

Multidisciplinary Literature Review

Remuneration and Executive Behaviour

Authors

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Foreword

Executive remuneration has been one of the hottest topics in 2009. Much of the public debate has been focussing on so-called ‘perverse incentives’ which have become almost synonymous with what is wrong with the financial system at large. However, the root causes of the financial crisis are clearly much broader than this as the various public inquiries are seeking to establish. Calls for change are abundant and here to stay for some time to come. Amidst the cacophony of voices the one calling upon shareholders and asset owners to act responsibly stands out clearly, a challenge and a duty that APG has long been taking on.

As a large institutional investor, APG is directly involved with the debate on governance and remuneration through its engagement with its investee companies and policy setters. We sometimes fear that the present discussion about board remuneration may overlook important facts, and hence we felt it necessary to look further into the link between remuneration and executive behaviour by tapping into current academic knowledge. To guide us through this territory, we commissioned the London Business School to conduct a literature review on ‘Executive remuneration and behaviour’.

We would like to thank Professor Likierman, Mattia Branca and Sandra Imelmann for their work, and would like to share this excellent review that we believe provides some very valuable insights with fellow investors, companies, policy makers and anyone else who is interested in this debate.

We hope that you find this study interesting and would like to hear from you if you have any comments or questions.

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Executive summary

This report summarizes the current academic research on the link between compensation packages and executive behaviour. The time frame is fixed. It starts in 2007 and ends in August 2009.

Recent research has been using the agency, as well as a number of other psychological/sociological theories, to explain the link between compensation packages and executive behaviour and interest alignment. Scholars acknowledge that compensation is not the only variable influencing behaviour/motivation. Psychological/sociological factors among others also play a role. In other words, interest alignment does not just come from the interests of executives in receiving extrinsic benefits. It also comes from intrinsic interests deriving from the inherent value of the work, sociological factors (cf. people's attributes), etc. Corporate culture is the glue that binds everything together. It shapes the environment that will eventually attract the right people. However, no simple solution has been found yet.

Monitoring can serve as a mechanism to align shareholders' and executives' interests. Scholars have analyzed the role of the board, the compensation committee and the ethical officer. However, the recent financial crisis has shown the current system's limitations. It seems that companies/executives always find a way around regulations and monitoring. Monitoring and incentive compensation work best in combination.

Stock options and other equity-linked compensation components are used to link shareholders' long-term risk interest to executive risk-taking behaviour. They also serve as an effective retention tool for talent. However, stock options reward success, but normally do not penalize failure. This often results in excessive risk taking. Scholars therefore discuss how to balance the upside with the downside. Most agree that it is difficult to find the right balance between encouraging risk and discouraging too much risk.

Various equity linked compensation components are not the only way to link shareholders' long-term risk interest to executive risk-taking behaviour. Research shows that external factors, such as regulation or wealth, influence executives' risk taking behaviours. As a result, these need to be considered when attempting to align the two parties' risk interests.

There seems to be a common understanding among academics that people's attributes influence executive behaviour and performance. However, not enough research has been conducted in this direction in recent years. Current research is quite fragmented. The same holds true for research regarding firm size or industry differences.

Finally, the report discusses the negative effects of attempting to incentivize certain behaviours through compensation packages. Research suggests that certain incentive structures can lead to goal misalignment or even worse, can incentivize managers to engage in unethical or illegal behaviours. Solutions come from politics/regulation, academia and field experience.

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1 Introduction

The dominant view on compensation and executive behaviour relies on the assumptions of the agency theory, elaborated by Jensen and Meckling in 1976. According to the theory: monitoring difficulties may arise when the principal (the employer) and the agent (the employees) are two different persons; asymmetric information problems can be mitigated by paying the agent for behaviour that aligns the principle's interest with the agent's.

Agency problems are thought to be solved by two mechanisms: one being control mechanisms (legal/corporate governance/use of shareholder rights) and the second being managerial remuneration. Recent experiences indicate that high remuneration packages do not guarantee high shareholder value. This report investigates whether management remuneration contributes to solving the agency problems.

1.1 Report scope

The scope of this report is to summarize the current academic research on the link between compensation packages and executive behaviour. The time frame starts in 2007 and ends in August 2009.

- **Definition of compensation.**

Compensation is defined as the monetary and nonmonetary rewards that people receive for performing a job. Monetary compensation can consist of fixed base pay and various variable incentive components. Nonmonetary rewards include fringe benefits, some of which are legally required, and some of which are discretionary. Although the academic literature on the subject of compensation and behaviour focuses prevalently on executive compensation, this report also captures other factors (other than compensation) that can motivate or influence people's behaviour.

- **Definition of behaviour.**

Behaviour is defined as the way that executives act or conduct themselves as a result of a particular compensation package. Economic literature mainly focuses on proxies of behaviour such as firm performance. Social/psychology literature mainly focuses on intrinsic (doing an activity for its own sake) or extrinsic (doing an activity for an instrumental reason) motivations of executive behaviour.

1.2 Methodology

Research has been conducted using major and most common academic databases. Papers and articles were included in the report when one of the following criteria was met: 1) the paper was published in one or more academic journal; 2) the ideas of the article were representative of a recognized industry expert or an academic.

Research was complemented with feedback from organizational behaviour professors at London Business School and industry experts based in the UK (e.g. consulting firms and HR departments of big corporations).

1.3 Structure of the report

The body of the report is articulated in four sections:

- “Alignment of interest: The need for monitoring” is about the levers that employers have to influence executive behaviour.
- “Incentives and risk taking: effects of equity” is about equity incentives and their role in aligning management and shareholder propensity to risk.
- “Personal Choices” is about shareholders’ value/ executive behaviour being dependant on individual choices/preferences.
- “Misalignments” is about the potential negative effects of the attempt to incentivize certain behaviours.

2 Alignment of interest: The need for monitoring

The goal of this section is to show that executive behaviour is linked not only to compensation packages, but also to other factors. The following section shows that shareholders can influence executive behaviour through ad hoc compensation packages, which result in shareholder value maximization. It also illustrates that compensation is not the only factor influencing behaviour. Evidence is provided from a review of articles that include sociologists and psychologists' views. Then, this section explains that monitoring is an important factor in complementing the incentives packages. Evidence is offered that boards, compensation committees and monitoring schemes complement well the incentive packages to align shareholder goals and executive interests. As a result, this section is articulated into two chapters: 1) Agency theory and further developments and 2) monitoring.

2.1 Agency theory and further developments

This chapter discusses the evidence on how compensation packages/individual pay components can influence executive motivation and behaviour. Recent work on agency theory will be discussed as well as recent theory developments. To complement the theory, the following includes real industry examples.

Agency

Ericsson & Villeval (2008) point out that switching from a fixed to a variable pay scheme increases the average output per worker because of incentive effects. In their study in the educational sector, Prince et al. (2008) take up this idea and use it to outline their thoughts on performance pay programs for teachers. Jeon & Menicucci (2008) follow a similar line of thought when discussing earnings structures in science and how to prevent the brain drain from the science sector into the private sector.

Theory developments

Single compensation packages components and executive behaviour

Latest research analyzes single components of compensation packages and how each component influences executive behaviour. It also looks at the interdependency between compensation packages/components and other factors, such as corporate culture, fame, awards, social groups, etc.. By doing so, academics have enriched the traditional agency theory. As a result, academics have moved closer to explaining the effectiveness of the various methods in influencing executive behaviour, motivation and retaining key talent.

One of the most comprehensive models to explain executives' psychological needs has been designed by Gagne & Forest (2008). They reconcile the traditional agency theory with the self-determination theory.¹ Using a model which combines both theories, the authors analyze

¹ Self-determination theory argues that contingent rewards can have detrimental effects on autonomous motivation

various compensation components² and their ability to satisfy executive psychological needs. The findings are mostly inconclusive. However, the authors are able to demonstrate that base pay, which is above market average, creates satisfaction. They also find that fairness encourages autonomous work and that work climate influences executives' judgment on their performance being accurately assessed.

Intrinsic/extrinsic motivation and executive behaviour

Although compensation is a valuable motivation mechanism, Colvin & Boswell (2007) demonstrate in their work that intrinsic motivation/commitment also plays a great role in achieving interest alignment between employee and organizational strategy. Kominis & Emmanuel (2007) enhance this thinking with a study on middle managers. They find that motivation is impacted by both extrinsic and intrinsic rewards. Chong & Eggleton (2007) find that the effect of incentive-based compensation schemes on performance may depend on the degree of information asymmetry, as well as manager's level of organizational commitment. And Frey & Neckermann (2008) conclude that awards, which lie between intrinsic motivation and extrinsic monetary rewards, deserve more attention of economists in the future.

Group and executive behaviour

Dorff (2007) approaches the topic from a different angle. Dorff compares different components of compensation plans using managerial power theory and group dynamics theory (GDT). In particular, he elaborates on how to dissolve groupthink³ and social cascades⁴, which according

to GDT are the main reason for problems with CEO compensation in public corporations (decision-making flaws rooted in group dynamics). Encinosa et al. (2007) also analyze group sociology in their work and its influence on pay practice; however, they find that the relationship is complex and there is no single aspect of group sociology that is entirely consistent with all the patterns in their data. Using game theory, Irlenbusch & Ruchala (2008) examine how to design compensation schemes to motivate team members. The authors conclude that firms face a trade-off when introducing relative rewards into a team setting, as they are likely to have counteracting effects. On the one hand, they increase output because of higher individual incentives. On the other hand, there are drawbacks from distracting team members to act cooperatively.

Industry examples

Hall (2008) uses a study in the healthcare sector to outline three incentive strategies (incl. Pros & Cons) an employer could use to maximize value of rewards. 1) activity incentives – reward employees for participating in activities (e.g. attending an educational session); 2) achievement incentives – reward individuals that demonstrate achievement (e.g. maintaining low cholesterol) and 3) adherence incentives – reward longer term maintenance of lifestyle goals (e.g. remaining tobacco free for 12 months). In their article, Shoshanah et al. (2007), follow a similar pragmatic approach as Hall. They suggest key points to keep in mind to improve operational performance, especially when designing incentives for executives working in the supply chain industry. The authors stress that incentives designed to boost inventory and delivery performance are effective. They then add that incentives for improving accuracy achieve better forecasts, particularly within a decentralized organizational model. Arthurs et al. (2009) discuss how to align interests and retain the talent of the entrepreneur (and other key individuals) by increasing contingent compensation.

2 E.g. pay level, ratio variable vs. fixed pay, objectivity regarding performance appraisals, culture, work, climate, etc.

3 Groupthink is defined as: The type of thought exhibited by group members who try to minimize conflict and reach consensus without critically testing, analyzing, and evaluating ideas. Individual creativity, uniqueness, and independent thinking are lost in the pursuit of group cohesiveness, as are the advantages of reasonable balance in choice and thought that might normally be obtained by making decisions as a group

4 Social cascades are defined as: The multiplying effect when one influential person expresses an opinion which is taken on by others and then further communicated

Contingent compensation is a mean to align interests between the entrepreneurs/employees and potential shareholders.

Several authors also research the impact of organizational approaches on performance/motivation/Behaviour. Wier et al. (2007) demonstrate that ERP-Systems⁵ and NFPI (non-financial performance incentives) combined produce greater corporate performance. Bizjak et al. (2008) state that companies mainly use benchmarking for compensation package structures. However, they also rely on the academic theory. Church et al. (2008) prove that the framing of incentive contracts is sufficient to affect individual behaviour (hence performance). This holds true even when the monetary value of contracts is the same.

Laff (2009), in his study about middle managers, finds that increased workload, insufficient credit for work and lack of clear career path were the three most cited frustration factors for middle managers. Lack of compensation was not in the top three.

2.2 Monitoring

This chapter highlights how monitoring complements incentives' packages by aligning employers and employees' interests. The board, the compensation committees and various company controlling functions achieve this.

Need for monitoring

The alignment of interests between the principle and the agent can be achieved not only through management compensation, but also monitoring.

Rutherford et al. (2007) suggest that the board should use monitoring and incentive mechanisms as complementary, in order to align CEO and shareholders' interests. Combining monitoring and incentives mechanisms create a virtuous cycle because information quality increases, board participation increases and CEO pay becomes more closely related to the firm's performance. This results in better protection for the interests of shareholders.

Yang (2008) argues that monitoring systems can reduce the principal-agent problem and recommends monitoring top management using dedicated organizational structures, such as the supervisory board or the auditors. He also stresses the importance of recruiting well, paying for competencies, establishing a trial period, and rewarding (punishing) for performance (underperformance).

At the business unit level, Laux (2008) suggests the use of capital budgeting as an alternative tool to management compensation to reduce agency information asymmetry problems. Capital budgeting provides the manager with incentives for information acquisition, as the formal approval of a project will be dependent on the information gathered and the positive results of the analyses. The manager also has an incentive to acquire more information, because if asked to implement the project, he/she wants to be sure that energy is not wasted in implementing a project that fails due to its poor quality.

Board, compensation committee and ethical officer

The board, the compensation committee and other monitors (e.g. the ethical officer) are examples of

monitoring systems that can reduce asymmetrical information problems.

Board

Rutherford et al. (2007) suggest that the quality of information increases with increased board participation.

Tonello (2008) discusses how boards can better align executives' interests with the interests of long-term shareholders. He recommends adequate performance metrics to track and compensate managerial results. He also advises against executive compensation policies that may negatively impact on the enterprise's culture of risk. According to the author, performance should be assessed based on a combination of financial and extra-financial metrics; the intended metrics should be difficult to manipulate; shareholders should be better informed; and, compensation committees should disclose performance targets, and encourage the sustainability of the company through long-term results.

Brain V. Breheny (2009) says boards need to be more accountable for their decisions, particularly regarding issues such as compensation structure and risk management. In his address to the US Financial Services committee he argues that disclosure of executive compensation has increased thanks to 2006 regulatory amendments (see Appendix). But he adds that structure of incentives has not followed. In particular, incentives need to be reviewed to take into account the company performance over the long-term. Lastly, he argues that shareholder-voting power should increase to include the nomination of the board and the directors.

Compensation committee

Tonello & Brancato (2007) have produced a comprehensive and practical book on the development of corporate governance issues. In particular, they focus on the Compensation Committee practices and provide guidance for the role of the Compensation Committee, the design of a compensation program and a report.

Sun et al. (2009) raise the question of whether future firm performance and chief executive officers' (CEO) stock option grants are affected by the quality of the compensation committee. The relationship between CEOs' stock option grants and future operating income increases, as compensation committee quality increases. A higher quality compensation committee produces better compensation contracts that result in superior firm performance in the future. Higher quality compensation committees appear to improve incentive alignment. As a result rent extraction is likely to be reduced.

Agen (2009) touches upon some regulatory issues on executive compensation and suggests new developments. With regard to the compensation committee, the author argues that it should be more independent from a financial and decision-making perspective. It should reunite at least annually to monitor excessive risk taking behaviour. It should publish a report that includes risk evolution and top executives compensation (not just CEO). In order to better align compensation practices with risk management and long-term growth, the author recommends compensation plans 1) to measure and reward performance, 2) to account for the time horizon of risks, 3) to hedge risk, and 4) to increase transparency and accountability.

Ethical officer

Hechler (2009) focuses on three lessons learned from the credit crunch and emphasizes the role of the ethical officer. Using a case study based on Countrywide, the author stresses the importance of the ethical officer's role. He argues for increased powers for the ethical officer with regard to advice, counsel and responsibility. He also acknowledges that it takes time to build an ethical culture and that the ethical officer should make sure that compensation is aligned with company performance.

Further discussion

Karlin (2008) stresses the difficult task that governments have in regulating excessive compensation schemes for executives. According to the author, controls can always be enhanced. But companies will always find ways to get around laws, especially with regard to full disclosure of the

performance goals on which executive fixed and variable pay is based. Companies consider this information as a competitive secret. It is unlikely that the new regulations would account for every eventuality/possibility.

2.3 Section conclusion

Recent research has been using the agency as well as a number of other psychological/sociological theories to explain the link between compensation and executive behaviour and interest alignment. Scholars are starting to acknowledge that compensation is not the only factor that influences behaviour/motivation. Psychological/sociological factors also play a role. No simple solution has been found yet.

Monitoring can serve as a mechanism to align shareholders' and executives' interests. Scholars have analyzed the role of the board, the compensation committee and the ethical officer. However, the recent financial crisis has shown the current system's limitations. It seems that companies/executives always find a way around regulations and monitoring. Monitoring and incentive compensation work best in combination.

3 Incentives and risk taking: effects of equity

This section focuses on risk alignment between shareholders and company executives. Agency theory assumes that attitudes towards risk diverge between shareholders and executives. Therefore, compensation packages should be used to align management and shareholders' propensity to risk.

Firstly, the following section shows the effects of short/long-term variable incentives on risk behaviour. Secondly, it also covers the fact that compensation plans do not sufficiently punish excessive risk taking behaviour, or poor company performance. Thirdly, this section illustrates the importance of using options for reasons other than aligning risk interests (i.e. retaining talent). Lastly, there is evidence that external factors have to be added to the equation when structuring a compensation plan. As a result, this section is articulated in four chapters: 1) long term versus short term incentives, 2) incentives under loss aversion, 3) stock option and behaviour, and 4) external/other factors.

3.1 Long term versus short term incentives

This chapter covers the debate about different kinds of stock options and other performance-linked equity products with regard to their role in aligning management interests and shareholders' wealth. Special focus is given to long term vs. short-term incentives and their effects on risk alignment and risk behaviour.

Interest alignment over the long term

Using the private equity industry as an example, Bhagat & Romano (2009) argue that incentive pay is a useful tool for aligning executives' interests and shareholders' interests over the long-term. The authors suggest that the majority of executive incentive pay should consist of long-term incentives. Long term is defined as a locked period of at least two to four years after the executive's resignation or last day in office.

Kuang & Qin (2009) examine the difference between stock options and performance-vested stock options (PVSO). The authors argue that PVSO are preferred over normal stock options, because the interests of managers with PVSO compensation packages are more aligned to shareholders' interests. The authors then suggest that measuring performance could be the main obstacle to achieving interest alignment.

The discussion is furthered enriched by Durfee (2006). Durfee explains that firms are relying increasingly on performance-linked options. The author adds that performance targets can be based on internal targets (e.g. EBITDA) and/or external targets (e.g. total shareholder return). Also, shareholders are more aware of accounting and performance measurement problems and the impact those problems have on executive behaviour. Lastly, the author recommends compensation packages are kept simple and tailored to the industry, shareholder preferences and desired behaviour of the executive.

Devers et al. (2006) analyze the impact of long-term incentives on firm performance. They demonstrate that, on average, long-term incentives exhibit a positive influence on shareholder returns. Regarding mergers and

acquisitions, long-term incentives are positively associated with acquisitions (proxy for risk behaviour). However, the effect of incentives on acquisition behaviour is not guaranteed when the amount of incentives varies widely among top managers of the same organization. In fact, top managers' propensity for risk depends on the amount of long-term incentives they receive. If this amount varies widely, it can reduce the risk seeking/acquisition behaviour of the organization.

Elliott (2008) argues that behaviour that fosters volatility should be minimized. As a result, the author advises a focus on risk management strategies, as well as revenue generation strategies.

3.2 Incentives under loss aversion

Stock options reward success, but normally do not penalize failure. This chapter covers the debate surrounding how to balance the upside (e.g. using restricted stock grants) and the downside (e.g. capping losses). The chapter focuses on finding the right balance between encouraging managers to take more risk than they would normally do (theory of loss aversion), while discouraging them from taking too much risk from a shareholders' perspective.

Options are a good incentive mechanism under loss aversion

Sawers et al. (2006) compare the effects of stock options/restricted stock on executive behaviour and study the effects of in-the-money and out-of-the-money options on executive behaviour. The authors surprisingly find that managers endowed with stock options are less risk-seeking than managers endowed with restricted stock. Overall, managers are more risk-seeking in the loss context than the gain context. These results suggest that as managers have greater wealth at stake (and therefore greater risk bearing), they become less risk-seeking. The authors' interpretation of results is consistent with the behavioural agency model. This considers the interaction between the decision context and the wealth in stock-based compensation in describing managerial risk-seeking behaviour. Sawers et al. (2006) also study whether managers' perceptions of the value of stock options influences their risk-seeking behaviour. They conclude that subjective overvaluation of stock options increases risk-bearing. This in turn decreases risk-seeking behaviour in the loss context.

Dodonova & Khoroshilov (2006) study the structure of the absolute/relative optimal incentive contract for loss-averse managers. The authors argue that recent changes in the economy have fostered the use of stock options. Stock option grants provide the right incentive for loss-averse managers in the short term. But in the long-term, stock options grants result in an inefficient equilibrium as they risk over compensating executives. When managers look at other firms in different industries (i.e. benchmark), those with low pay-to-performance pay demand more options to

capture the potential upside. Meanwhile, managers with high pay-to-performance pay are unwilling to exchange their base salary for restricted stocks, because doing this will make them exposed to greater losses. Therefore, the authors conclude that shareholders must include more options in managerial contracts for firms in which they want to maintain high levels of pay-to-performance sensitivity.

Stock options are to be handled with care

Reed (2007) argues that too many stock-option grants encourage too much risky CEO behaviour, because there is no punishment mechanism for failure. In fact, the author's model shows a greater number of stock options increases the likelihood of taking riskier and on the whole negative investments. As a result, the author suggests alternative compensation incentives. For example, a good idea would be to "force" CEOs to purchase a certain amount of stock, which will tie their compensation more directly to shareholders' fortunes.

Should options not only reward but also punish?

De Meza & Webb (2007) argue that compensation schemes should reward success and not penalize failure. In fact, modeling suggests using carrots rather than sticks when risk aversion is low and reference income is endogenous. Also, the psychological impact of a fall in income is always greater than a corresponding increase in income. Lastly, loss aversion may account for areas in which pay is insensitive to performance (e.g. fixed bonus paid when performance is better than expected).

Bonus/malus

With regards to bonuses in the financial industry, Walter (2009) suggests a bonus/malus approach where bonuses could be retracted when targets are not met. Compensation should have a multi-year structure. This means that bad performances are subtracted from the bonus pool in the same way that good performances add to it. The author acknowledges the sensible development in the industry to compensate both senior managers and other employees in restricted shares, with lock-ups designed to align their interests with those of shareholders.

3.3 Effect of stock option on hiring and retaining talent

This chapter focuses on the effect of stock options on hiring the right people and retaining talents.

Hire and retain talent

Tzioumis (2008) analyses why corporations adopt stock option plans. The author finds that stock options are used as a retention tool. Consistent with principal-agent theory, high CEO turnover increases the chances of stock option plans being included in the CEO compensation package. He then adds that the model finds no evidence that stock options are used for long-term risk alignment (to avoid risk aversion of CEO), or that stock options would be effective to achieve this behaviour.

Hassan & Hoshino (2008) analyze the use of option grants in Japanese companies. The authors argue that stock options help not only to align executives' behaviour with shareholders' interests, but also to select and retain the most suitable employees for the firm (i.e. risk seeking qualified employees).

Dunford et al. (2008) also argue that equity-based compensation is a useful tool to retain talent. However, options that fall underwater pose a serious retention threat for organizations and especially for CEOs. Salary, bonus compensation and restricted stocks don't affect the likelihood of voluntary turnover. Therefore, the authors recommend firms increase the value of the executive stock option portfolios in order to avoid voluntary turnover.

3.4 External/other factors (regulation, transient ownership, etc.)

This chapter covers 1) external factors that influence the relation between options (or other long-term incentive contracts) and executive risk behaviour and 2) other factors that influence executive risk behaviour (e.g. pensions).

Effect of regulation on risk behaviour

Low (2008) analyses the effects of the Delaware regulation on firm risk. According to the author, the increase in takeover protection regulation (e.g. poison pill, etc.) encourages managers to become more risk adverse. This is particularly true in firms with low managerial equity-based incentives. As a result, to counteract the effect of the regulation (i.e. increase risk-seeking behaviours), firms provide managers with greater variable incentives.

Short term investors and risk behaviour

Dikolli (2009) analyses the case of transient ownership and its impact on CEO compensation. The author argues that firms with high levels of transient investors have a tendency to reward CEOs' actions that increase the firm's annual returns or earnings. This means that, when designing CEO compensation contracts, transient investors take into account their own specific interests. As a result they incentivize CEOs for the short term only (e.g. with annual equity grants).

Pension/wealth and risk behaviour

Prasad (2008) argues that a lucrative pension encourages management to behave more conservatively. It may affect steps CEOs take to counter competitors' moves, to choose among growth options, to structure capital, and to pursue governance-related issues. There is also evidence that executives, who are contractually entitled to receive large pensions, tend to pursue corporate strategies that reduce the overall risk of the firm. More specifically, these executives embark on fewer risky investment projects, avoid excess debt, reduce dividends, or prolong the average maturity of outstanding corporate debt. Also the probability that a CEO will retire voluntarily is far greater if the CEO's pension has vested and is payable immediately.

Along the same lines, Kim et al. (2007) argue that risk averse managers, have more of an incentive to hedge if their wealth is tied to the firm's performance. For example, when a year's performance is better than expected, managers are more likely to use derivatives in order to lock in high bonus payments. When a year's performance is worse than expected, managers are less likely to use derivatives, so as to avoid locking in low or zero bonus payments.

M&A and risk behaviour

Minnick et al. (2007) analyze the impact managerial incentives have on acquisitions in the banking industry. Bank CEOs who have higher incentive-based compensation, are less likely than others to engage in acquisitions. However, when these banks do acquire, the announced returns are significantly higher. Findings of the model also show that managers who are protected by anti-takeover provisions make value-destroying acquisitions. The authors conclude that managerial incentives are good, as they serve a double purpose: they discourage value-destroying acquisitions, and motivate CEOs to make value-enhancing acquisitions.

3.5 Section conclusion

Stock options and other equity linked compensation components can be effectively used to link shareholders' long-term risk interest to executive risk-taking behaviour. They also serve as an effective retention tool for top talent. Stock options reward success, but do not normally penalize failure. This often results in excessive risk-taking behaviour. Academics therefore increasingly discuss how to balance the upside (e.g. using restricted stock grants) with the downside (e.g. capping losses). Most agree that it is difficult to find the right balance between encouraging managers to take more risk (theory of loss aversion), while discouraging them from taking too much.

Various equity linked compensation components are not the only way to link shareholders' long-term risk interest to executive risk-taking behaviour. Recent research shows that external factors, such as regulation or wealth, influence executives' risk behaviour. As a result, external factors also need to be considered when attempting to align the two parties' risk interests.

4 Personal choice

The goal of this section is to show that compensation does not always have the effect of aligning shareholders and management interests. Managerial attitudes, gender, technology, skills or personal traits can influence pay. This means that shareholder value relates to individual preference. As a result this section is articulated into two chapters: 1) people's attributes and, 2) Industry differences.

4.1 People's attributes (managerial attitudes, education, etc.)

This chapter covers the link between compensation and management psychological traits, background, education, productivity, gender and skills. Evidence suggests that compensation packages vary depending on management attitudes or preferences.

Behavioural economics and decision making

Graham et al. (2007) examine the correlation between psychological traits, career experiences and education, and corporate decision making, through a survey of CEOs and CFOs, from public and private firms in the US and overseas. The study demonstrates that corporate policies are significantly related to the personality traits of executives and that the key area where this can be seen is mergers and acquisitions. The authors also analyze a variety of issues about how behavioural traits of CEOs and CFOs influence the kinds of companies they join and the types of compensation packages they are likely to demand. The findings suggest that CEOs who display personal risk-seeking traits are also more likely to display risk-seeking traits when taking business risks. The findings also show that risk adverse CEOs are more likely to seek compensation through base salary than performance related packages.

Westphal & Bednar (2008) apply the idea of behavioural traits when examining how executives use certain patterns of behaviour to influence powerful institutional investors. The authors focus on how persuasion⁶ and ingratiation⁷ are used to prevent changes in corporate governance and strategy.

⁶ E.g. CEOs may recruit independent directors to help persuade fund managers that the focal firm's governance practices and corporate strategy further shareholders' interests

⁷ E.g. fund managers who have received favors, flattery, and other forms of ingratiation from a CEO should experience cognitive dissonance about taking actions that would harm the CEO's interests

Socio economics and decision making

Vandegrift & Yava (2009) question whether gender influences the decision between a payment scheme that rewards absolute performance and one that rewards relative performance. Studying a series of sequential rounds in a simulated setting, the authors conclude that men are overconfident, while women are realistic or less confident.

Dierdorff & Surface (2008) focus less on traits, but more on the effect of skill based pay (SBP) on performance and skill enhancement. Their findings suggest that the amount of skill based pay is directly related to the change in skills. Individuals who receive SBP on their first attempt demonstrate greater rates of skill acquisition.

4.2 Industry differences

This chapter covers the link between executive compensation, behaviour, and performance, and factors such as company size and industry/environment.

Profit sharing & team productivity

Heywood & Jirjahn (2009) suggest that profit sharing becomes less likely as the size of the establishment grows. However, they conclude that it is unlikely that size is the only factor. Team productivity and team effectiveness have a key role. Profit sharing compensation plans are more likely to be implemented when team productivity and individual productivity are measurable. The larger the team, the more likely free-rider issues will occur. This questions the overall team productivity/individual productivity. The likelihood of profit sharing therefore decreases.

Socially responsible firms

Company size and industry have an impact on compensation plans. Frye et al. (2006) find that stock option grants for CEOs of Socially Responsible (SR) firms do not appear to create risk-taking behaviour. However, such grants significantly increase risk-seeking behaviour in non-SR firms. This suggests that CEOs working in SR-firms are motivated beyond money. This should be factored in their compensation plans.

4.3 Section conclusion

Overall there seems to be a common understanding that people's attributes influence executive behaviour and performance. But little research has been conducted in this direction in recent years. Current research is also fragmented. This applies to research regarding firm size or industry differences. It is therefore difficult to draw conclusions.

5 Misalignments

The goal of this section is to make the shareholder aware of the negative effects of attempting to incentivize certain behaviours through compensation packages. Three broad categories have been identified: incentives that are not linked to performance; incentives that create short-term behaviour; incentives that are conducive to unethical or illegal management behaviour. As a result, this section is articulated into four chapters: 1) performance not limited to management actions, 2) focus on long-term behaviour, 3) managers are bad, and 4) suggested solutions.

5.1 Performance not linked to management actions

CEO pay-for-performance schemes are often linked to performance measures, such as stock price. Shareholders believe that CEO performance can be measured using the stock price. However, in his study, Kolev (2008) found that stock performance is attributable to favourable market conditions, rather than superior CEO leadership and skills. The author concludes that shareholders tolerated excessive CEO pay for no rational reason.

Bebchuk & Fried (2005) take a similar view when discussing why corporate governance reforms often fall short in structuring and controlling effective executive compensation plans. Their recommendation to overcome this problem of differentiation between CEO performance and market influences is to tie pay to performance by awarding vesting options. Another recommendation is to base strike prices on relative performance to a peer group.

5.2 Focus on long-term behaviour

Shareholders have a more long-term focus regarding their investment. Incentive structures for executives should reflect this long-term focus. Recent studies however, provide evidence that executive compensation packages can incentivize short-term behaviour in executives.

Livne et al. (2009) analyze this misalignment in the financial services sector in the US. They find indications that investments in short-term speculative assets, which are measured at fair value, are highly associated with CEO cash bonuses. In contrast, investments in long-term assets that are measured at cost, such as loans, were not consistently “encouraged”, and in some cases discouraged, by compensation schemes. This practice clearly contradicts the long-term focus of shareholders.

In their research, Bolton, Scheinkman & Xiong (2006) found similarities. Using a theoretical model, the authors conclude that compensation contracts may emphasize short-term stock performance, at the expense of long-run fundamental value. However, in speculative markets, this short-term behaviour of executives may be desirable by shareholders who understand the speculative/short-term nature of the market.

Bebchuk & Fried (2009) outline their ideas for aligning long-term shareholder interest with executive behaviour. They argue that short-term distortions can be solved by staggering the option reward over a longer period of time⁸. However, they also point out that companies should avoid arrangements that block executives from cashing options and shares until the executive’s retirement. This would provide executives with counter-productive incentives to leave the firm.

5.3 Managers are bad

In addition to the misalignment of long-term interest and short-term focus, some authors have examined whether compensation schemes have a truly negative effect by encouraging illegal behaviour. Besancenot & Vranceanu (2007) use game theory to study whether compensation plans encourage managers to engage in fraudulent activities. Their model shows that under perverse incentive plans managers dominant strategy is to commit fraud regardless of whether they belong to a “bad” or “good” firm. The authors also note that if laws are amended or introduced, (e.g. expense stock-option grants according to their fair value) the dominant strategy might change. In his research, Sen (2007) used a theoretical model to prove this point. He asserts that unless the penalty is greater than the gains from fraud, managers may find it optimal to engage in fraudulent behaviour.

The theoretical models are enhanced through studies conducted within the last two years. Zhang, et al. (2008) found that CEOs are more likely to manipulate corporate earnings when they had more out-of-the-money options and/or lower stock ownership. However this finding could not be related to in-the-money stock options. The underlying theory therefore is that out-of-the money options create perceived loss situations in which CEOs are more likely to take aggressive actions to minimize loss. In her study Kuang (2007) concludes that managers who hold a larger proportion of their compensation in performance vested stock options (PVSO) are more likely to exploit their accounting discretion and manage earnings to meet their performance goals. She also points out that the relation between PVSO compensation and earnings management depends on how much time lapses between the different PVSO tranches and the end of the performance period. The correlation is strongest for PVSOs with the performance period ending in the current year.

⁸ Example: When an executive’s options or shares vest, one-fifth of them could become unblocked, and the executive would subsequently be free to cash them out, in each of the subsequent five years.

5.4 Suggested solutions

Recent literature discusses how the misalignment between shareholders' interest and managers' behaviour can be overcome beyond the pure regulatory/monitoring aspects. In their review of banker's bonuses, Gehrig & Menkhoff (2009) argue that simply banning bonus payments (or other compensation components) is detrimental. Instead, they recommend a debate about performance criteria and sustainable goals and how compensation packages can be tied to them. Lawler (2009) agrees with this in his review on whether a pay cap on executive pay is a solution to executive misbehaviour. In his view, government ordered pay caps are not the solution to the problem. Instead he suggests tying executive pay more closely to individual performance, as well as company performance. He recommends that failure and malpractices should be penalized. Davis et al. (2007) show that careful structuring of compensation plans can work. Using the mutual fund industry, the authors demonstrate how the likelihood of illegal activities (e.g. late trading⁹) decreases as the percentage of management fees paid increases.

5.5 Section conclusion

This section has discussed the negative effects of attempting to incentivize certain behaviours through compensation packages. Recent research suggests that certain incentive structures can lead to short-term behaviour or even worse, can incentivize managers to engage in unethical or illegal behaviour, such as earnings' manipulations. Officials cite the need for more monitoring and regulation. An additional solution might be to introduce a time component in the compensation package. This ties executives to the performance targets even after they have left the firm. Another option might be to introduce performance targets that not only reward success, but also "punish failure".

⁹ Cf. Investment Company Act Rule 22c-1.

6 Concluding thoughts

For the past 30 years, academics, shareholders, politicians etc. have argued for an increased alignment of shareholder and management interests. The unanimous solution for this interest alignment problem has been the introduction of the concept of pay for performance (i.e. top management compensation is linked to measures of work quality or goals). Stock option plans, performance linked bonuses and other variable incentives have been developed extensively and used for the purpose of aligning top executive interests and shareholder interests. However, all conclude that variable incentives are not the panacea they had hoped for.

Practice has shown the limitations of equity-based incentives and performance-linked bonuses. One limitation is that they have become too complicated: 1) they often require expert advice from external consultants; 2) sometimes they fail to motivate top management. Another drawback regards performance: 1) it is difficult to isolate and measure the individual's performance, and 2) the metrics can be manipulated. A third weakness is the creation of a risk-seeking culture for executives that does not penalize failure.

Another issue that complicates pay for performance is that each individual is unique. Variable pay may have a temporary incentive effect on executive behaviour, so it is difficult to know what drives executives' in the long term. What really drives individuals? ¹⁰

As a result, there is a need for monitoring. Monitoring and incentives' compensation mechanisms should be used in a complementary way to align shareholders' interests with executive behaviour. Many countries have improved their regulation with regard to corporate governance issues. Disclosure/transparency has increased. For example, boards are more independent and new organizational structures have been created (e.g. compensation committees, ethical officer, etc.). However, much more needs to be done. Tailored pay packages should be frequently revised, updated and re-formulated where necessary.

Following the recent financial crisis, politicians have a once in a lifetime opportunity to change the system. One year after Lehman Brothers filed for bankruptcy, clear and internationally recognized regulation has yet to be created.

¹⁰ Liu & Yermack (2007), for example, suggests new thinking in this direction. He analyses firms' performance when CEOs buy "expensive mansions".

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