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Will it Work as a Good Governance Mechanism in all Scenarios?

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Executive Stock Options: Will it Work as a Good Governance Mechanism in all Scenarios?

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Abstract

Agency theory proposes different mechanisms to mitigate agency costs in the firms. An executive stock options (ESoPs) is one of such mechanism, which is given to the CEO of the firm to align CEO's goals with that of the owners. In this paper, we contend that ESoPs will not work as a good governance or mitigation mechanism in all types of firms. ESoPs can be an effective mitigation mechanism for a firm with dispersed ownership but it might not be the case for a firm with majority or block shareholding. We extend this argument for ESoPs given to board members as well. We present a framework to understand when it makes sense for a firm to incentivise top management with ESoPs.

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INTRODUCTION:

According to the Primary Agency Theory (Fama and Jensen, 1983; Jensen and Meckling, 1976), owners of a firm with dispersed ownership are risk neutral because they are able to diversify the portfolio and divide the risk. Managers, on the other hand, are risk averse because of lack of diversification in their sources of income. As a result, the goals of the manager and the owners are misaligned. In such cases, managers has a tendency to take less risky decision because risky decision could cost him his/her job. However, less risky decisions will give low returns to shareholders and they will not be able to maximise their wealth. It is also possible that managers may act opportunistically and draw private benefits from the firm as expense of shareholders wealth. The cost incurred by shareholders is called agency cost. This issue of goal misalignment between shareholders and managers is called primary agency problem. Since shareholders are dispersed in nature so they do not have incentive to directly monitor the firm. In such cases, board represent shareholders interest and monitor managers on shareholders' part. To mitigate agency cost, goals of managers need to be aligned with that of shareholders. In case of a risk neutral owner, a risk averse manager gets various incentives to align his goals with that of owners-basically to encourage managers to take those decisions which will maximise shareholders or owners' wealth and increase firm's performance. An executive stock option (ESoPs) is one such incentive mechanism for the managers, which is considered to be the most significant risk bearing component of a manager's compensation (Beatty and Zajac, 1994). In addition, there is empirical evidence that the ESoPs are an effective way of increasing risk appetite of managers (e.g., Sanders and Hambrick, 2007; Williams and Rao, 2006; Wright et al., 2007).

LITERATURE and PROPOSITIONS:

Dispersed ownership makes owners risk neutral. However, risk neutrality of the owner changes as his/her ownership stake in the firm increases (Wright, Ferris, Sarin, and Awasthi, 1996). Wright et al. (1996) make a case for the impact of equity ownership by insiders on firm's risk taking decisions. According to them, as the level of equity ownership or shareholding of an owner goes up, it creates wealth un-diversification for the owner leading to risk aversion in owner's behaviour and consequence reduction in corporate risk taking. Therefore, there exists an inverted U curve kind of relationship between owners' stake in the firm and his/her risk neutrality (Please see figure 1). Following Wright et al. (1996), we extend this argument for the CEO (manager) as well; we argue that as the number of ESoPs given to the CEO increases, his/her risk neutrality initially increases and then it starts to decrease after a certain threshold of ESoPs because the same un-diversification argument applies to the CEO as well (Please see figure 2). We are limiting this discussion to firms with block-holdings (family owned) with non-family member or an outsider as the CEO (manager in agency theory) of the firm or having non-family members as board members in the firms.

Therefore, at high level of ESoPs, manager would start behaving in a risk-averse manner. Thus there would be alignment in terms risk averse behaviour between the majority owner and the manager with either high level of ESoPs or no ESoPs. Therefore, it makes sense to give ESoPs to the CEO to encourage risk taking behaviour in the CEO when firm has dispersed ownership and owners behave in risk neutral manner. But as the owners' equity stake in the firm increase they start behaving in risk averse manner and under such circumstances if the previous incentives like ESoPs of the CEO are still continued then again the goals of managers would become misaligned with that of owner this is because CEO would still be behaving in a risk neutral manner with limited ESoPs he/she has been given. This again creates agency problem in the firm. We present these arguments in Table 1a. Sanders and Hambrick (2007) show that CEO stock options bring out extreme performance and they could prompt the CEO to make high variance bets. Alessandri and Seth (2014) too have looked at the impact of managerial ownership on the product and international diversification making a case for trade-off between incentive alignment and risk bearing of the manager. For an undiversified majority owner, the impact of risky decisions/bets on his wealth may be too large in this case. Therefore, a firm should take precautions while choosing ESoPs as a governance mechanism or incentive structure if it has majority or block shareholding.

On the basis of the above, we argue that Executive stock options are not always a good mechanism to mitigate the agency problems. This argument can be extended for stock options given to board members also as they form the part of top management team of a firm. Board members are given stock options to align their goals with that of the shareholders. Stock options are given to board members to incentivise them to do effective monitoring of manager or the CEO. We argue that a board member will behave more like a minority shareholder than a majority shareholder given that the stock options given to a board member constitute small shareholding in the firm. According to Deutsch, Keil, and Laamanen (2011), ESoPs to outside directors have an even stronger effect on firm risk taking than CEO stock options and that these are substituting effects. So ESoPs to board members will help in aligning the goals of owners and board members in dispersed ownership however the goal alignment will be missing in case of concentrated or majority shareholding. Sometimes, excessive use of ESoPs in a firm with block-holding could lead to goal misalignment between the board member who would behave like a minority shareholder and the owners. We present our arguments in Table 1b.

These arguments have implications for emerging market like India where majority of the firms are family owned with owners having majority or block shareholding in the firm. In such firms, if the firm gives ESoPs to its CEO (or managing director-equivalent of CEO in India) as well as board members, then it will not help in aligning the goals of the CEO and board members with that of the owners. We must admit that we are assuming that ESoPs given to the CEO and board members will not be very high that both the parties would start behaving in a risk averse manner especially when the CEO and board members are non-family members or professional managers or outsiders. We are limiting the scope of this discussion to firms with block-holdings (family owned) firms with non-family members as board members and/or CEO of the firm.

On the basis of the above arguments, we suggest following propositions:

P1: Presence of majority or block shareholder in the firm has a negative impact on the use of ESoPs (no. of ESoPs distributed) to the top management of the firm.

P2: A firm with majority or block shareholder as well as ESoPs for top management will have poor performance as the top management's and owners' goals will be misaligned.

On the basis of the above arguments, we expect to not find the use of ESOPs in Indian firms because most of the Indian firms have block-holders and many of them are family owned. We examine 1464 firms listed on the National Stock Exchange of India and find that the use of ESOPs occurs in less than 10% of the firms and it is primarily the non-family CEO or managing director (MD, which is equivalent to the CEO in India) who receive ESOPs. However, stock options to board members are prevalent in many of these 1464 firms. We present this break-up of ESoPs for these 1464 firms in Table 2. These observations on Indian firms intrigue us to look deeper into the use of ESoPs for top management among firms with majority/block holder(s). Whether ESOPs are a fad, or used under peer pressure from developed countries or a sign of CEO-power, is a matter of speculation. Therefore, in our future work on this paper, we would like to empirically test the two propositions stated in this paper.

FUTURE WORK:

We plan to collect more data on Indian firms' shareholdings, use of ESoPs for both the CEO and board members, and other variables like firm's size, age, product and geographic diversification to carry out an empirical work to test the above mentioned propositions. We are curious to segregate the data between firms with block-holdings and firms with dispersed ownership to examine the differences in use of ESoPs for managers and board members. In addition, we plan to further segregate the block-holding firms sample into family firms and non-family firms and examine the same phenomenon in these subsamples. We expect some differences to be seen in the use of ESoPs among these subsamples. These findings, if present, would have important implications both for the researchers and the policy makers who are adopting Anglo-Saxon system of Corporate Governance in India.

Table 1a: Conceptual framework for goal (mis)alignment between the manager (CEO) and the owners in different types of firms.

		Owners' shareholding	
		Low	High
Managers' stock options	None	Misaligned goals (Here owners, being minority shareholders, will have diversified portfolio and will have risk neutrality while the manager will be risk averse)	Aligned goals (Owner, being a majority shareholder, will start behaving in risk averse way and manager is risk averse too, so their goals are matched)
	Low	Aligned goals (both owners and managers will behave like minority shareholders with diversified sources of income)	Misaligned goals (owner will behave like a majority shareholder and manager will behave like a minority shareholder)
	High	Misaligned goals (Manager will behave like a majority shareholder and owner will behave like a minority shareholder)	Aligned goals (both owners and managers will behave like majority or block shareholders and both would prefer risk averse choices and hence their goals will be aligned)

Table 1b: Conceptual framework for goal (mis)alignment between the board members and the owners in different types of firms.			
		Owners' shareholding	
		Low	High
Board Members' stock options (Board member will not belong to the family of owners)	None	Misaligned goals (Owner will be a Minority shareholder who would be unable to monitor the management and expect the board to do so. But board might not have incentives of doing so)	Aligned goals (Owner will be a majority shareholder and could monitor the management himself. He would not need to incentivize the board to oversee manager. Also, owner would be risk averse and so could be the board member; role of board diminishes in such scenarios so no need to incentivise the board)
	Low	Aligned goals (both will behave as minority shareholders)	Misaligned goals (Owners will behave as a majority shareholder and board members will behave as minority shareholders.)
	High	Misaligned goals (very unlikely scenario. Still, if it happens then board would behave as a majority shareholder and owners would behave as minority shareholders)	Aligned goals (Both board and owners will be majority or block holders and both may behave in risk averse manner and their goals will be aligned)

Table 2: Description of Data on ESoPs of 1464 Firms Listed on National Stock Exchange of India.		
S. No.	**Item**	**Numbers**
1	Total Firms	1464
2	Period of study	2009-2013
3	Number of Years	5
4	Number of Firm Year Observations	7320
5	Number of Firms giving ESOPs	138
6	Number of ESOP Observations (one firm would be having more than one director; also Managing director (equivalent of CEO) is one of the board members in India)	918
7	Number of Independent Directors getting ESoPs out of 918 observations	489
8	Number of Firms giving ESOPs to Independent Directors out of 138 firms	67

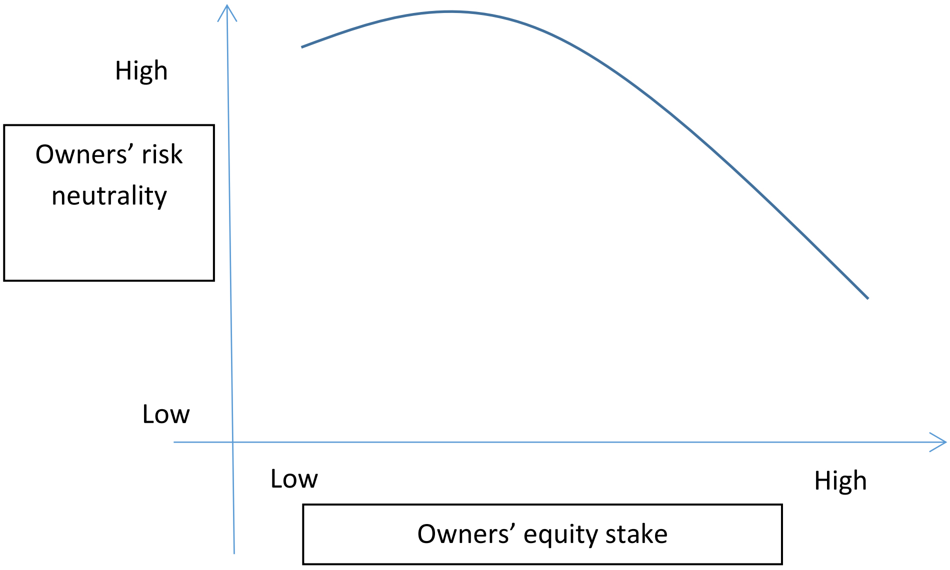

Figure 1: Change in Owners' risk neutrality with changing size of owners' equity stake in the firm

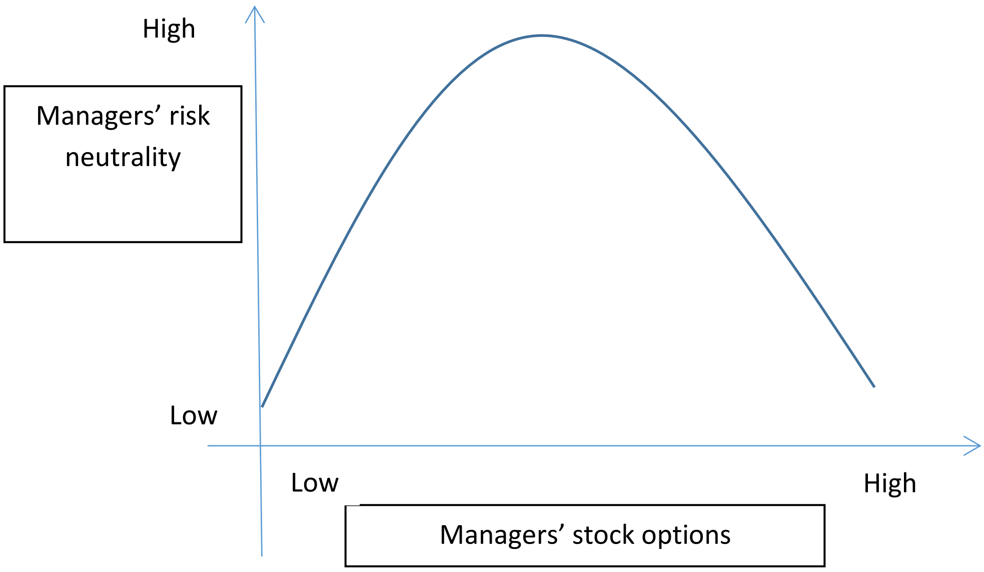

Figure 2: Change in Managers' risk neutrality with changing size of managers' stock options

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