COMPENSATION STRATEGY

How to Increase a Company's Risk Taking

Do stock options for outside directors encourage bolder decision making? Or could such financial incentives actually *inhibit* risk taking?

To be sure, the relationship between the CEO and the outside directors on a company's board is complex. Typically, directors play a monitoring role in which they review and approve (or veto) the CEO's major proposals, such as the acquisition of a business or a substantial investment in a new technology. At other times, the directors themselves might develop a new strategy that the CEO and other senior executives must then implement. But what happens when a company has continually been too conservative in its decision making, especially when aggressive competitors have been quickly gaining market share? In other words, what levers can an organization pull to become less risk-averse, for example, to seek new revenue streams from an emerging market in order to bolster a sagging product line?

One solution has been to provide the CEO with stock options: the right to buy a company's stock at a pre-specified price at a set date in the future. It is important to note that the options do not necessarily have to be exercised. If the stock price plummets, the executive can simply elect not to purchase it when the predetermined date arrives. Thus, there is little downside risk in owning a stock option, but there can be a tremendous upside if the stock price soars.

Past studies have shown that providing CEOs with stock options does tend to increase the risk taking of those individuals. Significantly less research, however, has investigated the effects of stock options upon outside directors. Do such incentives also lead to greater company risk taking? And what's the relationship between the two types of incentives — CEO and director stock options? Do they reinforce each other, and if so, in what ways?

Such questions were recently investigated by a team consisting of Yuva! Deutsch, associate professor of policy and entrepreneurial studies at York University's Schulich School of Business in Toronto, and Thomas Keil and Tomi Laamanen, professors of strategic management at the Helsinki University of

Technology's Institute of Strategy and International Business in Helsinki. The researchers examined data for the Standard & Poor's Composite 1,500 companies between 1996 and 2002. (Details of the research are contained in *Are the Wolves Watching Over the Sheep? The Joint Effect of Board and CEO Incentives on Firm-Level Risk-Taking.)* Changes in the risk taking of a company were determined by calculating the volatility of its stock in relation to the overall market: The assumption was that increased volatility over time indicates a greater level of risk taking. The study also investigated other measures of company risk taking, including research and development intensity (that is, R&D spending as a percent of revenues). The researchers controlled the data for a number of variables, including company size, past performance and level" of board independence (namely, the pro-" portion of outside directors on a board).

In general, the CEOs in the study owned far more value in stock options than did the outside directors (an average of more than $3.5 million versus about $100,000). Not surprisingly, both types of incentives did indeed lead to greater company risk taking. Interestingly, though, the effect of director stock options was substantially stronger than that of CEO stock options. One reason that outside directors might be more willing to assume greater risks is because their main livelihoods don't typically depend on the company's performance, whereas a CEO's usually does.

Moreover, one effect doesn't necessarily strengthen the other; in fact, they appear to be mutually substituting. Specifically, when CEO stock options are low, director stock options do have a significant effect in increasing the company's overall risk taking. But at higher levels of CEO stock options, the director effect decreases until it actually begins to *inhibit* risk taking. In other words, the additional director incentives can actually reduce the influence of the CEO incentives.

One explanation is that each company has, at a given point in time, an optimal level of risk. That level can be attained through various means, including financial incentives like CEO stock options. But once that level has been reached, additional incentives — namely, providing directors with stock options — don't necessarily induce the organization to assume more risk. Furthermore, providing both CEOs and outside directors with stock options can sometimes lead to the formation of separate camps of the two parties, each interested in more aggressive risk taking but in different ways. That could then lead to greater conflict on the board about a company's future strategic direction, eventually resulting in conservative "more of the same" compromises instead of entrepreneurial ventures that might be riskier but have greater potential payoffs.

One important limitation of the study is that it was conducted before the

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Sarbanes-Oxley Act of 2002. That legislation — in addition to a spate of corporate scandals involving WorldCom, Adelphia Communications, Enron, Tyco International and others — has led to an overhaul of corporate governance practices at many companies, and such changes will likely have an impact on organizational risk taking. Future work could help systematically analyze those effects. Nevertheless, the researchers contend that the general results of their study will still be applicable for companies trying to design CEO and director compensation packages that will encourage the level of risk taking that makes the best sense for the organization as a whole. For additional details of the study, contact Thomas Keil at thomas.keil@tkk.fi.

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