PERFORMANCE PAY
NEW IDEAS ON DIRECTORS REMUNERATION
About the High Pay Centre

The High Pay Centre is an independent non-party think tank established to monitor pay at the top of the income distribution and set out a road map towards better business and economic success.

We aim to produce high quality research and develop a greater understanding of top rewards, company accountability and business performance. We will communicate evidence for change to policymakers, companies and other interested parties to build a consensus for business renewal.

The High Pay Centre is resolutely independent and strictly non-partisan. It is increasingly clear that there has been a policy and market failure in relation to pay at the top of companies and the structures of business over a period of years under all governments. It is now essential to persuade all parties that there is a better way.

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November 2014
Contents

7    Foreword
     Deborah Hargreaves

8    Executive Pay: The Problem with Agency Theory
     Alexander Pepper

16   Directors’ Remuneration: towards a better solution
     Peter Montagnon

22   Why Paying Footballers for Goals Doesn’t Work
     Thomas Powdrill

28   CEO: a big job, and someone has to do it
     Simon Patterson
Foreword

By Deborah Hargreaves

When consultancy firm, Deloitte, reports that more than three-quarters of Britain’s biggest companies are altering their pay arrangements in response to shareholder pressure, it is clear there is some unease over remuneration in the UK’s boardrooms.

Since the financial crisis, remuneration committees have been under considerable pressure from shareholders, politicians and the public to take a tougher line on pay. “Getting pay wrong damages popular trust in business and undermines the duty to promote the long-term success of the company,” wrote Vince Cable, business secretary, to FTSE 100 remuneration committee chairs earlier this year.

While investors have shown little interest in publicly voting against pay schemes, they say they are working behind the scenes to encourage companies to reform their pay structures without the need for a damaging vote at the AGM.

According to Deloitte, remuneration committees are now making changes to variable pay which is often linked to performance targets and has been an important factor in burgeoning rewards for chief executives. One of the growing trends is for shares from bonus schemes and Long-Term Incentive Plans to be deferred over a number of years. If it takes longer for executives to receive their shares from performance-related pay schemes, it will encourage them to focus on long-term business success and not be driven by short-term profit motives, so the argument goes.

These performance-related pay awards are an important part of the chief executive’s overall remuneration – accounting for well over three quarters of the total package – up from about half in 2000. However, it is not clear that they have driven huge improvements in corporate activity. WPP justified CEO Martin Sorrell’s £30m pay package for last year as being 90% performance related, saying that considerable value had been created for share owners over the period. But 52% of Burberry shareholders voted against the award of £15m in shares for new CEO Christopher Bailey since it was not clear whether they were linked to any performance targets.

1 http://www.telegraph.co.uk/financialservices/Businessservices/11073434/FTSE-100-companies-amend-pay-packages-in-wake-of-revolts.html
The principle of performance pay seldom faces tough scrutiny in the corporate environment even though there has often been fierce criticism of it in the press.

Business hierarchies have been slow to question the essential nature and structure of the way pay is awarded for performance and the targets to which it is linked. This is in spite of the rumble of doubts from academics and practitioners that performance pay can be used to drive the right sort of behaviour.

But with shareholders asking questions behind the scenes, we could be starting to see the beginnings of a shift in opinion. This means that remuneration committees and consultants will need to look for innovative ways of using variable pay.

If companies are to effect meaningful and lasting change to the way they pay their executives, there needs to be some creative thinking about performance pay with new ideas for the future. As Prof Pepper says in this collection of essays: “The challenge is….for remuneration committees to put forward pay proposals that break out of the cycle of pay inflation.”

This collection of discussion papers is an attempt to introduce some new ideas and provoke a debate about performance pay.
Executive Pay: The Problem with Agency Theory

By Alexander Pepper Professor of Management Practice in the Department of Management at the London School of Economics and Political Science

This paper is an executive summary of my recent academic research on executive pay, prepared at the request of the High Pay Centre. The paper summarises the main issues raised in three recent papers published respectively in Human Resource Management Journal, Journal of Management, and Journal of World Business, along with other work currently in progress.1

Introduction

The theoretical underpinnings of the pay-for-performance model of executive pay are agency theory, made famous by a seminal article written by Michael Jensen and William Meckling in 1976, and tournament theory, first advanced by Ed Lazear and Sherwin Rosen in 1981. Agency theory models the relationship between shareholders and executives as an agency relationship characterised by different interests and motivations. It postulates that, in order to motivate executives (agents) to carry-out actions and select effort levels that are in the best interests of shareholders (principals), boards of directors, acting on behalf of shareholders, must design incentive contracts which make an agent's compensation contingent on measurable performance outcomes. Tournament theory extends the agency model by proposing that principals structure a company's management hierarchy as a rank-order tournament, thus ensuring that the highest-performing agents are selected for the most-senior management positions. Tournament theory postulates that executives compete for places in a company's upper echelons via a sequential elimination tournament. It predicts that compensation is an increasing convex function of an agent's position in the management hierarchy, with increases in remuneration between levels in the hierarchy being inversely proportionate to the probability of being promoted to the next level. By implication, the compensation of the CEO, ranked highest in the tournament, will typically be substantially more than the compensation of executives at the next highest level.

Agency and tournament theories have had a powerful impact on organisational pay strategies. The problem is that the two theories are based on a flaky and partial understanding of human nature. Standard economic thinking,
which underpins agency and tournament theories, assumes that agents are rational, self-interested and rent-seeking; that their utility is positively contingent on pecuniary incentives and negatively contingent on effort; and that there is no non-pecuniary agent motivation. It further assumes that time preferences are calculated mathematically according to an exponential discount function. These assumptions are abstractions, deliberately simplified, intended to make theory development more mathematically tractable, and justified by economists since Milton Friedman on the basis that the assumptions do not matter if the predictions of a theory are correct. Yet empirical research from 1990 onwards, the publication date of a large empirical study conducted by Michael Jensen and Kevin Murphy, has failed to demonstrate a conclusive link between agents’ pay and corporate performance. Ten years later, Tosi, Werner, Katz and Gomez-Mejia similarly found that incentive alignment as an explanatory agency construct for CEO pay was at best weakly supported by the evidence. In 2010, Carola Frydman and Dirk Jenter concluded that neither agency theory nor the “managerial power hypothesis” (the hypothesis that managers are in effect in a position to determine their own compensation) was fully consistent with the available evidence. Some agency theorists argue the empirical evidence demonstrates that in practice incentives are not strong enough, and that a greater focus on pay-for-performance would inevitably lead to improved corporate performance. However, this involves a logical sleight of hand: it is an attempt to convert a positive theory (describing what actually happens) into a normative theory (prescribing what should happen in the future) when evidence for the positive theory has been found wanting.

**Behavioural Agency Theory**

A number of studies, focusing on senior executives, which I have carried out in the last four years with my co-author Dr Julie Gore of the University of Surrey, have demonstrated that the behavioural assumptions on which agency and tournament theories are based appear to be fundamentally wrong, and have called into question the predictions of those theories. We have proposed a new version of agency theory, which we call *Behavioural Agency Theory*. Our research has identified various phenomena which are not consistent with standard agency theory.

**Agents are much more risk averse than standard economic theory would suggest** -the
majority of executives chose a “sure thing” (zero risk) option over more valuable options paying risk premiums of 9.1% and 16.7%. This compares with “rational choice” risk premiums estimated by Conyon, Core & Guay at between 5.8% and 11.0% for executives with a substantial proportion of their wealth tied-up in firm equity.

Executives are very high time discounters - with median discount rates for future receipts estimated at around 33%. According to standard financial theory, individuals should discount future receipts at rates which are consistent with the return on comparably risky future cash flows, adjusted for inflation. At the present time, therefore, discount rates should be close to the risk-free rate of around 1% per annum, subject to local inflation, which when the survey was carried out varied between under 1% (Switzerland) to over 9% (Argentina).

Intrinsic (i.e., non-pecuniary) motivation is a significant factor - executives would be prepared to give up on average nearly 30% of their income to work in more intrinsically-satisfying jobs;

The perceived fairness of reward is of major significance – most agents would prefer to receive a lower absolute amount of pay, provided that it compares favourably with their referent peer group, rather than a higher absolute amount which compares unfavourably with their peers.

The findings are consistent with work carried out by economic psychologists and behavioural economists such as Daniel Kahneman, the original proponent (with Amos Tversky) of “Prospect Theory”, and the author of the recent best-selling book Thinking Fast and Slow. While there are measurable differences between countries, it is apparent that these behavioural characteristics are largely universal, i.e., cultural factors do not cause risk, time and fairness preferences to depart significantly from the general precepts of prospect theory and economic psychology. This empirical evidence challenges conventional wisdom about the merits of highpowered incentives plans and pay-for-individual-performance. It suggests that longterm incentives may actually be fuelling increases in executive pay, rather than helping to contain pay inflation. We conjecture that boards of directors, acting on behalf of shareholders, increase the size of long-term incentive awards to executives to compensate them for the perceived loss of value when compared with less risky, more certain and more immediate forms of reward. Our research indicates that more balanced

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pay arrangements, incorporating low-powered incentives, may be more efficient and effective, especially when good measures of an individual’s effort or performance are not available, when multi-tasking is required, and when cooperation between different agents is necessary. A number of scholars have pointed out that it is difficult to calibrate individual contributions to a joint effort\textsuperscript{11}. They have also noted that, where metrics and complex and ambiguous, the scope for miscalculating one person’s contribution versus another is greatest. There are certain categories of job, such those involving sales or piecework, where metrics are more straightforward and where high-powered incentive and pay-for-individual-performance is more likely to be effective. However, these are not typically characteristics of senior executive positions in most commercial organisations.

The Remuneration Committee’s Dilemma

While Pepper and Gore provide a powerful critique of agency and tournament theories, they do not themselves answer the question of how current pay practices might be changed. There is a further problem. Companies face a prisoner's dilemma when it comes to chief executive officers’ pay. To illustrate this, assume that CEOs are paid broadly equal amounts, with any variations in pay justified by reference to job size, industry, specialist expertise, and so on. Assume also that in the available population of CEOs 20% are superior to the others and would, if they worked for your company, increase the value of the firm by more than the average. Conversely, 10% are inferior to the others and would, if you employed them, potentially reduce the firm’s value. If all companies offered modest remuneration, then it would be in the interests of an individual company to defect and pay over the odds. By doing so they might attract top talent and potentially be more successful than their competitors. Conversely, a company would not want to find itself in the position of paying significantly below average. To do so might mean it could only attract inferior chief executives. Thus offering higher salaries is the dominant strategy, even though by doing so companies will generally be no better off than if they all paid modest salaries.

The problem which remuneration committees face (which I call the Remuneration Committee’s Dilemma\textsuperscript{12} ) can be represented in a pay-off table (see Figure 1). In the table, $+\phi$ indicates a strong preference for a particular outcome (getting a top performer); 0 indicates a marginal

preference for an outcome (getting a satisfactory performer at the market rate); $\phi$ indicates a marginal preference against an outcome (getting a satisfactory performer at above market rate); and $-2\phi$ indicates a very strong preference against (getting an inferior performer). Scenario 1 is the neutral option; every company pays the market rate and accepts the quality of chief executive they get. In scenario 2, Company X defects and pays over the odds in the hope of getting a top performer who will materially influence the value of the company. In scenario 3, Company X is left paying the market rate while everyone else pays over the odds, thereby running the risk of hiring inferior talent who will negatively impact on the company’s net worth. Scenario 4 is the dominant strategy; everyone pays over the odds, but in doing so neither increases nor reduces the likelihood that they will recruit superior talent.

The Remuneration Committee’s dilemma explains why, despite the fact that it would be in the best interests of most companies

\[\text{PAY MARKET RATE} \quad \text{PAY ABOVE MARKET}\]

\begin{tabular}{|c|c|}
\hline
\text{PAY MARKET RATE} & \text{PAY ABOVE MARKET} \\
\hline
\text{SCENARIO 1} & \text{SCENARIO 3} \\
(0,0) & (-2\phi, 0) \\
\hline
\text{SCENARIO 2} & \text{SCENARIO 4} \\
(+\phi, 0) & (-\phi, -\phi) \\
\hline
\end{tabular}

\small{FIGURE 1: The Remuneration Committee’s Dilemma}

to moderate executive pay, it has proved to be seemingly impossible to prevent pay inflation in recent years.

**Is it time for a revolution in executive pay practices?**

Thomas Kuhn described the advancement of scientific thought in cyclical terms. He argues that there are periods of relative stability, when there is an established scientific paradigm (which Kuhn calls “normal science”), punctuated by scientific revolutions, when conventional beliefs are first called into question and ultimately disestablished\(^\text{13}\). A scientific revolution begins with a crisis in the form either of a substantive critique of the existing paradigm which normal science cannot rebut or the observation of a significant phenomenon which cannot be explained by, and assimilated into, the ruling framework. As a result, scientists lose faith in the current paradigm and cast around for alternatives. Among them is found a new theory, perhaps in rudimentary form, which appears to be capable of responding to the criticisms as well as explaining the aberrant phenomenon. Scientists align with the new theory as they carry out experiments which appear to confirm its main thesis. Thus a new paradigm gradually replaces the old one and the new theory becomes the new “normal science”.

Management practices are, in some ways, like scientific paradigms. The conventional “best practice” paradigms wax and wane like scientific theories: who now talks about total quality management or business process re-engineering, for example? Developmental cycles of this kind are also found in the domain of executive reward. Reuters Group plc was the first UK listed company to adopt a new style of long-term incentive plan in 1993. In 1995, the Greenbury Report recommended that UK companies should adopt performance-related long-term incentive plans rather than traditional share options\(^\text{14}\). Greenbury was in part a reaction to the “fat cats” scandal of 1994, in which executive directors of newly privatised utility companies were awarded substantial pay rises, typically in the form of share options. The Greenbury report pointed out that share options had a number of shortcomings: in particular, they might result in windfall gains simply as a result of general movements in share prices. Many other UK companies followed Reuters’ lead after 1995, switching from share options to long-term incentive plans, influenced by the Greenbury as well as by the withdrawal of tax relief for share options granted over shares with a market value in excess of £20,000 in the 1995 budget. Since that time, LTIPs


have become a major component of senior executive reward systems in UK listed companies. By 2013 long-term incentives comprised nearly 50% of the total earnings of executives in the FTSE 350\textsuperscript{15}. The academic community has generally been supportive of this development, pointing out that LTIPs are consistent with agency theory’s advocacy of high-powered incentives.

Viewed through the lens of Kuhnian theory, the switch after 1993 from share options to long-term incentives involved a crisis (the ‘fat cat’ scandal), a new theory in-action (the Reuters’ long-term incentive plan), alignment around the new theory following publication of the Greenbury report, and the establishment of a new norm (LTIPs comprising a major component of UK directors’ remuneration). More recently, following a further exogenous shock (i.e., the banking crisis of 2008-10, which raised questions about bankers’ pay specifically and executive pay generally) there has been gradual recognition at least by some academics that strong incentives may have exacerbated behaviours which contributed to the crisis\textsuperscript{16}. In 2011, in a special topic forum on theory development, an article in the Academy of Management Review asked: “Where are all the new theories of organization?” The foundational assumptions of agency theory and tournament theory have been challenged by behavioural agency theory. Agency theory’s predictions have been found not to be consistent with the empirical evidence. LTIPs have been widely adopted by UK listed companies, yet they seem to have contributed to inflation in executive pay without necessarily achieving the desired outcomes of aligning the interests of shareholder principals with their executive agents, and of improving corporate performance.

The challenge is now for academics to come up with better theories of executive compensation, for practitioners to design less highly-leveraged executive reward plans, for remuneration committees to put forward pay proposals which break out of the cycle of pay inflation, and for government and regulators to provide an institutional environment which encourages these things to happen.

\textsuperscript{15} Based on data obtained from Income Data Services (“The Director’s Pay Report-2013/14”) London, Thomson Reuters.

\textsuperscript{16} See, for example, comments by John Roberts, a leading agency theorist, who has commented that agency theory performed poorly during the 2008-9 financial crisis: Roberts, J. (2010). Designing incentives in organizations. Journal of Institutional Economics, 6, 125-152

\textsuperscript{17} Suddaby, R; Hardy, C; Huy, Q. (2011). “Where are all the new theories of organization?” Academy of Management Review. 36 (2), p236-246.
Directors’ Remuneration: towards a better solution

By Peter Montagnon

Introduction and summary

This paper examines the need for a more radical solution to the problem of executive remuneration. While the precise figures are disputed, there is general agreement that the pay premium commanded by executives now constitutes a social and political problem. Most wages have been held back or even fallen during the financial crisis, while the reward received by executives has continued to rise, partly as a result of options and share grants issued earlier. Public pressure gave rise to the introduction of new disclosure and voting measures by the coalition government and, while the premium continues high, there remains a risk of more measures being introduced in future.

Although the level reached by executive pay is now widely regarded as unacceptable by the general public, this paper does not suggest that there is something intrinsically wrong with high reward for successful executives. Business leaders are responsible for strategic and other decisions that do much to determine the success or failure of their companies. The good ones create substantial wealth for their shareholders, secure jobs for their employees and investment which boosts the economy. They deserve a high reward. Business needs to retain and motivate them.

The problem lies more in the market’s failure to design effective performance conditions and in operation of the ratchet, which seems constantly to drive up remuneration. Some reasons for the ratchet are structural. First, pay consultants have an inherent interest in arrangements that are both complicated and frequently amended, in order to maintain their flow of fees. Second, nobody really understands the value of share-based awards. This leads executives to undervalue them and demand more. Third, both remuneration committees and shareholders are risk averse. It is less risky for them to agree to lavish packages, than to run the risk, however remote, of a crucial executive leaving for better conditions.

The structure of remuneration needs to be simpler and based on clear principles so that the value of packages is clear and they are not subject to constant change. They should subject to some natural
built-in constraints. This paper starts with a critique of the new remuneration regulations, which, it argues, are liable to fail because they cement existing procedures in a way that will stifle innovation. Since the value of what executives receive is so uncertain, there is little point in addressing excess by increasing shareholders’ right to vote on something they cannot honestly evaluate. Without a real single figure, any approach based on the ratio of executive to general pay is also bound to fail.

The paper argues that executives should only receive awards whose value is clear and objective. This means basing reward around cash and using a share purchase and long term holding requirement to align the interests of the executive with those of the company. Second, dilution should no longer be acceptable. An approach based on cash and shares bought in the market will create a natural ceiling, and remuneration will reflect the success of the company in generating long term cash flow. Arguably such a system would do away with the need for bonuses, which are the cause of so much public objection.

Remuneration regulations and the single figure

New regulations entered force in October 2013, requiring companies to lay out clearly the amounts received by individual directors and to offer a periodic binding vote on policy. This included a requirement to calculate a “single figure” for each director’s remuneration in an effort to address the lack of clarity over what had been received and the sometimes widely varying estimates in the press. The government hoped that the result would give a reliable indication of amounts, provide a basis for comparison and enable shareholders and others to see how fast remuneration was or was not rising. In this way they would be better able to judge the relationship to performance.

The regulations require the elements of remuneration to be set out and quantified separately under the following headings:

1. The total amount of salary and fees
2. All taxable benefits
3. Performance-related bonus
payments relating to the financial year in question

4. Money or other assets (shares) received or receivable during the financial year arising from schemes of more than one year's duration where final vesting is contingent on performance measures or targets relating to a period ending in the financial year and is not subject to a performance measure in a future year.

5. All pension benefits and all benefits in the year from participating in pension schemes.

6. The total under each section is to be added up to give a single figure for the amount earned in the year in question.

A critical flaw arises under item 4 where companies must disclose the outcome of prior share awards. This allows shareholders to see what has happened to share schemes going back three years or more. But the result is muddled because it includes performance and benefit accumulated during prior years. It is also affected by market movements of shares, which may be quite short term and unrelated to the performance of the individual director. For example, a company may have had two good business years followed by one average one while the market has risen substantially as a result of monetary policy decisions in the US. Under those circumstances a director could receive a large payout based on performance in prior years and the general increase in the market in the current year. The so-called “single figure” would be swollen by these factors so that it could appear that the director has received a large amount for a mediocre performance in that year.

The regulations do not require awards under share schemes made during the financial year to be included in the single figure. So there is at least no double counting, but for the reasons given above, they still conflate pay relating to several years. The so-called single figure is thus not a figure for remuneration in the year in question but a description of the outcomes in that year. The waters are further muddied by the difficulty of dealing with pension pot valuations, which are obviously affected by extraneous factors, notably interest rate fluctuations, though this is a less urgent problem given the gradual demise of defined benefit schemes.

A true single figure for executive pay

Arriving at a true single figure would require us to calculate the value of everything that was handed over during the year at
the time at which it was handed over. Essentially this means understanding the value of share schemes. In the immediate aftermath of the financial crisis, the share market both fell and became more volatile, but companies continued to give share awards based on a fixed and unchanged relationship to salary. The result was that many directors received a larger number of options and performance shares than previously, each of which was more valuable than previously because of the volatility. That amounted to a large and unrecorded increase in remuneration which only came to light subsequently as the schemes matured. By then, of course, it was too late for shareholders to do anything about it. Had the schemes been properly valued at the time, the increase in remuneration would have been clear to all. Remuneration committees would have felt constrained and shareholders would have been able to take timely action to force a change in policy.

**Voting on a chimera**

The debate around the single figure revealed an awkward truth: nobody really knows what packages are worth at the time they are handed over. So there is little point in tackling the problem by increasing shareholder voting rights.

International accounting standards require companies to put a figure on the cost of share schemes. This has affected their design by moving companies away from options and into performance shares. Yet the figure is widely ignored as shareholders do not believe it is meaningful. Similarly, remuneration consultants may provide a figure for the net present value of the package but shareholders will dismiss these as being self-interested.

There is anecdotal evidence and some academic evidence that executives undervalue the share incentives they receive because the performance targets are unreal and out of their control. As they undervalue these awards, it is natural for them to want more.

The new regulations purport to show a single figure for remuneration, but it is in fact no such thing. The debate around them exposed the awkward truth that neither the remuneration committees, which make share awards, nor the directors who receive them, really know what they are worth. Some more radical action is needed.

**Knowing what is being handed over**

It ought to be possible to say with precision what executive remuneration is worth. Share schemes have become popular
because they are seen as a means of aligning the interest of management to that of shareholders, and of locking the management in for the medium term. These are sensible and laudable objectives, but they are impossible to evaluate with any real accuracy. The Black Scholes formula may allow us to derive an approximate valuation of options, but the challenge is made much harder by the uncertain impact of performance measures, which may, for example, be dependent on completely unpredictable performance in a comparator company. This suggests the adoption of a simple rule: if you can’t value it, you can’t give it.

Application of this rule would provoke a radical revision of the current approach. Because of the difficulty in valuing them precisely, options and performance shares would be outlawed and remuneration committees would have to fall back on a currency that could be properly valued at the time it is handed over. This essentially means cash or hard shares without performance conditions. There are no performance conditions attached to such awards, but a performance impact and long-term alignment with shareholders would be addressed by extending the required holding period for the shares to say five, or even preferably ten years, regardless of whether the executive is still working for the company. This is quite different from the old US options which could be cashed immediately without any performance conditions.

Senior executives would be less likely to take a short-term decision with bad long-term consequences if they were locked in in this way. It would provide a strong incentive to deal sensibly with succession planning, a current big weakness in the operation of corporate governance. It would prevent both the need for claw-back and the incidence of payment for failure, because a disaster that hit during or even after the executive’s period of tenure would hit the value of his or her share portfolio.

Though some companies, which are not cash-generative, will complain that they would find it difficult to use shares bought in the market, the balance of the argument favours this approach. The ability to issue dilutive shares means there is no natural cap on remuneration. A requirement either to give executives the cash and make them buy the shares for themselves, or for the company to buy the shares on their behalf would mean companies can only pay compensation they can genuinely afford.

Finally, there is the question of whether executives should be
able to keep the dividends paid on shares held under these arrangements, rather than roll them up into additional shares. On balance the answer is, yes, as this would tie their cash award more closely to the performance of the company than presently seems to be the case with bonuses and provide an incentive to long-term cash generation. Indeed this should be seen as an alternative to bonuses. One of the most perverse characteristics of the present system is that, when companies are in difficulty, bonuses continue even after the dividend stops.

**Conclusion**

This paper has argued for a radical new approach based on three simple principles: only give what can be clearly valued, outlaw dilution, and require executives to own shares for the long term even after they have left the company. It is preferable to the current government policy of trying to patch up the discredited existing system. Greater clarity and simplification would remove much of the obscurity around the operation of executive pay, which is the cause of much public mistrust. The process suggested could remove the need for bonuses. There is nothing in the proposal to stop companies paying high reward to successful executives, but the prospect of greater certainty especially for those willing to take a long term view and take succession planning seriously might even allow the market to settle around a lower level of overall quantum.
Why Paying Footballers for Goals Doesn’t Work

By Tom Powdrill Responsible investment co-ordinator International Transport Workers’ Federation

It’s interesting to note that corporate executives often like to compare themselves to sports stars. Not in terms of their athletic abilities, of course, but rather as a way of justifying the amount they are paid. Why, they ask, does society criticise how much we earn, but not rewards on offer to footballers? If you want talent in any field you have to pay for it.

Here is Barclays’ then chief executive John Varley, back in the mid-crisis year of 2009, defending the bank’s pay and bonus culture: “There is simply no higher priority than to ensure we field the very best people. That in a sense is exactly the same as a football manager if they are going to win.”

But there’s an important difference in the way that sports and business approach reward, and this is in their attitudes to performance-related pay.

In practice where performance-related pay is used in sports such as football, it is largely focused on team objectives, like avoiding relegation, or winning the league. In some cases, players can also earn more based on the number of appearances they make, encouraging them to stay fit, and play well enough to be included in the squad. But variable pay based on individual performances is much less common.

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1 It’s back to school for Fred the Shred, The Telegraph, 4 August 2009
2 City’s bumper bonus! Stars given £6.2m pot after thrilling title triumph, Daily Mail, 31 July 2012
And it seems that a major reason for this is the problem of perverse incentives. In his book *Goal*, former FC Barcelona finance director Ferran Soriano recounts a great story about the club’s then manager Frank Rikjaard’s attitude to bonuses. Rikjaard was furious when he found out that Argentine striker Javier Saviola had a clause stating he would receive €6,000 for every goal scored.

Soriano writes: “That explains some things!” he exclaimed. Rikjaard could relate Saviola’s behavior on the field to that financial incentive. At first glance there didn’t seem to be a problem because when a footballer is playing in a match the only thing he can think about is winning, not earning money, but it is difficult to know, in the fraction of a section when Saviola had to decide whether to pass the ball to a colleague or to shoot himself, whether the €6,000 goal bonus influenced his decision, even though it may have been almost imperceptible and unconscious. Whatever the case, Frank Rikjaard didn’t like it at all.”

Soriano himself is an advocate of the use of financial rewards, and introduced a model at Barcelona of a 2:1 ratio of fixed to variable pay. But he also argues that incentives must be team based, in order to avoid the kind of problems created by Saviola’s goal bonus.

And this applies to players in different positions, or in different sports. Consider the comments of former NBA star Tim Hardaway, who played as a point guard (a key position facilitating the team’s game). As part of his contract with the Miami Heat, Hardaway was eligible for a significant bonus based on the number of assists (passes to other players) he made. But, in a mirror image of the problem created by Javier Saviola’s goal bonus, he felt drawn to trying to pass even when easy shots were open to him. Hardaway was clear that the bonus scheme was bad news for his game.

“It’s like this big bag of money is hanging in front of you and you can’t reach it. It’s a terrible way to play, but I agreed to it. If I had it all to do over again, I would have taken what they could give me and said **** it to the incentives. Here I’m playing against other point guards and they’re just playing and I’m worrying about what’s gonna happen with every pass. It’s cost me in the way I’ve played.”

Perverse incentives aren’t the only problem with performance-related pay in sport, which arguably this can be countered by better contract design. Can the use of incentives actually make performance worse?

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3 Goal: The Ball Doesn’t Go In By Chance, Ferran Soriano, 2012 page 144
4 Hardaway Regrets Bonus In Contract, SunSentinel, 23 April 23, 1999
Large financial rewards can cause “choking” under pressure

There’s some evidence that the potential to receive large financial rewards can lead some people to ‘choke’ under pressure. An enlightening paper by Dan Ariely, Uri Gneezy, George Loewenstein, and Nina Mazar published in 2005 found that larger rewards tended to have a detrimental effect on performance in a number of experimental tasks. Looking again in the world of sports, a recent paper analyzing the performance of golfers on the PGA tour found that as the value of a putt increased, performance worsened.

And the more you dig into the results of performance-related reward, the less impressive it looks, even at the most simple level. Many parents try and encourage their children to work hard at school by promising them gifts, or cash, if they get good exam results. But the work of US economist Roland Fryer may give them reason to think again.

Driven by a desire to improve educational attainment, particularly amongst groups that seem to struggle, Fryer has undertaken extensive trials in schools of incentive systems for pupils. Perhaps even more than sport, this ought to be an ideal environment for performance-related rewards. After all, grades reflect a standardized test of individual performance.

Don’t pay children for good grades

Fryer found that it is possible to improve elements of academic performance amongst some pupils, but, to his own surprise, not by paying them for good grades. Fryer found that results-based rewards had no impact on performance. In contrast, paying pupils to read books, and rewarding them for attendance, wearing their uniform, or handing in homework, was linked with better results.

Fryer suggests that perhaps pupils don’t know precisely what they need to do in order to achieve good grades. In contrast, it’s obvious what is required to obtain a reward for turning up to school, or reading a book. And in the process of undertaking these tasks the pupil is exposed to educational experience. A key point here is that such incentives are going to have the biggest effect with those pupils who might not otherwise turn up to school, or read books. Those who are already motivated won’t gain.

Interestingly, Fryer found a similar picture looking at performance-based reward for teachers.
Introducing incentives for teachers in New York schools did not improve pupils’ results, and might even have a negative effect.

Like the examples from football, basketball and golf, Fryer’s findings challenge the common sense idea that we should be trying to tie rewards to measurable, individual performance. Aside from the fact that this seems to open the door to unethical behaviour, performance-related rewards don’t seem to work very well, and may even have a negative effect.\(^8\)

But if we can’t rely on incentives to work well in encouraging a sports star to play well, or a school kid to pass a test, why do we trust them to motivate those who run companies? It is not obvious why these findings shouldn’t apply just as much for corporate executives (assuming most of them will turn up to the office every day in a suit without the need for an extra reward).

Faced by this sort of challenge, defenders of variable pay tend to shoot the measurer. The targets are the problem, they say, what we need is more intelligent measurement of performance and delivery of reward. This had led to two important trends in executive pay – more complex targets (employing multiple elements) and deferral of awards.

Executive incentive schemes are too complex

Whilst no doubt well intentioned, these reforms create their own problems. The one thing that everyone in the executive pay debate agrees upon is that incentive schemes have become too complex. Yet this is the inevitable outcome of repeated attempts to improve their design. Executives are now often subject to individual and group performance targets, and success is judged against both company objectives and its peer group. Some executives themselves acknowledge that the resulting complexity means they don’t really know what will make incentive schemes pay out. Like Fryer’s school kids, there is no simple way to generate the performance to get the reward. And executives, of course, are reliant on the performance of others too. In practice, incentive schemes become viewed more like a lottery ticket than a reward for hard work.

Deferring awards also seems like a smart idea at first glance. In finance in particular, a great deal of faith is now placed in paying on the basis of long-term results, and making sure awards are only available once it is clear that the performance that justified them was real.\(^8\)
Unfortunately, in the real world, this conflicts with the well-established human trait of hyperbolic discounting. This simply means that we value rewards that come sooner rather than those that come later. Humans, in general, put a massively lower value on deferred rewards. This inevitably means that they are going to have a weaker behavioural ‘pull’ than short-term rewards.

If we believe that extra reward is necessary to motivate a banker or executive then we have to accept that their motivation will be reduced by deferral. Or, if we want to maintain the same level of motivation, we have to make the reward that is further away bigger again in order that it feels equivalent to the recipient.

Of course humans also, understandably, put a higher value on a ‘sure thing’ than a potential reward. In combination, this means that variable pay, especially if deferred, needs to be very large for it to be valued by the recipient.

And this helps explain what we see in practice. Total potential variable pay for those at the top has grown massively in recent years, and is now typically a multiple of several times base salary. And as those at the top are on high base salaries too, the potential incentive awards available are very large indeed.

To those within the system this all makes sense. It’s built on the premises that paying for performance is a good thing, but that it should be long-term performance. To the ordinary member of the public it is profoundly shocking that those on the highest salaries apparently also require enormous financial incentives in order to ‘motivate’ them. It has also led to the incredible position of the UK government taking legal action to allow bankers to receive rewards above 200% of their base salary. It is no surprise that executive pay remains such an incendiary topic.

There’s a simple solution. Instead of repeatedly trying to redesign incentive schemes for directors, we could, instead, greatly reduce the emphasis on variable pay. Not only would this get around the many problems that performance-related pay both faces and creates, it could be considerably cheaper.

Some remuneration consultants think this could be the way forward. Research by PwC on the psychology of incentives (see Prof Pepper’s essay in this collection) found that even most executives don’t like the way they are paid, and this led to higher demands. It concluded: “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.⁹

This might mean higher base salaries, but less paid overall.

Perhaps boardrooms could learn a lesson from the shopfloor, rather than the sports stadium. Millions of employees go to work every day and do a good job without any expectation of a bonus, often moaning about useless, overpaid football players in their breaks.

And if executives think they get too much stick about their pay at the moment, perhaps they haven’t learnt the right lessons from sports. Footballers get vocal ‘feedback’ on their performance (and how much they are paid for it) from fans week in, week out, from a few yards away. They also face constant media commentary. Executives only have to tolerate the odd bad headline, or a moan from a displeased small shareholder at the company AGM once a year. They should think themselves lucky in comparison. The crowd could be a lot nastier.

⁹ Making executive pay work. The psychology of incentives, PricewaterhouseCoopers, 2012, page 26
CEO: a big job, and someone has to do it

Simon Patterson, managing director of Patterson Associates, a Pearl Meyer and Partners practice

Why the total value the CEO delivers to shareholders for every pound he is paid is what we should be reading in our financial press

There is general consensus that the problem of executive pay is still a prevalent issue, despite at least 20 years of scrutiny and a plethora of regulations. Over the years we have seen improvements in disclosure and transparency and the Enterprise Bill (Vince Cable’s recent reform) has led to uniformity across quoted companies and a minimum standard to which all companies now conform. Yet most commentators still believe that executive pay is too high.

We would argue that looking at levels of pay is seeing the problem from the wrong end of the telescope. Where we can do better is to provide companies with more insight into the total value that their executives deliver to shareholders and link the financial measures that drive this value to remuneration. This is what led us to develop the CEO Value Test™ (‘Index’), a simple measure of how much an individual or group delivers in performance for every £1 they are paid. For the moment, for simplicity, we will focus on the Chief Executive (‘CEO’) role, alone.

The Index is calculated by dividing Total CEO Remuneration over four years into Total Value Added over four years. The ingredients of the index are: realized (actual ‘take-home’) pay over four years and value added to ALL shareholders. Total Remuneration consists of salary, actual (including deferred) bonus and the vested value of long-term incentives. Total Value Added includes the change in market cap, dividends and share buybacks over the period.

By taking all of the elements of both pay and performance into consideration in one go, over a given period of time, we are able to determine – at a glance - how well an individual’s pay is aligned with performance. In effect, what is the value they deliver to their shareholders for a unit of executive pay?

This is very important, for several reasons; it allows us to very simply demonstrate who is ‘value for their money’, it shows us a great deal about the importance of high or low incentive opportunity, of short vs long term pay (as a proportion of whole pay package), it also focuses on the value of...
an executive not the cost of an executive – after all, simply because an executive is well paid should not be the primary concern, the focus should be on what they do for that money. Pay should be viewed in the context of performance, always. By focusing on the value of an executive rather than the cost of an executive, we gain an insight into the effectiveness of pay programmes. Importantly, we can highlight those pay programmes which are over-leveraged (too much is paid for a given level of performance) or we can show that simply paying bottom dollar is ineffective (low long-term pay opportunity is associated with mediocre performance). Without disputing the rights and wrongs of ‘market benchmarking’ - and there are many - we can calibrate the level of performance which will be necessary in the future for an executive to deliver good value, given any level of pay.

It is worth a word here about benchmarking. It has its place in the wealth of data which is available to remuneration committees, but it can be too heavily relied upon and where this happens the results are ‘me too’ pay programmes which do not truly reflect the business drivers of that particular organisation.

So, after analysing some 30,000 pieces of data for the 2014 report, what does the 2014 CEO Value Test show this year?

We have calculated the four-year Index ending 2012, 2013 and now 2014 (to be published in November 2014). This year we have sampled 229 of the largest 350 listed companies in the UK (of those not included 17 actually lost shareholders’ money over the four years and for various other reasons we could not include the remainder). Some headline findings for this year are as follows:

> The Best Value CEOs – the top 10% (23 companies in our sample) have an Index ranging which ranges from £691 going to all the shareholders for every £1 paid (to the CEO) to £3,737. The Median – or middle company amongst those 23 companies – had an Index of £1,089 going to all the shareholders for every £1 paid (to the CEO).

> The Worst* Value CEOs – the bottom 10% (excluding the 17 companies which lost value) had an Index which ranged from just £3 (going to all shareholders, for every £1 paid to the CEO) up to £66. The Median Index for the Worst Value CEOs was £40 going to all shareholders for every £1 paid to the CEO.
We say ‘Worst’, but in fact this is the ‘nearly worst’ group. The worst outcome for shareholders was in fact the 17 companies that lost shareholders’ money over the four years. We have not analysed these companies.

> The whole sample of 229 companies had a **Median Index of £180** (Upper Quartile of £319, Lower Quartile of £110)

> **FTSE100** companies in our sample had a median Index of £388 (Upper Quartile of £691, Lower Quartile of £243) – 13 of the 83 FTSE100 companies achieved an Index of £1000 or greater

> **FTSE250** companies in our sample had a median Index of £130 (Upper Quartile of £198, Lower Quartile of £85)

In addition to providing a tracker that compares CEO value against other companies in the FTSE 350, the Index has also dispelled a number of myths that have built up over the years.

Myth number one: ‘SMALL IS BEAUTIFUL’: It is often believed that the hard working mid-cap executive is under-paid relative to the ‘fat cat’ CEO who is running a company many multiples the size of theirs. In fact, pound for pound, executives running large organisations tend to be far better value for their shareholders. Why? There are several reasons.

Firstly, the outcome in terms of value to all shareholders of an improved performance in a large organisation is vastly greater than the equivalent improvement in a smaller firm. It is like asking someone to move a super-tanker or a ferry from one island to another. Both leave harbour, both travel the same distance, but a few cars arrive when the ferry docks, while the entire island has oil for a year when the super-tanker docks. Which captain has the tougher job? You guessed right.

Secondly, the Chief Executives of mid-cap firms tend to be served by the same type of Remuneration Committee process, and remuneration advisors. As a result, they begin to expect (or are served up) a ‘FTSE100-Lite’ pay programme when they are actually running a FTSE 250 company, which requires much different pay calibration.

Myth number two: ‘BANKERS ARE BAD’: the phrase ‘bankers bonus’ is now part of the lexicon of pejoratives so common is the view that bankers are over-paid, and under-delivering. In fact, the evidence doesn’t support that view. The chart A below shows the Upper Quartile, Median and Lower Quartile Index of CEO Value for Banks vs Other Sectors, classified
according to size of company. In all cases, bank CEOs add more value than CEOs in companies of similar size in other sectors.

Myth number three: ‘CHANGING THE CEO COSTS MORE’ – we looked at the companies in our sample which changed their CEO (once or more than once), and compared them to those with the same leadership throughout. We were fascinated to learn two important things: firstly, the total pay, when one includes the out-going and incoming CEO packages, is very comparable; second, the Index of CEO Value is markedly in favour of changing the CEO. This is something we suspected, but the data is hard to ignore.

Myth number four: ‘HIGH PAY IS BAD and LOW PAY IS GOOD’: to read the UK media, one could be forgiven for coming to this conclusion. However, in economic terms this does not hold to be true. Again, the Value Test™ provides a tremendous insight here.

Figure A: showing the CEO Value Index for Banks and Others, by Company Size.
Figure B: 4-year pay and CEO value Index: companies that changed CEO (Red) vs No change in CEO (Green)

Figure C: showing four-year Total Remuneration, by Top Middle and Bottom Index CEO Value Index
We analysed the highest and lowest Value CEOs in the FTSE 350 (Chart C below). Those in green have the top index outcomes (they are delivering the most value for every £1 paid). The data from companies shown in brown in the chart opposite are those where the company delivers the least to shareholders for every £1 paid. The chart demonstrates that the four-year salary, bonus and long term incentive (LTI) are much lower in brown companies than for the top (green) companies. What this means is that the OUTCOME is much, much better for the green companies, those receiving high pay, yet the Low Pay companies deliver much less. Which company would you rather invest in?

We have been observing pay and performance over an interesting economic period. In the four years ending 2012, as a result of the global downturn, far less value was added by companies than in the period ending 2013 or 2014. This is what you would expect.

Here are the numbers from the Index: median Total Value Added by companies sampled in the period 2010 to 2014 was £668bn while the equivalent figure from 2008 to 2012 was £444bn – a much lower sum going to shareholders. If there is less value for shareholders, and the prevailing wisdom is that CEO pay is not aligned with performance - this suggests that the CEO Index will be lower in the period ending 2012, rather than 2014? In fact, that is not the case. Because overall CEO pay was lower, the value that CEOs delivered to shareholders for every £1 paid in the four years to 2012 was actually greater. This strongly suggests assumptions about pay:performance alignment are wrong.

Few business issues create more ‘heat and light’ than executive pay but we are finding that the approach that focuses on the Value of executives rather than the Cost of executives is providing some important insights into the pay debate and a very practical tool for companies to use. I leave you with a comment we picked up about the Index:

‘...An easy to understand approach to a subject where widespread absence of financial literacy, greed, back scratching, egregious assertion in place of facts and deep personal interest have had undue power for some decades now. Is it flawed? Of course, but it is a better attempt to move the debate along than many I have seen.’

Norman Bernard, former partner of Booz Allen & Hamilton (May 2014)
The High Pay Centre would like to thank all of the writers who generously gave their time to the project. As always, we are grateful for the support of our funders.

Design Rachel Gannon
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Printed on Cylcus Offset; 100% recycled paper made from de-inked post consumer waste.