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Independent celebrity directors in closely held financial institutions

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ABSTRACT

This paper addresses corporate governance issues around the use of celebrity independent directors in closely held financial institutions. In doing so we illustrate how the power of the celebrity nature of the directors encouraged deposits from members of the public who would not have normally utilised a finance company. The authors employ the failure of Lombard Finance, a closely held New Zealand finance company, to illustrate the agency conflict between directors, who were nominally independent, and outside debt holders. This approach is taken as New Zealand finance companies are unique in that they are predominantly closely held bank-like firms who sourced the bulk of their funds from retail fixed term deposits. The research highlights the conflict inherent when utilising independent celebrity directors as spokespeople for closely held finance companies in a small, loosely regulated market. As a result of the failure of companies such as Lombard, the government changed the law to prevent the use of celebrity spokespeople promoting finance companies. This research contributes to the academic discussion surrounding independent celebrity directors and their influence in the collapse of closely held finance companies at a particular time in recent history and the practical steps taken to ensure that such episodes are lessened in the future.

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1. Introduction

New Zealand has for many years been a proponent of the light-handed regulation of financial institutions. New Zealand investors are solely responsible for their investment decisions, unable to rely on official government regulators/examiners, or the perverse crutch of deposit insurance.[1] Instead, armed with disclosure statements, New Zealand bank and non-bank depositors are expected to apply market discipline to ensure the safety and soundness of their deposits. Wilson, Rose, and Pinfold (2012b) demonstrated New Zealand's bank disclosure was effective in moderating bank risk, although this was found not to be due to market discipline but a result of bank directors and managers exercised self-discipline. In the case of New Zealand finance companies,[2] Wilson (2009) judged disclosure to be of such a poor quality that it was of little value. Further, Wilson, Rose, and Pinfold (2012a) found some finance companies merely paid lip service to any code of corporate governance. Boards dominated by inside directors appeared more concerned with their own investment than the investments of outside debt investors.

Unsurprisingly, in 2006, New Zealand saw the beginning of a systemic failure of the finance company industry, with over 48% of its 200 finance companies failing between 2006 and 2009. In total over NZ$6 billion of depositor funds were placed at risk, the bulk of which were the retirement savings of unsophisticated retail investors. As a result of failures, funding to non-bank deposit-takers (NBDTs) from New Zealand residents dropped from a high of NZ$13.578 billion in June 2009 to NZ$6.430 billion in June 2013 (RBNZ, 2013).

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[1] In October 2008 the NZ government introduced a temporary deposit guarantee. This was not primarily designed to protect depositors but was justified by the perceived difficulty for NZ financial institutions to raise capital on international credit markets. The NZ government felt it was necessary to introduce the temporary deposit guarantee, as the Australian government was intending to introduce a similar guarantee, which would have disadvantaged NZ institutions.

[2] NZ finance companies are unique in that the bulk of their funding comes from retail fixed term deposits called debentures.

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The failure of finance companies in New Zealand began prior to the global financial crisis (GFC) and continued after the GFC. While New Zealand finance companies felt the impact of the GFC, the GFC was not the cause of the collapse of the New Zealand finance company industry. In general, the market was financed from domestic retail sources with little capital coming from international capital markets. This paper utilises the failure of Lombard Finance and Investments Ltd (this and the various other related companies are generically referred to in the remainder of the text as Lombard) in 2008, to examine issues of trust specifically related to two of the directors of Lombard. They were the Right Honourable (Rt Hon) Sir Douglas Graham and his colleague the Honourable (Hon) William Jefferies, whom we argue took on the persona of a ‘celebrity’ in the mind of the investors.

An unusual feature of the Lombard case was the high calibre or public profile of its board of directors, which on formation included three well respected former Ministers of the Crown, as directors[3]; Rt Hon Sir Douglas Graham, the Hon William Jefferies, and the Hon Hugh Templeton.[4] Graham, Jefferies and Templeton would, at the time of appointment to the Lombard board have been ranked as among the most trustworthy of New Zealanders, due to their celebrity status, as mentioned in various media outlets,[5] and their years of service to the New Zealand public. While other finance companies failed and some even had celebrity promoters,[6] Lombard was the only one where the celebrity directors sat at the board table and, despite their trustworthiness, an agency conflict is evident between investors and directors. The issue relating to celebrity endorsements of finance companies and the effect they had on the general public was recognised by the New Zealand government post 2008. For example, in 2011 The Minister of Justice Simon Power announced that the government was investigating legislation that would prevent such measures. He is quoted in the New Zealand Herald in 2011 as saying “In at least one case, a celebrity specifically endorsed the strength of a finance company” (NZPA, 2011). Further, he is also reported as saying “in another instance the person may have been used because their primary employment created a sense of integrity” (NZPA, 2011). It is widely believed that the minister was referring in the first instance to Colin Meads, an ex-all black who described Provincial Finance as “solid as” (a New Zealand colloquialism meaning very secure and trustworthy). In the second case he is referring to Richard Long, a well-known and, at one time, one of New Zealand's most trusted news readers. In both cases the finance companies that these two ‘celebrities’ endorsed collapsed owing a total of NZ$855millon, mainly to small ‘mum and dad’ investors.

We argue that Lombard and the influence of Sir Graham is different from the above, as Sir Graham was not only a spokesperson but also stood to gain financially from the increase in Lombard deposits. We argue, in particular, that he faced an agency conflict. Agency conflicts are common in business, normally occurring between managers and shareholders. In financial institutions depositors who don't have representation on the board are able to free-ride on agency protections enjoyed by shareholders who have elected directors. What was unknown to depositors, when Lombard was first formed, was that all the shareholders of Lombard were also board members of Lombard. This resulted in a significant agency issue for Lombard depositors. We aim to illustrate the clear danger in public reliance on celebrity endorsement in highly technically environments and how by ignoring such dangers retail investors take excessive risk, which cannot be justified by the returns they receive. As Wilson (2009) found, the regulatory regime for finance companies was so flawed that the New Zealand Government had a duty to intervene to ensure public financial safety.

The remainder of this paper includes a brief literature review looking at three areas; agency conflict in financial institutions, the benefits of independent directors, and lastly the use of celebrities as directors. The following discussion utilises public disclosure documents, receivers' reports along with Court documents from the trials of Lombard directors, to detail events at Lombard from its formation in 2002 to its collapse in 2008. Throughout the discussion these events involve agency issues and highlight the actions of Lombard's celebrity and independent directors. The question posed in this paper is; what, if any, value did these *independent and celebrity* directors bring to investors in Lombard?

2. Literature

Trust is paramount in business transactions; there are extensive strands of academic literature examining agency problems, and the concept of independent and celebrity directors. The following review identifies those aspects of the literature that are relevant in the discussion relating to the failure of Lombard.

Whenever you employ another party, to whom you give decision making authority, you face agency issues and costs. Agency issues are related to information asymmetries. In business, the managers of the firm have superior information to that held by investors. There is an academic history looking at both agency theory and the closely linked moral hazard (where the agent uses the funds supplied for a different, more risky purpose) (Fama & Jensen, 1983; Ross, 1973). In banking type organisations this is further compounded by the presence of adverse selection, where lenders (in this case, depositors) are unable to accurately measure the risk of a financial product and settle for an average rate of interest. Average interest rates are not appropriate as low risk borrowers (who are able to demonstrate their risk) seek alternate financing, leaving only high risk borrowers, for which the average interest rate is no longer appropriate.

Asymmetric information has long been recognised by researchers as a problem, with attempts made to curb its negative impacts (Sharpe, 1990). Sharpe's (1990) findings reflect the comments of Selznick (1947/1966) in his study of the Tennessee Valley Authority, in that agency may be subsumed by organisational buy-in. In other words the managers of the organisation fail to see the conflict due to institutional factors. Bank type organisations are unique in that they generally employ low levels of equity, often less than ten percent; regulators attempting to address this have resorted to official bank examiners to check on mandated minimum levels of capital, public disclosure of relevant risk information, and compulsory deposit insurance. Although Lombard was not a bank, the fact that it took fixed term deposits from the public meant it was undertaking financial intermediation, which is one of

[3] Lawrence Bryant was the fourth independent director, Alan Beddie was an executive director Lombard Finance and Investments Ltd. 2002. *Lombard Finance and Investments Ltd Prospectus*. Wellington: NZ Companies Office. and Michael Reeves joined the board in December 2002 Phillips Fox Lawyers, 2002. *Consent and certificate of director or directors*. Wellington: NZ Companies Office.

[4] Hugh Templeton resigned as a Lombard director on 31 March 2007, a year before the Lombard receivership. As he was not charged by the FMA we make no comment on his actions.

[5] See, for example, Anderson, 2013. *Sir Douglas Graham and the Cult of Privilege*, ***NZ Herald***, Vol. WEEKEND REVIEW. Auckland, New Zealand.and in Cheng, 2012. *Strip Graham of knighthood*: *Victim*, February 25 ed. Auckland, New Zealand: New Zealand Herald.A Mr Walsh is reported as saying he would not have invested in Lombard had Graham and Jeffries not been at the helm.

[6] Provincial Finance, which failed in 2006, was endorsed by ex-all black rugby player Colin (Pinetree) Meads, and Hanover Finance, which failed in 2008, used Richard Long, a well-respected television news reader, to promote its products.

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