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Breaking Down the Breakdown of Corporate Governance: Incentives, Information, and a Rational Course for Policy

The issue of corporate governance has been making headlines for well over a year. Once-revered companies such as Arthur Andersen, Enron, Tyco and WorldCom have been severely damaged, in some cases beyond repair, by failures in corporate governance. Thousands of jobs and billions of dollars of shareholder value have been lost. And we've seen the spectacle of corporate executives being led away in handcuffs.

In this environment, the cartoon I saw recently isn't too surprising. It showed a mother trying to break up a fight between her two children. "Mommy, Mommy!" one of them cried in tears. "Billy just called me a CEO!"

How did the leaders of corporate America become the objects of such ridicule? I don't want to get bogged down discussing all of the ins and outs of the high-profile cases we're all familiar with. And I don't think it would be helpful to focus on how particular individuals or firms may have schemed to enrich themselves at the expense of company shareholders.

But I can give you my perspective from having worked for 14 years in private industry before coming to the Fed. When corporate governance is good, it helps safeguard shareholders, customers and employees without hindering appropriate risk-taking. But when it is ineffective, misguided or just plain bad, it can have a disastrous economic impact on key stakeholders and affect the long-term viability of the enterprise.

So I believe that it is most useful to discuss corporate governance issues in terms of their fundamental economic principles. Taking this approach, I will emphasize two such principles that I believe will allow us to identify more clearly:

- How our system of corporate governance is supposed to work;
- Why in some recent instances it has not worked very well; and finally
- How we should — and should not — attempt to repair it.

I want to emphasize, however, that I'm speaking to you as an individual today, sharing my personal views, not necessarily the views of the Federal Reserve.

The macroeconomic implications of failures in corporate governance

To begin, we usually think about corporate governance issues at the microeconomic level — that is, looking at the relationships between managers, directors and shareholders at a particular corporation. But it's important to keep in mind that corporate governance also has important implications for macroeconomic performance.

Next to the laws that establish and protect private property rights, the corporate form of organization is perhaps the most important legal framework for modern capitalism. It allows great sums of capital to be mobilized and invested by limiting the personal financial liability of investors. Corporate governance — in other words, the manner in which the corporation is governed — is the system of checks and balances aimed at making sure that these funds are wisely and efficiently invested by corporate managers.

For many years, the American system of corporate governance has been the envy of the world. One simple measure of this success can be found by comparing how much economic activity is financed in various western nations by capital markets. These markets rely on the information provided to them by the corporate governance system.

Here in the U.S., two dollars of financing comes from the stock and bond markets for every one dollar of financing from bank loans. In the UK, only one pound of financing comes from capital markets for every one pound of bank loans. And in Germany, France, and Japan, only about a half euro or a half yen of financing comes from the capital markets for every one euro or yen of bank loans. This is an indication of how important our system of corporate governance is to financing economic activity — and it is a reminder of how important it is that investors have faith that our system operates properly.

A lack of faith in our corporate governance has serious macroeconomic consequences. One example was the dramatic rise of credit spreads that occurred during the first nine months of 2002. Credit spreads measure the premium paid by private sector companies to borrow money relative to what the U.S. Treasury pays.

Over this time frame, the credit spread faced by investment grade firms rose by approximately 100 basis points. In part, this dramatic change in credit spreads reflected the market's increased uncertainty regarding whether our system of corporate governance was capable of delivering accurate information regarding the value of our corporations.

Although credit spreads have declined some in recent months, they remain above what we might call "normal" levels. As a result, the real cost of capital to almost every U.S. business remains high. And as long as the cost of capital remains above where it otherwise might be, the level of business investment will be adversely affected.

To be sure, the uncertainty caused by geopolitical risk and concerns about terrorism at home also has contributed to elevated risk spreads. Unfortunately, we have much less control over these external sources of uncertainty than we would like. But we have considerable ability to address the uncertainty caused by the shortcomings of our corporate governance system. And we must use this ability to restore investors' faith in our corporations.

Two principles for good corporate governance

The most publicized corporate governance failures have truly been scandals —they involved outright fraud and deception. I cannot state more strongly that whenever we find incidents of lawbreaking, we must root it out and prosecute it, even if, and perhaps especially if, the criminals are in executive suites.

But the problems with corporate governance in America today are more subtle than cases of lawbreaking. They can be traced, in part, to the fact that corporations are far more complex today than when our governance system originally evolved. Let me try to cut through this complexity.

Corporations are owned by thousands of separate shareholders who are too numerous and too widely dispersed to run the firm themselves. So the shareholders vote for a board of directors. In turn, the board hires professional managers to make the day-to-day business decisions.

Inevitably, conflicts of interest arise between the managers, the directors, and the shareholders. For example, instead of making all of the aggressive investments needed to maximize shareholder returns, managers might decide to play it safe and enhance their job security. This is one example of what economists typically call the "principle-agent problem."

Two tools are supposed to guard against this:

- First, the board of directors has an obligation to oversee management to ensure that it acts in the interest of the firm's shareholders.
- Second, the shareholders, both individuals and institutions, have a financial incentive to sell their shares in the firm if they believe that the value of those shares is not being maximized. This sends a warning signal to managers and the board by causing the price of the stock to fall.

The shareholders make their decisions based on information they receive about the performance of the firm from the firm itself and through outside parties:

- Auditors review the financial statements of all public corporations,
- Stock analysts evaluate publicly traded corporations on an ongoing basis, and
- Financial markets are constantly re-assessing the value of the corporation.

The interactions among these four parties — the shareholders, the managers, the boards of directors, and the outside auditors and analysts, together with the laws, regulations and institutions that govern their actions— comprise the American system of corporate governance.

At first glance, this system may seem complicated, but at its core it can be reduced to two fundamental guiding principles:

- First, the incentives of managers should be aligned with the goals of the shareholders.

- Second, transparency and disclosure of corporations' true financial condition should be sufficient for shareholders to effectively evaluate a firm's performance.

In my view, the recent spate of highly publicized governance failures in no way indicates that the American system of corporate governance is in decline. But I do see these incidents as wake-up calls telling us to carefully examine where the system is failing to follow these two fundamental principles.

Examples of the problems that arise when we fail to follow the principles

Let me now discuss some examples of where we have failed, whether intentionally or not, to follow these guiding principles.

A key example relates to executive compensation. Back in the 1970s and 1980s, there was a general movement at U.S. corporations to better align the incentives of managers with those of shareholders by linking managerial compensation to the price of the firm's stock. Companies used a number of tools to do this, including market-based bonus pay, managerial stock ownership and stock options.

In theory, each of these tools is completely consistent with effective corporate governance practices. Stock options, for instance, can be powerful performance iv motivators, because even a small increase in the price of the company's stock can cause the value of these options, and the wealth of the managers, to increase dramatically. But in practice, as we have since discovered, option awards have often resulted in sub-optimal outcomes.

Looking back, we can now see that options may have been overused as a tool of management compensation. One possible explanation for the excessive use of options can be found in our tax code, which states that executive compensation above one million dollars must be "performance-based" in order to be tax deductible to the firm.

Another reason for the excessive option awards we have seen is simply that when option contracts were written, it was never imagined that the stock market would increase three-fold in less than a decade. Of course, this led to enormous — and let me say quite unexpected — increases in the wealth of some executives.

We also realize now that the options contracts themselves were often poorly designed. For example, by not indexing the strike prices of these options to the overall market or a specific industry, managers were handsomely rewarded from an overall run-up in stock prices even if their firm was only turning in average or even below average performance relative to it's peers. Moreover, given the large amounts of personal wealth that were at stake, there often was an incentive for managers to focus on the short-run stock price rather than the long-run value of the firm.

Our experience with stock options reminds us that corporate governance problems can arise when we run afoul of the first principle of corporate governance – that is, failing to align the incentives of managers and shareholders. Problems can also arise when we fail to adhere to the second principle of corporate governance – namely, having sufficient disclosure and transparency to allow investors to accurately value managerial performance. Two roles that are critical in providing such transparency are those of outside auditors and stock analysts.

The role of external auditors is to verify that the information released in financial disclosures is a fair and accurate depiction of the firm's financial condition. We have come to learn, however, that accounting audits can be less than reliable when auditors' incentives are improperly aligned.

For example, audit firms sometimes had separate consulting contracts with the same corporations they were auditing. This presented audit firms with conflict-of interest situations, because they often earned significant fees from consulting contracts. In some well-known cases, this eroded the independence of their audits.

As with the case of corporate auditors, we now know that the incentives of stock analysts were also not always in perfect alignment with those of the shareholders of the firm being analyzed. Stock analysts often worked for investment banks that had highly profitable investment banking contracts with the same corporations that the analysts were charged with evaluating. This arrangement can create pressure for analysts to overstate the true value of the firm.

A recent economic study documented that analysts employed by firms that were also the lead underwriters of initial public offerings "issue 50% more buy recommendations on the IPO than do analysts from other brokerage firms." This evidence suggests that stock analysts provided overly optimistic research on companies that also were investment-banking clients. Indeed, after investigating such practices, the New York State Attorney General and federal regulators ultimately reached agreement whereby 10 top securities firms will offer $1.4 billion as a settlement for misleading small investors.

Setting a course for reform

These problems in our corporate governance system came to light only after the stock market began to fall. The investing public – many of whom lost substantial wealth as a result of these failings – has rightly put increased pressure on policymakers and corporations to do something.

Clearly, there is much that can be done. As I stated earlier, we must enforce laws against those who commit fraud, who breach fiduciary trust and who violate securities laws. Where penalties need to be made more severe, we should do so.

Another important source of reform resides at the top of the corporate organization chart. Those of us in leadership positions have a responsibility to our stakeholders. We have to set out a vision and lead by example. But most important of all, we must set the tone for behavior inside our organizations.

Corporate executives have more than a legal obligation to their shareholders –they have a social compact to fulfill as well. Corporate executives must follow their moral compass. Strong corporate leaders must discern not only between good and bad business decisions, but also between right and wrong. And as leaders, we must create an atmosphere where employees are not afraid to come forward if they believe that laws are being violated or improper behavior is taking place.

We sometimes hear that it is difficult to set a high moral tone within the corporation and at the same time maximize firm performance. I am here today to tell you that this is a false choice. The morally right decisions made in the short-run typically turn out to be the most profitable decisions for the firm in the long-run. And it is the long-run in which the organization should be concerned.

A classic example is how Johnson & Johnson handled the Tylenol tampering episode in the 1980s. CEO James Burke acted decisively by recalling more than 30 million bottles, putting customer safety before financial gain. Sales recovered and the company has steadily progressed after what could have been a fatal blow to its reputation.

Unfortunately, we cannot rely entirely on moral principles to fix the problems in our corporate governance system. There are a number of important legal, regulatory and institutional changes that should be made.

To be meaningful, these reforms must be consistent with the two guiding principles of corporate governance that I stressed earlier. Meaningful reform must strengthen, not weaken, the alignment of manager incentives with shareholder objectives. And they must increase, not decrease, the transparency of the corporation to the public.

We have made a start.

The Sarbanes-Oxley Act passed last July has made some highly visible changes to our corporate governance system.

- For the first time, CEOs and CFOs must certify that their companies' financial reports not only satisfy generally accepted accounting principles (GAAP), but also fairly represent the financial condition of the company.

- Audit committees must now consist solely of independent directors, and external auditors are now prohibited from providing certain internal audit and consulting services to their clients.

- And a Public Company Accounting Oversight Board was created to monitor accounting standards and the conduct of accounting firms.

Initiatives have come from the private sector as well. The New York Stock Exchange has initiated new policies that strengthen the role of independent directors. Among these are requirements that independent directors approve CEO compensation, that a board must have a majority of independent directors, and that boards must hold part of their meetings without the presence of management.

The Conference Board has established a Commission on Public Trust and Private Enterprise. In recent months, this group has published recommendations — regarding,executive compensation, boards of directors, accounting principles and audit procedures. There also has been much action taken by the largest firms on Wall Street to alleviate the conflicts between investment bankers and stock analysts.

Proposals for further reform

But we must go further before our memories of recent events fade. We can begin by eliminating accounting rules or provisions of the tax code that influence the manner in which boards of directors choose to compensate executive hrs.

For example, firms should be able to fully expense and fully deduct all forms of executive pay. One rule that would be eliminated is the current one-million-dollar cap on non-performance based compensation that is tax deductible. This would reduce the incentive for corporations to pay their executives with stock options rather than with straight salary or cash bonuses. Boards should design their executive compensation plans to reward managers for exemplary firm performance, not to exploit tax and accounting rules that imply preference for one form of compensation over another.

But even in an environment where all forms of compensation receive equal tax and accounting treatment, we can expect stock options to remain a significant part of many executives' compensation. These options contracts should be carefully designed. One approach would be to link the strike prices to the performance of the company's stock relative to a market or industry index.

This would insure that overall run-ups in the stock market do not benefit managers whose companies are underperforming. It also would ensure that overall declines in the stock market do not penalize managers whose firms are doing well relative to their peers. Indexing also will reduce the incentive to re-set option strike prices at firms whose stock price has declined.

Quite frankly, I find it difficult to understand the justification for re-setting option strike prices. Not only should managers be rewarded for good performance, they should be penalized for poor performance by having their options lose value. The routine re-setting of strike prices creates a moral hazard because managers may act as if they do not bear the downside risk of a declining stock price.

We also can implement reform to increase adherence to our second principle of good corporate governance — improved transparency and disclosure. One way to achieve this would be to change our tax code so that all forms of corporate income are taxed at the same rate.

Congress is currently considering a proposal to eliminate the tax on dividend income. Some supporters of this proposal have argued that double-taxation of corporate dividend is simply unfair, while others have pointed out that the current tax encourages corporations to use too much debt financing.

There is a further, more subtle, and potentially more powerful motivation for eliminating the tax on dividends. Because eliminating this tax will encourage firms to pay larger dividends, the stock market's focus will to some extent shift away from short-run earnings and capital gains and re-focus on a more fundamental measure of corporate performance – the corporate cash flows that are necessary to pay a healthy, regular dividend.

This gives corporations a greater incentive to generate earnings that are sustainable in the long-run. And having to pay out a larger portion of those earnings on a regular basis makes the fundamental profitability pf the corporation more transparent to the market.

Conclusion

Debating the relative merits of these proposals would make an interesting discussion – but that will have to wait for another day. I do not want my main message to get lost in the myriad details of these and other proposals. I simply want to stress that the proposals I just mentioned are consistent with the two fundamental principles of good corporate governance that I laid out earlier.

They align the incentives facing managers and directors more closely with the objectives of the shareholders, and they make corporations more transparent by increasing the amount and the accuracy of information available to the shareholding public.

As we move forward, we must continue to pursue such policies. But as we do this, we should take extreme care that we do not destroy the risk-taking culture and run our businesses in a pure risk-avoidance mode. We need to design our economic institutions so that they harness, not hobble, the self-interest of managers.

Achieving these forward-looking policy goals will help reduce economic uncertainty by improving the sense of fairness in capital markets. We need to get it right because the stakes are so high. Getting it right means lower risk premiums, a reduced cost of capital, greater business investment and faster economic growth. Getting it wrong means slower economic growth and a lower standard of living.

In conclusion, the long-term prospects for our economy are bright. The U.S. economy time and again has proven itself resilient and dynamic, driven by an entrepreneurial culture and market-based principles. As we reform our system of corporate governance, we will do well to keep these principles in mind. Our reforms must do no harm to the incentives that fuel the entrepreneurial spirit, and our reforms must make sure the marketplace has access to the information that it needs to operate fairly and efficiently.