

Speeches

Ethical Challenges in a Market Economy

Jack Guynn
President and Chief Executive Officer
Federal Reserve Bank of Atlanta

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Thank you, Phil [Stone], for the nice introduction and for inviting me to be your speaker this evening for the Scott Symposium on Business Ethics. You have been a gracious host, and I can certainly sense why Bridgewater College has become even more special under your leadership.

As Dr. Stone mentioned, I grew up near Staunton, so it's always a pleasure to come back to the Shenandoah Valley. My roots are here, and this is also where I got my first lessons in right and wrong. My parents were both public school teachers, and as I was growing up I had the sense that they were always looking for "teachable moments"—chances to give to their students, along with my brothers Jimmy, Doug and me, lessons in life to go with their academic teaching.

I'm not sure where I heard it—maybe from a teacher or a Scout leader—but somewhere along the way in my early life I heard a simple test of ethical behavior that has stuck with me for all these years. And that is, "Do the right thing when nobody's looking."

That phrase was in the back of my mind as I went off for my freshman "rat" year to Virginia Tech. At that time, Tech was run like a military academy, and when a member of the corps of cadets broke the ethics code in a serious way he was "drummed out." The drumming-out ritual was chilling. In the middle of the night, every cadet was roused out of bed and marched in formation to the courtyard. With an eerie drum roll, we were commanded to turn our backs to the offending cadet as someone recited his honor code violations. It was an experience one never forgets.

Just as I learned many important lessons during my years at Virginia Tech, I am sure that those of you who are Bridgewater students will reap many benefits from your education in this very special place. To make it to the top in today's very competitive workplace, you'll need a broad understanding of how the business world works. But if you want to stay there and remain successful over the long term, then you'll need something even more important: a solid ethical foundation.

Now that may seem like a surprising statement because, as I'm sure you're aware, the picture of business ethics that has emerged over the past few years isn't very pretty. It seems like every week we hear another story about corporate dishonesty, deception, or self-serving acts. Sometimes, it seems like we have a business culture that is ethically challenged.

Let me say up front that I'm no expert on the academic study of business or economic ethics, and I certainly don't want to place myself or my organization on an ethical pedestal. In my role at the Federal Reserve, our nation's central bank, however, I interact with a wide cross section of business leaders. And in my role as a monetary policymaker, I have become especially sensitive to the health and integrity of our United States financial system. Let me emphasize that I believe that corruption in business is still the exception and not the norm. But I have seen how just a few instances of unethical behavior can seriously undermine our market economy and our broader society.

It's from this perspective that I'm going to argue today that the ability to provide leadership in ethics is more important than ever—for current and future business managers.

To make my case about the importance of ethics, let me start by assessing the scope of the problem and the damage caused by recent lapses in business ethics. Then I'll turn to some potential reasons for these problems, and finally share some thoughts on what steps we need to take as a society and as individuals to address today's challenges to business ethics.

The scope of the problem

Between 2002 and the end of last year, the U.S. Securities and Exchange Commission brought more than 1,300 civil cases against businesses and obtained orders for penalties in excess of \$5 billion. Those numbers are higher than for any comparable period in the agency's history.

For many of us, the list of fallen corporate stars in recent times probably began with Enron. Then there was WorldCom, Tyco, Adelphia, and HealthSouth, to name just a few of the most notable companies that have been subjected to SEC enforcement actions. In addition, some of the top names in the mutual fund industry have settled SEC enforcement actions. And in October 2003, ten of the biggest firms on Wall Street paid a \$1.4 billion settlement related to conflicts of interest between research and investment banking.

The nature of the ethical breaches has varied widely. Many cases involved accounting tricks used to inflate earnings and to protect the value of a company's stock. Some cases involved efforts to defraud investors through misleading advice or schemes that broke the rules, such as after hours trading of mutual funds. And in other cases, the motive was to directly benefit the personal wealth and ego of the top executive—for instance, spending millions of dollars of company money on personal art work, lavish parties or home improvements. And according to a news story last week, a senior corporate executive may have used company money to pay for an expensive kennel for his hunting dogs. I would argue that whatever the motive, all are examples of greed, hubris and poor ethical conduct. And while all such actions may or may not be illegal, unethical behavior often imposes a cost not only on the victim and the wrongdoer, but also on countless others including, I expect, many of us in this room.

As we saw with Enron and WorldCom a few years ago, many long-time employees lost their jobs and their retirement pensions as well. Shareholders also have taken

a beating in the aftermath of corporate scandals, and many of the investors who were burned were highly sophisticated. Going back to peak valuations, shareholders saw a loss of market capitalization of some \$66 billion in the case of Enron and \$177 billion in the case of WorldCom.

But it's not just deep-pocketed investors and institutions that have suffered. Today, nearly half of all adult Americans participate in the stock market. That's compared with only about 6 percent in 1952. Millions of households invest in employer-sponsored plans and in mutual funds. In the aftermath of recent scandals, I've heard a number of young people express skepticism about investing in equities. Given the huge losses in recent years, it's understandable that folks are being more cautious in how they allocate their hard-earned savings.

In 2002, when many ethical scandals were coming to the surface, stock market investors saw years of gains vanish in a matter of months, in some cases in just days and weeks. In one survey taken in November 2003, 77 percent of investors reported they were less confident in the trustworthiness of corporate management, with 59 percent less confident in the safety of financial markets overall. These numbers jibe with my gut sense that the overall level of trust in businesses and financial markets has taken a big hit.

Moreover, we can't ignore the costs of new regulations that I believe were necessary to prevent such malfeasance in the future. In 2002, Congress overwhelmingly passed the Sarbanes-Oxley Act, a new law that is designed to tighten standards for accounting and require more disclosure on the part of public companies. The law also provides for much tougher penalties for executives and even directors who participate in or enable fraudulent behavior.

When it passed three years ago, only three votes were cast against this sweeping and complex legislation. That decisive congressional action is a testament to the public outcry for reform in corporate governance.

But the legislation brings a very substantial cost. A top executive of a large company with annual revenues of about \$37 billion told me recently that his company estimated that Sarbanes-Oxley had added approximately \$16 million a year to expenses. Another executive with a company with about \$12 billion in annual revenues put the added costs at about \$40 million annually. And it's not possible to quantify other indirect costs as senior executives shift their attention and resources from growing their businesses and creating new jobs to regulatory compliance. But based on anecdotal reports, I do have the sense that the extraordinary attention devoted to the new corporate governance rules very likely delayed strategic business decisions and capital investment decisions that we would have seen earlier as the economy recovered from the 2001 recession.

Clearly, corporate governance reform—while necessary—has been expensive. And that burden is being carried by the vast majority of businesses in our country that have always played by the rules. The money to pay for improved corporate governance comes out of corporate profits and represents another price we are all paying for corporate fraud and deception.

Reasons for ethical lapses

As we evaluate these costs, I think it's important to explore the underlying factors in the recent spate of business scandals. You can't blame it all on greed and hubris; these fundamental human flaws have been with us forever.

So what's new? Well, I believe one difference is the complexity of many of today's businesses. In the past decade or so, new technologies have spurred the evolution of our financial markets. New and innovative financial products enable transactions to occur more rapidly and efficiently than ever. The bad news is that this new automation has the potential to open new avenues for fraud.

Take Enron, for example. With the help of Wall Street investment bankers, accountants, and complex derivative instruments, Enron engaged in transactions that were nearly impossible to understand and untangle. In fact, a special investigative committee of Enron's board reviewed 430,000 pages of documents and interviewed scores of people about the so-called special purpose entities that were part of the Enron corporate hierarchy. Even with that intense level of scrutiny, I've read that they still haven't gotten to the bottom of everything Enron was doing. If boards of directors and experienced financial analysts couldn't figure out what's going on, how were novice individual investors supposed to understand these transactions?

A second factor that I believe makes ethical behavior more challenging is the intense competitive pressure of today's global marketplace. The temptation to cheat rather than fail is timeless, but in recent years this ethical dilemma may have become even more widespread.

Our most recent economic boom and bust cycle demonstrates how these pressures can play out and lead to a series of business scandals. During the late 1990s, people were investing huge sums of money based on extremely optimistic assumptions that rapid economic growth and market appreciation of corporate stock values would continue indefinitely.

It's true that the late 1990s saw great technological innovation and productivity gains that brought real value to our economy. The potential of the Internet and other technologies generated great excitement on Wall Street, and analysts fueled the fire by hyping dot-com companies and other hot stocks. They predicted sharply rising profits, quarter after quarter. But then the market got ahead of itself as investors poured money into undisciplined businesses, which were then held to improbable short-term targets. In the end, businesses and entire industries imploded.

Looking back at this climate of unrealistic expectations, we can see how these problems unfolded. Executives who were unable to meet their targets began to make use of confusing financial reporting, which helped to hide their actual performance. In some cases, businesses that reported clear and accurate numbers were actually at a competitive disadvantage.

The term "creative accounting" became a popular euphemism for non-standard accounting practices involving novel ways of characterizing income, assets and liabilities. Enron touted its own accounting wizardry, and even some business schools were reported to be teaching creative accounting—something I trust you never taught here at Bridgewater.

A third factor contributing to the erosion of business ethics involves lapses in corporate governance. Starting at the top, businesses are designed with checks and balances to ensure management accountability and above-board operations, since in the modern corporation managers are distinct from owners, or stockholders.

If you're a member of a board of directors, it's your fiduciary duty to ask tough questions and intervene in questionable practices. But as businesses have become more complex and competitive, as I discussed a moment ago, these protections have not always sufficed and in some cases have broken down completely.

Aside from the additional analytical challenges, too many directors fell short on their core responsibilities. In some cases, there were conflicts of interest because directors had major deals pending with the businesses they were supposed to be overseeing on behalf of shareholders. In other cases, management gave themselves and their directors significant privileges and perks. As Abraham Lincoln once said, "Knavery and flattery are blood relations."

The structure of executive compensation also has led to problems and in some cases is now being rethought. For the past decade or so, many directors have been granting stock options as an incentive for management to run their businesses in a way that increases the company's stock price. While it makes sense to align performance with compensation, stock options have not always been carefully structured. In the worst cases, stock options actually motivated managers to do the wrong thing, such as manipulate short-term earnings to meet bonus targets or cash in on insider knowledge.

So, in addition to age-old traits such as fear of failure, greed, and pride, modern-day ethical challenges in business have been exacerbated by technologies that have spawned increasingly complex financial products and accounting techniques. Fierce global competition and more complex and demanding governance responsibilities are other factors. Since the underlying characteristics of these new developments are positive, we don't want to attack them. But we also can't ignore systemic flaws that lead to ethical lapses.

Society's prescriptions

I would like to spend my last few moments thinking with you about what I believe we can do to bolster the ethical foundation of our economy. As I noted earlier, after the initial flare-up of corporate scandals a few years ago, Congress overwhelmingly passed the Sarbanes-Oxley Act to demand greater business accountability. So as a society, we've already taken steps to address some of the most glaring ethical weaknesses in our economy.

Despite the expense of the legislation that I described to you earlier, I believe Sarbanes-Oxley has led to some positive developments in business. In my view, stricter and more uniform accounting standards were needed, and I applaud the work of former New York Fed President Bill McDonough, who is now in charge of the Public Company Accounting Oversight Board, an authority created by Sarbanes-Oxley.

With tougher oversight and penalties on the books, today's boardroom culture seems to be changing. Corporate governance reform has weeded out some of the most egregious conflicts of interest.

As investors and board members become more skeptical and assertive, chief executives face more tough questions. In recent months, boards have "drummed out" several CEOs and senior executives for ethical lapses. I am optimistic that business leaders are becoming more accountable and are getting the message about ethics.

Moreover, there is evidence that with all the attention devoted to fraud and the risks in the marketplace, investors are doing more homework. In the same survey from November 2003 that I mentioned before, 79 percent of investors report being more interested in how corporations are governed, with 68 percent more likely to seek financial and accounting information about investments.

I am encouraged that investors now seem to be getting more savvy. Markets are extremely sensitive to information flows, and they work best in a climate of accountability and transparency. With human nature as it is, secrecy is the enemy of ethical behavior. But transparency is an iterative process, not one that occurs all at once. Financial and commercial corporations are actively working on transparency and ethical behavior, and I believe they are making good progress to get it right.

As more information pours into the marketplace, we as individuals have obligations as well. It's up to each one of us to take advantage of this new openness and bear more responsibility for our investments. Read the footnotes, check multiple sources of information and use common sense to recognize that higher returns generally entail higher risk. As they say, if something sounds too good to be true, then it probably is too good to be true.

Next steps—individual actions

Clearly, as a society we've taken forceful measures to address recent corporate scandals. But make no mistake: It takes everybody acting in a spirit of trust to make markets work effectively. That's why a strong ethical foundation is so important. Albert Einstein summed it up pretty well when he said, "Every kind of peaceful cooperation among men is primarily based on mutual trust and only secondarily on institutions such as courts of justice and police."

Of course we are a society of laws, and if you commit a corporate crime, you stand a high probability of getting caught and going to jail. That is certainly an incentive to behave ethically. But ethics requires obeying not just the letter of the law, but also the spirit of the law. As Federal Reserve Chairman Alan Greenspan has observed, our economy functions smoothly in large part because we can generally rely on trust.

Our first line of defense in preserving trust in our market economy should be a culture of ethics in all our organizations. Ethical behavior is good business, and it needs to take place on a day-to-day basis. Formal controls that foster ethical behavior on the part of every employee are part of the process. Ethics needs to become a habit.

All CEOs have to set the right tone at the top. But management cannot see and do everything, and lofty words can only do so much to foster good ethical behavior. In fact, many if not most of the companies now being prosecuted had high-minded vision statements, and their executives made eloquent speeches about corporate values. But in addition to just talking about ethics from time to time, we have to instill ethics throughout the workplace culture and up and down the whole organization, day after day and year after year.

Summing it all up

This evening, I have tried to think with you about some of the reasons behind the recent flare-up in corporate scandals. I also have tried to convey a sense of the costs that fraud and corruption have imposed on all of us.

In closing, let me say again that we are fortunate to live in a competitive free-market economy that thrives on self-interest and the pursuit of maximum profit. As the Scottish economist and philosopher Adam Smith observed back in the late 18th century, "It is not from the benevolence of the butcher, the brewer, or the baker that we expect our dinner, but from their regard to their own interest."

But just as we are free to pursue our self-interests, individuals sometimes do bad things. And we live in a representative society where the public demands accountability and a reasonable degree of fairness. We have to acknowledge this tension between public and private interests without restraining the forces that make our economy strong. Above all, we must continually strengthen, and, when necessary, repair our ethical foundation to ensure trust in our financial markets and business enterprises.

Unless I miss my bet, as I was thinking out loud earlier in my remarks about some of my own growing up experiences that occurred just down the road from here, you were thinking about your own ethical issues. To the students here, I would suggest that your ethical challenges will only become tougher as you move into the workforce and gain more responsibilities. Having a strong ethical foundation will serve you well throughout your life. To the faculty here, I encourage you to continue to look for those teachable moments when you can underscore the importance of how one achieves results. And to the business and civic leaders, I challenge you to make a culture of ethics one of your high-priority objectives not just in 2005 but every year.

One of the things that I learned growing up in the Valley is the value of your word and your name. Living in a small community, you see one another most every day, and I expect it's still true that in many personal and business deals a handshake around here is as good as a notarized contract.

Now, I know things are more complex in our fast-paced global economy. You have to watch your back, read the footnotes, and be realistic about balancing risk and reward. But I still think we'll all be more successful, and ultimately happier with ourselves, if we practice that advice someone gave me many years ago somewhere along the way: "Do the right thing when nobody is looking."

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CONTACTS

Jean Tate
404-498-8035