Notes 3

Claims & Hypotheses

As the previous note described typical CEO compensation schemes have two components: The first is a fixed payment, which is paid as long as the firm is solvent. In the event of insolvency the executive may lose this component, say the fixed salary or the defined benefit pension that yields an equal claim with other creditors in bankruptcy. The second component is a variable component made up of executive stock options that depends positively on the performance of the financial institution as measured by its common stock prices or some other profit measures.

- Hall and Liebman (1998:658): “the most direct solution to [the] agency problem is to align the incentives of executives with the interests of shareholders by granting (or selling) stock and stock options to the CEOs.’’

A controversial claim / hypothesis in the recent literature is that such compensation schemes lead a CEO or other agents involved in trading to take imprudent risks (with the firm’s assets):

- “One of the problems of stock options and similar instruments is that executives rewarded with stock options benefit when the stock price rises but experience no reduction in real wealth if the stock price declines. Managers may respond to these instruments with excessive risk-taking actions since they would not see their wealth damaged in the case of stock price drops. .... Moreover, executives need only short-time improvements in share value to exercise their options. ...” (Pacual Berrone)

- “... hugely popular form of equity-based executive pay, share options ... encourages a focus on short-term highs, regardless of the potentially destructive long term consequences.”

- “The asymmetric stock options payoff encourages risk-taking that is more careless and uncontrolled than envisioned by the theoretical models justifying options. Indeed, it is not difficult to imagine CEO who drives a large portion of his compensation in stock options, and stands to make millions from those stock options, who undertakes a spate of far-fetched, exceedingly long-shot initiatives - in hopes of the big win that will push the company's share price greatly upward. Concerns about failure are minimized not only because of the floor-effect of the stock options, but also possibly by other forms of protection, including a co-opted or congenial board (Mace, 1971; Westphal, 1998;1999), the CEO's ability to create the impression that he or she was acting in an appropriate entrepreneurial fashion (Davidson et al. 2004), and even a handsome severance agreement (Almazan and Suarez, 2003; Dalton et al 1993)” (Hambrick and Sanders, 200 16)

So your task is in part to examine if paying a CEO with stock options (which are valuable only if the firm’s share price is above a certain level) will lead a CEO to take imprudent risk (with the firm’s assets). Surely, to this aim, you may also consider other forms of compensations common in the literature (such as severance agreements). Future notes will touch on this and other issues.