BANK BONUSES ENCOURAGED EXCESSIVE RISK-TAKING: New evidence from the Austrian, German and Swiss financial sectors

Excessive financial sector bonuses caused banks to earn more in the short term but led to unsustainable risks that eventually materialised in the financial crisis. That is the finding of research by **Johannes Steinbrecher** and colleagues, to be presented at the annual congress of the European Economic Association in Mannheim in August 2015.

Their study looks at the effects of bonuses in 67 Austrian, German and Swiss banks. They find that the extremely high bonuses in the years leading up to the financial crisis increased trading income but also made the trades even riskier, ultimately destroying bank asset value. Pre-crisis bonuses encouraged too much gambling, but the bonus moderation after 2007 seems to have reversed some of this effect, perhaps by too much. The authors comment:

> 'Performance-contingent bonus payments affect both the profitability and riskiness of banking. Efficient incentive pay systems need to target the optimal trade-off between these two. Unfortunately, this trade-off varies across banks and is difficult to quantify.'
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> 'Arbitrary bonus caps, as proposed by the European Banking Authority, may bring us far away from ideal incentives for bankers. Linking bonuses with long-term performance, as suggested by the Bank of England, seems generally desirable. But leaving this issue to bank shareholders raises doubts as to how much reform effort can be expected.'

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Excessive compensation practices in banks are often said to have contributed to the recent financial crisis. Yet lack of data on banker pay has so far prevented an empirical analysis of this allegation.

This is the first study of the bonus payments in the capital market divisions in 67 Austrian, German and Swiss banks over the years 2004 to 2011. The unique data set makes it possible to explore the causal effect of incentive pay on both the level of trading profits as well as their variability.

The researchers develop a methodology to assess the trade-off between trading profitability and trading risk and to investigate if high-powered pay incentives can tilt this trade-off towards the destruction of bank asset value. They show that bonus payments were excessive before the crisis, whereas the moderation in the crisis period removed excessive pre-crisis incentives and might even have led to an over-adjustment.

The study asks two questions:

- First, does the prospect of earning a high bonus give traders incentives to gamble? To increase the probability of receiving a bonus, bankers might implement extremely risky trading strategies, which, on average, pay higher returns.

- Second, are bonus payments excessive from a social welfare perspective. Bonus-induced gambling does not only increase average trading returns but also their volatility and the risk of high losses during economic downturns. If bonus incentives are too strong, gambling might be excessive and destroy bank asset value.

The analysis is careful to identify the causal effect of promised bonus payments on trading strategies. In particular, the researchers rule out that higher bonuses are associated with higher trading profits and risk simply because bonuses are never paid to traders who realised a loss. To disentangle the effect of bonus incentives on trading from such reverse causality, the researchers identify two exogenous reasons why some traders receive particularly high bonuses that have nothing to do with trading profitability directly.

First, the researchers use the bonuses paid in retail, private and corporate banking segments as a proxy for the bonuses paid to traders. Typically, employees in the retail segment do not receive larger bonuses because their colleagues in trading have generated high profits. Yet, banks that generally pay high bonuses to employees in retail banking do tend to pay high bonuses to their traders, too.

Second, the study uses the size of the capital markets divisions relative to total bank employment as another instrument. A bank with many more employees in retail, private and corporate banking might monitor its few traders with a lower intensity than banks whose core business is trading.

The instrumental variable regressions show that the extremely high cash bonuses in the years leading up to the crisis increased both trading income and risk. More importantly, the overall effect destroyed bank asset value. Pre-crisis bonuses gave incentives for too much gambling, thereby, reducing the Sharpe ratio and NPV of trading income. By contrast, the bonus moderation after 2007 seems to have reversed the effect and reduced excessive bonus incentives.

A general conclusion of these findings is that performance-contingent bonus payments affect both the profitability and riskiness of banking. Efficient incentive pay systems need to target the optimal trade-off between these two.

Unfortunately, this trade-off varies across banks and is difficult to quantify. Arbitrary bonus caps, as proposed by the European Banking Authority, may bring us far away from optimal incentives. Aligning variable compensation with long-term performance, as suggested by the Bank of England, seems generally desirable. But leaving the issue of optimal variable compensation to bank shareholders raises doubts as to how much reform effort can be expected.

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Incentive Pay and Bank Risk-Taking: Evidence from Austrian, German, and Swiss Banks
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