Pay gone astray: the failure of executive incentive schemes

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Introduction

Executive remuneration has recently re-emerged as a significant political issue. The continued growth in boardroom pay, whilst the economy has flat-lined and many working people have faced a squeeze on their own living standards, has proved inflammatory. Even business leaders now worry that executive reward is out of control, and urge radical reform (Darrington, 2012).

Notably, this year has seen an unusually high level of shareholder opposition to executive remuneration policies at UK companies. More company remuneration reports have been rejected by shareholders this year than in any other since the introduction of a mandatory shareholder vote on executive pay in 2002. Although a total of six defeats for the year to date means that it's still only a fraction of the total, there have been some very high-profile corporate casualties, including Aviva and WPP. These defeats are also indicative of wider opposition. Analysis by PIRC has found that the average vote against a remuneration report is around 8.5 per cent this season. That compares with an average vote against of just under 6 per cent last year, and a little over 3 per cent back in 2008 (PIRC, 2012).

Institutional investors are undoubtedly at least in part reacting to political pressure to rein in top pay. David Cameron has criticised excessive pay in the UK's boardrooms, and made clear earlier this year that he wanted to give shareholders more powers to tackle it. Separately Business Secretary Vince Cable has exhorted institutional investors to do more, and initiated a new round of shareholder-focused remuneration reforms. Whilst his original set of proposals have been scaled back, Cable has pressed ahead with plans to introduce a new binding vote on remuneration policy, which should further strengthen the hand of shareholders (Department for Business, Innovation and Skills, 2012).

The state of pay

The underlying trends in executive pay that shareholders, and policymakers, are reacting to are important in this discussion. To take some headline figures, according to Incomes Data Services, FTSE 100 directors saw an average 49 per cent increase in total reward from 2010 to 2011, to just under £2.7 million. However, the story here is not one of spiralling executive salaries. IDS found that the average increase in base pay during the period was actually just 3.2 per cent (IDS, 2011).

The reality is that the large part of the growth in executive pay in recent years has actually been in performance-related rewards, rather than salaries. According to IDS, cash bonuses were up by 23 per cent, from an average of £737,624 in 2010 to £906,044 in 2011, which in turn suggests that share awards are a significant part of ballooning executive reward. This is a trend that extends well beyond one-year's figures. PIRC has looked at the average cash bonus actually paid to a FTSE 100 director as a percentage of salary over a 10-year period from 2001 to 2010. It increased from approximately 80 per cent to around 130 per cent.

The growing pay-outs under cash and share-based incentive plans reflect the fact that these schemes have become increasingly generous. Research by the High Pay Commission shows that the average maximum bonuses available and maximum potential grants under share-based long-term incentive plans (LTIPs) have broadly doubled between 2002 and 2010 (High Pay Commission, 2011). As a result, for many executives base salary now accounts for only a relatively small part of the total potential package.

This outcome is also what we ought to expect, given current attitudes toward pay in both the corporate and investment worlds. There is a mainstream consensus in corporate governance that directors' interests need to be aligned with those of shareholders, and that performance-related pay, increasingly share-based, is the way to achieve this. Essentially, this is rooted in an agency theory view of the world, where directors may pursue their own interests, rather than those of the company and its shareholders, if incentives are not correctly structured. As such, incentive schemes are seen as a behavioural tool to ensure alignment occurs.

In one sense, then, the current structure of executive pay is in line with best practice. One might even have argued a few years ago that the 'success' in achieving alignment was evidenced by the tailing off in shareholder opposition to remuneration policies immediately prior to the financial crisis. No company remuneration reports were defeated in either 2007 or 2008, and votes against were at a low ebb.

Problems with performance pay

However, all is not right with performance-related rewards for directors, and its growth has not been without problems. Already we have seen a shift in the nature of performance-related rewards provided. Originally, it was believed that offering directors share options was the best way to align interests. However, this approach has fallen out of favour in the UK, because of the fear that options can create perverse incentives. LTIPs have now displaced options as the principal share-based incentive schemes. More recently, LTIPs themselves have been criticised for not being sufficiently long-term in nature.

Concerns have also been expressed in the financial sector that short-term cash bonuses may have incentivised inappropriate risk-taking, and as such remuneration policy may have played a contributory role to the crisis. There has therefore been a further round of remuneration reform, with a greater focus on long-term performance targets, payment in shares, and the introduction of clawback policies.

In addition to a shift to more long-term assessment periods, there have been various other attempts to reconfigure the targets on which performance-related rewards are based. Bonus and incentive schemes often now look at a mixture of business and financial measures of success, plus some personal targets. Increasingly, some reward is also tied to 'non-financial' factors, for example environmental targets, or the company's health and safety record.

These various attempts to reform incentive schemes have been well-intentioned, but the result is increased complexity. Company remuneration reports frequently run to a dozen or more pages, setting out the terms of various different types of incentive schemes and the awards made under them. This complexity has created its own problems, making it harder to understand exactly what executives can expect to receive.

In addition, repeated attempts to redesign incentive schemes have diverted shareholder attention away from the overall scale of rewards. Indeed, until relatively recently some asset managers made it almost a point of principle that their interest in remuneration was limited to the way it was structured. Unfortunately, this emphasis on structure has served to legitimise a growth in executive reward that is much less likely to have been tolerated if it occurred in base salaries. Certainly, directors and business lobbyists often seek to defend large overall packages on the basis that much of it is performance-related.

Despite this year's greater challenge from shareholders, and the sense that something fundamental may have gone wrong with executive pay, to date the central role of performance-related reward has not come under much scrutiny. As Duncan Watts has recently written, efforts to reform pay have almost exclusively been about redesigning incentive schemes, rather than questioning whether they are ever likely to do the job expected of them in the first place:

> [O]nce we realise that some particular incentive scheme did not work, we conclude simply that it got the incentives wrong. Once they know the answer, in other words, policy-makers can always persuade themselves that all they need to do is design the correct incentive scheme – overlooking, of course, that this was precisely what they thought they were doing previously as well. (Watts, 2011, 52)

However, given the failure of previous rounds of reform, there is a good case to be made that now is the time to ask more fundamental questions about the use of performance-related reward. Is the explosion in variable pay actually delivering? Here we take a detour into psychological theory.

Different theories of motivation

In fact, there is a long, and interesting, academic debate about the extent to which contingent rewards of any kind can actually improve performance. To greatly simplify, two major camps in the argument over the psychology of incentives are those informed by behaviourism, and those who favour what has latterly become known as self-determination theory.

Behaviourist theory in relation to incentive schemes and other rewards sees their function as the positive reinforcement of behaviour that we wish to see repeated. When someone does a job well, the application of a positive reinforcer (a reward) will encourage them to repeat that behaviour. In this view, reward systems need to be carefully designed, and regularly reviewed and refined to take account of changing behaviour. In addition, rewards need to be clearly tied to the behaviour they are intended to reinforce. One business textbook on the use of rewards at work that is explicitly informed by behaviourism is clear that they should be deployed quickly:

> Behaviour is affected by the consequences which follow it. Consequences either strengthen or weaken behaviour. Because a consequence affects the behaviour that precedes it, it is critical that the consequences be timed to follow the behaviour we want to be affected. (Daniels, 2004, 26)

Clearly, the use of bonuses and other incentive schemes could fit this model, with some qualifications. In my opinion, the widespread provision of performance-related reward is underpinned by implicit motivational assumptions based on an essentially behaviourist model of human activity. However, motivational assumptions are rarely made explicit in corporate governance debates about incentive schemes.

In contrast, self-determination theorists argue that humans have other sources of internal, or intrinsic, motivation. According to this perspective, humans desire autonomy, seek to achieve mastery of tasks and skills, and wish to experience relatedness. Self-determination theorists argue that extrinsic motivation, such as the application of rewards, can 'crowd out' the intrinsic motivation to do a job well. If the job concerned is simple and repetitive, there may not be any intrinsic motivation to crowd out, but for complex, engaging tasks the use of rewards can be problematic. The recipient may come to see the reward, rather than their own desire to do a good job, as their reason for undertaking a particular task. Once extrinsic has replaced intrinsic motivation, if you take away the reward, then performance drops away too.

This view provides very different motivational assumptions which do not support the emphasis in traditional corporate governance thinking on performance-based reward. Edward Deci, the psychologist most closely associated with self-determination theory, believes that financial incentives can actually damage performance:

> The rationale behind all these motivational incentives is that "money talks". People want money, so if you structure the situation correctly you can get them to do what you want … Of course, these practices can motivate people, but in the process, they will likely encourage shortcuts and undermine intrinsic motivation. They will draw people's attention away from the job itself, towards the rewards it can yield, and that without doubt will result in less effective, less creative problem solving. (Deci and Flaste, 1996, 29)

There is one interesting overlap between the two camps. Both believe that rewards may be ineffective if they are seen as controlling. This is significant, since in corporate governance debates incentive schemes are usually explicitly intended to control executive behaviour.

Self-determination theory, and the assertion that rewards can be bad for motivation can, on first hearing, jar with existing views of why people exert themselves at work. Faced with this unusual view of motivation, critics often retort that it is naïve to think business leaders aren't interested in money. However, the question we are seeking to answer in relation to incentive schemes is not 'do people want more money?' but rather 'will tying more money to performance targets lead to better results?'

In fact, studies from the 1970s onwards seem to bear out the predictions of self-determination theory (Lepper and Greene, 1979), although behaviourists challenge these claims (Cameron and Pierce, 2006). Rewards can boost performance of simpler, routine tasks, where extrinsic motivation may be lacking, but are not effective when there is an element of cognitive complexity. In addition, if rewards are taken away from tasks that the recipient used to perform without an extrinsic motivator, performance does indeed tail off.

This debate within the field of psychology has spilled over into economics. The economist Bruno Frey has undertaken a review of academic research and concludes that 'motivation crowding' is a real phenomenon, although whether or not it will occur depends on the setting. He believes that incentive pay can be problematic:

> When employees get rewarded only if they have performed exactly according to their chief's directions, their intrinsic motivation is negatively affected. The more a reward is contingent on the performance desired by the principal, the more strongly the locus of control is shifted from intrinsic to extrinsic incentives, and the more work morale is crowded out. (Frey, 1997, 94; see also Frey's article in this issue)

The implications for executive pay are obvious. As noted earlier, the big shift in remuneration policy has been towards making more pay 'variable', or performance-related. Yet psychological theory suggests that this is only going to motivate directors positively if the tasks are simple and measurable, and they aren't very motivated to undertake them. This does not sound like an accurate picture of a typical boardroom. It seems unlikely that performance-related reward will make much of a difference to those who are highly motivated, a point made by another psychologist, Kenneth Thomas:

> [I]f intrinsic motivation is already high ... monetary incentives provide little or no additional force. Past some point, it simply becomes impossible to be "more motivated" in any sustainable way. So if you are successful in building high intrinsic motivation, don't expect your pay system to have a major positive effect on performance. (Thomas, 2002, 119)

A changing debate over rewards

There is some evidence that wider opinion may be shifting against the overwhelming emphasis on performance-related rewards in the boardroom. This has been helped by the way that critiques of a reliance on financial incentives have started to become more visible. For example, in 2010 the author and former Al Gore speechwriter Dan Pink published the book *Drive* (Pink, 2010), which popularised Edward Deci's research and argued against a 'carrot and stick' approach to motivation and performance.

Closer to the field of corporate governance policy, perhaps the most surprising critique of the proliferation of incentive schemes has come from one of the remuneration consulting firms, PricewaterhouseCoopers (PwC). PwC has undertaken research into the psychology of incentives in conjunction with Dr Alexander Pepper of the London School of Economics which, importantly, sought the views of executives themselves. Most executives surveyed said they were driven by more than money, and many also reported that incentive schemes did not motivate them. One executive compared share awards to a lottery ticket.

Based on its research, PwC argues that the complexity inherent in many long-term incentive schemes lessens any motivational effects. It also found that executives sharply discount deferred awards, leading to an even weaker behavioural impact. PwC suggests that incentive pay can be considered to be at least half as valuable as fixed pay in executives' minds. This means that incentives need to be very large if they are to have an impact. PwC's conclusions are surprisingly radical:

> This research suggests that many aspects of long-term incentive plans mean they are designed to fail. Executives are risk-averse, don't like complexity and discount deferred pay. The pay systems we've adopted have many features executives dislike and don't value – and we've had to pay executives more to compensate. If pay better reflected executive psychology, maybe it could be lower. (PwC, 2012)

Regrettably, however, there are no signs that the UK's institutional investors are likely to champion a shift away from performance-related reward any time soon. In general, they remain implicitly wedded to a view of executive motivation where incentives can be designed to elicit the right behaviour. As evidence of this, consider that the new 'big idea' in the investment community is 'career shares', whereby executives are required to hold at least some share awards until retirement. As is by now hopefully obvious, this seems to be a non-starter from a motivational point of view, since recipients will put very little value on rewards that lie a long way into the future. The proposal also does nothing to address the political problem of growing overall executive reward. Instead the emphasis is, once again, on structure.

Similarly, the Coalition has not attempted to tackle the problems inherent in performance-related pay. Both Vince Cable's recent reforms and the recommendations of the Kay Review do not challenge a reliance on incentive schemes, despite the latter including some discussion of the merits, or otherwise, of bonuses (Kay, 2012, 77). In the end, Kay plumped for something close to the 'career shares' idea.

As such, there is still a need for serious reform, and it is to potential interventions that we now turn.

What Labour could do

We should not forget, and to his credit Vince Cable has acknowledged, that the governance framework within which this year's wave of shareholder activism has taken place was introduced by Labour. The existing advisory vote on executive pay, now being utilised by shareholders, and the standardised reporting of remuneration, were both Labour reforms. These were significant interventions and shaped the direction of UK corporate governance.

But we should also acknowledge that much has changed since 2002. We now have extensive experience of attempting to control executive pay through disclosure and shareholder oversight alone. The results are mixed, to say the least. Labour needs once again to break new ground in corporate governance.

If we believe there is a problem with the scale of executive reward, and want to undertake reform that will make a difference, then we must challenge the growth in variable pay head on. If the narrative that it is inherently desirable to pay significant extra reward to directors on the basis of performance is left unchallenged, then the experience of the past decade will be repeated. Variable pay will continue to grow, and overall rewards will also increase further. Vested interests will portray the problem as one of 'rewards for failure' at the margins, which can be solved by a further round of attempting to improve performance linkage. This is a dead end, as even the former head of the CBI acknowledges (Lambert, 2012).

A review into the growth of boardroom incentive pay and its effectiveness, early in a future Labour administration, could mark an important shift in direction in corporate governance policy. Such a review should properly consider the academic evidence, drawing on the work of experts in the field. It should also seek the views of directors themselves about the value of incentive schemes. I believe that many business people share the view that the current system is not working, but feel bound by existing corporate governance dogma. We could find we are pushing at an open door. If the evidence is clear, Labour should not shy away from calling for a shift away from relying so heavily on incentive schemes.

By challenging the emphasis on performance-related rewards, Labour could also champion radical simplification of remuneration arrangements, something all parties in the debate say they want. In addition, it would enable Labour to talk more positively about the motivations of directors. As some critics of performance-related pay have argued, business leaders, like the rest of us, need to find meaning in their work. A relentless focus on the use of financial incentives in the boardroom obscures this (McConvill, 2005). A change in the terms of the debate about executive reward would seem to fit with Ed Miliband's ideas about the need for a more 'responsible capitalism'.

There are some indications that Labour is willing to start talking about these issues. In January, Shadow Business Secretary Chuka Umunna MP gave a speech on executive pay which touched on the behavioural aspects of pay (Umunna, 2012). It is certainly the only speech on executive pay by a senior politician I am aware of that has referred to the problem of motivation crowding.

We also need greater transparency in relation to the existing oversight of executive remuneration. Despite the general upsurge in opposition this year, it is clear that many large shareholders nod through a significant majority of company remuneration policies. It is important to know which institutions are trying to make a difference and which are not. Labour should therefore enact the reserve power in the Companies Act that would make it compulsory for institutional shareholders to make their voting records public. Asset managers and other large shareholders only have economic power through the aggregation of the public's savings. They must be accountable for how they utilise that delegated power.

However, there remains a broader question of whether shareholder oversight alone is likely to be enough to tackle excessive pay. On the basis of the past decade's experience, it seems reasonable to conclude that we should be looking to supplement shareholder-focused reforms with other interventions.

A final, essential reform is therefore the introduction of employee representation on remuneration committees. This idea was on the fringes of the executive pay debate until relatively recently, and typically only advocated by trade unions. However, employee representation on remuneration committees is one of the core recommendations of the High Pay Commission, and has also been supported by Sir Michael Darrington, the former head of Greggs Plc.

No doubt many Labour supporters would favour representation of this kind in its own right, because it would recognise employees as one of the key players in the governance of successful businesses. However, there are also some grounds for thinking that it could actually change the operation of remuneration committees in a positive way.

For example, research by Cass Sunstein has shown that when people who share the same kinds of views are put together in groups they reinforce each others' beliefs (Sunstein, 2009). This can lead those groups to reach more extreme decisions than the individual members would do alone. As Sunstein has argued, this research has implications for corporate governance. Thinking about remuneration committees, the research might suggest that if they comprise solely of senior business people there may well be a reinforcement effect. Current or former directors are likely to have views about high pay that cluster towards one end of the spectrum. They seem more likely, for example, to believe that companies need to pay very highly to attract and retain the right people. Putting people who all share this viewpoint together could lead to more extreme decisions on pay issues. Including employee representation on remuneration committees could help break up this reinforcement effect.

Seeking to address executive pay through reform of remuneration committees also has the advantage of trying to tackle problematic proposals before they are finalised, rather than relying on shareholders to challenge decisions already made.

Taken together, these reforms could start to get executive pay back under control. They would also represent a significant break with the past, but that is what is now required. Human motivation is more complicated than mainstream corporate governance, and its emphasis on behavioural control through incentive schemes, assumes. In addition, relying on the market solution of more disclosure and shareholder oversight alone will see only a handful of companies face significant pressure. If we try to persevere with the existing model we are very likely to be disappointed by the results. It is time for a new start.

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