Bonuses influence where bankers go but it’s not all about pay

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The UK has [given up](https://theconversation.com/the-uk-has-given-up-on-challenging-the-european-court-of-justice-over-its-cap-on-banker-bonuses-22669) on challenging the European Court of Justice over its cap on banker bonuses. The cap that’s in place restricts bonuses to 100% of banker’s pay or 200% with shareholder approval. And there are now fears that this will [*undermine London’s status as a financial hub*](https://theconversation.com/the-uk-has-given-up-on-challenging-the-european-court-of-justice-over-its-cap-on-banker-bonuses-22669).

A key argument made for scrapping the cap is that it will drive talent elsewhere and this will put European banks at a disadvantage when it comes to attracting the best talent. In other words, it is argued that there is a market for managerial talent and that banks competing for talented managers must pay the market price for their services. But the relationship between offering big bonuses and attracting talent is a complex one.

**A talent market**

Consider the central argument for having high salaries: if there is high demand for talented managers and financial professionals and if there are banks and institutions ready to pay high salaries for them, then everyone has to follow suit and pay them. It is sort of like saying that there are not too many top class footballers and so long as Real Madrid is willing to pay £78m for Gareth Bale, Barcelona has to pay £80m for Luis Suarez, with the same being true about the personal terms these footballers agree with their respective clubs. The question therefore is whether this kind of market place exists for managerial talent in the banking-financial sector globally.

Economists R. Glenn Hubbard and Darius Palia examined this idea of a market for managerial talent [*in the context of the US banking industry*](https://theconversation.com/the-uk-has-given-up-on-challenging-the-european-court-of-justice-over-its-cap-on-banker-bonuses-22669). For decades, the US had severe geographic restrictions on the ability of banks to compete across state boundaries. But since the 1980s (and especially since the passage of the Riegle-Neal Interstate Banking Act of 1994) there has been increasing inter-state competition in the US banking sector.

Hubbard and Palia investigated the degree to which banks that operate in states that permit inter-state banking – and are therefore subjected to greater competition – would have to pay skilled managers above the competitive level. Their empirical analysis suggests that managerial pay is indeed higher for banks that operate in more competitive markets. Overall, they find that in the more competitive banking markets there is a higher level of managerial compensation, higher turnover of managers and greater sensitivity of managerial pay to performance. All of these indicate that there is indeed a market for managerial talent in competitive markets.

“Golden handcuffs” – where financial benefits are given to keep employees – do not appear to significantly affect a company’s ability to stop employees from jumping ship. In their [*research*](https://theconversation.com/the-uk-has-given-up-on-challenging-the-european-court-of-justice-over-its-cap-on-banker-bonuses-22669), C. Edward Fee and Charles J Hadcock show that the stock price performance has an effect on
whether or not a senior manager decides to leave one company to join another. But the opportunity of career progression at a new company matters over the value of their stocks. So golden handcuffs for executives leaving for a CEO position (as opposed to a similar position) are weak.

The weakness of golden handcuffs is at least partially explained by the “golden keys” offered by the new employers in the form of stock options, restricted stocks and cash signing bonuses. In other words, high bonuses being paid by banks may not necessarily help them retain talent, but these may be necessary to poach talent from other banks in these competitive markets.

The analogy of the football transfer market becomes even more relevant in situations where talent is industry-specific, can only be revealed on the job and, once revealed, become public information. Marko Tervio argues that where talent is industry-specific, companies (which can include banks) can bid excessively for the pool of incumbent workers instead of trying out new talent.

Where there is such bidding for workers, the compensation packages for (at least some of) them can become inflated. More importantly, this inflation in compensation is not on account of a competitive market for managerial talent. It results from market failure whereby new managers who can potentially be better than the incumbents are ignored, thereby reducing competition for them.

Finally, it has been argued that large compensation packages for senior executives of companies may have more to do with the so-called agency problem than with either competition for managerial talent or failure in the market for managerial talent. Boards can find it difficult to negotiate compensation packages of executives without giving these executives a significant influence over their compensation packages.

Such managerial power over their own pay obviously has direct implication for the level of the compensation and Bebchuk and Fried argue that managerial influence over their own pay can also de-couple their pay from firm performance. There is empirical evidence of CEOs rigging incentive pay in companies by shifting the weight towards better performing measures.

**Not the whole story**

Research into this issue of banker pay and talent management therefore suggests that large compensation packages can undoubtedly be important for attracting talent, but that may not be the whole story. Indeed, large compensation packages for executives in general can also be driven by other factors such as (ironically) market failure in the market for managerial talent and managerial influence over their own pay.

Hence, both banks and regulators make arguments that are difficult to disregard completely. The banks may have a point when they claim that large bonuses are necessary to attract talented professionals. But the regulators also have a point when they argue that large bonuses are an outcome of bank managers simply paying themselves too much.
But what is lost in this focus on capping banker bonuses is the importance of ensuring that the pay structure of banking executives aligns their interest with that of stakeholders who favour a low degree of fragility in the financial sector. These stakeholders can include regulators, central banks and ultimately governments who have to step in if there is a banking crisis. From this perspective, the efficacy of a cap on bankers’ bonuses is not obvious and other debates such as those about breaking up “too big to fail” banks might be of greater importance.