Discussion of "Incentive Compensation, Accounting Discretion and Bank Capital" by Timothy W. Koch, Dan Waggoner, and Larry D. Wall

Ned Prescott[1]

Federal Reserve Bank of Richmond

November 24, 2014
Southern Economic Association

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

What this Paper is About

Incentive compensation banking regs

- Push towards deferred equity
- Designed to reduce bank risk
- But, also effects earnings management

Earnings management

- Effects cyclicality of buffer (capital + LLR + hidden earnings)

Finding

- Use of more equity in comp is a force for a procyclical buffer
  - But only when a manager is selling stock
- Want a countercyclical buffer (up in good times, down in bad)

Note: customary usage of countercyclical is referring to its effect on credit not on levels of the buffer.

Assessment

General idea is a good (and old) one

- Rules that focus on one problem may have effects elsewhere

Assessment

General idea is a good (and old) one

- Rules that focus on one problem may have effects elsewhere

The Challenge

- Paper is ambitious
- Lots of elements
- Points at a potentially important issue, but not all the way there yet

Model

$t = 0, 1, 2$
risk neutral manager

$t = 0$, manager sees LE_1 and LE_2
$t = 1$, manager reports RE_1
$t = 2$, RE_2 realized

LE - latent earnings
RE - reported earnings

Model (cont.)

Manager has discretion, can adjust earnings by DA where

$$-MAXDA \leq DA \leq MAXDA$$

$$RE_1 = LE_1 + DA$$
$$RE_2 = LE_2 - DA$$

Model (cont.)

Manager has discretion, can adjust earnings by DA where

$$-MAXDA \leq DA \leq MAXDA$$

$$RE_1 = LE_1 + DA$$
$$RE_2 = LE_2 - DA$$

Manager only affects timing of earnings. So no real risk to bank.

Manager

TE_t - target earnings

If target met

$$pay(RE_t) = fixedbonus + share\ \ of\ \ earnings\ \ greater\ \ than\ \ target$$

If target not met

$$pay(RE_t) = -share\ \ of\ \ earnings\ \ less\ \ than\ \ target$$

(presumably, salary too)

Target earnings and contract form exogenous

Manager

Manager chooses DA in $t = 1$
Sets up two subproblems: one if TE_1 met and one if not.
Solves both for interior solutions.

Note: What if $DA = TE_1 - LE_1$? Then solution not interior to subproblems.

Stock Market Extension

Extends model to allow for stock, which manager can sell.

- Adds shock to LE_t and $MAXDA$ (now some risk)
- Market prices stock
  - Based on expectation of LE_t based on observations of RE_t

If manager selling stock, then wants to manage earnings

- So more equity comp can lead to more incentives to manage earnings
- They want to argue this lowers buffer during good times
- Why not just use restricted stock?

Theory Comments

Paper is really an earnings management model

- Analysis points out that this potentially has implications for assessing compensation regs

What would help the paper

- Solve for the optimal contract
  - Now, restricts to bonus plus linear share, fixed target
  - Owners would adjust compensation parameters in response to regulations
    - Definitely happening in Europe
- Missing the risk element
  - Not really in model
  - Cash flow is not affected by discretionary reports
  - Maybe could add dividend payouts to bring some risk in

Empirics Comments

Executive compensation data used as motivation

- Murphy (1998)

Lots of changes in compensation form since then

- Stock options replaced by restricted stock, etc.
- Have data on split between accounting based and stock based compensation
- Need to update

Furthermore

- Most CEOs own some firm stock and some own a lot
  - Clementi and Cooley (2009)
- Need to also take these holdings into account when assessing the incentives to manage earnings
- For established manager, these probably more important than one-year compensation contract for incentives