

Discussion of “Compensating Financial Experts” by Vincent Glode and Richard Lowery

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¹The views expressed in this discussion do not necessarily reflect the views of the Federal Reserve Bank of Richmond or the Federal Reserve System.

What is This Paper About?

1. Why are traders paid so well?

- Senior fixed-income traders' income (2009): \approx \$1 million

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 - Senior fixed-income traders' income (2009): \approx \$1 million
2. Should banker pay be regulated?
 - Dodd-Frank, Fed doing this now

Model Basics

N firms

Measure ξ of risk-neutral traders, β reservation wage

Stage 1: Each firm hires a measure of traders

Stage 2:

Firms randomly matched with equal probabilities ($1/(N-1)$).

Who is buyer and seller is also random

Can trade security with common value v

$$v = \begin{cases} v_L & \text{prob } 1/2 \\ v_h & \text{prob } 1/2 \end{cases}$$

Gain from trade of 2Δ

Model Basics: Traders

Basic Model

- Seller's traders give signal about v .
- More traders give better signal.

Full Model Can also use some traders to increase Δ

Ultimatum bargaining: Buyer makes take-it-or-leave-it offer.

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Ultimatum bargaining: Buyer makes take-it-or-leave-it offer.

Seller information matters for bargaining

Hires few traders - improve bargaining, social **deadweight cost**

Hires too many traders - also **adverse selection**

- If seller signal too good
- Buyer offers low price
 - If offers high price - seller only sells when v_L
- Lose some gains to trade

In equilibrium don't hire "too many" traders

Basic Model Results

Low Supply of Traders ($\xi < (N-1)\frac{\Delta}{v_h-v_l}$)

$$w = \frac{v_h - v_l}{2} \frac{N}{N-1} \approx \frac{v_h - v_l}{2}$$

$\frac{N}{N-1}$ reflects that hiring reduces counterparty hiring

High Supply of Traders ($\xi > N\frac{\Delta}{v_h-v_l}$)

$$w = \beta$$

Intermediate Supply of Traders

For reasonable N , region too small to worry about

Full Model Results

Traders do valuation or improve gains from trade
 m_i is firm i traders devoted to gains from trade

Low Supply of Traders ($\xi < (N-1) \frac{\Delta}{v_h - v_l}$)

Wages of bargaining traders still

$$w = \frac{v_h - v_l}{2} \frac{N}{N-1} \approx \frac{v_h - v_l}{2}$$

Wages of surplus-creator traders

$$w = \max\left\{\frac{v_h - v_l}{2} - \frac{1}{N-1} \Delta_2(m, m), \beta\right\} \approx \max\left\{\frac{v_h - v_l}{2}, \beta\right\}$$

Again, reasonable value of N should be very high.

Punchline for Wages

$$w \approx \frac{v_h - v_l}{2} \quad \text{or} \quad w = \beta$$

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Wages depend on variability of v **and** seller acquiring private information **or** depend on reservation utility (β).

- Private information essential
- Otherwise, traders just do surplus creation and are paid β .

Reservation utility is exogenous, so that implication doesn't explain high pay.

Implications

Pay level tied to variability of security's value v

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An aside Suspect that trader pay is right skewed

- Like earnings, CEO pay, etc.
- Does theory have anything to say about that?

Final Comments

Model is random matching with inefficiencies from bargaining and hidden information

Maybe useful for thinking about pay and trading inefficiencies

- Also applicable to bilateral markets like real estate, labor hiring

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Implications for regulating banker pay

- Come from the inefficiencies above
- These inefficiencies are **not** what motivated the banker pay regulations
 - Reg writers believe that pay structure is connected to bank risk