Bankers on Fed Boards: Is Good News for the Banks Bad News for the Fed?

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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 $\Longrightarrow$

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