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Financial regulation in geographically-segmented executive labor markets: Evidence from TARP☆

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ABSTRACT

Prior literature finds that the Troubled Asset Relief Program's (TARP) executive pay restrictions imposed significant labor market costs on participating banks. I investigate whether outcomes studied in prior literature vary cross-sectionally with the local labor market conditions surrounding the headquarters of TARP participants. Results suggest that the costs borne by banks and their executives from TARP participation are significantly influenced by the strength of executives' local employment alternatives. My evidence suggests that executive labor markets in the financial services industry are geographically segmented, and that regulatory intervention in pay can impose differential costs on firms depending on their geographic location.

1. Introduction

Over the past several years, policymakers have increasingly viewed executive pay regulations as a means of moderating risks and incentives in the financial services industry. Critics argue that significant regulatory interventions in executive pay practices can have unanticipated consequences on firms' ability to remain competitive in the market for executive talent. A recent example is the U.S. Treasury Department's Troubled Asset Relief Program (TARP), which imposed a series of executive compensation restrictions as a condition of banks' participation. Subsequent empirical research provides evidence generally consistent with the view that the costs of compliance with TARP's executive pay restrictions were significant. Compensation concerns reportedly influenced banks' initial participation in TARP, banks' election to repay TARP funds early, and executives' decision to depart from participating banks (e.g., Bayazitova & Shivdasani, 2012; Cadman, Carter, & Lynch, 2012).

Largely overlooked in prior analyses is whether the costs of financial executive pay restrictions vary cross-sectionally as a function of individual banks' geographic location. Although prior research has traditionally assumed top U.S. executives operate in a nationally segmented rather than geographically segmented labor market (e.g., Kedia & Rajgopal, 2009), recent evidence suggests that geographic location plays a significant role in determining top executive mobility (e.g., Bouwman, 2012; Francis, Hasan, Kose, & Waisman, 2012; Yonker, 2012). This study investigates whether local labor market conditions surrounding banks' headquarters induce cross-sectional variation in a range of corporate outcomes associated with TARP's pay restrictions.

If U.S. banking executives operate in a highly fluid national labor market, banks' executive retention concerns associated with TARP's pay restrictions should be independent of banks' geographic location within the U.S. Conversely, if executives' external employment alternatives are geographically constrained, then the costs imposed by TARP's pay restrictions will be determined by the strength of banking executives' local labor market opportunities. In labor markets characterized by strong outside employment opportunities, the costs of TARP's pay restrictions are expected to be borne primarily by the participating bank and its shareholders. Executives affected by TARP's pay restrictions in a fluid labor market can readily obtain alternative employment, leaving banks participating in TARP at a disadvantage in recruiting and retaining executive talent. As labor market frictions increase and employment opportunities decrease, the costs of TARP's pay restrictions will be borne more heavily by the affected executives, who are more likely to remain with their current employer despite adverse changes to their compensation.

My empirical results suggest that the costs of TARP participation on banks and their executives vary cross-sectionally in ways generally predicted by variation in local labor market conditions. Overall, my findings indicate that banks operating in areas with stronger employment alternatives faced greater costs associated with TARP's executive pay restrictions. Results from this study suggest that a blanket restriction on financial executives' compensation can impose differential costs on banks in ways possibly unanticipated by regulators.

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Results from empirical tests provide some evidence that local labor market conditions influenced banks' decision to participate in TARP. In addition, local labor market moderated the relationship between executive pay levels and the likelihood of accepting TARP funds, as well as the relationship between executive pay levels and abnormal returns surrounding the U.S. Treasury Department's announcement of additional TARP-related pay restrictions on February 4, 2009. My results suggest that the timing of banks' repayment of TARP funds was influenced by executive turnover concerns associated with the strength of executives' local employment opportunities.

I next consider whether local labor market conditions are associated with changes in compensation levels among TARP participants. TARP prohibits certain forms of executive pay such as cash bonuses and stock option awards but places no restrictions on other forms of pay such as executives' salaries. However, my empirical tests find no evidence that banks headquartered in more fluid executive labor markets respond to TARP's pay restrictions by increasing unrestricted forms of pay. Finally, I find that local labor market conditions help explain incremental executive turnover in TARP recipients after TARP's passage.

My study extends existing literature that explores the parameters of executive labor markets in at least three important ways. First, it shows that geographic segmentation of top executive labor markets exists even in the financial services industry, where executives are considered to be particularly mobile due to their lack of reliance on firm-specific inputs such as patented processes or technology (Baily, 2010). Second, it demonstrates that cross-sectional variation in local employment opportunities moderated a variety of corporate outcomes that prior literature has linked to TARP's pay restrictions. Third, it strengthens existing evidence that TARP is associated with greater executive turnover (e.g., Cadman et al., 2012).

Policymakers contemplating future intervention in executive compensation practices can benefit from understanding how geographically-segmented executive labor markets lead to cross-sectional variation in policy effects. Although it is likely unfeasible for regulators to implement different policies across different geographic regions, results from this study can help regulators anticipate the extent to which the net effect of future policies is likely to be consistent with or stray from policy objectives.

2. Institutional details on TARP and the financial services industry

The Troubled Asset Relief Program was established in October 2008 to stabilize the U.S. financial system by stimulating loan supply in the economy. This object was at least partially met according to Li (2013), who finds that infusions of capital under the TARP program are associated with increases in lending by TARP participants. However, TARP also imposed a series of executive compensation restrictions as a condition of banks' participation in order to protect taxpayers' money from being used to overpay financial executives benefiting from bailout funds. Regulators also expressed concern that executive compensation packages in the banking industry promoted risk-taking. This notion is supported in the academic literature by Chen, Steiner, and Whyte (2006), though Fahlenbrach and Stulz (2011) argue that executives' pay incentives are not to blame for the financial crisis.

Table 1
Sample selection of TARP participants.

Start with 283 TARP participants listed as a “public bank” on the ProPublica website	Number of firms remaining
Eliminate:	
Firms for which no CIK can be located	275
Firms with no Compustat coverage or missing Compustat data	243
Firms with insufficient CRSP coverage	220
Firms missing proxy statements used for executive compensation data	219
Firms with insufficient MSA-level data	212
Final sample of TARP participants	212

2.1. TARP's executive compensation restrictions

Although compensation restrictions for TARP participants were announced as part of the Emergency Economic Stabilization Act (EESA) passed in October 2008, the precise form of those restrictions evolved over the proceeding several months.[1] The original pay guidelines required “clawbacks” of any incentive compensation paid for earnings that later proved to be inaccurate, restrictions on golden parachute payments, and an elimination of tax deductions for any executive compensation in excess of $500,000 per executive. In addition, firms were required to ensure that incentive compensation for senior executives did not encourage excessive risk taking.[2]

Increased compensation restrictions were imposed by the Treasury Department on February 4, 2009, and Congress passed additional pay restrictions under the American Recovery and Reinvestment Act (ARRA) on February 13, 2009. Under ARRA, existing executive compensation restrictions were combined with new prohibitions on executive bonuses, retention payments, and golden parachute payments. Restricted stock compensation was allowed only up to one-third of the executive's annual compensation. Furthermore, the pay restrictions imposed by ARRA applied retroactively to all TARP participants, including those who had accepted TARP funds before these restrictions were put into place.

TARP's executive compensation restrictions generally apply to the senior executive officers of each participant, defined as those executive officers whose compensation is required to be disclosed in the firms' Summary Compensation Table in the prior year. The primary exception is the bonus prohibition under ARRA, which applies to a different number of SEOs and/or additional highly-compensated employees depending on the level of bailout assistance received. The prohibition on bonuses does allow for the payment of restricted stock up to levels no greater than one-third of total annual compensation, but this restricted stock vests only on a pro rata basis according to the proportion of TARP funds repaid. Notably, the restrictions impose no cap on executive salary levels.[3]

2.2. The labor market for executives in the financial services industry

Traditional views of top executive labor markets within the U.S. generally do not explicitly account for the role of geography. Standard optimal contracting theory posits that firms select top executives on the basis of factors such as expected marginal product and risk aversion. Empirical evidence on how geographic considerations influence executive labor market outcomes is limited. Kedia and Rajgopal (2009) find evidence that neighboring firm pay practices influence pay for lower-level employees but not for top executives and conclude that executive labor markets are nationally segmented rather than geographically segmented. The extent of top executives' mobility may be enhanced by factors such as their relatively broad social networks and access to executive search firms (e.g., Bailey & Helfat, 2003; Liu, 2010). The advent of websites designed to facilitate professional networking and executive job search also likely increases the mobility of executives across geographic boundaries.

[1] Seven firms receiving “exceptional assistance” under TARP are subject to increased executive oversight and regulation with regard to executive pay. These seven firms are AIG, Citigroup, Bank of America, Chrysler, GM, GMAC and Chrysler Financial. Anecdotal evidence indicates these firms were under significant pressure to receive TARP assistance at the outset of the program. These “exceptional assistance” firms are excluded from my sample, which focuses on banks participating in the Capital Purchase Program, or “healthy bank program”, administered as a subprogram of TARP.

[2] http://www.treasury.gov/press-center/press-releases/Pages/hp1208.aspx.

[3] Because there is no TARP-imposed cap on executive salaries, there is no limit to the total compensation TARP participants can pay to senior executives. To provide salaries at a competitive level while preserving cash flow, some TARP companies paid senior executives in “salary shares”, which is salary payable in stock units that only vest under stringent guidelines as prescribed under TARP. However, under an optimal contracting view of compensation, exogenous changes in the structure of compensation are expected to result in pay packages that both executives and firms view as suboptimal.