



After Lehman Brothers' collapse, people questioned if the bonuses paid to bankers on Wall Street were in part responsible for the excessive risks taken that led to the financial crisis. After all, Wall Street has always relied on variable performance-related pay to get the best out of employees. PHOTO: AGENCE FRANCE-PRESSE

## How to change bankers' bonuses to curb excessive risk-taking

Jussi Keppo and Yuan Xuchuan

It has been nine years since the fall of Lehman Brothers rocked the world. People questioned whether the bonuses paid to bankers on Wall Street were in part responsible for the excessive risks taken that led to the financial crisis.

Wall Street has always relied on variable performance-related pay to get the best out of employees.

Prior to the financial collapse, it was not uncommon for the fixed component of senior bankers' packages to be only 10 per cent of their total remuneration.

But this compensation structure did not prevent the financial crisis from occurring.

In Singapore, an efinancialcareers.com study revealed an annual salary range of \$400,000 to \$750,000 at the managing director level for private bankers, with bonuses ranging from 8 per cent to 30 per cent of revenue generated.

This means that if a private banker made \$3 million in revenue and the bonus percentage is 20 per cent, his package is \$600,000.

Mr John Cryan, chief executive of Deutsche Bank, one of the world's biggest banks, considers bonuses a waste of money as he

does not believe they motivate bankers to work any harder.

The Barclays chairman, Mr John McFarlane, believes investment bankers should not get huge bonuses as they encourage short-termism.

Instead, if he had his way, he would reward bankers after three or five years when he knows how much value they have created.

Bankers' compensation has thus become a major issue for banks' corporate governance as well as regulation.

Can large short-term bonuses spur too much risk-taking that may result in a financial crisis?

In response to such concerns, regulators and banks have started to take restrictive measures on compensation. For instance, the European Union has imposed a bonus cap, and in the United States, there is the possibility of clawbacks on bonuses.

Notwithstanding this, banks' risk-taking is important to keep the economy growing, if such risks are well managed. This requires talented employees, and to attract such talent, banks pay bonuses.

Given this, should such bonuses be deferred or capped to curb excessive risk-taking?

In a collaborative study between the National University of Singapore Business School and Aalto University, we found that capping bankers' bonuses equal to fixed salary reduces the risks they take on average by 13 per cent.

In one example, this translates into reducing the bank's leverage – the amount of debt banks borrow to gear up profits – from 25 to 21.6.

The higher the leverage, the more the bank borrows and the less it is able to take losses and stay in business. The year before Lehman Brothers collapsed, its leverage was over 30.

On the other hand, we found that bonus deferrals – a policy that regulators in the US and Britain favour – did not reduce risk-taking significantly. Specifically, increasing the length of bonus-accrual period

from the one-year standard to two years has no material effect on risk-taking.

Our research also demonstrates that imposing a bonus cap to be no larger than the annual fixed salary is more effective in reducing risk-taking, particularly for larger banks. As big banks typically impose the biggest systemic risk on the financial system, bonus caps may contribute to containing systemic risk.

It is important to note that our analysis is mute on how much risk-taking is desirable and what level should be considered excessive.

Our aim was simply to assess the effectiveness of the various bonus restrictions in limiting risk-taking.

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The opinions expressed are those of the writers and do not represent the views and opinions of NUS.

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