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Executive Compensation and Risk Taking

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Agency theory suggests that granting stock-based compensation to executives incentivize risk-taking by aligning managerial interests with those of the shareholders. This study examines the relationship between executives' stock-based compensation and managerial risk-taking behavior in the property liability insurance industry. We calculate the sensitivity of the value of executive's stock and option holdings to stock price movement and hypothesize that the more sensitive an executive pay is to stock price movement, the greater the incentive it provides to induce risk-taking that may result in equity volatility.

Using data of publicly traded property-casualty insurance companies in the U.S in the period of 2006 to 2010, we find that firms whose executive compensation is more sensitive to stock price movement are associated with greater unsystematic risks. Additionally, our results show that the positive relationship between stock-based compensation and firm risks is weakened when fixed compensation accounts for a greater percentage of executives' current year compensation. Our main results remain consistent and robust when we use different model specifications.