Compensation and Risk

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17th Bank Research Conference

September 7, 2017

Remarks are Carey's opinions, not those of the Federal Reserve.

Background

- Pre-crisis, almost all literature on compensation focused:
  1. On nonfinancial firms
  2. On senior executives
- But smoking-gun bonus-based informal evidence of agency problems and risk-insensitive incentives during crisis
  - Financial firms are different: Higher risk increases short-term revenue, whereas revenue decreases at nonfinancial firms
  - Agency problems within the big banks; limited liability
- We need analysis and evidence, but it is slow in coming because:
  - Focus on optimal-contract models
  - Data are generally available only for senior executives
- Today's papers provide some evidence

Gao, Kleiner & Pacelli

- Nice addition to the literature: Clear, clever paper making creative use of data to shed light on an important problem.
- Thesis: Imprudent risk-taking incentives associated with loan officers’ volume-based bonuses might be moderated by firing them if loans go bad.

Gao, Kleiner & Pacelli

- Findings:
  - Credit events are followed by increased likelihood of job-changes and demotions
  - Confirms that higher volume increases likelihood of promotion
  - Lending terms get tougher after terminations and credit events, that is, lenders respond to the discipline
  - Unconvincing 2SLS test using home values

Gao, Kleiner & Pacelli

- An alternative story:
  - Corporate loan credit events are cyclically clustered: in this sample, 2000-02, 2008-10
  - Banks with observably riskier portfolios will have more events
  - Such banks will feel more pressure to cut expenses and thus fire more loan officers
    - They are more likely to fire junior people
    - Bigger banks will feel more pressure because volume will fall more for them, and because they are more likely to make very risky loans
    - Lending terms have more cyclical variation for riskier borrowers
- Best fix: Bank-time fixed effects
- Second-best fix: Restrict to rated subsample, use borrower ratings for each loan officer's portfolio as control variable
- Even if the alterative turns out to be true, paper important

Gao, Kleiner & Pacelli

- Key to the story is that loan officers have soft information known only to them (otherwise discipline could be based on observables)
- Authors do 2SLS test of whether credit events instrumented by declines in local home values affect terminations
  - But the finding that terminations are affected supports that terminations are NOT driven ONLY by soft information…consistent with my alternative

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- Nice, convincing paper that finds that employees in the RMBS-creation market were not disciplined by terminations more than other employees
- Little about compensation…implicit in the paper is the idea that the employees profited during the boom years but did not suffer later

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- Measurement:
  - Identify employee population of interest
    - Signers of RMBS proxy statements & similar docs
    - Also identify RMBS people from social media profiles
    - Control groups are ABS and i-banking employees
  - Identify labor market outcomes
    - Paper not clear about this, I assume social media
      - Potential for sample selection here…for example, individuals banned from finance less likely to appear

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- Results:
  - RMBS bankers not less likely to be employed at their firm or at another bank than control groups
    - Junior somewhat less likely…but they are junior
    - All types employees at acquired firms are retained less often
    - Many variants of specification, controls
  - Promotion rates similar
  - Employment not related to DoJ penalties at original employer, nor to RMBS losses or fraud intensity
  - Interestingly, employees of all types from top-25 undergrad schools less likely to remain

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- Quibbles
  - The sample sizes are not large. Core sample of signers of SEC documents is 300ish. That’s around 15 people per top-20 underwriter.
    - Suggests auxiliary question: How many did the fraud?
  - The selection concern noted previously. It would be worse for subpopulations more likely to be banned
  - All types of structured finance and i-banking people likely suffered in 2008-10. But measurement in 2011
  - Overall, as I noted previously, the paper is persuasive

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- Philosophy
  - The paper has a moralistic/legalistic overtone…
    - Premise: Lots of fraud; shareholders suffered; perpetrators didn't
  - Has speculation at the end about why senior executives did not want to punish underlings
  - Has speculation about literature finding punishment in other businesses
  - Notes that lack of prosecution of individuals may be inefficient
- That's all fine, but from a purely corporate governance standpoint, we'd like to have good incentives in the financial services industry. Shareholders should be able to design better setups, even without DoJ. How?