Rank and Risk among Traders

News are coming out that some banks are reducing bonuses for their employees or even invoking clawback clauses (taking back bonuses already given) because of low financial results, or even results that needed to be re-stated because of losses unknown at the time.

The trading desk has been the source of problems in some cases, as in the case of UBS, which lost more than 2 billion dollar in apparently unauthorized trades made by trader Kweku Adoboli. The case is similar to earlier trading scandals involving Nick Leeson at Barings Bank and Jerome Kerviel at Societe Generale, among others.

What makes these trading scandals happen? So far attention has focused on how individuals who fall behind their goals may ratchet up their risks to avoid losses, but in doing so can end up absorbing even greater losses. In some cases these losses spiral out of control, as has been the case for some traders. The solution seems obvious: always monitor risk; monitor risks even more closely when a trader is making losses.

Unfortunately this is not the end of the story. In a forthcoming paper, Elizabeth Boyle and Zur Shapira have looked at how people behave in tournaments with prizes for placing first. The results are worrying because they show two kinds of risk taking. One is that those below the leader position sometimes look up to the objective of beating the leader, and sometimes down to the objective of not going broke. (As the trading scandals suggest, they don't always remember the looking down part.) The second is that the leader is looking at those trying to catch up, and taking greater risks in order to stay ahead.

Why is such risk taking a concern? Many organizations have systems of bonus, recognition, or promotion that depend on placing first in formal or informal tournaments. This is an economical way to make incentives for employees because the many are motivated to chase a prize that only one person gets. But what if these employees can win by taking risks and getting lucky, not just by working harder and more diligently? For those types of jobs, the organization is facing a stark choice between offering weaker incentives and having stronger monitoring. Of course, the third option is to wait for something to go bust.

Reference

Boyle, Elizabeth and Zur Shapira. The Liability of Leading: Battling Aspiration and Survival Goals in the Jeopardy! Tournament of Champions. Organization Science, forthcoming.

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