Labor market key to reducing excessive risk taking by bankers

March 11 2015, by Anton Van Boxtel

Excessive bonuses and risk taking in the financial sector are inherent in the competition on the labor market for bankers. This is argued by Anton van Boxtel in his PhD thesis, which he will defend at Tilburg University on March 16. Given this situation, reducing excessive risk through taxes or bonus caps is very hard to achieve. Measures reducing labor market mobility might provide a solution. "Making it harder for bankers to switch from one employer to the next will make it cheaper for banks to keep their employees. This in turn may lead to lower bonuses and thus to less risk," Van Boxtel states.

There is widespread perception that bankers engage in excessively risky activities in order to obtain their bonuses. Van Boxtel studied the economic logic behind this perception. In a theoretical model, he analyzed the reasons why banks pay bonuses to their bankers, and why banks would make these bonuses so high that they tempt bankers to take excessive risks. He also studied how labor market flexibility can be a decisive factor in the amount of risk that bankers take.

In his model, banks try to hire workers without knowing the skill level of each of the aspiring bankers. Therefore, the bank offers a remuneration structure that attracts the best potential bankers and scares away the less skilled ones. This is possible by offering a relatively low base salary and rewarding good results with a bonus. Good bankers know they have a good chance to perform well enough to earn such a bonus.

Bonuses stimulate risk taking

"In order to reduce risk taking, the bank can 'punish' bad results, for example, by withholding the bonus, blocking career opportunities, refusing to extend a contract, or even firing an employee. In practice, however, the extent to which a bank can do so is always limited," Van Boxtel explains.

"If good bankers demand a much higher salary than less talented ones, it becomes necessary to pay a very high bonus to attract these good bankers. Combined with the limited extent to which bad performance can be punished, this can lead to a convex remuneration structure: good results are rewarded more than bad ones are punished. A banker remunerated in such a way is inclined to take excessive risks."

A flexible labor market

According to Van Boxtel, the extent to which this happens is dependent upon the competition in the labor market for bankers. "If competition is particularly fierce, the better bankers increase their market value and thus the level of the bonuses needed to keep these bankers."

"If it becomes harder for bankers to switch from one employer to the next, it becomes cheaper for banks to keep their workers. This can lead to lower bonuses, which in turn leads to lower risk taking. That would be my very cautious recommendation," Van Boxtel concludes.

Provided by Tilburg University

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