Employee Representation and the Risk of Corporate Pension Plans

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Representation and the Risk of Corporate Pension Plans

>> How does labor representation on supervisory boards affect corporate pension plans?

Background

- Firms sponsoring German corporate pension plans can substitute financial debt for pension debt in a largely unconstrained manner as there are no regulations concerning minimum funding levels.
- Clear conflict between shareholders and employees

Setting

- Studies the effect of direct labor representation in corporate governance affects corporate pension plans
- Uses the Codetermination Act 1976 is a German law that requires companies of over 2000 employees to have half the supervisory board of directors as representatives of workers
- The change goes from a minimum of 1/3 labor representation to minimum of 1/2 of labor representation

Summary of Results

1. Pension plans increase their funding ratio in response to increase oversight by employees
   - Parity Employee Representation (PER)

2. Increase in contribution from pension funds, coming from employers
   - This is *not* accompanied by employee contributions or changes in discount rates of liabilities

3. Decrease in riskiness of assets
   - However, do not find clear evidence of a change in equity allocation

4. There is a decrease in the ROA and ROE of firms

Takeaway:

Oversight leads firms to improve their funding of pension liabilities, which substitutes away from other investments.

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Interesting Paper

Interesting paper studying an important question:

- Thoughtful in the analysis
- Intuitive results, what I would expect before flipping to the results
- Important, especially given the renewed interest in ‘stakeholderism’
- Made me asked more questions about the mechanism and their implications

My comments are primarily about the implementation of the paper

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Many Papers Have Used This Shock

Very Partial List:

Baums and Frick (1998) – *Co-determination in Germany: the impact of court decisions on the market value of firms*

Gorton and Schmid (2004) – *Capital, labor, and the firm: a study of German codetermination*

Fauver and Fuerst (2006) – *Does good corporate governance include employee representation? Evidence from German corporate boards*

Gerke et al. (2008) – *Empirical risk analysis of pension insurance: the case of Germany*

Lin et al. (2018) – *Employee representation and financial leverage*

Kim et al (2018) – *Labor Representation in Governance as an Insurance Mechanism*

Jenter et al. (2019) – *Does firm size matter?*

…

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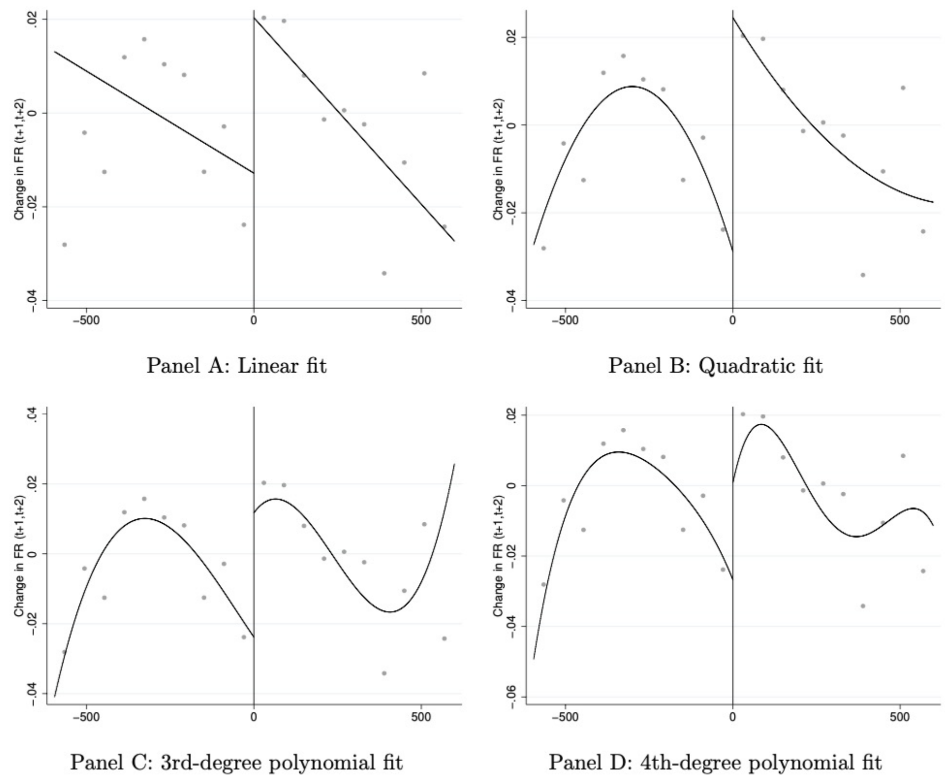
Comment 1

Rights and Production Functions: An Application to Labor-Managed Firms and Codetermination, Jensen and Meckling (1979):

"If co-determination is beneficial to both stockholders and labor, why do we need laws which force firms to engage in it? Surely, they would do so voluntarily. The fact that stockholders must be forced by laws to accept co-determination is the best evidence we have that they are adversely affected by it."

Figure 4: Change in Pension funding from t+1 to t+2



Also, would avoid high-order polynomials
- see Gelman and Imbens (2018)

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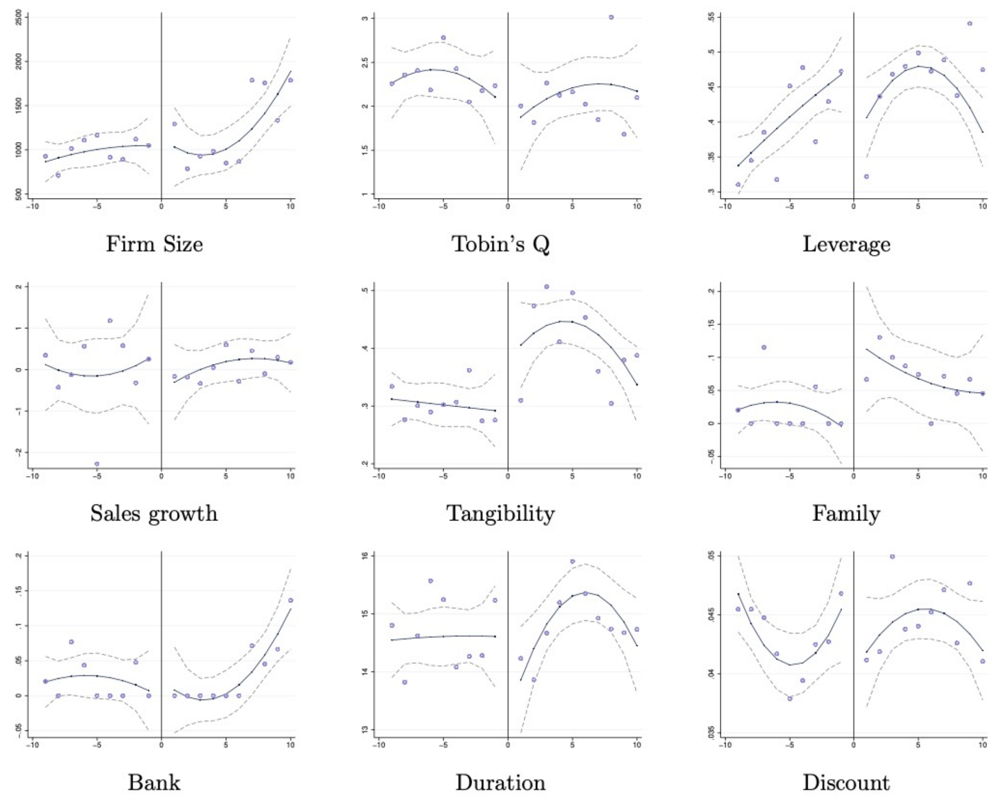
Comment 1

- Visually many of the covariates looks similar around the cutoff
  - Size, Tobin's Q, Sales Growth, Bank
- However, there are several covariates that are look significantly different
- If there is manipulation around the cutoffs, these may threaten the Fuzzy RDD approach used in the paper
- Would report a table of covariates, show they are balanced.

Figure 3: Firm characteristics around the threshold - (t+1)



Let’s Assume The Fuzzy RDD is Perfect

- Now, imagine that we didn’t read this paper (you should!)

- What if I told you that more oversight by employees will lead to improved outcomes allocations to defined benefit plans… what would your null be?
    - The baseline results of this paper

- This is the point of research!

>> What is more interesting, in my opinion, are the firm level decisions, how they are made, interpreting the magnitudes, and any policy implications

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Comment 2: External Validity

Is This Result Only at the 2,000 Cutoff?

- The results are for the LATE around the cutoff
- However, the author will need to justify any extrapolation to the other sub-population (treatment homogeneity)

Is the paper able to consider the 500-employee cutoff from the Codetermination Act of 1976?

- This will give another cutoff from no mandatory employee supervision to 1/3. This provides a potentially useful cutoff.
- May help in understanding if the PER is driving this LATE results. Or is it increased monitoring, in general
- This may not work for various reasons (as discussed in the paper). So not finding a result does not mean employee oversight is not important.

Can you use the shock around March 1st 1976?

- This approach is used in Lin et al. (2018) for Leverage
- This would reduce also the possibility of manipulation

Comment 3: Interpretation

- **ECONOMIC MAGNITUDES:** Betas, Changing in Contribution?
  - Outside of statistical significance, what does the size of the effect say about the results?
  - Modest change in employer contribution
  - From my reading, there is a large reduction in portfolio risk
  - Large change in ROE…!

- **ASSET RISKS:** Equity levels do not change but the asset risk (as measured by beta) changes
  - This result is suggestive of a risk-management behaviors.
  - How does this relate to Rauh (2008), and An et al. (2013)?
  - Is it driven by conservatism of employees where they were taking abnormally high risks before?
    - Consider tests in Section 5 of Lin et al. (2018), that studies bank ownership

- **CHANNELS:** What other measures of firm performance would you expect to change?
  - Related results? Are they funding this increase through operations? Changes in capital expenditures?
  - Positive Results? Better funded pension liabilities are likely understood by current and future employees?

Summary

- Supports the agency view of supervisory boards on pension liabilities
- With the increased emphasis on the welfare of stakeholders in firms, this paper has additional importance
  - Direct corporate governance seems to be an important ingredient
- Room for the paper to push a bit further with additional test and interpretation
- I enjoyed reading and thinking about this paper a lot!

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