Redesigning executive pay schemes for transparency and performance

Professor Alexander Pepper's research revealed the psychological and economic flaws in complex pay schemes intended to incentivise top executives.

What was the problem?
In Western economies, executive pay levels have risen dramatically over recent years in a way rarely matched by the performance of their companies.

For example, the Economic Policy Institute found that the remuneration of chief executives in the U.S. rose over 900 percent between 1978 and 2013 (adjusted for inflation), compared to just 10.2 percent for the average worker and more than double the growth in the stock market.

The traditional response by shareholders and company remuneration committees has been to devise complex incentive schemes intended to link the pay of senior executives to company performance over the longer term. These have included cash and share-based awards, long- and short-term targets and measures of success, from earnings per share to total shareholder return on equity. But such schemes have demonstrably failed to curb the inflation in senior pay and have even been considered a contributing factor in its excessive growth.

What did we do?
In September 2008, Professor of Management Practice Alexander Pepper began research into the psychology of incentives, beginning with an empirical study of the effectiveness and efficiency of long-term incentives employed by companies in the Financial Times Stock Exchange (FTSE) 250

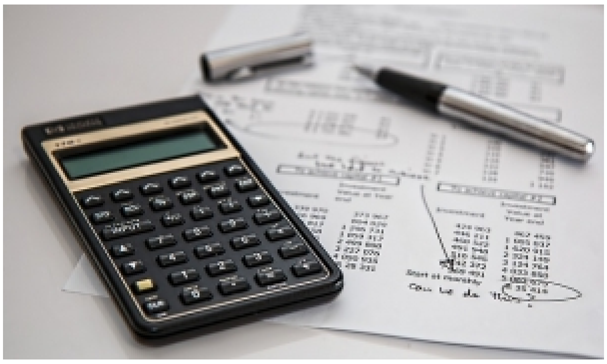
index. According to Pepper, the missing evidence in most studies of executive pay was how executives themselves perceived and responded to the incentives they were being offered. His plan was to examine executive pay using theories and research techniques drawn from behavioural economics.

Two more studies in the same vein followed: a theoretical study of incentivising executive pay, conducted in collaboration with Dr Julie Gore of the University of Surrey; and a large-scale empirical study that gathered primary data from around 1000 senior executives in over 40 countries around the world, undertaken between September 2011 and June 2012 in collaboration with Gore and PricewaterhouseCoopers (PwC).

The research overturned much of the accepted wisdom underlying the traditional approach to incentivising senior executives in Western and emerging economies. It found that senior executives are often much more risk-averse and discount for time at much higher rates than standard economic theory predicts. Therefore they can be expected to demand a premium for riskier forms of compensation. A majority of executives also prefer a clear pay package that they can understand and control, as opposed to a more ambiguous package offering potentially higher rewards. There are some regional differences; for example in China executives have a greater appetite for risk, while still being heavy time discounters. Nevertheless, the overall conclusions of the research are not significantly affected by cross-cultural variations.

The research also found that, far from restraining the rise in executive pay, the vesting periods and complex performance criteria attached to many incentive schemes might actually be contributing to the excessive rewards being offered to senior executives. Executives discounted long-term incentives and deferred bonuses by around 30 per cent per annum (equivalent to a 50 per cent reduction in value over a typical three-year deferred compensation vesting period), leading to demands for ever higher awards to compensate. Two-thirds of executives preferred an internal performance measure they could control (such as profit) to an external measure of relative performance, such as relative total shareholder return, even though shareholder bodies and regulators have been arguing for precisely the opposite.

Society's demand for greater transparency might also be contributing to senior pay inflation: most executives would choose to be paid less in absolute terms but more than their peers. Personal fulfilment also remained an important criterion for senior executives, suggesting that companies wishing to reduce their executive wage bill should pay more attention to what makes these jobs rewarding and fulfilling.



What happened?

The research was discussed by PwC's UK Board and became a central pillar of PwC's major campaign around reward and talent issues across its client base. Tom Gosling, leader of PwC's UK Reward Practice, considered it 'an outstanding piece of research, with amongst the highest impact of research in the executive pay field, and… something that we are extremely proud to be associated with'.

PwC shared the research findings with clients in the UK, Australia, Switzerland, the US, South Africa and elsewhere by running more than a dozen dedicated client workshops and publishing practitioner reports for client remuneration committees.

In Australia the local report attracted media exposure in Australia's leading business press, reaching a wide audience across the business community. The research was presented to the 60-strong Australian PwC People and Change consulting team and at PwC client events. Amongst clients, a number of senior remuneration professionals intended to incorporate the study into training materials for their corporate remuneration teams.

The global reach of the research was further advanced through presentations at academic conferences hosted by the International Association for Research in Economic Psychology in Cologne, the European Reward Management Conference in Brussels, and the Society for the Advancement of Behavioural Economics in Granada. In the UK, researchers presented the findings to the FTSE100 Remuneration Directors' Conference at Downing College Cambridge, the High Pay Centre's workshop on top pay, and the Global Total Rewards Network of major companies' reward directors. In Auckland, New Zealand, the findings were presented to the New Zealand Governance Centre's Executive Remuneration Conference. The results have also been presented to the Round Table meeting of the chairmen of Sweden's largest companies.

The research generated wider attention through press reports in Australia (*Sydney Morning Herald),* India (*Times of India* and *The Economic Times*), the UK (*Financial Times*) and the US (*Forbes*), all of which echoed its findings by questioning the prevailing views about incentivisation of senior executives.

Individual management consultancies used the research to advise clients on the design of performance share plans to reward executives in relation to sustained performance. This advice was being applied across all economic sectors, including financial services where the design of remuneration schemes was subject to increased regulatory intervention.

In January 2013 Pepper also drew on this research when he was invited to give evidence on bankers' pay to the UK Parliamentary Commission on Banking Standards.

Pepper has drawn together the research in a book, *The Economic Psychology of Incentives – New Design Principles for Executive Pay*, published in August 2015 by Palgrave Macmillan.

Notes:

- *This article was initially published as an Impact Case Study and re-published on our blog with the authors' permission.*

Alexander Pepper joined the LSE Department of Management in September 2008 as an ESRC/FME Fellow. He was appointed Senior Fellow in September 2011 and Professor of Management Practice in January 2013. He previously had a long career at PricewaterhouseCoopers (PwC) where he held various senior management roles, including global leader of the Human Resource Services consulting practice from 2002-2006.

About Afroditi-Maria Koulaxi

Afroditi was the editor of the Management with Impact blog between February - June 2017. In September, Afroditi is starting her PhD at LSE to investigate the mediation of migration.

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