The Revolving Door for Financial Regulators

by

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Comments by

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Concerns with Regulatory Revolving Doors

- Individuals sometimes become government regulators of the private sector firms that formerly employed them.

- The concern is that these regulators may treat their former employers favorably.

- In other cases, former regulators (and legislators) take positions in private sector firms and work or lobby on regulatory matters.

- These ex-regulators may have gained their position by treating their current employers favorably in the past.

- Or they may have connections with, and sympathy from, their former government colleagues on regulatory matters.
Motivation of Current Paper

- The Shive and Forster paper focuses on this latter situation in the context of financial firms hiring their former regulators.

- They consider the “influence buying” motive for such hiring, but they also consider a socially beneficial motive: an ex-regulator’s expertise improves the firm’s risk-management.

- Note that a (small) financial firm might indirectly hire an ex-regulator by hiring a consulting firm that employs ex-regulators.

- For example, one quarter of the employees at Promontory Financial, a.k.a. the “Shadow O.C.C,” were former regulators.
Data

- The paper does a nice job constructing a dataset on high-level executives who were regulators before being employed at financial firms.

- Some data construction questions/issues:
  
  1. What defines a regulator? Does a banker serving on a regional Federal Reserve Bank’s Board of Directors count as being a regulator?

  2. Measuring distance from a firm to its regulator: Many Federal Reserve Banks have Branch Offices (that have separate Boards of Directors) $\Rightarrow > 12$ cities?

Aside: might closeness to a regular be an instrument for hiring (due to lower moving costs)?
3. **Survivorship Bias?** A firm that hires a regulator but soon fails or is rescued by another firm might be missing from the sample. (e.g., Wachovia, WaMu, Bear Stearns, Lehman, Merrill Lynch)

4. **Regulator Experience:** firms might hire regulators with little experience at lower level positions not recorded in Boardex.
The paper finds a positive abnormal stock return when a firm announces the hiring of one of its ex-regulators.

That investors believe hiring regulators adds to shareholder value is an interesting result.

Why might an ex-regulator add to shareholder value?
1. Better risk management expertise raises firm value.
2. Better ability to buy influence from the regulating agency raises the government’s subsidy to the firm.
3. Regulator’s acceptance of employment is certification of the firm’s quality.
4. Hiring of regulator signals that the firm is committed to implementing reforms.

So multiple motives could lead to a positive stock reaction.
When Are Regulators Hired?

- Perhaps the most interesting finding is that financial firms tend to hire regulators when they are in regulatory trouble.

- However, hiring an ex-regulator is not associated with the firm paying lower penalties due to regulatory violations.

- These findings are consistent with at least two actions. The firm:
  1. does not use the ex-regulator to buy influence.
  2. hires an ex-regulator when penalties are expected to be very high, and the ex-regulator uses influence to reduce penalties to a normal level.

- This illustrates the endogeneity of ex-regulator hires. Is there an instrument that can sort out these motives?
The paper finds that after a firm hires one of its ex-regulators:
1. the firm’s stock return volatility declines.
2. capital ratios improve.
3. loan loss provisions decline.

But recall that firms hire ex-regulators when they are in regulatory (and perhaps financial) trouble.

Might these improvements simply be a reversion to normalcy conditional on the firm surviving (and being included in the data sample)?

Might a better control be to match these firms to similarly-distressed firms that did not hire a regulator?
Conclusion

- This paper compiles a unique dataset to analyze an important topic.

- It uncovers interesting statistically significant relationships consistent with ex-regulators improving a firm’s performance.

- If an instrument for regulatory hires could be found, the paper might provide more convincing evidence of a causal relationship.