CEO Ownership, Risk Management, and Bank Runs at Unlimited Liability Banks During the 1890s

(by Anderson, Choi, and Rhee)

Discussion by Sasha Indarte
Wharton, UPenn

Can skin in the game reduce manager risk-taking?

- Setting: 1890s California banking sector
  - Bank managers had significant on and off balance sheet exposure
  - *On* balance sheet: significant equity holdings (30%, 15-18% for presidents)
  - *Off* balance sheet: liable to deposit holders in the event of bank failure

- Find a large relationship between off balance sheet exposure and unsecured % of loans
  - 1 SD increase in president's off-balance sheet holding ➔ 13pp lower unsecured %

- Results are consistent with other evidence from same era
  (Calomiris Carlson 2016, Koudijs Salisbury 2020, Koudijs Salisbury Sran 2021)

Comment 1:

Why might *off* balance sheet exposure limit risk-taking more than *on* balance sheet?

Differences between off and on balance sheet exposure

- Here, off balance sheet exposure only matters in the event of **failure**
  - Corresponds to losses in event of failure
  - Noisily related to expected gains in the absence of failure
  - It’s **like selling a put option** on the bank

- On balance sheet exposure could have competing effects
  - Risk-taking could increase value of shares in the short-run
  - Is short-termism offsetting disincentives to mitigate risk?

- Why would on balance sheet exposure matter **after** the Panic of 1893?
  - Salience of risk reducing short-termism?

Comment 2:
What influences manager exposure to bank risk?

Manager preferences for risk

- What could shape the relation between risk preferences and exposure?
  - Selection: **risk-seeking** people may prefer higher exposure/banks where high exposure is the norm
  - Reverse causality: **risk averse** managers are willing to accept higher exposure when good risk mitigation measures are in place

- Selection could attenuate estimates, reverse causality could exaggerate
  - Possible to find other information on presidents to assess their risk preferences? Other investments? Leverage?

- **Policy significance:** if we mandate managers have high exposure will that lead to more adverse selection (i.e., risk-loving managers)?

Manager expectations

- Optimistic managers should be more willing to have high exposure
- Excessive optimism: high exposure associated with **worse** outcomes
- Rational optimism: high exposure associated with **better** outcomes
- Findings are more consistent with rational optimism
  - Can you find any letters/writing from bank presidents reflecting their beliefs? Did low-exposure presidents anticipate greater vulnerability/risk?

Conclusion

Misc. comments

- IV would be subject to the same selection issues and possibly exclusion restriction violations (likelihood of depositors running, access to capital, etc.)

- Why does the number of banks ***increase*** between Tables 6 and 7
  - Wouldn’t it, if anything, be lower from banks exiting because of failure?

- Would love to see a scatter plot version of the regressions (to get a sense of whether any particular observations are driving results)

- Why probit and not linear probability model?
  - LPM is more transparent and less vulnerable to model mis-specification

In conclusion…

- Very interesting paper!
- Important Q: how can regulators incentivize bank managers to avoid excessive risk taking?
- Analysis sheds light on an important historical financial crisis
  - Differences in regulatory environment are relevant to modern policy debates