The External Effects of Bank Executive Pay: Liquidity Creation and Systemic Risk

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Recent Spotlight on Executive Comp

• Designed to control the internal effects of managerial decisions.

• Those decisions may also have external effects – a major raison d’être for bank regulation.
  o APRA’s Prudential Practice Guide SPG 511 – Remuneration (November 2013)
  o OSFI’s Corporate Governance Guidelines (January 2013)
  o Swiss FINMA’s 2010/01 “Circular on Remuneration Schemes”
  o Fed’s 2011 Executive Compensation standards

• Major policy relevance.
Paper’s Goal

• Explore here how privately optimal(?) executive compensation affects systemic risks.

\[ \pi = \pi(X(\text{delta, vega})) + \epsilon \quad (1) \]

\[ \sigma_\pi = \sigma_\pi(X(\text{delta, vega})) + \delta \quad (2) \]

• Really nice insight. Operationalized as:

\[ L^M_i = a + b\pi_i + \epsilon_{Li} \quad (4) \]

\[ S^M_i = a + b\sigma_\pi^i + \epsilon_{Si} \quad (7) \]
Creative(!) Identification

\[ L_i^M = a + b\pi_i + \varepsilon_{Li} \quad (4) \]

\[ S_i^M = a + b\sigma_i^\pi + \varepsilon_{Si} \quad (7) \]

- Residuals are orthogonal to shareholders’ benefits.
- Therefore can regress residuals on measured managerial incentives (delta, vega) without further adjustment.
Paper’s Execution

• Execution is well documented

• Show results for the effect of
  • CEO’s delta and vega
  • “Top 5 executives’” delta and vega
Two questions

1. How do we measure the total effects of bank managers’ decisions?

2. Are we sure we have measured all the internal benefits of managers’ decisions?
Question 1: measuring total effects

- Analysis requires measures of the TOTAL effects of managerial decisions.
- Actual measures seem asymmetric: total liquidity vs. external risk effects
- If this is correct, perhaps make more of the first stage regressions’ relative abilities to explain the two dependent variables?
Question 1: Liquidity Measure

- Liquidity - $L_i^M$ is said to be “any available empirical measurement of total liquidity creation”.

- The authors use one due to Berger and Bouwman (2009).

- Puzzled: “A portion of the liquidity created by a financial institution can be viewed as a positive externality to society, because it stimulates future economic activity between parties who are unrelated to that financial institution.” (p. 8)

- How and why?
Liquidity Measure

- I’d have liked a specific discussion of liquidity external effects: how and why?

- Why aren’t bank shareholders short the liquidity created by a bank, leaving zero net (external) effect of bank’s maturity imbalances – at least according to Bouwman and Berger?
Question 2: Orthogonality

\[ S_i^M = a + b\pi_i + \varepsilon_{Si} \quad (7) \]

- If the included variables do not capture ALL of the private benefits from risk-taking, the residual may be correlated with the exec comp parameters, in which case we cannot take the residuals as measuring purely external effects.

- \( \rightarrow \) over-estimation of social (external) effects.

- Good defense: Their Table 6, which adds explanatory variables one-at-a-time, with relatively little effect on estimated coefficients of interest.
Some small complaints about variables

- Liquidity is thought to provide profits, as proxied by

  \begin{itemize}
    \item Private return variables
    \item \textit{Market-to-Book}
    \item \textit{Interest Margin}
    \item \textit{ROA}
    \item $\Delta\text{MktCap/Assets}$
    \item \textit{ROE}
    \item \textit{Expected Return}
  \end{itemize}

  Assets; should be equity?

  Why the change?

However, there is really no basis for complaining about specification here – except insofar as we want to extract ALL the private benefits.
Conclusions

- Fascinating insight/experimental design.
- Extremely relevant to the way regulators think about the world.
- Surprised to see ANY significant correlations in second-stage regressions, which suggests that the authors have really found something worth exploring.
- I hope others can provide constructive suggestions for making the paper more widely read and more influential.