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Panel 1

THE CAPITAL MARKET AS A GROWTH ENGINE

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THE AGENCY COSTS OF OVERVALUED EQUITY

In the past few years, we have seen many fine companies end up in ruins and have watched record numbers of senior executives go to jail. And we will surely hear of more investigations, more prison terms, and more damaged reputations.

What went wrong? Were managers overtaken by a fit of greed? Did they wake up one morning and decide to be crooks? No, the root cause of the problem was not the people but the system in which they were operating – a system in which equity can become so dangerously overvalued that CEOs and CFOs find themselves caught in a vicious cycle of ever higher stock valuations and (in the not-too-long-run) ever greater destruction of corporate and social value.

What Is Overvalued Equity?

Equity is overvalued when a firm's stock price is higher than its underlying value, when a company cannot deliver the performance that would justify that price. We can take a brief look at agency theory – an idea William Meckling and I wrote about in 1976 – as a way to think about the consequences of overvalued equity. An agency relationship exists whenever one or more people (principals, such as a corporation's shareholders) engage one or more other people (agents, such as a corporation's managers) to perform a service. Of course, agents will not always act in the best interests of the principals, and vice versa, and efforts to manage the conflicting interests of both parties in an agency relationship generate costs.

In part, the massive overvaluation of equity that occurred in the late 1990s and early 2000s was an understandable market mistake. Society often seems to overvalue what is new – in this case, high-tech, telecommunications, and Internet ventures. But this catastrophic overvaluation was also the result of misleading data from managers, large numbers of naïve investors, and breakdowns in the agency relationships within companies, in investment and commercial banks, and in audit and law firms many of whom knowingly contributed to the misinformation and manipulation that fed the overvaluation.

Gaming the System

I've written in recent years about the fundamental problems of our corporate budgeting systems. Because compensation is tied to budgets and targets, people are paid not for what they do but for what they do relative to some target, which leads people to manipulate both the setting of the targets and their numbers, to game the system.

Corporate managers and the financial markets have been playing a similar game. Just as managers' compensation will suffer if they miss their internal targets, CEOs and CFOs know that the capital markets will punish the entire firm if they miss analysts' forecasts by as much as a penny. And just as managers who meet or exceed their internal targets receive a bonus, the capital markets reward a firm with a 3 percent premium for meeting or beating the analysts' expectations at the end of a quarter. The only way for managers to meet those expectations is to cook their numbers, to mask the inherent uncertainty in their businesses – that is, to lie.

Indeed, when I served on the boards of a couple of large public companies, I learned that "earnings

management" was an integral part of every top manager's job. But when managers smooth out earnings to meet market projections, they're not creating value for the firm; they're both lying and making poor decisions that destroy value. I realize that it is not fashionable to use such harsh language to describe what are almost universal practices. But when numbers are manipulated to tell the markets what they want to hear – it is lying, and when real decisions, that would maximize value, are compromised to meet market expectations real long-term value is being destroyed.

Once you start lying, it's nearly impossible to stop. If you're having trouble meeting the estimates for this year, you push a few expenses forward. You pull some revenues from next period into this period. Revenues borrowed from the future and today's expenses pushed to tomorrow require even more manipulation to forestall the day of reckoning.

Managerial Heroin

Like taking heroin, riding at the helm of an overvalued company feels great at first. If you're the CEO or CFO, you're on TV, investors love you, your options are going through the roof, and the capital markets are wide open. But as the heroin user learns, massive pain lies ahead. You realize the markets will hammer you unless your company's performance justifies the stock price, so you start to take actions that you hope will at least appear to generate the expected performance. But, by definition we know that you cannot, except by pure luck, produce the performance required to justify your overvalued stock price. You use your overvalued equity to make acquisitions to satisfy growth expectations, you use your access to cheap debt and equity capital to engage in excessive internal spending and make risky investments, and eventually you turn to further manipulation and even fraudulent practices. None of these actions truly improve performance. In fact, they destroy part or all of the firm's core value. But what's your alternative? How could you ever argue to your board that a major effort must be made to reduce the price of the stock?

In summary, overvalued equity sets up a set of organizational forces that in the not-too-long run will destroy value, and these organizational forces are extremely difficult to stop.

Look at Enron. My guess is that at the time of Enron's peak market value of $70 billion, the company was actually worth about $30 billion. It was a good, viable business; the company was a major innovator. But senior managers' efforts to defend the $40 billion of excess valuation, which was nothing but a big mistake – a mirage that was going to go away anyway – cut in to the $30 billion core value. Enron's managers had a choice: they could have helped the market reduce its expectations. They could have found the courage to reset the company's value. Instead, they destroyed it.

Nortel is another case in point. Between 1997 and 2001, Nortel acquired 19 companies at a price of more than $33 billion and paid for many of these acquisitions with Nortel stock, which had increased dramatically during that period. When the company's stock price fell 95 percent, all the acquisitions were written off. Nortel destroyed those companies and in doing so destroyed not only the corporate value that the acquired companies – on their own – could have generated but also the social value those companies represented in the form of jobs and products and services.

Because neither top managers nor board members have had the language to talk about the danger of overvalued equity, few have fully understood it. And even those who have sensed the problem have been unable to stop playing the game. The *New York Times Magazine* published a piece in which the author describes the scene on the floor of the New York Stock Exchange as eToys' stock price skyrocketed on its first day of trading in May 1999. CEO Toby Lenk was quoted as saying to his CFO, "This is bad. We're going to live to regret this." Lenk knew something was wrong, but he and his management team went ahead and built the capacity for $500 million in sales. Sales peaked at $200 million, and in February 2001, just 21 months after that first heady day, the company filed for bankruptcy protection and was eventually liquidated.

Walking the Straight and Narrow

I believe that the solution to the problem of massive overvaluation is to stop it from happening in the first place. This means going against our very human reluctance to endure short-term pain for long-term benefits. We must refuse to play the earnings management game. We must stop creating

and consuming the heroin. If our company's stock price gets too high, we must talk it down. And we must help others in the business and financial communities recognize that growth is not a synonym for good:

- Senior managers must understand what drives value in their organization and align internal goals with those drivers, not with analysts' expectations.
- Senior managers must promise only results they believe they can deliver, and they must provide investors and markets with auditable data on the benchmarks that are critical to the achievement of their strategy.
- Business educators, while teaching students the desirability of maximizing value, must also teach them about the dangers of overvaluation.

Resetting corporate value and resetting the conversation between corporate management and Wall Street won't be easy, but I see a window of opportunity. I hear people talking about the malaise that has gripped the business world. I know executives who are wondering how to invest in their integrity. I see researchers starting to examine some of the issues. It is now clear that these actions have destroyed both value and personal and organizational reputations Because they do not create value there is no long-run incentive to continue them. Witness the destruction of Arthur Anderson and the severe damage to the reputation for other auditing firms, investment banking firms, analysts, commercial banks and law firms who played supporting roles in this value destruction. This window won't remain open forever. Right now we're not suffering from substantially overvalued equity anywhere in the US economy that I know of, but if we don't seize this moment to identify the problem, talk about it, and learn from it, we could find ourselves trapped once again in a vicious, destructive cycle.

JOHN KAY
Fellow of St John's College, Oxford University

CHALLENGING THE CLAIMS FOR THE ROLE OF CAPITAL MARKETS

Like most people who learned economics since 1970, I was brought up on the efficient market hypothesis. Like most people who learned economics since 1970, I hung above my desk Michael Jensen's famous quotation of twenty five years ago

> 'there is no other proposition in economics which has more solid empirical evidence supporting it than the Efficient Markets Hypothesis' (Jensen, 1978, p.95).

Like most people who have lived through the 1990s, I no longer have the faith in capital market efficiency that I once did.

Professor Jensen acknowledges that stock prices were routinely overvalued in that period. If I understand his argument, however, it is that overvaluation occurred because corporations provided inaccurate information to the market, not because of inefficiencies in the processing of information by the markets.

It is, of course, true that some, perhaps many, corporations provided misleading accounts of their affairs. This is what is currently at issue in the legal cases which surround Enron and WorldCom. And we are now aware of the extent to which even the most respected businesses used devices to smooth their quarterly earnings reports – such as the special purpose entities which became notorious in the Enron collapse.

But I do not think it can be seriously argued that all the fault lies with executives and none with market participants. We need look no further than the titles of – influential – books like *Dow 36,000* or *New Rules for the New Economy,* to see that mistakes were made in analysing information. We need look no further than the evidence which emerged in New York Attorney General Spitzer's case against leading investment banks to see that misleading accounts of corporate activities were propagated, not just by companies themselves, but by those who made markets and purported to give advice to prospective investors. We need only have talked to a few participants in the great market boom of 1999 to realise that they were motivated, not just by reassessments of the fundamental value of securities, but by the expectation that they could sell the securities they bought at higher prices to someone else within a very short period of time. We have lived through the greatest speculative bubble in world economic history, and the efficient market hypothesis, at least in the form it has been traditionally presented, cannot survive that era.

Efficient market theory contains an important element of truth. It stimulates us to ask ourselves the question 'what do I know that other people don't?' every time we buy or sell an asset. It goes with its sister question 'what do other people know that I don't?' Reflecting on these questions can save us a good deal of money. Many people, both professional investors and corporate managers who engaged in acquisitions, would be richer today if they had made that reflection.

But I realise now that the question 'what do I know that other people don't' can have the answer 'plenty'. Never were the basic principles of economics and accounting so conspicuously on trial as in the last decade. How often were we told 'there are new rules for business success in the new economy' or 'old valuation principles aren't relevant to knowledge businesses'. But in the end, the old rules and the old principles vindicated themselves, as they were bound to.

So among the things that I know and knew that other people don't, or didn't, are that the market for mobile phone connections cannot grow indefinitely, and that margins in it will come under competitive pressure as other people enter: that the internet reduces, not increases, barriers to entry in

the (comparatively small) number of industries – classified advertising, financial services, entertainment – in which it has economic significance; and that there are limits to the likely profitability of trading energy contracts, since market making is a low margin activity it is difficult to make money from on a sustained basis from proprietary trading.

Over the last five years, I have been glad to know these things that other people didn't, and have even made returns from such knowledge that efficient market theory says are difficult or impossible to realise; but there have been nail-biting times on the way. And I was glad that in 1999 I escaped from both business school leadership and commercial consulting, because in both these activities I recognised the strength of commercial pressure to espouse to doctrines which I knew – in my heart, but more importantly in my head – were complete nonsense. Not everyone resisted that temptation – or wanted to.

When I learned efficient market theory as a student, I also learned economic history, and I read of the great speculative bubbles of the past. I first learned the name Goldman Sachs when I read Kenneth Galbraith's great book on the 1929 crash, and enjoyed the chapter entitled 'In Goldman Sachs we Trust.' I wondered how people could then have behaved so foolishly. But now I know. And I also now know that my idealistic belief that what I learned about efficient markets in the course on finance theory made what I had learned about inefficient markets in the course on economic history redundant, was false.

In understanding the events of the late 1990s, we learn more from economic history than efficient market theory. A remarkable characteristic of the boom and bust was how it paralleled earlier speculative bubbles not just in general but in considerable detail. Galbraith's book is instructive, but I found Arthur Miller's play *The Crucible,* his famous account of the Salem witch hunt of 1692, even more valuable in understanding the events that were taking place. Miller describes with great skill the process by which nonsensical beliefs can seize an entire community when childish folly is whipped up by self-interest, opportunism and social pressures.

So it's an interesting moment for us to debate the proposition that capital markets are an engine of growth. The claims generally made for the role of capital markets in stimulating economic growth are of three principal kinds. Liquid and transparent capital markets lead to a higher level of savings, because they offer higher returns and greater confidence in the realisation of these returns. The transparency of market processes promotes a better allocation of physical investment and a reallocation of capital to the most efficient firms. And active equity markets achieve effective corporate governance by emphasising the accountability of corporate managers to their shareholders.

All of these claims are hard to sustain today. The US and Britain have the most developed capital markets among advanced economies, and the lowest savings rates. For the US, at least, there is a direct connection. The story of US macroeconomics since 1996 is fundamentally simple. Believing themselves much richer than they were – taking seriously the income and wealth projections implied by inflated stock markets – Americans spent accordingly, and borrowed the money to pay for it from the rest of the world.

Have liquid capital markets created a better allocation of physical investment? The national telephone companies of Britain, France, Germany and Spain are all businesses which have more or less destroyed themselves in a frenzy of overpriced acquisitions, the installation of fibre optic cable capacity that will probably never be required, and wild overbidding for third generation licences. It is hard to argue that this represents a triumph of market driven investment allocation. The best we can say of it is that the market makes you pay for mistakes. It does, but you can inflict a lot of collateral damage along the way.

And what of corporate governance? I don't want to say more about Enron and WorldCom. At least Europeans bring a touch of novelty to the process of corporate destruction. The story of Vivendi Universal, of the transmogrification of Jean-Marie Messier from mundane head of France's largest water company into an international media mogul, with glitzy Manhattan apartment and starlets by his side, is itself worthy of Universal Studios.

The more serious failures of corporate governance in the last decade are not, however, instances of fraud and corruption. They are less extreme, but often more serious, instances of the arrogance and

incompetence shown at Vivendi. Coming here from London, I am conscious of the failures of once iconic British companies – Marks and Spencer, for decades Britain's most admired company, fallen from its pedestal, GEC and ICI, the two largest British manufacturing companies at the beginning of the decade, struggling for survival.

Marks and Spencer imploded. It sought to grow earnings per share at the pace demanded by a premium stock market rating, and faster than the growth of its underlying business. It succeeded, for a time, by putting pressure on relationships with suppliers, and its reputation for value for money with customers – the factors which had been the source of its competitive advantage for so long. In 1998 it achieved the highest margin on sales in the history of the business – shortly before its profits fell off a cliff as the magical reputation which had been the basis of its competitive advantage began to erode.

GEC, later called Marconi, exploded through a process of meta fund management: corporate executives saw their role as managers of a changing portfolio of businesses rather as asset managers see themselves as managers of a changing portfolio of stocks. The company disposed of its boring old defence businesses in return for whizzy new telecoms ones. Today its former executives are spending more time with their families, and their present executives much time with their creditors.

It is time to halt, or at least slow the pace of, these capital market misadventures. The long-term strength of companies lies in the effective management of their operating businesses, not in their relationship to capital markets.

The hubris about the US economy in the 1990s was mirrored in a decline in European self-confidence. The spread of American capital markets has been represented as not only right, but inevitable. In a bizarre reversal, the claims of economic determinism and historic inevitability, once made by the political left, are reproduced today by the political right. The corporate collapses I have described might have been expected to reduce the stridency of these claims, but the unilateralism of US policies after September 11 have increased them. If you are tempted to think I exaggerate, let me refer you to the symposium on the European economy in *American Enterprise* in December 2002.

The tenor of that review is summarised by Mark Steyn:

> "I find it easier to be optimistic about the futures of Iraq and Pakistan than, say, Holland or Denmark. What's wrong with the Islamic world is relatively straightforward. With Europe, it's harder to foresee any happy endings."

In truth, differences in productivity between Western Europe and North America are not significant. The important economic dichotomy in the economic world today is that between Western Europe and the countries – including the United States – which West Europeans settled and with the former Communist and underdeveloped world. It is not a transatlantic divide. Holland and Denmark have labour productivity levels above those achieved in the United States.

And the cheese-eating surrender monkeys have, since they were liberated in the second world war, raised their productivity from the levels of their British allies to those of their American allies. French national income per head is below American, but that is because the French take five weeks holiday, and lunch; French national income per hour worked is slightly higher. Not a bad way to live: part of the reason, perhaps, why France attracts more visitors than any other country; part of the reason, perhaps, why I personally choose to spend as much time there as I can.

It is no part of my brief, or my intention, to make counter claims for the superiority of a European economic model. There are many economic problems in Europe: those who point to structural rigidities in the German economy are not engaged in idle gossip. But in the last decade, Europeans have been brainwashed into supposing that the economic performance of European economies is markedly inferior to that of the United States, a claim which has no factual basis. We should all agree that the market economy is the only economic system which has created sustained and growing material prosperity for large numbers of people. All the twenty or so rich countries of the world – two thirds of them in Europe – are market economies.

But since the fall of the Berlin Wall we have been presented with an account of how markets work which is facile and which fails to acknowledge the

central role of the social context of markets. Nor is it sensitive to the genius of the coevolution of technological and organisational innovation which is the strength of the market economy. It fails to acknowledge the complex structures of disciplined pluralism which are its essence. Capital markets are a necessary part of that market economy, but they currently attract a disproportionate fraction of the attention of business people and a wholly disproportionate fraction of business talent.

Professor Jensen raises the question: what should a director of a company whose share price is overvalued do? It is indeed a problematic issue, and it is all the more problematic when the overvaluation is a compound of misperceptions about the specifics of the business and misperceptions about the overall economic situations, as was typically the case during the stock market bubble. It forcibly demonstrates the problem created by putting forward the creation of shareholder value as a corporate goal: shareholder value is a compound of the realities of the business and the assessment by others of that reality, and the latter aspect has as great an impact as the former.

Let me offer what I think is the only possible resolution of the dilemma Professor Jensen describes, but one with wide-ranging implications. It is that managers should as far as possible ignore the share price, and get on with running the business as best they can. The experience of the last decade has shown us that the capital market is as much a forum for sophisticated, and often not very sophisticated, professional gambling as much as it is an engine of growth. That experience has reasserted the truth of that. Keynes's observation in the aftermath of the greatest speculative bubble prior to this: 'When the allocation of capital is the byproduct of the activities of a casino, the job is likely to be ill done'. To change the metaphor slightly, but only slightly: speculation in company securities, like betting on horses, is something which it is impossible to prevent even if it were desirable to do so: but the horses in the race should compete against each other as best they can with as little regard as possible to the punters outside.

In the simplifications of an American business model which applauds greed and asserts an ideological form of market fundamentalism, an account has been presented of how capitalism works that is at once repulsive and false. The consequence has been an undermining of both the efficiency and legitimacy of the real market economy.

HARVEY L. PITT
Former Chairman,
US Securities and Exchange Commission

Good afternoon. It's an honor and a pleasure to be here today. I am indebted to the American Academy in Berlin, vital for harmonizing German and American ideals, for sponsoring my trip to Germany.

I have five observations to offer:

- First, our capital markets are the engines that drive our respective standards of living, corporate competition, and delivery of all the products and services that make up our free economies.
- Second, investor confidence is fundamental and critical to the success of global capital markets, and individual national capital markets.
- Third, investor confidence is predicated, in increasing part, on notions of good corporate governance, not just share price.
- Fourth, investor confidence wasn't shattered due to a lack of regulations or regulatory action, and merely more regulations or more regulatory action cannot restore it.
- Fifth, restoring investor confidence isn't a job for one regulator, or even all regulators; it's a job for every participant in, and every beneficiary of, our capital markets.

After becoming SEC Chair in August 2001, we were confronted with the tragedy of September 11th. Although occurring in the U.S., capital markets around the world felt its effects, demonstrating their interrelationship and mutual dependency. Terrorism was followed by breathtaking US corporate collapses, reflecting a failure of corporate governance as well as corporate malfeasance, misfeasance and nonfeasance. Companies like Phillip Holzmann, Babcock-Borsig, Kirch, Polly-Peck, Comroad, and MobilCom proved this wasn't limited to the U.S.

In the U.S., these scandals produced adverse investor reactions, and the value of world equity securities fell. Indeed, last year US investors took more money out of stock mutual funds than they put in, for the first time since 1988. While German business hasn't traditionally been as reliant on equity capital as are US businesses, the impact of these scandals was, and is being, felt in all aspects of our global capital markets, debt and equity. A recent McKinsey study found that 50 percent of investors surveyed now regard corporate governance as equal in importance to financial performance when making an investment, and 75 percent said they'd be willing to pay premiums for companies with good governance.

The erosion of investor confidence made us see that the system of self-regulation of the accounting profession was broken. We also embarked upon long-needed disclosure reforms to improve the quality and increase the timeliness of disclosure. The SEC compelled the NYSE and Nasdaq to improve corporate accountability and corporate governance through listing standards. And, the SEC's "real time enforcement" program pursued wrongdoing with alacrity.

Since then, Sarbanes-Oxley emerged, adding legislative fiat with extraterritorial reach to already-existing administrative regulation and securities industry self-regulation. These responses reflect that investor confidence is predicated upon two essential components – an ironclad belief that markets aren't rigged, and comfort that any who attempt to rig markets will be caught and punished meaningfully.

But, it's also important to recall that neither the absence of regulations nor an absence of regulators caused our current crisis of investor confidence. Everything uncovered since the fall of Enron had already been illegal. Does this mean there was no need for new regulations or regulatory activity? Emphatically »not«. Government can ensure that market participants operate in an environment in which certain fundamental principles that benefit the markets, and our economies, as a whole apply. When a crisis of confidence occurs,

the only solution is to provide assurances we've learned from history, and won't merely repeat it. Thus, legislation like Sarbanes-Oxley, and the extensive rulemaking it obligated the SEC to undertake, were necessary – not to ensure that conduct that was already illegal became even more illegal, but rather, to ensure that excuses, ambiguities, oversights, inattentiveness and venality, had even less justification.

The advent of Sarbanes-Oxley brought with it an extended reach of US regulatory jurisdiction, causing consternation, especially on the part of the EU. Thus, it's essential to understand why US rules have extraterritorial reach, and the extent to which that is appropriate or critical.

The primary focus of US securities laws is to protect US investors and promote the quality and performance of US capital markets. When entities transact business in a foreign country, by definition they subject themselves to the possible jurisdiction and oversight of foreign regulators. We saw that when the EU prevented GE and Honeywell from merging due to European competitive considerations.

Equity capital is finite. Since a US investor can invest in US or foreign companies, there is competition for his or her equity dollars. Competitors for those dollars should compete pursuant to the same general standards. If not, some will have an unfair competitive advantage. Worse, disparities in regulatory constraints may cause those subject to higher standards to seek to evade them in favor of less stringent requirements abroad.

A statute with extraterritorial reach is not, therefore, uncommon or even unjustified. Those who play in the same market should be bound by similar standards. Notice I said "similar," not the "same," standards. That's because global markets, governed by global regulators, require global accommodations.

The U.S. in general, and the SEC in particular, has always recognized this principle. There are three critical standards that must be employed in my view in harmonizing different regulatory regimes – equivalence, reciprocity and transparency.

Equivalence, or convergence, means foreign and US regulators must produce standards and rules that are substantively addressed to the same concerns. We are well on the road to achieving that result in the area of accounting principles. Reciprocity requires that what's good for the goose is also good for the gander. Regulatory accommodation is, and must be, a two-way street. And finally, transparency means that, where differences can't be reconciled, they must be disclosed, so investors know what they're getting, and what they're not.

The SEC continues to make necessary accommodations. For example, it extended the deadline for non-US companies to comply with certain of its new rules to July 2005, while most US companies will have to comply by October 2004. Similarly, the SEC granted a series of exemptions regarding membership of listed company audit committees, to accommodate foreign practices that would have made it impossible for companies that trade ADRs in the US to follow Sarbanes-Oxley to the letter.

Conversely, the EU has sought an exemption for EU auditors from Sarbanes-Oxley. Requests of this nature make sense, of course, as will careful consideration of them. More problematic, however, is the letter's suggestion that, in the absence of exemptive relief, it is likely that EU regulations will require US auditors to register with the EU. A tit-for-tat approach is inconsistent with the practices of the EU, and detrimental to developing comprehensive and rational regulatory regimes governing areas of common concern.

The answer lies not in interactions between regulators and those to be regulated, but between regulators. At the SEC, I initiated direct forums for foreign regulators to talk with SEC members and staff, so we could avoid impinging upon foreign regulatory systems. There is a need for more consultation of this sort. It is incumbent upon regulators to identify issues having extraterritorial effects, and to work together before proposing or adopting rules.

Even beyond regulations and regulators, there is more that must be done, and more who must do it. The people who benefit most from the safe and sound operation of our capital markets – accountants, lawyers, securities market professionals, corporate officers and directors – must also assume the burden of making the system work. Confidence only comes if investors believe those who take

their money, or make money from their investments, care about what happens to them. No amount of government, in any form, or in any country, can provide that level of confidence by itself.

Forces outside the corporation, but within the market place, will require companies to pursue investor confidence. For example, rating agencies have indicated they will rate governance in determining debt ratings. This, of course, will have a direct, bottom line, impact on the cost of raising capital in the non-equity markets. Similarly, insurance companies, which have been hit hard in making payments on behalf of those companies that have surfaced with problems, will condition the grant of D&O (Directors and Officers) and E&O (Errors and Omissions) insurance policies, and the premiums for those policies, on the extent to which good governance prevails.

What this means is that, one way or another, wittingly or not, corporations will be compelled to meet new governance standards in order to survive; once they do, our capital markets will again function efficiently as the engines of growth and prosperity they were meant to be.

Thank you.

JÜRGEN STARK
Vice President,
Deutsche Bundesbank

RESTORING CONFIDENCE IN CAPITAL MARKETS

Aftermath of a bursting bubble

The overarching topic of this afternoon's first panel discussion is "The capital markets as a growth engine". Indeed, the ability of capital markets to provide long-term funding for growth-promoting investment has suffered visibly since the waning of the global stock market boom.

The bursting of the stock market bubble, in particular the "new economy" bubble, was accompanied by a series of confidence shocks caused by the confluence of cyclical, structural and political problems. The impact of the market correction was aggravated by accounting irregularities and major corporate failures and scandals. Therefore, a large segment of my remarks will be devoted to the reliability of financial reporting and incentive structures.

Enron and Worldcom are undoubtedly the most prominent examples of abuses and excesses during the preceding boom. Yet in Germany, too, the "Neuer Markt" for innovative enterprises saw its share of fraudulent activities. These scandals – along with the disillusionment at not living after all in a new era with continuously higher productivity growth rates – have dealt the incipient "equity culture" in Germany a major setback.

The drastic stock market corrections involved considerable losses of assets and also massively eroded investors' confidence in capital markets.

The repercussions of this downturn are being felt not only in the financial sector but also in the real economy and have depressed growth perspectives.

It is difficult to determine the extent to which the increased difficulties companies are having in obtaining finance are due to the necessary market correction in the wake of the bubble, the economic slowdown or to the damage to confidence caused by the scandals. It should be noted, after all, that confidence is essential to the ability of financial markets to function properly.

Why is confidence important?

A core function of capital markets is to ensure the efficient allocation of capital. On the markets, investors are constantly assessing and reassessing yield opportunities and the risks associated with alternative forms of investment. An assessment of the risk-return profile of a capital investment in a firm is predicated on reliable financial reporting. In the interests of the capital suppliers – and, of course, other stakeholders as well – a true and fair view of the actual situation regarding assets, liabilities, profits and risks needs to be ensured.

Doubts about the reliability of financial reporting are affecting lenders' and investors' appetite for risks. One sign that uncertainty is on the rise is that companies are finding it more difficult to obtain financing. This is especially true for the funding of young, innovative firms which have the potential to drive economic growth.

I would like to mention just one example to illustrate my point: The number of new companies which were floated on stock markets in Germany has fallen dramatically. Whereas the years 1999 and 2000 saw some 175 and 140 initial public offerings (IPOs), respectively, in 2002 this number fell to less than 10.[1]

Another sign of higher risk aversion is that investors are demanding a higher risk premium: in other words, it is getting more expensive for companies to borrow funds, especially long-term. This is visible in the corporate bond markets, where losses in confidence were accompanied by a rise in credit risk spreads compared with risk-free govern-

[1] Source: Deutsches Aktieninstitut.

ment bonds. In the stock markets, heightened uncertainty is probably part of the reason for the increase in the equity risk premia being sought by investors, which is straining share prices even in the event of unchanged profit expectations.

All in all, restoring confidence in the reliability of financial reporting is the key to helping the corporate sector to obtain finance on more favourable terms. At this stage, it has to be pointed out that this comprises several elements. It is not enough to close loopholes in accounting rules.

Instead, and even more importantly, the incentives have to be strengthened to produce adequate financial reports as well as to certify, to disclose and to analyse them. The remedy must therefore begin with internal and external bodies, i.e. with management, auditors, participating investment bankers and other market participants. Serious misalignments of incentives of these parties and failures of key checks and balances were the core problems in the reported scandals and have to be tackled.

How can confidence be restored?

In order to restore confidence, key standards for the functioning of markets and key incentives for the relevant participants in the market process have to be reconsidered. This is a complex issue and careful work is necessary to improve market foundations.

Authorities always have to figure out which measures should be left to the market process and which issues require public sector intervention. In principle, the public sector should confine its activities to setting the framework or taking "ordnungspolitische Maßnahmen".

The government needs to take measures especially in situations where the self-corrective forces of the market process cannot take hold owing to misdirected incentive structures. One example of a potential public intervention is the codifying of best practices, in order to "lock in" progress in market behaviour and extend it to cover all companies.

In globalised markets, the development of adequate standards and incentive structures is increasingly becoming an international task. Only effective international co-operation among and consultation of public authorities will guarantee the consistency of measures, avoid regulatory arbitrage and create a level playing field for market participants. This does not require identical standards or practices across countries but rather a coherence of measures.

An internationally co-ordinated approach should also prevent cross-border market participants from being subject to conflicting rules or unnecessary multiple strains. This is predicated, however, on giving much thought to where coherent measures have to be implemented. Practical implementation could be left to the national authorities and adapted to local circumstances.

More consistent international standards in, for example, accounting and disclosure rules across countries would also reduce uncertainty resulting from non-comparable financial reporting and, thus, contribute to reducing the cost of capital due to cross-border capital flows. It would also promote a more efficient allocation of capital across countries.

What types of measures can be taken?

Over the last few months, there have been intense discussions by market participants, national authorities and international standard-setters and organisations on a broad range of issues related to potential improvements in financial reporting and incentive structures. In particular, the Financial Stability Forum (which comprises *inter alia* representatives from G-7 finance ministries, supervisors and central banks) acts as a sort of "clearing house" and promotes reform efforts to strengthen the underpinnings of financial markets.

I would like to group these efforts under four main headings.

1. Improvement of corporate governance

Without doubt, personal integrity and competence of all parties involved in corporate interactions remain indispensable in dealing with potential conflicts of interest.

Checks and balances need to be strengthened in order to ensure that CEOs and other executive

board members, supervisory board members, managers, audit and compensation committees and external auditors fulfil their responsibilities and obligations.

In this respect, new domestic and international measures have joined existing initiatives such as the German Corporate Governance Code (so-called Cromme Code) and the German Federal Government's Ten-Point Plan of February 2003. On the European stage, some months ago the Jaap Winter Group likewise presented recommendations which form the basis for an EU action plan expected to come out shortly.

The OECD has announced that it will review its Corporate Governance Code with a view to updating it in the light of the lessons learned and the progress made in developing national standards. This is particularly relevant as the OECD code is one of the 12 key standards for sound financial systems whose implementation is being promoted by the FSF and other international bodies such as the IMF. This is opening the way to strengthening the international benchmark for adequate corporate governance regimes.

Please let me add a related, more general, point. The incentive structures of corporate governance should not encourage a short-term stance of corporate policy. The scandals have shown that some equity-based remuneration schemes have promoted short-term value maximation, which might come into conflict with the long-term interests of shareholders and other stakeholders. Therefore, strengthening incentive structures towards long-termism and sustainability of corporate policy remains an essential issue in which all capital market participants should have a significant interest.

2. The complex web of accounting standards

A key issue in this connection is the debate on the advantages of principles-based accounting systems over rules-based systems. The speed of structural change in the global economy, the vast number of financial innovations and the high capacity of financial engineering, in my view, make a strong case for using a mainly principles-based accounting system such as the International Accounting Standards (IAS). Even in the US, a more constructive stance regarding principles-based accounting standards is becoming evident, though rules are still considered to be an integral element of the US GAAP.

In the EU, all listed companies will be required to apply IAS by 2005. The fact that a convergence project has been initiated by the relevant bodies in Europe and the US, the IASB[2] and the FASB[3], respectively, in order to identify and to develop global accounting standards, is to be welcomed. From a European point of view it must be stressed that convergence is not a one-way street. US accounting standards also need to converge towards the IAS to some extent. In the short term, US authorities should also be ready to accept IAS financial statements of EU companies for listing the US – without reconciliation with US GAAP as is now required.

3. Improvement of auditing

Shortcomings in audit practices and conflicts of interest were the main reasons why the misleading accounting practices of those scandal-rocked companies remained undiscovered for so long. In addition, principles-based accounting standards, owing to their greater discretionary scope, particularly need to be complemented by high-quality accounts audits.

Many countries and bodies have now embarked on initiatives to enhance the quality of audit standards and practices and to limit potential conflicts of interest arising from parallel consultancy work.

There is now a consensus that compliance with audit standards needs to be monitored by means of effective supervision of auditors. A number of countries have now established public oversight bodies.[4] Such action is also necessary in Germany as well as at the EU level. The European Commission is expected to publish an audit strategy in May.

Let me stress, at this stage, that the extraterritorial implications of the Sarbanes-Oxley Act need to be reviewed. This act requires foreign auditors to be registered and supervised in the U.S. if they audit European companies listed on a US stock exchange. The potential prolongation in complying

[2] International Accounting Standards Board.
[3] Financial Accounting Standards Board.
[4] See, for example the Public Company Accounting Oversight Board (PCAOB) in the U.S. which will be chaired by the former New York Fed president William McDonough.

with the registration requirement for non-US auditors, which US authorities are apparently considering, is a welcome step towards a position of greater compromise, but it is not enough. This time should be used to develop and present a European solution for supervising auditors which can be considered the equal of the Sarbanes-Oxley Act so that the mutual recognition of standards and oversight systems can be achieved.

4. Disclosure and market oversight

Disclosure of high-quality financial reports is a cornerstone on which market discipline rests. In the light of financial innovation, disclosure practices have to be updated constantly to provide comprehensive and timely insight into developments of the companies and their risks.

Suitable disclosure policies, however, need to be complemented by functioning market oversight on the part of market participants, such as banks, rating agencies and investors.

Concerning banks, I would like to draw special attention to potential side effects of the fast-growing market for the transfer of credit risk. Without doubt, this market has the potential to contribute to the more efficient allocation of credit risks in the financial system. However, it is worth asking whether banks will still have enough incentives for an ongoing and intense monitoring of the respective debtors even after transferring the bulk of those credit risks to third parties. Therefore, potential investors like insurance companies should strengthen their own credit risk expertise and risk management.

At this stage, the role of rating agencies comes into play, too. As "agents", they assume an important role for their "principals", such as investors and regulators, who delegate their monitoring tasks to these agencies or use them as an additional source of information.

There is no doubt that rating agencies, because of their prominent role in financial markets, have an obligation to fulfil: their methods, should be as transparent as possible – for both the rated enterprises and the other financial market players.

Moreover, market players should also be able to rest assured that the independence of rating agencies' judgements is not infringed upon by conflicts of interest, such as outside consultancy services.

I would like to add a further aspect to this subject. Often, precisely when the economy is performing poorly, rating agencies are accused of being either behind the market curve or of operating procyclically in their judgements. I believe the complexity of the tasks facing rating agencies must not be underestimated, and we should not be tempted to make rash judgements.

Let me also emphasise that private and institutional investors alike should be encouraged to assess the disclosed information prudently in order to make informed investment decisions. There seems to be a need to promote investor education.

Support through appropriate macroeconomic policies

Allow me to sum up. The road to restoring confidence is long and hard. While a loss in confidence happens quickly it takes time to rebuild trust. Many single steps are necessary. Taken together, these measures are mutually reinforcing and suited to strengthening market foundations and restoring confidence.

The restoration of confidence will above all require to overcome the current sluggishness of the global economy. The bursting of the "new economy" bubble has given many sectors a "hangover", akin to the aftermath of a wild party.

At the global level, the corporate sector is still burdened with huge debt, overcapacity and funding gaps in defined benefit pension plans. I suspect it will take some time until the large volumes of debt are reduced, huge losses are absorbed and restructuring measures bear fruit.

Compared with earlier financial cycles, one main difference seems to be that, at least so far, there has not been a severe disruption in the financial system. The financial system has proved to be more resilient than in the past. Nevertheless, banks and insurance companies, in particular in Germany and some other European countries, have come under considerable strains, and their risk buffers have suffered badly.

This development has raised the question as to whether financial institutions are withdrawing

from risk-taking, causing restraints on credit availability. In particular, small and medium-sized enterprises, which represent an essential part of the German economy, have complained about a more restrictive lending policy by banks.

There is no doubt that credit conditions have tightened generally. This reflects the cyclical deterioration in borrowers' creditworthiness as well as a more prudent lending policy on the part of financial institutions. There are some indications that, over the last few months, banks have continued to raise their risk margins on commercial loans. Further measures have been more stringent collateralisation requirements and loan covenants. One of the driving forces behind this seems to be the less favourable and more uncertain economic outlook.

Furthermore, individual banks are consolidating their credit business in order to improve profitability. It should be noted that the pressure to restructure reflects, not least, the high degree of competition in the German banking market. Companies and households have benefited from the existence of a broad range of competitors and relatively favourable financing conditions.

At this juncture, there is no evidence of a "credit crunch" in Germany or elsewhere in Europe. Rather, the credit assessment of banks has become more selective especially vis-à-vis highly leveraged firms and companies at the lower end of the rating spectrum. The ability of financial markets to provide financing is still assured, though probably at higher rates of interest.

Fortunately, the quick end to the Iraq conflict has removed some geopolitical concerns. The financial markets are seeing a cautious easing of tensions. Nevertheless, a number of vulnerabilities continue to exist. They include

- the continuation of anaemic growth in Europe, particularly in Germany, as well as in Japan;
- the fact that the large debt volume of US households makes consumer spending vulnerable to the effects of a lengthy slump;
- the fact that housing markets in some countries, especially the UK and the US, are stretched;
- the vulnerability of foreign exchange rates to disorderly adjustments in light of rising global imbalances.

Against this background, the contribution of monetary and fiscal policy lies, above all, in following a reliable medium-term track. Macro policy should itself not create uncertainty, add to volatility and destabilise expectations.

The current stance of monetary policy, in Europe as well as globally, is highly accommodative. In particular, the monetary policy of the ECB is not a barrier to economic recovery. The best way to help restore confidence is through a steady monetary policy oriented towards maintaining monetary stability. Hectic countermeasures and a short-term monetary policy would, by contrast, only promote the risk of "boom and bust" cycles and would, in the long term, have a destabilising effect.

The requirement of a medium-term strategy applies to fiscal policy as well. A "deficit spending" policy is not appropriate, since potential cyclical effects often dissipate, yet at the same time doubts are created regarding the sustainability of the fiscal position. In Europe, it is therefore essential for fiscal policy to continue to observe its self-imposed rules under the Stability and Growth Pact. A more promising approach would be to tackle the necessary structural reforms, especially in the labour market.

To sum up, improving the regulatory policy framework for market processes and pursuing a medium-term and reliable monetary and fiscal policy are the best recipes for surmounting the current uncertainties and laying the groundwork for a lasting upswing.