THE WRONG PERSPECTIVE ON EXECUTIVE PAY

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Abstract

Controversial commentaries as brought on by the financial crisis of 2008 regarding corporate remuneration policies give misplaced priority to political considerations over the governance considerations of capitalist orthodoxy. Executive pay rules during the crisis reflected the market's sense of low risk that was prevalent at the time. The existing pay-for-performance model as applied demonstrates that the agency problem is not widespread and more a matter of transparency than one of systemic corporate graft. The wrong perspective involves pushing for social equality, rather than business efficacy, as the ultimate driver of reforms in executive remuneration.

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1 Introduction

There is no doubt that the global financial crisis has thrown the current form of capitalism into turmoil. From public expressions of sentiment as demonstrated in the "Occupy Wall Street" movement to the disquiet shown by many shareholders in corporate AGMs, it cannot be denied that many in society are upset due to what they perceive as an injustice. The ongoing nature of the recession has only strengthened the personal frustration that many feel with regard to an unfair economic arrangement.

These beliefs stem from a variety of factors in relation to corporate actors during the crisis, but one of the most tangible points of contention is that of executive remuneration, often referred to by the media as the issue of "bankers' bonuses." It is, perhaps, well illustrated with the example of the public and governmental anger at AIG, the underwriter of a large amount of "sub-prime loans" issued before the crisis, for paying out hundreds of millions in annual bonuses after having received $170 billion in a taxpayer-funded bailout (Andrews and Baker, 2009). Many saw this as the result of a policy to reward failure–the failure of executives who took unnecessary and serious risks on the market in the blind pursuit of personal wealth. While often discussed by the media as purely a matter of social justice, it is also ultimately a corporate governance problem: whether policies of remuneration appropriately incentivise executives to further corporate goals.

It will be argued here, as a matter of fact, that incentives to perform as determined by the market *do* generally lead to achieving the corporate goals of stronger financial performance, proper risk management, and talent retainment. The credit crisis itself is a unique opportunity to show that these incentives did not, in and of themselves, cause poor performance. Furthermore, the existing remuneration framework, if and when supplemented by additional long-term rewards, is capable of maintaining the alignment of interests between top-level executives and their companies, strongly benefiting shareholders and customers. Recently proposed and adopted reforms have demonstrated confidence in this model while recognising that greater transparency, along with new approaches in compensation, is essential to securing the long-term goals of the incentive effect of pay. While current policies (as applied) are imperfect, it will be shown that much of the public controversy surrounding the issue of executive pay, is based on social and ideological preferences rather than on the principles of better corporate governance.

2 Financial incentives for stronger performance

Strictly speaking, all financial rewards for employment can be classified as a simple exchange of goods and services on the market. The issue for corporate governance involves the remuneration for executives, who are deemed to be not just responsible for any single project, but rather for the company as a whole. Thus, it is seen as important to create financial motives for management to "contribute to the long-term success of [the company], … [to promote] business stability and growth," and, thus, in doing so, the shareholders can "attract, incentivise and appropriately reward executives, so that the value of the companies they invest in increases over time" (Dept. for Business, Innovation and Skills, 2011, p. 4).

A key contention regarding performance is that higher pay, in fact, fails to lead managers to stronger financial performance. Embedded within this argument is the theory of managerialism, which sees directors and executives as a cabal, utilising the resources of the company at will, oftentimes to perpetuate a line of like-minded executives (Tricker, 2012, p. 68). These beliefs have led to a "myth of managerial power[, which] satisfies the need for a simple explanation for the failed pay-for-performance model and meshes with recent reports of corrupt governance practices and ineffective boards" (Kay and Putten, 2007, p. 9). In doing so, this theory makes the mistake of taking individual cases of failed pay-for-performance scenarios and creating a narrative that ultimately fails to appreciate the ebb and flow of real-world economics. The ultimate example of this is the effect of the credit crisis on firms–whereupon there was a renewed emphasis on what was deemed to be excessive remuneration, ignoring the fact that the early twenty-first century had brought with it a significant economic boom with no concern regarding pay. Studies have shown that this is part of a historic pattern where great attention is paid to executive pay during times of economic downturn, while periods of "economic prosperity and rising stock prices" lead to "little attention" (*ibid.*, p. 48).

The truth is that, due to the cyclical nature of the economy, any proper analysis of the incentive effect of pay should not relate just to financial performance, but rather to the actions and risks that corporate actors take as a result of the incentive. Indeed, the financial crisis has provided a perfect setting to explore this problem. As discussed above, the aftermath of the crisis led many to believe that higher pay for executives ultimately led to the alleged disregard for excessive risk that caused the recession. The problem with this view is that it fails to consider "whether particular economic actors—real bankers at actual banks—were [actually] knowledgeable about the risk of losing money" or, in other words, whether those executives believed they were taking excessive risks *at all* (Friedman, 2009, p. 149). As Friedman noted, the fact that investment bank executives personally lost billions in the market crash (through stock awards) demonstrates that these actors themselves had believed their investments were sound and were *not* in excess, including many of which were rated Triple-A by reputable agencies (*ibid.*, p. 150). Simply put, executive pay was not a factor as to whether the firms would have been exposed to the sub-prime loans: the mortgage crisis was an unpredictable facet of the greater economy, not a reflection of a failed pay-for-performance experiment. At the very least, it would have merely mitigated a small fraction of risk that managers had then seen as already minimal.

In addition, there is the separate issue of whether high levels of executive remuneration are weighted too far in favour of managers, to the detriment of shareholders (Tricker, 2012, p. 321). Critics of recent increases in executive pay attribute what they perceive as injurious to the stockholder to a "ratchet effect," where directors seek to maintain a certain "reputation" by increasing executive remuneration in relation to the industry (Russell, 2012). The problem with this theory is that it discounts entirely the possibility of competition for talent, which would naturally lead to fluctuations in remuneration. In actuality, it has been shown that the chief cause for the large increases in pay over the last few decades is the result of "increase[s] in market capitalisation" of large firms, rather than any conspiracy to hurt shareholders (Gabaix and Landier, 2008, p. 50). The reality is that research has shown that the "markets are efficient to the extent of increasing demand for talent and the valuation of the price for this talent" and that the real problems lay in the *transparency* of how pay is determined, not in any false economic effect (Jurow *et al.*, 2009, p. 7). While the misuse of incentives (including options) must ultimately be dealt with, such issues are ultimately of a practical (albeit serious) nature–at a fundamental level, there is nothing wrong with the free market competition for talented executives.

3 Sustainability and agency: refining the system

There is also serious controversy, however, regarding the corporate and financial direction that some types of remuneration might encourage executives to take. On a wider scale, there has been public concern that executives, with access to what has been perceived as undeserved gifts in the form of "excessive" bonuses, often act against the interests of the shareholders in favour of creating personal benefits for themselves. This sentiment reflects the agency hypothesis of Berle and Means (1932, p. 127), which set the stage for ensuring that directors of companies must be prevented from acting for themselves instead of the owners. A contention made by some is that the underlying "deal" of higher pay for higher performance has effectively broken down in favour of executives seeking to enrich themselves through the structure of remuneration packages (Bebchuck and Fried, 2010, p. 5). This has especially been perceived to be the case in terms of equity-based compensation (in the form of stock options), which some believe have become merely tools for executives to gain wealth illicitly through stock price manipulation, further encouraging short-termism (Hill and Yablon, 2002, p. 25). Yet it is also the case, however, that evidence from "before and after" studies of the financial crisis has found that the irresponsibility of the agent "cannot be blamed for the credit crisis or for the performance of banks during that crisis," as managers themselves suffered significant financial risk and failure due to the unforeseen financial collapse (Fahlenbrach and Stulz, 2011, p. 24). This shows perhaps that any short-term focus by managers on purely personal benefits is, at best, an uncommon phenomenon, especially among the large companies under the public eye.

Thus, while these problems of focus are real for some companies, it is apparent that they arise from procedural and structural failures in the *methods* of compensation, not the so-called "exorbitant" *amounts* in equity-based compensation. On the other hand, there is no doubt that, in order for the incentive effect of pay to benefit the company and its shareholders from a corporate governance perspective, both the law and boardroom practices have to be reformed. With regard to the problem of sustainability and how executives can be pushed to look further ahead (instead of merely considering when to exercise their own stock options), Bebchuck and Fried have suggested the enforcement of a corporate policy that bars executives from unloading shares already vested (2010, p. 9). This has the effect of ensuring that the system of options cannot be "gamed," and that executives will have to focus on the long-term success of the company before they can gain personally from the equity. This maintenance of equity-based compensation in a restricted mode fulfils the goal of "check[ing] management's short-term orientation without [forcing executives to choose] a suboptimal low level of risk," especially for financial institutions (Mülbert, 2010, p. 19). Such proposals would go far in alleviating one of the structural weaknesses in executive pay.

In addition to private rules, more widespread changes to *how* remuneration is determined have been recently codified to safeguard the agency relationship between the shareholders and the directors. In the United Kingdom, this has taken place under the auspices of the Enterprise and Regulatory Reform Act 2013. S. 439A of the Act provides for a binding vote on the remuneration *policy* of the company, strengthening the theoretical ability of shareholders to reject the way in which performance is rewarded. Gregory-Smith and Main, however, have noted that this reform, by itself, is unlikely to have strong effects due to the fact that the binding vote does not exclusively relate to pay and that any dissenting vote may have a negative "impact on market valuation" (2013, p. 14). While the results of the statute remain to be seen for many financial institutions (who are holding their AGMs in the coming months), it is interesting to note Gregory-Smith and Main's endorsement of the aforementioned restriction on vested options, which calls for forcing executives to hold on to their shares until a full *two years* after leaving the company (*ibid.*, p. 14). Such changes to the status quo would ensure that the high levels of performance already enjoyed by the company are maintained and the benefits secured in the long-run for shareholders.

4 An ideological controversy on pay

However, these points must not take away from the fact that much of the opposition to higher executive pay is based purely on ideological, rather than corporate governance, standards for corporate behaviour. It is clear that, while there are absolutely valid critiques from a governance perspective, there is a much more fundamental sentiment at work in the eyes of the general public. Indeed, one point that is often repeated is that of the "pay gap" between top-level executives and the rest of society, which has been steadily increasing for the last thirty years (Bell and Van Reenen, 2010, p. 16). Studies have shown that many are concerned about the perceived "distribution" of pay: test individuals "judged remuneration

policies and executive bonuses more acceptable when all employees received bonuses" (Heimann *et al.*, 2014, p. 8). It is unfortunate that the rationale for this continuing controversy about inequality means that higher executive pay, which inherently signals a stronger demand for good management, will continue to be characterised as the result of avarice (Quinn and Hall, 2009; Friedman, 2009, p. 146).

The problem with this thinking is that it transforms the issue of pay-for-performance into a matter of "justice" for society rather than efficacy for businesses. Professor Villiers argues that the real effects of the crisis on many "sits uncomfortably with the almost daily newspaper accounts of bonuses and high take-home salaries of corporate executives and financiers" (2010, p. 335). While this fact is true, it is no valid argument for redistributing wealth in the name of justice. Feelings cannot overrule freedoms. Simply because an economic downturn has negatively affected the lives of millions does not mean that those who have personally gained during the same period should share their earnings, especially since government regulation (and its reckless encouragement of free loans), not private risk-taking, is to blame for the sub-prime mortgage crisis in the first place (Friedman, 2009, p. 129). Alarmingly, some commentators are even of the belief that executives have a moral duty to "refuse the larger package in favour of the smaller one," should they be offered excessive pay, as they owe a "moral fiduciary duty" to maximise shareholder value (Moriarty, 2009, p. 6). Surely, this reasoning calls for that same executive to reject a salary altogether, since that would maximise the return to investors absolutely.

In reality, of course, executives agree to their pay based on their bargaining power–the free market ensures that *every* party gains the most it can possibly get from those on the other side of the table. The fact is, it should be of no concern to corporate governance how wealth is distributed among the employees of a certain company, or among members of society for that matter. To somehow regard the matter of executive pay as a facet of Corporate Social Responsibility is to expand that theory in a way that goes beyond widening the scope of the company as a corporate citizen–it is to divert it from its core function as a business and to transform it into a national tool for equalisation.

On the other hand, it cannot be denied *a* moral problem is both real and proven, as shown by the extent of the bailouts during the financial crisis (Dowd, 2009, p. 152). Here, the "problem" of executive pay and bankers' bonuses is an inevitable side effect of government assistance packages that arrive with little to no restriction on remuneration policies (Thomas, 2009, p. 439). From the evidence, it can be seen that this is the age-old problem of crony capitalism, where legislators and regulators pass on bailouts without any strings attached due to intensive lobbying. This controversy's real problem is the enormous moral hazard that comes with such a policy of "private profits and socialised losses" (Mitchell, 2012). It seems, however, that the goal of the progressive ideology underlying such opponents to excessive pay is to ensure that the profits, too, are socialised in order to balance out the spectacle of private firms being given virtually free assistance at the taxpayers' expense.

5 Conclusion

It is clear that executive pay is an issue vastly more complex than it at first appears. The controversy ignited by the events of the recent financial crisis has caused a serious reevaluation of priorities within both private corporations and national legislatures. However, it must be recognised that the contract of employment between a company and its executive leadership is a simple exchange of money and services that, at its heart, functions viably. It has been shown that the mere fact of higher levels of pay does not change the nature of the incentive. Furthermore, while pay-for-performance continues to fulfil its traditional goals of rewarding good decisions on the part of executives, it, just like any other economic principle, is also subject to the fluctuations of a market economy. The credit crisis, which affected all parties, including corporate executives, does not point to any reward for failure; rather, it demonstrates that the risks taken by investment bank managers were entirely legitimate and justified, considering the strong confidence in the economy at the time.

Certainly, this is not to say that the current *structure* of executive pay is perfect. While the underlying reasoning is correct, the problems of agency and sustainability are exacerbated through the use of one-off stock grants and opaque remuneration policies. As discussed, the proper solution to ensuring better corporate governance must involve private changes. Corporate actors, especially boards of directors, must be encouraged to adopt stronger measures regarding the long-term vision of executives when it comes to equity-based forms of compensation. This single act alone strongly mitigates any opportunity for short-

termism, as equity awards are often the norm in large firms today. It also ensures that executives will be able to maintain a strong agency relationship for much longer periods.

As a result, such advantages affect everyone, as the company's benefits of stronger and more stable leadership are passed on to shareholders and customers through the market. Yet, while the situation of executive pay continues to evolve for the better, there remains ideological opposition to *any* level of increased remuneration. As has been shown, it is based purely on the fact that some perceive the pay as "unfair" in a time of recession, where it is believed that executives must put in their "fair share" through a system of wealth or income redistribution. This model of discussion is arguably outside the realm of corporate governance, as it deals with using the company as a tool to build social justice, rather than to encourage private enterprise. In going beyond the pay-for-performance principles of remuneration, this controversy has diverted attention from meaningful reforms of executive pay.

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