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

Comments by
Mark Flannery

Seventh Conference on Financial Intermediation

Sintra, Portugal July 8, 2017

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'etre* for bank regulation.
  - APRA's Prudential Practice Guide SPG 511 – Remuneration (November 2013)
  - OSFI's Corporate Governance Guidelines (January 2013)
  - Swiss FINMA's 2010/01 "Circular on Remuneration Schemes"
  - Fed's 2011 Executive Compensation standards

- Major policy relevance.

Paper's Goal

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

$$\pi = \pi(X(delta,\ vega)) + \varepsilon \qquad (1)$$

$$\sigma_\pi = \sigma_\pi(X(delta,\ vega)) + \delta \qquad (2)$$

- Really nice insight. Operationalized as:

$$L_i^M = a + b\pi_i + \varepsilon_{Li} \qquad (4)$$

$$S_i^M = a + b\sigma_i^\pi + \varepsilon_{Si} \qquad (7)$$

Creative(!) Identification

$$L_i^M = a + b\pi_i + \varepsilon_{Li} \qquad (4)$$

$$S_i^M = a + b\sigma_i^\pi + \varepsilon_{Si} \qquad (7)$$

- 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

$$L_i^M = a + b\pi_i + \varepsilon_{Li} \qquad (4)$$

$$S_i^M = a + b\sigma_i^{\pi} + \varepsilon_{Si} \qquad (7)$$

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

$$S_i^M = a + b\sigma_i^{\pi} + \varepsilon_{Si} \qquad (7)$$

- 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.

- ➔ 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

Private return variables	
Market-to-Book	Assets; should be equity?
Interest Margin	
ROA	
ΔMktCap/Assets	Why the change?
ROE	
Expected Return	

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.