THE INTERNATIONAL JOURNAL OF BUSINESS & MANAGEMENT

A Failure of Stewardship on All Sides – The Finance Companies Debacle in New Zealand

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Abstract:
This article represents an analysis on the collapse of a large number of finance companies in New Zealand from 2008 to 2012. It identified a number of failures of stewardship by the board of directors, corporate trustees and the Securities Commission. The paper traces the root of the problem and the government's response to a lax regulatory regime that precipitates the crisis. There were notably similarities to the toxic mortgage crisis in USA. The root cause lies in excessive greed on the part of investors and financial advisors. Investors were chasing high income and so are the financial advisers who were given high commissions (from 0.5% to 2% of amount invested) by finance companies for investing client's money in them. This gave them huge incentives to put most of their client's money into finance companies, exposing investors to high risk that they could ill-afford. An analysis of the government's response indicates that financial reforms to prevent a similar crisis were swiftly implemented following a public outcry but there are still some lingering weaknesses. The lasting impact of the finance companies debacle to this day - investors remain extremely cautious to put their money in finance companies. The well-run reputable finance companies have been tarred in investor's mind by the same brush as poorly run, fallen companies where governance fell by the wayside. This was a preventable debacle which had lasted to this day.

Keywords: *Finance companies collapse, New Zealand, corporate governance, NZ financial reforms, financial advisers, investing risk, information asymmetry*

1. Introduction

In the decade from the late 1990s through to the onset of the global financial crisis of 2008, there was an unprecedented growth in finance companies (Keown, 2011). Lax regulations and ease of setting-up finance companies lead to an explosion of deposit-taking companies. Most of them dabbled in risky ventures and did not survive the global financial crisis of 2008.

The collapse of finance companies in New Zealand from 2008 – 2012 was also unprecedented in the country. By the end of 2011, about 50 finance companies had gone under receivership, affecting 200,000 investors who had invested about $6 billion; much of which were not recovered. Countless lives have been wrecked. It was a disaster of epic proportions that sent shockwaves throughout the finance industry in New Zealand. Brian Gaynor, executive director of Milford Management placed most of the blame on financial advisers. However, the reasons for the collapse were more complex. In this paper, a host of factors that contributed to the failures in finance companies are explored. It includes failure of corporate governance (by corporate trustees and mismanagement), regulatory failures (by the Securities Commission) and the lack of basic knowledge of risk and return by investors.

2. Methodology

This paper is designed as a case study on how poor corporate governance in an advanced country such as New Zealand had contributed to a profound failure of epic proportion that affected a large number of investors and involving a huge sum in a small country. The study represents an analysis of the debacle through interviews conducted over a three year period from 2011 to 2014. A critique of the government's response is given in this paper and discusses whether newly introduced legislations are adequate to prevent a similar crisis from occurring.

A limited number of 15 unstructured interviews were carried out with finance professionals in New Zealand, trust fund managers and business commentators. They gave insights into the nature of the problems and suggested some solutions to the issue of lack of public confidence in the finance companies. Opinions were also solicited on whether the financial reforms recently introduced by the government were adequate.

The study attempt to show that although corporate governance in the finance sector was lacking, governance from the public sector was grossly inadequate. Poor governance by the Securities Commission had allowed uncontrollable bad practises by finance companies of giving 'bribes' to financial advisors to go unrestrained for so long; even though there were evidence these practises had caused much harm to investors.

3. Similarities of the NZ Finance Companies Crisis to the US Mortgage Crisis

In the USA, the wrong incentives (in the form of high commissions) were given to mortgage brokers to initiate mortgage loans for the banks. It resulted in a large number of second or third grade mortgages which turn out to be toxic. These poor grade mortgages were solicited from borrowers who had little or no capacity to repay the loan. The mortgage lenders brokering the mortgages got their commissions for poisoned mortgages passed along to the government (Freddie Mack and Fannie Mae) and Wall Street banks.

Mortgage lenders contributed to the financial crisis by issuing or underwriting loans to people who would have a difficult time paying them back, inflating a housing bubble that was bound to pop. Lax regulation allowed banks to stretch their mortgage lending standards and use aggressive tactics to rope borrowers into complex mortgages that were more expensive than they first appeared. Evidence has also surfaced that lenders forged documents, hyped customers' creditworthiness and 'juiced' mortgages with hidden rates and fees (Goyette, 2011).

Similar incentives for the financial advisors in New Zealand contributed to the loss of billions by naïve investors who had no idea that investing in finance companies was highly risky.

4. Failure of Professionalism on the Part of Financial Advisers

Financial advisors are a large part of the problem (Gaynor, 2010). They were supposed to be professionals who should have put up a diversified portfolio of investment products that spreads the risk and get maximum return. Instead, investor's money was poured into finance companies that dabbled in highly risky commercial development. The essence of professionalism is painfully lacking from the financial advisers who had put their own interests before their clients as they rushed for the high commissions that many finance companies paid (Hawes, 2010).

Financial planners generate income from commissions, which are paid by product providers (finance companies) or from fees paid by investors. Finance companies pay commissions to financial planners based on the amount of money invested and the duration of the investment. In the mid-2000s, finance companies paid generous commissions of around 0.5% to 2% of the amount invested depending on the duration of the investment. The actual commissions were often higher and most finance companies paid trailing commissions, which are an additional yearly payment over the duration of the investment. It is no wonder that financial advisers had a huge incentive to encourage individuals to invest in finance companies that paid the highest commissions. Consequently, a large number of financial planners advised individuals to invest on finance companies that offered the highest initial and trailing commissions. It turn out to be disastrous as many of the finance companies paying the highest commissions; with Bridgecorp being a good example, were some of the biggest disasters.

5. Failure of Corporate Governance in Finance Companies

Prior to the collapse of the finance companies, the New Zealand government has a tendency to rely on good governance to ensure financial stability; but it has proven to be flawed. There were two major governance failures, the first in the governance of the sector by the authorities and the second concerns serious failings in corporate governance by the finance companies (Mayes, 2015).

The securities commission reported that finance companies failures were due to poor corporate governance, flawed business models, miscalculation of risk, failing property prices, some criminal activity and light-handed regulatory regime that was overseen by trustees and unregulated financial advisers (Prada and Walter, 2009).

The Economic Development Ministry's National Enforcement Unit reported on mismanagement, misleading information contained in the prospectus, defaults of the payment of interest and principal, misleading information provided to the trustee, and transactions involving personal interests (EDU, 2009).

5.1. Failure of Oversight by Corporate Trustees

Corporate trustees exercise oversight on behalf of investors. They exist to hold a company to account for convenants made under a trust deed. The New Zealand's Institute of Chartered Accountant was aware of instances where corporate trustees failed to act when finance companies are struggling (McLaughlin, 2012). There were no review being undertaken of the quality of their oversight during that period, unlike the spotlight being turned on directors and chartered accountants.

It has been uncovered that board of directors in these collapsed finance companies do not closely monitors the quality of its loan book to minimise bad exposure, or ensure that the company has sound and prudent lending policies. Where directors have doubts about the efficacy of transactions, little effort were made to probe further and take action. Good governance was clearly lacking.

The governance of listed property trusts (e.g. AMP NZ Office Trusts) has been a long-running contentious issue. Most of these listed entities have been managed by a separate management with investors having no ability to scrutinise them or vote for their directors. There is an inherent conflict of interest because management companies have a strong incentive to grow the trust, regardless of the profitability of the acquired assets, as its fees are based on the gross value of the assets.

Bernard Hickey, a business commentator, identified a list of the endemic problems – a frenzy of kick-back commissions, inaccurate and misleading reporting of asset values and results, widespread capitalising of interest, endemic related party lending and Ponzi-like deposit taking (Hickey, 2010).

In the case of South Canterbury Finance, it lent far too much money on high risk real estate deals and many of its loans were secured with only second or worse mortgages (Van, 2010). In addition, there were lax accounting standards, under-capitalisation and finally, a CEO and founder who operate under an outdated governance system.

Blue Chip's CEO, Mark Bryers style of management was described as "captaining a passenger ferry through the Cook Straits without maps or compass" (New Zealand Herald, 11.7.2010). Bryer's failings were fundamental. He chose to ignore legal responsibilities with 'wilful disregard'. Blue Chips failed to keep proper books and records and this was one of the main causes of the company's failure.
In the case of Feltex, there were breaches of the Financial Report Act. All parties in the corporate reporting process were well remunerated but none of them accept responsibility. There were clear signs that governance and regulatory issues played major roles in the huge losses suffered by investors (Gaynor, 2010).
Governance was a lingering issue in the finance companies collapse. There were doubts that the board of directors in these companies observed a sound and prudent lending policy. The board did not monitor the quality of its loan book to minimise bad exposure. It had a poor liquidity and funding policy and had not met insolvency requirements and securities regulations (Peart, 2008). Where directors have doubts about the efficacy of a transaction, they are obliged to probe their managers about it; asking the tough questions and then take appropriate actions. This had not been done. The boards of directors turned a blind eye to lending transactions that should have been critiqued and challenged on the way through.
The governance problem was compounded by the lack of independent directors. These directors would normally ask the right questions since their reputation is at stake. Regulations alone will not work well until there are independently thinking directors who make sure the right processes are adhered to.

6. Regulatory Failures

Prior to the collapse of the finance companies, the approach to regulation by NZ regulators was light-handed. Although a light-handed regulation regime may assist economic development, it can also increases fragility (Mayes, 2015). Heavy reliance on disclosure to market participants in the form of market discipline did not work as intended. A key failing was the poor quality of the information available to investors (Fiennes & O'Connor-Close, 2012). The failures of finance companies devastated the savings of many New Zealand residents and consequently the trust of investors in finance companies.
In 2004, the Securities Commission introduced a set of non-binding corporate governance principles which encourage voluntary reporting. Compared to other developed countries, these governance principles are too lenient. The Securities Commission had argued that it does not have a prudential regulatory role over finance companies, i.e. it cannot step in to stop a finance company, or take action against a finance company that fails or help investors recover their money. The Securities Commission had placed more emphasis on cost effectiveness for issuers and not protecting investors – a clear failure of regulation (Hickey, 2010).

6.1. Failure of Oversight over Financial Advisers

The Code Committee Standards of the Securities Commission have allowed some of the worst in the New Zealand financial planning scene to glide into authorised financial adviser (AFA) status without much efforts at all (Sheather, 2011).
There were doubts whether directors in these collapsed companies have fulfilled their responsibilities under the Companies Act. There have been a large number of corporate collapses, yet no single group seems to be responsible. It has yet to be established whether the directors, auditors, trustee companies, Securities Commission or Companies Office were at fault. Lines of corporate responsibility are extremely blurred in New Zealand (Gaynor, 2010).
The Securities Commission was never clearly established if it is an enforcement agency or an adviser to the government on securities industry law reform. An influential lobby group from public issuers have prevented the Commission from developing strong enforcement powers (Gaynor, 2008). The Commission was deliberately underfunded and therefore hasn't intervened effectively when malpractices occur. Consequently, it did a bad job of overseeing prospectuses and investment statements of finance companies. In addition, there is a failure by the commission to stem out Ponzi-type operations of many of the property-oriented finance companies (Gaynor, 2012). This is because most of the interest due to be paid to investors by property developers has been capitalised or added to the total value of the loan, rather than received in cash, and the interest paid to existing investors by finance companies was in fact paid out of capital contributed by new investors. Ponzi schemes collapse when new contributions drop off sharply, and this had happened to the property-oriented finance companies. Most investors were unaware that many finance companies were running Ponzi-type operations. This is because prospectuses didn't disclose the amount of interest capitalised and the amount actually received from property developers. The Securities Commission should take partial blame for lack of oversight of prospectuses and investment statements produced by finance companies. In fact, the commission effectively approved documents that allow operators of Ponzi-type schemes to continue for years.

7. The NZ Government's Response – Changes in Legislations

In the wake of the collapse of finance companies, the New Zealand government acted swiftly to introduce a series of reforms to its financial sector. Under the reforms, board governance demands are heightened. There is a stronger requirement for directors to be fit and proper for their role as directors of an issuer and their responsibility is increased. Regulators require more from directors and this result in greater demands on senior management in the company. There is a requirement to have an independent chairman and at least two independent directors, gaining trustee approval for risk management plans and limiting related-party exposure and setting liquidity limits in the trust deed. The bar has been lifted. All market participants must be registered and licensed. They need to meet more rigorous tests and there is greater emphasis on regulatory compliance. Companies need to adhere to new business processes which must be re-aligned and re-assessed to meet the new requirements.
In February 2008, the government introduced the Financial Advisers Act which regulates and licenses financial advisers. All those who provide financial advice must be registered. The Act also tightened up a flaw in the disclosure regime governing investment

advisors relating to commissions. Under a fee-based regime, investors will pay directly for advice at an hourly rate or a fixed fee. This is a much more transparent and sound payment structure than the traditional commission-based regime. The fee-based approach is preferred as long as the advisor is knowledgeable, experienced and recommends an investment strategy that is appropriate for an individual's age, risk-profile and overall financial position.

In September 2008, the government started to lift the bar quite high on finance companies (as issuers of investment products) by raising compliance costs and capital requirements to such an extent that finance companies are going to be as strong as a bank. New regulations for finance companies include creating risk-management profiles, getting annual credit ratings and having a certain amount of capital on their books. These new regulations are costly; companies pay between $500,000 and $1 million to comply. To afford these high compliance costs, companies must have an asset base of about 100 millions. This had effectively knock-out the smaller, weak companies.

The new 'super regulator' called the Financial Markets Authority (FMA) was introduced in 2011. This is powerful body since it has greater reach with broader search and seizure powers; and more resources through an industry-funded levy system. FMA has already increased its profile with the financial services industry - issuing guidance notes on effective disclosure, delivered warning notices to those who gave out low ball offers and commenced court actions against finance company directors. FMA ensures that investors are better informed and have access to accurate information to make investing decisions.

In August 2011, a bill was introduced requiring non-bank deposit takers to be licensed, placing fit and proper requirements on directors and management. The bill also grant extended powers to the Reserve Bank of New Zealand on matters pertaining to consents to ownership as well as the ability to appoint and remove directors.

In 2012, a new regime was introduced for statutory supervisors and trustees. Under the Securities Trustees and Statutory Supervisors Act 2011, trustees and supervisors of debt securities, unit trusts and Kiwi Saver schemes must be licensed. Licensed trustees are regulated by FMA and required to produce regular reports to FMA on their performance. Even though this had improved the management of finance companies, there are still weaknesses. Trustees are not prepared to engage the auditor directly even though they had remained focussed on having auditors report directly to them. It is not sufficient for corporate trustees to rely on audit work done in a different context. They should undertake their own work and form their own opinion (McLaughlin, 2012).

8. Investor Education

Most investors in New Zealand were inexperience and had not been sufficiently aware of the nature of the risks in investing in finance companies. The promised rate of return by these companies were high and investors did not realise it comes with a high risk. The financial advisors they had engaged were not interested in educating their clients on the risks involved. The high rates of commissions paid by these finance companies should had set off alarm bells for the financial advisors, but greed got the better of them.

The other issue is information asymmetry. Investors are exposed to serious asymmetries of information where company directors know considerably more than the investors. There will always be an information bias toward those who manage a company (the insiders) over those who invest their money in that company (the outsiders). To counter this problem, retail investors are encouraged to do research on the strength of the company they are investing in and their funding sources. All investment entails risk and this risk should be understood and identified. Therefore, there is a need to read companies prospectus thoroughly, particularly around the nature and direction of lending, related-party disclosures and risk management. There is a need to recognise that markets can change. Therefore, investors need to ask a series of "what-if questions" and try to model the outcomes of different scenarios on their investments.

A good strategy to follow is to adopt the well-developed investment rules such as the benefits of diversification. They should avoid chasing the highest returns by putting "all their eggs in one basket". As history has shown, such a scenario has wiped out the life's savings of many investors. Investors should also remain vigilant and appreciate their appetite for risk and these are closely linked with their age brackets.

The New Zealand Institute of Chartered Accountants in the meantime tightened their requirements by making all students aspiring to be accountants take up a finance paper in their course that discusses risk in investment. This is an attempt to expose accountants to the concept of investment risk and to learn from the finance company collapse since accountants can potentially be financial advisors. This had resulted in a spike in enrolments on finance papers in universities and polytechnics throughout New Zealand.

9. Conclusion

New Zealand's capital markets have been blighted by misleading and inaccurate prospectuses, poor corporate governance amongst public issuers, excessive related party transactions and more than a few Ponzi-type investment schemes. It was a failure of stewardship that was preventable at the outset.

The government had acted swiftly to plug the loophole in how financial advisors are remunerated and introduced far reaching legislations such as the Financial Markets Authority that acted as a super regulator with wide enforcement powers to prosecute errant directors. This had resulted in some high profile court cases involving a number of company directors in failed finance directors in recent years. It sends a strong signal that the government is serious in bringing those responsible to account for their actions. The recent reforms to the financial sector emphasised the important of corporate governance. It is no longer acceptable for directors to rely on advisers. They must retain an independent mind and carry out their duties with robust due diligence.

The trust in finance companies remained low to this day. The battle to rebuild trust in New Zealand's capital market and regulatory structures after the finance companies debacle will be a long one. It has become an investor confidence issue with some of the better-

managed companies become caught up in the tsunami of investor sentiment swinging against them. The combination of regulatory, legislative and enforcement changes introduced since the global financial crisis had given more confidence to investors.

The new regulations introduced since the finance companies collapse has been well received. They helped to align the country's financial sector regulations with international regimes around the world. They also increase director's exposure to liability and strengthen good governance requirements in the financial sector. New Zealand's financial sector regulations and enforcement is shaping up to be an excellent framework.

New Zealand is still in the process of catching up with new regulations introduced around the world recently. The legislations introduced in the last few years may not be adequate since the global financial market is currently experiencing instability. There is a global trend towards greater regulation in the financial services sector following the global financial crisis of 2008. This is expected to intensify following the recent financial turmoil in Europe as well as the on-going foreign debt crisis in USA.

Investors need to perform some due diligence on the companies they place their hard-earned money; and to diversify their investments so as to avoid putting all their 'nest-eggs' in one basket. Risk is part of investment, therefore investors need to get their heads around risk management and carry out due diligence on the companies they had invested.

On a final note, the failures of finance companies in New Zealand were in stark contrast to the fate of finance companies in Asian countries such as Malaysia, a developing country. In the aftermath of the Asian Financial Crisis of 1998/99, Malaysia's economy was devastated by a wave of corporate collapses as her currency and stock market plunges to its lowest level in recorded history. It was a financial disaster of epic proportions for the whole Asian region. Miraculously, none of Malaysia's finance companies collapsed and no investor lost any money in banks or finance companies. Naturally, some of the finance companies which dabbled in risky ventures were under stress because of the Asian Financial Crisis, but the government took a quick decision to merge them with stronger banks and finance companies. This positive outcome was due to the fact that finance companies in Malaysia are strictly regulated by the country's central bank and licensed by the government. There were only a handful of them and they are well capitalised with most of them being backed-up by big banks. Until today, these finance companies remain strong and well regulated.

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