Statement by Paul A. Volcker
Before the Senate Banking Committee
October 2, 2003

I have submitted, in lieu of a new statement, excerpts from remarks made on September 24, 2003, which directly pertain to the subject of the hearing.

AMERICAN LEADERSHIP AND BUSINESS RESPONSIBILITY

Excerpts from an Address by Paul A. Volcker
Washington University, St. Louis
September 24, 2003

Cast your minds back only a few years to the mid-1990's. Powered both by new technology and the ideology of free markets, the integration of markets internationally was in full swing ……

But then, in the glow of seeming success, something unexpected and disturbing happened. We had a succession of financial and economic crises, first in Mexico and then in Asia, in Russia, and back to Latin America. Those were big setbacks for the emerging world. With few exceptions, individual countries have not yet returned to earlier growth trends ……

In the wake of the crises, the theme of much of the analysis was that the emerging economies were fragile and vulnerable because of long-standing weaknesses in their business practices: in accounting and auditing, in the prevalence of cronyism and corruption, in badly skewed distributions of incomes, and in a lack of respect for the rule of law. If only, the refrain went, those countries would adopt western, and particularly American business practices, then the opening of financial markets would have proceeded more smoothly, with fewer excesses and surprises.

Well, from the perspective of today, all that seems simplistic, to say the least. We have had to recognize that our own stock market performances and accolades of business performance exaggerated reality. Enron, World Com, Tyco, Adelphia, Arthur Andersen – now the New York Stock Exchange itself -- have cast a different light on things. We obviously have a lot of work to do here at home if we are to restore confidence in our own securities markets and make good on our implicit claim to be a model for the world economy.

There are those who would dismiss the scandals as the work of a few bad apples. We are warned not to overreact, at the risk of undermining entrepreneurial energy and the spirit of innovation.

Well, I don't want to over-react, but I have been at least as concerned by a sense of denial or complacency.

I know perfectly well that the great mass of American businesses performs with skill and honesty as they respond to the incentives and competitive pressures in the market place. But we have seen enough examples of malfeasance, misfeasance and non-feasance to know that we are dealing with more than isolated anomalies. The egregious examples are a reflection of a wider willingness to cut accounting corners, to press at the edges of acceptable business practices, to tolerate conflicts of interest and to find elaborate and questionable ways and means around established accounting principles and tax regulations.

The demand for a response and some basic reforms strikes me as entirely legitimate, just as the financial excesses of the 1890's and 1920's led to constructive change that we now take for granted.

Accounting Reform and Sarbanes-Oxley

The accounting and auditing profession, sadly epitomized by the demise of Arthur Andersen, has borne the brunt of the criticism and the reform effort. There is a certain justification in that.

The auditing profession bears a clear and unique burden of attesting to the validity and integrity of a company's accounts. That responsibility of auditors, incorporated in law, runs to the investing public – to the market for private capital – rather than to the companies that hire and pay them. Honesty in accounting and reporting is, after all, the bedrock of the efficient allocation of capital.

There can no longer be doubt that internal conflicts within accounting firms greatly increased in recent years and became essentially unmanageable. All the big accounting firms took a basic decision to become general business consultants and advisors, sensing that those services would be more lucrative than the core auditing function. In the process, the drive for revenues had the consequence of eroding the auditing discipline that lay at the core of their professional responsibility.

This was an area, in my opinion and that of many others, that demanded a legislative response. If reliable accounting and auditing is essential to an effective capitalist system, I have come to realize what a demanding profession it is. There are very large intellectual and practical challenges. It's not a matter of obstructive technicians with green eye-shades, but a most demanding responsibility.

The sad fact is efforts at voluntary reform and professional self-regulation have been weak and ineffective. The need for a legislative response became clear.

The Sarbanes-Oxley Act appropriately deals with three crucial areas.

First the conflicts associated with the spread of consulting services have been sharply reduced. The sale of many non-audit services to audit clients is now prohibited or restricted, leading all but one of the remaining "big four" accounting firms to sell or spin off their lucrative hi-tech consulting practices.

Second, auditing standards and review of actual auditing practices – both revealed by events to have been inadequate -- has been delegated to a new regulatory body, the Public Company Auditing Oversight Board.

Third, the new Board, operating alongside the SEC under strong leadership, should be able to maintain the degree of oversight and surveillance that we have long assumed with respect to our securities market generally. In particular, the SEC now has the leadership, the funding, and potentially the staffing to meet its responsibilities in a world of finance ever increasing in complexity.

In focussing on accounting, auditing, and the SEC, I don't want to lose sight of the responsibilities of other so-called "gate keepers" in the financing process. Accounting firms were not alone in designing and encouraging elaborate schemes to circumvent accounting principles, to dodge taxes, and to embellish and smooth earnings. Far from it, there were battalions of investment bankers, lawyers, consultants, and financial engineers prepared to go to the edge or even beyond ethical practice. Too often they have lent their professional authority to practices of their own clients that fraudulently misrepresent operating results. In the process, investors are ill-served and the long-term prospects for the business jeopardized.

I don't think our great schools of business can entirely escape responsibility. I was taken aback a while ago when one of the leaders of Wall Street, sharing with me his sense of distress about the perceived lapse of standards, commented "What do you expect when our best business schools for twenty years have preached the doctrine that the only measure of success is the price of a company's stock, with the implication that any means of enhancing that price short of overtly criminal or unethical behavior is fair game?"

As I overcame my surprise, I had to agree there was at least a grain of truth in what he said.

Corporate Governance

Here, I would suggest, we are entering an area that is really beyond the ability of law and regulation to address. The discharge of professional responsibilities and methods of corporate governance – the arrangements made to run and oversee the operations of our business firms – seems to me to require a rather different approach. The hundreds of thousands of businesses in the United States, from the tiniest to the huge multinational corporations, can hardly be fit into a common pattern.

If government must tread with caution, there has been no shortage of comment and debate. Dozens of conferences and commissions and learned essays have opined on what, if anything, needs to be done. Long checklists of good practice have been developed – the appropriate size of board, the independence of directors, the emphasis on the auditing committee, appropriate remuneration practices, and on and on. Much of that strikes me as helpful.

But it is also clear one size cannot fit all. In the end, what will count is something less tangible, something that can’t be fully reflected in any checklist of good practice.

Boards of directors tend to be collegial bodies. The natural instinct is to support management. After all, they typically have been chosen by the chief executive officer; at the very least, he or she has heavily influenced the choice of directors. Or, if the CEO is relatively new, the appointment is by the Board, and that also implies a readiness and desire to provide strong support.

The CEO, in turn, naturally looks to the Board for counsel and support of strategic plans, of personnel appointments, succession planning, and the like. In effect, the Board acts in support of management, which raises a rather basic question.

It is the job of the CEO to manage. The basic and unique responsibility of the Board is rather different. It is to oversee – to satisfy itself that the CEO and his team are acting with integrity and in the best long-term interest of the stockholders. That implies a certain distance from the CEO, a skeptical eye, and a concern for other ”stakeholders” important to the success of the corporation. A priority must be attention to the integrity of management.

In sum, directors need to maintain independence – independence in fact as well as in form.

It seems to me, and increasingly to many others, that this is an area in which we need a change from what has been embedded in American corporate doctrine. The argument has been that combining the function of Chairman and CEO focuses responsibility, assures a clear line of authority, and encourages quick and effective decision-making. And so it does.

The difficulty is the “imperial CEO” may not leave much room for the Board to provide really effective oversight. True independence requires effective Board leadership, leadership able and willing to shape the agenda and to encourage full and regular discussion without management present.

My point is that it is difficult at best – and sometimes not possible – for those contrasting responsibilities of management and oversight to be discharged by a single person.

I realize the pattern of a non-executive chairman will not fit all companies. It may well not be suitable for new ventures and small corporations, for privately owned companies or in transitional circumstances. But I do think, for large public companies with widely dispersed ownership, a separation of the oversight and management functions should be recognized as preferable, as indeed is common practice abroad. At the least, companies departing from that practice should be required to explain and rationalize that decision, and to provide for a reasonable substitute such as a "presiding" or "lead" director.

Executive Compensation

I suppose no issue has raised more questions about corporate management and Board oversight than the matter of executive remuneration, in my mind justly so. I have seen reference to a truly disturbing statistic. Fifteen years ago,the average compensation of an American corporation reportedly ran to about 40 or 50 times the pay of the average employee; today that ratio approximates 500 times.

What is it that today produces, as a matter of course, tens of millions of dollars of compensation for CEOs in a single year, and occasional pay-offs of well over 100 million? Does it indeed take that kind of pay to motivate top executives? Are the powerful incentives involved really constructive, or have they encouraged excessive risk and even unethical behavior?

Those are serious questions, too often ignored in what clearly became a kind of competitive game, ratcheting pay higher and higher to maintain parity with one's peers.

One aspect has become rather clear. The escalating patterns of compensation over the past decade or so are, directly and indirectly, a by-product of the wide-spread use of stock options……

In the 1990's, in the midst of the greatest bull market in all of history, those options paid off in amounts far beyond anything that could have been foreseen by the Boards that granted them. The fact is the dramatic evaluation of the overall stock market lifted almost all individual stocks. The result was companies granting stock options richly rewarded their executives even when business performance fell below average. There have been grotesque examples of leaders of failing companies "cashing in" not long before the default. It is hard to maintain that fixed price options without downside risk truly aligned incentives with an ordinary stockholder.

The fact of the matter is that the enormous jump in total executive compensation was a reflection of the largely unanticipated payoffs on stock options in the 1990's. In effect, a new norm was established for executive pay, aided and abetted by the legions of compensation consultants quick to suggest to their clients the importance of maintaining comparable – or more likely, above average - pay.

Look no further than the stated rationale for the amounts paid the executive head of the New York Stock Exchange, once thought of as rather semi-public responsibility. The sums were justified as comparable to the pay of major financial companies, whose compensation is typically importantly in equity shares and stock options.

There is no doubt that stock options can provide a powerful incentive. For cash poor, risky and innovative companies they may well have an important role. In any case, the decision will appropriately be made by the dominant owner or owners. That is a very different situation from the large established public company, with ample financial resources and widely dispersed owners without direct decision-making authority.

Conceptually, the idea that executives and employees should have a stake in the financial performance of their own company surely makes sense. Equity ownership in some amount – taking the risk of losses as well as gains – should help align interests with owners. But taken to an extreme, particularly with heavy use of one-way options, there are demonstrable dangers.

Again, I do not say this is a matter for legislation; it is rather a matter of encouraging appropriate patterns of corporate behavior. Good accounting practices have a part to play. The strong and effective resistance in the past to the expensing of stock options by American business cannot, I believe, any longer be intellectually defended.

Several leading American corporations have recently decided voluntarily to expense grants of options, an approach, I believe, that will soon become required accounting practice right around the world. Others have now gone further, deciding to end fixed-price stock options entirely or to sharply reduce their use……

Conclusion

In sum, we are beginning to see real progress in bringing our practice of auditing, oversight, and corporate governance closer to what we have long preached…..

Most fundamentally, it seems to me, we as a society need to restore and emphasize the importance in the business world of strong professional values and ethical behavior.

I know that can't be legislated, certainly not in any detail. But I don't believe either, as some have argued, it's all a matter of what we have learned at Mother's knee, beyond later influence.

Rather, it seems to me, there is the intangible but real matter of societal norms, broadly understood and recognized, not just as a matter of professional and individual pride. What is at stake is the foundation of a truly democratic, competitive market system……

If this new world of globalization is to be a prosperous and peaceful world – a world in which a democratic system of capitalism is, indeed, the model – we'd better make sure our own markets are performing both effectively and ethically.