CORPORATE GOVERNANCE: IMPLICATIONS FOR FINANCIAL FIRMS
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Corporate Governance: A Rational Course for Public 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. We've seen the spectacle of corporate executives being led away in handcuffs; convictions for fraud and obstruction of justice; and large out-of-court settlements, some of which involved firms in the financial services sector.

Why has our system of corporate governance failed us? How did this happen so quickly, seemingly without warning? And what steps should we take to address these problems? Today I would like to give you my own personal perspective from having worked for 14 years in private industry before coming to the Fed.

When corporate governance is effective, it helps safeguard shareholders, customers and employees without hindering appropriate risk-taking. But when corporate governance is ineffective or just plain bad, it can have a disastrous impact on these key stakeholders and on the long-term viability of the enterprise.

Furthermore, if corporate governance problems are widespread, some investors may perceive that capital markets are "unfair." This can have serious macroeconomic effects — in particular, reduced willingness to participate in capital markets can lead to higher capital costs for businesses and ultimately to lower levels of business investment.

Corporate governance issues can be quite complex, and it is difficult to grapple with these issues without having a basic framework in place for understanding the identities and motives of all the corporate stakeholders. As the first speaker on today's panel, my main objective is to discuss such a framework.

The framework rests on two fundamental economic principles:

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

- Second, the firm's financial condition should be sufficiently transparent to enable shareholders to evaluate the performance of managers based on public information.

Our system of corporate governance

With these two principles in mind, let me briefly describe our system of corporate governance. 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 refers to the system of checks and balances aimed at making sure that these funds are wisely and efficiently invested by corporate managers.

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. Economists like to call these conflicts "principle-agent problems." 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. Indeed, there is some historical evidence of this occurring in the banking industry.

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

The shareholders make their buy and sell decisions based largely on financial information they receive from outside parties:

- Auditors that review the financial statements of all public corporations,

- Stock analysts that evaluate publicly traded corporations on an ongoing basis, and

- Financial markets that are constantly re-assessing the value of the corporation.

The interactions among these four parties — the shareholders, the managers, boards of directors, and

outside auditors and analysts, together with the laws, regulations and institutions that govern their actions — comprise the American system of corporate governance. The success of this system relies on the two guiding principles that I referred to earlier, namely manager/shareholder alignment and transparency.

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 provide alignment of incentives and transparency of information. Let me now discuss some examples.

Stock option design

My first example concerns executive compensation, a topic that is the center of much debate today. Let me preface my remarks by reminding you that my training as an economist, and also my experience in business, gives me no special knowledge about what constitutes "fair" executive compensation. This is a very subjective and sometimes very emotional topic, and no two people will agree on the same answer. And this is exactly why executive compensation is best left to the marketplace.

Over the past two decades, the marketplace has chosen to include stock options as a substantial part of executive compensation. Because even a small increase in the price of a company's stock can cause the value of these options to increase dramatically, stock options can in theory be an especially powerful way to align the incentives of managers and shareholders. In practice, however, executive stock options have not always accomplished this goal.

One problem is our tax code, which states that executive compensation above one million dollars must be "performance-based" in order to be tax deductible. Thus, the tax code encourages firms to pay their top executives with stock options rather than with shares of stock or with cash. The code also doesn't allow any tax deductions at all for stock options that have variable strike prices, which encourages firms to design stock options with fixed strike prices.

When many of these option contracts were written, it was never imagined that the stock market would increase three-fold during the 1990s. Because these options were not indexed to the market, this led to enormous — and let me say quite unexpected — increases in the wealth of some executives. And many of them reaped these windfalls even though the price of their firms' stock had under-performed that of their peers.

Thus, questionable tax incentives that encouraged the use of poorly designed stock options created a situation where large increases in executive compensation resulted from even small increases in a firm's stock price. This encouraged some managers to over-emphasize the firm's short-run stock price instead of the firm's long-run value to the shareholders.

Incentives for outside auditors

Our experience with stock options illustrates how problems can arise when we fail to properly align the incentives of managers and shareholders. Similarly, our recent experiences with outside auditors and stock analysts illustrate how problems can arise when we fail to have sufficient disclosure and transparency so that investors can accurately observe managerial performance.

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 outside audits can be less than reliable when auditors face misaligned incentives themselves.

For example, many corporations have awarded consulting contracts to the same accounting firms that were performing their outside audits. This created clear conflicts of interest for some auditors, because the accounting firms they worked for earned significant consulting fees from the very same clients they were charged with auditing. In some well-known cases, this eroded the independence of their audits.

Incentives for stock analysts

We also have learned that many stock analysts faced similar conflicts of interest. The role of the stock analyst is to convert a complex array of public information about a company into an estimate of the fair-market value for that company. But stock analysts often work for financial institutions that have investment banking contracts with the very same corporations that the analysts are charged with evaluating.

This arrangement can create internal pressure for stock analysts to issue over-optimistic firm valuations. In fact, a recent study documented that analysts employed by firms that were also lead IPO underwriters "issue 50% more buy recommendations on the IPO than do analysts from other brokerage firms." These practices create uncertainty about stock prices and make capital markets less efficient.

Setting a course for reform

These problems came to light only after the stock market began to fall. The investing public lost substantial wealth in the process, and has rightly put pressure on policymakers and corporations to improve the manner in which corporations are governed.

A number of changes have been set in motion. The Sarbanes-Oxley Act strengthened auditing and accounting practices. And the New York Stock Exchange, the Conference Board and other private-sector organizations and firms have taken action to enhance the oversight role of directors and the flow of information to the investing public. The speakers who follow me will describe some of these changes in more detail.

We have made a good start, and I believe we can go further. But let me be very clear. I do not believe that our system of corporate governance needs a massive overhaul, and any changes that we make must be consistent with a fundamental reliance on the market as the arbiter of a firm's performance.

To be sure, the market will occasionally make mistakes — but the danger in replacing the market with regulations is that the regulations typically make even more mistakes than the market. Just recall the unintended effects that the Glass-Steagal Act had on our financial system and the 60 years it took for us to repeal the harmful portions of that Act.

Proposals for further reform

I'd like to finish my talk today by making three proposals for strengthening our system of corporate governance, each of which is consistent with the principles I outlined earlier.

We can begin by eliminating accounting rules and tax laws that interfere with the manner in which boards of directors choose to compensate executive officers. Boards should design their executive compensation plans to reward managers for exemplary firm performance, not to exploit tax and accounting rules that favor one type of compensation over another. Firms should be able to fully expense and fully deduct all forms of executive pay.

Similarly, we should tax all forms of corporate income at the same rate. One positive reform would be to eliminate the double-taxation of dividend income. Taxing shareholder income twice makes equity financing more expensive, and encourages corporations to carry high amounts of financial leverage.

But there is a more powerful economic reason to eliminate the tax on dividends. Eliminating this tax will increase investors' demand for dividends, and as a result, corporate managers will pay less attention to short-run earnings and will re-focus on a more fundamental measure of corporate value — the cash flows needed to pay a regular dividend over the long-run. Firms that pursue strategies to maximize predictable long-run value rather than short-run earnings will be more transparent to the market.

Finally, firms should re-design their executive stock options to provide better incentives for managers. 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.

Indexing stock options strengthens corporate governance by better aligning the incentives of managers and shareholders. And eliminating unearned windfalls to CEOs — while maintaining rewards for successful financial performance — will help return a sense of fairness to capital markets.

Conclusion

In closing, I want to emphasize that I support these proposals first-and-foremost because they are consistent with the principles of good corporate governance that we've discussed. 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.

I also support these proposals — and others like them — because they will help reduce uncertainty by improving the sense of fairness in capital markets. This should result in lower risk premiums, a reduced cost of capital, greater business investment and faster economic growth.

And finally, I support these proposals because they enhance our economic institutions without damaging the entrepreneurial culture and market-based principles that have always driven our economy. They will better harness the self-interest of shareholders and corporate managers, and will improve the ability of the market to measure performance.

The views presented here are my own, and are not necessarily those of the Federal Open Market Committee or the Federal Reserve System.