

CURRENT ISSUES

IN ECONOMICS AND FINANCE

September/October 2002

Volume 8 Number 8

Issues in Corporate Governance

William J. McDonough

On September 29, William J. McDonough, President of the Federal Reserve Bank of New York, delivered the William Taylor Memorial Lecture in Washington, D.C., at an event cosponsored by the William Taylor Memorial Fund and the Group of Thirty, a private, international consultative group on economic and monetary affairs. In his lecture, Mr. McDonough describes the actions already taken by private and public sector groups to strengthen corporate governance and accounting standards and identifies areas where reforms are still needed.

I am honored this evening to be invited to deliver the William Taylor Memorial Lecture. Bill Taylor was a very special person. He was deeply committed to public service and to the well-being of this nation's financial markets in his many years as head of Bank Supervision at the Federal Reserve Board and as chairman of the Federal Deposit Insurance Corporation. For many of us, he embodied the ideals of a central banker and a bank supervisor: measured, professional, impartial, and unstinting in his willingness to go the extra distance in his search for the right answers to the problems he needed to address. His years in the bank supervisory community were cut all too short. We have sadly missed the benefits of his wisdom.

This evening I would like to honor Bill's memory by talking about some issues I know would have been of profound interest to him. Specifically, I would like to focus my remarks on the elements that make for a sound banking and financial system and the issues that have been raised over this past year that have led many to question the quality and integrity of the information available to our markets.

Financial stability, as I have suggested on several occasions, can be achieved only by the interaction of three basic necessities: sound leadership at the firm level, strong prudential regulation and supervision, and effective market discipline. These three elements provide the foundation for the health and soundness of the financial system as a whole.

Sound leadership at the firm level is the first bulwark against financial system instability. It begins with good corporate governance: capable and experienced directors and management, a coherent strategy and business plan, and clear lines of responsibility and accountability.

The board of directors is meant to oversee the development of the overall strategy of the organization and the decisions made by senior management in pursuit of those strategic objectives. This means that individuals with skills and competencies consistent with the institution's strategic focus must be represented. In addition, the board should establish clear guidelines regarding the independence of its directors. Senior management is meant to set the business strategy, oversee day-to-day decisions, and ensure that these decisions support the long-term objectives and policies as determined by the board.

To ensure financial stability, execution of the overall objectives of the firm must be supported by rigorous internal controls and effective risk management. An effective internal control apparatus is critical to provide reasonable assurance that the information produced by the organization is timely and reliable and that errors and irregularities are discovered and corrected promptly. Such an apparatus is also needed to promote the firm's operational efficiency and to ensure compliance with managerial policies, laws, regulations, and sound fiduciary principles.

Effective risk management is based on a foundation of good corporate governance and rigorous internal controls. Taking calculated risks is part of any business enterprise. That is well understood. At the same time, each firm needs to have in place the technical systems and management processes necessary not only to identify the risks associated with its activities but also to effectively measure, monitor, and control them.

An effective risk management and control structure is not sufficient, however, if it is not accompanied by an institutional culture that ensures that written policies and procedures are actually translated into practice. Ultimately, a firm's culture is determined by the board of directors and the senior management it installs. In particular, the actions of senior management and the consistency of their decisions and behavior with

It is vital that managers make certain that their commitment to an environment that includes effective risk management and rigorous controls filters fully down the line to all employees in their organization.

the values and principles they articulate are critical to shaping firm culture. It is vital that managers make certain that their commitment to an environment that includes effective risk management and rigorous controls filters fully down the line to all employees in their organization.

Official regulation and supervision provide a second line of defense against financial instability. Governments have long recognized that banking and other financial institutions, because of the nature of the functions they perform, must be subject to at least some form of regulation and official oversight. Governments have a broad mandate here. Their job is to ensure that markets operate in a fair, transparent, and efficient manner, and that participants comply with the rules of the game. Governments must not rely on outdated notions as to what constitutes risk and effective risk management. Official supervision must evolve in line with the way financial institutions manage their activities, which is increasingly across business lines rather than across legal entities.

The Basel Committee on Banking Supervision, which I chair, has developed principles for sound and effective banking supervision and continues to add to its guidance on minimum and advanced supervisory practices. Its proposed revisions to the Basel Capital Accord call for these principles to be applied to all internationally active banks within a more dynamic,

risk-based, and process-oriented framework. The revisions are intended to align regulatory capital requirements more closely with underlying risks and to provide banks and their supervisors with a range of options for the assessment of capital adequacy.

The third line of defense against financial instability is effective market discipline, an increasingly important ally of policymakers in a global marketplace. What do I mean by market discipline? In my view, market participants, when armed with timely, meaningful, and accurate information about a firm's performance, can, by their investment and credit decisions, encourage managers and boards of directors to manage their risks soundly. Equally important, market participants can penalize firms that do not manage their risks soundly.

If market discipline is to be effective, however, it must be supported by substantial and meaningful public disclosure—as well as sound accounting standards and an efficient and credible legal framework. Knowing a company's appetite for risk and its approach to, and methodologies for, managing risk is essential to understanding the risks of being a shareholder, a creditor, or a counterparty.

While significant progress has been made in recent years in improving disclosure practices, it unfortunately remains the case that many of these practices have simply not kept pace either with the rapid changes in many firms' business activities and risk exposures or with how these exposures are measured and managed. For this situation to be fully remedied, notions of what is proprietary information and what should be in the public domain must change.

There can be no doubt about the need for dramatic progress in improving disclosure practices. Clearly, a full appreciation of risk cannot be achieved without sufficient information. This past year has made all too clear that there is no greater enemy to financial stability than a loss of confidence—and nothing undermines confidence more than a lack of reliable information. Discipline imposed by markets might not be pleasant, but fuller, higher-quality information—in a word, transparency—bolsters the confidence of depositors and other creditors and thereby makes doing business easier and more secure for everyone.

Progress on the disclosure front, however, will be limited until accounting standards are enhanced to ensure proper valuation and to reflect innovations over the past decade, in terms of both new products and modern risk management techniques. Accounting systems serve a variety of purposes, but none is more important than helping creditors and investors make rigorous and clear-eyed decisions as to which enterprises meet the market tests of efficiency, competitiveness, and profitability.

Sound accounting systems also enable investors to determine the value of enterprises. In so doing, the systems assist in attracting capital, both foreign and domestic. In my view, therefore, ongoing efforts to enhance and harmonize accounting standards worldwide should continue and even intensify.

This past year brought widespread questioning of the quality and integrity of the information available to the market and the behavior of some corporate executives. Although the developments that gave rise to this questioning are regrettable, there has, in fact, been a positive side. The public uproar that these developments have created and the turmoil they have generated in the financial markets have been immensely powerful as forces for meaningful reform. I further believe that the painful experiences of this year will help educate a generation of younger managers about the importance of integrity and sound corporate governance based on independent oversight and strong internal checks and balances.

The process of addressing these problems has clearly begun. In this country, we already have on the table a number of proposed changes from both private and public sector participants. These initiatives reflect a tradition in our country of cooperation between the private and public sectors that is a major reason for the effectiveness, efficiency, and flexibility of our financial markets. Let me touch briefly on what some of these proposals and new measures entail.

On the private sector side, the New York Stock Exchange approved a wide-ranging set of changes which it submitted to the Securities and Exchange Commission (SEC) in August. The proposed changes include improved corporate governance standards as well as related changes to certain other rules on its books. For example, the New York Stock Exchange would require all listed companies to have a majority of independent directors as well as nominating/corporate governance committees and compensation committees composed entirely of independent directors.

The NASDAQ Board of Directors also approved a number of improvements in corporate governance measures in May and July. Its proposals range from requiring shareholder approval for the adoption of all stock option plans to increasing and strengthening the role of independent directors and the authority of audit committees.

The Business Roundtable, which represents the business community, stands firmly behind the proposals of the New York Stock Exchange and NASDAQ to improve listing requirements. The Conference Board has endorsed reforms to stock option plans. Moreover, the major rating agencies are committing more of their resources to analyzing the quality of financial

accounting and governance at the companies they cover—efforts that will complement the private sector reforms.

The major initiative by the public sector has been the passage by Congress in July of the Sarbanes-Oxley Act of 2002. Although most of the new laws governing public companies are not immediately effective—and many require implementing regulation by the SEC—several provisions were put into effect right away. One

While significant progress has been made in recent years in improving disclosure practices, it unfortunately remains the case that many of these practices have simply not kept pace . . . with the rapid changes in many firms' business activities and risk exposures.

of these provisions required CEOs and CFOs to certify, as of the second quarter of this year, that their quarterly and annual reports fully comply with the reporting requirements of the SEC Act of 1934 and that the reports fairly present the financial condition and operating results of the firm. Included in the legislation are criminal fines and imprisonment for false reporting.

These critical efforts at reform recall the private/public sector cooperation that was so successful in the preparations for the Y2K century date change. Experience has shown that such cooperation works best when both sectors go beyond the need to solve the immediate problem—that is, when they work together to learn from past experience and to anticipate problems and thereby strengthen the financial system on a longer run basis.

Why is this private/public sector cooperation so productive? I would argue that it is because each sector has its part to play. The private sector is motivated by self-interest, the public sector by the public interest. In this instance, private self-interest and the public interest coincide: both have a stake in the healthy functioning of the financial markets.

In a world of instantaneous communication, interconnected markets, and more complex instruments and risks, effective cooperation between private and public sector players is vitally important for financial stability, both domestically and globally. At the same time, we must be certain that our joint efforts to ensure the safe and sound operation of our financial markets do not stifle the innovation and creative energy that are constantly improving how financial markets operate and the way firms do business.

With these thoughts in mind, we must ask ourselves how, by working together, we can best meet the challenges to our financial markets posed by the loss of trust stemming from corporate governance breakdowns and misleading accounting practices at some prominent businesses. In answering this question, I am mindful of a basic reality. Namely, despite the successes of previous private/public sector cooperative efforts, additional issues that need our attention will always arise because of the open and dynamic nature of our financial system.

As I noted, we have already begun to address some of the causes for investor skepticism. Still, we have much to do. I would like to comment on four broad issues: corporate governance, executive compensation, accounting, and disclosure.

Corporate Governance

Looking to the immediate future, I believe that one challenge for directors and executive management is to find outside directors who are sufficiently independent but still knowledgeable about and engaged in the business of the company on whose board they will sit. Independence reflects qualities of objectivity, experience, insight, and force of character. The need for directors to possess this blend of knowledge plus independence is critical, given the increased technical complexity of most business activities and the rapid pace of change in financial markets and practices.

Finding such outside directors can involve a tough balancing act. Directors who are paid too little or who are kept at the perimeter of the corporate structure may be truly independent but have little incentive or insufficient knowledge about the organization to govern effectively. By contrast, directors who are paid well or who are fully integrated into the corporate structure may have the incentive and the knowledge to govern effectively but lack the desired independence to discipline incompetent or dishonest management.

The risk is that as outside directors' compensation increases, their independence may wane and, instead of functioning as watchdogs for shareholders, they may increasingly function as lapdogs for management. Getting the right balance of expertise and independence so that the board does not rubber-stamp the decisions of top management is a major challenge.

Another challenge in selecting outside directors is how to balance general business knowledge with specific industry knowledge and technical expertise in areas such as accounting, finance, and labor markets. Boards of directors clearly need individuals with a broad range of expertise. But as business problems evolve—and in large multinational corporations business inevitably changes—the range of expertise needed

similarly evolves. Developing a well-rounded, appropriately balanced board of directors is a tough assignment. It is especially so considering that the shareholders who elect the board are generally a diffuse group with little economic incentive or capability to monitor the corporation closely—until, of course, something goes terribly wrong.

Added to these challenges is the difficulty of finding qualified directors who have the time to devote to the affairs of the company and who are willing to face the risk of shareholder lawsuits. Some qualified directors may be reluctant to serve for fear that the potential bad performance of the firm will damage their reputations. The irony is that directors who are most qualified may be the least willing to serve because of the opportunity costs of the time they must spend and the potential threat to their reputations.

Given what has transpired over this past year, there may in fact be a need to reconceive the role of directors. Some firms reportedly are already moving away from the tradition of choosing the CEO of another company as a director to choosing people who are equipped with more specialized and technical knowledge. Still open, however, are questions concerning how much time directors should devote to their duties and what the appropriate remuneration should be.

Executive Compensation

I have already publicly expressed my views on the trend toward excessive executive compensation. As I argued earlier this month, I can find nothing in economic theory to justify the levels of executive compensation that are widely prevalent today. I believe that corrective action—taken voluntarily—is not only overdue but also morally sound.

This evening, I would like to focus on the effects of public policy on executive compensation. As you know, in 1993, the Internal Revenue Service (IRS) ruled that the maximum tax-deductible salary a company can pay an employee is \$1 million per year. Compensation above \$1 million has to be “performance-related” to be considered a tax-deductible expense. This change in public policy gave firms that wanted to minimize taxes the incentive to introduce performance-related pay structures for executives earning more than \$1 million a year. The policy change is a key reason that stock options have become the most prevalent performance-related structure for executive compensation.

Option-based executive compensation raises a number of issues. For example, one feature of the 1993 IRS ruling is that the \$1 million salary cap for tax deductibility is nominal and not indexed. This means that as the average total compensation for executives rises over time, the incentive to use stock options increases.

Another issue stems from the fact that stock options are nontransferable. Therefore, an increasingly large fraction of an executive's compensation in the form of stock options represents a nondiversified risk. Moreover, if the firm goes bankrupt, the options become worthless at the same time that the executive's job is lost. As a result, firms may have to increase the amount of options they offer an executive to offset the increased riskiness of this form of compensation.

From my perspective, a more neutral tax policy toward executive compensation would reduce the reliance on stock options and not penalize firms if they opted instead to use other forms of contingent-pay mechanisms. A reconsideration of stock options is

What is key is that firms have the flexibility to structure new types of incentive compensation and that public policy be responsive to these initiatives.

already under way. Clearly, there is room for changing the incentives that have been driven by tax policy. For me, what is key is that firms have the flexibility to structure new types of incentive compensation and that public policy be responsive to these initiatives.

A deeper issue, in my view, relates to dividends. It is true that dividend payout ratios—dividends divided by earnings—have fallen over time and have been replaced by share repurchases, so that overall payout ratios have remained remarkably flat. The periodic payment of dividends to shareholders represents a formal corporate policy that is more precise and more visible than share repurchase programs. The ability to make dividend payouts is a barometer of cash flow. Dividend payments and the consequent need for external finance subject firms to market discipline.

Currently, however, share repurchases offer certain advantages over cash dividends from a tax perspective. For one, capital gains taxes on share repurchases are lower than income taxes on dividends. Second, with share repurchases, investors can time their capital gains or losses, whereas with dividends, investors cannot choose when they will receive their taxable cash inflow.

Regardless of any specific decision a firm may decide to make, I strongly support more transparency in financing and payouts, including share repurchase programs. In my view, public policy should aim to eliminate distorting incentives and to encourage instead

the role of market discipline. Transparency is a necessary ingredient for market discipline to be effective.

Accounting

Accounting issues have gotten a lot of attention this past year. It may be helpful to distinguish between the business of accounting and the rules of accounting. I would first like to discuss the business of accounting.

The accounting business has gone through a dynamic period of change over the past several years. A number of this country's accounting firms were considering or had already begun the separation of their consulting business from their more traditional accounting and auditing business well before this past year's turmoil.

In this process, accounting firms face a difficult challenge. Once a firm has done a thorough job in its accounting and auditing business, it is well positioned to apply its firm-specific expertise to a consulting problem. However, accounting firms are no longer allowed to provide accounting and consulting services to the same organization. Thus, the challenge for accounting firms is how to develop a business model that will allow them to maintain some of their natural economies of scope and at the same time avoid the conflicts of interest proscribed by law.

On a broader level, it seems to me that the accounting industry also faces important personnel issues. At the Federal Reserve, experience has shown that supervising large, complex banks calls for supervisors with a high level of technical expertise, the intellectual ability to make difficult specific judgments based on general principles, and the strength of character to remain open-minded but steadfast in the face of pressure from the management of supervised institutions. The accounting industry needs to be certain it is attracting people with these same attributes.

As to accounting rules, one of the major issues today concerns executive stock options, as I have noted. Grants of stock options and the exercise of these grants are, as we know, disclosed in the footnotes of a firm's reports, but this information typically is not accounted for in the firm's income statement or balance sheet. Some might argue that as long as the information on stock options is disclosed, exactly how the information is accounted for is unimportant since disclosure in and of itself is sufficient. In theory, this view may be justified. In practice, however, what we have found is that information that is disclosed but remains off the accounting statements is unlikely to be fully incorporated in the price of the stock.

Another major issue with respect to accounting rules—and there is some overlap with disclosure issues here—concerns how intangible assets and complex financial transactions are treated. Intangible assets are generally thought to include a valuable trademark, a renowned reputation, or an efficient process in delivering goods or services. Each of these intangible assets has value, but this value can be lost in a heartbeat. While it is true that a tangible asset such as a factory can burn to the ground overnight, intangibles, unlike a factory, usually cannot be insured. A challenge to current accounting—and disclosure—rules, therefore, is how to reflect accurately not only the value of intangible assets, but also their vulnerabilities to sharp downward revaluations.

In terms of complex financial transactions, this past year's events have made clear that accounting and disclosure rules have failed to keep pace with financial innovation. Complex financial arrangements, such as those funded offshore or through special-purpose entities, are not effectively addressed in today's accounting and disclosure rules. We have also seen telecom equipment manufacturers run up billions of dollars' worth of customer guarantees, which under current accounting and disclosure guidelines do not have to be recognized in financial accounts or disclosed to investors until their customers default or are near default.

In these cases, it seems clear, one of the basic tenets of accounting and disclosure rules—that there should be no “hidden” liabilities—seems to have been violated. I would like to see much more done to address these deficiencies without unduly burdening the readers of accounting statements.

Disclosure

Disclosure is most useful as a complement to accounting statements. The need for mandatory disclosures will certainly continue, but firms should also be encouraged—and in some cases required—to make otherwise nonmandatory disclosures if accounting statements are misleading or incomplete.

I would further argue that it is simply not enough for companies to disclose information. Investors also have to pay attention to the information disclosed. A lot of information underlying the proposed governance reforms is already disclosed. For example, by reading proxy statements, investors can make up their own minds about such issues as whether the audit committee members have sufficient financial expertise and how many stock options executives have received.

What is clear is that the outstanding performance of the U.S. economy over the past decade lulled investors into a false sense of security. Recent events may, therefore, serve as a wake-up call—not only to management that the market is watching them, but also to investors and analysts to pay attention to the information already disclosed.

While there have been many major improvements in disclosure practices over the past several years, with hindsight, I think that less progress was made than initially hoped and more could have been done. In short, I believe that there is a public policy need to rethink the entire disclosure framework.

In my remarks this evening, I have underscored a number of issues that I believe merit immediate attention. Not one of these issues presents obstacles that cannot be addressed through the cooperative efforts of private and public sector participants. There are currently more than 6,000 publicly traded companies in the United States. Only a handful of these companies have been the object of concern this past year.

At the end of the day, I have no doubt that the underlying depth and flexibility of the U.S. financial markets—combined with the heightened awareness of individual investors and the general public—will provide the necessary resilience to allow private and public sector initiatives to take root. Through these cooperative efforts, I believe that we will see an even stronger financial system evolve. In this way, we honor the memory of the man whose life we celebrate this evening.

About the Author

William J. McDonough is the President and Chief Executive Officer of the Federal Reserve Bank of New York.

The views expressed in this article are those of the author and do not necessarily reflect the position of the Federal Reserve Bank of New York or the Federal Reserve System.

Current Issues in Economics and Finance is published by the Research and Market Analysis Group of the Federal Reserve Bank of New York. Dorothy Meadow Sobol is the editor.
