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CEO Bonus Pay and Firm Credit Risk

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ABSTRACT

This article examines the association between the bonus component of managerial compensation and the impacts on a firm's credit risk using data from the U.S. The empirical findings suggest that bonus compensation could potentially play a role in mitigating the agency costs of debt and restraining the CEO's risk-taking behavior, as bonus pay is significantly associated with lower credit risk in a broad sample across various industries. Cash compensation including salary and bonuses, however, have different impacts on credit risk. Bonus compensation does not add to credit risk as suggested in the financial press, but firms should differentiate impacts of bonus and salary pay on firm risk when designing executives' compensation package.

KEYWORDS

Bonus, Compensation, Credit Default Swap (CDS), Credit Risk, Salary

INTRODUCTION

In the U.S., bonuses are viewed as additional income and are taxed at the combined household income marginal tax rate. Specifically, a bonus component refers to a manager's short-term incentive and performance-sensitive cash. According to the Financial Times, former Volkswagen CEO Martin Winterkorn was recently awarded € 5.9 million in bonus pay for 2017 despite the diesel emissions scandal in 2016. Even though this is a steep cut from the nearly €16 million that Mr. Winterkorn earned in 2014, the bonus payout sparked an outcry among investors and unions (Wall Street Journal, April 28, 2016). Executive compensation is not only a controversial topic in the U.S but has also been discussed widely throughout Europe. In 2014, EU parliament set a bonus cap on bank employees limiting bonus pay to not exceed a banker's fixed salary or at twice the salary if shareholder approval is obtained (PwC FS Regulatory Brief). Many believe that EU regulators set the rules to reduce excessive risk-taking in the wake of recent financial crises.

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In the U.S., the bonus component of annual CEO pay is larger than the cash salary in contrast to some European countries, such as Germany, where bonuses can be approximately half of the total CEO compensation[1]. Most of the vast literature on CEO compensation examines equity-based compensation and effects on risk taking/performance, while there is only scarce empirical evidence about the link between the proportion of bonus pay and risk behavior or credit risk[2]. Given the importance and relevance of cash bonuses in compensation structure combined with little emphasis in academic research, this article examines the link between cash bonuses and CEO risk taking in a broader sample across industries in the U.S.

A related work from Erkens et al. (2012) hypothesize that CEO bonus pay is associated with larger losses during crises and more risk taking before crises. On the other hand, Duru et al. (2005) argue that accounting-based cash bonuses provide an incentive for managers to seek stable and positive cash flows to meet debt obligations. This study examines the relationship between compensation and risk to determine whether compensation (specifically bonuses) contribute to excessive risk taking and thus lead to higher credit risk in firms across industries using a broad sample and are not limited to the U.S. banking industry.

In addition, one potential problem in identifying the relationship between executive compensation and firm risk is how to appropriately measure default risk. One traditional measure is to use corporate bond yields. However, recent research shows that corporate bond yields are increasingly influenced by other factors, e.g. tax aspects and liquidity risks (Amato & Remolona, 2003; Longstaff, Mithal & Neis, 2005). The credit default swap (CDS hereafter) market, on the other hand, is the market where credit risks can be traded easily. CDS spreads can reflect private information before the information is made public (Acharya and Johnson, 2007). CDS spread, therefore, is argued to provide a better estimate of a firm's default risk in recent research (Zhu, 2006).

This article examines the short-term component of compensation and its impacts on credit risk with an innovative measure of default risk. The authors adopt econometric models and perform robustness tests to examine the relationship between bonus and the firm's credit risk, and also address the endogeneity problem. One common source of endogeneity in corporate finance is unobserved heterogeneity (Himmelberg, Hubbard, & Palia, 2009; Wintoki, Linck, & Netter, 2012; Schultz, Tan, & Walsh, 2017). The authors take account of this heterogeneity by using a fixed-effects panel model. Therefore, any biases caused by the presence of unobserved time-invariant heterogeneity at the firm level are mitigated, such as the effect of corporate culture or corporate governance quality on the firms' credit risk.

A negative relation between the percentage of bonus compensation and the CDS spread of the firm is found. The higher the bonus component, the smaller the credit risk to which a firm is exposed to. This finding suggests that the bonus component of CEO compensation could play a role in restraining a CEO's risk-taking behavior and lead to lower credit risk. On the other hand, salary compensation shows a positive relationship with credit risk suggesting that salary component does not play a role in