Bonuses and risk not linked, says research

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(PhysOrg.com) -- New research into the causes of the credit crisis has cast doubt on the alleged link between bonus payments and risk exposures in the UK financial sector.

Bonuses were widely condemned in the wake of meltdown, with political leaders and regulators among those calling for them to be capped to help prevent future crises.

But a study by Nottingham University Business School suggests that the alleged connection between bonuses and risk is not supported by empirical evidence.

A detailed analysis of remuneration data instead indicates payouts were principally influenced by firms' profitability and the number of targets on which awards were based. Academics say the findings raise 'important questions' about the pursuit of curbs on bonuses and the failure to translate rhetoric into an effective regulatory response.

One of the study’s authors, Professor Alistair Bruce, said: “Our results are significant in the context of the debate regarding levels of bank bonus awards and the structure of bonus schemes. Most strikingly, they suggest an absence of empirical evidence on which to base a policy of restricting annual bonuses as a means of modifying exposure to risk.

“In the UK context, as captured by degree of leverage, the connection between bonuses and risk exposure at the level of the firm turns out to be spurious. But what does emerge clearly from the analysis is a significant link between the level of bonus and the number of targets on which a bonus award is based.

“If this shows the attack on bonuses was ill-founded in terms of an evidence base then we have to consider alternative rationales for the strong statements of policy intent. It’s tempting to conclude political motivations were at the root of not just those statements but the subsequent failure to follow them with robust regulatory action.”

The study examined the bonus arrangements of the top 40 UK-based financial services firms’ CEOs during the period from 2001 to 2007 — the run-up to the crisis. Together with other company-level data, the information was used to examine issues such as bonus ceilings, award/salary ratios, forms of payment and number of targets.

The results expose the ‘fragility’ of the notion that bonuses influenced CEOs’ leverage decisions, said Professor Bruce, a Professor of Decision and Risk Analysis.

He added: “There now appears to be a growing realisation that changing the incentives inherent in pay structures is not the answer to moderating risk appetites. Rather, addressing risk management in the banking sector directly – for instance, by increasing banks’ capital requirements in terms of capital ratios – is the key.

“The zeal of political leaders and the regulatory community in condemning bonuses in early 2010 is perhaps more understandable in terms of their own needs at the time. Being seen to take a lead in addressing what was popularly characterised as one of the root causes of the financial crisis was a clear imperative for the government.

“And the Financial Services Authority’s support for bonus-capping served to deflect attention from the agency’s own failures in anticipating and responding to the crisis.

“In the year or more since we’ve seen a lack of political will on the part of the Conservatives, with whom the financial sector has a long-standing and close relationship. There has also been concern that a strong unilateral position by the UK could lead to the defection of institutions and a flight of individual talent from our banking sector.

“Finally, there’s a feeling that effective discipline is simply difficult to impose. Even the mere possibility of tougher regulation has led to a radical upward adjustment in base salaries. This is in keeping with a recent history of restraint in relation to one particular instrument of pay prompting a rapid shift in emphasis towards other instruments.”

Despite challenging the link between bonus levels and risk exposure, the study is still critical of certain elements of payment structures within the sector. It suggests recent changes in bonus practices might be motivated less by a wish to demonstrate increased transparency and more by a desire for obfuscation.

Professor Bruce warned: “Trends in voluntary disclosure should be treated with caution. Seemingly greater transparency may not be a genuine gesture towards accountability."

Provided by University of Nottingham