Session on “Risk Management”

Tobias Berg

“Playing the Devil’s Advocate: The Causal Effect of Risk Management on Loan Quality”

Olivier De Jonghe, Maaike Diepstraten and Glenn Schepens

“Banks’ Size, Scope and Systemic Risk: What Role for Conflicts of Interest”

Bob DeYoung
University of Kansas
Discussant

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- Both papers report interesting empirical findings about bank risk.
- In both papers, the results are economically large and very robust.
- High quality work, but both papers leave me unsatisfied:
    - To make full sense of the reported results, we need to learn more about the underlying phenomenon being studied.

Berg (1)

- **Mortgage loan applications at a large German bank**
  - Risk managers on salary.
  - Loan officers on bonus pay (by loan volume).
  - <u>Policy change in May 2009</u>: Risk manager approval is now required for a broader set of accepted loan applications.

- **Headline result:** Defaults declined by over 50% in the newly treated loan category.
  - Robust to various econometric methodologies.

- **Direction of the result is no surprise.**
- **Magnitude of the result may or may not be a surprise.**

Berg (2)

- **<u>More direct</u>: Why not change loan officer incentive contracts?**

- **Banks have long rewarded loan officers based on loan volume.**
  - So these incentives must be solving a problem.
  - Retail lending is a sales culture. In a sales culture, volume-based incentives are efficient!
    - In a loan securitization model, sales culture is strong.
    - In a loan portfolio model, sales culture likely weaker.

- **The point is that synergies/gains to specialization exist:**
  - Give loan officers incentives to maximize sales.
  - Pay risk managers to weed out the mistakes.

Berg (3)

- **Policy change was implemented in 2009.**
  - Mortgage defaults were very high at the time.
  - Economy had entered a downturn.

- **Why didn't the bank implement this policy during the previous expansion?**
  - Perhaps this policy is <u>not efficient</u> during expansions?
  - Does the optimal balance between (a) loan officer sales incentives and (b) risk manager involvement shift across the business cycle?

- **Future research. Cannot be addressed using data in-hand. But crucial for understanding the efficacy of this policy.**

Berg (4)

- **Similarly, how did the policy change affect other aspects of the bank's performance?**
  - Earnings?
  - Growth?
  - Loan portfolio mix?

  - Loan officer turnover?

De Jonghe, Diepstraten and Schepens (1)

- **Traded banks from 76 countries, 1997-2011.**
- **In this panel, how is systemic risk related to bank size and bank noninterest income?**
- **Authors find a very robust empirical result.**

"<u>The Result</u>"

- For small banks, systemic risk <u>increases</u> with noninterest income share.
- **For large banks, systemic risk <u>decreases</u> with noninterest income share.**
- "The Result" kicks in for banks with assets > $2 billion.

De Jonghe, Diepstraten and Schepens (2)

- **"The Result" is an empirical regularity in the data. But:**
  - No ex ante theory is offered that predicts it.
  - No ex post explanation is offered to explain it.

- **I would really like to know <u>why</u> and <u>how</u> "The Result" obtains.**
  1. How (and why!) is systemic risk related to bank size?
  2. How (and why!) is noninterest income related to noninterest income activities?
  3. Why (and how!) does bank size neutralize the systemic risk effects associated with noninterest income?

- **Any investigation of these primary questions should start by identifying the channels through which these effects occur.**

De Jonghe, Diepstraten and Schepens (3)

- **A second empirical finding:** "The Result" occurs only in countries where it is difficult to exploit conflicts of interest!

- Potentially intriguing. By neutralizing conflicts of interest, a country can get the following pleasing outcome:
  - Increased bank size ➔ offsets the systemic risk-increasing effects of noninterest income.
  - …Or is it the following?
  - Increased noninterest income ➔ offsets the systemic risk-increasing effects of bank size?

- Until we have a fuller understanding of "The Result," we cannot begin to understand this governance result.

De Jonghe, Diepstraten and Schepens (4)

- **Median bank in the data has assets = $2 billion.**
  - A substantial number of banks in the data are not systemically important.
  - Over half the banks are U.S. banks.

- **Authors use MES as their proxy for systemic risk.**
  - A default event—or at least a high probability of one—is a necessary trigger for systemic risk episodes.
  - **MES** measures asset volatility (bank i's stock returns on the worst 12 market trading days of the year).
  - **MES** includes no information about a bank's equity cushion.
  - Why not use **SES**, which captures both asset volatility <u>and</u> financial leverage.

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