CEO Option Compensation, Risk-Taking Incentives, and Systemic Risk in the Banking Industry

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Summary

This study examines the relation between CEO risk-taking incentives induced by stock option compensation and a bank's contribution to systemic risk for a sample of U.S. BHCs and commercial banks for the period 1992–2009. We find that option-induced CEO risk-taking incentives are positively associated with a bank's contribution to systemic distress risk and systemic crash risk, consistent with the argument that CEOs' risk-taking incentives motivate them to engage in and herd in risky business activities, which increases distress and crash risks in individual banks and amplifies risk spillover and contagion to other banks. We also find that non-interest income-generating activities, maturity mismatch, and innovative financial products, including asset securitizations (particularly CDOs) and CDSs, act as mediating channels for the positive relation between CEO risk-taking incentives and a bank's contribution to systemic risk. Moreover, we find that CEO risk-taking incentives induced from previous (new) option grants are positively (weakly) associated with a bank's contribution to systemic risk, in line with the notion that the freedom (restriction) of cashing out on stock options encourages (confines) excessive CEO risk taking that increases systemic risk. Further analysis reveals that information opaqueness, market illiquidity, and financial crisis amplify this positive relation, whereas bank size mitigates it. The results are robust to potential endogeneity, alternative measures of option-induced CEO risk-taking incentives, and alternative systemic risk measures.

This study contributes to the literature on executive compensation and financial crisis by documenting original and strong evidence on the impact of CEO risk-taking incentives induced by stock option compensation on a bank's contribution to sector-wide systemic risk. The evidence also extends previous studies connecting managerial incentives to bank-specific performance and risk and sheds additional light on the role of CEO option-based compensation schemes in systemic risk contagion and financial crisis. Evidence reported in this study has immediate policy implications for compensation reform in the post-crisis era and recommends the usage of more restrictive stock option compensation plans for CEOs.