Research report – summary

April 2014

Executive reward

A review of the drivers and consequences

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Executive reward: A review of the drivers and consequences

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Acknowledgements

This summary was researched and written on behalf of the CIPD by Professor Alexander Pepper and Rebecca Campbell of the London School of Economics and Political Science.

Foreword

This publication is a summary of a review of academic research on executive reward, carried out on behalf of the CIPD by Professor Alexander Pepper and Rebecca Campbell of the London School of Economics and Political Science. The purpose of our report is to review recent academic research into top pay (2007 and 2013), to highlight the findings and consider the implications for remuneration practice and public policy. The report is written for and aimed at reward and HR professionals working in the area of executive remuneration, as well as those who would like to know more about this topic.

The research focuses on two main areas, namely reviewing those studies that attempt to explain what has been driving executive reward upwards and those studies that endeavour to explore what, if any, have been the consequences of this increase in pay.

Those hoping for straightforward explanations for why executive remuneration has increased by so much or simple solutions to ensure pay reflects performance may be somewhat disappointed by the subject matter presented in this summary and in the supporting research publication. In part, this is due to different perspectives regarding 'reward' and 'performance' adopted by the various research projects.

I believe that it is also partly due to traditional thinking about executive reward. The model of what makes an effective leader has evolved over the past 20 years. As a recent CIPD report on leadership (*Engaging Leadership: Creating organisations that maximise the potential of their people*) concludes: *'New notions of leadership stress that leadership is not simply the domain of a few, but is prevalent throughout the organisation in the untapped talent of all its employees. The role of the organisation and its formally appointed leaders is to create a culture in which such latent potential is nourished, recognised and released in daily interactions and ways of "being", and of doing things together.'*

Yet how is this new appreciation of what makes for effective and sustainable leadership being supported by how we currently reward and recognise chief executives? Under agency theory, the current and dominant framework for thinking about executive pay, the focus is on evaluating outcomes rather than assessing behaviours. Yet while it is cheaper and simpler for investors to monitor performance than behaviour, overly focusing on what has been achieved at the expense of how could reduce shareholder value.

While our research does not find any single best way to manage executive pay, it does suggest the importance of: ensuring the right behaviours and achievements are being rewarded and recognised; reviewing these on a regular basis; assessing the appropriateness of how the employment and reward package is structured; and strong corporate governance and transparency.[1] This suggests that a simpler reward structure with less aggressive incentives may be more appropriate.

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[1] For guidance on managing executive pay, see the CIPD's *Executive Pay: The principles and putting them into practice.* Available at: http://www.cipd.co.uk/hr-resources/guides/executive-pay-principles-into-practice.aspx

Introduction

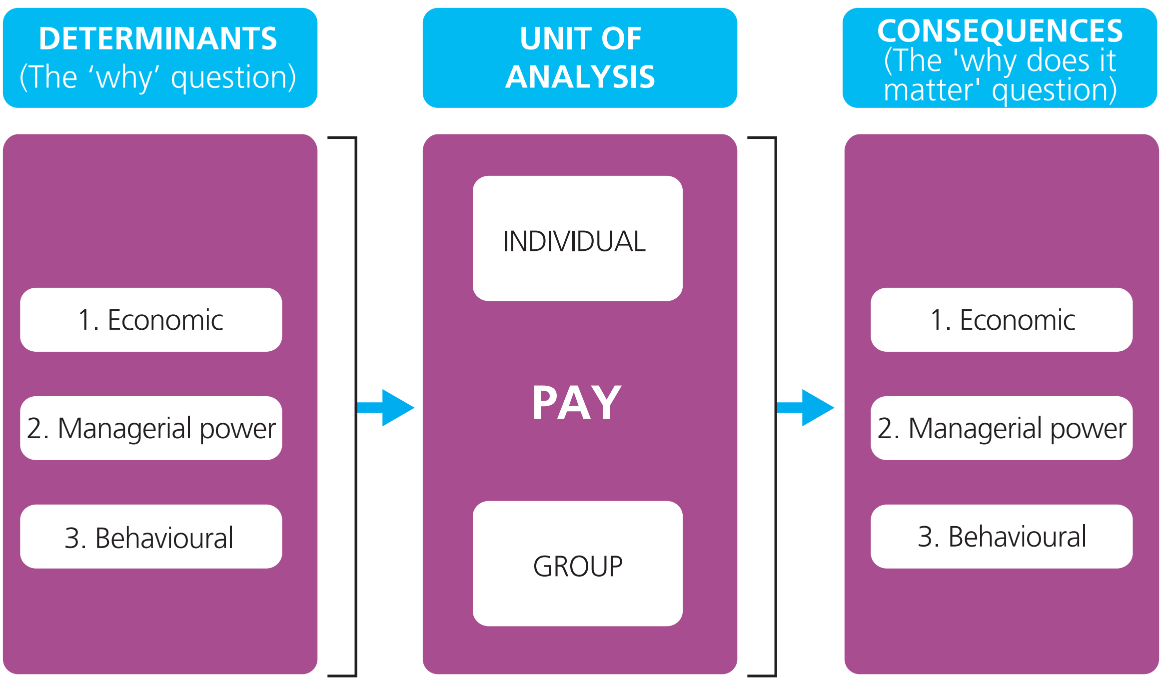
The literature on executive reward in the academic press is large. Much of it is largely invisible to practitioners because it is published in peer-reviewed academic journals that are not widely read, except by other academics. In this report, we comment on some of the most important articles about top management pay published in academic journals between 2007 and 2013. This is a significant period, because it coincides with the global financial crisis, when executive compensation has once again been under the spotlight.[2]

The last major literature review of the research on executive pay was carried out in the US by Cynthia E. Devers et al in 2007. We based the choice of academic journals that we searched on those used by Devers, although some additional UK-based journals were included in order to provide more local perspective. In nearly all cases, articles were drawn from three-star and four-star rated academic journals. The choice of keywords used when searching the journals was also based on Devers, the chosen keywords being: 'executive compensation'; 'compensation design'; 'incentive pay'; 'corporate governance'; 'risk'; 'agency theory'; and 'behavioural theory'.

Recent academic writing on executive pay can be segmented in a number of different ways. Some articles examine the key factors that determine top management pay, while others consider the consequences of high executive rewards. The main viewpoints are the standard economic perspective, which focuses on economic efficiency, and the managerial-power perspective, which hypothesises that executives exercise power in such a way that they are able to influence their own pay levels. There is also an emerging behavioural perspective, which draws on psychological theories about motivation and risk. Most articles take the individual executive as the primary unit of analysis, but a small number focus on top management teams as a whole. We summarise this segmentation in a model (see Figure 1), which we also use to frame the rest of the discussion.

Figure 1

A model for thinking about senior executive pay



[2] A more detailed review of the literature, from which this summary is drawn, is available in PDF format at **cipd.co.uk/executivereward**

Determinants of executive reward

This section looks at the various explanations as to why executive pay has increased so much.

Economic perspective

The standard economic theory used to explain executive reward is agency theory, which hypothesises a link between company performance and executive pay. Yet one of the consistent findings in the literature is that the best predictor of executive pay is firm size rather than financial performance. Gabaix and Landier (2008) argue that this finding is economically rational on the basis that the marginal impact of CEO talent increases with the value of the firms under their control. They contend that the six-fold increase in US CEO pay between 1980 and 2003 can be entirely attributed to the corresponding increase in the market capitalisation of large companies during the same period. However, the argument that increasing pay is an efficient response to growth in the market value of firms is challenged by other academics.

Frydman and Saks (2010) offer a historical perspective, showing that, while executive pay and firm size have indeed expanded at almost the same rate from the 1980s onwards, this was not the case in previous periods. Before 1980, aggregate market capitalisation increased considerably, while the level of top management pay experienced little change.

Philippon and Reshef (2012) also question the strength of the economic justification for changes in executive pay. Their study looks specifically at the financial sector in the United States in the period 1909–2006, focusing on the impact of deregulation and comparing wages and skill levels with those in the wider economy. They argue that the Gabaix and Landier model leaves much of the excess wage in the finance sector unexplained. They demonstrate that high pay has not been a permanent feature of the financial services industry and argue that the impact of deregulation explains why high wages appear in some periods, but not others. Between 1909 and 1933 finance was a high-pay, high-skills industry. There was then a dramatic decline, starting in the mid-1930s. By the1950s, the average skill and wage levels in the financial sector were similar to those in the broader economy. From 1980 onwards, the financial sector began a dramatic recovery, with both average skills and pay levels returning to their 1930s levels. By 1995, executive compensation in finance services was, on average, 2.7 times greater than in other parts of the private sector.

Other authors defend incentive pay as a device for aligning the interests of shareholders and managers. Nyberg et al (2010) propose a new concept of 'CEO return', broadly analogous to total shareholder return, which looks at percentage yields based on underlying assets. They measure the degree to which a CEO's firm-based wealth, including accumulated stock and option holdings, change in a given year, expressed as a percentage of the CEO's wealth at the start of the period. They find substantial evidence of the alignment of CEO return and shareholder return.

Banker et al (2013) present a possible explanation for the weak links found between pay and performance. They look at the different roles played by salaries, bonuses and incentives, and argue that only salaries, as the fixed components of total compensation, should exhibit a positive association with past performance. Conversely, the authors expect bonuses to be negatively related to past performance, because, if past performance is high, principals will be confident enough to provide a higher salary and less high-powered bonuses.

Custodio et al (2013) argue that in the CEO labour market, general managerial skills have become more important than firm-specific skills. Based on a study of over 25,000 'CEO-firm-years' in the period 1993–2007, they estimate that there is an annual pay premium for generalist CEOs of 19% relative to specialist CEOs. Cunat and Guadalupe (2009) suggest that increased foreign competition is an important factor in explaining some of the recent trends in compensation structures. Their analysis is complementary to Custodio et al in that foreign competition could be an additional reason why general skills are more important than firm-specific skills, one where a small difference in talent can make a big effect.

Fulmer (2009) argues that, while the most commonly cited justification for CEO pay is incentive alignment, the importance of retention has been underestimated by academics. If companies really want to keep highly talented executives, they need to make sure they provide larger amounts of forfeitable equity and deferred pay than their peers.

Managerial power hypothesis

The notion of 'rents', the difference between a manager's actual compensation and the compensation that would have been received under an optimal contracting scenario, has received considerable attention since the publication of a book by Lucien Bebchuk and Jesse Fried, *Pay without Performance: The unfulfilled promise of executive compensation,* in 2004.

Bebchuk and Fried contend that hidden benefits are one of the ways in which over-powerful executives obscure their remuneration to limit the 'outrage' factor. Kalyta (2009) tests this argument, suggesting that pensions, one of the more opaque forms of compensation, are most vulnerable to managerial rent extraction. He finds a positive association between proxies for CEO power and pension increments. Kalyta surmises that less transparent forms of pay are most influenced by power, while more visible forms are most influenced by economic variables such as firm size and financial performance. Bebchuk et al (2010) examine the incidence of 'lucky' option grants (grants made at the lowest available price in any given month) in the cases of both CEOs and outside directors. They find that the incidence of lucky option grants is correlated with factors associated with greater CEO influence on corporate decision-making and consistent with significantly higher reported total compensation.

The debate over how pay is determined is often presented as a binary one. In one camp you have the proponents of the standard economic perspective, supporters of agency theory and the shareholder value model, who argue that increases in senior executive pay are a rational response to economic forces. In the other camp are those who subscribe to the managerial power hypothesis, who highlight numerous compensation practices which appear not to be consistent with market efficiency. The main hurdle for advocates of the managerial power hypothesis is that inflation in senior executive compensation has been observed even as corporate governance regimes have been tightening. DiPrete et al (2010) argue that governance failures must be conceptualised at a market rather than firm level: even in the case of companies with good corporate governance, there will be a feedback loop that may result in rent extraction.

Behavioural perspective

A feature of recent literature on executive pay is a focus on behavioural and social factors. Using data on the preferences of top managers of FTSE 350 firms, Pepper et al (2013) look at what motivates senior executives, arguing that agency theory has focused excessively on alignment, while at the same time neglecting the equally important objective of executive motivation. They argue for a 'behavioural theory of agency', to replace the standard agency model. Pepper and Gore (forthcoming, b) argue that risk, uncertainty and time-discounting affect the subjective value that executives perceive in certain types of incentive. They conjecture that boards of directors have increased the size of long-term incentive awards to compensate executives for the perceived loss of value when compared with less risky, more certain and more immediate forms of reward.

Gabaix and Landier (2008) acknowledge the role played by contagion in driving increases in compensation. They explain how, if 10% of firms want to pay their CEO twice as much as their competitors, the compensation of all CEOs inevitably doubles. DiPrete et al (2010) argue that the process of compensation determination for executives is fundamentally relational in character, with social comparison one of the principal non-economic forces driving pay upwards. As they put it: '*In a "Lake Wobegon world" where no one should be below average and many are above average there will be an inexorable upward pressure on wages*' (Di Prete et al 2010).

Conyon et al (2009) find, based on UK and US data, that pay levels are generally higher in firms that are advised by compensation consultants. However, they caution that this result could be open to alternative explanations. They note that firms using compensation consultants also pay their CEOs with more 'at risk' pay such as stock options. The positive correlation between pay and the use of compensation consultants may exemplify the effect of higher compensation for higher risk-bearing, rather than an inappropriate ratcheting-up of executive pay. However, Hwang and Kim (2009) argue that *'it pays to have friends'*. They find that, when a conventionally and socially independent board is monitoring pay and performance, CEO compensation is lower, on average, by $3.3 million.

Consequences of executive reward

This section looks at the possible consequences of a rise in executive remuneration.

Economic perspective

Another feature of the recent academic literature has been the number of investigations into the connection between equity incentives and corrupt practices. Benmelech et al (2010) discuss the impact that stock-based incentives have had on the propensity of CEOs to conceal bad news. They argue that stock-based compensation implicitly punishes CEOs for truth-telling. Laux and Laux (2009) concede that high levels of equity pay increases the incentive for CEOs to manipulate earnings, but argue that this will not necessarily result in accounting misrepresentation, because independent directors will be forced to increase their oversight efforts.

Harris and Bromiley (2007) also examine the impact compensation structures have on the likelihood of financial misstatement. Their data strongly supports the hypothesis that increasing the proportion of CEO compensation provided in the form of stock options increases the probability of accounting misrepresentation. Harford and Li (2007) find that, following a merger or acquisition, the pay and total wealth of the acquiring company's CEO often increases substantially. They also find that, except in the best-governed firms, CEO pay following a merger typically becomes much less sensitive to performance.

Roberts (2010) argues that badly designed incentives in the banking industry were dangerous because of the way that they encouraged short-termism: *'I'll be gone, you'll be gone'* was, apparently, a catchphrase on Wall Street prior to the financial crisis. However, the empirical data does not all point towards short-termism. In a study of the US cable industry, Souder and Shaver (2010) examined the effect of stock options on a manager's predisposition towards long-term decision-making. They find that executives holding relatively high levels of un-exercisable options and low levels of exercisable options are more likely to make long-term investment decisions.

Managerial power hypothesis

Bebchuk et al (2010) looked in detail at the compensation of the top five senior executives at Bear Stearns and Lehman Brothers, arguing that large incentives designed around short-term performance targets contributed to poor decision-making, leading managers to ignore the possible risks of incurring large losses on behalf of their companies at some time in the future. They conclude that incentives should be more strongly linked to the creation of long-term value.

Further empirical evidence is provided by Hagendorff and Vallascas (2011), who use mergers and acquisitions to test the proposition that the use of equity pay in the banking industry motivated excessive risk-taking. They find that, following deregulation, in particular in the US after the Gramm-Leach-Bliley Act of 1999, risk-taking incentives increased, particularly in larger banks.

Malmendier and Tate (2009) find that firms run by award-winning CEOs subsequently underperform. Morse et al (2011) also present evidence that powerful chief executives manipulate their incentive compensation and that this is negatively related to future firm performance.

Behavioural perspective

Martin et al (2013) revisit the behavioural agency model, arguing that stock options are likely to have a mixed impact on risk: while the prospect of generating future wealth will increase managerial risk-taking, the more sober possibility of losing equity value which has already been mentally 'banked' reduces an executive's inclination to risk future losses. Sanders and Hambrick (2007) examine how stock options affect CEO perceptions of risk, concluding that, when it comes to incentivising appropriate managerial risk-taking, the heavy use of stock options gives rise to more unfavourable than favourable results.

Wright et al (2007) discuss both the sorting and incentive impacts of pay structures on the propensity to take risk. They argue that the sorting effect means companies which put higher proportions of pay at risk will perversely tend to attract less risk-averse individuals. Wowak and Hambrick (2010) build a theoretical model that develops propositions about the relationship between personal characteristics and compensation, and suggest that missing from the general debate is the important question of personal differences. Fong et al (2010) looked at how CEOs who are underpaid, relative to the general CEO labour market, resolve their own sense of fairness. They hypothesise that relatively disadvantaged CEOs will attempt to redress the balance, either by seeking to increase the size of the firm or by quitting.

Han Ming Chung et al (2012) examine the relationship between managers' self-confidence, incentives and firm performance. They find that executives with higher core self-evaluation respond to incentive compensation with greater perseverance, competitive strategy focus, ethical behaviour and strategic risk-taking in comparison with managers who have a lower core self-evaluation.

Top management teams

Most of the academic literature on executive compensation takes individual executives, especially CEOs, as the unit of analysis, a scientific approach known as 'methodological individualism'. A line of research dating back to Hambrick and Mason (1984) focuses instead on top management teams. Roberts (2010) argues that in some situations low-powered ('weak') incentives are more effective than high-powered ones. These situations include those where good measures of an individual agent's efforts are not available and where co-operation among different agents is desired: in other words, weak incentives may be more appropriate in top management teams.

On the other hand, Aguinis and O'Boyle (forthcoming) argue that changes in the nature of work in the twenty-first century have led to the emergence of the concept of 'star performers', whose talent leads to the creation of extraordinary value and who are therefore deserving of exceptional rewards.

Trevor et al (2012) find that, if high pay dispersion is the result of providing exceptional rewards for star performers, this is consistent with high firm performance and better retention of outstanding employees. Kale et al (2009) and Kini and Williams (2009) present empirical evidence in support of the economic efficiency of tournament models, which involve disproportionate rewards for high-performers in order to motivate others to aspire to equivalent levels of achievement.

However, in a study of pay dispersion among top-five company executives, Fredrickson et al (2010) suggest that the position is rather more complex and that excessive pay dispersion can have a negative impact on firm performance.

Gender

This report would be incomplete if it did not mention the relationship between gender and executive rewards. There is a wealth of academic research on the impact of gender on company leadership, but little which focuses specifically on pay. Interested readers might like to refer to research conducted by the Cranfield International Centre for Women Leaders[3] on gender diversity among top management teams.

[3] See, for example: http://www.som.cranfield.ac.uk/som/dinamic-content/media/Research/Research%20Centres/CICWL/FTSEReport2013.pdf

Conclusion

The overriding impression with which one is left after reviewing recent academic literature on executive pay is that it is long on ideas and analysis, but short on solutions and recommendations. Few papers offer alternatives to the standard model of salary, short-term bonuses, long-term equity incentives and, sometimes hidden, pension benefits, with an increasing proportion of total reward being subject to deferral.

Indeed, some commentators argue that long-term equity plans may be contributing to the inflation in executive reward. We need more academics to turn their attention to the design of new mechanisms which might offer better solutions to the problem of how best to reward top managers. And, if we may reveal our personal prejudices at this stage, we believe that the richest vein of enquiry is in the behavioural aspects of pay, using ideas from behavioural economics and economic psychology to do to the study of executive remuneration what behavioural finance has done to the science and practice of investment decision-making (Pepper and Gore forthcoming, 2012 a). Perhaps this will be a feature of a future review of the academic literature on executive reward.

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