

# BLAKE JOHNSON

TO: President Barack Obama  
FROM: Blake Johnson  
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RE: Reviving the World Economy

Reviving the world economy is at the forefront of the endless tasks that the world is asking of you and your Administration. The U.S. economy has witnessed the greatest credit crisis since the Great Depression, and other countries are now suffering the consequences as well. Once-revered companies continue to face pressure as fire sales, failures, and seizures that were considered implausible became an unpleasant norm. The driving factor for the crisis is not risk, but improper handling of risk in their portfolios. In order to repair the global economy, the U.S. cannot dictate the actions of other countries; rather, your Administration must serve as a leader in reforming the business world.

This memo addresses three problems and possible (partial) solutions your Administration ought to consider. First, the memo discusses the widespread use of derivative products and the dangers of unregulated trading; second, the memo discusses executive compensation and how pay caps may not offer the best solution for excessive risk taking; and third, the memo analyzes the shortcomings of the 2005 reform of U.S. bankruptcy rules and its impact on economic growth.

## DERIVATIVES

Derivative instruments have gone largely unregulated in the U.S. economy. The recent fall of the financial sector throughout the world, along with the near-collapse of American International Group because of the use of derivative products, has sparked public outcry for increased regulation of these instruments. Recent financial statements have proven the extent to which derivatives can detrimentally impact a company's health.

The use of derivatives as a mechanism to hedge risk will continue to be an important tool for businesses throughout the world. The dilemma is controlling companies, especially financial institutions and insurance providers, from engaging in speculative practices and in reducing the opaqueness with which these financial instruments.

The Commodity Futures Modernization Act allows derivative instruments to remain largely unregulated. The derivative market was relatively small when the law was enacted, but has since surged as financial institutions and insurance providers became attracted to the potential gains. (According to the Bank of International Settlements, the face value of all derivative contracts totalled \$680 trillion USD as of 2008 year end.)

The dilemma is twofold: derivatives are not openly traded on public exchanges (hence, their valuation is difficult for even the savviest investors to agree upon), and firms provide minimal disclosure about their activities. It is because of these limitations that new regulations should be implemented, not to needlessly impair the market's efficiency, but to expose the latent uncertainty to which both participants and non-participants are vulnerable.

On May 13, 2008, the U.S. Department of the Treasury outlined a plan to analyze regulatory reform for over-the-counter derivatives with the stated goal to work with the Obama Administration to create a

regulatory framework for the derivative market that will (1) prevent activities within the over-the-counter market from posing risk to the financial system; (2) promote efficiency and transparency within the over-the-counter market; (3) prevent market manipulation, fraud, and other market abuses; and (4) ensure that over-the-counter derivatives are not marketed inappropriately to unsophisticated parties.

The most glaring omission is addressing the lack of transparency with derivative instruments. A combination of a public exchange and improved financial reporting practices will reduce the complexity in valuation and limit the asymmetric information that disadvantages investors reliant upon financial statements.

It is no surprise that executives have favoured derivative instruments. First, enormous returns can be generated owing to the fact that non-public trading limits the investor base. Second, there is an insignificant risk of job loss compared to the compensatory rewards that can be gained. The result has been excessive risk-taking that is now leading the public to demand pay caps.

## EXECUTIVE COMPENSATION

The most widely used performance-based compensation mechanism is the use of stock options to align the interests of shareholders with those of executives. Recent research suggests that the sensitivity of stock options to a firm's market performance is approximately thirty times greater than that of cash compensation.<sup>1</sup> However, while short-term equity investors may be well-served by this device, stock options cannot alone serve the diverse interest of a firm's stakeholders.<sup>2</sup>

Executives may engage in excessive risk-taking to maximize the value of their stock options. The worst case is that the executive makes a mistake that renders the options worthless and possible job loss. Shareholders, creditors, suppliers, customers, and employees on the other hand, stand to lose far more.

Some have argued that pay caps may be the best solution; however, limiting incentives to maximize the value of the firm without devising new incentives to serve the interests of a wider class of stakeholders may create a new incentive for mismanagement and perquisites.

Instead, a broader compensation framework should be created that encourages executives to focus on long-term risk and returns. Executives should be evaluated on conventional measures, like stock price and returns, as well as "soft" measures, like being upstanding corporate citizens. Improving compensation practices may require taking a broader view of the firm's constituents and time horizon, rather than over-reliance on annual stock returns.

It is important to note that whatever policy is implemented, it must not discourage risk-taking entirely. The world economy relies on risk taking for economic growth. The goal should be to encourage responsible risk taking; unfortunately, one piece of legislation by the prior administration seriously hampered this.

## BANKRUPTCY

The United States has more bankruptcy filings than any other nation. Pre-2005, filers were allowed to exchange their assets for a full discharge of their indebtedness. Many argued that the U.S. system made it too easy for people to borrow money they had no way, or worse, no intention to repay, and to use their borrowings on unnecessary goods<sup>3</sup>.

The previous administration aimed to reduce this behaviour by enacting The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005. The Act was intended to discourage people from taking

on too much debt by (1) requiring them to pay creditors as much as possible, and (2) allowing courts to waive full discharge debts.

Two problems resulted from the 2005 reform. First, those who had credit problems due to purchasing unnecessary consumer goods without the means continued to do so, as these borrowers still overemphasize the discounting of future consumption. Second, entrepreneurs became less willing to borrow money because their downside risk became too burdensome. Hence, the Act effectively discourages the type of borrowing that bankruptcy ought to permit; that is, the Act inhibits economic growth by discouraging entrepreneurship.

The 2005 Act hinders entrepreneurial activities within the U.S. Stifled innovation and reduced competition adversely impacts the global economy. The U.S. should consider revising the Act to make the rules more forgiving to those that used borrowed money for investment purposes, or by extending limited liability – the hallmark of the American corporation – so that emergent firms can gain financing, spur the development of new products and technologies, and generate job growth. Allowing bankruptcy for honest entrepreneurs will strengthen the domestic and global markets and overcome the most central obstacle to a revival of the economy: the reluctance to take on new risk.

## CONCLUSION

Risk – by improper management, insufficient disclosure, imprudent compensation, and inadequate encouragement – has displaced the U.S. and wider global economy and is preventing recovery. Satisfying the world's appetite for risk requires that the U.S. financial system be recalibrated along these lines; towards that end, this memo identifies three areas for improvement: overly speculative and opaque use of derivative products, social welfare-reducing risk-taking by executives, and discouragement of entrepreneurship under the bankruptcy code. As the financial system is not in a condition to repair itself, inaction will surely protract the crisis. The Administration must dispel the notion that the global economy can or should be returned to its prior course, with its fallacy of returns absent risk.

<sup>1</sup> Hall, Brian J. and Jeffrey B. Liebman. "Are CEOs Really Paid Like Bureaucrats?" *The Quarterly Journal of Economics* Vol 113, No 3 (1998): 653-691.

<sup>2</sup> Tirole, Jean. "Corporate Governance." *Econometrica* Vol 69, No 1 (2001): 1-35.

<sup>3</sup> McArdle, Megan. "Sink and Swim: Bankruptcy Helps the Undeserving - and That's the Way it Should Be." *The Atlantic Monthly* Jun 2009: 30-32.