

Discussion of the paper "Bankers' Pay Structure and Risk" by John Thanassoulis

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The concern of excessive risk taking in financial industry

- As it can result in huge negative externalities for society; bank failures, systemic risk, and huge costs for tax payers.
- The worry is that financial institutions take more risks than they would if they internalized all the costs of failure.
- A rationale for intervention/regulation of executive compensation in financial services.
- In particular, how to constrain risk taking behaviour by structuring the banker's compensation packages optimally.
- In general, "agreement" among economists that one should not regulate the level of compensation but rather the structure of compensation packages in financial sector.
- In particular, deferred compensation has been advocated as a solution. (focus away from short termism and excessive risk taking)
- Squam Lake Working Group (2010) ends up recommending the adoption of deferred compensation. Also FSB (2009).

What the paper is about - Sketch of the model & main results

- Focus on banker's pay structure and risk taking behaviour
- Competitive labour market for bankers (CEOs)
- Bankers ranked with ability/type [learn their type after being hired but before investing]
- Banks ranked in size; assets
- Matching of bankers and banks (competitively, banker specific offers)
- Two frictions: moral hazard and risk shifting
- To control moral hazard: short run bonuses needed, but they introduce a possibility for risk shifting
- To control risk shifting; deferred payment needed, but are costly due to inpatience of managers

- Trade off: short run bonuses vs. deferred payments.
- Interestingly now, different types of compensation contracts can be observed in eq.
- It is possible to prevent or allow risk shifting in eq. by choosing the pay structure accordingly.
- Maint point: industrial structure (consolidation) in financial sector \rightarrow type of equilibrium contracts.
- As the banking sector becomes more consolidated, the marginal value of talent goes up, and drives up also the remuneration, thus required deferred payment goes up even faster (due to discounting)
- One has to compare costs of preventing/allowing risk shifting in eq.
- It may be optimal NOT to prevent risk shifting as it is too expensive for the bank.
- Of course, this can be very costly for the society!

This Paper vs Prior Literature

- Builds on Gabaix and Landier (2008) and Edmans, Gabaix and Landier (2008) by introducing moral hazard and risk shifting in the equilibrium model of CEO pay.
- The modelling framework used here is developed in Thanassoulis (2011), where the issues related to the level of compensation in financial sector has been addressed.
- Here, instead focus is on the *structure* of CEO pay; fixed pay, immediate bonus and deferred bonus.
- Novelty: linking the industrial structure of financial industry to equilibrium employment contracts.

Comments

- *Model of Bank? What makes the proposed model as a model of bank as such? What is the feature that is specific to a bank? (Basically applies to all industries.)*
- *Competition: competition on managerial (labour) market plays a key role here - what about the competition between the banks for customers*
- *Talent's role in a story? Is it crucial to have different talents? Alternatively one type of manager who either behaves (safe project) or does not (riskier project) in period one and keep the idea of industrial structure (consolidation) → would go through?*
- *If talent has a role, then changes in structure of executive compensation → not only the behavior of bankers but also the talent pool entering for financial industry at outset. (Here the talent tool pool is fixed)*

- Reservation level of banker's, here $u \geq 0$ for all but if talent has a role, should we have $u_i \geq 0$, and $u_i \neq u_j$ [probably talented managers have possibilities to do career in other industries as well]
- Robustness: risk neutrality of bankers, multiplicative utility function (income effect)
- *Conclusion/implication*: In equilibrium we may have "risk shifting contracts" in place in the financial sector, and especially in largest banks....what to do?
- Should be regulate the size of the banking industry?
- Testing the model in other industries?

Conclusion

- Clearly defined and very interesting research problem with practical relevance.
- If one would have to summarize the MAIN LESSON OF THE PAPER IN ONE SENTENCE. [what would it be?]
- The model and its predictions I believe are more general and go well beyond the banking industry.
- Good luck for revision and publication process!