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CEO inside debt and hedging decisions: Lessons from the U.S. banking industry

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ABSTRACT

Theoretical literature (Jensen and Meckling, 1976; Edmans and Liu, 2011) argues that inside debt – pension benefits and deferred compensation – has debt-like payoffs, and can therefore curb executives' excessive risk-taking incentives created by equity holdings. We test this theory in the banking sector by investigating whether CEOs with larger inside debt holdings compared to their equity-based compensation hedge more their banks' interest rate risk. Our results show that CEO inside debt holdings have a positive effect on the extent to which a bank uses interest rate derivatives for hedging purposes, implying that debt-like compensation mitigates bank executives' risk-taking incentives. Our results have important implications for financial regulation attempting to prevent financial crises due, at least partially, to perverse incentives provided to bank executives through compensation.

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1. Introduction and motivation

As the financial crisis continued to unfold, a quasi-consensus emerged among academics, regulators and consulting groups that compensation structures influence executives' incentives and can induce excessive risk taking by banking organizations. Specifically, there is an agreement that the compensation practices of banks were a factor that contributed to the build-up of excessive risk, which,

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in turn, precipitated the recent global financial crisis[1]. Much of the blame is directed towards stock options, as numerous studies document a strong link between stock option holdings-and-incentives and risk-taking by financial institutions (Chen et al., 2006; John et al., 2007; Mehran and Rosenberg, 2007; Bebchuck and Spamann, 2010; Belkhir and Chazi, 2010; DeYoung et al., 2010). Compensation contracts where stock options represent a significant component are said to promote short-termist behavior (Jensen, 2004; Jensen and Murphy, 2004; Graham et al., 2005; Bolton et al., 2006)) and to insulate executives from downside risks of their actions (Bebchuck and Spamann, 2010).

With compensation of bank executives pointed out as one of the flaws of the financial system, it is no surprise that the redesign of management compensation structures is mentioned as an important pillar in many financial regulation proposals aimed at fixing this system. For instance, the Dodd-Frank Wall Street Reform and Consumer Protection Act assigns to federal regulators the task of prescribing rules and regulations that prohibit any pay structure that "encourages inappropriate risks[2]". In their effort to implement this recommendation, U.S. regulators (FRB, FDIC, SEC, etc.) came to an agreement that required deferred compensation would be an effective mechanism that reduces any incentives that bank managers have to pursue risky policies that may doom the safety of the institution[3]. In a book published in 2010, the Squam Lake Working Group on Financial Regulation recommended that systemically important financial institutions should be required to hold back a significant share of each senior manager's annual compensation for a period of time[4]. The authors also recommend that such retained compensation should be for a fixed dollar amount – not stock or stock options. Deferred compensation has therefore become central to any debate on reforming compensation structure in the banking industry. It is, however, worth recalling that the deferral of executives' compensation by banks has been practiced for many years, as is shown by the latest disclosures of deferred compensation. Like other firms, banks can withhold two components of senior executives' compensation for payment in the future, namely, pension benefits and voluntary deferred compensation. These two compensation components are at risk because they represent unsecured and unfunded liabilities of the bank. Executives stand in line with other unsecured creditors in case the bank came to default. This debt-like compensation is usually referred to as inside debt (Jensen and Meckling, 1976)[5].

This paper contributes to the ongoing debate on the merits of deferred compensation as a component of financial regulation by investigating whether debt-like compensation enhances managers' incentives to hedge bank risk. Specifically, we examine whether inside debt – pensions and deferred compensation – enhances CEOs' incentives to hedge more interest rate risk using derivatives contracts. To the best of our knowledge, this is the first study that tests the effect of inside debt holdings on executives' risk-taking incentives through the channel of risk management. It builds on the idea that if the holding of inside debt influences executives' risk preferences, this should be reflected in banks' risk management decisions. Given their pay-off structure, CEOs holding inside debt are interested in operating with low levels of default risk. This is because CEOs holding inside debt bear the cost of their bank failure since their deferred compensation is forfeited if the bank becomes bankrupt. They will, therefore, make risk choices that help in keeping the bank's default risk at low levels (Bennett et al.,

[1] For instance, in November 2008, the Treasury Department, the Federal Reserve and the Federal Deposit Insurance Corporation (FDIC) issued a *Statement on Meeting the Needs of Creditworthy Borrowers* that emphasized the importance of structuring management compensation in a way that prevents perverse incentives, which can ultimately jeopardize the safety and soundness of the banking organization.

[2] See Section 956 of the Dodd-Frank Wall Street Reform and Consumer Protection Act on Enhanced Compensation Structure Reporting (page 530: http://www.sec.gov/about/laws/wallstreetreform-cpa.pdf).

[3] See for instance the statement of Marc Steckel on behalf of the FDIC on executive compensation oversight after the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 before the committee on financial services of the U.S. House of Representatives, on September 24, 2010 (http://www.fdic.gov/news/news/speeches/chairman/spsep2410.html).

[4] The Squam Lake Working Group on Financial Regulation defines itself as a group of 15 academics who have come together to offer guidance on the reform of financial regulation (http://www.cfr.org/projects/world/squam-lake-working-group-on-financial-regulation/pr1404).

[5] Jensen and Meckling (1976) make a brief reference to inside debt (a firm's debt held by insiders, such as managers) in their seminal work on ownership structure and managerial behavior. They conjecture that agency costs of debt due to the conflict of interest between stockholders and debtholders can be mitigated (or eliminated) by having the manager hold equal proportions of the firm's equity and debt.

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