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Executive pensions, risk-shifting, and foreign exchange exposure

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ABSTRACT

Using a hand-collected executive compensation database of 272 large U.S. firms from 2000 to 2009, we present the first study of its kind to analyze the effects of executive pension-based compensation on foreign exchange exposure. We find evidence that higher executive pension compensation results in lower foreign exchange exposure among our sample firms, an effect that is strongest when sample firms are closest to bankruptcy. Our results have important implications for the structuring of managerial compensation contracts for multinational firms.

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1. Introduction

Value-maximizing firms are motivated to manage foreign exchange (FX) exposure in order to reduce risk. Several factors determine the level of risk management undertaken by a firm, including impending financial distress, tax policy, and agency issues (e.g. [Bessembinder, 1991](#); [Leland, 1998](#); [Smith and Stulz, 1985](#); [Stulz, 1984](#); [Tufano, 1998](#)). Agency effects include the structure of contracts, risk aversion of managers, and wealth incentives. Although several papers have examined the link between compensation structure and hedging, to our knowledge no work has focused on debt-based pension compensation and its effects on corporate FX exposure. Using a hand-collected database and building on existing international and corporate agency literature, we examine the relation between pension-based compensation and firm-level FX exposure.

The connection between managerial incentives and risk-taking has been explored in several papers. Notably, [Smith and Stulz \(1985\)](#) demonstrate that the level of managerial risk aversion and the structure of management contracts can be significant drivers of corporate hedging. Further, [Rogers \(2002\)](#) and [Adkins et al. \(2007\)](#), find that managerial incentives are an important determinant in corporate derivatives usage. However, managerial incentives were historically regarded as a matter of equity compensation; only with [Sundaram and Yermack \(2007\)](#) was pension-based compensation considered an important driver of aggregate firm risk. Building on agency literature extending to [Jensen and Meckling \(1976\)](#), [Sundaram](#)

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and Yermack (2007) posit that high proportions of debt-like compensation (such as pensions) reduce managerial risk-taking behavior. Inversely, greater risk-taking is observed when executive compensation schemes are equity-heavy.

Combining the findings from both international finance and corporate finance literature, we posit that managers with high proportions of debt-like compensation are more likely to manage FX exposure aggressively, thereby reducing overall cash flow volatility and assuring the firm's long-term survival. Although data limitations do not allow us to observe managerial risk-taking directly, we argue that pension-based managerial compensation is ultimately reflected in lower corporate FX exposures. Managerial capital budgeting decisions can also serve as a link between compensation and FX risk exposure.

The papers closest to ours are Francis et al. (2013) and Belkhir and Boubaker (2013). Francis et al. (2013) use Delta and Vega measures of CEO compensation to study the relation between CEO compensation and FX exposure. Their study reports that a 4.5% (7.9%) increase in the sensitivity of CEO wealth to stock price (equity return volatility) results in a one standard deviation decrease in FX equity exposure. Using a sample of banks, Belkhir and Boubaker (2013) analyze the effects of pensions and deferred compensation on CEO hedging of interest rate risk. Their study identifies a positive relation between CEOs' inside debt and the use of interest rate derivatives for hedging purposes.

Our paper differs from the Belkhir and Boubaker (2013) and Francis et al. (2013) studies in several ways. First, we focus our analysis on the relation between pensions and FX exposure; FX exposure is consistently identified by survey results as a major source of risk that is commonly managed (Bodnar et al., 1996, 1998, 1995). Second, we expand our analysis to include other top executives of the company, not just CEOs. This inclusion is important because often the CFO and/or the Treasurer are more directly involved in risk management and capital budgeting decisions than the CEO. Third, hedging policies primarily focus on the reduction of the firm's cash flow volatility. Although equity returns are commonly used as a cash flow proxy when estimating FX exposure, we estimate FX cash flow exposure using an accounting-based cash flow proxy. This alternative provides us with a more direct measure of FX cash flow exposure.

In our empirical analysis we study pension plans for 272 of the largest U.S. firms over a ten-year period (from 2000 to 2009). We report two important results. First, we document a negative relation between pension-based executive compensation and firm-level FX exposures. This is consistent with a reduction in managerial risk-taking incentives, which would lower FX-related risk taking and ultimately be reflected in corporate FX exposures. Second, consistent with the notion that the risk-shifting problem is magnified in distressed firms (Eisdorfer, 2008), we document a stronger relation between pension-heavy compensation and FX exposure reduction in a subsample of financially distressed firms.

The paper proceeds as follows. Section two provides a discussion of the hypotheses. Section three presents a description of the methodology and sample data used in this study. In section four we discuss the results and its implications. Section five concludes the study.

2. Hypotheses

Typically, managers are compensated with a debt-like components (such as pensions and deferred compensation) and equity-like compensation (such as stock awards and stock options). Researchers observe that when the ratio of debt to equity components in the compensation structure of an executive (compensation leverage) is different from the debt to equity ratio of the firm as a whole (firm leverage), substantial disincentives can develop.¹ Executives with high compensation leverage will have interests more closely aligned with the firm's bondholders. Conversely, executives with low compensation leverage have interests more closely aligned with shareholders.

In this paper, we study firm-level FX exposures that reflect managerial risk-taking with respect to FX rates and corporate international investment. We argue that pension-compensated managers, because of their increased incentive to reduce the firm's cash flow volatility, will more aggressively manage FX exposure and/or make less risky capital budgeting decisions associated with corporate international diversification. As a result, firms with pension-compensated managers will have lower levels of FX exposure. We test our first hypothesis:

H1. Firms with relatively larger executive pension plans will have lower levels of FX exposure.

In our second hypothesis, we draw on prior literature covering agency theory, financial distress, and bankruptcy. The risk-shifting incentive increases for managers of financially distressed firms.² In such firms, equity holders are more inclined to take large gambles (Eisdorfer, 2008; Jensen and Meckling, 1976) due to relatively larger potential payoffs. From an FX exposure management perspective, equity-compensated managers are more likely to leave FX exposure unhedged or even participate in FX speculation. Conversely, pension-compensated managers have an increased incentive to manage FX exposure when the firm is financially distressed due to their fear of losing their pensions. This leads to our second hypothesis:

¹ Core and Guay (2002) and Coles et al. (2006) describe increased managerial risk-taking when executive compensation packages include high proportions of stock options. Sundaram and Yermack (2007) and Cassell et al. (2012) find that high levels of pension-based compensation have the opposite effect: managers are inclined to engage in less risky projects to preserve the firm's value in the long run. Edmans and Liu (2011) show that during crises, firm compensation packages that are pension-heavy can preserve long-term firm value.

² We use the Moody's KMV distance-to-default measure, which measures how many standard deviations in asset value would need to occur to generate firm bankruptcy (defined as the point at which a firm's value falls below its short-term debt plus one-half of long-term debt value). Higher values indicate the firm is farther from bankruptcy; lower values indicate the firm is closer to it.

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