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# Caps Are Not the Answer

By Dalibor Rohac

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Ever since the collapse of Lehman Brothers, policymakers have tried to curb bankers' bonuses, which are said to encourage excessive risk-taking by financial institutions. These efforts are not likely to yield much fruit. At most, they are a distraction from the much more serious problem of implicit government guarantees to the financial sector and ill-conceived aspects of financial regulation in Europe and in the United States.

According to new European Union rules, which came into force on Jan. 1, bonuses paid to bank executives must not exceed their basic annual salaries without the explicit consent of shareholders. And even then, the total amount is capped at twice the annual salary.

That will not do the trick. As Financial Times' Tim Harford put it, the cap "is the equivalent of trying to limit alcohol consumption by saying your consumption of beers cannot exceed the number of tequila shots you downed at the beginning of the evening." HSBC is already planning to augment the base pay for roughly 1,000 of its senior employees with stock paid every three months, which will need to be held for another 5 years, effectively increasing the scope for bonuses that can be paid.

Even if we ignore the flaws of this particular rule, existing research on the relationship between bonuses and risk-taking in finance is far from conclusive, with some studies arguing that it is "unlikely that incentive structures could be held responsible for inducing bank executives to focus on short-term results."

More fundamentally, involving the government in micromanaging executive compensation in the financial sector does not solve the too-big-to-fail problem. Instead of interfering with private contracts between shareholders and bank executives, governments ought to ensure that financial institutions cannot impose the costs of their failures on the wider population.

*Dalibor Rohac is a policy analyst at the Center for Global Liberty and Prosperity at the Cato Institute. He is on Tweeter.*