

# Financial Policies and Internal Governance with Heterogeneous Risk Preferences

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# Puzzling Observation

- ① Members have different impacts on group decisions.
- ② Risk matters - a group is more risk-averse than the average in high-risk situations.

# Modeling Choices

- ① Heterogeneous risk preferences.
- ② Dynamic setting
- ③ Fully flexible equity compensation schemes.

# Results

- ① More risk-averse members get paid more in bad times.
- ② Less risk-averse members get paid more in good times.
- ③ Degree of compensation translates to degree of influence.
- ④ Firm policy features cyclicalities.

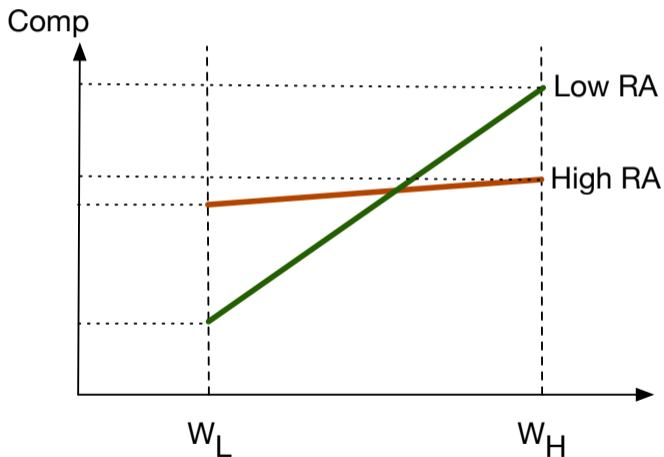
# Savitar's Trilemma of Theory Papers

All but impossible to avoid all of the following.

- ① You have a (particularly) unreasonable/unrealistic assumption.
- ② Your results are difficult to interpret.
- ③ Someone else has done this already.

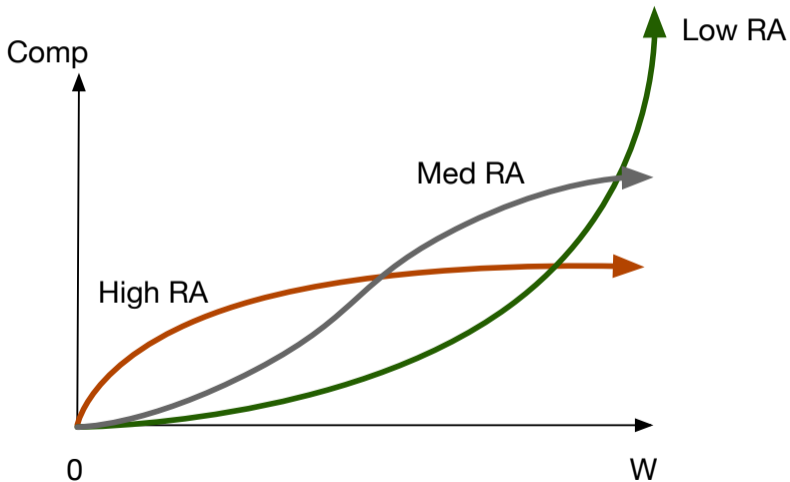
# Simple Static Model

Two agents, two risk-aversions, two future states, risky aggregate income, complete markets.



## Less Simple Static Model

Three agents, continuum of states.



# Dynamic Model

Introducing Dynamics:

- ① Allows for closed-form solutions.
- ② Does not significantly change the compensation structure.
- ③ Results are time-consistent!



Embedding in a Corporate Finance Model:

- ① Investment policy is just a weighted average of compensations
- ② More compensation  $\Rightarrow$  higher correlation with strategy.
  - Would be good to get a lot more explanation here.
  - What happens with restrictions on the compensation process?
- ③ Dynamics implies cyclical predictions.

## Possible Extensions

- What about clawbacks/negative compensation?
- What if  $\mu$  was time varying and unobservable? Would optimism/pessimism amplify results?