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A Fair Deal for Taxpayer Investments

Public Directors Are Necessary to Restore Trust and Accountability at Companies Rescued by the U.S. Government

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Executive summary

During the financial markets crash of 2008, the Treasury Department and the Federal Reserve—of necessity—improvised dramatic and aggressive solutions to rescue the financial sector from imminent collapse. A welter of creative regulatory and monetary solutions provided massive amounts of government assistance to rescue private firms from probable failure. However, the benefits of government intervention have so far largely flowed one way only—from the taxpayers to the financial sector—and there has been a marked absence of accountability or transparency associated with these government-provided benefits.

Taxpayer bailouts have become a central policy tool since the onset of the current economic crisis—with approximately $12 trillion dollars to date deployed to support or rescue private companies in total.[2] The de facto policy of providing taxpayer support to struggling "systemically important" companies has produced an ill-defined terrain of shared governance between financial executives on the one hand and federal regulators who hold both the power of government and the power of ownership on the other.

This unusual mix of private and public power requires a more visible implementation of financial accountability to regain the trust of the American public. The American people must know that their interests as taxpayers are being safeguarded, and that as investors they can have confidence that federal intervention into the private markets is following a consistent, well-defined, and transparent process—one which follows well-established guidelines for ensuring accountability, rather than a series of ad hoc approaches. This paper argues that the best vehicle to accomplish this goal is the establishment of public directors[3]—positions of direct representation in the boardrooms of companies that have received significant amounts of government funds and which will provide federal agencies that are the new owners and regulators with a visible structure of accountability.

The prospects for a robust prudently guided financial sector have been substantially clouded by the fact that the both the corporate governance structure and the executive leadership of the financial sector remain largely unchanged—92 percent of the management and directors of the top 17 recipients of TARP funds are still in office. The Obama administration has outlined an ambitious and sweeping plan to reform the regulatory system governing financial institutions and markets. This regulatory reform is certainly indispensable, but perhaps insufficient. The recent market crashes exposed severe deficiencies in the fiduciary obligations and public-regarding culture of financial firms. In order to prevent future crashes, we must not only seek to change how these firms are regulated, we must also seek to change the structures by which they are run. One major issue in this regard is the passivity, insularity, and narrow band of values represented by those who oversee these firms—the directors who make up the boards of the country's largest financial institutions.

A driving force of the 2008 market collapse was the imprudent risk taking by financial sector leaders. The CEO and board of directors of each company have the legal responsibility to make decisions that advance shareholder interest. In the period leading up to the crisis, the conventional wisdom among financial sector CEOs was that the high returns available from mortgage-backed securities, and the highly leveraged balance sheets and off-balance sheet transactions concentrated in exotic financial instruments were the way to maximize short-term profitability and thus advance shareholder interests. This industry-wide consensus proved to be fatally flawed.

Public directors will provide a corrective to the boards of the financial institutions that helped cause the crisis. Public directors can offer increased independence of thought and diverse perspectives among board members. Public directors should be chosen for a strong public service history, financial and corporate literacy, as well as independence from links to the financial sector. The primary aim of the public director appointments should be to diversify traditional board member profiles and to avoid replicating the disastrous pool of narrowly self-reinforcing financial sector conventional wisdom and experience that led to the crisis. As the economy heals, there are troubling signs that banks have not increased lending, and have instead resumed planning risky strategic acquisitions, and excessive compensation practices. Proportional representation by public directors can ensure that systemically-important firms that have any measure of government ownership do not relapse into the homogenous, CEO-dominated boards that were in place before the crisis.

Regulators should determine most of the details of the public directorships—after all, they have the most direct experience in trying to regulate private companies that have received public funds. But the decisions should be made with two critical principles in mind. First, the principle of proportionality should be applied to government investments in private firms. Public directors should be appointed to the boards of directors on a roughly proportional level to the amount of funding received by the rescued firm—and this should include not just purchases of company stock, but other investments and subsidies provided to help support the firm. For example, if a company receives government funding equivalent to 25 percent of its market capitalization, public directors should make up roughly 25 percent of that company's board.

Second, because public directors should represent taxpayer interests, they should have a history of public service, and they should be chosen to provide both intellectual diversity and diversity of perspective gained from individual experience.[4] They should also have experience and expertise from outside of the economic sector in which they serve. Diversity is necessary for good governance, as it breaks up the "groupthink" that too often characterizes corporate boards, which are typically filled by allies of management.[5] And experiential diversity is also important for the appropriate representation of taxpayer interests. When other stakeholders—such as pension funds, unions, or hedge funds—invest major sums in corporations, they demand board representation, and their directors are picked to represent the interests and worldview of these stakeholders. Taxpayers should not be treated any differently.

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