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Corporate governance: Implications for financial services firms

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When corporate governance is effective, it helps safeguard shareholders, customers, and employees without hindering appropriate risk-taking. But when it is ineffective, it can have a disastrous impact on these key stakeholders and on the long-term viability of the enterprise. This year's Conference on Bank Structure and Competition brought some of the nation's top policymakers and bankers together to discuss corporate governance reform and the role of financial firms and regulators.

Recent examples of corporate malfeasance have led to greater investor skepticism and increased uncertainty in the equity and credit markets.

On May 7–9, 2003, the Federal Reserve Bank of Chicago hosted its 39th annual Conference on Bank Structure and Competition. This year's conference focused on the effectiveness and appropriate role of boards of directors, shareholders, creditors (including banks), financial regulators, accounting standards, and disclosure rules in governing the behavior of corporate managers. Recently, a number of highly publicized events have highlighted the importance of having an effective corporate governance structure. Once-revered companies such as Arthur Andersen, Enron, Tyco, and WorldCom have been severely damaged, in some cases beyond repair, by failure to follow appropriate corporate governance principles. Thousands of jobs and billions of dollars of value have been lost. Financial services firms have been affected through their credit exposures to firms that followed questionable accounting practices, as well as through their own corporate governance practices.

In his opening remarks, Chicago Fed President Michael H. Moskow emphasized that the recent examples of corporate malfeasance have "led to greater investor skepticism and increased uncertainty in the equity and credit markets." This "uncertainty affects asset prices and can negatively impact the economy," he added.

The corporate governance system can be defined as the interactions among shareholders, managers, boards of directors, and outside auditors and analysts, together with the laws, regulations, and institutions that govern their actions. When this system is effective, it helps safeguard shareholders, customers, and employees without hindering appropriate risk-taking. But when it is ineffective, it can have a disastrous impact on these key stakeholders and on the long-term viability of the enterprise.

Key questions that were addressed during the conference include:

- How should we reform our corporate governance structure?
- What should financial firms be doing to address these reforms?
- How should financial regulators respond? Is there the potential for overreaction?
- What best governance practices exist in the industry? Are they transferable? Does the structure of bank boards significantly affect the extent of corporate governance?

A special theme panel on these issues, featured Susan Schmidt Bies, governor, Board of Governors of the Federal Reserve System; Elizabeth A. Duke, vice chairman, American Bankers Association, and senior vice president, South Trust Corporation; Randall S. Kroszner, member, President's Council of Economic Advisors and University of Chicago; Katherine Schipper, member, Financial Accounting Standards Board; and Kenneth Scott, Ralph M. Parsons Professor of Law and Business Emeritus, Stanford Law School. Other sessions addressed the financial services regulatory and legislative agenda, future directions for the financial markets, banking relationships and corporate behavior, and the potential for extracting information from market and accounting data.

In his keynote address to the conference, Federal Reserve Board Chairman Alan Greenspan was optimistic about both the future of financial services and the state of corporate governance, notwithstanding recent events. Our system of corporate governance "has evolved over the past century to more effectively promote the allocation of the nation's savings to its most productive uses. And, generally speaking, the resulting structure of business incentives, reporting, and accountability has served us well. We could not have achieved our current level of national productivity if corporate governance had been deeply flawed," said Greenspan. Moskow, in a session on the private and public sector responses to corporate governance problems, agreed that the U.S. system of corporate governance is not deeply flawed. "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." He indicated that the success of this system relies on two fundamental economic principles: 1) The incentives of managers should be aligned with the goals of the shareholders; and 2) the firm's financial condition should be sufficiently transparent to enable shareholders to evaluate the performance of managers based on public information.

According to Moskow, the corporate governance system should include checks and balances to make sure that funds are wisely and efficiently invested by corporate managers. Kroszner concurred, adding that the system of checks and balances should be readily observable by outsiders.

Markets versus rules and regulations

Cynthia A. Glassman, commissioner, U.S. Securities and Exchange Commission, who also spoke in the session on the private and public sector responses, cautioned against the unintended consequences of rules and regulations and argued in favor of market-based solutions. "The nature of regulations is that they have general applicability," said Glassman, "and it is difficult to consider and craft a response that is appropriate to all situations." Moskow also discussed the consequence of relying on regulation rather than the marketplace to discipline and monitor managers' behavior. "To be sure, the market will occasionally make mistakes—but the danger in replacing the market with regulations is that regulations typically make even more mistakes than the market. Just recall the unintended effects that the Glass-Steagall Act had on our financial system and the 60 years it took for us to repeal the harmful portions of that Act," noted Moskow.

Glassman said that one of the most important jobs a manager of a public company has is accurate disclosure. "To make sure that the disclosures fairly present the company's financial condition ... managers should spend their time on the critical accounting judgments and corporate events that are most important to ensuring clear and accurate disclosure." Greenspan noted, however, that "although we have made great strides in expanding the volume of publicly disclosed information ... a more complex question is whether this greater volume of information has led to comparable improvements in the transparency of firms." He argued that public disclosure and transparency are not interchangeable, and that "transparency challenges market participants not only to provide information, but also to place that information in a context that makes it meaningful. Transparency challenges market participants to present information in ways that accurately reflect risks. Much disclosure currently falls short of these more demanding goals."

Bies suggested that investors and creditors should be provided with the information necessary to understand the risks that a firm is bearing and those that it has transferred to others. Thomas M. Hoenig, president, Federal Reserve Bank of Kansas City, who spoke in a session on the financial services regulatory and legislative agenda, came to the same conclusion, saying that "a critical goal for us [regulators] to explore is how to enhance market discipline by providing market participants with adequate, timely, and accurate information for making decisions." He indicated that the bank supervisory agencies could help in this area. Bank supervisory agencies make use of proprietary and internal information at each bank, as well as confidential information on customers that, in general, is not available to market participants. While acknowledging that the Securities and Exchange Commission already requires publicly traded banks to disclose any significant news in a timely manner, Hoenig argued that the release of significant or material examination findings could enhance market discipline. "Disclosure of significant examination findings could ... help make a bank's own disclosures more accurate and more reflective of supervisory concerns. At the same time, the prospect

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of having to make such disclosures would provide banks with an added incentive to monitor and manage their risk exposures carefully and to comply with regulatory objectives," said Hoenig.

While Hoenig examined steps that bank supervisors could take to improve the market access to information, Gary H. Stern, president, Federal Reserve Bank of Minneapolis, in the same session, discussed how market information could be used in the supervisory framework. Stern said that market prices of equity, debt, derivatives, and other financial instruments contain valuable information on the riskiness of individual banks, and the risk measures derived from these prices provide useful information that adds to the existing knowledge of bank examiners.

Effective risk-management and transparency practices

Bies discussed how developments in risk-management practices could strengthen corporate governance and market transparency. Risk-management processes are designed to identify risks and report on the effectiveness of internal controls to senior management and boards of directors. During the last two decades, dramatic changes have occurred in financial innovation, financial engineering, and risk-management practices. Financial services firms have altered their operations, shifting away from the management of traditional products, such as deposits and loans, to management of nontraditional products, such as credit derivatives. These nontraditional products have facilitated the separation and reallocation of risks to parties more willing and able to bear them. An important part of this evolution has been the development of methodologies for measuring and monitoring risk. "As companies have become increasingly diverse, and risk-management tools more sophisticated," said Bies, "the time has come for companies, including financial firms, to look at risk in a more formal way across the organization and in all its dimensions."

Greenspan discussed the importance of incentives for effective risk management. He challenged the view that government regulation is essential to ensuring efficacious risk management and stated that "private regulation generally is far better at constraining excessive risk-taking than is government regulation." He noted that "market participants usually have strong incentives to monitor and control the risks they assume in choosing to deal with particular counterparties. In essence, prudential regulation is supplied by the market through counterparty evaluation and monitoring rather than by authorities."

CEO compensation and independent directors

An aspect of the discussion on corporate governance problems is how chief executive officers (CEOs) are compensated. The use of equity-based compensation (stock options and restricted stock) has come under increasing public and congressional scrutiny. While equity-based compensation contracts are intended to encourage executives to take actions that are consistent with the expectations of shareholders, they have not always accomplished this goal. This has led to demands for greater transparency in executive stock option programs and, in some cases, to elimination of the programs.

In his luncheon speech, Jamie Dimon, chairman and chief executive officer of Bank One, argued that compensation has become excessive, indicating that compensation levels are unrelated to how well firms are performing. "This, I put in the category of lack of leadership. It hurts companies; it hurts America; and [that's] why it will have legs in Washington," said Dimon.

The tax code, which states that executive compensation above $1 million must be "performance-based" in order to be tax deductible, encourages firms to pay their top executives with stock options rather than with cash. Moskow suggested several changes in the way firms compensate their top executives. "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," said Moskow.

If stock options are to remain an important part of many executives' compensation, Moskow argued that the contracts should be redesigned to allow for variable strike prices. The current practice of using fixed strike prices has led to enormous increases in executive wealth when the overall stock market rises as it did 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 underperformed those of their peers," said Moskow.

Linking the strike prices to the performance of the company's stock relative to a market or industry index, Moskow said, "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 reset option strike prices at firms whose stock price has declined."

In her discussion on the oversight of executive compensation, Glassman

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suggested that the corporate board could carry out its oversight role by providing appropriate incentives to management, and "compensation is the biggest carrot the board has in terms of incentives." As a principle of good governance, Glassman further suggested that "the compensation committee should be comprised solely of independent directors" and by independent, she meant the "true independence that goes beyond the technicalities of Commission rules or listing standards."

According to Duke, "one of the biggest issues concerning large, publicly traded banks is the definition of director independence." She stressed that the current proposals discussing director independence fail to recognize that banks are different. Banks are different, because they "need a definition of director independence that recognizes that directors should be able to do business with the banks on whose boards they sit. Yet some of the proposals would forbid bank directors from 'purchasing' their bank's products and services." Duke cited the example in which a director of Wal-Mart is not prohibited from walking into the store and buying something, and "similarly, a bank director should not be prohibited from doing business with the bank under the same terms and conditions offered to the public."

During his luncheon speech, Kenneth D. Lewis, chairman, president, and CEO of Bank of America, stressed that it is more interdependence than independence that makes a board of directors strong and effective. He said that while "independence is a very useful tool for insulating some functions from inappropriate influence or conflicts of interest… excessive independence also has disadvantages." Lewis defined excessive independence as "the lack of a meaningful relationship between a director and the company he or she is charged with directing, or the lack of a strong relationship between board members and the CEO." According to Lewis, "it is dangerous to assume a direct correlation between ever-greater degrees of board independence and improved corporate performance." It is not the degree of independence from the company or chairman that determines whether an individual is a strong and effective director, but rather "it is their character, values, strategic insight, business knowledge, and their ability to influence and work well with others. It is their ability to create productive interdependence with their fellow directors."

Scott pointed out that the current corporate governance problems extend well beyond the structure of the board of directors. "The general problem in corporate governance is the principal controlling the agent—the owners trying to control the managers to act in the interest of the principal or owners and not be self-serving. The board is only one device for achieving that kind of control over management," said Scott. He concluded that one really has to look at the structure of share ownership in the firm and at the legal system.

Conclusion

This year's Bank Structure Conference highlighted the importance of having an appropriate system of corporate governance for both financial and nonfinancial firms. Conference participants were in general agreement that our system of market discipline and corporate governance has served us well, but the recent examples of corporate misconduct have revealed areas where repairs are needed. Bank supervisory agencies can play an important role by using internal data and market data in their supervisory framework and encouraging the banking industry to be leaders in strengthening the system of corporate governance. "Banking supervisors will continue to encourage the banking industry to be leaders in strengthening corporate governance, risk management, and internal controls and in implementing transparent accounting and disclosure practices," noted Bies.

The 40th annual conference will be held May 5–7, 2004. The 2004 theme, "How do banks compete? Strategy, regulation, and technology," will focus on how commercial banks have repositioned themselves to compete under new economic, technological, and regulatory conditions. For more information on the upcoming conference, go to www.chicagofed.org.