CEO Compensation and Risk Taking:

Evidence from the Pre-Crisis Banking Industry

Rakesh Bharati[a], Jingyi Jia[b]

a. Department of Economics and Finance, School of Business, Southern Illinois University – Edwardsville, IL., USA

b. Department of Economics and Finance, School of Business, Southern Illinois University – Edwardsville, IL, USA

Abstract: We study the risk-vega relation for banks and find a significant, negative relationship between firm risk measures and vega conditional on moneyness (proxied by delta, vested options or CEO stock and option related wealth). Further, the negative risk-vega relation is driven by the 1999-2006 subperiod where deltas were generally high and the banks were deregulated. In contrast, the earlier 1993-1998 subperiod actually supports a positive risk-vega relationship. Finally, large banks reliably show a negative risk-vega relationship while the same cannot be said of small banks. Our results inform on two separate debates. First, merely granting stock-options to bank CEOs does not always encourage risk-taking in the banking industry. Option-incentivized risk taking also depends on other characteristics – bank size, CEO's exposure to stock price change (delta), and regulatory and market conditions. Also, option grants are often blamed for the excessive risk taking by the bank CEOs. However, our evidence indicates that risk-taking declined in stock options (as measured by vega) in the period leading to the financial crisis of 2008.

Keywords: CEO compensation, risk taking, compensation sensitivities

JEL: G010 (Financial Crises), G210 (Banks; Other Depository Institutions; Micro Finance Institutions; Mortgages; Foreclosures), G340 (Mergers; Acquisitions; Restructuring; Voting; Proxy Contests; Corporate Governance)