

*If executive pay is broken,
making it more complex is
not the answer*
The psychology of incentives

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“Executives are all different. Some will seek and be motivated by risk and reward, but not all. Remember that a private equity style arrangement will not turn a bureaucrat into an entrepreneur.”

Foreword



There is much that is wrong with executive pay in the UK. The flaws in the current model are recognised by remuneration committees and shareholders but there is genuine willingness on all sides to move towards a better future. There are positive signs with some improved designs coming through to shareholders for approval this year. For this reason, we remain optimistic. But to make real progress will require a rebuilding of trust from all parties in order to allow a better world to emerge, combined with a willingness to think beyond the constraints of current practice. We believe that a good place to start is the beginning. In order to get executive pay right – we need to understand how it can drive human behaviour. Our Psychology of incentives study, in conjunction with the London School of Economics, aims to provide a contribution to the understanding of this important issue.

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Executive pay has been transformed in recent years

Over the last couple of decades, executive and senior management reward in western companies has been transformed. In the past, base pay and pension formed the bulk of the package, with bonuses and share options being a nice and occasional added extra. Now base salary is only a small part of the package with the real punch to be found in incentives, particularly long-term incentives (LTIs). For the most senior executives, fixed pay is often less than a quarter of the total pay package, and LTIs can account for half the package or more.

This transformation in reward practices has been driven in large part by the global governance developments of the last fifteen years. The underlying model (shareholder value, underpinned by an agency-theory model of company management) is based on the assumption that executives will perform better for shareholders if they are heavily incentivised. The aim is to align reward outcomes with the best interests of shareholders. Such alignment is considered essential to prevent managers from extracting unjustified short-term rewards for themselves at the expense of the company's shareholders.

If it is broken, surely we need to fix it

Perceived problems with incentive pay have been addressed not by discarding it, but by using it to an even greater extent and with ever more demanding performance requirements. The simple stock option of old is increasingly replaced around the world by vastly more sophisticated LTI arrangements, with ever more complex pay-out formulae. It's striking how strongly the governance-driven performance-pay model has taken root, despite the mixed evidence as to its effectiveness.

The recent financial crisis, and the perception that bonuses played a role in causing it, has led to a renewed focus on performance pay. Trust in the executive remuneration process has sunk to a new low. But even now, the solutions proposed are still based on the assumption that performance pay works – except the solution is to use performance pay better, to have more sophisticated pay-out formulae and to defer pay over longer periods. Can this work?

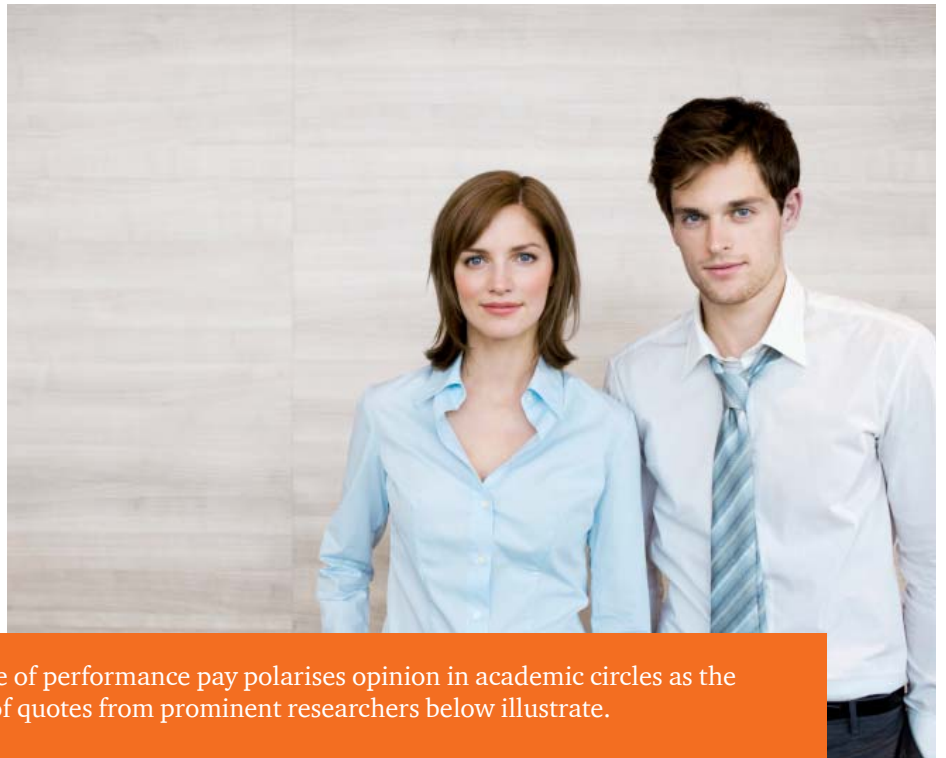
The evidence is mixed

Given the mixed academic evidence about the effectiveness of incentives (see box), for some time we have been trying to shine an evidence-based light on incentive practices, and sounding

alarm bells over aspects of current practice. Over the last five years we have:

- demonstrated the lack of alignment and arbitrary outcomes that can arise from the relative total shareholder return formulae
- analysed the benefits and dangers of private-equity style reward programmes
- shown how findings from brain science and human reaction to risk suggests that modern LTIs are frequently designed to fail
- investigated reward programmes in outstanding companies, showing that they often buck the trend of the governance-driven herd, and
- interviewed senior business leaders to identify the lack of effectiveness of many LTI programmes.

But we need to keep gathering the evidence of what is and is not effective, to influence remuneration committees, reward practitioners, regulators, shareholders, governments and to help move the debate forward to a more effective approach. A missing piece in our jigsaw is robust evidence about how executives themselves – the population whose performance is meant to be enhanced by incentive pay – react to incentives.



Academic evidence on incentive pay is mixed

The issue of performance pay polarises opinion in academic circles as the sample of quotes from prominent researchers below illustrate.

Against

“Bribes in the work place simply can’t work.”

Alfie Kohn¹

“Most merit-pay systems share two attributes: they absorb vast amounts of management time and make everyone unhappy.”

Jeffrey Pfeffer²

In favour

“Where there is trust, involvement, and a commitment to fairness, performance related pay schemes work.”

Marc Thompson³

“There is a less audible chorus of those who have collected evidence that financial incentives do improve performance.”

Michael Armstrong⁴

The most vocal advocates on incentive pay are sometimes found to have a vested interest in a particular performance measurement system on which incentives are based. Those against incentive pay do not deny that incentive pay influences behaviour, but simply contend that the unintended consequences outweigh any benefits. Even those researchers who find incentive pay works tend to say its success is situational, and the requirements for success are difficult to achieve.

1 Punished by rewards: The Trouble with Gold Stars, Incentive Plans, A's, Praise, and Other Bribes (Houghton Mifflin, 1993/1999) Alfie Kohn.

2 Jeffrey Pfeffer is the Thomas D. Dee II Professor of Organizational Behavior at the Graduate School of Business, Stanford University.

3 Marc Thompson is Academic Director of the MSc Consulting and Coaching for Change at Said Business School, University of Oxford.

4 Michael Armstrong is a Companion of the Chartered Institute of Personnel and Development and author of several reward text books.

How does incentive pay affect senior executives?

Much research on the direct effect of incentives is carried out either on university students or on sales forces, neither of which form a good test lab for the reactions of senior business leaders. Our latest research, in conjunction with Alexander Pepper at the London School of Economics and Political Science⁵, seeks to address this gap.

The research involved asking senior executives to complete a structured interview questionnaire that explored the trade-offs that individuals make between risk, reward, time and fairness. The research was completed by around 100 senior executives, of whom around 25 were compensation professionals. The results below focus on the non-expert population of around 75 senior executives in a variety of business roles at executive committee level within FTSE 100 and FTSE 250 companies.

The results are perhaps not surprising, but reinforce how much is wrong with the norms of incentive pay design today.

1. Fairness is fundamental

The attitude of executives to fairness was tested through a variation of the famous prisoner's dilemma.

Testing attitudes to fairness through the ultimatum game

Adam and Zoe are brought together in an experiment:

- Adam is given £100,000 and is told he can split this in any way he likes with Zoe.
- Zoe can then choose to accept or reject Adam's offer.
- If Zoe accepts the offer, they both get their money.
- If Zoe rejects the offer then they both get nothing.

Adam and Zoe both know that the total amount is £100,000, and they both know the rules of the game. They cannot negotiate because they are kept separate the whole time.

Participants were asked how much they would offer if they were Adam, and how much they would accept if they were Zoe. The economist's answer is to accept whatever you are offered, as even £1 is better than nothing. But you might be wise to offer half the money, to ensure that you at least get your £50,000. However, this answer goes against our instinct of fairness (not a known characteristic of economic man). A £1 offer is too derisory to accept, and offering half the money ignores the fact that Adam has been given the right to determine the offer.

Attitudes to fairness were tested by creating an index based on the difference between what an individual would offer, and what they were prepared to accept. A small difference suggests a strong aversion to inequity and a strong requirement for fairness.

- Most respondents would have offered, and accepted, less than half of the money.
- Around 50% said that their maximum offer and minimum acceptance were the same – indicating a strong preference for fairness.
- Nearly 75% said Adam should offer more than one-third of the money.

⁵ Are long-term incentive plans an effective and efficient way of motivating senior executives? Alexander Pepper, Julie Gowe and Dr Alf Crossman (to be published)

A more direct approach to assessing attitudes to fairness is shown in the questions below.

Testing attitudes to fairness through the relativity question

Jean and Jacques are two friends leaving business school. Jean is offered a job to join the management team of company A, paying £600,000. Jacques is offered a job at company B for £700,000.

Subsequently, Jean discovers that the average pay in the management team at company A is £500,000, whereas Jacques finds out that at company B the figure is £800,000.

Who is more motivated?

Over 60% of respondents said Jean as more motivated, and only 17% said Jacques. So fairness is clearly an important issue for executives, but why does this matter for the design and governance of pay?

The importance of fairness has two important implications

First, complex formulaic incentive plans can generate outcomes that participants think are arbitrary and unfair. This is bound to cause trouble because people are far more likely to remember bad news over good. One year when they believe the outcome is unfair can outweigh several years of undeserved windfall. So it is vital to ensure that the measurement approach enables outcomes to be perceived as fair.

Second, there are implications for disclosure. Many believe that transparency is the best way to ensure sound pay and governance practices – ‘sunlight is the best form of antiseptic’. The reason for the recent drive for greater pay disclosure by banks is the assumption that transparency will somehow make firms and individuals exercise pay restraint. Our research findings on fairness suggest that the opposite will be the case. It matters less to individuals what they are paid in absolute terms. What is most important is what they are paid relative to those they consider to be their peers.

Fairness will become increasingly important as levels of disclosure increase. There are already a number of factors that are accelerating this change.

- The Equality Act 2010 makes pay secrecy clauses in employment contracts ineffective.
- Ongoing pressure for the disclosure of remuneration levels in the financial services sector is likely to spread to all companies.
- Gender pay reporting is likely to be required by the UK Government at some point over the next two years.
- In the public sector all salaries in excess of £58,000 are now published.

So it is vital that pay systems are fair, properly explained and the rationale behind pay decisions is well communicated. The ultimate test of the fairness of any pay system is judging how people would react if every employee’s pay was posted on the staff notice board.

“Fairness will become increasingly important as levels of disclosure increase.”

2. People don't just work for money

This statement may seem obvious, but it is worth remembering in these bonus-obsessed times. To test the relationship between money and motivation, two approaches were used.

Ideal job discount

Participants were asked to imagine their ideal job. They were then asked what pay cut they would accept to do this.

The same question was also asked in the third person, by asking participants to imagine an unfulfilled senior executive who is also a musician, and is head-hunted to become chief executive of a prestigious music college.

The answers showed people would be willing to take a pay cut of around 50% to do their ideal job. Interestingly a quarter of respondents would accept a pay cut of 70% or more. Only 5% of respondents would not take any pay cut for their ideal job. Perhaps they were lucky enough to be in it already!

A second way of looking at intrinsic versus extrinsic motivation was to look at responses to question on the importance of goal setting and correlate these to results of work preference questions. This indicates the balance for individuals between intrinsic and extrinsic motivation. Goal setting was found to be important for motivation, regardless of whether people were intrinsically or extrinsically motivated. In other words, the process of identifying and setting challenging goals is in itself motivating for many, regardless of whether money is attached to the outcome. So incentives do not replace management.

3. The longer you have to wait the less it is worth

Participants were asked to make a series of choices between an amount of money tomorrow and an amount of money at some time up to three years in the future.

Impact of time on perceived value

Which would you prefer?

- (a) 75% chance of £250,000 tomorrow (25% chance of nothing)
- (b) 75% chance of £400,000 in three years (25% chance of nothing)
- (c) Indifferent to (a) and (b)

The slight uncertainty of receiving the money is important. Without that, the rational economic responses can come into play, such as “could I remortgage to get the cash today anyway?” Despite the fact that waiting three years would earn a return in this example of 17% per annum (pa), more than half of respondents would take the smaller sum tomorrow. Overall, the results showed that if people are made to wait, they discount the value of the money by over 20% pa.

With interest rates on savings at less than 5% pa this is a striking result. It also raises a question over the policy of bonus deferral, a current favourite device of shareholders and regulators. It suggests that an LTIP or deferred bonus award payable after three years will have a perceived value of only around half the level if paid immediately.

Two immediate consequences: increased deferral is likely to lead to pressure for increased overall quantum; and deferred compensation may not have the behavioural influence desired if its value is immediately written down in executives' minds compared to the bonus paid immediately this year.

“The answers showed people would be willing to take a pay cut of around 50% to do their ideal job.”



“The moral of the story: know your audience.”

4. Complexity and ambiguity destroy value

Participants were asked to make a series of choices between risky offers which had similar expected or average outcomes, but which varied in the complexity of their construction.

Impact of complexity on take-up

Which would you prefer?

- (a) 50% chance of £100,000
- (b) P% chance of winning £100,000 where P is unknown but between 25% and 75%
- (c) Indifferent to (a) and (b)

The results showed that people don't like uncertainty. For example, only a quarter of respondents were prepared to grapple with the ambiguity of (b). People were more comfortable when the source of uncertainty was something familiar (a share award versus a cash award). But abstract and complex formulations (as above) proved unpopular.

The clear lesson here is to avoid unnecessary complexity, an unfortunate feature of many incentive plans. Recognise that relevance and simplicity are closely related. For example, an incentive plan with a large set of measures may appear complex to the uninitiated. But if those measures are based on a set of reporting information that is viewed and managed to on a monthly basis by executives, then this may actually appear simpler to them than a plan based on two metrics that they only look at when the time comes to measure performance.

5. Executives are risk averse – but not always

A range of questions were asked comparing trade-offs with different levels of risk.

Attitude to risk

Which would you prefer?

- (a) 50% chance of £18,000 (or nothing)
- (b) £8,000 for certain
- (c) Indifferent to (a) and (b)

Which would you prefer?

- (a) 50% chance of £370,000 (or nothing)
- (b) £165,000 for certain
- (c) Indifferent to (a) and (b)

Unsurprisingly risk aversion increases with the sum at stake. 40% of respondents were prepared to take the gamble on the smaller amount, but this fell to around 25% when the stakes rose. Across the population as a whole, there was a significant bias towards risk aversion. But there were some (around 25%) that were active risk seekers.

The moral of the story: know your audience. Unsurprisingly most corporate executives are not risk-taking entrepreneurs. Yet we load them up with highly geared incentives as if they were. It is hardly surprising that this often leads to frustration and disengagement. Yet a quarter are risk seekers so the motivation provided by private equity style risks and rewards may be significant. The trick is to know who they are within your executive population.



What does it all mean?

It is often easier to criticise the status quo than to come up with a better answer. However, failure in the UK executive pay model is so widespread that improvements are not hard to find. Here are some possible yard-sticks.

Think hard about who gets an LTI – does it add value?

As soon as pay is deferred beyond one year, you're battling the forces of tens of thousands of years of evolution. People see no advantage in strategising beyond a year. Faced with discount rates in excess of 20% per annum, deferred pay had better be worth it.

A focus on stock ownership may be better than complex LTIs

Our previous research has shown that complex performance conditions, especially relative total shareholder return (TSR), tend to reward volatile performance rather than sustained strong performers. By contrast, making executives significant shareholders creates direct long-term alignment, in a way that is much more visible to them. The fall in value of a stock portfolio is felt immediately – the theoretical fall in value of an unvested LTI award subject to complex conditions is meaningless to the individual.

One size does not fit all

Executives are all different. Some will seek and be motivated by risk and reward, but not all. Understand the perspectives and psychology of your management teams and use the right motivational tools for them. Remember that a private equity style arrangement will not turn a bureaucrat into an entrepreneur.

Minimise ambiguity – make it relevant

Try to avoid opaque, complex and arbitrary performance conditions that executives feel have nothing to do with them. Relevance is the key to simplicity – align your incentives with how you monitor and manage the business and define success. An apparently complex scheme that is relevant is better than a simplistic scheme that has no connection with the day-to-day work of executives. Relative TSR is often criticised as being complex. The truth is that it is no more complex than a 100 metre race – only the first three get medals. But it is felt by executives to be irrelevant to their day job, so the perception of complexity is high.

Make sure incentives pay out something most of the time

We often hear it said that incentives should not pay out all of the time. They should be an exceptional payment for exceptional performance. Unfortunately this ignores the psychological reaction of the individuals they are meant to motivate. The human propensity to remember bad news over good means that each year a plan doesn't

deliver has a disproportionate effect on perceived value. But of course if incentives pay out regularly, this needs to be recognised in total compensation – that is the trade: greater certainty in exchange for lower maximum reward levels.

Ensure outcomes are fair – this may need discretion

Perceived unfairness is the main reason incentive pay goes wrong. And yet we persist with formulaic and simplistic approaches that cannot produce a fair outcome. Boards need to have more discretion to ensure that outcomes are fair and aligned with performance delivered and value added. This requires shareholders to place more trust in remuneration committees and to give them more freedom. This in turn requires remuneration committees to earn that trust: through more transparency and disclosure to explain and justify their decisions; and through a greater willingness to stand up to the executive when required.

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