

# *CEO Compensation and Loan Contracting*

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**Time:** **10:30a.m. – 12:30p.m.**

**Venue:** **GE101, B. Y. Lam Building**

## **Abstract**

The Agency Theory literature implies the pay-performance based managerial compensation can relieve the agency problem between shareholders and managers. As the interests of shareholders and managers are aligned, managers have incentive to invest in best projects and hence to improve firms' performance. While the use of equity compensation to managers may reduce the agency cost between managers and shareholders, its impact on agency cost of debts is ambiguous. On one hand, a large portion of equity compensation discourages risk-averse managers to invest in risky investment and hence reduce the credit risk. On the other hand, while the equity compensation brings the interests of managers in alignment to shareholder it may encourage managers to take opportunistic corporate strategies and to exploit the wealth of creditors. As a result, creditors may response to the CEO compensation package by imposing different covenant restrictions according to their perception of the credit risk.

Supported with empirical evidence, this research finds that loan agreement contains more restrictive covenants if the firm's CEO has a higher portion of option compensation to the total compensation, but contains less restrictive covenants if the firm's CEO has a higher portion of stock compensation to the total compensation. It implies that creditors view the increase in use of option compensation would increase the credit risk of the firm, while the increase in use of stock compensation would decrease the credit risk.

This research also investigates the relation between the CEO option sensitivity to loan covenants. The finding shows that the number of covenant, the use of coverage covenant and debt to cash flow covenant are positively related to the CEO option sensitivity.

**ALL ARE WELCOME**