

Comments on Koudijs and Mulder, “Holding Bankers Liable: Personal Guarantees and Risk-taking in Security Underwriting”



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Overview

Interesting paper: extraordinary data, clever empirical design

Valuable insights into internal organization and incentive structures within an investment bank (NHM)

My comments:

- Some context for the personal guarantees via contrasts with U.S. case
- Some constructive suggestions regarding empirical design

Debt Underwriting – U.S. Case

Small number of underwriters dominated the business

Those underwriters were generally organized as partnerships (JP Morgan & Co., Kuhn Loeb & Co., etc.)

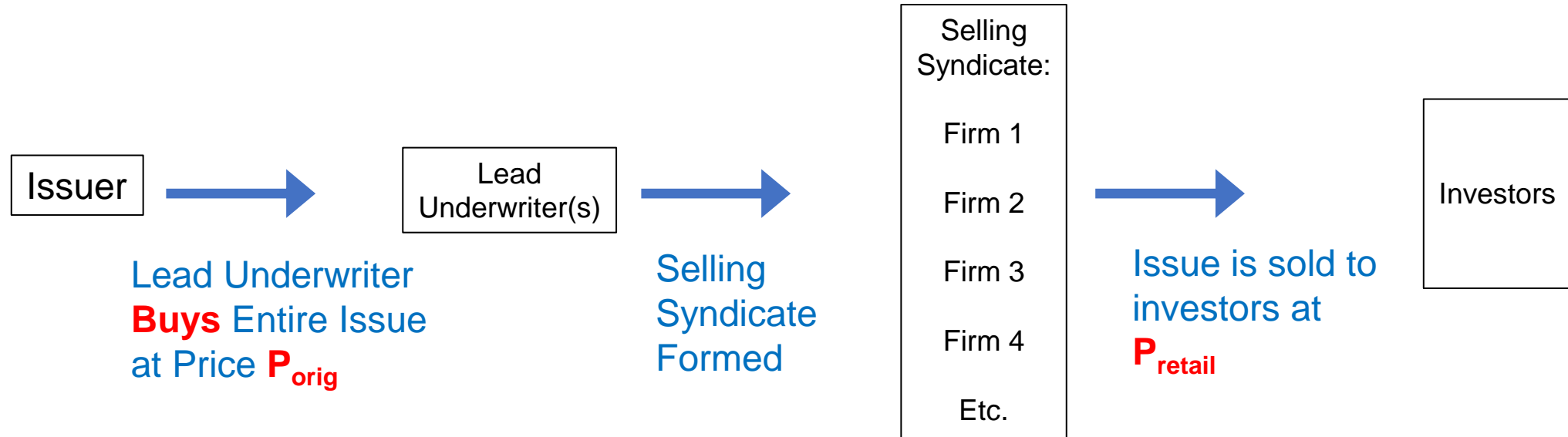
Frequently, lead underwriter and issuer have longstanding relationships (e.g., Frydman and Hilt, 2017) – helps underwriters make the case that issue is priced correctly

Lead underwriters bear risk by purchasing entire issue – earn profits from the spread between the price they pay and the price at which the issue is sold

Any unsold shares remain on the firm's books until eventually sold or written off; any losses from unsold shares are directly borne by partners via firm's profits

Unsold shares, at least at JP Morgan & Co, were quite uncommon

U.S. (Morgan) Debt Underwriting



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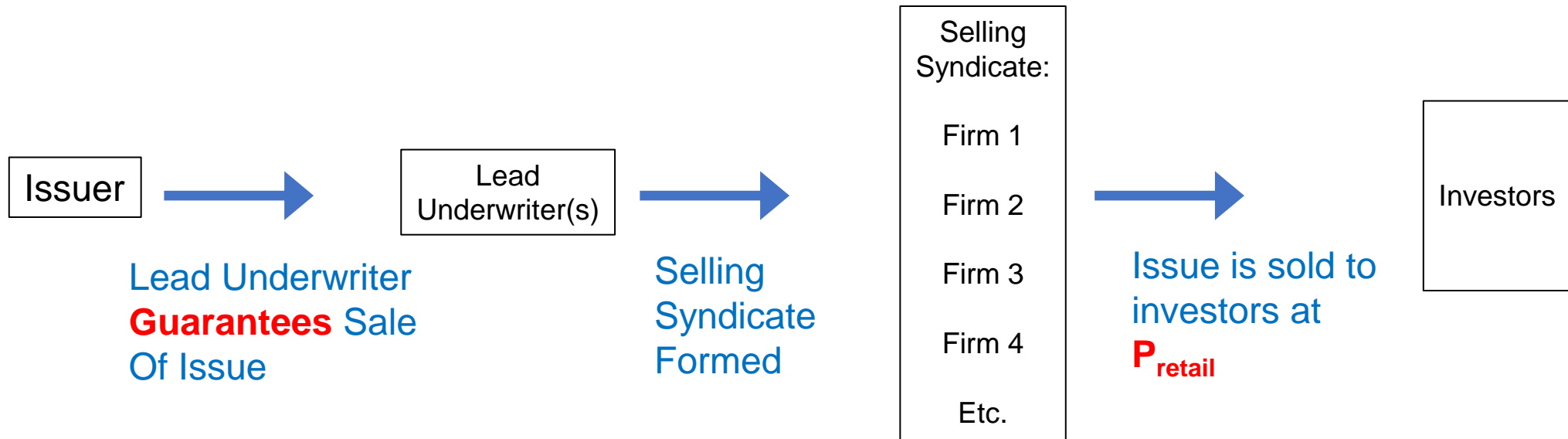
Compensation for underwriting (per share): $P_{\text{retail}} - P_{\text{orig}}$

What if some shares go unsold? If there are n partners and q unsold shares, each partner bears the loss

$$q(P_{\text{sale}} - P_{\text{orig}})/n$$

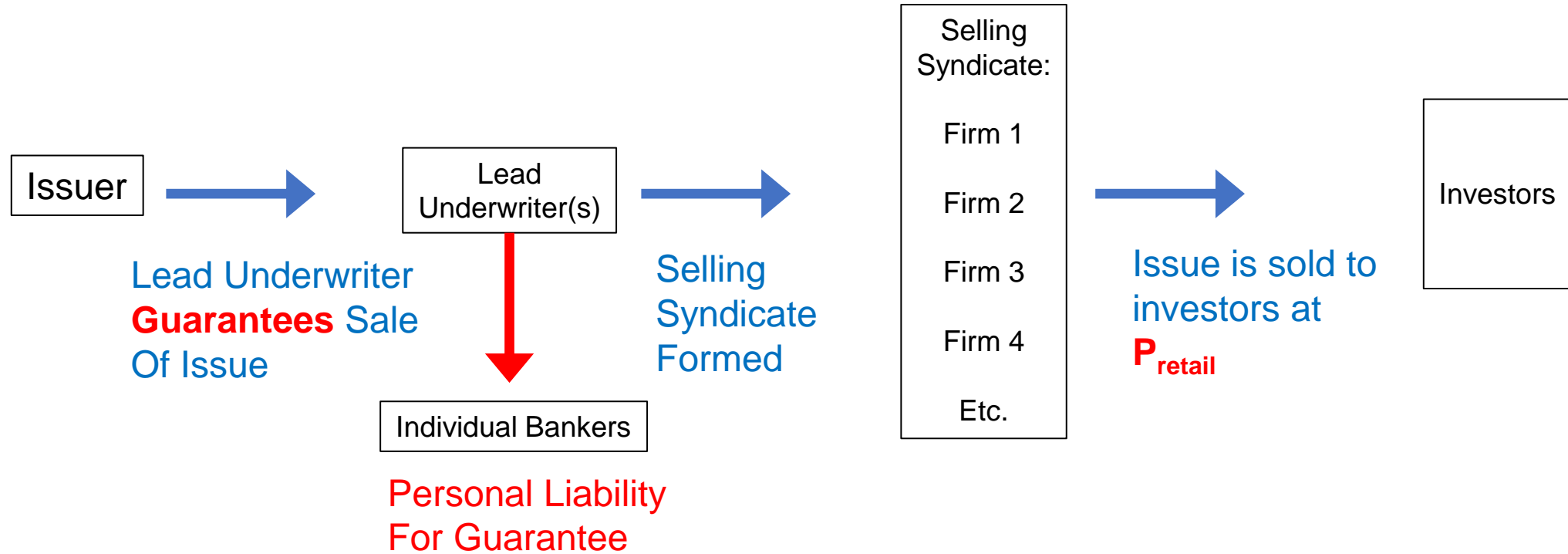
This does not happen very frequently at all

Dutch (NHM) Debt Underwriting



Compensation for underwriting (per share): **Fee**

Dutch (NHM) Debt Underwriting



Compensation for underwriting (per share): **Fee**

Differences: NHM vs. Morgan Cases

Dutch underwriters do not purchase issue but guarantee its sale, committing to purchase any unsold shares

Undersubscribed issues are relatively common (50% of issues in dataset)

Seems to have been less flexibility around pricing of issue

- Market 'clears' via quantity adjustments
- Possible explanation: many foreign issues, price set elsewhere (?)
- Less scope for underwriter-issuer relationships to 'matter'

NHM organized as corporation, owned by shareholders

Individual bankers within NHM made personally liable for share of guarantee

- Corporation creating structure similar to partnership shares
- Likely much greater, more immediate impacts than partnership shares

Interpretation of Personal Guarantees

Dutch securities underwriters face risk that new issues will fail to sell (market-clearing quantity is lower than expected)

In a corporation, the costs of unsold securities would be borne by shareholders – moral hazard problem

To limit risks of losses, NHM imposed personal liability for a share of issue sales on its bankers, creating an extreme version of partnership-like incentives

Effects of Personal Liability

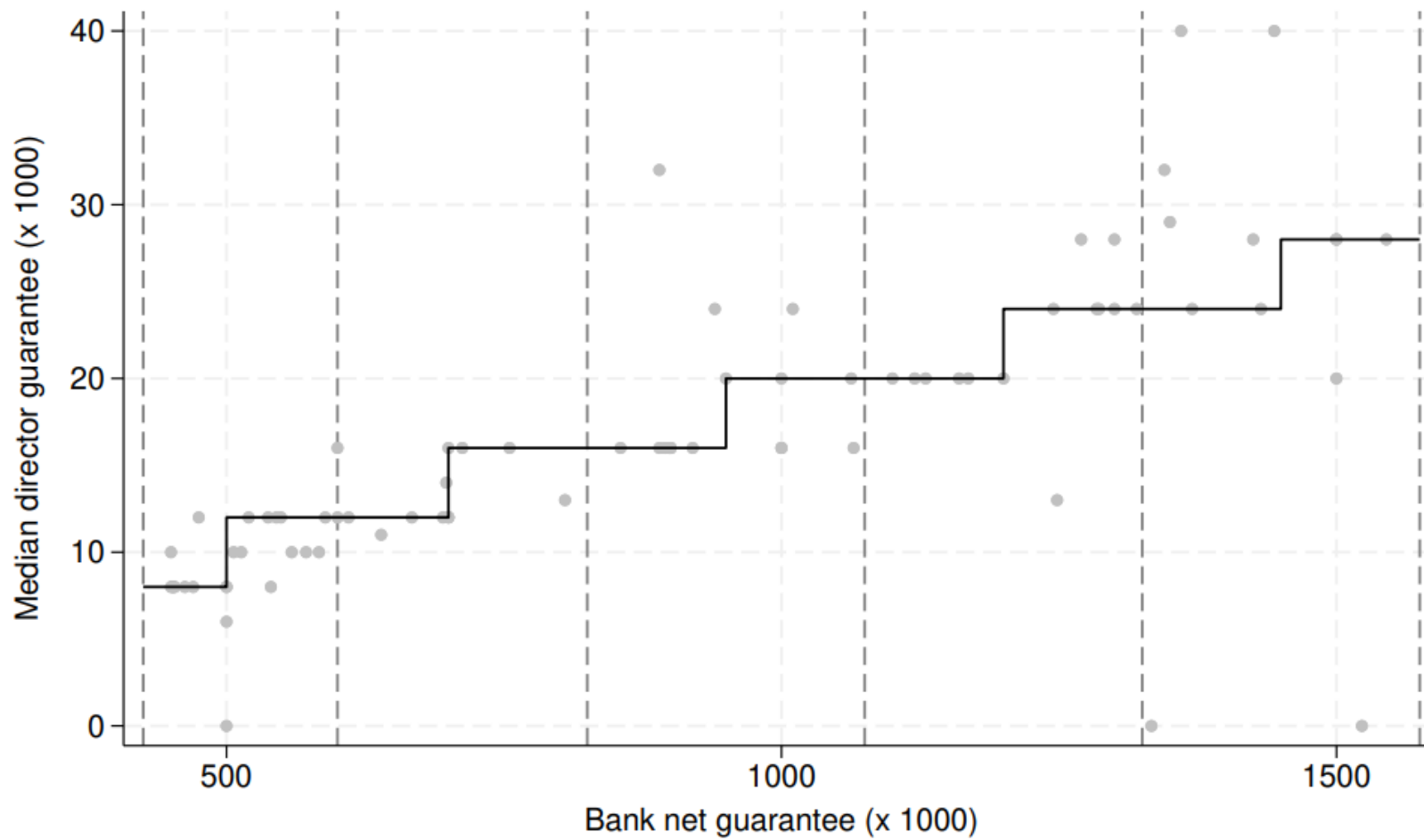
Main result – issues for which greater personal liabilities was imposed on bank executives sold better

Possible interpretation: issues with greater personal liabilities attached were priced more accurately

Could be related to effort in negotiation with issuer (liability -> price), or it could be that bankers were willing to assume more responsibility for better-priced issues (price->liability) (The former only works if liability is known prior to completion of negotiations with issuer).

Would be nice to know more about how pricing was determined (giving large number of undersubscribed issues), and also size of fee were also correlated with issue success

Figure 4: Within bin comparison



Suggestions

Each step up is of roughly equal size – and therefore the successive steps are proportionally smaller. A nice test would be to see if the effects are smaller for the bins corresponding to larger amounts

All comparisons are within bins – would be nice to see whether results are robust to alternative partitioning into bins

In some bins, there does not seem to be as clear a mechanical rule as in others – would be nice to see whether results are robust to alternative versions of the rule

Wrapping Up

Nice paper!