The Federal Reserve Board

Remarks by Governor Susan S. Bies

At the Carnegie Endowment for International Peace, Washington, D.C.
October 1, 2002

The Challenge for Corporate Governance Posed by Financial Innovation

I appreciate the opportunity to speak with you today about corporate governance in the United States. The unfolding concerns in recent months have thrust the quality of accounting, auditing, and disclosure practices of major U.S. companies into the limelight. At the heart of these issues is the breakdown in professionalism of independent auditors. Auditors have been too focused on cross-selling new services to corporations, and have lost sight of the fact that their independent attestation to the quality of financial reporting is the core value that they bring to the market place. The customers of an audit engagement are investors and creditors. The absence of leadership within the profession to call for true reform will make regaining market confidence all the more difficult. The weight of regulatory reform rests on the SEC and the new Public Company Accounting Oversight Board and we should all support this new entity as it endeavors by enforcement to change the culture of an industry.

While I could focus on the issue of auditor independence, it has already received much attention. I want to instead talk about some broader, long-term issues affecting accounting and corporate governance that have not been the center of as much of the recent debate. Looking beyond the isolated cases of outright fraud, I believe a fundamental problem is this: As organizations have grown in size and scope, innovative financing techniques have made it more difficult for outside investors to understand a particular firm's risk profile and the performance of its various lines of business. Traditional accounting standards have not kept pace with the risk-management tools employed by sophisticated corporations. Thus, the disclosure of firms' risk-management positions and strategies is crucial to improve corporate transparency for market participants.

The second issue I want to focus on is that financial innovation has helped increase the importance of institutional investors, such as mutual funds and pension funds, in our equity markets. Because shareholders play a key role in corporate governance, the emergence of institutional investors as major holders of corporate equity also has implications for corporate governance.

As I shall discuss, a necessary response to the recent wave of financial innovation is a combination of enhanced transparency and market discipline applied by creditors, counterparties, and investors-including the institutional investors that now hold a large share of corporate equity. Together, these efforts should help lay a foundation for more effective corporate governance.

Financial Innovation and Risk Management
The last decades of the twentieth century were, without doubt, a period of dramatic change in financial engineering, financial innovation, and risk-management practices. Over this

period, firms acquired effective new tools to manage financial risk, one of which was securitization. Many of the assets on a firm's balance sheet, such as receivables, can now be securitized--that is, grouped into pools and sold to outside investors. Securitization helps a firm manage the risk of a concentrated exposure by transferring some of that exposure outside the firm. By pooling a diverse set of assets and issuing marketable securities, firms obtain liquidity and reduce funding costs. Of course, moving assets off the balance sheet and into special-purpose entities, with the attendant creation of servicing rights and high-risk residual interests retained by firms, generates its own risks.

Several types of securitization have grown rapidly over the past decade. One of the fastest growing has been asset-backed commercial paper, which soared from only $16 billion outstanding at the end of 1989 to more than $700 billion as of the second quarter of this year. Commercial mortgage securitizations have also proliferated noticeably since the early 1990s. The dollar amount of outstanding securities backed by commercial and multifamily mortgages has risen from $36 billion at the end of 1989 to nearly $400 billion as of this past June. In addition, commercial banks and finance companies have moved business loans off their books through the development of collateralized debt obligations. Securitized business loans amounted to $125 billion in the second quarter of 2002, up from a relatively miniscule $2 billion in 1989.

Derivatives are another important tool that firms use to manage risk exposures. In the ordinary course of business, firms are exposed to credit risk and the risk of price fluctuations in currency, commodity, energy, and interest rate markets. For example, when an airline sells tickets months before a flight, the airline becomes exposed to fluctuations in the price of jet fuel. A higher price of jet fuel translates directly into lower profits and, perhaps, a greater risk of bankruptcy. Firms can now use derivatives--options, futures, forwards, and so on--to mitigate their exposure to some of these risks. The risk can be transferred to a counterparty that is more willing to bear it. In my example, the airline could buy a forward contract or a call option on jet fuel to hedge its risk and thereby increase its financial stability.

The use of derivatives, like securitizations, has been growing rapidly in recent years. The most recent statistics from the Bank for International Settlements indicated that the notional amount of over-the-counter derivatives outstanding totaled $111 trillion in December 2001, up from $80 trillion just three years earlier. For exchange-traded derivatives, notional amounts outstanding rose from $14 trillion to $24 trillion over the same period.

Complex Organizations Are Opaque

As indicated by my brief discussion of securitization and derivatives, financial innovations have facilitated the separation and reallocation of risks to parties more willing and able to bear them. In the twenty-first century, businesses will use almost limitless configurations of products and services and sophisticated financial structures. A byproduct of these developments will be that outsiders will have ever more difficulty understanding the risk positions of many large, complex organizations; and traditional financial reporting--which provides a snapshot at a particular moment--will be even less meaningful than it is today.

The intended or unintended consequences of the opaqueness that comes with complexity raise serious issues for financial reporting and corporate governance. Effective governance requires investors and creditors to hold firms accountable for their decisions. But its prerequisite is having the information necessary to understand the risks that the firm is bearing and those it has transferred to others.

With sufficient, timely, accurate, and relevant information, market participants can evaluate a firm's risk profile and adjust the availability and pricing of funds to promote a better allocation of financial resources. Lenders and investors have an obvious interest in accurately assessing a firm's risk-management performance, the underlying trends in its earnings and cash flow, and its income-producing potential. In this regard, transparency is essential to providing market participants with the information they need to effect market discipline.

Sound, well-managed companies will benefit if enhanced disclosure enables them to obtain funds at risk premiums that more accurately reflect their lower risk profiles. This would be a positive. Without such disclosure, otherwise well-managed firms will be penalized if market participants cannot perceive their fundamental financial strength and sound risk-management practices. In recent months, I have been heartened to see that renewed market discipline does appear to be forcing companies to compete for investors' support by improving the transparency of corporate reporting.

Improving Accounting and Disclosure for Complex Firms
Most firms and market participants favor sound accounting standards and meaningful disclosure, but some companies have not been completely transparent in their application of accounting and disclosure standards to specific transactions. In these situations, financial reports have neither reflected nor been consistent with the way the business has actually been run, or the risks to which the business has actually been exposed.

In some of these cases, the company's external auditors appear to have forgotten the lessons they learned in Auditing 101. Auditors have focused on form over substance when looking at risk transfer activities, and they have failed to maintain the necessary independence from the client. But the issues run deeper than just a breakdown of basic auditing standards.

As a result of the recently recognized failures of accounting, auditing, and disclosure, the market was unable to appropriately discipline the risk-taking activities of these firms on a timely basis because outsiders lacked the information from financial statements or other disclosures to do so. As critical information became available--after the fact, as it virtually always will--the market reflected its concerns about underlying business practices and accounting through the declining values of equity and debt.

At this point, we do not have all of the facts about many of the situations involving alleged accounting and auditing problems, but a consensus is growing that changes should be made to some underlying accounting standards and to their application by companies and their auditors. Various groups are undertaking initiatives to correct the problems that have recently been identified. For example, the U.S. Financial Accounting Standards Board is considering how to improve the accounting standards for special-purpose entities. This is a direct response to the rapid growth of securitization and the opacity that securitization has introduced into financial reporting.

The Sarbanes-Oxley Act, which became law in July of this year, contains a number of provisions to improve accounting and disclosure. CEOs and CFOs are now required to certify that their financial reports fairly represent the financial condition of the company, not just that the reports comply with Generally Accepted Accounting Principles. Sarbanes-Oxley directs the Securities and Exchange Commission to issue new rules on the disclosure of off-balance-sheet transactions. It strengthens the role of corporate audit committees and requires that audit committees are comprised exclusively of independent directors. To bolster the independence of external auditors, Sarbanes-Oxley prohibits them from providing certain internal audit and other consulting services to their clients. Finally, it creates a new

Public Company Accounting Oversight Board, independent of the accounting industry, to regulate audits of public companies. These are all changes for the better.

But improvements in accounting and auditing standards are also needed to address other problems that have been identified. In particular, it would be very helpful if fundamental principles and standards could be revised to emphasize that financial statements should clearly and faithfully represent the economic substance of business transactions. We need to insist on higher professional standards. We also need to move toward principles-based accounting standards rather than continue our reliance on rules-based accounting standards, since accounting rules tend to lag behind market innovation. Standards should ensure that companies give appropriate consideration to the substantive risks and rewards of ownership of their underlying assets in identifying whether risk exposures should be reflected in consolidated financial statements.

Besides applying sound accounting treatments, company managers must ensure that public disclosures clearly identify all significant risk exposures--whether on or off the balance sheet--and their impact on the firm's financial condition and performance, cash flow, and earnings potential. With regard to securitizations, derivatives, and other innovative risk-transfer instruments, traditional accounting disclosures of a company's balance sheet at a point in time may not be sufficient to convey the full impact of a company's financial prospects.

Equally important are disclosures about how risks are being managed and the underlying basis for values and other estimates that are included in financial reports. Unlike typical accounting reports, information generated by risk management tends to be oriented less to a point in time and more to a description of the risks. To take an example from the world of banking, where the discipline of risk management is relatively well developed, an accounting report might say that the fair value of a loan portfolio is $300 million and has dropped $10 million from the last report. However, the bank's internal risk report would show much more extensive information, such as the interest rate and credit quality of the assets and the range of values the portfolio would take under alternative future scenarios. The user of a risk-management report could determine whether changes in value were due to declining credit quality, rising interest rates, or sales or payoffs of loans.

Corporate risk officers have developed other types of reports that provide information on the extent to which the total return in a particular line of business compensates for the line's comprehensive risk. On an enterprise basis, a reader of such a report can determine whether the growing lines of business have risk exposures that tend to offset those in other business lines -- thereby resulting in lower volatility for the earnings of the corporation as a whole.

Complex organizations should continue to improve their risk-management and reporting functions. When they are comfortable with the reliability and consistency of the information in these reports, they should begin disclosing this information to the market, perhaps in summary form, paying due attention to the need for keeping proprietary business data confidential. Not only would such disclosure provide more qualitative and quantitative information about the firm's current risk exposure to the market, it would help the market assess the quality of the risk oversight and risk appetite of the organization.

A sound risk-management system in a complex organization should continually monitor all relevant risks--including credit, market, liquidity, operational and reputation risks. Reputation risk, which recent events have shown can make or break a company, becomes especially hard to manage when off-balance-sheet activities conducted in a separate legal entity can affect the parent firm's reputation. For all these risks, disclosures consistent with the information used internally by risk managers could be very beneficial to market participants. Companies should ensure that they not only meet the letter of the standards that exist but also that their financial reports and other disclosures focus on what is really essential to help investors and other market participants understand their businesses.

In this regard, I believe that the Financial Accounting Standards Board has missed an opportunity in their recent exposure draft proposing changes to the accounting treatment of special-purpose entities, or SPEs. The exposure draft focuses on the choice of consolidating or not consolidating an SPE but says little about disclosure. If FASB's goal is to make the financial reporting of firms' dealings with SPEs more informative, disclosure of the effect of the SPE on the firm would be equally necessary. For example, if firms securitize receivables through commercial paper conduits, those receivables are no longer on the company's books under current accounting standards. Yet the aging of receivables is a key indicator that investors and lenders use to assess the quality of sales and operations. If the receivables move off the balance sheet, information about the aging of the receivables should continue to be part of the firm's disclosures. Further, the disclosures should include the firm's internal assessment of how its dealings with the SPE alter its risk exposures. I hope that as FASB debates this issue in upcoming weeks, due attention will be paid to the benefits of enhancing disclosure of SPEs.

I particularly want to emphasize that disclosure need not be in a standard accounting framework nor exactly the same for all organizations. Rather, we should all be insisting that each entity disclose the information its stakeholders need to evaluate the entity's risk profile. Companies should be less concerned about the vehicle of disclosure and more concerned with the substance of what information is made available to the public. And, we should keep in mind that disclosure without context may not be meaningful. These improvements in transparency are a necessary response to the recent corporate scandals and will help strengthen corporate governance in years to come.

Financial Innovations, Equity Holdings, and Shareholder Activism
Just as financial innovations spawned a variety of risk-management tools for businesses, they have also been responsible, in part, for changes in the structure of equity ownership. Along with advances in computer processing power that have facilitated the management of ever-larger portfolios, an increasing awareness among investors of the value of portfolio diversification has led to a dramatic secular rise in the share of equity that is held by institutional investors on behalf of households. According to the flow of funds accounts published by the Federal Reserve, the combined share of household equity managed by mutual funds, pension funds, and life insurance companies grew from only 3 percent in 1952 to over 50 percent at the end of 2001. Mutual funds held 16 percent of household equity at the end of last year, and public and private pension funds held about 10 and 20 percent, respectively. Life insurance companies held about 7 percent of household equity at that time, mainly through separate accounts that were, in effect, mutual funds with insurance wrappers.

These changes are indeed dramatic and motivate an important policy question: Should we be comforted or concerned that an increasing share of household equity is in the hands of institutional investors? A primary issue is whether institutional investors are more "active shareholders" than individual investors. That is, are institutional investors more likely than individual investors to actively monitor and influence both management actions and corporate governance mechanisms at the firms in which they invest? Shareholder activism may provide market discipline directly by preventing management from pursuing its own interests at the expense of shareholders. Shareholder activism may also pave the way for other forms of market discipline--such as corporate takeovers, share price changes, and funding cost changes--by eliminating management-takeover protections and by inducing greater transparency.

It is not clear whether institutional investors have more or less incentive to be activist shareholders than individual investors. On the one hand, because institutional investors make large investments in companies, they will have more bargaining power over company management than individual investors have, and they will derive more benefits from mitigating corporate malfeasance than individual investors will. Among institutional investors, pension funds and insurance companies are thought to benefit the most from shareholder activism because they tend to have relatively long-term investment horizons, while more actively managed mutual funds are thought to benefit the least.

On the other hand, index fund managers may have no interest in shareholder activism since they merely adjust their holdings when the mix of the index changes and only want to follow the index, not influence it. In addition, mutual funds and pension funds may have conflicts of interest that encourage passivity. Activism by a mutual fund complex or a pension fund manager could strain its relationships with corporate clients. For example, a fund manager bidding for the management of a firm's 401-K plan may be reluctant to vote against the Board of Directors' proxy recommendations.

In practice, institutional investors appear to have been relatively passive shareholders, in the sense that they have tended to initiate relatively few reform proposals. Prior to the past twenty years, most reform proposals were submitted by a handful of individuals and religious groups. Since the mid-1980s, some institutional investors--mainly large public pension funds and a few union funds--have stepped up to the plate and offered their own proposals, but corporate pension funds, mutual funds, and insurance companies have remained on the sidelines.

However, appearances can be misleading. Some institutional investors are active behind the scenes, keeping close contact with the management of the firms in their portfolios directly rather than through reform proposals. Moreover, passive institutional investors may still benefit shareholders as a whole by facilitating the building of shareholder coalitions that are initiated by others or by posing a possible threat to managers who might fail to act in the interest of shareholders.

Ultimately, the question of whether institutional investors mitigate corporate governance problems is an empirical one. Academic work in this area has not convincingly linked institutional holdings to firm performance, but some studies have shown that institutional shareholder activism does appear to be motivated by efforts to increase shareholder value, and other studies have confirmed that institutional activism is associated with a greater incidence of corporate governance events, such as shareholder lawsuits and corporate takeovers. Based on these findings, concluding that the rising share of household equity held by institutional investors is clearly good in terms of sound corporate governance would be premature. That said, it does seem reasonable to believe that there are benefits from institutional shareholder activism and that these benefits may help pave the way for market discipline in a broader sense.

Looking ahead, I am encouraged by signs that institutional investors are becoming more active shareholders. Mutual funds reportedly have been paying closer attention to proxy voting in response to recent corporate accounting scandals. Two of the largest fund complexes in the United States now publicize their proxy voting guidelines, and one of them reportedly maintains a full-time governance staff. I am further encouraged by the recent activity of shareholder rights organizations, such as the International Corporate Governance Network, and other informal groups, which galvanize institutional and private investors to promote corporate governance reform. Also, I am hopeful that changes in the regulatory environment will promote greater attention to corporate governance. As you are no doubt aware, less than two weeks ago the SEC proposed a rule calling for compulsory disclosure of mutual fund proxy voting records. Currently, mutual funds have no legal obligation to disclose proxy votes, and in practice, few do so.

As we go forward, even if transparency through corporate financial reports improves, shareholder activism will continue to be important in mitigating conflicts between management and shareholders. However, we must recognize that shareholder activism is not a substitute for disclosure. Neither activism nor the more common discipline device of selling the firm's debt and equity can work well without adequate disclosure. All forms of market discipline are built upon the solid foundation of accurate and complete disclosure.