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Supervising the Supervisors?

• Fascinating yet disturbing observation
• **Current** bankers serve on the board of directors of the federal reserves, who provide regulatory and supervisory role of banks

• Something looks odd

• Why? Imagine
  – Current Fed/OCC regulators sit on banks’ boards
  – Current SEC officials serve on the boards of publicly listed firms
  – Current FDA officials serve on the boards of pharmaceutical firms
What Could Go Wrong?

• Similar to concerns in my mentioned examples,
  – Private access to valuable information
  – Influence policy making process
  – Influence supervising outcome

• Why bad?
  – Other market participants exploited
  – Economic or resource allocation implication
Positive Value

- Federal reserve banks are owned by membership banks

- Director responsibilities
  - Appoint the Reserve Bank President and Vice-president
  - Review budget and responsible for internal audits
  - Select representative to the Federal Advisory Council
  - Advise Reserve Bank President before FOMC meeting

- Value added by having banker on board
  - Provide relevant input on the local economic and banking conditions
  - Facilitate policy making and/or supervision
This Paper’s Contribution

• Formally documents the phenomenon and tests the hypothesis of potential conflicts of interest
  – Why no one has done this before?
• Manually collect information regarding Federal Reserve banks’ directors and information about their nomination and election (1990-2009)
  – Thorough and careful effort
Key Findings

• Documents the characteristics of employers of the elected directors
  – They tend to be larger in asset size and employment
  – These banks make more acquisitions
  – These banks do not have superior performance

• Event Study Analysis: CAR around director nomination and election windows
  – Positive CAR for employers of elected class A directors
  – Stronger result if employers are banks
  – Among banks, stronger result for less well performing banks, for the New York district, during the crisis, or when banks make frequent acquisitions

• Banks with elected directors are less likely to go out of business
Interpretation of Findings

• Consistent with the conflicts of interest hypothesis
• But may also be consistent with alternative hypothesis
  – Certain bank characteristics provide better matches for supervising Reserve Banks
  – Market updates their prior about these characteristics
• More importantly, difficult to prove that (private) values generated by the banks necessarily are “bad news” for the Fed
  – Win-win
• Next, suggest possible ways to trace out such costs to the Fed, market, or the economy
Obtaining Private Info

• Directors may obtain private information regarding
  – local economic conditions
  – information of other bank competitors in the region

• Can we test whether banks of elected directors are able to increase their market share subsequent to director election?
  – Especially in regions with more banking competition
  – When economic conditions are deteriorating

• This is potentially costly, as it can decrease (local) banking competition, hurting consumers and investors
  – Can show by looking at their subsequent market share and interest rates
Influencing Fed Decisions

1. Federal Reserve banks approve (or reject) mergers
   
   – Do we see more mergers by the employers of elected directors when they are in office?
   
   – And, do we see the employer banks achieve better M&A deals (e.g., announcement CAR)?
   
   – Decrease in banking competition
Influencing Fed Decisions

2. Directors advise Reserve Bank Presidents on regional business conditions before FOMC meeting ⇒

Can we look at FOMC outcomes by exploiting the variations in

– The director’s employers ability to influence monetary policy—e.g. using absence of their district’s Fed president in the FOMC meeting

– The director’s employers incentive to influence—e.g., banks with a larger fraction of non-performing loans or lower-quality borrowers stand to benefit more from a lower interest rate
Influencing Fed Decisions

3. Reserve Banks make bank supervisory decisions
   – Banks of elected directors may receive direct benefits in the form of capital injection
   – Some evidence in the literature e.g., TARP
What’s in it for Individual Bankers?

• Most of Class A banker directors are top (84%) or high level (14%) managers
• Opportunity cost of serving on boards extremely high
• Will only do it when the expected benefit is sufficiently high
  – Reputation capital and subsequent career path
• Suggests stronger incentive for
  – Lower rank bankers
  – Managers at smaller banks
  – Younger bankers
• Can we exploit this variation?
Sample Clarification Questions

• Sample sizes
  – 539 unique directors, with 207 class A and 170 class B (pages 11-12)
  – 275 class A elections (page 18) – does this take into account of re-election?
    • Shall we focus on the first time of election?
  – 171 class A and B elections (page 23) – this is for publicly traded firms only?

• Sample selection
  – Variation in availability of election coverage across time and space/bank
  – Missing circulars for nomination/election dates
  – Worrisome if not random
  – Suggest to remove areas or time periods that have substantial incomplete coverage
Event Analysis

• Any other confounding events on the election dates?
• Given the selection concerns, shall we focus on the election dates rather than nomination dates?
• Explicitly show the CAR results for
  – non-bank employers (of elected directors)
  – Class C director nominations/elections
• Some interesting but puzzling results
  – Significant negative CAR in (-30,-2) window before director nominations
  – Significant negative (-30,-2) CAR for Class A contested elections
  – Significant negative (+2, +30) CAR for Class B contested elections