

Paying CEOs with stock options doesn't drive their business strategy: research

Written by The Conversation

The CEO pay of the United States' biggest corporations is seen as the world benchmark. A large part of the way these executives are remunerated is through receiving stock options in the company they direct.

However [our research](#) shows that compensating executives in this way doesn't necessarily lead to a higher payout of dividends to shareholders.

In dollar terms, average pay of CEOs of the US top 500 firms has increased from US\$3 million in 1992 to US\$12 million in 2016. A major contributor of this increase has been stock options.

For example, Thomas Rutledge, CEO of US telecommunications company Charter Communications received a US\$98 million pay package in 2016. And 80% or US\$78 million was in [stock options](#).

A stock option is a financial contract that basically allows someone the right but not the obligation to buy a certain number of company shares in the future, at today's market price. Thus, stock options allow CEOs to benefit if the company's stock price rises, but not lose out if the stock price falls. Because in the latter case CEOs simply walk away from the transaction as the contract is not binding.

The idea behind it is to give risk averse CEOs incentives to take risk, so as to increase the stock price, and therefore their remuneration. This also works out for shareholders, who benefit from an increased stock price.

But this may also lead CEOs to take excessive risks with their firm's strategy in order to drive up the stock price. While choosing riskier strategies increases CEO pay, stock options provide CEOs with insurance when these policies fail. Shareholders do not have this same insurance and are therefore left to experience the pain alone.

In 2005, regulations were introduced that required US firms paying CEOs with [stock options to](#)

[list them](#) in financial statements. The change caused firms to think twice about using stock options.

Many firms decided to significantly reduce or at the extreme [no longer grant stock options](#) . Taking advantage of this change in regulation, we are able to determine if stock options are in fact a driver of the strategies of these businesses. It would seem not.

For example, [previous research](#) found stock options were the reason for the demise in dividends. But [we found](#) , that before and after the regulation, companies that didn't have stock options increased dividends more than firms which did. So the stock options had no bearing on dividends.

Our findings also answer another question on whether a firm's risk strategy aligns with stock options. If stock options drive the choice of riskier policies, holding less cash is certainly consistent with that. Examining the 1,500 largest US firms from 1992 to 2016, we found that [stock options have no impact on the amount of cash held by these firms](#)

If stock options drive cash holdings then firms most affected by this US regulatory change should have experienced a bigger change in cash balances than firms least affected. That is, firms that were not using stock options extensively prior to the regulatory change would have been less affected than those using them extensively. By finding that the decline in cash is the same for both types of firms, we dispel the notion that stock options drive cash holdings.

All of this raises questions about the effectiveness of stock options as a driver of business strategy. This is quite surprising as stock options are often touted by [numerous academics](#) as the answer to creating [pay that leads to better business performance](#)

Since 2005, US firms have begun to grant their CEOs long-term incentive plans, changing the [way companies pay their CEOs](#) . These plans may or may not be tied to the company's share price.

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Long term incentive plans are typically structured to include a targeted level of performance and a stretch component to reward CEOs for achieving abnormal performance. Many also contain restricted stock - shares that can only be sold, once a certain hurdle has been met, for example, when earnings per share increase by 10%.

Although, these long-term incentives are not stock options they nonetheless reward CEOs for good performance, but do not penalise CEOs for bad performance. So they could have a similar lack of effect on business strategy.

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