The Carrot and the Stick: Bank Bailouts and the Disciplining Role of Board Appointments

(by Christian Mucke, Loriana Pelizzon, Vincenzo Pezone, and Anjan Thakor)

Isha Agarwal

UBC Sauder

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  - Do banks actively avoid government board appointments? **Yes**
  - Do government directors improve bank performance? **Yes**

Discussion

- Hard question to answer since private effort is unobservable and the empirical analysis in the paper is an important first step
- Clear discontinuity in the severity of "punishment" at the 6th missed dividend payment allows identification of "costs" of governance mechanism
- Important lessons to better prepare regulators for future crises
- Main suggestions:
  1. Tighter link between the broader research question and the empirical analysis
  2. Mechanisms through which the CPP affected bank behavior (ex ante and ex post incentives)
  3. Heterogeneity tests

Evidence on risk shifting

- Motivation
  - Bank bailouts can be costly because banks engage in risk shifting activities if they anticipate being bailed out
  - If the restrictions associated with bailouts are **costly enough**, it should **mitigate banks' ex ante and ex post risk shifting incentives**
- What does the paper do? It assesses whether these restrictions (board appointments) were **costly enough** for banks
- Great first step. But what does banks' aversion to government directors tell us about their incentives to engage (or not) in risk-shifting activities?
- Does the policy attenuate bank moral hazard? Does it really discipline banks?
- Do banks avoid being punished by being more prudent or more reckless?

Evidence on the disciplining effect for ex post incentives

- Ex post incentive distortion: using government funds to pay existing shareholders or to extract private benefits, leading to missing dividend payment to the Treasury
- How does the threat of a government appointed director affect banks' incentives to engage in such activities?
- The disciplining effect should be highest for banks that stand to lose the most from government director appointments and hence avoid missing the 6th dividend payments
- How do these banks make the 6th payment?

Disciplined banks or do whatever it takes approach?

- Do managers of such banks give up part of their private benefit to make the 6th dividend payment?
  - Do we see lower bonuses or reduction in other private perks for managers in banks that see a large reduction in the probability of missing the 6th payment?
  - Do we see improvement in earnings or reduction in dividend payout?
- Do whatever it takes to generate high return: invest in high return but high risk projects
- More discipline should not affect the bank's risk while risk should go up if banks engage in "do whatever it takes approach"

Evidence on the disciplining effect for ex ante incentives

- How does the policy affect banks' ex ante incentives to engage in risk-shifting activities?
- Cost of CPP is assessed **conditional on being in the program**. Could these anticipated restrictions also affect banks' **willingness to participate in the program**?
- Were all banks eligible to participate in the program?
- Did all eligible banks apply?
- High cost of government intrusion (warrants, general restrictions on CEO compensation) could affect banks' decision to participate in the program
- Results could be an underestimate if banks whose managers enjoy the highest private benefit and therefore stand to lose the most from government monitoring are the ones that choose not to apply
- Do we see banks reducing dividend payout and/or CEO compensation to preserve capital?

Heterogeneity in fear of being punished

- Conditional on having the incentive to "cheat", the governance mechanisms will "discipline" banks depending on their fear of being punished
  1. Probability of being punished
  2. Loss conditional on being eligible for punishment

- Exploit heterogeneity in the probability of punishment
  1. The Vikram Pandit Shock
     - Since all restrictions in the CPP could materialize with a probability, the perceived threat of being fired after missing the 6th payment will be larger after the Vikram Pandit shock
     - Test if banks that miss their 5th payment after the Vikram Pandit shock more strongly avoided missing the 6th payment compared to banks that missed their 5th payment before the Vikram Pandit shock
  2. After 2010, the Treasury announced that it will prioritize board appointments for institutions with greater than $25 million investment.
     - Test if banks above this threshold display a larger reduction in probability of missing the sixth payment after 2010
  3. For banks that missed the fifth payment, the probability of government director appointment is larger for banks that do get a non voting observer

Heterogeneity in fear of being punished

- Exploit heterogeneity in the loss conditional on being eligible for punishment

  1. Cost of missing 6th payment higher for cumulative preferred shares compared to preferred shares

  2. CEOs with low vs high compensation

Effect of board appointments on bank profits

- What kind of directors are expected to make an impact on bank profits?
  - Exploit heterogeneity in directors' professional background
  - How long do they stay?
  - One vs two director appointments
- Which agency problems do these directors fix?

Other Comments

- Do you observe similar discontinuity for missed interest payments?
- Is there a difference between missing consecutive payments vs missing payments over time?

Conclusion

- Important research question
- Careful analysis, a more detailed discussion of mechanisms would enable better interpretation of results
- Encourage everyone to read it!