STOCK OPTION GRANTED TO CEOs AND ITS EFFECTIVENESS ON OPERATIONAL EFFICIENCY: AN EMPIRICAL STUDY WITH PUBLIC BANKS

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ABSTRACT

Stock options have been used in the banking industry to attract and retain executives and to align their interests as closely as possible with the interests of shareholders, who are primarily interested in stock price maximization by minimizing agency conflicts between shareholders and executives in companies. However, their effectiveness have not been formally studied in prior studies. The purpose of this study is to empirically investigate the effectiveness of stock options granted to chief executive officers (CEOs) in public banks to observe the relationship between stock options granted to CEOs and operational efficiency of these banks. Further, we analyze the longevity effects of stock option granted to CEOs on the operational efficiency of the banks as stock option granted is vested over a specific period of time (e.g., two or three years).

We used a multiple-regression model where return on equity (ROE) was used as a measure of organizational performance. In particular, instead of accounting earning, we used an adjusted earning measure for ROE to reduce earning manipulation. The adjusted earning is defined as the earning which bad debt expense is added to and the loans charged off are subtracted from the accounting earning. The model includes three main independent variables to express granting CEOs' stock options: an increase of CEOs' beneficial ownership, a distribution of CEOs' stock options among highly compensated executive officers, and a ratio of CEOs' stock option values to cash compensation. Also, the model includes several controlling variables such as firm size, capital structure, total compensation, and corporate governance variables because prior studies indicated that such variables would affect firms' operational efficiency. Forty public banks were randomly selected and their data for this study were collected from public records.

Results of the study indicated that there was no statistically significant relationship between CEOs' stock options and organizational performance as claimed by agency theory. The results imply that the stock options granted to CEOs may not be effective in improving the banks' performance in both short-term and long-term aspects. However, the failure to examine the significant relationship may result from the small size of sample and inaccurate measure of performance such as ROE. Thus, further study should be carried out in the future with a larger size of sample and with more rigorous measure of performance.