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Press contact
Rafael Barth
Tel +49 345 7753 832
presse@iwh-halle.de

Scientific contact
Michael Koetter
Tel +49 345 7753 727
Michael.Koetter@iwh-halle.de

Study on Europe's top bankers: Risky business despite bonus cap

Ten years ago, the EU Parliament decided to cap the flexible remuneration of bank managers. But the cap on bonuses misses its target: Managers of systemically important European banks take high risks without changes, shows a study by the Halle Institute for Economic Research (IWH).

Europe's most important banks have increased the fixed salaries of their board members after the European Union (EU) capped flexible remuneration. With the cap on bonus payments passed in 2013, the European Parliament wanted to reduce the incentive for bank managers to engage in particularly risky business. But the regulation remains ineffective. Economists of the Halle Institute for Economic Research (IWH) found no evidence of reduced risks in the credit and capital market business after the introduction of the bonus cap. An increased turnover of executive board members, which the financial industry had warned about, is confined to Chief Executive Officers (CEOs) from poorly performing banks.

Ten years ago, in the aftermath of the global financial crisis, the EU Parliament pushed for regulation to curb excesses in the financial sector and thus increase financial stability. Since then, bonuses may not exceed 200% of the fixed salary. But contrary to expectations, bank executives sometimes even accept higher risks when performance-related bonuses play a smaller role. This is shown by increased risk indicators. "It acts like insurance when bankers are paid regardless of the success of their work," says Michael Koetter, Vice President and Head of the Financial Markets Department at IWH. He wrote the study together with his IWH colleagues Stefano Colonnello and Konstantin Wagner. "The bonus cap misses its target," Koetter concludes. "It should be abolished because until then it can tempt cautious bankers to take more and even too high risks."

Bankers who make difficult risk-return trade-offs should also receive incentive-compatible compensation. "An envy debate about bankers' salaries is not conducive to this end. They should be allowed to earn a lot, but it should be performance-based." Instead of a cap, the remuneration of all bankers, including those below board level, should become more transparent to the public to make it easier to monitor. As a recently published report by the European Banking Authority (EBA) shows, the number of bank managers earning one million euros or more per year has recently increased significantly.

While earlier studies on the effect of bonus caps focused mainly on the USA and in particular on CEOs, Koetter, Colonnello and Wagner provide empirical evidence for the actions of entire boards of major European banks thanks to new data. They studied 45 systemically important financial institutions with a total of 130 board members

Halle Institute for Economic Research (IWH) – Member of the Leibniz Association
Tel +49 345 7753 60
Fax +49 345 7753 820

Kleine Maerkerstrasse 8
D-06108 Halle (Saale)
Germany

P.O. Box 11 03 61
D-06017 Halle (Saale)
Germany

www.iwh-halle.de

three years before and three years after the decision on the bonus cap. They compared bank managers whose remuneration was affected by the new regulation and therefore had to be changed with those whose remuneration did not need to be changed. Accounting for confounding factors, such as the European debt crisis or the Basel III regulation, the economists analysed the banks' earnings and related them to different risk classes to identify the effect of the bonus cap.

Publication – freely available until 10 March 2023:

Stefano Colonnello, Michael Koetter, Konstantin Wagner: Compensation Regulation in Banking: Executive Director Behavior and Bank Performance after the EU Bonus Cap, in: Journal of Accounting and Economics, forthcoming.

Scientific contact
Professor Michael Koetter, PhD
Tel +49 345 7753 727
Michael.Koetter@iwh-halle.de

Press contact
Rafael Barth
Tel +49 345 7753 832
presse@iwh-halle.de

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