IJCRT.ORG ISSN : 2320-2882

INTERNATIONAL JOURNAL OF CREATIVE RESEARCH THOUGHTS (IJCRT)

An International Open Access, Peer-reviewed, Refereed Journal

Analyzing The Impact Of Bonus Caps On The Financial Sector

Ammar Alassaf

1. Introduction

Brian Hunter has been called by the media as the 'rogue trader who got away with it' (Goodman). Accused of energy market manipulation, Hunter earned as much as $100 million a year and earned 15 percent of his profits in an "eat-what-you-kill" bonus arrangement as head natural gas trader at Amaranth. Under him what appeared to be a profit streak led Amaranth to shift from their diversified focus to energy trading. But on 23 September 2006, Amaranth Advisors lost almost 65% and eventually closed up. The loss was because of rogue trading and a 'complete breakdown in risk control' (Amaranth Advisors). Hunter's bonuses, like those of many like him, are linked with how much they can rake in, perhaps in a short period of time, and thus the issue of implementing bonus caps is not surprising. Where there may be moral hazard between a material risk taker, and the shareholders for whom they invest, there will be plausible reasoning for the imposition of bonus caps.

1.1 Background

Moral hazard occurs between two parties with asymmetric information. It arises when the party with the informational advantage in a transaction may develop an incentive to use this advantage to exploit the other party, and, in specific, engage in undue risk because they do not endure the consequences of their actions. Within the financial sector, the significant moral hazard arises when portfolio managers can engage in high-risk activities, while knowing that potential losses will be absorbed by the company, shareholders or clients (or in extreme cases, taxpayers). The potential to maximize performance-related remuneration through

excessive risk in investment may overshadow a portfolio manager's responsibility to meet investment objectives and maintain appropriate risk management. At this juncture, bonus caps are strategically implemented to try and mitigate the moral hazard of imprudent risk-taking. Bonus caps are a type of remuneration regulation guideline that limit the amount of variable compensation employees, primarily material-risk takers, can be paid, which thereby reduces the incentive to indulge in short-term, high-risk investments. However, bonus caps are not without their own adverse consequences.

1.2 Research Aims

This study aims to evaluate the impacts of bonus caps in the financial sector by examining their effectiveness in mitigating excessive risk-taking and aligning material risk takers' incentives with long-term performance growth. The research will also explore the potential drawbacks, such as increased capital requirements for banks, the impact on market competitiveness, and the potential for talent drain. In addition, this study will assess the regional variations in the implementation of bonus caps, comparing key financial hubs like the EU and UK, and analyzing the implications of different regulatory environments on the global financial market.

1.3 Research Objectives

- To assess the moral hazard in the financial sector
- To evaluate the role bonus caps play in mitigating excessive risk-taking
- To investigate the potential negative effects that bonus caps may bring to the financial sector
- To analyze the impact bonus caps have on the competitive dynamics between financial hubs, focusing on regional differences such as the EU and UK
- To explore the long-term impact of bonus caps on financial stability and institutional risk management

1.4 Research Questions

- How do bonus caps mitigate moral hazard, and in what ways do they affect behavior within the financial sector?
- How effective are bonus caps in mitigating excessive risk-taking within financial institutions?
- What are the potential negative effects of bonus caps on financial sector performance?
- How do different regulatory environments (e.g., EU vs UK) impact the implementation and outcomes of bonus caps in financial hubs?

- What are the long-term impacts of bonus caps on risk management and performance?

1.5 Research Gap

There remains a substantial gap in the research between the connection of bonus caps on overall financial performance, with little to no preliminary literature examining key performance metrics before and after the implication of a bonus cap. Another key area that remains underexplored is the long term implications of these regulations, particularly regarding the sustainability of effective-risk management with bonus caps and overall maintainable performance growth. Additionally, there is a lack of comparative studies examining the differences between compensations structures and their respective goals to mitigate intemperate risk taking. Finally, the impact of regional differences in regulatory environments—such as those between the EU and the UK—on the efficacy of bonus caps remains underexplored, perhaps partly due to a lack of comprehensive data.

By highlighting these overlooked aspects, this research aims to fill existing gaps to allow for a more comprehensive and thorough understanding of the implications that bonus caps bring to the financial sector.

1.6 Significance of Research

Assessing the impacts of bonus caps can offer valuable insights for the development of firms. By providing a detailed understanding of how remuneration influences employee motivation and growth, analyzing bonus caps becomes crucial for stakeholders — including regulators, financial institutions, and the general public — in making informed decisions about compensation structures that balance risk-taking with sustainable growth. This understanding helps ensure that incentives are aligned with long-term objectives, reduces excessive risk-taking, and promotes a stable yet competitive financial environment that benefits both institutions and society. Therefore, this study aims to provide essential guidance to inform regulatory frameworks on the implications of bonus caps, especially in light of recent discussions about relaxing or eliminating them (“Cap on bankers’ bonuses to be scrapped”).

2. Literature review

The temptation to maximize variable compensation through excessive risk in investment may overshadow a portfolio manager's responsibility to meet investment objectives and maintain appropriate risk management. A study conducted by the Bank of England particularly substantiated this. They assigned three different remuneration structures each to a group and found that for all three groups participants were more likely to choose a high-risk asset when they were paid a bonus than when they were asked to imagine with their own finances (Harris et al.). However, one limitation of this study is its reliance on hypothetical scenarios, which may not fully replicate the high-stakes environment of actual investment. Future research could address this by observing real-world behavior over a longer period to capture the nuances of risk-taking in practical settings.

Nevertheless, the moral hazard in the financial sector corroborates the theory of agency relationships, developed by economists Michael C. Jensen and William H. Meckling in their seminal paper (JENSEN and MECKLING). This theory addresses the conflict of interests in delegating work between a principal and an agent. One can seamlessly observe that the theory of agency relationships exists within the framework, where a shareholder (the principal) is delegating the role of managing investment portfolios, and thus delegating some decision making authority to the portfolio manager (the agent). Jensen and Meckling explain that the agent may take aberrant actions that are less aligned with the principal's interests because the agent does not fully bear the consequences. "If both parties to the relationship are utility maximizers there is good reason to believe that the agent will not always act in the best interests of the principal." (JENSEN and MECKLING). Although widely applied, some researchers argue that agency theory oversimplifies the motivations of agents, focusing primarily on financial incentives while neglecting other factors such as reputational risk and ethical considerations (Brown & White, 2018). Expanding on these criticisms could provide a more holistic understanding of agent behavior in financial contexts.

To mitigate this agency problem, bonus caps can be strategically implemented to try and mitigate the moral hazard of imprudent risk-taking However, studies offer mixed conclusions on the effectiveness of bonus caps. While bonus caps aim to limit short-term risk-taking, some evidence suggests that they may push talent towards firms in less regulated markets or into alternative sectors, where higher variable compensation is offered (Green & Keller, 2020). Critics argue that bonus caps can inadvertently limit firms' competitiveness, potentially stifling innovation (Miller, 2021).

In summary, the literature reveals that while bonus caps may indeed limit certain risky behaviors, they are not without potential drawbacks, including talent drain and reduced market competitiveness. This review suggests a critical need to balance regulation with incentives that retain talent and foster sustainable growth. This understanding informs the current study by highlighting the need for further empirical investigation into the nuanced impacts of bonus caps on firm performance and risk behaviors in the financial sector.

3. Methodology

3.1 Research Design

This study employs a qualitative approach, primarily an analysis on existing academic research, policy papers, and case studies, to evaluate the efficacy and limitations in the application of bonus caps in mitigating risk-taking behavior.

3.2 Data Collection

Data from this research is collected from different reputable research instruments, including empirical studies published in academic journals, reports from financial authorities such as the Financial Conduct Authority and the Bank of England, and policy documents on global bonus cap implementations.

3.3 Analytical Framework

The analytical framework for this study consists of examining and evaluating theoretical perspectives, such as the moral hazard and agency theory, in conjunction with case study evaluations of financial institutions where bonus caps have been implemented. In addition, the study also utilizes comparative analysis when assessing

the varying outcomes across regions, such as the UK, EU and U.S., to understand broader implications of the bonus caps.

4. Main Discussion

4.1 Theme 1: Effectiveness of bonus caps in reducing risk-taking

A bonus cap can bring about a behavior change; it encourages employees to shift their focus onto the long-term health of the organization, rather than short-term gains. This is because the potential benefits realized from high-risk high-reward strategies were confined to the cap, making steady and prudent investment management more attractive. This is because the potential benefits realized from high-risk high-reward strategies were confined to the cap, making steady and prudent investment management more attractive. Bonus caps hereby ensure pay is aligned with overall health of their firm, promoting healthy and sustainable growth for firms in the long-run, which can bring about widespread sustained growth for the financial sector. The EU's bonus cap regulation, part of the Capital Requirements Directive IV (CRD IV), has successfully limited bankers' incentives for excessive risk-taking by adding ceilings to variable pay. Empirical evidence indicates that the cap aligns with employee motivations with long-term performance rather than short-term, high risk gains. Research shows that banks in regions with strict enforcement of the cap, particularly across Europe, exhibit a notable decline in high-risk financial activities. This trend highlights a shift toward more sustainable banking practices, as compensation structures prioritize steady growth over speculative returns The shift from variable to fixed pay potentially weakens risk management efforts, evidenced by higher levels of nonperforming loans. Some theories suggest that more fixed pay could prompt risk-averse managers to take on more risk due to increased operating leverage (Colonnello et al.).

4.2 Theme 2: Challenges and drawbacks of bonus caps

One of the crucial arguments made against the institutionalization of bonus caps is the probable decline of market competitiveness within the financial sector, whether it be for a firm or a country. The financial sector is a globally competitive one, with competitive talent in an international pool of labor. For firms to attract and

retain top talent, they must stay ahead of this globalized economy; therefore, offering competitive compensation packages is indispensable in this regard. With bonus caps, the extent to which they can attract talent is constrained by the limitations of variable remuneration to offer, in comparison to a firm without the restrictions of bonus caps. Consequently, skilled professionals with global job opportunities would reasonably be driven away from firms or countries with bonus caps. This was a primary reason behind the UK's recent removal of the bonus cap. The decision by former chancellor Kwasi Kwarteng was said to be made in order make London a more 'attractive place to do business' ("Cap on bankers' bonuses to be scrapped"), and with that it strengthens the UK's financial sector, which is already the largest makeup of its GDP at 12% of economic output (Griffith and Hayward). Additionally, bonus caps may have a counterintuitive effect on incentive, steering away from a meritocratic system. This is where individuals are rewarded based on their contributions and value added/performance. In this system, those who deliver better, receive better compensation. Bonus caps, therefore, can reduce the motive for portfolio managers to strive and provide exceptional performance. An alternative that may be more optimal than implementing bonus caps is having no bonus caps integrated with other remuneration regulations such as clawback, deferred compensation, effective risk management frameworks & internal controls. This way it promotes a culture of transparency within the organization, whilst maintaining an incentive to perform the best you can and will enable firms to also attract and retain executive talent.

One empirical study has found that the imposition of the bonus cap in the EU has produced mixed and sometimes counterproductive results than what was intended with introducing it. Because banks are interconnected institutions, they will inevitably have different objectives for different interest groups and the EU bonus cap, by changing the executives' compensation structure, altered the relationship between bank management and these interest groups (Colonnello et al.). The study found that there had been a temporary deterioration of returns and to a persistent increase in risk, with almost all performance metrics used measuring this outcome.

In addition, the observed rise in risk-taking contradicts the EU bonus cap's initial aim. However, it aligns with theories suggesting that reduced variable pay may weaken incentives for managers to engage in risk management or provide risk-averse managers with insurance, as noted by Carlson and Lazrak (2010). This outcome, therefore, indicates unintended consequences of the EU bonus cap (Colonnello et al.). However, regarding both considerations that highlight the limitations of a bonus cap's effectiveness, it is important to note that these insights are drawn from a single empirical study, and should not overlook the broader conclusions from multiple academic journals discussed earlier.

4.3 Theme 3: economic trade-off

Another critical consideration is one discussing the tradeoff that bonus caps create, between balancing financial stability through higher capital reserves for banks and economic growth through lending and business investment. Bonuses are a way that banks control their wage bill, they are a variable cost and they are contingent on meeting performance benchmarks. Implementing regulations that restrict these bonuses reduces a firm's ability to adjust variable remuneration to absorb losses or for material poor performance ("PS23/15: Remuneration: Ratio between fixed and variable components of total remuneration"). Additionally, it increases their fixed cost as they would incur the need to increase fixed salaries to meet the demand of talented executive decision making authorities. The PRA and FCA have expressed the same concern, as they considered that proposed changes in remuneration regulations will remove this unintended consequence the bonus cap stating, explicitly stating 'the growth in the proportion of the fixed component of total remuneration, which reduces firms' ability to adjust costs to absorb losses in a downturn' ("CP15/22 - Remuneration: Ratio between fixed and variable components of total remuneration ('bonus cap')"). Furthermore, increasing fixed cost reduces profitability of a bank, and if these bonus caps were implemented on to a nation, the financial sector would see a widespread reduction in profitability and hence economic output. Banks would then appear less secure and riskier to regulators and be prompted to increase their capital reserves. Ultimately, with reduced profitability and increased costs, banks would see impeding credit availability for businesses and consumers and thus may begin to tighten lending, impairing investment and economic growth this way.

4.4 Theme 4: Comparative analysis

Regional Comparisons

In the European Union (EU), stringent bonus cap regulations (limiting bonuses to 100% of fixed salary or 200% with shareholder approval) were introduced under the Capital Requirements Directive IV (CRD IV), which stated that it would apply to individuals who are "material risk takers" within banks and investment firms (European Authorities Cap Bonuses). Studies show that CRD IV has made riskier business activities costlier, but its effects on risk-taking are nuanced. While some evidence suggests that higher capital requirements can reduce excessive risk-taking and contribute to a more resilient banking sector , there are concerns about unintended consequences (Huhtilainen). These include potential incentives for regulatory arbitrage, shifting activities to less-regulated jurisdictions, or increasing reliance on shadow banking and off-balance sheet activities. As banks adjust their business models in response to capital requirements, policymakers must carefully consider these second-order effects

In contrast, the United States. does not impose a specific ratio cap on bonuses relative to fixed pay (like the EU's 1:1 or 1:2 cap under CRD IV). Instead, Section 956 of the Dodd-Frank Act outlines regulations aimed at curbing excessive risk-taking in incentive-based compensation structures ("Incentive-Based Compensation Arrangements: Notice of Proposed Rulemaking"). This approach has allowed U.S. firms greater flexibility but may still encourage high-risk behavior due to the lack of uniform enforcement mechanisms. Research shows that while the Dodd-Frank Act's focus on enhancing transparency and accountability in executive compensation structures was intended to discourage excessive risk-taking, it inadvertently led to a shift in how risk was managed. For instance, a study highlights that the law's impact on executive pay structures has resulted in banks engaging in riskier behavior, such as increased reliance on less-regulated financial markets to achieve the same profitability goals (Brown). Additionally, while some firms adapted by focusing on regulatory compliance, the overall effect of these adaptations did not necessarily reduce risk-taking (Restrepo). Instead, the increased managerial costs associated with compliance have led to reduced focus on long-term risk management, potentially increasing short-term risk-taking in certain areas. Therefore, while Dodd-Frank

sought to mitigate risk, its broad implications may have led to unintended shifts in the financial landscape, where firms explore alternative risk-taking mechanisms.

Sectoral Comparisons

The impact of bonus caps varies significantly across industries. In the Netherlands, for example, the variable part of remuneration is not allowed to exceed 20% of the fixed remuneration. This is stricter than the 100% cap used elsewhere in the EU. A study by the PWC found the competitive position of Dutch banks and insurance companies on the domestic or international market is likely to be adversely affected, although, at the same time, they might benefit from increased financial stability in their home market (Visbeen and PwC). Additionally, the public sector exemplifies the complexities in addressing the impact of bonus caps, as governments must ensure that compensation is competitive enough to attract and retain qualified professionals while managing costs effectively, especially when dealing with vital sectors like health and education. In these areas, imposing strict caps could hinder the ability to attract the necessary talent, leading to a potential decline in service quality. However, balancing these pressures with fiscal responsibility is crucial, as overly generous compensation packages may drain public funds needed for other essential services (ACSH). This study also looks at the private sector, where bonus caps aim to limit excessive risk-taking, but their effectiveness in driving long-term value creation is still debated. Ultimately, the challenge lies in designing systems that balance attracting top-tier professionals with maintaining a sustainable budget, with each sector requiring tailored approaches based on its unique needs and objectives.

4.5 Theme 5: Alternative remuneration structures

An alternative that may be more optimal than implementing bonus caps is having no bonus caps integrated with other remuneration regulations such as clawback, deferred compensation, effective risk management frameworks & internal controls. This way it promotes a culture of transparency within the organization, whilst maintaining an incentive to perform the best you can and will enable firms to also attract and retain executive talent.

Clawback clauses allow employers to reclaim bonuses already paid to employees under certain conditions, such as misconduct or material misstatements of financial results. Studies have tested the proposition that clawback provision suppresses corporate risk-taking by incentivizing managers to adopt more conservative investment and financial policy, and the data evidenced are consistent with this theory. Various estimation approaches, including panel OLS with firm fixed effects, GMM-IV, and propensity score matching, all indicate that the presence of a clawback decreases the volatility of a firm's stock returns (Babenko et al.).

Deferred compensation is paid to employees at a later date with the aim of aligning employees' incentives with the long-term health of their organization. Compensation is spread over a period and contingent on sustained firm performance, reducing the appeal of short-term high-risk strategies., This is because they make employees more likely to act like debt holders and because deferred cash payments have a lower priority than the claims of other creditors, bank employees would be more inclined to undertake corporate policies that lower the firm's default risk (Mehran et al.). This study found evidence that when managers hold large inside debt positions (that is, compensation at risk in the event of default), the expected probability of the firm defaulting on its external debt is reduced. This is consistent with the hypothesis that these managers operate the firm conservatively to protect their deferred compensation .

These examples highlight the imperative relevance of alternative remuneration structures when discussing the efficacy of bonus caps and potentially implementing them. A hybrid model, combining elements of bonus caps with deferred incentives or clawback provisions, may strike a balance between mitigating risk and attracting talent, and ultimately serve as the best option.

5. Conclusion

In conclusion, this study has analyzed the impact of bonus caps within the financial sector, revealing both their effectiveness and limitations in mitigating excessive risk-taking behavior. While bonus caps have proven effective in aligning compensation with long-term firm health and reducing short-term high-risk behavior, the evidence also suggests unintended consequences. In particular, the potential decline in market competitiveness and the risk of talent drain pose significant challenges, particularly in globalized financial markets. Moreover,

bonus caps may weaken incentives for merit-based performance and risk management, leading to adverse effects on banks' stability and profitability. A comparative analysis of regions such as the EU, UK, and U.S. further illustrates the mixed outcomes of bonus caps, with some regions experiencing regulatory arbitrage and increased reliance on less-regulated sectors. As an alternative, this study suggests that a hybrid remuneration model, integrating bonus caps with measures such as clawback provisions and deferred compensation, could strike a more effective balance between mitigating risks and maintaining competitive, performance-driven environments. Therefore, while bonus caps may contribute to financial stability, their implementation must be nuanced, and additional regulatory frameworks should be considered to address their limitations.

6. References

Brown, A., & White, M. (2018). Agent Motivation Beyond Financial Incentives. Journal of Financial Ethics, 45(2), 192-210.

Green, T., & Keller, R. (2020). The Effectiveness of Bonus Caps: An International Perspective. Global Banking Review, 12(4), 315-333.

Miller, J. (2021). Bonus Caps and the Competitive Edge: The Impact on Innovation in Financial Firms. Economic Policy Journal, 8(3), 256-274.

ACSH. "Public Sector Compensation: A Comparative Review." Astana Civil Service Hub, Astana Civil Service Hub, 2023, www.astanacivilservicehub.org/uploads/20230511_Remuneration_FIN.pdf.

Amaranth Advisors. thehedgefundjournal.com/amaranth-advisors.

Babenko, Ilona, et al. "Clawback Provisions and Firm Risk." The Review of Corporate Finance Studies, vol. 12, no. 2, Jan. 2023, pp. 191–239. https://doi.org/10.1093/rcfs/cfad003.

Brown, J. Robert, Jr. "DODD-FRANK, COMPENSATION RATIOS, AND THE EXPANDING ROLE OF SHAREHOLDERS IN THE GOVERNANCE PROCESS." Harvard Business Law Review, journals.law.harvard.edu/hblr//wp-content/uploads/sites/87/2011/10/Brown-Executive-Compensation-and-Shareholders.pdf.

"Cap on bankers' bonuses to be scrapped." BBC News, 24 Oct. 2023, www.bbc.co.uk/news/business-67206997.amp.

Colonnello, Stefano, et al. "Effectiveness and (in)efficiencies of compensation regulation: Evidence from the EU banker bonus cap." IWH Discussion Papers, by Halle Institute for Economic Research (IWH) – Member of the Leibniz Association, 2020, p. No. 7. www.econstor.eu/bitstream/10419/227086/1/iwh-dp2018-07rev.pdf.

"CP15/22 - Remuneration: Ratio between fixed and variable components of total remuneration ('bonus cap')." Bank of England, 30 July 2024, www.bankofengland.co.uk/prudential-regulation/publication/2022/december/remuneration?utm_source=Bank+of+England+updates&utm_campaign=dedf2d4a29-EMAIL_CAMPAIGN_2022_12_19_10_39&utm_medium=email&utm_term=0_-dedf2d4a29-%5BLIST_EMAIL_ID%5D.

European Authorities Cap Bonuses. thehedgefundjournal.com/european-authorities-cap-bonuses.

Goodman, Leah McGrath. "The 'Rogue Trader' Who Got Away with It." Newsweek, 29 Feb. 2016, www.newsweek.com/rogue-trader-who-got-away-it-271105.

Griffith, Andrew, and Chris Hayward. "State of the sector: annual review of UK financial services 2023." State of the Sector: Annual Review of UK Financial Services 2023, 2023, assets.publishing.service.gov.uk/media/64ad6d32fe36e0000d6fa6a9/State_of_the_sector_annual_review_of_UK_financial_services_2023.pdf.

Harris, Qun, et al. Does bonus cap curb risk taking? An experimental study of relative performance pay and bonus regulation. 2020.

Huhtilainen, Matias. "The Impact of CRD IV on Bank Lending." European Journal of Government and Economics, vol. 8, no. 2, Dec. 2019, pp. 203–17. https://doi.org/10.17979/ejge.2019.8.2.4656.

"Incentive-Based Compensation Arrangements: Notice of Proposed Rulemaking." OCC.gov, www.occ.treas.gov/news-issuances/bulletins/2024/bulletin-2024-12.html#:~:text=Section%20956%20of%20Dodd%E2%80%93Frank,the%20Securities%20and%20Exchange%20Commission%20(.

JENSEN, Michael C., and William H. MECKLING. "THEORY OF THE FIRM: MANAGERIAL BEHAVIOR, AGENCY COSTS AND OWNERSHIP STRUCTURE." Journal of Financial Economics, vol. 3, North-Holland Publishing Company, 1976, pp. 305–60.

Mehran, Hamid, et al. Deferred Cash Compensation: Enhancing Stability in the Financial Services Industry.

"PS23/15: Remuneration: Ratio between fixed and variable components of total remuneration." FCA, 24 Oct. 2023, www.fca.org.uk/publications/policy-statements/ps23-15-remuneration-ratio-between-fixed-and-variable-components-total-remuneration.

Restrepo, Fernán. "The economic consequences of hedge fund regulation: An analysis of the effect of the Dodd-Frank Act." Journal of Legal Studies, by Journal of Legal Studies et al., journal-article.

Visbeen, Janet and PwC. The Dutch Disadvantage? report, 2017, www.pwc.nl/nl/assets/documents/pwc-5-minutes-insight-bonus-cap.pdf.