Risk Incentives of Executive Stock Options: Evidence from Mergers and Acquisitions

Haigang Zhou, Ph.D.

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Advisor: John Geppert

Using a sample of mergers and acquisitions completed between 1992 and 2004, I examine the risk incentives provided by executive stock options for the managers to undertake risky projects by employing two competing approaches to valuing options: the Black-Scholes approach and a certainty-equivalent approach.

In the Black-Scholes framework, I find some evidence to suggest that firms with higher ESO risk incentives tend to engage in transactions that lead to higher firm risks.

Next I examine the theoretical implication of ESOs under a certainty-equivalent framework. Contrary to the Black-Scholes model, the certainty-equivalent approach predicts that subjective values that an executive assigns to the ESO grants decrease as stock volatility increases. Therefore, instead of providing incentives for the executives to undertake riskier projects, ESOs make executives more risk-averse. Overwhelming evidence from the sample firms in ExecuComp supports the argument that the Black-Scholes method overstates the subjective values that an executive assigns to the ESOs she receives, and therefore overstates the risk-taking incentives provided by the ESOs.

In the certainty-equivalent framework, I find weak evidence that ESOs make executives more risk-averse.