

Note 12

Inside Debt

Proposal: In order to prevent imprudent risk taking, the incentives of the CEO in highly leveraged firms such as investment banks should be aligned to those of the creditors.

1. In the aftermath of the recent financial crisis, it has been argued that it is not enough in highly leveraged firms such as investment banks to simply align the interests of the CEO and shareholders. In such firms, due to the low equity level, shareholders may themselves encourage or indeed require the CEO to take excessively risky decisions. To prevent this, the CEO's compensation in highly leveraged firms must thus be linked to the overall firm risk so that the interests of the creditors are also accounted for and the firm can comfortably make obligatory payments to the creditors.
2. One way to link compensation to the firm risk is through **deferred compensation** and pension, alternatively called **inside debt** (Edmans and Liu, 2010; Wei and Yermack, 2010). Deferred compensation refers to schemes to delay the CEO's receipt of a certain amount of current-year salary and bonus, leaving it invested with the firm at a fixed rate of return until retirement or even sometime after retirement. Wei and Yermack (2010) argue that inside debt is **unsecured** like bonds and other creditor loans in the event of default. Inside debt forces the CEO to lose the same percentage from his deferred compensation pool as the debt holders' losses, which discourages the CEO to engage in excessively risky behaviour to reduce the possibility of going bankrupt and also reduces "go for broke" incentives during financial distresses. Consequently, CEOs with high holdings of deferred compensation and pensions are likely to take less risk in order to protect their future income stream, minimising future defaults.
3. The use of inside debt in banks has received some empirical support in a number of studies, including in a study by Tung and Wang (2010) who report that bank CEOs with higher levels of inside debt compensation exposed their firms to less risk and hence performed better during the subprime financial crisis.

An excellent essay should try to analyse critically the proposal described in this note – the inside debt proposal. There is already a nascent literature studying the pros & cons of inside debt.

Bibliography:

Tung, F and Wang, X. (2010). "Bank CEOs, Inside Debt Compensation and the Financial Crisis." *Emory Law and Economics Research Paper*, No.10-63.