

JANUARY 30, 2019 | NUMBER 148

For Richer, for Poorer

Bankers' Liability and Risk-Taking in New England, 1867–1880

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Banks carry large debts relative to capital, largely in the form of deposits. At the same time, owners and management face limited liability. As such, they can cash in on a bank's profits while shifting losses to depositors and other debt holders. This encourages risk-taking, contrary to the interests of depositors and, potentially, society as a whole. Lawmakers have been aware of this moral hazard problem for as long as deposit-taking banks have existed. In response, they used to force bank owners—which generally included managers—to shoulder significant downside risk. For example, during much of the 19th century, bank shareholders in the UK faced unlimited liability. In the US, most faced “double liability,” which became the norm after the Banking Act of 1863. For each dollar invested in the bank, shareholders could lose two dollars. Double liability fell out of fashion after the Great Depression and was largely abolished in the US by 1933.

The 2008 crisis has sparked renewed interest in the question of how much downside risk bankers should bear. Some

view bank managers' limited liability, or their lack of “skin in the game,” as one of the culprits of the crisis. Many commentators argue that the financial sector would be more stable if bank managers shouldered more downside risk and have called for the reintroduction of more stringent liability rules. For example, past bonuses could be “clawed back” if a bank suffers a loss. At the same time, it is not obvious that increasing managers' liability will effectively reduce banks' risk-taking. Reputational concerns, the fear of losing bank-specific human capital, and active monitoring by depositors and other stakeholders may be sufficient to curb risky behavior, rendering such a measure redundant.

Despite interest in the topic and its relevance for policy, there is little direct evidence that increasing the liability of bank managers reduces risk. In recent years, bank managers' liability has generally been limited, and it is difficult to observe the counterfactual. Commentators often point to the fact that investment banks, traditionally partnerships with unlimited liability, became much riskier in the 1980s when

they went public. However, this evidence is largely anecdotal, based on a limited number of observations, and coincides with a period of general financial deregulation. More recently, there are differences across banks in the degree to which managers' compensation depends on the share price, but this primarily affects managers' upside, as shares have limited liability and banks are highly levered. As a result, high sensitivity to the bank's share price is usually associated with more risk-taking, not less.

We evaluate the extent to which historically stricter liability rules for bank managers were effective at reducing risk. We focus on a setting in which we observe plausibly exogenous variation in bank managers' downside exposure. We study banks in New England between 1867 and 1880. At the time, bank CEOs (presidents) owned a large fraction of their banks' shares, which carried double liability. If a bank failed, unable to repay creditors, the Comptroller of the Currency could seize additional assets from shareholders up to the value of the initially paid-in capital. This period intersects with a major change in the marital property regime. Under the existing common law, ownership of women's property transferred to their husbands upon marriage. Starting in the 1840s, states in New England introduced Married Women's Property Acts (MWPAs) that allowed newly married women to retain separate ownership over their property. This introduces variation in the downside exposure faced by bank presidents. If a president was married before the enactment of an MWPAs, all of his family's assets were at stake; if he was married after, his wife's separate assets were protected. The larger the proportion of household assets standing in the wife's name, the more protection was afforded. We investigate whether a bank president took more risk if he faced less downside exposure. We measure risk through (1) leverage, (2) the propensity to "evergreen" loans, (3) the propensity to make loans in violation of regulation, and (4) *ex post* losses of capital and deposits. Importantly, we can measure the impact of limited liability on risk-taking, keeping constant the regulatory environment, time, and place.

The context that we consider differs from today in two key dimensions: in the 1860s and 1870s there was no deposit insurance, and banks were too small to be considered "too big to fail." This means that moral hazard problems induced by (implicit) government guarantees only played a marginal role. Moreover, individual depositors had a clear incentive

to monitor the banks themselves and exert discipline on the banks' management. Rather than a weakness, we see this as a strength of our analysis. We are able to isolate the effect of bank managers' liability on bank behavior absent bailout expectations and under close scrutiny of depositors.

Our evidence indicates that reducing bankers' liability increased risk-taking. Banks managed by presidents married after an MWPAs had more leverage, were more likely to evergreen loans and violate lending rules, and lost more capital and deposits in the Depression of 1873–1878. We document that the effect is stronger for bank presidents married to richer women. Variation in the marital property regime under which a bank president was married comes from four sources: (1) different timing of states introducing an MWPAs, (2) the banker's age, (3) the timing of the banker's first marriage, and (4) possible remarriage after the death of an earlier spouse (divorce was rare). States introduced the MWPAs at different points in time, and bankers tended to get married at different ages. That means that we can simultaneously include fixed effects for (1) the state (or county) a bank president lived in, (2) age and (3) age at first marriage. Doing so, we difference out any spurious effects coming from a banker's age or state of residence, as well as a banker's decision to marry later in life. We do not difference out variation coming from remarriage, as this generally occurred if the banker's first wife died, which we view as exogenous.

We also explore the real effects of increasing bankers' liability. It is not obvious that reining in risk-taking is socially optimal if this leads to underinvestment in risky projects with positive net present value. We investigate this issue using a sample of about 1,000 firms from the 1870 Census of Manufacturers. We study the decision to introduce a new technology in need of high up-front investment: steam power. We find that firms in counties with more banking capital are more likely to use steam power. However, it makes no difference whether this bank capital is managed by presidents married before or after an MWPAs.

NOTE:

This research brief is based on Peter Koudijs, Laura Salisbury, and Gurpal Sran, "For Richer, for Poorer: Bankers' Liability and Risk-Taking in New England, 1867–1880," NBER Working Paper no. 24998, September 2018, <http://www.nber.org/papers/w24998>.