PERFORMANCE COMPENSATION CONTRACTS
AND CEOS' INCENTIVE TO SHIFT RISK TO
DEBTHOLDERS:
AN EMPIRICAL ANALYSIS

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Abstract
The paper investigates the relationships among CEO incentive contracts, manager ownership, charter value, and bank risk taking. We analyze whether the presence and magnitude of incentive contracts induce CEOs of financially distressed firms and firms with high manager ownership to take unprofitable risks that shift wealth from debtholders to equity holders. Our sample focuses on banks that had both the incentive and opportunity to shift risks, and compares them with those that did not. We compare weak and strong banks in periods when the banks' principal creditor, the FDIC, was a lenient and then a stringent monitor. The evidence is consistent with bonus compensation inducing CEOs of financially weak firms to shift risk to debtholders only if they do not have large insider ownership. The evidence is also consistent with these contracts rewarding CEOs for their effort to manage unforeseeable risk albeit not their ability. Low charter value banks with high managerial ownership took profitable risk during the lenient regulatory period. (JEL G30, G34)

Introduction

It is widely accepted that debt potentially changes stockholders' choice of operating policies for their businesses [e.g., Fama and Miller (1972), Jensen and Meckling (1976), Myers (1977), Barnea et al. (1980, 1985), Haugen and Senbet (1981), Berkovitch and Kim (1990), Campbell and Kracaw (1990), Moshe and Maksimovic (1990), and Mallo and Parsons (1992)]. Authors of these papers (among others) call attention to stockholders' incentive to shift risks to in-place debtholders, thereby transferring wealth to themselves. However, CEOs of publicly traded corporations may be unwilling to make investments that shift risk to debtholders, because the CEOs' interests are not or cannot be sufficiently well aligned with those of stockholders.1 Perhaps for this reason, numerical analyses presented by Parrino and Weisbach (1999) indicate that potential risk shifting is unlikely to have an economically significant effect on the investments of large, publicly traded non-financial corporations, except among corporations with high debt/equity ratios.

We provide an empirical test of whether incentive compensation is related to an increase or decrease of risk with a unique sample of 141 highly levered firms (banks), many of which had

1 Some evidence of risk shifting to the Federal Savings and Loan Insurance Corporation (FSLIC) by savings and loan associations (S&Ls) that converted from mutual to stock ownership in the early 1980s is reported by Esty (1997), Cebenoyan et al. (1999), and Chen et al. (1988). However, these S&Ls generally were organized by stockholders who controlled (and often managed) them, which differ from the situation for most publicly traded corporations. Indeed, of the FSLIC's twenty-five most costly S&L failures resolved in 1988, four were stocks for which the ownership could not be determined, five were mutuals, and the remaining sixteen stocks, only one was widely traded and the CEO was the principal owner of fifteen. (Data provided by Professor James Barth, formerly Chief Economist, Federal Home Loan Bank Board.) Saunders et al. (1990), Brewer et al. (2003), Harjto and Mullineaux (2003) and Galloway et al. (1997) find evidence of greater risk shifting in laxly regulated environments by banks.
considerable incentives and opportunity to shift risk. The depleted capital of these banks (as indicated by their low market-to-book value of equity ratios and, thus, reduced unrecorded charter values) during the period we study (1988-1994) may have enhanced their managers’ incentives to increase the variance of their banks’ expected cash flows and unprofitable risk taking, especially considering that the nature of bank investments allows them to shift to riskier investments quickly. In addition, our sample meets an important criterion mentioned by Guay (1999), who argues that inclusion of failed firms or firms with severe financial problems is a necessary condition for testing risk shifting. During the seven years, 39 of the banks we study were “financial failures”: liquidated, sold, or merged under conditions of severe financial distress. Our focus on these firms in a period when their industry was distressed (1988-91) allows for the possibility that future good performance was not the main reason that these firms adopted or maintained incentive compensation.

To examine CEOs’ risk shifting incentives, we contrast periods when creditors were first lenient and then stringent monitors and enforcers of risk taking. Prior to enactment of the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA), the banks’ principal creditor, the Federal Deposit Insurance Corporation (FDIC), was a lenient monitor of risk taking. Similar to the ability of creditors to intervene when firms are contemplating debt restructure or bankruptcy, FDICIA gave the banking agencies both the mandate and power to stringently monitor and constrain risk-taking by financially weak banks. Hence, the weakened economic position of many banks and “regime shift” in creditor monitoring provides a useful test of the risk-shifting hypothesis. In each of these periods (1988-91 and 1992-94) we examine the use and effect of both short-term (bonuses) and long-term (e.g., stock options/rights) compensation contracts that might reward CEOs for accepting risky projects, and compare weak (low market-to-book value of equity ratios) and strong banks.

Our study has implications for bank regulation. Apparently, the drafters of FDICIA accepted the validity of the risk-shifting hypothesis and believed that financially weak banks use compensation plans to give their CEOs incentives to shift risks to the FDIC. FDICIA empowers regulators to monitor and restrict CEO compensation at those banks. Indeed, John and John (1993), Noe et al. (1996), and John et al. (2000) theorize that manager-shareholder alignment, as evidenced by option-based contracts and bonuses, may have been a key reason for imprudent risk taking in the banking industry. Consequently, John et al. (2000) directly propose linking the FDIC insurance premium to incentive features of top-management compensation as a direct mechanism for controlling risk taking.

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2 Macey and O’Hara (2003a, 2003b), Marcus (1984), Esty (1997), and Lee et al. (1997) forcefully argue that risk shifting is particularly a concern in regulated environments.

3 Kole (1997) and Yermack (1995,1997) provide empirical evidence of reverse causality among financially healthy firms. For example, Yermack (1997) finds that the timing of stock option awards coincides with favorable movement in companies’ stock prices shortly before favorable news. This hypothesis is less plausible for severely financially distressed firms.

4 Reviewing this period, Kaufman and Benston (1993, p. 21) explain: “the sharp increase in the number of seriously troubled institutions in the mid-1980s changed the regulators’ resolution practice substantially. As they became overwhelmed by the extraordinary number of troubled and failing institutions, regulators increasingly failed both to impose their discretionary sanctions either as harshly as necessary or in the time required and to enforce even the weak closure rule of zero book value capital. They frequently found it in their best interests to deny the existence of serious bank problems in the hopes that they would reverse themselves or would not worsen catastrophically until later, on someone else’s watch. As a result, some economically insolvent or weak institutions were provided with both the incentive and time to gamble for resurrection.” See Barth et al. (1992, Chapter 2) for an analysis showing that the problems of the late 1980s were centered on large (publicly traded) banks. They state (ibid., p. 88): “the big banks are those with the most distress at the moment (1991) and may be the biggest beneficiaries of regulatory forbearance.” As we show later, FDICIA represented a sharp change in regulatory behavior.

5 Although franchise value is related to the market value of equity, this study also focuses on the book value of equity because in a regulated environment it determines the extent and degree of monitoring by the primary debtholder.