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

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The views expressed are solely my own and do not necessarily represent the opinions of the Board of Governors of the Federal Reserve System

This Paper

- DEPARTING POINT: bank bailouts can be unavoidable $\rightarrow$ how should a government bailout a distressed bank taking into account the adverse ex-ante and ex-post effects on bank incentives?
- SETTING: exploit the CPP program under TARP, which provided capital to troubled US banks during the 2007-2009 financial crisis
  - Crucial feature: if a bank missed 6 quarterly dividend payments on the securities held by Treasury, the government had the option to appoint up to 2 voting directors on the bank's board

Research Questions

1. **Ex-ante incentives:** do banks try to avoid director appointments by the Treasury? i.e., do banks view these appointments unfavorably?
2. **Ex-post incentives:** does the performance of banks improve after the appointment of government directors?

This Paper

Main Results

1. **Ex-ante incentives:** do banks try to avoid director appointments by the Treasury? i.e., do banks view these appointments unfavorably?

   Yes: banks try to avoid triggering the appointment of government directors on their boards—specifically, there is a discontinuity in the distribution of missed dividend payments to Treasury between 5 and 6.

2. **Ex-post incentives:** does the performance of banks improve after the appointment of government directors?

   Yes: after receiving government-appointed directors, banks' profitability improve, NPLs decline, and earnings management becomes less likely.

MAIN TAKEAWAY:

- Bailouts with conditional government interference in banks' corporate governance can mitigate ex-ante and ex-post moral hazard associated with this type of resolution mechanism

1. Ex-post analysis

- The first set of results (ex-ante incentives) are convincing

  ...but, in my view, the analysis in the second part (ex-post incentives) is still too much on the surface

- Sample limitations:
  - 569 banks in the sample participated in the CPP program
  - 193 (34%) missed at least 1 payment
  - 162 (28%) missed at least 6 payments, becoming eligible to receive government-appointed directors
  - 16 (3% of total, 10% of those eligible) received at least 1 board appointment—26 directors in total
  - 12 treated banks in the DiD (4 dropped due to matching)

1. Ex-post analysis

- While no. treated banks is rather small, try to exploit heterogeneity in the effects as much as possible:

  1. **No. directors** → if 2 directors are appointed, the treatment year is the year of the 1st appointment only. Why not use a continuous treatment variable? Or split the average effect into treated banks with 1 and 2 appointed directors?
  2. **Function of directors** → audit, asset/liability, corporate governance, compliance, compensation, loans, risk, funds management committees
  3. **Previous job history of directors:** from government (Fed, Treasury, OCC—4 out of 16 banks) or from industry?
  4. **Director departures after CPP:** Did the director leave within 1 year of exiting the CCP program or not?

1. Ex-post analysis

- **Current baseline control group:** all the banks in the CPP not subject to government appointments.
  - But treated banks are worse performers than control banks, even if the difference is statistical insignificant (N=56 banks in Table 4).
  - Treated and control banks also likely differ across unobservables.
- **More conservative alternative:** only banks eligible for government appointments (i.e., that crossed the 6 missed payment threshold) but not selected by the Treasury.
- Table A4, Panel B reports these results, which are consistent with the baseline → but matching variables are different: only revenues, a listed dummy, and dummy =1 if Treasury provided more than $25m.
- More importantly → show the event study plots to make sure the parallel trends assumption still holds
  - Selection seems to be an issue: bank size is a strong predictor of the government's decision to whether or not to exercise its option, as well as loans-to-deposits and retained earnings-to-assets (Table 7)

1. Ex-post analysis

- Given the relatively few treated banks, why not use the **synthetic control method** of Abadie et al. (JASA 2010)?
  - In a context in which an intervention affects a small number of units, SCMs can provide several advantages over traditional regression analysis (Abadie, JEL 2021).
  - It relaxes the parallel trends assumption and permits the creation of an optimal synthetic control—a weighted average of the control units which best approximates the treated unit in the pre-period.
- To include FE under the synthetic control framework, the authors could also implement the **synthetic DiD estimator** of Arkhangelsky et al. (AER 2021)—see Lang et al. (AEJ:EP 2022) for a recent practical application of both approaches.

2. Bail-ins

- There's only 1 mention of bail-ins in the entire paper...
  - "Clayton and Schaab (2020) find that in the optimal regulatory regime, bail-ins generally dominate bailouts."
- Bail-ins not only wipe out shareholders and potentially creditors (changing the ownership structure) but also replace managers (changing the governance structure)
- Changes to governance structure only prevalent in bail-ins → not an option but part of a statutory power in the resolution regime that mandates such changes to occur (Beck et al., RFS 2021)
  - Management changes occurred following the bail-in of BES in Portugal (2014), SNS Reaal in the Netherlands (2013), Andelskassen in Denmark (2015), Banco Popular in Spain (2017)
  - Bailouts do not imply an immediate change in governance e.g., Portuguese banks in 2012, Commerzbank in Germany (CEO only stepped down in 2016), Lloyds in the UK (new CEO only in 2011)
- *If governance changes are crucial, why not a bank bail-in instead?*

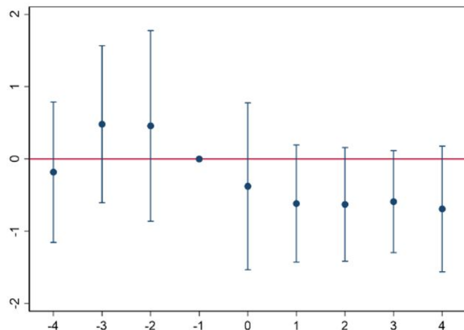
3. Minor comment—theoretical model

- **Contribution:** "In sharp contrast to theoretical papers that do not consider the (temporary) appointment of government directors as an incentive alignment tool, . . . "
- **Missing connection:** Lambrecht and Tse (JFQA 2022)
  - Relative to bank bailouts, bail-ins reduce managerial risk-taking and improve loan quality but also lead to lower levels of credit provision and value created net of recapitalization costs.
- **In their model:**
  - Bailout: government appoints new managers that replace some existing managers and dilute the stake of surviving managers
  - Bail-in: management is replaced

3. Minor comment—abnormal accruals

- Inconsistency in the abnormal accruals results?

Dependent Variable:	Abnormal Accruals
	(6)
Post × Treated	-0.751***
	(0.200)
Post	-0.170
	(0.283)
Observations	425
R^2	0.443
Year FE	X
Firm FE	X



Overall

- Excellent work on a extremely policy-relevant topic!
- Very polished paper $\rightarrow$ only a few comments and suggestions
- Looking forward to seeing it published!