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Direct and Indirect Risk-Taking Incentives of Inside Debt*

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Abstract

We develop a model of compensation structure and asset risk choice, where a risk-averse manager is compensated with salary, equity and inside debt. We seek to understand the joint implications of this compensation package for managerial risk-taking incentives and credit spreads. We show that the size and seniority of inside debt not only are crucial for the relation between inside debt and credit spreads but also play an important role in shaping the relation between equity compensation and credit spreads. Using a sample of U.S. public firms with traded credit default swap contracts, we provide evidence supportive of the model's predictions.

JEL Classification: G32, G34

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