure through the loan made to Stratacorp Financial Ltd. Eastern Equities Ltd (formerly Eastern Deer Ltd) provides further evidence of the sectors to which DFC NZ was exposed. Eastern Equities had investments in deer, kiwifruit and transport. The difficulties of its transport arm in the 1987 year were ascribed to the rural downturn (New Zealand Company Register 1988, p. 93), and this highlights the flow on effects associated with the bursting of the agricultural bubble.

Cruise Corporation provides another interesting example of the interplay between DFC NZ and associated companies. In its former institutional role DFC NZ had developed small companies with the goal of selling them for a capital gain. In June 1987 DFC NZ acquired a 10 percent stake in Cruise Corporation in exchange for its 24 percent shareholding in Telesis Corp (New Zealand Company Register 1990, p. 63). A year later Cruise Corporation acquired Healtheries NZ Ltd from DFC Ventures Ltd, for $0.81 million plus 7 million 50 cent shares acquired at a 5 cent premium (New Zealand Company Register 1989, P. 66) . Soon after, Cruise Corporation also acquired Pacific Marine Ltd from DFC and a number of private partners for $100,000 plus 1.207 million 5.0 cent shares. Given that Cruise Corporation provided mainly shares in consideration for these assets, DFC NZ (through DFC Ventures Ltd) was still exposed to the companies it had originally helped to finance (albeit less directly).

In October 1988 DFC Ventures Ltd's shareholding in Cruise Corporation was transferred to Stratacorp Financial Services Ltd (New Zealand Company Register 1990, p. 63). Cruise Corporation's 1989 Annual Report also reveals that Alan Langford, managing director of DFC Ventures in 1988, was chief executive of Stratacorp Financial Ltd. It is hard to accept that the equity sale to Stratacorp Financial was conducted on a disinterested arms-length basis, and Langford's new role indicates that the change of ownership was not in itself acting as a rigorous discipline on management behaviour.

Cruise Corporation's relationship with DFC NZ was certainly responsible for a large proportion of Cruise Corporation's problems, but this relationship was by no means the sole cause: in March 1989 Cruise wrote down its property portfolio by $1.396 million, only $108,000 less than the $1.504 million writedown in intangible assets that were primarily related to acquisitions (Cruise Corporation, 1989: 16). In the light of Cruise Corporation's later problems it seems odd that Capital Reserves were increased during the 15 month period to March 1989 by a "$1.541 million revaluation of non monetory (sic) assets in subsidiary companies" (Cruise Corporation Ltd 1989, p. 17). The valuation of the assets purchased from DFC NZ was, directly and indirectly, dependent on directors' valuations (see Cruise Corporation Ltd, p. 18; and CH 311409, p. 8 Touche Ross Report on the acquisition of Healtheries N.Z. Ltd). A number of these directors were DFC NZ appointees (e.g. Coombe and Langford). In March 1989 marine farming structures and leases were valued at $2.027 million. In June 1990 receivers were appointed under a National Bank debenture assigned to DFC New Zealand Ltd (which was a far larger creditor than the National Bank). At that time the book value of Pacific Marine Farms had fallen to $1.329 million – though its realizable value was estimated at zero, according to the Director's Statement of Affairs (CH 311409, Document 78). The loss incurred on the investment in Pacific Marine Farms was compounded by the fact that only $2 million of a $2.795 million advance to Pacific Marine Farms was expected to be recovered (CH 311409, Document 78). It was estimated that unsecured creditors, of which DFC NZ was by far the largest (owed $4.588 million), faced a shortfall of $1.556 million (total liabilities of $9.955 million) – before any allowance was made for receivership costs. Stratacorp Financial's shareholding in Cruise Corporation is thus very unlikely to have been worth anything.

Another example of assets being transferred to related parties is provided by Agricola Resources Ltd. Agricola was another resource-based company, but with assets in areas more diverse than most, including: kiwifruit, salmon farming, nashis, alpacas, apiaries, goats and so forth. Agricola's exposure to these agricultural activities made it difficult for it to meet its debt obligations with DFC NZ when the profitability of these activities declined. For instance a planned sale of goats from the 1986 kid-drop was abandoned because of the fall in stock prices (New Zealand Company Register 1988, p. 11). In June 1988, to provide some relief from Agricola's cash-flow problems (particularly whilst it was developing its kiwifruit orchard), an $8 million debt was converted into preference shares. Within a month a further 25 million 50 cent shares were issued to DFC NZ in exchange for a number of businesses, including New Zealand Beef Packers Ltd. This beef processing plant was originally owned by Finance and Resources Ltd (later renamed Beef City Holdings), which had a $1.28 million mortgage over the plant and land of its subsidiary. Although it has not been possible to ascertain whether or not the debenture over this Napier-registered company was in favour of DFC NZ, it seems highly likely, given that one of the founding directors of NZ Beef Packers, David Miller, worked for DFC NZ (The New Zealand Farmer 1989, p. 35). NZ Beef Packers was sold to DFC Ventures Ltd which then passed the parcel to Agricola. Agricola later wrote down the value of the businesses that it had acquired from DFC Ventures Ltd by $4 million (Goudge 1990, p. 2).

Following DFC NZ's statutory management in October 1989 Agricola placed NZ Beef Packers on the market, in order to be able to meet short-term liabilities (loans and commercial paper) with DFC NZ, which were due in June 1990. DFC NZ's statutory management meant there was little prospect of being refinanced. In August 1990 DFC NZ placed Tasman Kiwifruit, Agricola's kiwifruit subsidiary, into receivership (WN 297162). Two days later it sold the orchard and associated chattels for $960,000. This was a significant decline from its

1986 valuation of $5.4 million (The New Zealand Kiwifruit Report 1990). The speed of this divestment is suggestive of a fire-sale approach, particularly as negotiations were reportedly underway by Agricola with another party for $1.5 million. Inter-company advances, for example between Agricola and its alpaca subsidiary and to NZ Beef Packers, were also written off. Again, DFC Ventures Ltd's ordinary shareholding had been transferred to Stratacorp Financial prior to DFC NZ's March 1989 balance date, though it appears that the preference shares were retained by DFC Ventures Ltd (see WN 297162 Document 32 "Annual Return"). It was reported that DFC NZ lost $1.9 million on its debenture with Agricola Resources Ltd (New Zealand Herald 1992a, p. 2), and if it had, indeed, retained the preference shares this loss would have been $8 million greater. During its entire lifetime Agricola Resources Ltd never issued dividends. This is another case where DFC NZ had substantial assets tied up in non-performing assets.

Similar problems within the agricultural and tourist accommodation/property development sectors were also experienced with Horner Greenlees Corporation and its listed subsidiary Woodstock Investments. As an unlisted company Horner Greenlees had promoted investments in agricultural partnerships and had developed hotels and time-share agreements. Before Woodstock was listed many of the assets in these partnerships were sold to Woodstock in exchange for shares. The Crash and the decline in the agriculture sector caused the value of Woodstock to decline and, by association, Homer Greenlees too. Woodstock's investments in kiwifruit, goats and deer suffered from substantial declines in value.

In September 1987 Woodstock believed that slower growth in kiwifruit output meant that $8.50 a tray was a realistic estimate of the price that would be realised in future (Broad 1987, p. 7). That this reflected an optimistic view is revealed by the ex post price, which was around $5.52 for producers or $3.02 at the farm gate (New Zealand Kiwifruit Marketing Board 1993). Similarly, Woodstock's general manager, Hugh Jellie, seemed to have a rose-tinted view of the value of deer stock. He believed that the economic value of deer stock closely approximated the current market price, around $650-700 per hind (Fisher 1988, p. 47). In the same article Elaine Fisher notes that the price of deer could drop further if valued purely on a carcass basis, and such a drop did in fact happen in the years that followed.[19] Naturally, as promoters of investment in kiwifruit and deer, Horner Greenlees and Woodstock investments virtually had an obligation to be optimistic. In March 1989 Horner Greenlees was placed into receivership by DFC NZ. Seventy per cent-owned Subsidiary Woodstock Investments was thus indirectly in the control of receivers too. DFC, an unsecured creditor of Woodstock Investments, was owed $1.2 million, but is unlikely to have received anything from Woodstock given that the Rural Bank, the debenture holder, had debts in excess of Woodstock's assets (New Zealand Herald, 7/3/1990: 6). Horner Greenlees failed to repay $6.3 million owed to creditors and, again, un-

[19]More detail on the state of specialist agricultural and horticulture, and the property market, is available in a companion article available from the author.

secured creditors were expected to get nothing (New Zealand Herald 1990, p. 5).

The asset merry-go-round was also played out by DFC NZ and Ararimu Resources (see AK040932: Document 30, Agreement for Sale and Purchase of Real Estate"). In this case a kiwifruit orchard in Maungatapere, Northland was transferred to Ararimu in exchange for a $1.21m shareholding in Ararimu and $47,500 to settle an obligation with the Rural Bank. This transaction was effectively a mortgagee sale conducted by DFC NZ. Allan Hawkins used Ararimu Holdings Ltd as a vehicle to control Equiticorp Holdings Ltd (later transformed into Equiticorp International Plc). As a result Ararimu was caught up in Equiticorp's statutory management in January 1989.

DFC NZ made provisions worth $13 million dollars for DFC, providing in full for unsecured lending of $3.6. million (National Business Review 1989a, p. 1). However, it is difficult to tell how conservative these provisions actually were, for instance one cannot ascertain whether DFC NZ was fully taking into account the ramifications of Equiticorp's failure. Nor is it clear how large their provisions were with respect to their secured lending: Equiticorp Holdings Ltd debentures (secured funds) were only projected to recoup 32 cent in the dollar (New Zealand Herald 1992c, p. 1). This was a significant increase on the 18.5 cent estimate just five months earlier, because of a favourable outcome in court (New Zealand Herald 1992b, p. 1). Equiticorp had lending and equity relationships with many of the newly formed investment and property companies listed on the stock exchange, some of which have already been mentioned. After a lengthy investigation and trial, Allan Hawkins and a number of other Equiticorp directors were also among those convicted of fraud (Greene 1993, p. 17) and Hawkins was also adjudged bankrupt (New Zealand Herald 1991a, p. 22).

The cases above show that corporate linkages affected DFC NZ's ability to achieve asset sales, which may have delayed recognition of non-performing assets. Personal relationships also seem to have had an adverse impact on DFC NZ's position. DFC NZ lent Calathea Holdings Ltd $4 million to purchase shares in Inter-Pacific Equity Ltd (IPE), at a time when IPE was the Australian parent of McConnell Dowell Corporation Ltd – of which Malcolm McConnell was chairman and a major shareholder (see above for DFC NZ's relationship with McConnell Dowell Corporation Ltd). Calathea Holdings was a private company owned by Malcolm McConnell and at the stage where this DFC NZ finance was provided McConnell was also Chairman of DFC NZ's board. Originally, the loan was provided for the purchase of IPE shares, against which the loan was to be secured, but 12 million shares in Wellcare Corporation (a private health company formed in 1986) were substituted as security instead (National Business Review 1989c, p. 2). In April 1988 Calathea's lawyers wrote to DFC NZ saying that it wished to settle its $4 million debt, but it did not have the cash to do so and instead relinquished the shares held as security. The shares at that time were valued at 42 cent each, a valuation which DFC NZ accepted, and Calathea Holdings was subsequently paid $936,830 over and above the $4.1 million owed to DFC NZ (National Business Review 1989c, p. 2). DFC Ventures, already a major shareholder in Wellcare Corporation, took over

Calathea's Wellcare shares from DFC Financial Services.

Early in 1988 DFC Ventures had arranged an option to buyout Wellcare's other major shareholders – Calathea Holdings and Kerrendale Finance – to expedite a complete sale of the company should the opportunity arise to sell Wellcare in toto. The option specified that if one of the other parties was bought out the other had to be too. DFC NZ was later taken to court by Kerrendale Finance for failing to fulfil this agreement. John Egan, of Kerrendale, swore in an affidavit that DFC Ventures general manager, Alan Langford, claimed that the shares had been surrendered by Calathea because it had not been able to meet its obligations, and DFC Ventures had not exercised the option (National Business Review 1989d, p. 1). However, the judicial system did not agree with Langford and required DFC NZ to purchase Kerrendale's shareholding (New Zealand Herald 1992d). Kerrendale was awarded $2.52 million for its worthless Wellcare shares (The Press 1991e, p. 14).

Malcolm McConnell's relationship with DFC also extended to a partially paid shareholding in a DFC subsidiary, Fernbank Industries (WN 267465). McConnell with Murray Smith, V. Tony Hartevelt (also a DFC NZ director) and David Hill (managing director of Fernbank) subscribed for 2.5 million $1 shares, which were only paid to 1 cent. Because Fernbank was one of DFC NZ's equity arms (effectively it was an investment company) it was passed to Stratacorp Financial prior to DFC NZ's March 1989 balance date, as were the shares held by McConnell and the others (see Document 33, WN 267465).

One can see why DFC NZ would not want a former chief executive and a former chairman to retain shares in its subsidiary, but it is difficult to understand why David Hill and Tony Hartevelt were allowed to sell their shares. The fact that the shares were only partially paid up and that the shares were subsequently passed back to a DFC-related entity, Stratacorp Financial, means that the incentives on managerial and directorial performance may not have been significantly improved, which is the ostensible goal of profit-sharing agreements. Stratacorp Financial's equity investment in Fernbank had a par value of $14.5 million in May 1990 (WN 267465, Document 33). Fernbank's liquidation in November 1993 yielded DFC NZ and DFC Financial Services a total of $2,842.48, a dividend on proven debts of 0.011877 cent in the dollar, i.e., DFC NZ was owed a total of $23.933 million (WN 267465, Document 42). Although the Serious Fraud Office investigated DFC NZ no charges were ever reported, nor is the Serious Fraud Office obliged to make the details of its investigations public.

6 Conclusion

This article provides a case study describing the failure of DFC New Zealand Ltd in 1989. Although a comparatively small institution, and indeed not even a registered bank, DFC had a profound effect on a number of major listed companies – and vice-versa. The case study reported here describes not only the behaviour of DFC, but delves into the complex web of relationships that connected DFC NZ with a number of the most notable company failures in the late 1980s and early 1990s. The failure of DFC NZ was prompted in part by changes in its liabilities – perpetual subordinated debt holders exercised an option that required DFC NZ to repurchase subordinated perpetual debt because the government had ceased to control 51 percent of the company. However, the underlying failure of DFC NZ reflected the (lack of) quality of its *asset* portfolio. DFC NZ's asset portfolio was in such a parlous state that its solvency was questionable.

One might have expected DFC NZ to have a diversified portfolio of assets, with well-managed credit risk mechanisms. In fact, DFC NZ's portfolio was heavily concentrated in a small number of high value central business district property developments and in non-traditional agricultural and horticultural lending, like deer, goats and kiwifruit. Many of these projects declined hugely in capital value, indicative of their values being subject to the expectational euphoria that Minsky emphasizes. 'Connected lending' – to parties related to DFC NZ – also appears to have been an important problem for DFC NZ. In a number of cases directors and managers of some of the companies that DFC did business with stretched the boundaries of accepted business practice, and in some cases individuals were later found guilty of various criminal acts.

From one perspective, this article is simply a case study of DFC NZ and the companies with which it was involved. However, the article also seeks to shed light on 'Minsky's financial instability hypothesis'. Minsky's financial instability hypothesis emphasises i) expectational euphoria; ii) the greater articulation of income and expenses as good times progress; iii) 'financial layering' of different institutions (making more entities vulnerable to cash-flow disruptions of related parties); and iv) fire sales in response to disrupted cash-flows (with attendant consequences for borrowers that have collateralized their borrowing with similar assets).

The rapid expansion of DFC New Zealand's balance sheet in the 1980s proved to be ill-founded, based on euphoric expectations of financial returns that were unachievable. DFC New Zealand's financing of CBD property contributed to an expansion of supply of office space. The collapse of the investment and financial sector following the stock market crash of 1987 greatly reduced the demand for such office space. Further, DFC NZ's failure and the failure of other related parties contributed to the collapse of CBD property asset values, as statutory managers, receivers, and liquidators sought to wind up failed companies. These 'fire sales' are an integral part of the resolution of company failures. Receivers have priority over all other financial claimants, and their costs are often considerable. Consequently, receivers have an incentive to sell off asset portfolios in short order, to obtain returns for creditors, though the potential cost of such speedy resolutions is a decline in the returns obtained from asset sales.

In the 1980s many economists and policy institutions were advocating market mechanisms to allocate resources. DFC NZ crossed the public-private divide during the period reviewed here. DFC NZ's failure – and the fact that both the NPF and Salomon Brothers purchased DFC NZ – illustrates that people on either side of the public-private divide may make very poor decisions if given suitable opportunities.

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