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On the compensation implications of commercial bank entry into investment banking

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Abstract

We provide evidence regarding the extent to which commercial banking organizations that have entered investment banking have adopted pay-performance compensation systems that are like those used by investment banks. We find that pay-performance sensitivities for these banks once they begin securities underwriting are very similar to the sensitivities for commercial banks that have chosen not to enter investment banking. We also find that pay-performance sensitivities for both types of commercial banks are less than for investment banks. © 1999 Elsevier Science B.V. All rights reserved.

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1. Introduction

Large commercial banking organizations have expanded rapidly into investment banking since the late 1980s through their "Section 20" subsidiaries. From 1986 to 1994 total assets of these subsidiaries grew from $20 billion to

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over $120 billion (Robinson, 1995). Securities subsidiaries of bank holding companies now rank among the largest investment banking firms (in terms of total securities underwritten) for certain types of corporate debt. They also account for a smaller but significant share of corporate equity and have substantial market shares in the underwriting of mortgage-backed and asset-backed securities. In August of 1996 the Federal Reserve Board proposed (and subsequently implemented) further relaxation of the limits on commercial bank underwriting activities through Section 20 subsidiaries. The rapid expansion of commercial banks into investment banking coupled with this recent action taken by the Federal Reserve Board are widely interpreted as evidence that the formal elimination of the Glass–Steagall Act appears inevitable. [1]

Rajan (1994) points out that the debate over expanded commercial bank powers – to include underwriting, brokerage, and insurance – focuses on three issues: the efficiency of commercial banking organizations in providing these services, the effects on the stability of the financial system, and the proper role of government. The purpose of this research is to provide evidence relevant to the first of these issues – presumably if commercial banks are to successfully compete with existing investment banking firms they must adopt compensation systems which contribute to efficient and effective operations. These compensation systems are likely to be those that enhance pay-performance sensitivity. That is, firms with performance based pay schemes are likely to be more efficient and effectively run.

We expect incentive pay systems that tie CEO compensation to firm performance to be more readily adopted by commercial banking organizations with substantial opportunities for expansion. Smith and Watts (1992) point out that firms with greater opportunities for growth have higher compensation levels. Moreover, as organizations such as commercial banks shift from more regulated to less regulated activities (i.e., from commercial to investment banking) or as the industry is deregulated, we would expect greater use of performance based compensation systems. Smith and Watts refer to this as the "contracting hypothesis".

Crawford et al. (1995) present evidence from the banking industry that is consistent with the contracting hypothesis. They show that a significant increase in pay-performance sensitivity took place for a large sample of commercial banks in the post-deregulation (1982–1988) period as contrasted with the pre-deregulation (1976–1988) period. In addition, Hubbard and Palia

[1] The coalescing of commercial and investment banking has stimulated interest in the potential for conflict of interest between the lending and underwriting roles of the new "universal" banks. However, Gande et al. (1997) find no evidence of a conflict of interest for debt securities underwritten by Section 20 subsidiaries. Puri (1996) examines the evidence on this issue in the pre Glass–Steagall era.