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Better Safe than Sorry? CEO Inside Debt and Risk-taking in Bank Acquisitions

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Abstract

Widespread bank losses during the financial crisis have raised concerns that equity-based compensation for bank CEOs causes excessive risk-taking. Debt-based compensation, so-called inside debt, aligns the interests of CEOs with those of external creditors. We examine whether inside debt induces CEOs to pursue less risky acquisitions. Consistent with this, we show that acquisitions announced by CEOs with high inside debt incentives are associated with a wealth transfer from equity to debt holders. After the completion of a deal, banks where acquiring CEOs have high inside debt incentives display lower market measures of risk and lower loss exposures for taxpayers.

JEL Classification: G21, G34, J33

Keywords: Banks; inside debt; CEO incentives; mergers and acquisitions

1. Introduction

The risk-taking behavior of senior executives in the banking industry has become a concern for the public and for policymakers. Undue risk-taking jeopardizes the safety and soundness of individual institutions as well as the stability of the entire financial sector. Undue risk-taking also

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