Box 1

THE RECENT SURGE IN US SHARE BUYBACKS: CAUSES AND POSSIBLE FINANCIAL STABILITY IMPLICATIONS

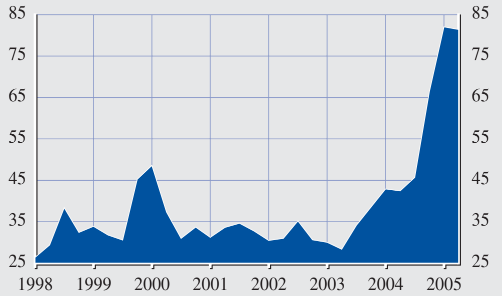
From the second half of 2004 onwards, US corporations retired an extraordinary volume of equity from the market. Throughout 2004 and the first half of 2005, equity retirements in the US non-financial corporate sector exceeded gross equity issuance by USD 1,149 billion. In the first half of 2005, share repurchases by public companies listed in the S&P500 index reached a historical record (see Chart B1.1). This Box discusses some of the causes behind the surge in equity repurchases by US firms, and highlights some of the possible financial stability implications of this.

Companies decide to buy back their shares for a number of reasons. Managers may believe that their best investment option is in the company itself; they may think that the company's shares are undervalued, as a reduction in the number of shares outstanding raises expected earnings per share (EPS), thereby possibly boosting share prices; and finally, they may fear hostile takeovers. As buybacks imply a distribution of profits to shareholders, US companies have repurchased their shares in addition to, or as an alternative to, distributing dividends. Repurchased shares may be either retired, or they may be held within the company. In this case, they may be reissued for mergers and acquisitions, or to meet employee stock options (ESOs) and benefit plan obligations.

Standard and Poor's has largely attributed the recent pick-up in share repurchases to an increase in exercised ESOs and to US companies' desire to reduce their share count outstanding. Among S&P500 companies, buybacks occurred in conjunction with the greatest number of dividend increases since 1998, although on the other hand, in the US corporate sector as a whole, profits have risen at a faster pace than dividends, with the share of net dividends in after-tax profits gradually declining in recent quarters (see Chart B1.2).

Chart B1.1 Share buybacks by S&P 500 corporations

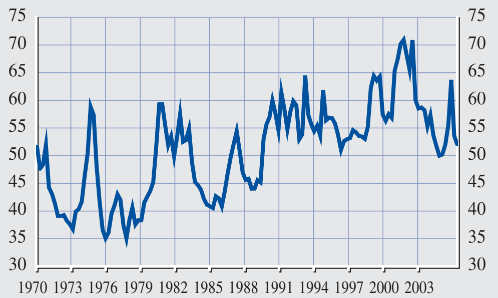
(USD billions)



Source: Standard and Poor's.

Chart B1.2 Net dividends paid out by US corporations

(% of profits after tax)



Source: US Bureau of Economic Analysis.
Note: Profits include inventory valuation and capital consumption adjustments.

Starting in the mid-1990s, the use of non-qualified ESOs to compensate labour has become increasingly common in the US. According to the US National Center for Employee Ownership, in 2003 16.3% of companies granted stock options to at least 50% of their employees. By early 2005, there were an estimated 10 million non-qualified stock option holders, with ESO plans valued at several hundred billion US dollars.

A non-qualified ESO gives the employee the right, but not the obligation, to purchase a company share at a set strike price – which typically coincides with the market price of the share on the day the option is granted – over a specific time after an initial vesting period. Companies award their employees stock options as part of their labour compensation. Options are often seen as a mechanism for increasing employee motivation and retention, as well as a way of better aligning the incentives of employees with those of the shareholders. Furthermore, options provide fiscal benefits and, until recently, accounting-related advantages.

The granting of non-qualified ESOs has led to corporate income tax savings, as the difference between share current market and strike prices when employees exercise the options is deducted from corporate income tax. Such deductions have been extremely large for firms which have made intensive use of ESOs, and whose stock prices have risen. Sullivan (2002)[1] estimates that US corporate tax savings from the deduction of stock options totalled around USD 56 billion in 2000, when options tax deductions exceeded net income for eight of the 40 highest market-capitalised US companies. Graham et al. (2004)[2] show that in 2000, stock option deductions reduced the median marginal tax rate of firms within the Nasdaq from 31% to 5%, and argue that the tax benefits associated with ESOs may help explain the recent downward trend in debt issuance by US corporations, since options tax savings may outpace the value of interest rate deductions.

Until recently, US companies were allowed to decide whether to subtract the value of outstanding ESOs from their income statement reported to the Securities and Exchange Commission – thereby reducing reported profits – or simply to note the expense in a footnote.

1 M. Sullivan (2002), "Stock Options Take $50 Billion Bite out of Corporate Taxes", *Tax Notes*, 18 March, pp. 1396-1401.
2 J. R. Graham, M. H. Lang and D. A. Shackelford (2004), "Employee Stock Options, Corporate Taxes, and Debt Policy", *Journal of Finance*, Vol. LIX, No 4.

As a consequence, the reported profits (and EPS) of companies not expensing their options would turn out higher than the actual ones, possibly increasing the risk of asset price misalignments. Starting from June 2005, the revised Financial Accounting Standards Board (FASB) Statement No 123 requires all US public companies to recognise the value of ESOs (estimated by a single fair-value-based method – option-pricing models –) on the date of issue, and to expense it through the vesting period. In such a way, all US public companies will be forced to treat stock options uniformly, enhancing transparency and comparability of profits. Standard and Poor's estimate that the expensing of stock options would have reduced reported EPS of the companies within the S&P500 by 21.5% in 2001 and by 19% in 2002. Thereafter, following the episodes of corporate malfeasance in 2002, some firms began to expense options. Hence the underlying reported EPS of S&P 500 would have fallen by a smaller amount of 8.6% in 2003 and 7.4% in 2004.

All in all, it appears that by increasing the award of stock options to pay for labour services, US companies appear to have gained some control over their reported corporate performance. Specifically, to the extent that companies have significantly improved their announced profitability, ESOs may have altered the efficient functioning of financial markets, and questioned the reliability of EPS as an indicator of corporate performance. Looking ahead, the new accounting standards may temporarily lead to smaller returns for investors should they lead to a fall in reported profits and EPS. Furthermore, should the leveraged buybacks that some companies are engaged in trigger a fall in the credit ratings of their debt, bond investors may incur unexpected losses.